

Some had inherited substantial interests in business, as was the case with the Ford Foundation. Others had purchased control of businesses. A Tax-exempt cancer research organization, for example, had acquired a variety of industrial firms. Mr. Royal Little and the operations of his Textron trusts were given due attention. In fact, the record lists about 40 different types of businesses controlled by educational and charitable organizations." Patman Report, Page 1. (1962)

"Many foundations have become a vehicle for trading in securities and dodging the capital gain tax. Capital gains of foundations are not only tax exempt but they are permitted to place them in the principal account instead of the income account." -- Patman Report, Page 130 (1962).

A-14 The Foundation may provide "FRIENDLY" loans.

Speaking of loans to persons allowed by the tax law, the report says: "The advantages to the borrower of such a loan by a foundation -- and the corollary value of the favor done by the foundation to the director or donor who arranged the loan - can, nevertheless, be considerable. The delays, inconveniences, and formalities of applying for a bank loan can be eliminated; embarrassing questions can be avoided; the assurance that one's obligation resides in friendly hands can be secured." - Treasury Report, Page 51.

B. Benefits in operating business resulting from control over an exempt foundation.

B-1 Keep control in friendly hands over the generations.

"Foundations have commonly been established as convenient vehicles for maintaining control of a private corporation within a family while substantially diminishing the burden of income, gift, and estate taxes for the family." - Treasury Report, Page 37.

"It is true of course that the foundation's donor is parted with legal title to the money, securities or property donated and in that sense is no longer beneficial owner of the foundations, but there can be little doubt that the typical family foundation exists solely to accomplish the donor's goals. Its funds come indirectly from him and, were it not for the foundation, they would come directly from his pocket. In either case, the foundation's assets are directly and totally within his control. If the foundation owns securities, the donor-controller in effect can vote the securities, can cause them to be sold or pledged,

or direct the disposition of their income. Thus, to a very great extent he has benefits substantially equivalent to those of ownership." U.C.L.A. Law Review, May, 1966, Page 960.

"For all practical purposes, they are subject only to the authority of their own directors or trustees, who are not accountable to stockholders or to public regulatory agencies. . . . After the death of Edsel Ford in 1943, the Ford Foundation was used to save the Ford family from losing control of the Ford Motor Company. If not for the foundation device, they would have had to sell stock to the public long before they did in order to pay estate taxes. The foundation permitted Henry Ford's heirs to run the company for many years without the inconvenience of answering to stockholders or the Securities and Exchange Commission." - - Patman Report, Page 73. (1962)

B-2 Provide through deductions or other arrangements for reduction of corporation tax but keep money available.

"Mr. Ewing further testified that under the provisions of such a trust indenture, it would be feasible for a manufacturer in collusion with such a charitable trust, to avoid tax and thereby accumulate millions of dollars to gain a competitive advantage over orthodox manufacturers. He further contended that under such trust indenture, it would be possible for a manufacturer to create trusts with a preconceived plan of having their foundations at its beck and call with little of the trust capital ever paid to the beneficiaries." - -- Senate Report #101, 81st Congress, 1st session, Page 13, 1949.

"The Internal Revenue Code contains no provision to prevent large funds from being built up by foundations from contributions received by them. Since a corporation's annual contribution to its foundation is capital in the hands of the foundation and only the income from these contributions need be distributed, the Internal Revenue Service cannot prevent large funds from being built up by corporation-created foundations. And, since contributions are not subject to the provisions for distribution annually, the prohibition against unreasonable accumulations does not apply." --Patman Report, P. 16. (1962)

"Foundations have loaned money to their creators, traded stock and property with them, paid for insurance policies on the life of the donor, financed benefit programs for a contributor's employees, and engaged in many other activities whose relevance to charity and social welfare seems remote." --Patman Report, P. 71 (1962)

B-3. Provide "good-will" assistance to keep workers happy.

"Allegedly, the provisions of the Scholler trust also include the right to use the foundation as a conduit for employee benefits. When a foundation-controlled company is able to use tax-free funds for the benefit of its employees, the inherent competitive advantages to the company are obvious." ---Patman Report, P. 15 (1962)

"Other foundations have been used to pay benefits to employees of a private company: The Harnischfeger Foundation, Inc., of Milwaukee, has regularly contributed sums from \$100 to \$10,000 to employee organizations of the Harnischfeger Corp. From 1952 to 1958, the Harnischfeger Employees Benefit Association received \$40,500 from the foundation. The benefit association, the foreman's club, the engineers club, and the trap club and all benefited from the foundation's largess in 1959. Mr. Walter Harnischfeger, himself, received a loan of \$40,000 at 4 percent interest in 1955 from the foundation." ---Patman Report, P. 80 (1962)

"The operations of the three Baird Foundations, of New York City, indicate clearly that control of foundation funds affords boundless opportunities for lavishing favors upon business acquaintances and friends."---Patman Report, Page III. (1963)

"The corporate foundation is formed for convenience, or, more likely, as an entity into which excess profits can be funnelled for later use. On the business side, it can be used as a source of loans to the corporation or its officers, or to other corporations with which closer dealings may be desired." --U.C.L.A. Law Review, May, 1966 Page 945.

B-4 Use it as source of "friendly financing" from tax-free accumulations.

In December, 1945, the Rhode Island Charities Trust (foundation controlled by Textron, Inc.) purchased the Manville Mill, consisting of real estate, machinery and fixtures belonging to the Manville-Jenckes corporation, which was a wholly owned Textron subsidiary, for \$1,200,000. In this manner, Textron was able to secure a substantial amount of money from the trust to be used as working capital against its various operations. The Manville Mill was then leased back to Textron so that its use thereby could be continued without interruption." ---Senate Report #101, 81st Congress, 1st Session, P.13, (1949)

"The Sears Foundation is controlled by the Sears Company . . . the relationship of the foundation to the company should not be taken lightly. When Sears needed a loan of 1.2 million dollars, it went to the Sears Foundation and obtained the money at 3% interest." . . . U.C.L.A. Law Review, May, 1966 Page 947.

"It is to be noted that these trusts were particularly helpful to Textron during the period of rapid expansion in 1945 and 1946. It was during this period that Textron's credit was strained to the limit. It was questionable whether the company would have been able to complete this expansion program, except by the use of these trust funds." - - -Senate Report #101, 81st Congress, 1st Session, 1949, P. 16.

"Such sale and lease-back deals are the equivalent of providing these companies with instant capital with which they can accelerate their growth in competition with independent service station operators, and small retailers. This enables these big oil companies, General Electric, and the Woolworth chain to expand without having to go into the money market for capital." ---Patman Report, Page 14. (1962)

"It is alleged that the Scholler Foundations' deed of trust, as amended, permits the foundation to make loans to the business corporations, which it controls, at such rates of interest as the trustees see fit. This permits funds earmarked for charity to be used as venture capital. The foundation's business corporations are thus given a great advantage over other private business corporations by being able to make taxfree contributions to the foundation and thus build up a large reserve which they may tap at will. How can private business-especially small business-compete with such an arrangement." ----Patman Report, Page 15. (1962)

"At least three of the four Mott Foundation wholly-owned department stores, all competing with numerous small retailers, have used the Foundation as a handy source of cash. This of course adds up to quite a competitive advantage." ----Patman Report, Page XII. (1963)

B-5 Foundation's name on public service activities can create good will for business (e.g., Ford Foundation & Ford Motor Company.)

Bob Hope sold rights to publication of Bob's life story to Bob & Dolores Hope Foundation. Publicity to private party was an ancillary benefit not affecting exemption. (1961)

- B-6 Foundations can accumulate income and income so accumulated not subject to surtax and may be used for internal improvements.

"Another advantage which foundation businesses have over their taxable competitors is their freedom from the demands of shareholders for current distributions of earnings. A remarkable number of foundation-owned enterprises proceed from year to year realizing substantial profits, but making negligible or no distributions to their parent organizations." - Treasury Report, Page 33.

"This common willingness of foundations to defer indefinitely the realization of profits from their commercial operations -- an attitude frequently not shared by the shareholders of other businesses -- makes it possible for the profits to be invested in modernization, expansion, and other programs which improve the competitive posture of the foundation-owned business." -- Treasury Report, Page 33.

Tax on accumulation of profits may not apply to foundation owned businesses. "The restrictions of existing law upon accumulations of income by businesses become operative only where a corporation is "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders"; where the shareholders of the business are themselves tax exempt, the limitations may not apply. Similarly, the statute which prohibits unreasonable accumulations of income by foundations applies only to accumulations within the foundation itself; it does not prevent retention of earnings in a separate, though controlled, entity. As a consequence, many foundations have permitted large amounts of income to accumulate in their business subsidiaries." --Treasury Report, Page 34.

- B-7 It is many times the case that a business may be itself operated as an exempt organization.

For example, Educational Testing Service of Princeton sells educational testing materials and enjoys tax exemption, yet the California Testing Bureau of Monterey, California sells the same type of material, yet must pay taxes. Patman Report, Page 9 (1962)

It is well known that the Rand Corporation of Santa Monica performed research work yet because of its relation to its purpose it is tax free. ---Patman Report, P. 13 (1962)

Business Week and Fortune report on American business scene and must pay tax on the operations. Nations Business, a publication of the U.S. Chamber of Commerce performs the same services in competition yet it is tax exempt. A

similar situation obtains between the tax exempt Journal of the American Medical Association which last year had \$10-1/2 million of advertising revenue and the tax paying Medical Economics and Medical World News. Thus, in large part due to its tax exempt status, the National Geographic is able to offer lower advertising rates than its competitors Holiday and Venture. Time Magazine, October 7, 1966, p. 64.

Advantages accrue to both the foundation and the donor:

1. The foundation pays no Federal income tax.
2. The donor neither pays gift tax nor estate tax on contributions to the foundation.
3. For income tax purposes, an individual donor is granted a deduction up to 30 percent of his net income; a corporate donor is allowed to deduct up to 5 percent.
4. The donor's contributions constitute capital to the foundation - not income -- so they need not be distributed. --Patman Report, Page 15-16.(1962)

C. Miscellaneous Benefits of Exempt Operation

C-1 Favorable Postage Rate.

Non-profit organizations often are eligible for reduction in postage rates. Eligibility may depend upon the type of organization, and the class and content of the material to be mailed. Reductions are available in 3rd and second class mailings. Specific details may be obtained from your postmaster.

C-2 May be exempt from certain state taxes, e.g., sales and realty taxes.

A foundation's exemption from the state taxes depends on the various state laws, but as a general rule will follow the results of a Treasury Department determination of your exemption from federal taxes.

It is often the case that an exempt organization will voluntarily pay an amount in lieu of taxes to cover the benefits it receives from police and fire protection. This not only seems a just arrangement to foundation managers, but also may cause the local taxing authorities to be more co-operative in recognizing a property tax exemption.

C-3 An exempt organization may be eligible to receive surplus government property.

Both real and personal surplus government property may be obtained at preferential rates by certain exempt organizations. Through a program administered by the Department of Health, Education, and Welfare, surplus federal property is allocated to state agencies for surplus property which distribute it for health or educational purposes. The Federal Property and Administrative Services Act of 1949 governs the donation of surplus property to non-profit organizations.

C-4 A foundation need not pay social security tax. (i.e., the Federal Insurance Contributions Act.)

The fourth paragraph of the standard determination letter issued by the Internal Revenue Service recognizing a claim for tax exemption provides:

"You are not liable for the taxes imposed under the Federal Insurance Contributions Act (social security taxes) unless you file a waiver of exemption certificate as provided in such act. You are not liable for the tax imposed under the Federal Unemployment Tax Act . . ."

C-5 An exempt organization can receive special fares on overseas flights.

Generally speaking, these lower group fares may be available to membership organizations whose members have more in common than a mutual desire to travel cheaply. Details on the terms of special rates authorized by the Civil Aeronautics Board for overseas flights as well as an advisory opinion as to a group's eligibility for special fares may be obtained from the Bureau of Air Opinions, CAB, Washington 25, D.C. Arrangements may also be handled through a travel agent.

Savings on such arrangements may be substantial. For example, round trip charter flights from New York to London or Paris are available for less than one-half the usual minimum for such a trip.

C-6 Miscellaneous Benefits of Foundation

Your n-f-p exempt status has financing advantages.

- (a) Federal financing under Small Business Act, National Housing Act, the National Institutes of Health, Hill-Burton Act and numerous others.
- (b) Financing through private sources is assisted by the foundation's freedom from tax liens and its inability to milk corporate assets through excessive salaries or high dividends. There is also the availability of not only your own untaxed surplusses but that of other foundations.

"Despite the fact that the IRS disapproves of the use of borrowed funds for the purpose of financing purchases of mortgages and other types of investments, the Noyes Foundation has been constantly engaged in churning money by borrowing at one rate and lending it at a higher rate. From 1951 through 1962, the foundation borrowed over \$5 million for such purposes. (See page 64 for details of such transactions." --Patman Report, Page VII. 2nd Installment.

"On March 29, 1957, the Noyes Foundation borrowed from the Bankers Trust Co., \$550,000 on a note due March 31, 1958, bearing interest at 4-1/2 percent annually. Payment of the note was guaranteed by Mr. Charles F. Noyes. This sum was borrowed for the express purpose of making a loan in the same amount to the Glickman Corporation, of New York City, at 10 percent interest. The transaction enabled the Foundation to receive interest of \$55,000 per year at an interest expense of only \$24,750 annually. Hence, with no cash outlay the Foundation received a net return of \$30,250 per year. At these interest rates, it is not surprising that the Glickman Corporation has been in deep financial distress. The loan was paid off in full by the Glickman Corp. on February 1, 1960. (See pp. 61, 61)" --Patman Report, PP. VII and VIII. 2nd.

"Some Ford Foundation loans were made at what appear to be preferential rates of interest. Why, for example, was the Duke Power Co., of Charlotte, N. C., charged only 2.65 percent interest on \$3 million, 20 year loan, while other borrowers paid 6-1/2 percent? Duke Power, incidentally, is owned 57% by Duke Endowment, another tax-exempt foundation." ---Patman Report, Page 79., 1st installment.

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HIS OWN FOUNDATION.

Taxpayer Tempted to Become Exempted

BY VINCENT J. BURKE

Times Staff Writer

WASHINGTON. — According to reports circulating here, John T. (for Tired) Taxpayer is threatening to set up his own private tax-exempt foundation and operate it on the theory that charity begins at home.

If the reports were true, it would be enough to panic Washington officialdom.

For if every taxpayer were to set up his own private foundation and operate it selfishly, there might be a significant drop in either federal tax revenue or in the flow of money into charity, or both. Certainly, more money would go into the pocket of John T. Taxpayer.

John Quizzed

In view of the fiscal and social implications, John T. Taxpayer was questioned about his plans by a reporter in the following interview:

Question—John, you're not serious about setting up your own private tax exempt foundation?

Answer—I sure am. At first, it was just a joke. When I read about the CIA using foundations as conduits to send money abroad, I told Mrs. Taxpayer that if there's any more surplus CIA money around, we might as well get our share. A private tax-exempt foundation provides one of the few ways still around of having your cake and eating it, too.

Contributes \$2,000

For years I've been contributing \$2,000 a year to my church and to charities and I have nothing to show for it but some used-up tax deductions and a feeling of having performed my duty. Twenty years ago I should have set up my own foundation and appointed myself, my wife and children as trustees. Anybody can do it. You fill out Internal Revenue Service Form No. 1023.

Q. Suppose that for the last 20 years you had given your \$2,000 in contributions to church and charity to the John T. Taxpayer Charity Fund, and claimed tax deductions for it. What difference would it make?

A. Well, by now I would have control of a fund of perhaps \$60,000. As a trustee, I would have bought stocks and bonds for the fund with the \$40,000 I had contributed to the fund and I would have plowed back into fund investments the tax-free earnings of the fund.

How About Charity?

Q. How about charity? Wasn't your fund set up to make grants to religious charitable and educational institutions?

A. Sure, but not right away. In the first place the Internal Revenue Service isn't likely to know what my fund is doing. There's no penalty for failing to file reports every year. Some foundations don't bother to file reports. And the revenue agents inspect very few reports. Besides

the law merely bars unreasonable accumulations of capital in a private foundation. Who's to say what's unreasonable? One federal judge upheld a foundation's right to go for 10 years without making any grants. I would go for 20 years.

Q. What would you have done with the \$60,000 fund? You couldn't spend any of the money on yourself.

\$8,500 Profit

A. Don't be so sure about that. Right now I would like to sell my house. I paid \$20,000 for it. It probably would bring \$30,000 on today's market. After the brokerage fee, I'd net only \$8,500 in profit. But if the John T. Taxpayer Charity Fund held \$60,000, I would sell my house to my foundation. I'm sure that the house is worth \$40,000 to the foundation. So we'd have a \$20,000 profit on the house—no brokerage fee and no tax on the profit because we'd invest all of the \$40,000 in a bigger house. My foundation then

would lease the old house to me for \$150 a month and I would sublease it to a third party for \$250 a month. After management expenses, I'd be making a modest sum every month as a management fee.

Q. But John, is that legal?

A. The law says you mustn't have dealings with your own foundation that result in a substantial

diversion of its funds into your pocket, and that your foundation mustn't pay you more than adequate prices for anything you sell to it, but who's to say what's substantial or adequate. The Treasury says that many foundation operators have gotten away with much worse than that.

Charity Grants

Q. What about some grants to charity?

A. Yep. At this point, the fund would be earning \$1,200 a year in rent on the house and we'd decide to grant that much to church and charity every year. In addition, the fund would be earning about \$1,000 a year on its investment of about \$20,000 in stocks and bonds. But we'd divert the \$1,000 a year into our own pockets.

Q. How could you do that?

A. The trustees (Mrs. Taxpayer and the kids and I) would vote to award a salary of \$1,000 a year to Mrs. Taxpayer as a consultant fee, or salary, for reading the financial pages to keep us posted on what securities we should buy or sell. The law allows a reasonable allowance for services rendered to the foundation.

Q. It sounds pretty immoral to me. When are you going to set up the John T. Taxpayer Foundation and start your wheeler-dealer operation?

A. I'm not sure I will.

Q. Why not?

A. I'm afraid my conscience would bother me. There's another reason, too.

Q. What's that?

A. The Treasury has asked Congress to bar transactions between foundations and their donors and to generally tighten laws to eliminate what President Johnson says are foundation abuses. If the Treasury's proposals are approved by Congress, the John T. Taxpayer Charity Fund won't be able to wheel and deal for my own profit. I think I'll wait and see what Congress does.

And a final point I'd like to make: Most foundations are conscientiously run and do a lot of good. It's the minority that are wheeling and dealing for their own profit.

Foundation Twist How Families Create Organizations to Cut Their Liability for Tax

Group Gives 30-Hour Course That Teaches Its Members Way to Revamp Finances But Prober Doubts Legality

By BYRON E. CALINE

Staff Reporter of THE WALL STREET JOURNAL

Dr. M. R. Saxon, a general practitioner in Aurora, Ill., took a job last year as the salaried "medical administrator" of a nonprofit foundation engaged in research and development in the fields of "health, education and welfare."

Though his salary is less than the revenues from his medical practice, Dr. Saxon concedes that taking the job was no financial sacrifice.

Why not? Dr. Saxon has continued to treat the same patients with the same equipment in the same office building as before. However, there's one big difference: Now, the nonprofit foundation collects all his fees, in turn providing him with a house, a car, a retirement plan and insurance—all tax free. Mrs. Saxon, her husband's nurse, is employed as the foundation's "assistant medical administrator." And the Saxons' four children are attending college on educational grants from the foundation.

The foundation contributes more money to charitable causes than Dr. Saxon did personally. But, the doctor says, he winds up paying "substantially" less in income taxes than he did before.

Easy as ABC

Where did a medical man pick up such sophistication in the nation's complex tax laws? From a nonprofit membership trust called Americans Building Constitutionally, or ABC. Dr. Saxon paid a \$7,000 membership fee to join ABC shortly after it was formed early in 1968. (The fee was raised to \$10,500 last May 1.)

An ABC trustee says the organization is "Henry Fordizing"—or mass producing—legal and tax expertise long available only to the wealthy. In little more than a year of existence, this trustee says, ABC has helped more than 800 members in nearly all 30 states establish nonprofit foundations and related trusts that lessen the income, property and estate taxes the members pay.

ABC's purpose is to "awaken the average creative person" to the benefits of "restructuring" his business and estate on a not-for-profit basis, says Robert D. Hayes, a Barrington, Ill., sales training expert and one of ABC's trustees. Wealthy families recognized early in this century, Mr. Hayes says, that the principle of tax exemption for nonprofit endeavors "provides a means of giving people a chance to benefit mankind and have certain advantages." He adds: "If it's legal, moral and ethical for them, it ought to be ethical for everyone else."

At a time when Congress is considering tighter controls over tax-exempt foundations, ABC is attracting the attention of some state and Federal officials. California and Illinois officials and a Congressional subcommittee are known to be poking into ABC's affairs.

Unanswered Questions

In California, the state attorney general has taken legal steps to try to require two ABC members, B. Douglas Fahy and Charles R. Billings, both Long Beach insurance men, to answer 33 questions about the trust's operations. The members so far have declined. Deputy attorney general Lawrence R. Tapper has told a state court that he "had reason to believe that information furnished by ABC to its members regarding the creation and use of charitable trusts and foundations was false and misleading and thereby inclined to lead its members into activities which would subject them to civil and criminal liability."

Messrs. Fahy and Billings have denied that Mr. Tapper's statement is accurate. In a reply filed in the court by an attorney for the two members, they deemed it "shocking that the citizens of the state of California should be summoned to sweeping and undefined inquiries such as is sought by the head of the (state) department of justice." Mr. Hayes, the ABC trustee, calls the organization's activities "legal and sound." James R. Walsh Jr. of Chicago, a law school graduate who plays a big part in ABC though he has no title and isn't one of its three trustees, says the California attorney general is "whistling in the dark."

Mr. Walsh emphatically denies any suggestion that ABC's plan is a tax dodge. "I'm going to program that out of your mind," he says to an interviewer.

The consumer fraud section of the Illinois attorney general's office is investigating ABC, which has its main office in Barrington, Ill. A spokesman for the attorney general's office says the organization's activities were brought to its attention this year by the Illinois Bar Association, which had investigated the group. "We still are not sure what the plan consists of," says the spokesman.

Wright Patman, Too

A House of Representatives small business subcommittee, which has been studying private tax-exempt foundations since 1962, is about to consider ABC's operations. "I am deeply concerned about it," says Rep. Wright Patman of Texas, who is chairman of the subcommittee. H. A. Olsner, the subcommittee's director of foundation studies, has gone to Illinois to learn about ABC first hand.

A spokesman for the Internal Revenue Service says the IRS is "apprehensive" about ABC. But the IRS has taken no position toward it. "We expect an investigation of the whole organization by the IRS," says ABC's Mr. Hayes.

ABC's growing membership list is kept confidential, but it is known to include newly established foundations of some prominent professional men and women. It includes one foundation of some national repute, the Philip Schuyler Memorial Foundation, on whose advisory board sits Henry Cabot Lodge. Officials of ABC have approached the National Farmers Organization (NFO) about the possibility of helping farmers establish tax-exempt foundations for themselves. One organization has been set up in Illinois to help foster such foundations. The NFO, however, has declined to connect itself with the ABC program.

ABC recruits members by word of mouth.

Foundation Twist: How Families Use Nonprofit Groups to Cut Taxes

Continued From First Page

Prospects get invited to an introductory meeting. An ABC representative spends three to four hours explaining the plan. If the prospect decides to join ABC, he makes an initial payment of \$1,050. This pays for 30 hours of instruction in how to use the complex legal web of foundations and trusts that ABC can create for him. But he is supposed to promise never to divulge any of the "methods, procedures or techniques" used, or the identity of any other member.

After instruction, the new member has the option of paying \$4,200 more to have a nonprofit foundation created for his benefit, or paying \$9,540 more for the entire ABC "package" that would take over his business and assets. The package normally would include several related foundations and trusts.

A recent prospect for membership in ABC describes what took place at his introductory meeting. He first was introduced by an ABC member who told him the ABC plan was "not a program to evade or avoid taxation, but rather a philosophy, a veritable way of life, by which one through serving himself and his family would ultimately render a greater than normal benefit to mankind."

Then the prospect was given a paper of quotations about citizenship, including an excerpt from a decision by the late Federal Judge Learned Hand on taxation: "Anyone may arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which best pays the Treasury; there is not even a patriotic duty to increase one's taxes."

The prospect says the ABC package plan was explained something like this—First, you establish a trust for a "recognized beneficial purpose" under your state's law. You give your home and car and possibly a money endowment to the trust; these assets are no longer subject to state or local real or personal property taxes.

The trust establishes a nonprofit corporation, or foundation. You sign a contract with the non-profit corporation that permits it to sell your services as a doctor, lawyer, engineer or whatever. Your patients, clients or employers pay the nonprofit corporation for your services; the income to the corporation isn't taxable income.

The nonprofit corporation pays you a small salary and reimburses you for most of your living expenses ("just about everything except your booze and cigars," says one man familiar with the setup). The rest of its income is transferred to a second nonprofit organization. The transaction by which it is transferred supposedly changes the income into capital, which is invested.

The capital accumulated by the second nonprofit organization presumably could be used from time to time for your benefit or your family's—as in Dr. Saxon's case, for example, in the form of educational grants to children in college.

Joining ABC brings other benefits. If one member can convince another individual to join, his foundation receives a \$2,000 "endowment" out of the fees paid by the new member. The first member's foundation also gets \$1,000 of the fees paid by any members attracted by the second member, and \$500 of the fees paid by the next "generation" of members.

This arrangement, says ABC's Mr. Walsh, is much like the "referral system" in many professions. "The incentive (to bring in new members) had to be strong," he says.

An Eastern lawyer critical of ABC says, on the other hand, "It's the chain letter idea on a big scale." An Illinois doctor who is a member of ABC says, "I thought this (endowment plan) was not very professional."

Legal services in setting up a new member's foundation or foundations, and his trusts are handled by lawyers in his state who are recommended by Barrington Institute, a nonprofit organization that is itself a member of ABC. Mr. Walsh says the legal instruments that these lawyers tailor to each member's individual situation are an "amalgam" of knowledge that he—and an associate he declines to name—pieced together over 40 years. Some of the legal expertise, he says, came indirectly from lawyers involved in some well-known foundations and trusts.

Mr. Walsh figures it would take the average lawyer a year to duplicate the ABC package, and it would cost between \$25,000 and \$50,000 in legal fees.

One ABC member says a significant number of its members are medical men—chiropractors, dentists, general practitioners, and osteopaths. He says that members are able to turn over their assets to the ABC-created trust, yet still control them.

ABC members, however, say that salaried individuals also could utilize the ABC concept by assigning future earnings to their foundation and having it "vend" their services to their employer. The key is to relate the foundation's tax-exempt purpose to the business or profession of the member. For example, an insurance man who is a member of ABC controls a foundation created for "research and development in the utilization and insuring of human life values, both material and non-material. . . ." This, he says, describes his insurance sales work for a California insurance agency.

Mr. Walsh says nonprofit "civic organizations" are to be set up in every county in Illinois. These civic organizations would recruit members, many of them farmers who would set up foundations for research and development in food nutrition and related areas such as cattle-feeding and soil improvement.

Of the \$10,500 membership fee paid to ABC, Mr. Walsh says, \$3,500 goes in the form of an endowment to Barrington Institute and \$3,500 for ABC. (\$3,500 is reserved for "endowments.") Mr. Walsh says that Mr. Hayes and the two other trustees—Richard J. Stephenson and J. Alton Lauren, both of Chicago—use the \$3,500 paid to ABC to achieve the "highest and best good" for ABC's members. None of the trustees receives any money from ABC, says Mr. Walsh. However, Mr. Walsh says his own foundation, a member of ABC, receives money from ABC for certain services that his foundation provides. He declines to say how much money.

Mr. Hayes' foundation is called Sales Analysis Institute Foundation of Illinois Inc. Its employees teach the 30-hour course for new ABC members around the country. The foundation offices are in the same building in Barrington as ABC. The institute is much older than ABC, and much of its business consists of providing training services for large companies such as General Motors Corp.

Mr. Hayes says the Sales Analysis Institute Foundation pays no income taxes and never has applied for a ruling from the Internal Revenue Service on its tax-exempt status. Many tax lawyers believe that a regular corporate tax return has to be filed, and income taxes paid, unless an organization submits an application for a ruling.

That doesn't bother Mr. Walsh. "One group

is interpreting the law one way, and one group is interpreting the law another way," he says. He and Mr. Hayes both say they think the question will wind up in a court some day. Mr. Hayes says an IRS representative has "visited" his foundation.

A disagreement over "the treatment of certain tax items" has caused a falling-out between Mr. Hayes' Institute and the big accounting firm of Ernst & Ernst, according to an Ernst & Ernst spokesman in Chicago. The firm dropped Mr. Hayes' outfit as a client six to nine months ago.

Mr. Hayes is not the only ABC member who has not applied for a tax exemption ruling from the IRS. The Saxon foundation hasn't filed either. "I don't have any intention to file," says Dr. Saxon, who says he is taking that position on ABC's advice.

Mr. Walsh says part of the \$3,500 which goes to ABC from a membership fee is set aside in a legal defense fund. Money from the fund goes to protect ABC members from legal attack by the IRS or any other governmental agency, he says. ABC is paying the legal expenses of Mr. Fahy and Mr. Billings, the two Long Beach, Calif., members who have been subpoenaed by the California attorney general in his investigation.

Mr. Walsh says a summation of the information given new members in the 30-hour ABC training course will be made available "shortly" to all state attorneys general.

In its only formal public announcement to date, ABC said last month that more than 50 member organizations had made grants totaling about \$30,000 for various research and development projects in Vietnam. The grants were all made to the Philippa Schuyler Memorial Foundation, which will supervise the use of the grants through a program called "Winning the Peace."

Though he has a law degree, Mr. Walsh is not a practicing lawyer. Neither is Mr. Stephenson, a trustee of ABC, though he also has a law school degree. Mr. Lauren, also an ABC trustee, is a real estate man.

A person close to the operations of ABC says Mr. Walsh originated the ABC concept and went looking for the "best training outfit in the country" to sell it. Thus he met Mr. Hayes and learned about his sales training institute. Mr. Walsh says his own Walsh Foundation was formed in the District of Columbia in 1947. He hasn't paid any Federal income taxes since, he says. He says his father, now dead, was active in the establishment of pension funds, and dealt with some of the New York law firms that handled the establishment of nonprofit foundations.

The Sales Analysis Institute of Mr. Hayes was operated as a profit-making corporation until it became part of the Sales Analysis Institute Foundation last year. "Bob Hayes is a very shrewd gentleman," says an old acquaintance, "but he has never lied once in his life."

Mr. Hayes says he had many doubts about the ABC plan when Mr. Walsh first explained it to him, but he says he is wholly convinced now that it is perfectly legal.

Tuesday, August 29, 1967

U-6

IRS Is Starting Inquiry Into Foundations Set Up by Individuals to Pare Federal Tax

By RICHARD F. JANSSEN

Staff Reporter of THE WALL STREET JOURNAL

WASHINGTON — The Internal Revenue Service is starting an intensive investigation of a plan promoted by a Barrington, Ill., group for individuals to minimize Federal income taxes by setting up foundations to manage their business affairs, a high IRS official said.

As detailed in yesterday's Wall Street Journal, the Illinois group, called Americans Building Constitutionally, or ABC, advises individuals on how to channel most of their income through such foundations.

Particularly in light of the new attention focused on the operation, the IRS official said, "we will attack . . . we sure as hell aren't going to let these things go unchallenged."

For one thing, the official said, IRS agents will seek the membership list of ABC, which claims more than 800 members in nearly all 50 states. The agents then will study the situations of the individual members to see if tax-exempt law rulings they've received should be kept in force or revoked in a civil proceeding. If any false statements are found in exemption applications, criminal action could result, officials said.

Robert D. Hayes, ABC trustee, noted in

Barrington that the organization had expected the IRS investigation to come "sooner or later." He said IRS officials had contacted ABC "about three days ago." The IRS has indicated it will submit a list of questions it would like to have answered about ABC's activities, the trustee said.

"We haven't done anything illegal," Mr. Hayes declared. "And we're going right ahead with what we're doing," he said.

Mr. Hayes said ABC officials had told the IRS that its membership list was regarded as "confidential" and that ABC "wouldn't divulge" any names.

Some of the individuals, according to the account, haven't ever sought IRS rulings conferring tax-free status on their foundations.

"Without a ruling, they're completely vulnerable," the official maintained.

The organization's comments indicate, though, that it disputes the idea that such rulings are necessary, and officials suspect ABC or its members might well fight any IRS challenges in court.

The IRS, however, maintains that Federal law authorizes the service's ruling on tax exemptions. "I suspect we're going to have a good fight on our hands, but we won't lose it for lack of trying," an official said.

When advance rulings are requested, the IRS usually issues them on the strength of the organizers' own statements on the purposes of the foundation without taking time to thoroughly check them out. Such requests, numbering more than 14,000 annually, usually appear to be very "innocent," an official said, but he noted that whether a group is permitted to retain its exemption depends on its "actual operation" rather than just its stated purposes.

The matter of determining when tax-free status is justified by an organization's activities isn't a simple one, analysts conceded, and they aren't ruling out the possibility that they may have to seek a tougher law from Congress.

As an example of the foundations' workings, the Wall Street Journal story described one set up by a Midwest doctor who said his foundation collects all his fees and in return provides him, tax-free, with a house, a car, a retirement plan and insurance, and is providing grants with which his four children are attending college.

Revenue men believe the providing of tax-free housing leaves a foundation open to question. Generally, the only situation in which housing can be provided without giving rise to a tax liability, they say, is when the nature of the job requires the person to live on his duty post. A doctor ordered to live in a hospital wouldn't be taxed on the value of his quarters, for example, one says, "but if he starts living down the street, he's open to challenge."

Another red flag to revenue men is when a foundation gives some of its money to members of the family that created it. They also are particularly skeptical when a foundation "pays" benefits that recipients in the family consider to be tax-free.

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U. S. Congress, House, Reports of the Special Committee to Investigate Tax-Exempt Foundations and Comparable Organizations (Reece Committee) 1954, Document No. 55647, House Report No. 2681.

U. C. L. A. Law Review, June, 1966, No. 4, Entire Issue devoted to review of law and activities of tax-exempt organizations, with emphasis on private foundations.

American Bar Association, Journal of Real Property, Probate and Trust Law, Report of the Committee on Exempt Organizations, concerning the Treasury Report of February 2, 1965. December 1966, Fall Issue. (Opposes Treasury proposed changes as being unrealistic, unworkable, and not being applicable to the actual problems in the field of tax-exempt organization).

Foundation Directory, Edition Two, Foundation Library Center, under the auspices of Russell Sage Foundation, New York. 1965, contains brief review of 7000 foundations from 1962 records. Although the capitalization figures are usually inaccurate, the review of foundation activities is interesting.

Foundations and Government, State and Federal Supervision, Marion Freemont-Smith, Russell Sage Foundation, 1965, New York. A critical review of foundation activity and an excellent historical survey of foundations and tax-exempt supervision at all major levels of government.

CAVEAT: Most of the material offered by the Russell Sage Foundation in their philanthropic library does not apply to present-day methods, nor to the type of foundations you will create. If, however, you wish to do scholarly research in the field, the R.S.F. material is of the highest caliber.

A more complete list of Government Publications available from the U. S. Government Printing Office is available on request. In addition, selected reading lists concerning any special topic will be compiled upon a request relating the nature of the problem encountered by associate counsel.

Excellent Basic Review material may be found in Prentice-Hall, American Jurisprudence Second, and the Treasury Pamphlet on How to Apply for Exemption. We must remind you, however, that this material is basic and sometimes misleading. The scope of permissible foundation activity and "law" far exceeds the scope of this review material.

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American Jurisprudence-Summary

34 Am Jur 2d

§ 7900—Exempt Organizations

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§ 7900. Exempt Organizations and Taxable Activities.

The Code exempts from income tax many types of organizations including religious, charitable, and educational organizations. Exemption depends on the facts of each case and is generally determined on application and may be revoked. The conditions for exemption vary. Some organizations are exempt only if they don't engage in certain prohibited transactions or don't unreasonably accumulate income. In addition, the unrelated business income of some otherwise exempt organizations is taxable. And business organizations all of whose profits are paid to exempt organizations are generally fully taxable.

§ 7901. Scope of tax exemption. So-called tax-exempt organizations consist of a long list of organizations specified in the Code traditionally regarded as not organized for private profit. In general, these organizations are exempt from income tax.¹

But some of them are exempt only if they refrain from engaging in certain prohibited transactions and from unreasonably accumulating income, and others are exempt if they just refrain from prohibited transactions.²

Also, some exempt organizations are nevertheless taxed on their unrelated business income.³

Exemption is denied to communist-controlled organizations.⁴

Observation: The fact that an organization is exempt from income tax doesn't relieve it from the obligation to withhold income tax from its employee's wages.

1. Code Sec. 501(a).
2. Code Secs. 503 and 504.
3. Code Sec. 511(a)(2).
4. Regs. § 1.501(c)-1.

§ 7902. Organizations exempt if they don't engage in prohibited transactions and don't accumulate income. The religious, charitable, and educational organization group is perhaps the most important category of exempt organizations. With certain exceptions, such organizations are exempt only if they refrain from engaging in prohibited transactions and also refrain from improper accumulation, use or investment of income. These restrictions apply to corporations, community chests, funds, or foundations, organized and operated for any of the following purposes:

- ... Religious
- ... Charitable
- ... Educational
- ... Literary

- ... Scientific
- ... Testing for public safety
- ... Prevention of cruelty to children or animals.¹

But neither the prohibited transaction rule nor the rule against improper accumulation, use, or investment of income applies to the following:

- ... Religious organizations other than trusts
- ... Educational organizations with regular faculty, curriculum, and enrolled student body in attendance at a regular place.

... Organizations normally receiving, from the U.S. or the general public, a substantial portion of their support (other than income from their exempt activities).

... Organizations operated, supervised, controlled, or principally supported by an exempt religious organization that isn't a trust.

... Organizations the principal purpose of which is to provide medical or hospital care, medical education, or medical or agricultural research.² This doesn't include an organization engaged primarily in making contributions to tax-exempt hospitals but not itself providing medical or hospital care.³

1. Code Sec. 501(c)(3).
2. Code Secs. 503(b) and 504(a).
3. Rev. Rul. 34-137, CB 1934-1, 289; *Samuel Friedland Foundation v. U.S.*, 144 F. Supp. 74.

§ 7903. Other organizations exempt if they don't engage in prohibited transactions. Two categories of employee trusts are exempt only if they don't engage in prohibited transactions, namely:¹

... Employees' supplemental unemployment benefit trusts.²

... Qualified employee pension, profit sharing, or stock bonus trusts.³

This rule is subject to certain exceptions of limited application with respect to employee trusts.⁴

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The rule against improper accumulation, use, or investment of income doesn't apply to either of these two types of employee trusts.⁵

1. Code Sec. 503(a)(1)(B) and (C).
2. Code Sec. 501(c)(17).
3. Code Sec. 401(a).
4. Code Sec. 503(b).
5. Code Sec. 504.

§ 7904. Other exempt organizations. The additional organizations listed below, which are exempt from income tax, aren't subject to the rules against engaging in prohibited transactions or improper accumulation, use or investment of income. These organizations are generally of such a character that it isn't ordinarily possible for them to engage in those practices. This group of exempt organizations includes:

- ... Religious organizations other than trusts.¹
- ... Religious or apostolic associations or corporations that have a common or community treasury and are engaged in business for the common benefit of the members *but only if* the members include in their gross incomes their pro rata share of the taxable income. The income must be reported by the members whether or not it is distributed, and it is treated as dividend received.²
- ... Educational organizations with regular faculty, curriculum, and enrolled student body in attendance at a regular place.³
- ... Organizations normally receiving from the U.S. or the general public, a substantial portion of their support (other than income from their exempt activities).⁴
- ... Organizations operated, supervised, controlled, or principally supported by an exempt religious organization that isn't a trust.⁵
- ... Organizations the principal purpose of which is to provide medical or hospital care, medical education, or medical or agricultural research.⁶
- ... U.S. corporate instrumentalities organized under Act of Congress granting income tax exemption.⁷
- ... Corporations merely holding title to property and collecting and turning over income, less expenses, to an exempt organization.⁸
- ... Nonprofit civic organizations operated exclusively for social welfare.⁹
- ... Labor, agricultural, or horticultural organizations.¹⁰
- ... Chambers of commerce, business leagues, real estate boards, or boards of trade not organized for profit or private benefit.¹¹
- ... Social and athletic clubs not organized for profit or for the benefit of private shareholders.¹²

... Fraternal beneficiary societies, orders, or associations operating under the lodge system and providing for benefit payments to members and their dependents.¹³

... Local employees' associations whose net earnings are used solely for charitable, educational, or recreational purposes.¹⁴

... Voluntary employees' beneficiary associations providing for benefit payments to members and their dependents provided 85% or more of the income is collected from members and the employer.¹⁵

... Voluntary employees' beneficiary associations limited to U. S. government officers and employees.¹⁶

... Local teachers' retirement fund associations.¹⁷

... Local benevolent life insurance associations, mutual ditch or irrigation companies, mutual or cooperative telephone companies or like organizations *but only if* 85% or more of the income is collected from members.¹⁸

... Nonprofit cemetery companies and burial corporations.¹⁹

... Credit unions and certain nonprofit corporations organized before Sept. 1, '57 to provide reserve funds and insurance of shares or deposits in building and loan associations, cooperative banks, and mutual savings banks.²⁰

... Mutual insurance companies other than life or marine whose premium and investment income (other than capital gains) doesn't exceed \$150,000.²¹

... Farmers cooperatives meeting certain qualifications.²² These organizations are only technically exempt.²³ For circumstances in which they are taxed, see § 7627 *et seq.*

1. Code Sec. 503(b)(1).
2. Code Sec. 501(d).
3. Code Sec. 503(b)(2).
4. Code Sec. 503(b)(3).
5. Code Sec. 503(b)(4).
6. Code Sec. 503(b)(5).
7. Code Sec. 501(c)(1).
8. Code Sec. 501(c)(2).
9. Code Sec. 501(c)(4).
10. Code Sec. 501(c)(5).
11. Code Sec. 501(c)(6).
12. Code Sec. 501(c)(7).
13. Code Sec. 501(c)(8).
14. Code Sec. 501(c)(4).
15. Code Sec. 501(c)(9).
16. Code Sec. 501(c)(10).
17. Code Sec. 501(c)(11).
18. Code Sec. 501(c)(12).
19. Code Sec. 501(c)(13).
20. Code Sec. 501(c)(14).
21. Code Sec. 501(c)(15).
22. Code Sec. 501(c)(16).
23. Code Sec. 521.

§ 7905. Exempt organizations taxable on unrealized business income. Some, but not all, exempt organizations are nevertheless taxable on their unrelated business income. The following exempt organizations are so taxable:¹

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... Corporations merely holding title to property and collecting and turning over income, less expenses, to an exempt organization *but only if* the income is payable to an organization taxable on its unrelated business income or to a church or a convention or association of churches.²

... Corporations, community chests, funds, or foundations and trusts organized and operated for religious, charitable, educational (including state colleges and universities), literary, scientific, testing for public safety, or prevention of cruelty to children or animals *other than* a church or a convention or association of churches.³

The tax on unrelated business income applies only to certain religious organizations. It doesn't apply to churches and conventions or associations of churches, or to religious organizations (including religious orders) carrying out the functions of a church by engaging in the ministrations of sacerdotal functions and conduct of religious worship. The exemption extends to activities conducted through a separate wholly owned corporation other than one operated for the primary purpose of carrying on a trade or business for profit.⁴

Only other religious organizations that don't satisfy the above requisites are taxable on unrelated business income. It doesn't matter that they are operated under church auspices.⁵ A religious order engaged primarily in teaching rather than the ministrations of sacerdotal functions was held to be taxable on income from operation of a winery.⁶

... Labor, agricultural, or horticultural organizations.⁷

... Chambers of commerce, business leagues, real estate boards, or boards of trade.⁸

... Employees' supplemental unemployment benefit trusts.⁹

... Qualified employee pension, profit sharing, or stock bonus trusts.¹⁰

... Pre-Sept. 1, '57 corporations or associations operated to provide reserve funds or both reserve funds and deposit insurance for building and loan associations and other cooperative or mutual banking institutions.¹¹

¶ 7906. Feeder organizations aren't exempt. An organization isn't exempt merely because all of its profits are payable to exempt organizations. If such an organization is operated for the *primary* purpose of carrying on a trade or business for profit, it is *fully taxable*.¹ It is taxable on *all* its income including passive investment income. Since it isn't an exempt organization, its taxability isn't limited to its "unrelated business income."²

The regs provide that an organization owned by several *unrelated* exempt organizations and operated for the purpose of furnishing essential services to each of them isn't exempt and that exempt organizations aren't related merely because they engage in the same type of exempt activities.³ But the Court of Claims allowed the exemption to an organization owned by a group of unrelated hospitals for which it bought hospital supplies under jobbing arrangements with suppliers. This case was decided before the regs expressly provided that organizations aren't related merely because they engage in the same activities.⁴

The Treasury allows the exemption only if the organization is controlled by and furnishes its services solely to:

... A single tax exempt organization.

... A parent organization and one or more of its subsidiaries all of which are exempt.

... Exempt subsidiary organizations having a common parent.⁵

An organization that doesn't engage in a trade or business but *merely* holds title to property and turns over its income to an exempt organization isn't a feeder organization and is exempt, but it may be taxable on unrelated business income.⁶

1. Code Sec. 502; Regs. § 1.502-1(a).

2. *Sico Foundations v. U.S.*, 295 F. (2d) 924, reh. den. 297 F. (2d) 557.

3. Regs. § 1.502-1(b).

4. *Hospital Bureau of Standards and Supplies, Inc. v. U.S.*, 158 F. Supp. 560.

5. Regs. § 1.502-1(b).

6. Code Secs. 501(c)(2) and 511(a)(2)(A).

¶ 7907. What is a feeder organization trade or business. For the purpose of the feeder organization rule, the following have been held not to be trades or businesses:

... Rental of real property, including personal property leased with the real property.¹

... Investments in oil and gas production payments.²

... Casual sales of real estate acquired by gift or for charitable purposes.³

But an organization was held to be engaged in business where it sold at wholesale and retail used clothing and household objects which were contributed to it by the public. It do-

1. Code Sec. 511.

2. Code Sec. 511(a)(2).

3. Code Sec. 511(a)(2) and (b).

4. Code Sec. 511(a)(2)(A); Regs. § 1.511-2(a)(3).

5. Regs. § 1.511-2(a)(3)(ii).

6. *De La Salle Institute v. U.S.*, 195 F. Supp. 891.

7. Code Sec. 511(a)(2).

8. Code Sec. 511(a)(2).

9. Code Sec. 511(a)(2) and (b).

10. Code Sec. 511(a)(2) and (b).

11. Code Sec. 511(a)(2)(A).

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nated to an exempt charity its profits over and above amounts paid on the purchase price of its stores.⁴

1. Code Sec. 502; Regs. § 1.502-1(a).
2. Bright Star Foundation, Inc. v. Campbell, 191 F. Supp. 845; Southwest Endowment Corp. v. U.S., D.C. Tex., 5/28/59.
3. Marian Foundation, T.C. Memo. 1960-18.
4. Veteran's Foundation, 38 T.C. 66, aff'd (CA-10) 5/14/63; Veteran's Foundation v. U.S., 178 F. Supp. 234, aff'd 281 F. (2d) 912.

§ 7908. Investment activities may affect exemption. The investment of its principal and income by an otherwise exempt charitable organization in stocks, bonds, mortgages and other personal property or in real property won't ordinarily deprive the organization of its exemption. It is generally recognized that a charitable organization must invest its funds. This is only an incidental activity to its charitable purpose.¹ And even a temporary investment in merchandise (whiskey) acquired as a

dividend in kind paid on corporate stock doesn't affect its exemption.²

But the exemption may be lost if:

... Investment activities constitute a trade or business. The Ninth Circuit so held where a foundation with a vague charitable design traded in highly speculative securities which activities were conducted on its behalf by the grantor in the same manner as they had been conducted for his personal benefit before creating the foundation.³

... Investments of income are made in such a manner as to jeopardize the charitable purpose of the organization.⁴ This rule is fully discussed at § 7995.

1. Samuel Friedland Foundation v. U.S., 144 F. Supp. 74.
2. Alan Levin Foundation, 24 T.C. 15.
3. Randall Foundation v. Riddell, 244 F. (2d) 803.
4. Code Sec. 504(a)(3).

§ 7910. Religious, Charitable, Educational, and Similar Exempt Organizations.

The largest category of exempt organizations consist of those with religious, charitable, educational, literary, scientific, and animal cruelty prevention, and testing for public safety purposes. The exemption applies only if the organization is both organized and operated exclusively for one of these exempt purposes and doesn't engage in substantial propaganda.

One group of religious organizations, namely religious and apostolic associations may be exempt even though not operated exclusively for religious purposes.

§ 7911. Requisites for exemption. Corporations, community chests, funds or foundations and other organizations are exempt if¹

... they support religious, charitable, scientific, literary or educational activities, testing for public safety or the prevention of cruelty to children or animals.

... they are organized exclusively for these purposes.

... they operate exclusively for these purposes so that none of the net earnings benefits private shareholders of individuals.

... they do not in substantial ways attempt to influence legislation and do not intervene in political campaigns in support of a candidate.²

1. Code Sec. 501(c)(3).
2. Code Sec. 501(c)(3); Regs. § 1.501(c)(3)-1.

§ 7912. Organized exclusively for the exempt purposes. To be exempt as a religious, charitable, educational organization or the like, the document which sets up the organization,

whether it be a trust instrument, corporate charter, articles of association or any other written document must meet certain Treasury standards. The regs say that the documents must be drawn so that they:

- limit the organization's purposes to one or more of the exempt purposes and

- do not expressly empower the organization to engage, otherwise than as an insubstantial part of its activities, in activities which are not in themselves in furtherance of one or more exempt purposes.

The instrument can express the limitation to exempt purposes by reference to the Code. For example a charitable corporation's charter may say that it is formed "for literary and scientific purposes within the meaning of Sec. 501(c)(3) of the '54 Code." Or the instrument may specify a particular activity such as the operation of an adult education center and provide the details of the method of operation. Or the instrument may simply state that the organization is being formed "for charitable purposes" and that will ordinarily be sufficient.¹

The organizing instrument cannot give the organization the power to carry on in a substantial way activities which are not in further-

ance of its exempt purposes. So, if its charter gives the charitable organization the power to engage in a manufacturing business or to operate a social club, the organization would generally not qualify for exemption. This would be so, even though the charter stated that its purposes were exempt.² However, an organization may be exempt even though a trade or business is a substantial part of its operation, provided it is not organized and operated primarily to carry on an *unrelated* trade or business and the trade or business furthers its exempt purposes. There are no hard and fast rules for determining whether the trade or business is related to the exempt purposes. Among the factors to be considered are the size and extent of the trade or business and the extent to which its activities further the exempt purposes.³ The Treasury has said that renting a commercial building which the organization maintains to finance its charitable activities is sufficiently related to the exempt purposes.⁴ For further discussion of when a trade or business is unrelated, see § 8002 *et seq.*

Another aspect of the organizational test is the disposition of the exempt organization's assets on its dissolution. To qualify for exemption, the charter cannot provide for a transfer to anyone except another exempt organization, or the federal, state, or local government for a public purpose. It is not, however, necessary to provide for a disposition of the assets on dissolution if local law would require their permanent dedication to an exempt organization.⁵

The Treasury set up its organizational requirements in '59. Organizations which were granted exemption before July 27, '59, will not have their exemptions revoked solely on the basis that their charters do not meet the organizational requirements. However, organizations applying for exemptions after that date must meet these tests.⁶

1. Regs. § 1.501(c)(3)-1(b).
2. Regs. § 1.501(c)(3)-1(b).
3. Regs. § 1.501(c)(3)-1(c).
4. Rev. Rul. 64-182, CB 1964-1, 186.
5. Regs. § 1.501(c)(3)-1(b)(4).
6. Regs. § 1.501(c)(3)-1(b)(6).

§ 7913. Operated exclusively for the exempt purposes. In addition to being organized for an exempt purpose, a religious, charitable, educational, etc., organization must operate as an exempt organization. The regs say this means:

... it engages primarily in activities which accomplish one or more exempt purposes.
... it does not function as an action organization.

... no part of its net earnings inure to the benefit of private shareholders or individuals.

An organization that makes grants to individuals (writers, composers, painters, sculptors, scholars, etc.) for the purpose of assisting them to carry on their creative efforts qualifies for the exemption, where the results of the research and the rights to the artistic and scholarly work belong to the recipient of the grant.¹ But an organization which makes funds available to authors and editors for preparing teaching materials and writing textbooks does *not* qualify for the exemption where it receives a portion of the royalties earned by the authors and editors.²

Organizations were not considered operated exclusively for exempt charitable purposes where long-term credit was extended to the organization's founders after refusal by a bank even though the charity was repaid with an ample return.³ Publishers of educational and economic materials who operated on a competitive basis with other companies were held not to be operated exclusively for exempt purposes.⁴

An essential of qualifying for exemption is that no part of the organization's net earnings inure to the benefit of any private shareholders or private individuals.⁵ The by-laws may not permit the directors to declare dividends from profits,⁶ fix shareholders' salaries in proportion to their holdings⁷ or give them discretion to make or not make distributions to charities, so that the dedication is less than irrevocable.⁸

Many private schools will be taxable since they are operated for the owners' profit.⁹ This will also be true of many private hospitals.¹⁰

The benefit to the individual may be indirect such as excessive maintenance or similar allowances,¹¹ excessive rent to the organizations' managers,¹² reimbursement of expenses incurred by the founder before setting up the organization.¹³ The private benefit has taken the form of promoting the works of an author who was one of the organization's founders.¹⁴ On the other hand a foundation devoted to the spread of scientific knowledge did not lose its exemption because an unrelated publisher made a profit from the distribution of its books.¹⁵

The payment of reasonable compensation to the trustee, even though he is related to the founder will not disqualify the trust.¹⁶ Nor will the organization be disqualified for reasonable payments to or on behalf of staff members who are needed to achieve the organization's exempt purposes.¹⁷

The charity should keep records of its disbursements, showing the names and addresses of the payees and their relationship to the organization or its founder, the amounts and the purposes of the payments.¹⁸

A charitable organization may have an obligation to make annuity or other payments to

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the founder or his relations or heirs. In one instance the annuities paid to the founder and his wife were large in comparison to the amounts distributed to charities and so the foundation was not exempt.¹⁰ However, the obligation to make payments to private persons need not affect the organization's exemption. Some courts, distinguishing between annuities which are charges on property given to the organization and those which are not, have allowed exemption in the case of annuities which are charges on the donated property.²⁰ An annuity payable from a testamentary charitable trust to a relative of the testator was considered a legacy rather than an interest in the trust's earnings.²¹ A foundation did not lose its exemption because it was required to pay out annuities at the founder's death. Since the annuities were comparatively minor in relation to the foundation's assets, tax exemption would not primarily benefit the annuitants.²² However, the charitable organization should segregate the assets which are charged with an annuity unless the difference between the income from the assets and the annuity is relatively slight.²³

1. Rev. Rul. 66-103, IRB 1966-18, 9.
2. Rev. Rul. 66-104, IRB 1966-18, 10.
3. *Stevens Bros. Foundation, Inc. v. Com.*, 324 F. (2d) 633, cert. den. 376 U.S. 769, reh. den. 377 U.S. 920.
4. *American Institute for Economic Research v. U.S.*, 303 F. (2d) 934, cert. den. 4/22/63, reh. den. 6/3/63; Rev. Rul. 60-351, CB 1960-2, 169.
5. Code Sec. 501(c)(3).
6. I.T. 2937, CB XIV-2, 123 (1935).
7. *Carter, T.C. Memo.*, 1958-166.
8. *C. F. Smith Co., T.C. Memo.*, 1954-86.
9. *Kemper Military School v. Crutchley*, 274 Fed. 125.
10. *Kenner v. Com.*, 318 F. (2d) 632.
11. *Riker v. Com.*, 244 F. (2d) 220, aff'g T.C. Memo. 1955-225, cert. den. 335 U.S. 839; *Help The Children, Inc.*, 28 T.C. 1128.
12. *Texas Trade School*, 30 T.C. 642, aff'd 272 F. (2d) 168.
13. Rev. Rul. 55-610, CB 1955-2, 262.
14. Rev. Rul. 55-231, CB 1955-1, 72.
15. *Science and Research Foundation, Inc. v. U.S.*, 181 F. Supp. 526.
16. *Home Oil Mill v. Willingham*, 68 F. Supp. 525.
17. *St. Germain Foundation*, 26 T.C. 648.
18. Rev. Rul. 56-304, CB 1956-2, 306.
19. *Scholarship Endowment Foundation v. Nicholas*, 106 F. (2d) 552, cert. den. 308 U.S. 623.
20. *Com. v. Edward Orton, Jr., Ceramic Foundation*, 173 F. (2d) 483, aff'g 9 T.C. 533; *Davenport Foundation, T.C. Memo.*, 12/24/47, aff'd 170 F. (2d) 70.
21. *Lewis v. U.S.*, 189 F. Supp. 950.
22. *Francis Edward McGillicuddy Foundation v. Com.*, 278 F. (2d) 642, aff'g and rev'g 30 T.C. 1130.
23. *William L. Powell Foundation v. Com.*, 222 F. (2d) 68.

§ 7914. Action or propaganda organizations. A religious, charitable, etc., organization isn't exempt if, as a substantial part of its activities, it carries on propaganda, attempts to influence legislation, or participates or intervenes in any political campaign on behalf of any candidate for public office.¹ The Treasury describes an organization which carries on

any of these activities in a substantial way as an action organization and denies it exemption.² An organization enters the political arena by contacting legislators or urging the public to contact legislators in support of or in opposition to legislation, by advocating the adoption or rejection of legislation, by making statements, written or oral, for or against a candidate for public office. Legislation means action by Congress, a state legislature or a local legislative body as well as action by the public in a similar procedure.

These activities must be a substantial part of the organization's total activities in order to bar exemption. Insubstantial political activities will not disqualify the organization, nor will activities which are in furtherance of its basic exempt purpose.

In some instances it may be difficult to distinguish between an organization which aims at influencing political opinion and an educational organization. The Treasury admits that an organization which advocates a particular position may be educational provided it presents all the pertinent facts (not mere unsupported views) so that an independent judgment can be made.³ But it will deny exemption if the doctrine advocated by the organization can become effective only by the enactment of legislation.⁴

✓ *observation:* Whether an organization is an action organization must be decided in the light of all its activities and all the surrounding circumstances.

1. Code Sec. 501(c)(3).
2. Regs. § 1.501(c)(3)-1(c)(3).
3. Regs. § 1.501(c)(3)-1(d)(3)(ii).
4. Rev. Rul. 62-71, CB 1962-1, 85.

§ 7915. Charitable organizations. "Charitable" is given its generally accepted legal meaning. It includes relief of the poor, distressed or underprivileged, the advancement of religion, education or science, erecting and maintaining public buildings, monuments and works, and lessening the burdens of government. The regs also say that the term may apply to bodies that promote social welfare by easing neighborhood tensions, eliminating prejudice and discrimination, defending human and civil rights or by combating community deterioration and juvenile delinquency. The organization may advocate social reform and attempt to form public opinion on controversial issues, provided it does undertake the functions of an action organization.¹ Generally the charitable activities must benefit more than a narrow class such as a family. However, the needy employees of a particular business is a sufficiently public group.² But a trust to provide pensions for all retired employees regardless of need doesn't qualify.³

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The beneficiaries of a charity may make contributions to it, but the organization cannot be an instrument for distributing additional compensation and qualify for exemption as a charity.¹

1. Regs. § 1.501(c)(3)-1(a)(2).
2. *Harrison v. Barker Annuity Fund*, 90 F. (2d) 266.
3. *Watson v. U.S.*, 355 F. (2d) 269.
4. *Duffy v. Birmingham*, 190 F. (2d) 738.

§ 7916. Educational organizations. The regs say that education is the instruction or training of the individual to improve or develop his capabilities or the instruction of the public on subjects useful to the individual and beneficial to the community.¹ The organization need not be a formal institution such as a college; it may promote cultural appreciation, for example, on an informal basis.² Nor will the organization fail to qualify because of incidental entertainment or recreation especially where these activities promote interest in the organization's educational purposes.³

The regs give these examples of tax-exempt educational organizations.⁴

... Any school, whether primary, secondary, a college or university, professional or trade with a regular faculty and a student body regularly in attendance

... A correspondence school

... An organization which offers lectures and discussions, including broadcasts and telecasts

... Museums, zoos, planetariums, symphony orchestras and the like.

These organizations have also been held to be tax exempt.

... Organizations which operated a touring repertory theater company⁵ or which encouraged interest in repertory theater without actually operating one.⁶

... Organizations for promotion of group harmony singing;⁷ or an appreciation of jazz as an American art form;⁸

... An organization devoted to improving the quality of radio and TV programs and raising the public's standards.⁹

... Organizations devoted to teaching sailboat racing¹⁰ and other sports.¹¹

Auxiliary organizations. An organization may be exempt because it performs a function of an educational institution. Exempt organizations of this sort have:

... Published a law journal for a university.¹²

... Made low-interest loans to students.¹³

... Operated a campus store and restaurant under joint faculty-student control.¹⁴

... Run a high school intercollegiate athletic association.¹⁵

... Awarded fellowships to the undergraduate members of a fraternity.¹⁶

... Organized an alumni association under the control of the university's administration.¹⁷

... Made scholarships available to the employees or children of employees of business or group of businesses¹⁸ provided there is no discrimination in favor of the owners or their children.¹⁹

... Provided post-graduate training for doctors through seminars and lectures.²⁰

Exemption has been denied to:

... fraternities, although they may be exempt as social clubs.²¹

... an undergraduate discussion club whose members were chosen on the basis of compatibility, rather than scholarship.²²

... schools run to produce a profit for the operators and owners.²³

1. Regs. § 1.501(c)(3)-1(d)(3)(i).
2. *L.I.*, 1475, CB 174, 184 (1922).
3. *I.T.* 3330, CB 1939-2, 185.
4. Regs. § 1.501(c)(3)-1(d)(3)(ii).
5. *Rev. Rul.* 64-175, CB 1964-1, 185.
6. *Rev. Rul.* 64-174, CB 1964-1, 183.
7. *Rev. Rul.* 66-46, IRB 1966-9, 9.
8. *Rev. Rul.* 65-271, CB 1965-2, 161.
9. *Rev. Rul.* 64-192, CB 1964-2, 136.
10. *Rev. Rul.* 64-275, IRB 1964-1, 15.
11. *Rev. Rul.* 65-2, CB 1965-1, 227.
12. *Rev. Rul.* 63-235, CB 1963-2, 210.
13. *Rev. Rul.* 61-87, CB 1961-1, 191; *Rev. Rul.* 63-220, CB 1963-2, 208.
14. *Rev. Rul.* 58-194, CB 1958-1, 240, revoking *I.T.* 2036, CB XI-2, 102 (1932).
15. *Rev. Rul.* 55-587, CB 1955-2, 261.
16. *Rev. Rul.* 56-403, CB 1956-2, 307.
17. *Rev. Rul.* 56-486, CB 1956-2, 309; *Rev. Rul.* 60-143, CB 1960-1, 192, revok'g G.C.M. 22116, CB 1940-2, 100.
18. *Chase, T.C. Memo.* 1960-49; *Gimbel v. Com.*, 34 F. (2d) 780; *Sibley, Exr.*, 16 BTA 915; *T. J. Moss Tie Co.*, 18 T.C. 188, pet. for rev. dism'd 201 F. (2d) 512.
19. *Charleston Churr Co. v. U.S.*, 203 F. Supp. 126.
20. *Rev. Rul.* 65-298, CB 1965-2, 163.
21. *Rev. Rul.* 64-118, CB 1964-1, 182.
22. *Rev. Rul.* 64-137, CB 1964-1, 180.
23. *Birmingham Business College, Inc. v. Com.*, 276 F. (2d) 476.

§ 7917. Professional organizations. Bar associations are not exempt as charities, scientific or educational organizations, according to the Treasury, even though they maintain a library and an auditorium for discussion of legal topics.¹ However, the Second Circuit ruled that contributions to bar associations were deductible as gifts to charity for estate tax purposes² and the estate tax provision is similar to the income tax provision. The Treasury has ruled that American Bar Foundation³ and the American Bar Association Fund for Public Education⁴ are exempt educational organizations.

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The American Institute of Accountants is not a charitable organization for the deduction of contributions.⁵

1. G.C.M. 4805, CB VII-2, 58 (1928).
2. Dulles, Exr. (Cromwell Will), v. Johnson, 273 F. (2d) 362, rev'd 155 F. Supp. 275.
3. Letter to Foundation 12/24/52.
4. Letter ruling 12/15/61.
5. Rev. Rul. 60-143, CB 1960-1, 192, revok'g G.C.M. 22116, CB 1940-2, 100.

§ 7918. Scientific research organizations. The scientific research may be basic or applied but it must be in the public interest rather than for the benefit of a private person or industry. The Treasury has these tests for determining whether research is in the public interest:

(1) The results (including any copyrights, patents, processes or formulae) are made available to the public on a nondiscriminatory basis; or

(2) the research is performed for the United States, its instrumentalities or agencies or its state or its subdivisions; or

(3) the research is directed toward benefiting the public.¹

Among research which is directed toward benefiting the public, the Treasury lists:

- ... research in connection with the scientific education of college and university students
- ... research for obtaining scientific information which will be published or otherwise made available to the public
- ... research to cure a disease
- ... research to help a community attract, develop or retain an industry.

Research for these purposes is carried on for the public benefit even though a contract or agreement gives the sponsors the right to any resulting copyrights, patents or the like.²

Research organizations will not be exempt if they perform work only for their creators which are not themselves exempt charities. Nor will they be exempt if they do not make the results of their research available to the public on a nondiscriminatory basis. However, if the research is carried on for a government or for one of the funds listed above, the research organization will not lose its exemption by turning over the results to only one person where this is the only practical way of exploiting the discovery for the public.³

An exempt organization such as a university or a college may carry on non-exempt research. It will not lose its exemption if the non-exempt research remains secondary to its exempt purposes. However, any income from the non-exempt research may be taxable as unrelated business income. See § 8006. And in this connection the distinction between basic and applied research may be significant.

Here's how the Treasury has applied these rules.

... An organization which performed social science research and made its findings available to the public was exempt.⁴

... An organization which designed and developed machinery in connection with a commercial operation wasn't exempt.⁵

... An organization that prepared and distributed free abstracts of scientific and medical literature was exempt.⁶

1. Regs. § 1.651(c)(3)-1(d)(5).
2. Regs. § 1.501(c)(3)-1(d)(5)(iii)(c).
3. Regs. § 1.501(c)(3)-1(d)(5)(iv).
4. Rev. Rul. 65-60, CB 1965-1, 231.
5. Rev. Rul. 65-1, CB 1965-1, 226.
6. Rev. Rul. 68-147, IRB 1968-22, 15.

§ 7919. Hospitals and homes for the aged. An exempt hospital must be organized as a non-profit organization for the care of the sick. While it may charge fees for its services, to the extent of its financial ability it must admit for treatment those unable to pay. It may not restrict the use of its facilities to a particular group of physicians. Provisions for dividends in the by-laws automatically disqualifies a hospital. And a hospital will not be exempt if the salaries paid to its managers are designed to siphon off most of the income.¹ While the hospital may have a prepayment plan, the use of its facilities must be open to all the residents of an area including those unable to pay.²

A hospital won't be denied exemption merely because it charges doctors reasonable and non-discriminatory fees for use of its facilities in order to obtain funds to build a new hospital.³

A nonprofit hospital which fails to qualify as a charitable organization may be exempt as a civic organization.⁴

Homes for the aged will be exempt if services are rendered to all the residents or a reasonable portion of them for fees substantially below cost to the extent of the organization's financial ability.⁵ To determine whether the fees are below cost, entrance fees and any other lump sum fees may be prorated over the resident's life expectancy based on the Treasury's annuity tables.⁶ However, the home will not be denied exemption because some payment is demanded of all residents.⁷

1. *Fore Scott Clinic and Hospital Corp. v. Brod-rich*, 99 F. Supp. 515.
2. Rev. Rul. 56-185, CB 1956-1, 202.
3. Rev. Rul. 65-269, 2 1965-2, 159.
4. IRS Doc. No. 5551, (10/65), p. 5.
5. Rev. Rul. 61-72, CB 1961-1, 183.
6. Rev. Rul. 64-231, CB 1964-2, 139.
7. Rev. Rul. 61-72, CB 1961-1, 183.

§ 7920. Testing for public safety. An organization which does testing for public safety is exempt.¹ This includes testing con-

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sumer products to determine whether they may be used by the public.² An example of a consumer product would be commercially manufactured safety equipment for pleasure boats.³

1. Code Sec. 501(c)(3).
2. Regs. § 1.501(c)-1(d)(4).
3. Rev. Rul. 65-61, IRB 1965-11, 14.

§ 7921. Religious organizations. Exemption under this label permits great latitude for differences in creed and practices. However, the sect's income must be used for achieving its professed aims and not for the profit of an individual. Thus, an organization which practiced miraculous healing was exempt¹ while an organization which published self-improvement booklets for profit was not.² One religious organization operated several commercial enterprises such as a nursery, a laundry and a hotel. However, they were not operated for profit but to demonstrate how the sect's teaching might be put into practice and so

the sect was exempt.³

1. A. A. Allen Revivals, Inc., T.C. Memo. 1963-281.
2. Foundation for Divine Meditation, Inc., T.C. Memo. 1965-177.
3. Golden Rule Church Ass'n, 41 T.C. 719.

§ 7922. Religious or apostolic associations or corporations.

Religious organizations which carry on business activities aren't exempt as organizations organized and operated *exclusively* for religious purposes. But such organizations may be exempt under a different classification, namely as religious or apostolic associations. This exemption applies only if:

- ... the associations have a common or community treasury;
- ... each member includes as a dividend his share of the income whether or not distributed for the organization's taxable year ending with or within his tax year.¹

1. Code Sec. 501(d); Regs. § 1.501(d)-1.

§ 7955. Filing Requirements of Exempt Organizations.

An organization isn't exempt from income tax merely because it claims an exemption. Until the exemption is established, the organization must continue to file regular income tax returns or face possible penalties. Once the exempt status is established, the organization must generally file annual information returns. The type of annual return required depends on the type of exempt organization.

Generally, annual returns must report gross income, receipts, disbursements, etc. Information returns required because the organization is privately supported must also include many other items, such as distributions for exempt purposes out of income and out of principal, accumulated income, contributions and gifts received during the year, and a balance sheet. All exempt organizations must also keep the records required by the Treasury.¹

Though exempt employee trusts must file annual information returns, the trustee needn't include any information in the return which the employer states, in a written notice to him, will be or has been reported in the employer's return.²

Annual returns must be filed by exempt organizations regardless of the amount or source of income or receipts and regardless of whether it's a member of a group, unless it is included in a group return, see § 7957.

The return must be for the organization's established accounting period, or if it has none, for the calendar year.³

The tax exemption may be *revoked* for failure to file the required returns or statements or keep the required records.⁴

Identifying numbers. Exempt organizations need an employer identifying number for any required information returns.⁵ They must also furnish that number to payers of dividends or interest, etc., and use it on payroll tax returns.

For a discussion of whose number to use where an organization is required to file an

information return with respect to payments to or transactions with third parties, see § 2471.

How to obtain numbers and the penalties for failure to use or furnish numbers where required, are explained at §§ 1434 and 1435.

1. Code Sec. 6033; Regs. § 1.6033-1.
2. Regs. § 1.6033-1(a).
3. Regs. § 1.6033-1(b).
4. Rev. Rul. 59-95, CB, 1959-1, 627.
5. Regs. § 1.6109-1(b).

§ 7956. Exempt organizations which needn't file annual returns. The following exempt organizations needn't file annual information returns:¹

1) Organizations organized and operated *exclusively* for *religious* purposes, including exempt organizations which they supervise or control.

2) *Educational* organizations which maintain a faculty and curriculum and which have a regular student body in attendance. If an organization meets these requirements, it needn't file even if it temporarily must discontinue or curtail such activities.

3) *Charitable* organizations, or organizations for the prevention of cruelty to children or animals if they (a) are wholly or partly supported by state or federal funds or (b) receive half their income from voluntary public contributions. For (a) to apply, the government funds must be contributed without requiring specific services of the charity. For (b) to apply, the 50% contributions must be from the *general* public and not from those connected with the organization.

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4) *Fraternal organizations* operating under the lodge system and furnishing life, sick, accident or other benefits to members and dependents.

5) *Organizations wholly owned by the U.S. or its agencies* (and their wholly owned subs).

Changes in the character, operation, or purpose of the above organizations must be immediately reported in writing to the district director for the district where the organization has its principal office.

All other information returns must be filed by the above organizations in the same way as any other taxpayer. They are excused *only* from the filing of the annual returns described in § 7957. The information returns which all organizations must file include returns:

... on payments of \$600 or more in connection with its operations, see § 1413.

... on payments of dividends and interest, see §s 2472 *et seq.*

... on tax withheld, see § 3700.

For information returns on the payment of patronage dividends by cooperatives, see § 7640.

1. Code Sec. 6033; Regs. § 1.6033-1(g).

§ 7957. Annual returns of exempt organizations.

Form 990 is the principal information return of exempt organizations, and must be used unless the organization is required to file one of the special forms described below.¹

Labor organizations may use copies of Department of Labor Forms LM-2 and LM-3 in place of specific information required on the Form 990, though the Form 990 must otherwise be completed and filed.

Form 990-A must be used by charitable and other Code Sec. 501(c)(3) organizations which are required to file because they aren't supported by government or public contributions, see 7956.

A charitable foundation which leases property rent-free to an educational organization may deduct the rental expenses on Form 990-A as operating expenses or as a gift, providing the item is consistently treated.

Form 990-C is used by "exempt" farmers' cooperative marketing and purchasing associations. *Form 990-C* is actually an *income tax return*, since farmers' cooperatives are subject to tax and are only nominally exempt.²

Form 990-P is used by exempt employee trusts.

Form 990-T is used by otherwise exempt organizations which have *unrelated business taxable income*, see § 8000. This too is really an income tax return, since the unrelated business income is taxed on the Form 990-T.

Form 1065, the regular partnership return, must be filed by tax-exempt *religious or apostolic associations or corporations* having a common or community treasury whose members include in their gross income their pro rata share of the organization's taxable income. As any partnership return, the Form 1065 must show gross income, deductions, taxable income, and members' names, addresses, and distributive shares.

Group returns. A central or parent exempt organization must file a separate annual return for itself, but it may also file a group return on Form 990 or 990-A for 2 or more of its local chapters, branches, etc., in place of their separate returns. The parent's year is the reporting period.

To be includible in a group return the local organization must be (a) chartered by or associated with the parent at the close of its year, (b) subject to the parent's supervision, and (c) exempt under the same law provision as the parent.

The parent must advise each district director where a local would ordinarily file as to whether the local will or won't be included in a group return.

Federal credit unions may have a group return filed with the district director, Baltimore, Md.³

State-chartered exempt credit unions may have a group return filed by the state agency controlling and supervising the group. The state agency must notify each appropriate district director, as explained above.⁴

For information returns of trusts claiming a charitable deduction under Code Sec. 642(c), see § 1955.

1. Regs. § 1.6033-1(a).

2. Code Sec. 522.

3. Rev. Rul. 60-169, CB 1960-1, 621.

4. Rev. Rul. 60-364, CB 1960-2, 382.

§ 7958. When and where annual returns are filed. Otherwise exempt organizations which are *taxable as corporations on their unrelated business income* must file their Form 990-T on or before the 15th day of the 3rd month following the close of the taxable year (by the following March 15th for calendar year organizations).¹

"Exempt" farmers' cooperatives must file their Form 990-C by the 15th of the 9th month after the close of the taxable year (by the following Sept. 15th for calendar year cooperatives).²

Religious or apostolic associations or corporations required to file Form 1065 must file by the 15th day of the 4th month following the close of the taxable year (by the following April 15th for calendar year associations).

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Other exempt organizations must file their information returns (Forms 990, 990-A, and 990-P) by the 15th day of the 5th full calendar month following the close of their annual accounting period (by the following May 15th for calendar year organizations).³

Annual returns are filed with the district director for the district where the organization's

principal place of business is located.⁴

For the rules as to filing extensions, payment (where applicable) and filing requirements generally, see § 2445 *et seq.*

1. Regs. § 1.6072-1.
2. Regs. § 1.6072-2.
3. Regs. § 1.6033-1(e).
4. Regs. § 1.6033-1.

§ 7960. Determination, Revocation, and Recovery of Exempt Status.

An organization can't be sure it is exempt until a ruling or determination letter so stating is issued by the Treasury. This will ordinarily be issued only after the organization has filed a detailed application; although tentative or advance rulings will frequently be issued. Exemptions may be revoked or modified, and application may be filed to renew revoked exemptions.

§ 7961. How exemption is determined. An organization isn't exempt from income tax merely because it is neither organized nor operated for profit. It is exempt only if its organization, purposes, and activities fall within one of the exempt categories listed in the Code. The exempt categories and the extent of the exemption applicable to each, have been previously noted (§ 7900 *et seq.*)

The fact of exemption must generally be established by applying for and obtaining a Treasury ruling or determination to that effect. Until such a ruling or determination letter is issued, the organization must file an income tax return and pay any tax due. But when it is issued, the ruling or determination letter is effective as of the date the organization was formed if its purposes and activities satisfied the exemption requirements from its inception.¹

1. IRS Doc. No. 5551, (10/64), p. 3.

§ 7962. Application for exemption ruling or determination letter. All applications for exemption rulings or determination letters are filed with the local district director for the district in which is located the organization's office or place of business.¹ Only requests for rulings concerning feeder corporations, prohibited transactions, income accumulation, and unrelated business income should be sent to Washington by the taxpayer. These should be addressed to the Commissioner of Internal Revenue, Washington, D. C. 20224.²

Exemption applications must always be written, even where no official forms are provided. Oral requests won't be considered.³

Official application forms are provided for most cases. Where provided, the form should be used and the accompanying instructions should be followed.

Two copies of each major document required to be furnished by the official application form

should be attached to the application. These include:

- ... Articles of incorporation or trust agreements.
- ... Bylaws.
- ... Classified receipts and expenditures for each year of operation and assets and liabilities at the end of each year.
- If the organization has capital stock, the application also should show:
 - ... The number and par value of shares of each class of stock.
 - ... Consideration for which shares were issued.
 - ... By whom held. Give shareholder's names and number of shares held if less than 10 shareholders.
 - ... Whether organization certificate authorizes payment of dividends and whether any have been paid.
 - ... Copy of stock certificates.

Group rulings are issued for national organizations including churches, Boy Scouts, and fraternal organizations. Local branches or lodges don't have to file separate exemption applications if covered by the group ruling.⁴

Applications for exemption may be withdrawn at any time before issuance of a ruling or determination letters. But the information submitted won't be returned and may be used by the district director on audit of the organization's tax returns.⁵

1. Regs. § 1.501(a)-1(a)(2); Rev. Proc. 62-30, CB 1962-2, 512.
2. Rev. Proc. 56-8, CB 1956-1, 102; IRS Doc. No. 5551, (10/64).
3. IRS Doc. No. 5551, (10/64), p. 4.
4. IRS Doc. No. 5551, (10/64).
5. IRS Doc. No. 5551, (10/64).

§ 7963. Additional information required from charitable, religious, educational, etc., organizations. The exemption application

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must include a detailed statement of the activities or proposed activities of the following types of organizations:¹

- ... Religious organizations.
- ... Hospitals.
- ... Clinics.
- ... Old age homes.
- ... Community nursing bureaus.
- ... Community funds.
- ... Charitable and educational loan organizations.
- ... Charitable organizations supporting education.
- ... Educational organizations including a museum, zoo, planetarium, symphony orchestra and similar organizations.
- ... College campus organizations.
- ... Alumni associations.
- ... Athletic organizations.
- ... Scientific organizations.
- ... Literary organizations.
- ... Associations for prevention of cruelty to children or animals.

Consult your local district director for the specific information required with respect to any particular type of organization.

1. Regs. § 1.501(a)-1(b)(1)(iii); IRS Doc. No. 5551, (10/64).

§ 7964. Official application forms. Official exemption application forms are provided for the following categories:

- ... Charitable, religious, educational, literary, scientific, etc., organizations. Form 1025.
- ... Civic leagues, labor unions, local employee's associations, agricultural or horticultural organizations, chambers of commerce and similar organizations, and fraternal beneficiary societies. Form 1024.
- ... Social and athletic clubs. Form 1025.
- ... Title holding companies, cemetery companies, local benevolent life insurance associations, mutual ditch, irrigation or telephone companies. Form 1026.
- ... Voluntary employees' beneficiary associations and supplemental unemployment benefit trusts. Form 1027.

In any case when no official form of application is provided, the local district director should be consulted for the information to be submitted and the procedure to be followed in establishing exemption.¹

1. IRS Doc. No. 5551, (10/64).

§ 7965. Tentative or advance determination letters and rulings. In most cases, tentative

determination letters or rulings will be issued in advance of operation provided the organization can describe its proposed operations in sufficient detail to convince the Treasury that they will be clearly exempt under the law.¹

1. Rev. Proc. 63-30, CB 1963-2, 769, superseding Secs. 2 and 4 of Rev. Proc. 62-30, CB 1962-2, 512.

§ 7966. Revocation or modification of exemption. Exemption rulings and determination letters may be revoked. Causes for revocation include failure to file annual information returns and material changes in the organization's character, purpose, or method of operation.¹

The revocation may be retroactive and deficiencies (and penalties) may be claimed for open years. But the Treasury may not abuse its discretion in this respect.²

The general policy of the Treasury is to limit retroactive revocation to cases where:³

- ... A material fact was omitted or misstated.
- ... The organization operated in a manner materially different than that represented.
- ... The organization engaged in a prohibited transaction.

The foregoing policy is generally supported by the cases.⁴ It also has been held that the Commissioner isn't barred from revoking an exemption retroactively to the time of material change in relevant facts or applicable law occurring after the ruling was issued.⁵

1. Proc. Rules § 601.201(n)(10); Rev. Proc. 62-30, Sec. 8.03, CB 1962-2, 512.
2. *Automobile Club of Michigan v. Com.*, 353 U.S. 180, 1 L. ed. 2d 746, aff'g 230 F. (2d) 585.
3. Proc. Rules § 601.201(n)(10)(iii); Rev. Proc. 62-30, Sec. 8.03, CB 1962-2, 512.
4. *Lesavoy Foundation v. Com.*, 238 F. (2d) 589; *Loraino Avenue Clinic*, 31 T.C. 141.
5. *Stevens Bros. Foundation, Inc.*, 39 T.C. 93, aff'd 324 F. (2d) 633, cert. den. 376 U.S. 969, reh. den. 377 U.S. 920.

§ 7957. Protesting adverse and revoked or modified determination letters and rulings. A taxpayer is entitled to file a protest with the district director if the determination letter or ruling issued denies his exemption application or if an exemption is later revoked or modified. A timely protest starts the administrative review of the particular determination.¹

✓ *observation*: A protest consists of a statement of the facts and the law and the taxpayer's arguments in support of his contention.

If the taxpayer's protest is unsuccessful a deficiency will eventually be assessed against him. At this point, the taxpayer will have the usual alternatives of either contesting the deficiency in the Tax Court or paying it and filing a refund claim and thereafter suing for refund in the district court or the Court of Claims.

1. Proc. Rules § 601.201(n).

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§ 7968. Renewed exemption applications. An organization whose exemption application has been denied or revoked can always file a new one. But if it is denied or revoked because of a prohibited transaction, a new exemption application can't be filed before the taxable year following that in which notice of denial or revocation was issued. And a new exemption won't be granted before the beginning of the taxable year following that in which the new application is filed.¹

✓ **Illustration:** In the case of a calendar year organization, exemption is revoked in '65. New application may not be filed before '66. If it is filed in '66, the first year for which exemption may be granted is '67.

1. Proc. Rules § 601.201(n) (7) (vii).

§ 7969. Returns during exemption and after revocation. In general, exempt organizations must file annual information returns. But certain religious and charitable organizations are exempt from even this obligation.¹ This subject is more fully discussed at § 7956.

The filing of information returns by an organization that honestly believes itself to be

exempt starts the period of limitations on assessments and collection.²

But exempt organizations aren't excused from filing information or other returns concerning payments to employees and others.³

An organization whose exemption is revoked must file income tax returns. Such returns must include all income thereafter received or accrued even though derived from contracts issued or assets acquired before the exemption was revoked.⁴

Loss of its exemption doesn't affect the organization's accounting period. Unless the organization becomes taxable on the first day of its taxable year, it must file a short taxable year return beginning with the first day it is taxable and ending with the last day of that taxable year.⁵ The income for such a short year may not be arrived at by prorating the full year's income.⁶

1. Code Sec. 6033(a); Regs. § 1.6033-1(g) and (h).
2. Code Sec. 6501(e)(2).
3. Regs. § 1.6033-1(h)(3).
4. *Royal Highlanders*, 1 T.C. 184(A), rev'd on other grounds 138 F. (2d) 240.
5. *Royal Highlanders*, 1 T.C. 184(A), rev'd on other grounds 138 F. (2d) 240.
6. *Economy Savings & Loan Co.*, 5 T.C. 543 (NA), aff'd and rev'd on other issues 158 F. (2d) 472.

§ 7970. Prohibited Transactions.

Some organizations will be denied any exemption if they engage in so-called prohibited transactions. These are transactions with an organization from which its creator or a substantial contributor to it may benefit financially. Only real, not potential, prohibited transactions bar exemption.

§ 7971. Organizations affected. A requisite for exemption of an important group of organizations is that they don't engage in prohibited transactions. This rule applies to:

... Organizations in the religious, charitable, educational, literary, scientific, testing for public safety, and prevention of cruelty to children or animals category, *subject to important exceptions*, listed at § 7902.

... Employees' supplemental unemployment benefit trusts and qualified employee pension, profit sharing or stock bonus trusts, listed at § 7903.

The prohibited transaction rule doesn't apply to the large group of exempt organizations listed at § 7904.

§ 7972. What are prohibited transactions. The object of the prohibited transactions rule is to prevent the creator of, or a substantial contributor to, an exempt organization from directly or indirectly receiving financial benefit from dealings with the organization.

The prohibition applies to any transaction, between the organization and the creator or a substantial contributor to it or certain related persons, in which the exempt organization:

... Lends any part of its income or corpus without adequate security and reasonable interest.

... Pays any compensation in excess of a reasonable allowance for personal services actually rendered.

... Makes any part of its services available on a preferential basis.

... Makes any substantial purchase of securities or any other property for more than adequate consideration.

... Sells any substantial part of its securities or other property for less than an adequate consideration.

... Engages in any other transaction which results in substantial diversion of income or corpus.¹

The prohibition applies only when the person who is the other party to, and who re-

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ceives the benefit of, the transaction is one of the following:

- ... The creator of the organization (if a trust).
- ... A substantial contributor to the organization.
- ... A member of the family (brother, sister, spouse, ancestors, or lineal descendant) of the creator or of a substantial contributor.
- ... A corporation controlled by the creator or a substantial contributor through direct or indirect ownership of 50% or more of the total combined voting power or of the total value of all the stock.²

1. Code Sec. 503(c).
2. Code Sec. 503(c).

¶ 7973. Potential prohibited transactions don't bar exemption. The prohibited transaction bar is against *actually engaging* in prohibited transactions. The mere fact that an organization has authority under its governing instrument to enter into what would be prohibited transactions won't deprive it of its exemption as long as it doesn't actually engage in any prohibited transactions.¹

1. *Waller*, 39 T.C. 665(A).

¶ 7974. Decisions, rulings, etc., on prohibited transactions. The following have been held not to constitute prohibited transactions:

- ... Indirect benefit derived, from distributions by an exempt trust, by relatives of employees of the creator corporation.¹

... A loan by an exempt trust to a corporation which controls the creator corporation.²

... A loan to the creator who gave his note which required him to deliver as security, on request, mortgages on specific real estate worth several times the amount of the loan. The loan wasn't without adequate security.³

But the following have been held to be prohibited transactions:

... An unsecured loan to the creator of an exempt trust notwithstanding that the creator was solvent and in sound financial condition. *Adequate security* refers to collateral not to the creator's financial condition.⁴

... Loan to partnership by an exempt organization to which the general partner was a substantial contributor, notwithstanding that the loan was the joint and several liability of all the partners and each partner had sufficient assets to satisfy the entire loan, where it wasn't otherwise secured.⁵

✓ *observation*: The Sixth Circuit, suggests that where an exempt trust purchases equipment by borrowing under a chattel mortgage arrangement and then leases the mortgaged

equipment to the creator of the trust, the transaction may constitute a prohibited loan.⁶

✓ *observation*: Some decisions have allowed employer's deductions for their unsecured notes given to an employee trust in payment of their contributions. Where the deduction is allowed in one year and the note isn't paid until the following year, the effect is the same as if the employer had borrowed from the trust for the period from the end of the year in which deduction is allowed until the note is paid.

1. Rev. Rul. 96, CB 1963-1, 264.
2. Rev. Rul. 58-526, CB 1958-2, 269.
3. *William Clay, Jr., Foundation v. U.S.*, 233 F. Supp. 628.
4. *Van Products, Inc.*, 40 T.C. 1018.
5. Rev. Rul. 65-202, CB 1965-2, 172.
6. *Cooper Tire & Rubber Co. Employee's Retirement Fund v. Com.*, 306 F. (2d) 20.

¶ 7975. Security for loans by employee trusts. A special rule exempts certain loans by employee trusts from the *adequate security* requirement. This exemption applies only to:

... Employees' supplemental unemployment benefit trusts, described in Code Sec. 501(c)(17).

... Qualified employee pension, profit sharing or stock bonus trusts, described in Code Sec. 401(a).

A bond, debenture, note, or certificate or other evidence of indebtedness acquired by such an employee trust won't be treated as a loan made without adequate security if:

... The obligation is, in general, acquired by the trust either in the market at the market price or from an underwriter in an SEC registered offering at the public offering price at which a substantial portion of the same issue is acquired by persons independent of the issuer or from the issuer at a price that isn't higher than that paid currently for a substantial portion of the same issue by persons independent of the issuer. These rules are spelled out in detail in the Code and regs.¹

... Immediately following the trust's acquisition of the obligation, it holds not more than 25%, and persons independent of the issuer hold at least 50%, of the aggregate amount of obligations issued, in such issue, and outstanding at the time of acquisition.²

... Immediately following the trust's acquisition of the obligation not more than 25% of the trust's assets is invested in obligations of the creator of the trust or any other person or corporation with whom a prohibited transaction is barred.³

A change in the terms of an obligation is considered as the acquisition of a new obligation to which the foregoing requirements apply.⁴

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Prohibited Transactions—§ 7978

1. Code Sec. 503(h)(1); Regs. § 1.503(h)-1(b) and § 1.503(h)-2(b).
2. Code Sec. 503(h)(2).
3. Code Sec. 503(h)(3); Regs. § 1.503(h)-2(d).
4. Regs. § 1.503(h)-2(c).

§ 7976. Security for loans by stock brokerage employee trusts. A second exemption from the adequate security requirement applies only to loans by the qualified employee pension, profit sharing, or stock bonus trusts. This rule is aimed at giving relief to stock brokerage firms which are barred from pledging registered securities they own as collateral for loans from persons other than banks or brokers.

The rule exempts from the adequate security requirement, a loan (or renewal) by a qualified employee trust to an employer-creator who is prohibited by any U. S. law or applicable regs from directly or indirectly pledging as security for a loan from the trust, any of his assets representing more than half of the value of all his assets.

But this exemption from the adequate security requirement applies only if the following conditions are satisfied:

... The loan bears a reasonable rate of interest.

... It is approved in writing as an investment consistent with the exempt purposes of the trust by a trustee independent of the employer. If the trust has more than one independent trustee a majority of them must give the required approval.

... Immediately after the loan (or renewal) the amount loaned to the employer, without adequate security (including loans exempt from that requirement), doesn't exceed 25% of all the assets of the trust.¹

1. Code Sec. 503(i); Regs. § 1.503(i)-1.

§ 7977. Owner-employee trusts are prohibited from engaging in other transactions. A qualified employee pension, profit sharing or stock bonus trust that includes owner-employees who control the trade or business with respect to which the plan is established is barred from engaging in a second group of prohibited transactions in addition to the regular prohibited transactions described at § 7972.

Under this second group of prohibited transactions, the trust may not, directly or indirectly:

- ... lend any part of its corpus or income to;
 - ... pay any compensation for personal services to;
 - ... make any part of its services available on a preferential basis to;
 - ... acquire any property from; or
 - ... sell any property to,
- Any of the following:

... any person with whom a regular prohibited transaction would be barred (§ 7971);

... the owner-employee, his brothers, sisters, spouse, investors, and lineal descendants; or

... a corporation controlled by an owner-employee through direct or indirect ownership of 50% or more of the combined voting power or of the total value of all the stock.¹

The prohibition against acquisition of property by the trust doesn't include money. But it bars contribution of any other property to the trust by the employer.²

An owner-employee is either:

... an employee who owns the entire interest in an unincorporated trade or business, or

... is a partner who owns more than a 10% interest in either capital or profits.³

One or more owner-employees control an unincorporated trade or business if they:

... own the entire interest in the business; or

... own more than a 50% interest in either capital or profits of a partnership that owns the trade or business or of a partnership that directly or indirectly owns such a 50% interest in a partnership that owns the trade or business.⁴

1. Code Sec. 503(j).
2. Regs. § 1.503(j)-1(b).
3. Code Sec. 401(c)(3).
4. Code Sec. 401(d)(9)(B).

§ 7978. Bank deposits as prohibited loans. Savings accounts and ordinary checking accounts aren't loans for purposes of the prohibited transactions provisions. This rule applies to such deposits in national banks, state banks, savings and loan associations, and building and loan associations whose deposits are insured by the Federal Deposit Insurance Corp., the Federal Savings and Loan Insurance Corp., or their state equivalents. It applies notwithstanding that the bank reserves the right to require 30 days' notice prior to withdrawal.¹

Savings accounts in such banks aren't prohibited loans notwithstanding that they exceed the amount of deposit insurance.² But ordinary checking accounts to the extent of any excess over the insured maximum apparently may be treated as violating the prohibition against other transactions resulting in substantial diversion of income or corpus if left on deposit for longer than the period required for reasonably prompt investment.³

A time deposit, namely one made for a fixed period of time, is considered to be a loan. But the ruling so holding doesn't indicate whether such a deposit would be considered to be adequately secured to the extent insured by the Federal Deposit Insurance Corp. or the Fed-

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eral Savings and Loan Insurance Corp., or their state equivalents.¹

1. Rev. Rul. 62-183, CB 1962-2, 143; Rev. Rul. 59-29, CB 1959-1, 123.
2. Rev. Rul. 62-183, CB 1962-2, 143.
3. Rev. Rul. 59-29, CB 1959-1, 123.
4. Rev. Rul. 62-183, CB 1962-2, 143.

§ 7979. Penalties where exempt organization engages in prohibited transactions. An otherwise exempt organization that engages in a prohibited transaction won't be granted an exemption application and, if it has previously been granted an exemption application, will have its exemption revoked.

Revocation isn't automatic. It applies only after notification by the Treasury and only for taxable years after that in which the organization is notified. But the revocation may apply to any taxable year during or prior to which the organization commenced the prohibited transaction if it entered into the transaction:

... with the purpose of diverting corpus or income of the organization from its exempt purposes and

... the transaction involved a substantial part of the corpus or income of the organization.¹

Engaging in a prohibited transaction also results in disallowance of the charitable contributions deductions for income, gift, and estate tax purposes to individuals, corporations, or estates or trusts that make donations to the organization that engaged in the prohibited transaction. The date from which deduction is denied depends on whether or not the organization entered into a prohibited transaction deliberately and whether or not the donor was a party to that transaction.

If the prohibited transaction was engaged in with the purpose of diverting corpus or income of the organization from its exempt purpose

and the transaction involves a substantial part of the corpus or income, charitable contribution deductions are denied for donations made:

... In the organization's taxable year in which it commenced such prohibited transaction or thereafter, by a donor who was a party to it. This includes an individual who wasn't a party himself if any member of his family was. Family includes brother, sisters, spouse, ancestors, and lineal descendants.

... After the organization's taxable year in which it engaged in such prohibited transaction, by a donor who wasn't a party to it (and no member of whose family (as defined above) was a party to it). Apparently the year in which the organization engaged in such prohibited transaction is that in which the diversion of the corpus or income becomes substantial.

If the prohibited transaction wasn't engaged in for the purpose of, and didn't involve, diversion of a substantial part of the organization's corpus or income from its exempt purposes, charitable contribution deductions are denied only for donations made in the organization's taxable years after that in which it is notified by the Treasury that its exemption has been revoked.²

Although a transaction between an otherwise exempt organization and one in a fiduciary relation to it may not in particular circumstances constitute a prohibited transaction, it may still result in loss of the organization's exemption if it violates any of the basic requisites for exemption. Thus the transaction may show that the organization isn't in fact being operated for the requisite exempt purpose.³

1. Code Sec. 503(a); Regs. § 1.503(a)-1(b).
2. Code Sec. 503(c) and (f); Regs. § 1.503(c)-1.
3. Regs. § 1.503(a)-1(a).

§ 7990. Unreasonable Accumulations and Improper Use or Investment of Income.

Exemption is denied to certain organizations in the broad religious, charitable, educational, etc. category if they improperly accumulate, use, or invest their income. An exempt organization that does this will lose its exemption, but may file a new exemption application when the improper accumulation, use, or investment has been corrected.

§ 7991. Organizations affected. The Code bars improper accumulation, use, or investment of an exempt organization's income. This rule applies to a smaller group of exempt organizations than the prohibited transactions rule. The unreasonable accumulations rule applies only to organizations in the religious, charitable, educational, literary, scientific, testing for

public safety, and prevention of cruelty to children or animals categories, subject to important exceptions, listed at § 7902.

It doesn't apply to employees' supplemental unemployment benefit trusts or qualified employee pension, profit sharing or stock bonus trusts (§ 7903); or to the group of exempt organizations listed at § 7904.

FEDERAL TAXATION

Unreasonable Accumulations—§ 7994

§ 7992. Barred accumulations, uses, and investments of income. The rule against improper accumulation, use or investment of income is violated if the amounts accumulated out of income in or prior to the taxable year and not *actually* paid out by the end of year are either:

... Unreasonable in amount or duration in order to carry out the exempt purpose of the organization. This provision doesn't apply (a) to income attributable to property of a decedent dying before '51 transferred under his will to a trust created by it and (b) to income accumulated after the end of 21 years following the death of the last life in being designated in a trust created by the will of a decedent dying after '50 if income *must* be accumulated by the terms of the will creating the trust.

... Used to a substantial degree for non-exempt purposes.

... Invested in a manner that jeopardizes the tax exempt purposes of the organization.¹

The following aren't income for purposes of the improper accumulations rule:

... Contributions received by the exempt organization.²

... Gain on sale or exchange of donated assets to the extent of the excess of the fair market value of the assets *when donated* over their substituted basis to the organization. This gain doesn't have to be paid out.³

1. Code Sec. 504(a); Regs. § 1.504-1(b)(1).
2. Rev. Rul. 59-535, CB 1959-2, 270.
3. Regs. § 1.504-1(c)(1).

§ 7993. Unreasonable accumulation of income. The principal prohibition of the rule against improper accumulation, use, or investment of income bars accumulations of income that are unreasonable in amount or duration in order to carry out the purposes or functions constituting the basis for the organization's exemption.¹ The mere fact that an exempt organization may accumulate income won't bar its exemption. There must be an *unreasonable* accumulation.²

Accumulations of income were held to be unreasonable where they were excessive in relation to current expenditures and weren't otherwise justified by any specific program.³

But the following have been held not to be unreasonable income accumulations:

... Temporary accumulation of any gain on sale or exchange of income producing investment property, *but only if* such gains are reinvested within a reasonable time in other income producing investment property.⁴

... Accumulations to restore capital distributed in prior years.⁵

... Accumulations held as a reserve for a *specific and unconditional* charitable grant to be paid over a fixed period, or over the period necessary to accomplish the specific purpose of the grant, extending beyond the year of the commitment to make the grant. Apparently any undistributed balance of the reserve would be treated as distributable income for the year in which the commitment was otherwise satisfied or released.⁶

... Accumulations to build a reserve fund for an employee pension plan.⁷

... Accumulations to pay off debt on corpus of an otherwise bona fide exempt organization.⁸

... Accumulations over a period of six or seven years to build up (through income plus additional contributions) a fund to be donated to Brandeis University for construction of a medical research center.⁹

✓ *recommendation:* To protect deduction for charitable contributions to private foundations don't contribute more property than the foundation needs to meet the income requirements of its existing charitable program. The foundation, of course, can always prevent accumulations of excess income by contributing it to other exempt organizations.

1. Code Sec. 504(a)(1).
2. John Danz Charitable Trust, 32 T.C. 469, aff'd on other issues 284 F. (2d) 726.
3. Stevens Bros. Foundation, Inc., 39 T.C. 93, aff'd 324 F. (2d) 633, cert. den. 376 U.S. 969, reh. den. 377 U.S. 920; Erie Endowment v. U.S., 316 F. (2d) 151; Danforth Foundation v. U.S., 222 F. Supp. 761, aff'd 347 F. (2d) 673.
4. Regs. § 1.504-1(c)(2).
5. Rev. Rul. 54-137, CB 1954-1, 289; Rev. Rul. 54-227, CB 1954-1, 791.
6. Rev. Rul. 55-674, CB 1955-2, 264.
7. Truscott v. U.S., D.C. Pa., 4/1/58.
8. Tell Foundation v. Wood, D.C. Ariz., 11/26/57; Randall Foundation v. Riddell, 244 F. (2d) 803.
9. Samuel Friedland Foundation v. U.S., 144 F. Supp. 74.

§ 7994. Substantial nonexempt use of income. One of the prohibitions of the rule against improper accumulation, use, or investment of income bars use of income to a substantial degree for purposes or functions other than those constituting the basis for the organization's exemption.¹

It has been held that use of income to pay indebtedness wasn't an improper use, where: ... The indebtedness paid was incurred in acquiring income producing property, the income from which was used to make the debt payments.²

... The indebtedness paid was secured by mortgages on income producing property that the organization received as a gift subject to such mortgage debt.³

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1. Code Sec. 504(a)(2).
2. Shiffman, 32 C. 1073 (A).
3. Tell Foundation v. Wood, D.C. Ariz., 11/26/57.

§ 7995. Investment of income jeopardizing exempt purpose. Part of the rule against improper accumulation, use, or investment of income bars investment of accumulated income in such a manner as to jeopardize the carrying out of the purpose or function constituting the basis for exemption of the organization.¹

The test under this rule has been held to be whether whatever loss is likely to occur would imperil the capability of the organization to carry out its charitable purposes. It was held that:

... Investments which would have no substantial adverse effect on the organization's continued operation even if totally lost could be disregarded.

... A very substantial stock investment made with borrowed funds wasn't objectionable, even though a 15% decline in the price of the stock would have wiped out the foundation, where the investment was made on the recommendation of the grantor and principal stockholder of the corporation who had inside knowledge of its affairs and unquestioned investment acumen.

... Investment in amply secured second and third mortgages subject only to limited amounts of prior mortgages in relation to the value of the property.²

1. Code Sec. 504(a)(3).
2. Samuel Friedland Foundation v. U.S., 144 F. Supp. 74.

§ 7996. Penalty for improper accumulation, use or investment of income. An exempt organization that improperly accumulates, uses, or invests its income in violation of the rule against unreasonable accumulations is denied exemption for the taxable year in which the improper accumulation, use, or investment occurs.¹ An organization that has lost its exemption under this provision may file a new application for exemption showing that the cause for the loss of the exemption no longer exists.²

But a contributor to an otherwise exempt organization isn't denied a charitable contribution's deduction for a donation made in the year in which the organization lost its exemption solely for violation of the unreasonable income accumulation rule.³

1. Code Sec. 504(a).
2. Regs. § 1.504-1(c).
3. Regs. § 1.504-1(f).

§ 8000. Unrelated Business Income.

Virtually all exempt organizations, other than churches and certain other religious organizations, are taxable on their unrelated business income over \$1000. In general, the tax applies to a trade or business that isn't substantially related to the organization's exempt purpose. Special rules apply to trusts that qualify as exempt organizations. Unrelated business income includes so-called "business lease" income.

§ 8001. Organizations taxed on unrelated business income. The Code imposes income tax on the "unrelated business taxable income" of exempt organizations¹ without otherwise affecting their tax exempt status.² The tax applies only to unrelated business taxable income over \$1,000.³

The exempt organizations that are nevertheless taxable on their unrelated business taxable income are listed at § 7905.

1. Code Sec. 511.
2. Code Sec. 501(b).
3. Code Sec. 512(b)(12).

§ 8002. Unrelated trade or business of a trust. In the case of trusts, unrelated trade or business means any trade or business regularly carried on by the trust or by a partnership of which it is a member. This rule applies to:

... Exempt employees' supplemental unemployment compensation benefits trusts.

... Exempt qualified employee pension, profit-sharing, and stock bonus plan trusts.

... Non-exempt trusts.¹

Under the foregoing rule, the following have been held to be taxable unrelated trades or businesses of trusts:

... Leasing of railroad tank cars for a term of years with renewal option, by an exempt employee trust.²

... Leasing of tire manufacturing machinery by an exempt employee trust to the employer tire manufacturer.³

✓ *observation:* Nonexempt trusts are taxable under the general rules for taxation of estates and trusts. Those rules allow a deduction for charitable contributions made by the trust. A limitation on that deduction bars

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any deduction allocable to income of the trust that would be unrelated business taxable income if the trust were tax exempt.¹ For taxation of non-exempt trusts, see § 1700 *et seq.*

1. Code Sec. 513(b).
2. Rev. Rul. 60-206, CB 1960-1, 201.
3. *Cooper Tire & Rubber Co. Employees Retirement Fund v. Com.*, 306 F. (2d) 20, aff'g 36 T.C. 86.
4. Code Sec. 681(a).

§ 8003. Unrelated trade or business of exempt organizations other than trusts. In the case of all exempt organizations other than trusts a trade or business is unrelated only if it isn't *substantially related* (aside from the need of funds) to the exercise or performance of the purpose or function that is the basis of the organization's exemption.¹

The Code expressly excludes from classification as an unrelated trade or business any trade or business:

- ... in which substantially all the work is performed for the organization without compensation;² or
- ... which is carried on by an organization in the religious, charitable, educational, etc., category primarily for the convenience of its members, students, patients, officers, or employees;³ or
- ... which is the selling of merchandise substantially all of which has been received by the organization as gifts or contributions.⁴

The foregoing rules don't apply to trusts.⁵

1. Code Sec. 513(a); Regs. § 1.513-1(a).
2. Code Sec. 513(a)(1); Regs. § 1.513-1(b); Rev. Rul. 56-152, CB 1956-1, 56.
3. Code Sec. 513(a)(2); Regs. § 1.513-1(b); Rev. Rul. 55-676, CB 1955-2, 266.
4. Code Sec. 513(a)(3); Regs. § 1.513-1(b).
5. *Cooper Tire & Rubber Co. Employees Retirement Fund v. Com.*, 306 F. (2d) 20, aff'g 36 T.C. 86.

§ 8004. When is a trade or business substantially related to exempt purpose. A trade or business is substantially related to an organization's exempt purposes, and its income, therefore, isn't taxable, if the *principal purpose* of the trade or business is to further (other than through production of income) the organization's exempt purpose. This usually requires a comparison of the nature and size of the trade or business with the nature and extent of the exempt activities.¹

The following have been held to be taxable unrelated trades or businesses:

- ... Photography and electro-encephalography work performed by an exempt medical and scientific research foundation. The work was performed at rates comparable to those charged by commercial enterprises and accounted for 75% of the foundation's gross receipts.²
- ... Radio station operated by an exempt university which carried its educational programs

but was largely operated as a commercial station.³

... Cinder block plant originally acquired by an exempt university to supply its own construction needs and thereafter chiefly supplying the general public.⁴

... Manufacturing business operated by an exempt college in which the students as part of their educational program perform clerical or bookkeeping functions.⁵

... Building and selling houses where an exempt foundation built and sold 80 houses in 18 months to raise revenue for a church.⁶

... Buying supplies for resale to members by an exempt agricultural organization created for the purpose of improvement and advancement of agriculture.⁷

... Farms and orchards operated by a charitable trust.⁸

... Bingo games, open to the public, run semi-weekly by an exempt labor organization.⁹

... Restaurant, bar, and cocktail lounge which accounted for more than 50% of the income of an exempt horse-breeding organization.¹⁰

... Insurance promotion and property management done for remuneration by an exempt agricultural organization.¹¹

... Accounting and tax services performed for fees by an exempt labor organization for some of its members.¹²

... Management, for a fee, of health and welfare programs for employees of its members by an exempt business league.¹³

... Sale of "call" options on stock investments owned by an exempt organization.¹⁴

But the following have been held to be non-taxable *related* trades or businesses.

... Laundry operated by a university primarily for students and faculty though also open to the public.¹⁵

... Renting farms and orchards to tenants by a charitable trust.¹⁶

... Sale of articles made by handicapped persons as part of their rehabilitation training by an exempt organization engaged in rehabilitation of the handicapped.¹⁷

... Championship tournaments, grants of radio and television broadcasting rights, and sale of booklets on rules of the game by a national sports organization exempt as a business league. The income from radio and television rights was relatively insignificant.¹⁸

... "Bowl" football game arranged annually by an exempt community organization.¹⁹

... Lease of a building to a clinic by a foundation, organized in part for medical purposes.²⁰

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1. Regs. § 1.513-1(a)(4).
2. Rev. Rul. 57-313, CB 1957-2, 316.
3. Regs. § 1.513-1(a)(4).
4. Rev. Rul. 55-676, CB 1955-2, 266.
5. Regs. § 1.513-1(a)(4).
6. Rev. Rul. 55-449, CB 1955-2, 299.
7. Rev. Rul. 57-466, CB 1957-2, 311.
8. Rev. Rul. 58-492, CB 1958-2, 273.
9. Rev. Rul. 59-330, CB 1959-2, 153.
10. Rev. Rul. 60-80, CB 1960-1, 497.
11. Rev. Rul. 60-238, CB 1960-1, 700.
12. Rev. Rul. 62-191, CB 1962-2, 146.
13. Rev. Rul. 66-151, IRB 1966-22, 20.
14. Rev. Rul. 66-47, IRB 1966-9, 10.
15. Rev. Rul. 58-676, CB 1958-2, 266.
16. Rev. Rul. 58-482, CB 1958-2, 273.
17. Regs. § 1.513-1(a)(4).
18. Rev. Rul. 58-502, CB 1958-2, 271.
19. Mobile Arts and Sports Ass'n v. U.S., 148 F. Supp. 311.
20. Huron Clinic Foundation v. U.S., 212 F. Supp., rem'd on stip. 324 U.S. 43.

Q 8005. Unrelated business taxable income. Excludes income of trade or business not regularly carried on. The "unrelated business taxable income" of an otherwise exempt organization is comparable to the "taxable income" of a fully taxable organization.¹ Starting with the gross income and deductions of the unrelated trade or business, the computation of unrelated business taxable income is the same as the computation of taxable income subject to the additional exceptions, additions, and limitations hereafter explained. In the case of a *foreign* exempt organization only income (and related deductions) from U. S. sources is included in the computation.²

One of the principal exceptions is that *only* the gross income and deductions of an unrelated trade or business *regularly carried on* by the exempt organization are included in computing its unrelated business taxable income.³ A trade or business activity is regularly carried on if it is conducted with sufficient consistency to indicate a continuing purpose to derive some of the organization's income from that activity even though infrequent or seasonal.⁴ Casual sales of real property were held not to amount to a trade or business regularly carried on.⁵

1. Code Sec. 511.
2. Code Sec. 512(a).
3. Code Sec. 512(a).
4. Regs. § 1.513-1(a)(3).
5. Marian Foundation, T.C. Memo. 1960-18.

Q 8006. Research income excluded from unrelated business taxable income. Income from research activities and directly connected deductions are excluded from unrelated business taxable income in the following cases:

... Income derived by a college, university, or hospital from research performed by any person.¹

... Income derived from research performed for any person by an organization primarily carrying on fundamental research the results of which are freely available to the general pub-

lic.² Fundamental research doesn't include research carried on for the primary purpose of commercial or industrial application.³

... Income derived by any exempt organization from research performed for the U. S. or state or local governments.⁴

The regs state that excludable research doesn't include activities incident to commercial or industrial operations, such as *ordinary* inspection or testing of materials or products or the designing or construction of buildings, equipment, etc.⁵

1. Code Sec. 512(b)(8).
2. Code Sec. 512(b)(9).
3. Regs. § 1.512(b)-1(f)(4).
4. Code Sec. 512(b)(7).
5. Regs. § 1.512(b)-1(f)(4).

Q 8007. Income for labor or agricultural organization's retirement home or hospital. In the case of an exempt labor, agricultural or horticultural organization *all* income used to establish, maintain, or operate a retirement home, hospital or similar facility is excluded from unrelated business taxable income provided all of the following requirements are met:

... The facility is for the exclusive use and benefit of the members of the exempt organization.

... The income is derived from agricultural pursuits conducted on grounds contiguous to the facility.

... Such income doesn't provide more than 75% of the cost of maintaining and operating the facility.

... All deductions *directly* connected with such income must be excluded.¹

1. Code Sec. 512(b)(14).

Q 8008. Other income items excluded from unrelated business taxable income. The following items of income and all deductions directly connected with such income are excluded in computing unrelated business taxable income:

... Dividends, interest, and annuities.¹ This includes ordinary distributions by real estate investment trusts.² Capital gain distributions apparently also would be excluded from unrelated business taxable income under the rule excluding gains and losses from sales or exchanges.

... Royalties (including overriding royalties) whether based on production or on gross or taxable income from the property.³

... Rents from real property (including personal property leased with it) *other than business lease rents and deductions*.⁴

The Treasury holds that whether an item of income falls within one of the excluded

FEDERAL TAXATION

Unrelated Business Income—§ 8012

categories is to be determined from all the facts and circumstances of each case. Thus it will disallow exclusion of rents or royalties if it finds that they are in fact:

... a return of profits by a person operating the property for the benefit of the exempt organization or

... a share of profits retained by the exempt organization as a partner or joint venturer.⁵

But the Treasury's attempts to bar exclusion of mineral royalties received by exempt organizations on the theory that, under the particular facts, they weren't really royalties haven't been sustained by the courts.⁶

1. Code Sec. 512(b)(1).
2. Rev. Rul. 66-106, IRB 1966-18, 12.
3. Code Sec. 512(b)(2).
4. Code Sec. 512(b)(3) and (4).
5. Regs. § 1.512(b)-1; Rev. Rul. 54-420, CB 1954-2, 128.
6. *U.S. v. Robert A. Welch Foundation*, 334 F. (2d) 774, aff'd 228 F. Supp. 831; *Amor G. Carter Foundation v. U.S.*, D.C. Tex., 1/31/58.

§ 8009. Gains and losses from certain sales and exchanges are excluded. Unrelated business taxable income doesn't include gains or losses from sale, exchange or other disposition of property *other than*:

... stock in trade, inventories, or property held primarily for sale to customers in the ordinary course of business.

... timber cutting treated as a Code Sec. 631 sale or exchange.¹

But unrelated business taxable income includes recapturable depreciation gain realized on sale or exchange of depreciable property. The regs so provide with respect to Sec. 1245 personal property and apparently the same rule applies to Sec. 1250 real property.²

1. Code Sec. 512(b)(5).
2. Code Sec. 1250; Regs. § 1.1245-6(b).

§ 8010. Deductions allowed in computing unrelated business taxable income. In computing unrelated business taxable income, all the same deductions as apply to the computation of taxable income are allowed¹ subject to the following special rules:

... A \$1,000 specific deduction is allowed.²

... The net operating loss deduction is computed by taking into account only those items included in the computation of unrelated business taxable income. Thus an unrelated trade or business operating loss isn't diminished by dividend income. Only years in which the exempt organization is subject to tax on unrelated business taxable income are included in computing an unrelated trade or business operating loss. But *all* years are counted in determining the span of years for which the loss may be carried back or forward.³

... The charitable contribution deduction limitation is 5% of unrelated business taxable income (before the charitable contribution deduction) for those exempt organizations taxed at corporate rates and 20-30% for those exempt trusts taxed at individual rates.⁴

... Bad debt deduction may be taken as specific deductions or under the reserve method subject to the same rules as apply to other taxpayers. The exempt organization may choose either method in its first return of unrelated taxable income but only if it hasn't already selected a method in a prior year in which it made a return of income subject to tax. In that event, it can't change its method without the Commissioner's prior consent.⁵

1. Code Sec. 511.
2. Code Sec. 512(b)(12).
3. Code Sec. 512(b)(6); Regs. § 1.512(b)-1(c).
4. Code Sec. 512(b)(10) and (11); Regs. § 1.512(b)-1(g).
5. Regs. § 1.511-3(c).

§ 8011. Partnership unrelated trade or business taxable income. If an exempt organization is a member of a partnership that carries on an unrelated trade or business, the exempt organization's share of the partnership income and deductions is included in the computation of its unrelated business taxable income, subject to all the exceptions, additions, and limitations applicable to that computation. The partnership items included in the computation of the exempt organization's unrelated business taxable income are those for the partnership taxable year ending with or within the organization's taxable year.¹

A special rule applies to certain trusts created by the will of an individual who died after Aug. 16, '54, and before '57 where by virtue of the provisions of the will the trust is a member of a limited partnership. Under this rule, the trust excludes its share of the partnership's income from an unrelated trade of business, but only to the extent that partnership income is actually distributed.²

1. Code Sec. 512(c).
2. Code Sec. 512(b)(13).

§ 8012. "Business lease" income and deductions are included in unrelated business taxable income. Business lease rents and deductions are included in the computation of unrelated business taxable income.¹

A "business lease" is a lease of real property for a term of more than 5 years, by a tax exempt organization or by a partnership of which the exempt organization is a member. The lease is a business lease only if at the end of the lessor's taxable year there is *business lease indebtedness* with respect to the leased property.² Real property includes personal prop-

§ 8013—Unrelated Business Income

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erty leased under or in connection with the lease of real property.³

Distributions received on shares of a *qualified* Code Sec. 856 real estate investment trust aren't treated as lease income even though the real estate investment trust derives its income from rents received from mortgaged real estate. The distributions are treated as corporate distributions which are excluded from unrelated business taxable income.⁴

Business lease deductions include:

... Taxes and other expenses with respect to the leased real property.

... Interest on the business lease indebtedness.

... Depreciation on the leased property.⁵

In general, only that percentage of the rents and deductions allocable to the business lease indebtedness is included in computing unrelated business taxable income. This is the same percentage (not over 100%) as the business lease indebtedness is of the adjusted basis of the leased premises, at the close of the taxable year.⁶

The adjusted basis of the leased premises is determined under the rules applicable to taxpayers generally for the entire period since acquisition of the property by the exempt organization. Thus depreciation must be deducted for all taxable years whether or not the organization was exempt in any year. And the entire amount of depreciation must be deducted from basis notwithstanding that only a portion of the depreciation is taken into account in computing unrelated business taxable income.⁷

The Treasury regs contain examples illustrating the computation of business lease income.⁸

1. Code Secs. 512(b)(4) and 514(a).
2. Code Sec. 514(b)(1).
3. Code Sec. 514(d).
4. Rev. Rul. 66-106, IRB 1966-18, 12.
5. Code Sec. 514(a)(3).
6. Code Sec. 514(a).
7. Regs. § 1.514(a)-1(a)(2).
8. Regs. § 1.514(a)-1(b).

§ 8013. Leases related to exempt purpose aren't business leases. The following aren't "business leases":

... Lease entered into primarily for purposes substantially related (apart from need for funds) to the purpose constituting the basis for the organization's exemption.

... Lease of premises in a building primarily designed for occupancy, and occupied, by the exempt organization.¹

A lease, under ordinary commercial arrangements, by an exempt foundation of a school building to an exempt educational institution was held not to be for a purpose substantially related to the foundation's exempt purposes notwithstanding that the foundation was or-

ganized in part for educational purposes.² But lease of a building by a foundation, organized in part for medical purposes, to a clinic was held not to be a business lease by a district court which found the lease to be within the ambit of the foundation's exempt purpose. This decision was later reversed on stipulation without consideration of its merits.³

1. Code Sec. 514(b)(3).
2. Rev. Rul. 58-247, CB 1958-2, 275.
3. *Huron Clinic Foundation v. U.S.*, 212 F. Supp. 847, rem'd on stip. 324 F. (2d) 43.

§ 8014. When is term of lease over 5 years. Only a lease for a term of more than 5 years is a business lease. The term of a lease includes:¹

... Any period for which a renewal or extension option may be exercised. This includes a renewal option in a separate agreement.²

... The period of the prior lease, in the case of a lease made by exercise of a renewal or extension option.

If real property is acquired by the exempt organization subject to a lease, the term is deemed to begin on the date of acquisition.

Even though there is no over-5 year lease or any lease at all, real property will be deemed to be occupied under a lease for a term of more than 5 years beginning with the 6th year of continuous occupancy by the same tenant. Successive tenants are considered to be the same tenant where they are so related that losses on sales or exchanges between them would be disallowed under the Code provision barring recognition of losses in transactions between related taxpayers.³

✓ *observation:* The mere fact that the lease term isn't over 5 years doesn't necessarily mean that rents received by the tax exempt organization aren't taxable. The rents may be taxed under the general definitions of unrelated business taxable income unless they fall within the Code Sec. 512(b)(3) exclusion for rents from real property. The Treasury may attempt to tax such rents if it determines that they are really profits rather than rents, as noted at § 8008.

1. Code Sec. 514(b).
2. *Chamber of Commerce of Kansas City, Kans.*, 35 T.C. 562.
3. Code Sec. 514(b)(2).

§ 8015. Property only partly leased for over 5 years. If real property is partly leased for a term of over 5 years and partly for 5 years or less, the over-5 year leases will be considered business leases during the taxable year only if one of the following requisites is satisfied:

... The over-5 year leases account for 50% or more of the rents for the year.

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Unrelated Business Income—§ 8018

... The over-5 year leases account for 50% or more of the total rented area at any time during the year.

... Any tenant (or group of tenants that are members of the same consolidated return affiliated group or partnership) under an over-5 year lease accounts for more than 10% of the rents for the year.

... Any tenant (or group of tenants that are members of the same consolidated return affiliated group or partnership) under an over-5 year lease accounts for more than 10% of the total rented area at any time during the year.

Over-5 years continuous occupancy by the same tenant is treated as an over-5 year lease under the two 10% rules above, but not under the two 50% rules.

Under the 50% rules only, the unexpired portion of a lease on the date that a new lease is made isn't tacked on to the second lease in determining whether the term of the second lease is over 5 years. But this rule applies only if the second lease takes effect after the end of the first lease and is made during the last half of the term of the first lease.¹

1. Code Sec. 514(b)(3)(B).

§ 8016. Business lease indebtedness. Business lease indebtedness is the unpaid amount of indebtedness with respect to real property leased for a term of over 5 years. It includes indebtedness:

... Incurred by the lessor in acquiring the property.

... Subject to which the property was acquired (whether the acquisition was by gifts, devise, or purchase).

... Incurred by the lessor in improving the property.

... Incurred before acquisition or improvement of the property if it wouldn't have been incurred but for such acquisition or improvement.

... Incurred after acquisition or improvement of the property if it wouldn't have been incurred but for such acquisition or improvement and its incurrence was reasonably foreseeable at the time of the acquisition or improvement.¹

Whether indebtedness subject to which property is acquired on liquidation of a corporation in which the exempt organization held stock is business lease indebtedness isn't settled. A district court held that it isn't basing its decision on the ground that indebtedness subject to which property is acquired is business lease indebtedness only if the property was acquired by gift, devise, or purchase and that none of these includes prop-

erty acquired on liquidation of a corporation.² But the Treasury holds that property received in a corporate liquidation is "acquired" within the meaning of the business lease indebtedness provision.³

If only part of the real property is subject to a business lease, only part of the indebtedness with respect to the property is business lease indebtedness. This is determined by making a proper allocation.⁴

Special rules apply in the following cases:

... Property subject to indebtedness acquired by gift, bequest or devise before July 1, '50.⁵

... Property subject to a lease requiring improvements, acquired by gift, bequest, or devise before July 1, '50.⁶

... Certain Code Sec. 501(c)(2) title holding corporations.⁷

... Certain Code Sec. 401(a) qualified pension, profit-sharing, and stock bonus trusts.⁸

... Code Sec. 501(c)(17) employees supplemental unemployment compensation trusts.⁹

1. Code Sec. 514(c)(1) and (2).
2. *Broderick v. U.S.*, D.C. Wash. 6/19/64.
3. Rev. Rul. 66-107, IRB 1966-18, 13.
4. Code Sec. 514(c)(6).
5. Code Sec. 514(c)(2).
6. Code Sec. 514(c)(3).
7. Code Sec. 514(c)(4) and (5); Regs. § 1.514(c)-1(i).
8. Code Sec. 514(c)(5) and (7).
9. Code Sec. 514(c)(8).

§ 8017. Tax on unrelated business taxable income. The tax on unrelated business taxable income is computed at the corporate income tax rates as if the exempt organization's "unrelated business taxable income" is its "taxable income."¹ But if, except for its exempt status, the organization would be taxable as an estate or trust, its tax on unrelated business taxable income is computed at the income tax rates applicable to individuals.²

In computing the limitation on the credit for taxes of foreign countries and U. S. possessions, the exempt organization's "unrelated business taxable income" is used instead of "taxable income."³

✓ observation: The investment credit allowed by Code Sec. 38 apparently also is allowed since that credit applies to the tax imposed by Chapter I of the Code, and Code Sec. 511 which imposes the tax on unrelated business taxable income is part of that chapter.

1. Code Sec. 511(a)(11).
2. Code Sec. 511(b).
3. Code Sec. 515.

§ 8018. Returns and payment of tax. Form 990-T is used to report and pay tax on unrelated business taxable income. The same form is used whether the tax is computed at corporate or individual income tax rates.¹

§ 8050—Foreign Income and Foreign Taxpayers**34 Am Jur 2d**

...e returns are due and the tax due must be paid at the same time that corporate returns and income tax payments are due where the unrelated business income is taxable at the corporate rates (Mar. 15 for calendar year organizations) *and* at the same time that individual returns and income tax payments are due where the unrelated business income is taxable at the individual rates (Apr. 15 for calendar

year organizations). Always consult the latest official instructions to Form 990-T, obtainable from your local district director.

The rules on assessment, collection, and penalties applicable to ordinary income tax also apply to the tax on unrelated business income.²

1. Regs. § 1.6012-2(c) and § 1.6012-3(a) (5).
2. Regs. § 1.511-3(a).

TREASURY PROPOSALS ON PRIVATE FOUNDATIONS

A summary of the Treasury Proposals regarding changed in the law on private foundations from a report prepared by the Senate Finance Committee, dated February 2, 1965.

I. There should be a general prohibition on self-dealing more stringent than the present Section 503 which would be expanded to include officers as well as donors and other related parties.

This prohibition would be subject to the following exceptions:

- (a) A foundation may purchase incidental supplies from such parties
- (b) Related parties may buy at fair market value assets from the foundation in forced sales.
- (c) Related parties may make interest-free loans where such loan is to be used for a bonafide charitable purpose.

II. Private non-operating foundations should be required to distribute all of their current net income on a reasonably current basis.

The purposes for which income would have to be expended are:

- (a) To publicly supported charities.
- (b) To privately supported operating organizations.
- (c) On direct expenditures for charitable programs conducted by the foundation.

- (d) For the purchase of assets which the foundation uses as part of its program of charitable activities.

"Income" would include short-term capital gains.

Current operating expenses would be treated as current expenditures for charitable purposes. Otherwise, net ordinary income is defined as total income (less capital gains), less expenses incurred in earning such income.

The income would have to be expended within one year after the year of receipt. This would be subject to two exceptions - (1) Funds could be accumulated for a definite charitable purpose, and (2) Funds could be accumulated to make up for past expenditures in excess of income.

INCOME EQUIVALENT

Because foundation ownership of growth assets or unproductive property may result in little "income" within the scope of this rule, the Secretary of the Treasury should have regulatory authority to set a percentage rate called an "income equivalent", which will be charged on a foundation's assets and which would become a floor for distributable income under this rule. This would be figured at the fair market value of the foundation's investment assets.

III. A foundation should not own over 20 percent of the voting stock or equity of a corporation engaged in an unrelated business.

Stock held "for the benefit of" a foundation should be attributed to it but that owned by officers, donors, etc., for their own benefit should not.=-

IV. Because a gift to a foundation of stock in a family business lacks a true element of finality, it would not be counted as a deductible contribution until: (a) The stock was sold by the foundation.

(b) The property was directly applied to charitable uses. (c) Donor control of the business ceases.

These three occurrences are called "qualifying actions". Until one of these qualifying actions occurs there would be (a) No charitable deduction. (b) No recognition of a gift. (c) Property would be included in the donor's gross estate.

V. Restrictions should be placed on financial transactions unrelated to the foundation's charitable functions.

A.. Borrowing

All borrowing for investment purposes would be prohibited.

B. Loans

Loans of private foundations should be limited to categories which are clearly necessary, safe and appropriate for charitable fiduciaries.

C. Trading and Speculation

All trading and speculating, either with corpus or income, should be prohibited.

VI. After the first 25 years, donor related parties should make up no more than 25 percent of the managing board of the foundation.

ADDITIONAL PROPOSALS

A. No deduction (or recognition of contribution) for unproductive property will be recognized until that property is (a) made productive; (b) disposed of; (c) applied to charitable uses.

B. Any contribution will be diminished by the amount of ordinary income which the donor would

have received had he sold it. This would include particularly Section 306 stock, collapsible corporation stock or inventory.

C. The marital estate tax deduction would be figured without reference to amounts contributed to charity by will, etc.

D. There should be workable sanctions for failure to file annual returns. Specifically, there should be a fine of \$10.00 a day, up to \$5,000.00, levied upon both the foundation and the officer responsible.

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JUS-622

STATE OF CALIFORNIA
OFFICE OF THE ATTORNEY GENERAL
REGISTRAR OF CHARITABLE TRUSTS
ROOM 300, 923 12TH STREET
SACRAMENTO, CALIFORNIA 95814

PERIODIC REPORT OF CHARITABLE TRUST

1. Name

Address

City

2. Covering period of _____, 19____ to _____, 19____.

3. Financial Statement (Please refer to other side for instructions before preparation.)

4. Income:

5. Expenditures:

6. Name, address and amount of benefits to recipients under Charitable Trust.

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7. If during the period of this report there have been any changes in the provisions of the Trust, please explain. Attach list of present officers and directors with addresses.

I certify (or declare) under penalty of perjury that this report (including any accompanying schedules and statements) has been examined by me and to the best of my knowledge and belief is a true, correct and complete report.

_____	_____	Registrar's Use Only
Title	Date	
_____	_____	Audit by: _____
Trustee	Date	
_____	_____	Date: _____
Trustee	Date	

INSTRUCTIONS FOR PREPARING AND FILING PERIODIC REPORT OF CHARITABLE TRUST

WHO MUST FILE

Pursuant to Sec. 12586 of the Gov. Code and Sec. 301 of the Calif. Adm. Code, Title 11, every Trustee except those exempt under Secs. 12583 and 12586 of the Gov. Code must file with the Attorney General a periodic written report under oath or by declaration under penalty of perjury.

WHEN TO FILE

The first periodic report shall be filed as required by paragraph (d) of Section 12586 of the Government Code. Subsequent reports should be filed on an annual basis not later than four months and fifteen days following the close of each calendar or fiscal year period.

ALTERNATIVE METHOD OF FILING

Section 12586, paragraph (a) of the Government Code and Section 303-b of the California Administrative Code, Title 11, provide for an alternative method of filing report.

CONTENTS OF REPORTS—Sections 3, Financial Statement; 4, Income; and 5, Expenditures

Detailed statements of financial condition and operations are required which will result in a complete disclosure of the activities of the organization during the reporting period.

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(a) A balance sheet including all assets, liabilities and a statement of the net worth at the end of the reporting period. *Securities in an investment portfolio with a total market valuation in excess of \$100,000 shall be scheduled on a form provided by the Attorney General.*

(b) A statement of all receipts or income during the period classified as business income, interest, dividends, rent, gain or loss from sale of assets, contributions, gifts or grants received, giving amount and source.

(c) A statement of all disbursements and operating expenses during the period classified as salaries and wages, interest, taxes, rent, depreciation, contributions, and miscellaneous.

(d) A statement of the purposes for which the distributions, donations or payments have been made giving the name, address and amount disbursed to each recipient of benefits under the Charitable Trust.

Other pertinent information concerning the Trust and its administration. When requested by the Attorney General any periodic report shall be supplemented to include such additional information as the Attorney General deems necessary to enable him to ascertain whether the corporation, trust or other relationship is properly administered.

MODIFICATION IN TRUST STRUCTURE (Item 7)

Please submit a detailed report of any changes in trust indenture or any change of Trustee. In the case of a corporation formed for the administration of a charitable purpose, please submit any amendments to the Articles of Incorporation or changes in By-Laws; and any changes in officers or directors of the corporation.

CERTIFICATION

An officer of the organization, authorized to execute such documents, must certify to the correctness of the periodic report in the manner provided on the form under penalty of perjury, showing the date and place of such certification, or in lieu thereof may swear to the same before a notary public or other officer authorized to administer oaths.

WHERE TO FILE

Please forward (1) copy of completed form to the Registrar of Charitable Trusts, Room 300, 923 12th Street, Sacramento 95814.

If additional information is required, please refer to the Uniform Supervision of Trustees for Charitable Purposes Act (Secs. 12580-12595, Gov. Code) and the Administrative Rules and Regulations pursuant to the aforesaid Act (Secs. 300-310, Title 11, Calif. Adm. Code).

CC-1

STATE OF CALIFORNIA
 OFFICE OF THE ATTORNEY GENERAL
 REGISTRY OF CHARITABLE TRUSTS
 ROOM 306, 923 12TH STREET
 SACRAMENTO, CALIFORNIA 95814

REGISTRATION OF CHARITABLE TRUST

Date: _____

1. Name of Charitable Trust
 or
 Charitable Corporation
 Address of headquarters:

2. Charitable Trust under:

A. Estate of

Will probated County of

Probate No.

Last account rendered on

B. Inter vivos trust of

Date of instrument

C. Charitable Corporation or corporation formed for the administration of a Charitable Trust

Name of corporation:

Address:

3. Names and addresses of trustees or directors and officers of corporation:

4. Attached hereto are the following documents:

5. Description and value of Trust assets:

6. Purpose of the Trust:

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7. Accounting Period:

Calendar year _____ Fiscal year ending _____
month day

Registration No. CT _____

Date of Registration _____

For use of the Registrar's office only

Executed by

Name _____

Title _____

Address _____

SEE OTHER SIDE FOR INSTRUCTIONS

INSTRUCTIONS FOR PREPARING AND FILING REGISTRATION FORM OF CHARITABLE TRUST

WHO MUST FILE

Pursuant to Sec. 12581 of the Gov. Code and Sec. 300 of the Calif. Adm. Code, Title 11, all Trustees holding property for charitable purposes in the State of California must register with the Registrar of Charitable Trusts except those parties exempt by Sec. 12583 of the Government Code.

WHEN TO FILE

Pursuant to Sec. 12585 of the Gov. Code and Sec. 300, Calif. Adm. Code, Title 11, every Trustee subject to the Uniform Supervision of Trustees for Charitable Purposes Act shall file with the Attorney General within six months after any part of the income or principal is authorized or required to be applied to charitable purposes.

NAMES AND ADDRESSES OF TRUSTEES OR CORPORATE OFFICERS (Item 3)

In the case of a testamentary or inter vivos trust, please submit the names and addresses of all individual and corporate trustees.

In the case of a Charitable Corporation or corporation created for the administration of a Charitable Trust, please submit names, titles, and addresses of all corporate directors and officers.

DOCUMENTS REQUIRED TO BE ATTACHED (Item 4)

Testamentary Trust: A certified copy of Will and Decree of Distribution
Inter Vivos Trust: A certified copy of instrument creating Trust
Corporate Trust: A certified copy of the Articles of Incorporation and amendments thereof and By-Laws.

FINANCIAL STATEMENT (Item 5)

Please present a detailed description of all assets and liabilities, including cash on hand and in banks, name and number of investment securities at cost or book value, personal and real property, etc. Attach separate sheets when necessary, to supply all information.

EXECUTION OF REGISTRATION FORM

Where there is a single trustee, the form is to be executed by that individual.

Where there is a group of individuals or corporation holding as trustees, any one of the trustees may execute the form. In the case of a charitable corporation the form should be executed by an authorized officer.

WHERE TO FILE

Please forward (1) copy of completed form to the Registrar of Charitable Trusts, Room 306, 923 12th Street, Sacramento.

If additional information is required, please refer to the Uniform Supervision of Trustees for Charitable Purposes Act (Secs. 12580-12595, Gov. Code) and the Administrative Rules and Regulations pursuant to the aforesaid Act (Secs. 300-310, Title 11, Calif. Adm. Code).

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* * * * *

EXHIBIT 1 (PART 2)

(Section 1 has not been submitted to the subcommittee.)

Section 2

ORGANIZATION OF 501 (c) (3) PRIVATE FOUNDATION
and
DISCUSSION OF CIVIC LEAGUE 501 (c) (4)

NFP FOUNDATION MANAGEMENTPreface

Last evening you began work on your foundation by briefly discussing the legal purpose of your foundation. In addition, the preliminary reading material which you completed prior to the seminar gave you insight into the proper philosophy for managing foundation activities to avoid questions, harassment or trouble. With these principles in mind, we would like to discuss and teach in a seminar style the procedures and principles which would best be employed to operate a small NFP tax-exempt corporation.

These procedures will be discussed in three classifications:

1. The organization of the foundation
2. The operation of the foundation
3. Miscellaneous principles and rules to provide protection or ease of operation.

This will be basic material but it will be discussed in some detail. Some subjects, however, may not be discussed as extensively as you desire. If you desire a deeper understanding of any subject,

we would suggest that you hold your questions until the end of this session or until the follow-up question meetings. We do not, however, desire to restrict your questions.

THE ORGANIZATION OF THE FOUNDATION

From this point on I recommend that you ask any and all questions that may occur to you as we discuss each subject, and that if you have an idea for a solution or an answer to the question or a new idea that the instructor is not aware of, don't hesitate to bring it up, raise your hand or blurt it out. There are only 30 or 40 provisions in the federal code and eight or ten laws in each state which apply to non-profit organizations with any force or effect. There may be solutions to problems that are simply not covered by the law and require more practical discussion than legal counsel often consider, and since we are here to discuss basic principles which will guide a person to properly operate a foundation, we desire that each of you ask questions until the method or procedure under discussion is completely understood.

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We will try to save your time and logically develop your understanding of the material by following a general outline. If you see that some immediate question you have will be covered later in the seminar, you might write the question out and save it for that time. If we don't answer your question in the course of discussion please ask it then. Here is the outline, would you glance at it for a few minutes and then we will begin.

DISTRIBUTE EXHIBIT #1

Federal Requirements of Creation of a Foundation

Tax-exemption of a non-profit organization is based upon two things:

1. That you are organized expressly for certain purposes
2. That you are operating exclusively for these same purposes.

Basically this is a simple test, as the words indicate. Starting with your purpose you must be recognized under Section 501 (c) (3) of the Internal Revenue Code as being organized exclusively for one

EXHIBIT 1

OUTLINE OF SEMINAR

- I. Preface
 - A. Overall objective of foundation material (to give basic information on management).
 - B. Outline of foundation material.
- II. Organization of the foundation
 - A. Explanation of the federal requirements for exemption.
 - B. Articles of incorporation
 - C. The board of directors
 - D. Officers
 - E. Bylaws
 - F. Meetings of the board of directors
 - G. Foundation bank account
 - H. Additional corporate paper work
 - 1. Waiver of notice to members of the board of directors
 - 2. Corporate seal
 - 3. Newspaper notices
 - 4. Membership certificates
 - I. The employment relationship between the foundation and the executive director
 - J. Federal tax exemption of the foundation
 - K. Special types of foundations
 - 1. Medical foundation
 - 2. Agricultural foundation
 - 3. Religious foundation

- 4. Educational foundation
 - 5. Scientific foundation
- III. Civic League
 - A. Benefits
 - B. Organization
 - C. Operation
- IV. The operation of the foundation
 - A. Foundation income sources
 - 1. Contributions
 - 2. Fees
 - 3. Investments, etc.
 - 4. Buying and selling property
 - 5. Other properties
 - 6. Taxable income
 - B. Restrictions of foundation activity
 - 1. Prohibitive transactions
 - (a) Political activity
 - (b) Endangering foundation funds
 - (c) Self-dealing
 - 2. Distribution requirements
 - C. Outgo
 - 1. Grant programs and charity
 - 2. Salary (relating to organizational material)
 - 3. Fringe benefits
 - (a) Insurance
 - (b) Foundation business
 - (c) Hobbies
 - (d) Retirement
 - (e) Advertising
 - (f) Other normal related expenses

- D. Continuing Management
 - 1. Accounting practices
 - (a) Corporate accounting
 - (b) Foundation fund accounting
 - 2. Continuing control
- E. Federal and state regulations
 - 1. Social security and federal withholding
 - 2. State reporting requirements
 - 3. State membership requirements
 - 4. Federal reporting requirements
 - 5. State tax requirements
- V. Review of foundation material using structural chart

TRUSTS

- I. Trust outline
 - A. Introduction
 - 1. Difference from foundation
 - 2. Historical background
 - 3. Purposes
 - B. Organization of the trust
 - C. Operations of the trust
 - 1. Privacy
 - 2. Economic operations
 - D. Trust foundation
 - 1. Organization
 - 2. Operation
- II. Tandem operations outline
 - A. Introduction

1. Purpose
- B. Management of property
- C. Management of activity
- D. Management of income

* * * * *

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or more of the following purposes:

1. Education
2. Science
3. Religion
4. Charity
5. Literary
6. Testing for public safety, and
7. Prevention of cruelty to children and animals.

Your desires for foundation activity will probably fall within the areas of education, religion, science, or literary. If you decide to form your own foundation and are a Junior or Senior member, an attorney - and there are a number who are members of ABC and acquainted with foundations, who can help you create the proper purpose and other technical language required on your articles of incorporation.

Articles of Incorporation

The first step in organizing your foundation is to execute the articles of incorporation for a non-profit or non-stock corporation. In most states this is quite simple. Attorneys who are familiar with

foundations, especially attorneys who are members of ABC, are aware, however, of many fine points which can aid the efficiency of your foundation without disclosing unnecessary information. For example, your foundation's purpose would conform to the requirements of federal law. Federal law is accepted by every state. Your attorney would know the precise words necessary to most efficiently qualify a foundation - under both state and federal law. You, on the other hand, might have to read several books or try incorporation a few times to develop the most efficient organization. Once the articles of incorporation have been executed they are usually filed with the Secretary of State of your state with the proper fee. A complete charter is then issued by the Secretary of State and once this has been recorded under state law, your foundation is in business. Your next step is to complete the paper organization of your foundation.

The attorney again is prepared to perform most of the paper work which will include the creation of your foundation records (i.e. the minutes of your board of directors, by-laws, the membership rules and

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The membership certificates and any other records required by state law). In this paper work your primary concern will be with choosing the right course of action and the right personnel to accomplish your desires. An attorney who is knowledgeable in foundations is trained to use these ideas and personnel to create the proper paper work for your foundation.

Even though the attorney will accomplish most of this organizational work, it is wise that you have personal understanding of some of the principles involved so that you will not be confused by legal language or be afraid to touch your corporate record books.

The Board of Directors

The board of directors of your foundation (not-for-profit corporation) has the ultimate control over the activities of the foundation. The minimum number is dictated by the state law although maximum numbers are usually not limited. We recommend however that a comparatively small number of persons be placed on the board of directors. The husband and wife of a

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particular family may both be on the same board of directors as will children who have reached the age of maturity and perhaps collateral relatives such as aunts, mothers, cousins, etc. The board of directors would be chosen with two ideas in mind:

1. The compatibility of the individuals, and
2. The geographic convenience of the individuals.

Your board of directors may be required to "meet" frequently in the initial forming stages of the foundation and thereafter would meet regularly at a rate of once a month or four times a year. This would normally require that the individuals be within the same geographic area to facilitate the meetings and to avoid the so-called "paper meetings" that are conducted entirely by mail. However, compatibility of the members is much more important than the geographic convenience, and if you desire four or five members on the board of directors who live in three or four states, this is proper provided that they are compatible with your desires as founder and a director of the foundation. Even though you might obtain an undated letter of resignation from other members of

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the board of directors, you would wish that they be familiar with and in accord with the purposes of the foundation as you have chosen them without forcing you to use the "influence" of the letter of resignation. Since it is more difficult to find five or seven compatible individuals than it is to find three or four, we recommend a minimum number.

Your purpose as a director of the foundation should be distinguished from your possible position as an officer or employee of the foundation. Your powers as a director are superior to that of an officer or employee, but are usually not exercised in any capacity other than ratification of the acts of employees and officers.

The initial meetings of your board of directors will accomplish standard organizational acts enabling your foundation to operate. These acts will be discussed later. Thereafter the minutes of the meetings of your board of directors will usually reflect only those activities which your foundation has accomplished. Attorneys are trained to maintain these minutes in proper language, but once the legal form is mastered,

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everyday English is quite sufficient to record the minutes of the board of directors. We will discuss these minutes in a few moments.

Officers

The officers of your foundation may be the same people as the board of directors. Just remember to keep the many hats of the various individuals on their proper racks. The capacities of the officers are different and distinct from those of directors. Officers are empowered by the board of directors to conduct the day-to-day activities of the foundation. You will probably have five officers under our recommended procedures. You may have more or less depending upon state law and your own desires. The five officers recommended by ABC are president, vice-president, secretary, treasurer, and executive director. You are probably familiar with the general duties of the first four officers and we won't spend any time discussing the duties unless there are questions.

Distribute collateral EXHIBIT #2 on duties of officers.

EXHIBIT 2

COLLATERAL EXHIBIT ON DUTIES OF OFFICERS OF CORPORATION FOUNDATION

The duties of the various officers and the authority of the various officers of a corporate foundation are generally similar, if not identical, to those of the officers of a business corporation. If a person is held out to the general public as a principal officer of a corporate foundation, such as the president, vice president, secretary or treasurer, then that person has inherent powers and duties which would enable him to accomplish activities without further minutes or actual authorization from the board of directors. In other words, if you deal with a man who has offered a business card stating that he is president of the Smith Foundation, and you have no reason to doubt this, then for all practical purposes he is the president of the Smith Foundation and can do all things that any president of any foundation can do. Oddly enough, the legal view of the authority and powers of the various officers of a corporation is much more limited than that of the ordinary conception of the powers of presidents and other officers. We will discuss briefly the duties and powers of each major officer, first in the strict legal sense, and second, in the general common understanding of such officers. We will not discuss the authorities of the officers in terms of parliamentary procedure. If you are interested in discussion along these lines we recommend the appropriate sections of Roberts Rules of Order.

The President: The strict legal rule is that the president of any corporation does not have by virtue of his office alone any power to act for the corporation. His authority must be derived from the articles of incorporation, minutes of the board of directors or by state. You should check with your state's non-profit corporation act to determine if any statute gives the president any power. However, the broad view taken in most cases is that in the absence of a charter or bylaw provision to the contrary, the president of the corporation is the general manager of the corporate affairs with the authority to act for the corporation in its business. The president of the corporation is usually presumed to have full authority to do acts within the general domain and business of the corporate purpose and objective.

Of course, the board of directors may always vest the president with full authority to act as the chief executive officer of the company, and in fact, the initial bylaws of most corporate foundations do this automatically. Any person dealing with the president of a corporate foundation in the usual manner is entitled to assume that the president has actually been vested with full authority to manage the general affairs of the corporate foundation. In other words, a corporate foundation's president is usually considered its general manager and has the implied authority

to perform any act in the ordinary course of business. In many foundations, the executive director may be expressly given superior powers to that of the president, but since in these same cases the president and executive director are the same individual, there should be no conflict.

The Vice-President: The inherent power of the vice president would seem merely to be to act in the absence of or during the vacancy in the office of the president. Frequently, however, the vice-president of a corporate foundation is given certain executive duties by the board of directors or bylaws of the corporation. In addition, authority may be given to do whatever is necessary to effectuate the main authority conferred or duties delegated by the board of directors. In other words, the board of directors usually sets out the duties of the vice president and he has the authority to carry these out. If, however, the office of the president is vacated or he is absent when some necessary business arises, the vice-president has the authority to take over.

In some states, by law, a single individual may not be both president and vice-president. You should check with your own state statutes.

The Secretary: The primary function of the secretary of any corporation or corporate foundation is that of keeping a record of the business transactions conducted at membership, directors or committee meetings. The secretaries of most corporations, however, are considered more than mere clerks or record-keepers. Secretaries of corporations often have the power to sign contracts and conduct other business. Secretaries of corporate foundations have been usually considered to be just as much general managing agents of the corporation as the president. In fact, the duties and powers of the president have often been conferred on secretaries in interchangeable fashion. It is difficult to state precisely what the implied powers of a secretary of a corporate foundation are. They seem to be fairly extensive, although not as extensive as those of the president.

The Treasurer: The ordinary duties of a treasurer are to receive, safely keep, and disburse the funds of the foundation under the supervision of the directors. The treasurer ordinarily does not have the power to sign contracts for the foundation without the express approval of the board of directors. The treasurer, like any other officer, however, may be given special duties by the board of directors which may involve matters of general corporate business.

Executive Director, Administrator, Managing Director, Superintendent, etc.: The individual taking office under one or more of these titles or similar titles has only the power vested in him by the board of directors. These are special offices which are created under the power of the board of directors and

are solely dependent upon the minutes of the meeting of the board of directors which created the office. These offices may be created by bylaw or by corporate minute, and in no case have any implied powers under their title.

If the offices and duties of the officers are created by bylaws, the powers are usually set out in these bylaws. An example of such a bylaw is included below.

(a) The president shall manage the affairs of the foundation, except as shall be reserved by the bylaws or action of the directors. He shall preside at the meetings of membership, and shall be vested with the powers and duties incident to the office of president.

(b) The vice-president, in the absence of the president, or his inability or refusal to act, is empowered to act in lieu of and in the stead of the president, and shall thereupon be vested with all the powers and duties of the president.

(c) The secretary shall keep the minutes and a record of other matters transacted by the members and the directors; mail or cause to be mailed all notices required by the bylaws; have custody of the corporate seal and records; maintain and have custody of names and addresses of the membership; and perform such other duties as are incident to the office of secretary.

(d) The treasurer shall have custody of the funds of the foundation, collect dues and other monies owed the foundation, and perform such other duties as are incident to the office of treasurer. In the discretion of the directors, the treasurer may be required to furnish bond for such amount and under such conditions as the directors may see fit to impose.

If you have any question concerning the duties, powers, or authority of any officer, you should consult with your attorney or a good book on corporate organization.

* * * * *

The executive director, however, is an unusual position. Under our recommended procedures the executive director is empowered with general authority to conduct and oversee all foundation activities. Under the ABC recommended bylaws the executive director is the only officer working under an employment contract for a salary. The other officers are merely titular heads. The executive director is clothed with the power to hire and fire all other employees, sign checks and other contracts and generally run the business. This office is created to centralize active authority in one individual. If you, as founder, decide not to be director and not to be a regular officer, you might wish to be executive director in order to maintain control over your foundation. We will discuss this employment shortly.

Bylaws

The bylaws of your foundation are the rules and regulations of the corporation. The bylaws set out the rights and duties of the corporation members, officers and directors and may be considered as statutes. Bylaws may be amended by the board of

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directors but are usually not amended with any frequency.

Bylaws must be distinguished from resolutions. While a bylaw or a set of bylaws may be adopted by a resolution, a resolution is not necessarily a bylaw. A resolution may authorize a single corporate act or transaction where a bylaw is permanent and continuing rule. If a resolution of the board of directors is inconsistent with a bylaw, the bylaw must prevail. The bylaws are secondary only to the charter of the organization; that is, the articles of incorporation. In some states, the law requires that bylaws be adopted. These bylaws should govern the powers, rights and duties of various persons connected with the organization and the proper procedure for exercising these powers, rights and duties.

Tailor your bylaws to your organization purposes and capabilities and make them realistic. Create only a charter and bylaws and do not create a third constitution. It only causes confusion. Once your bylaws are adopted, if any amendments are made, be certain to include these at the positions in your

corporate records. Keep your bylaws up-to-date to avoid conflict. Outsiders are not bound by what is in your foundation bylaws unless you can prove that they had actual or constructive knowledge of their contents. Careful drafting of your original bylaws is important because amendments should be made infrequently, if at all.

Distribute EXHIBIT #3 - illustrating bylaws

It is suggested, for exemption purposes, that your bylaws be as simple and concise as possible and that the language be drafted in general terms. You should have considered all possible activities without setting out special rules and limitations on each separate activity. Even though your foundation bylaws are general in nature your foundation may act in a limited way. For example, we have passed out an illustrative set of bylaws. In this illustration you will notice in article 3, section 2 that almost everybody in the world may be elected a member of your foundation. It is obvious, however, that you will not elect

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EXHIBIT 3

ILLUSTRATIVE BYLAWS OF A PRIVATE FOUNDATION

(These bylaws are for educational purposes only and are not to be used for any legal purpose. These bylaws are incomplete and are not necessarily applicable in any state.)

The bylaws of a private foundation form the constitution of the foundation. Although they may be amended frequently and generally at the will of the directors or members they should not be treated lightly. The bylaws will govern the operation of the foundation, particularly in terms of who has what powers to do what. Therefore, the bylaws should be general in nature in order to provide for flexibility and freedom of action. Bylaws seldom apply to any specific situation with detailed language but usually give general guidelines to govern every situation.

The following are some examples of bylaws about which you may have question or which might help you in drafting additions or revisions to the initial bylaws of your corporation. The initial bylaws of your corporate foundation will usually be drafted by the attorney who helped you create your foundation.

ARTICLE I - DEFINITIONS

The following words and terms, as used in the Bylaws of _____, an Alaska corporation not-for-profit, shall, unless the context shall otherwise require, mean and be defined as:

- (a) "Foundation": the aforesaid corporation.
- (b) "Member": the persons who are qualified and elected to membership as hereinafter provided.
- (c) "Directors": the duly constituted members of the Board of Directors.
- (d) "Certificate of Membership": a written instrument signed by the designated officers evidencing that the person named therein is a duly elected member.
- (e) "Registered Office": that office maintained by the foundation in this state, and the address which is on file with the Secretary of State.

* * *

ARTICLE II - MEMBERS

Sec. 1. Election of Members: Application for membership may be presented by members, and shall be elected by a vote not less than a majority of the Board of Directors.

Sec. 2. Class of Members: The Board of Directors may establish more than one class of members and determine the designation and their qualifications.

(a) Sustaining Members: Sustaining members shall be those members who enter the foundation upon payment of a membership fee and approval by the Executive Director.

(b) Family Members: Family members shall be non-dues paying members of the foundation upon election by the Board of Directors.

Sec. 3. No class of membership, however created, is entitled to vote on any matter.

* * *

Sec. 5. Transfer of Membership: Memberships may be transferred only upon the consent of, and upon such terms as shall be fixed by the Board of Directors.

(a) Transfer of sustaining membership may be permitted upon the approval of the Board of Directors.

(b) Family membership may not be transferred under any conditions.

* * *

ARTICLE IV - MEETING OF MEMBERS

Sec. 1. Place of Meetings: All meetings of the membership shall be held at the registered office of the foundation or at such other place as the Directors or President shall, from time to time, designate.

Sec. 2. Meetings: The annual meeting of the membership will be held at a place designated by the Board of Directors on the ___ day of ___ of each calendar year. Failure to hold such a meeting will not cause forfeiture, failure or penalty on any rights, duties, power or obligation of the foundation, officers, directors or members.

* * *

ARTICLE V - THE DIRECTORS

Sec. 1. Powers: The Board of Directors shall:

(a) Manage the affairs of the foundation, except as otherwise provided in the Articles of Incorporation or Bylaws.

(b) Adopt a corporate seal as the seal of the foundation.

(c) Designate a banking institution or institutions as depository for the foundation's funds; and the officers authorized to make withdrawals therefrom, and to execute obligations on behalf of the foundation.

Sec. 2. Number of Directors: The number of directors shall be _____ in number.

Sec. 3. Election and Term: Directors subsequent to the initial Board of Directors named in the Articles of Incorporation shall be elected or appointed by the existing members of the Board of Directors at the time such election or appointment is necessary. Directors shall serve for a term of _____ years and may be reelected.

Sec. 4. Qualifications: A director subsequent to the initial board, shall be a family member of the foundation, shall be aged twenty-one or over and a citizen of the United States.

* * *

ARTICLE VI -- THE OFFICERS

Sec. 1. The officers of the foundation shall be: a President, Vice-President, Treasurer and Secretary and Executive Director, and such other officers as the directors shall designate. As hereafter determined by the directors, any one or more officers may be made ex-officio members of the Board of Directors.

Sec. 2. Election and Term: The officers shall be elected at the meeting of the directors held immediately after the annual meeting of the members or at such other meeting of the directors as shall be called for such purpose, and officers elected shall hold office for the ensuing year and until their successors shall be elected.

* * *

ARTICLE VII - CERTIFICATES OF MEMBERSHIP

Sec. 1. Certificates of Membership: The Board of Directors may, as it sees fit, provide for certificates of membership to be issued to duly elected members in good standing, and in such form as they shall determine. Such certificates shall be signed by the president and secretary and shall bear the seal of the foundation.

ARTICLE VIII - THE FISCAL PERIOD

The fiscal year of the foundation shall begin on the ____ day of _____ and end on the ____ day of _____.

ARTICLE IX - AMENDMENTS

The Bylaws of the foundation may be amended, repealed or new Bylaws adopted by the directors.

* * * * *

everybody in the world to membership in your foundation, but only those you desire as members. In article 5, section 4 of the illustration it seems that your foundation can elect anybody in the world as director. If this were the Smith Foundation, even though Jones and Anderson and others might qualify as directors, it would not be improper if only Smiths were elected as directors and only Smiths of a certain family. Broad by-laws give freedom to an operation without forcing you to employ the entire scope of each by-law. Regardless of what the particular bylaw is you may act as restrictively as you wish within the scope of the bylaw.

The illustrative bylaws for the private foundation are designed to create and vest control in one individual. They create a dictatorship. A second example of foundation bylaws, however, is that of a civic club, which you as a class may or may not wish to form. The civic club does not vest control in one person but acts on democratic theories with decisions being made by consent of the majority.

Minutes of the Meetings of the Board of Directors

Distribute EXHIBIT #4 - Minutes of the meeting and some illustrative resolutions

Minutes of the meetings of the board of directors of your foundation are among the most important records you will keep. The minutes will show clear authorization of the acts of the officers, employees and members of the foundation. The minutes should be kept up-to-date and accurately. They should not be abused or neglected.

Minutes of your board of directors meetings will reflect only general statements of the activities of the board of directors. These minutes are not intended to be word-for-word records of discussions, nor should they contain any details of foundation activities with the possible exception of annual financial report. Your minutes may in fact be prepared in advance of every meeting and agreed upon by the directors when they meet.

As you may have noticed, all of the business of

EXHIBIT 4

ILLUSTRATIVE CORPORATE FOUNDATION MINUTES

Corporate minutes of the meetings of the board of directors are usually general in nature and summarize what occurs at each meeting. Word-for-word discussions are almost never published in the minutes, nor are detailed discussions of the results of any transactions ever discussed. There are usually two kinds of corporate minutes. First, the authorizing minute, or that minute which empowers a director, officer or employee of the foundation to do something; and, second, the ratification minute, or a minute that approves of something already accomplished.

(a) Examples of authorization minutes that might occur in the first few meetings of your foundation's board of directors might be as follows:

- (1) Upon motion duly made and seconded and carried, the following resolution was adopted:

RESOLVED: That the foundation open a bank account with the First National Bank which is hereby designated as the depository of the funds of the foundation. That the forms of resolution required by the bank be hereby approved and adopted as a resolution of the directors as though set forth verbatim in these minutes.

FURTHER RESOLVED: That the following officers are authorized in the name of the foundation to withdraw funds from said depository, and to make loans on behalf of the foundation and to do and transact such other business with the depository as shall be required: the president, secretary, and treasurer.

- (2) Upon motion duly made and seconded and carried unanimously the following resolution was adopted:

RESOLVED: That certificate of membership of the foundation shall be in the form of certificate submitted to this meeting and that this certificate be inserted in the minutes of this meeting.

As you will note, each of these minutes authorizes somebody to do something in the future or at the time the minute is passed. Such minutes may be specific or general as required by the business of the foundation.

(b) The following are examples of ratification minutes that might be passed by your foundation's board of directors at the initial meetings.

(1) Upon motion duly made and seconded the following resolution was unanimously adopted:

RESOLVED: That the articles of incorporation filed with the Secretary of State and the provisions therefor be and the same is hereby approved.

(2) Upon motion duly made, seconded and carried, the following resolution was unanimously adopted:

RESOLVED: That the actions of the president and secretary in executing a lease with the John Smith Realty Corporation for the premises in which the principal office of the foundation is located is hereby ratified and approved under the terms of said lease. The secretary is ordered to retain a copy of the lease in the foundation's permanent files.

Ratification minutes may also be specific or general in nature as each case or situation indicates. Ratification minutes should never be passed more than six months after any act. In other words, your board of directors should meet at least annually to review the foundation's business. Your board of directors, however, should not meet any more frequently than is necessary to efficiently conduct foundation business.

Other suggestions on corporate minutes:

- (1) Corporate minutes should be written as clearly as possible to avoid confusion.
- (2) Corporate minutes need not contain legal jargon.
- (3) If a vote on any proposition put before the board of directors is less than unanimous the dissenting directors should be named.
- (4) Corporate minutes should always be signed and dated by the secretary of the organization.
- (5) The corporate seal is not necessary but lends a touch of authenticity and finalization to any minutes.
- (6) Usually, several resolutions are included in every meeting. There is no need to hold a separate meeting for every resolution that you wish to pass.

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- (7) You should obtain a waiver of notice of the board of director's meeting signed by every director prior to holding any meeting. This serves as written evidence of the approval of the meeting by all directors and eliminates the necessity of sending registered notices of each meeting. Your attorney can explain this in detail.
- (8) Attendance of every director at each meeting should be kept by the secretary.

The following language is commonly used to open and close a meeting of the board of directors. Included in this language is an illustrative resolution that was used to approve the employment of an executive director. (This resolution is incomplete legally, and should not be used verbatim in any case.)

MINUTES OF THE REGULAR MEETING OF THE BOARD OF DIRECTORS

A meeting of the Board of the Directors of the _____ Foundation, Corporation Not-for-Profit, duly authorized under the laws of the State of _____, said Directors properly holding office under the Bylaws, was held on _____ at the hour of _____, at _____ pursuant to waiver of notice executed by all members of the Board of Directors.

The following members of the Board of Directors were present in person:

Upon motion duly made and seconded, the following resolution was unanimously adopted:

RESOLVED: That the offer of _____ to serve as Executive Director of the _____ Foundation, communicated by letter dated _____ is hereby accepted. The Executive Director shall serve until further notice is given by either the Board of Director or the Executive Director to terminate their relationship.

There being no further business to come before the meeting, a motion duly made and seconded and carried, the meeting was declared adjourned.

Secretary (SEAL)

* * * * *

the foundation is conducted in the form of resolutions. The resolutions of the board of directors have the strength of contracts and do in fact empower and accomplish all the activities of the foundation. The resolutions of the foundation may be as specific or general as is required by the type of activity. For example, a resolution to enable the president of the foundation to create a grant program or a scholarship program may be a general resolution, but the resolution accepting the proposed program of the president or declaring the winner of a scholarship contest will be specific in nature. An attorney can always determine what type of resolution will be required and even to write the resolution. However, so called legal language and "whereas" and "wherefore" are not really required if the form is properly followed. If you write your own minutes, simple sentences and simple words are preferred to complex statements. If you refer the matter to your counsel, and if he has been properly trained, you need not concern yourself with the wording. You ought to be able to review the minutes of your foundation board of directors and understand

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everything that has been accomplished or authorized.

Foundation Bank Accounts

Included as part of the organization of your foundation is the requirement that your foundation have a depository for its funds. This depository usually amounts to a checking account in the bank of your choice. Again, counsel or the man at the bank would be able to complete these simple papers at your request, but it is just as efficient for you to do it yourself.

If you do decide to open your account without advice from counsel, then ABC suggests the following procedures:

Distribute EXHIBIT #5

1. Shop around for a bank. Many banks do not charge not-for-profit corporations for checking services, but this is a local option with the bank and has nothing to do with state and federal law. Other banks charge a small fee which is usually less than charges made for a normal corporation account. Still other banks charge regular fees.
2. When you decide upon a bank obtain the proper complete bank resolution papers for opening an account and for authorizing a loan. Most banks do not have specific resolution papers for not-for-profit corporations. If your

EXHIBIT 5

FOUNDATION BANK ACCOUNTS

The following steps may help you open a foundation bank account. Your corporate foundation would use the standard forms available for other corporations. It is recommended that you pick a bank where your affairs will be kept private and not be discussed generally. If you do decide to open your account without advice from counsel then ABC suggests the following procedures:

1. Shop around for a bank. Many banks do not charge not-for-profit corporations for checking services, but this is a local option with the bank and has nothing to do with state and federal law. Other banks charge a small fee which is usually less than charges made for a normal corporation account. Still other banks charge regular fees.
2. When you decide upon a bank obtain the proper complete bank resolution papers for opening an account and for authorizing a loan. Most banks do not have specific resolution papers for not-for-profit corporations. If your choice of banks does not use not-for-profit forms, then use normal corporate forms. Do not use the papers supplied for churches, clubs or hospitals. If business corporation resolution forms are used, then interline the words "not-for-profit" or "non-stock" in front of the first few lines where the word "corporation" is used; that is, replace all words "corporation" with the term "not-for-profit or non-stock corporation."
3. ABC recommends, for simplicity, that only one signature be required, but that at least two signatures be recognized.
4. Printed checks, if they are to contain the name or names of the directors or officers, should be printed so that the foundation's name appears in a discernibly larger type than the names of the officers or directors.
5. It is suggested that a business bank book rather than a pocket bank book be obtained for your foundation's checking account for clarity in record keeping.
6. Your foundation account should not be opened initially with any great sum. No more than \$50 to \$500 should ever be placed in the foundation initially. Larger transfers would only cause the counsel additional and unnecessary work in obtaining exempt status recognition for your foundation.

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choice of banks does not use not-for-profit forms, then use normal corporate forms. Do not use the papers supplied for churches, clubs or hospitals. If business corporation resolution forms are used, then underline the words not-for-profit or non-stock in front of the first few lines where the word "corporation" is used. That is, replace all words "corporation" with the term "not-for-profit or non-stock corporation".

3. ABC recommends, for simplicity, that only one signature be required, but that at least two signatures be recognized.
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6. Your foundation account should not be opened initially with any great sum. No more than \$50 to \$500 should ever be placed in the foundation initially. Larger transfers would only cause the counsel additional and unnecessary work in obtaining exempt status recognition for your foundation.

Additional Corporate Paper Work to Complete Organization

Most of the remainder of the corporate paper work, with the exception of the employment contracts, will be prepared or edited by counsel, but you should have some idea of what is involved and the significance of

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each of the documents.

1. Waivers of notice to meetings of the board of directors: These are simply papers which give written evidence that all the directors of the foundation had knowledge that a meeting of the board of directors was held. It does not mean that all of the directors attended the meeting, but simply that no secret or "railroad" type meetings were held.

2. Corporate Seal: The corporate seal is an historic remainder from the days when seal rings were used by illiterate kings to sign papers. Since most business men, even kings, in the world today are literate, the use of the seal has lost importance. Nevertheless, the corporate seal still remains the legal signature of your foundation and it should be respected in its use just as you would respect your own signature and its use. Do not idly impress blank sheets of paper with it or allow your children to use it as a nut cracker. You should use your corporate seal to endorse all publically filed material, major contracts and meetings of the members and board

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of directors. The seal should be entrusted to one person, preferably the secretary of the foundation. If your counsel is chosen to maintain the formal records and the corporate record book of the foundation then he may have possession of the seal. Some states do not require corporate seals.

3. Newspaper Notices: In most cases legal notice of the creation of the foundation in newspapers is not required. There are however isolated jurisdiction and isolated circumstances that do require public notice of the creation of foundations. These situations usually occur when a foundation takes over an existing business, not only in terms of ownership, but also in terms of operation. You should consult with counsel to determine whether such legal notice is necessary. If it is, counsel is trained to prepare such notice.

Public notice through classified advertisements in newspapers may be necessary to inform creditors, suppliers and customers or patients of a change of business form or business name. It is necessary to

inform such persons to avoid confusion in business transactions. A published notice in a daily newspaper circulated locally is usually sufficient to constructively notify the necessary persons.

4. Membership Certificates: Your foundation will issue membership certificates to all members of the foundation. These certificates will be initially of two or three classifications and may eventually be of many classifications. Your counsel will help you draft a membership certificate that will conform with your state law requirements and your foundation's structure. These certificates are similar to stock certificates. In the event of a dissolution of the foundation, members, as represented by the membership certificates, may have property rights in the assets of the foundation. Because the rights and identity of the members will be important to your control of the foundation, you will want to keep clear and careful records of the foundation's membership and you will want to issue distinctive membership certificates. These may be as detailed and elaborate as stock

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certificates and bonds, or they may merely consist of a clearly typed letter on your foundation's stationery. The language of the certificate may vary from state to state, but each certificate should be numbered and signed by both the secretary and president of the foundation, regardless of the state. One example of a membership certificate will be distributed for illustrative purposes.

Distribute EXHIBIT #6 showing membership certificate example

The Employment Contract Between the Foundation and the Executive Director

One of the primary benefits of control of a private foundation is that you may be employed by that foundation and thereby obtain salary and fringe benefits in return for services actually rendered. The creation of this employment relationship may be handled in many ways. However, ABC suggests a three step approach to create a proper relationship, providing flexibility in the relationship and providing

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This exhibit has been prepared for educational purposes and should not be used for other purposes without the advice of counsel.

THE ROAB FOUNDATION

THE BOARD OF DIRECTORS AND THE OFFICERS OF THE ROAB FOUNDATION, DULY ORGANIZED UNDER THE LAWS OF THE STATE OF ILLINOIS, DO HEREBY DECLARE THAT _____ HAS BEEN ELECTED A SUSTAINING MEMBER OF THE FOUNDATION, AND IS ENTITLED TO ALL OF THE RIGHTS, POWERS AND PRIVILEGES APPERTAINING THERETO.

Effective this _____ day of _____, 19__.

Secretary

MEMBERSHIP CERTIFICATE NO. _____

President

the clearest evidence of the relationship. These three steps include:

1. A letter from the individual offering his services to the foundation in return for an employment or management contract.

2. A resolution by the board of directors accepting this offer and authorizing the creation and execution of a contract.

3. The execution of the contract itself. Alternate methods for creating this employment relationship are:

1. The simple exchange of letters between the foundation and the individual which set out and confirm the terms of the contract.
2. The execution of a contract without an offer or acceptance between the board of directors or secretary of the foundation and the employee.
3. The deliverance of a memo from the foundation to the employee evidencing in writing the existence of an oral agreement or working relationship.

These methods are all legally sound and are being used all over the United States today. The first method, although more complex, provides better evidence and more flexibility for the relationship. An attorney

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acquainted with foundations would have the proper language to be used in all three of the above documents. Your primary job, as an individual, will be to determine what fringe benefits you desire so that counsel may write them into the employment contract.

Distribute EXHIBIT #7 discussing the possible contractual benefits and what factors one must consider concerning each fringe benefit.

We will discuss "fringe benefits" in detail at a later section of this seminar.

Foundation Tax-Exemption

ABC has available through its members extensive research material in the field of tax-exemption of foundations. Under section 501 (a) of the Internal Revenue Code, every organization which is properly organized and operating is tax-exempt. This particular Internal Revenue Code provision does not require foundations to apply for exemption, nor does the Code give any authority to any government agency to absolutely determine a tax-exempt status. In other words, under the law you are exempt if you have been properly

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EXHIBIT 7

FRINGE BENEFITS

There are benefits to being an employee of a foundation that are not stated in the employment contract. Among these are:

1. Educational opportunities
2. Research projects
3. Research grants
4. Use of foundation facilities and equipment

Other benefits are specifically stated in the employment contract and are usually governed by the Internal Revenue Code. Among these are:

1. Insurance (disability, life, professional liability, health, accident, medical)
2. Vacations
3. Adequate housing
4. Reimbursement for business expenses
5. Time for educational activities
6. Professional membership fees
7. Retirement

* * * * *

organized and if you continue to properly operate. Up to this point in our coverage of foundation procedures we have been properly organizing your foundation. The next section will give you guides in how to properly operate. You may operate under the definitions of the Internal Revenue Code for as long as you wish without paying taxes, without paying social security and take advantage of all not-for-profit tax-exempt benefits without going to court or to the Internal Revenue Service for prior determination of tax-exempt status.

The primary disadvantage of lack of government "notice" is that the federal, state and local tax agencies might not recognize this tax-exemption without some inconvenience. It is therefore advantageous to obtain tax-exempt recognition from your federal, state and local governments. Of the many methods that ABC has researched and developed, only four represent practical methods to obtain tax-exempt recognition. These are determinations by:

1. State agencies
2. State courts

3. Federal courts
4. Federal agencies.

State Agencies

State agencies may determine whether your foundation is exempt or simply recognize the foundation's tax-exempt status. If you have not received prior recognition of the exempt status from other agencies or courts, then your state treasurer, secretary of state or state attorney general might be empowered to determine the exempt status of your foundation. This recognition or determination however is usually only valid as to that particular state agency and neither the federal government or other state agency is forced to recognize this determination. In practice it is not unusual for the state treasurer to determine that a foundation is tax-exempt, while at the same time the attorney general finds that the foundation is not tax-exempt. Application to state agencies is usually slow and is not efficient. It is, however, a valid method and has been employed by some rather large and famous foundations.

State Courts

In most states a Probate or Surrogate court is empowered to determine the taxability status of a not-for-profit corporation or determine the tax-exemption of an organization owned or controlled by a decedent. Since this method of obtaining tax-exempt recognition usually requires that a director or officer of the foundation die, we don't recommend it. The death is often irrevocable and the determination is often slow.

Federal Courts

For the individual who desires the most freedom from regulation and has the patience and courage to withstand pressure, the federal courts offer the most satisfactory place to adjudicate tax-exempt recognition. The court order may be obtained from a federal court to determine whether an organization foundation is, in fact, both organized and operated exclusively for proper purposes. Such an order may be obtained upon petition by a single party (ex parte action), or may be obtained in an adversary proceeding (e.g. an attack by the Internal Revenue Service on the exempt

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status of your foundation). The court order is the strongest determination of exempt status.

The disadvantage to this procedure is that the strongest pressure occurs when the Internal Revenue Service attacks. Great patience by the foundation executives is usually necessary before the Internal Revenue Service does attack.

During the last few years foundations have grown from approximately 7,000 in 1952 to an estimated 106,000 in 1966. During this time the Internal Revenue Service has followed the activities of less than a thousand foundations. The Internal Revenue Service has audited less than 500 foundations each year. The Internal Revenue Service has brought less than 100 cases or attacks against foundations each year. This would mean that unless your foundation was one of the fewer than 100 chosen out of 100,000 each year you would have to wait to get your court order. As you can see, the odds are against the IRS litigating your foundation, but, if you choose this procedure always keep in mind that you are exempt without a court order if you are organized and are operating

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properly. You do not require determination by the court.

Federal Agencies

The only federal agency prepared to determine your foundation's exempt status is the United States Treasury through the Internal Revenue Service. The Treasury has in fact set up mechanical procedures to determine this exempt status, but the use of these mechanics is not required. Due to these mechanical procedures, however, determination by the Treasury Department is the fastest and most efficient means to obtain exempt recognition. Organizations formed under code Section 501 (c) (3) should use form 1023 to apply for exempt determination. Counsel who worked with ABC are often acquainted with the most efficient ways to complete and apply form 1023 to your foundation. If you choose form 1023, you will have to think out certain projects and assignments so that the counsel may in fact present a proper picture of your foundation's structure and intent to the Treasury to obtain a favorable determination. The primary disadvantage

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of form 1023 is that a great amount of information must usually be exposed for public record and that form 990-A must be filed by May 15th of each calendar year after Treasury determination. Form 990-A is a pain in the neck, but may be completed without too much trouble by a competent accountant.

Determination through form 1023 usually takes about four months in a normal situation and might be completed in a shorter time. The time depends upon the speed of the IRS in receiving the application. In unusual situations where politics has entered the picture, form 1023 has taken up to three years, but because normal administrative procedures may be employed, determination can usually be forced one way or the other. The Treasury Department section on tax-exempt organizations has advised our research staff that they are most happy to help in any way they can in bonfide attempts to form foundations. (If you have questions you might obtain some information from the Internal Revenue Service itself such as Treasury Document #5551). We have found no hostility from the Treasury on this matter.

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Once tax-exempt determination of your foundation has been made it is wise to immediately pursue all procedures required to get exempt recognition from state and local taxes. While the "tax-exempt number" on your federal letter is still available (that is, if it hasn't been lost in your files), all the procedures should be completed to eliminate future red tape. Such completion of procedures on a federal, state and local level will often prevent unnecessary harassment or questioning by government officers simply by having as evidence, letters by superiors or predecessors of these offices. What methods you will actually use to obtain exempt recognition locally depends entirely on your own circumstances. The "legal strategy" should be determined after a conference between you and your counsel

Special Types of Operating Foundations (foundations with limited purposes)

Special structures or types of foundations have particular advantages in the view of the Internal Revenue Code when the organization is directed to one particular activity or to one particular purpose.

Some of these advantages may make one or more of these structures desirable to you. One thought should be kept in mind, however, that because these special structures have limited purposes they also have limited scope of activity and flexibility.

A. Medical Foundations

Foundations formed primarily for medical or health purposes are sometimes given exemption from self-dealing and accumulation of income prohibitions.

The Hughes Medical Institute was formed to take advantage of some of these advantages. Medical foundations may either conduct medical activity, (research or treatment) or primarily support organizations carrying on medical activity. The Salk Institute and the Mayo Clinic carry on direct medical activity. The Searle Foundation supports medical activity through medical contributions or scholarships. The granting of medical scholarships or nursing scholarships may be one means of obtaining a medical exemption

recognition. The advantages of a medical foundation are simply a lessening of applicable regulations, but the "disadvantage" is that medical activities must be supported as a primary purpose of the foundation.

B. Agricultural Foundations

Foundations formed for agricultural research purposes have the same advantages as medical foundations (freedom from same regulations). Agricultural research, however, must be performed by the foundation. Support of agricultural research alone is generally not considered to be sufficient to meet the definition. ABC recognized that many persons working in agriculture seriously consider doing research and development to help solve the present food problem and the potential food problem that is being caused by the population explosion. New and effective methods have increased both the quantity and quality of agricultural productions, both plant and animal. This is a valid research

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purpose which is especially recognized by the federal government and some individual states such as Wisconsin and Illinois through privileges granted under the law.

C. Religious Foundations

Foundations formed exclusively for religious purposes or for actively advocating a religious philosophy are exempt from certain reporting requirements of the Internal Revenue Service. Such foundations may not advocate a philosophy developed by the founder alone, but must advocate an accepted religious philosophy or a philosophy with a broad base. The Billy Graham Crusade, the Black Muslims, Tim O'Leary's LSD Religion, the Knights of Columbus, the B'nai Brith, the Luther League and store front churches fall into this category. They all are considered religious foundations. If you have a real interest in a religious philosophy and wish to dedicate your life and activities to this purpose, then a foundation

formed exclusively for religious purposes, would give you freedom and flexibility and would give you relief from annual 990-A reporting requirements.

D. Educational Foundations

A foundation formed exclusively for educational purposes may secure many benefits if it meets the further test of being an "Education Institution". To do so it must have a faculty, an established curricula and a student body that meets regularly for a portion of the year at the place where the educational activities are normally carried on. This type of 501 (c) (3) organization is excused from annual reporting requirements set by the Internal Revenue Code (990-A). The foundation, however, must be a regular, bona fide institution to qualify for these advantages. All colleges and universities are, of course, this type of institution. Many training institutes,

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however, either are tax-exempt or could qualify for such tax-exemptions if they were organized under this law. The Sales Analysis Institute Foundation of Illinois, Inc. is one such organization.

E. Scientific Foundations

There are no particular advantages to being formed exclusively for science, but there are some special requirements. A scientific foundation must make the results of its research available to some portion of the general public on a non-discriminatory basis. Such a scientific organization must demonstrate upon inquiry that its methods are directed to some scientific cause and that its methods are scientific in nature. A scientific foundation must be formed for one of the following three purposes.

1. For doing research exclusively for the United States Government.
2. For doing research exclusively for a recognized educational institution.
3. For accomplishing research for the benefit of all mankind.

We recommend that your foundation qualify for a scientific organization in the third category.

Making research available on a non-discriminatory basis does not mean that you must give away your reports. You may charge for your findings or sell patent rights on your developments but you cannot prefer one company or individual over others. Social Science, Management Science, the Science of Finances and other "pseudosciences" have been recognized by the Treasury as being valid sciences for the purposes of the section.

Civic League

Before we go on to more detailed discussion of the foundation methods and benefits, ABC wishes to offer as a membership benefit to this class aid and service in creating a Section 501 (c) (4) organization, known technically as a civic league or club. This is a tax-exempt structure which consists of two or more

persons interested in furthering "social welfare" or furthering an employment status. The members of this civic club would include those members of this class, who would qualify either as employees of foundations or through interests in "social welfare". The purpose of the organization could be any community project or purpose decided upon by the members, but would normally include some phases such as community uplift, education of civic responsibilities, or to promote a better community and civic service. In terms of such emphasis the club would accomplish or improve itself and the community through many worthwhile projects. A 501 (c) (4) civic club has certain advantages and disadvantages that a 501 (c) (3) foundation does not have. For example, a civic club may participate in some political activities. A civic club may lobby for or against legislation where it affects the club's program. However, contributions to a civic club are not tax deductible. Income, however, to the organization itself is tax-exempt.

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Your civic club may decide not to participate in politics, and will probably not do so. However, the club may be formed for solely educational purposes. Your civic club could be a vehicle to bring special lecturers or programs from many sources, including, by the way, the ABC membership. Your civic club might decide to meet and discuss more detailed foundation and trust activity, once these official seminars have been completed. Your civic club might obtain the services of a knowledgeable local attorney to further instruct on the methods of estate and foundation management and structure. Outsiders could be (perhaps should be) invited.

A civic club is a non-profit corporation and is formed exactly like your private foundation. It varies, however, in the stated purpose of the organization and in the bylaws. A civic club is normally a democratic organization rather than an organization controlled by a single person like your private foundation. The board of directors of your civic club will probably be elected by the members, and, in fact, the board of directors could conceivably be all of

the members. The civic club would have officers who would probably be elected annually. The civic club would have bylaws that would resemble those of many other similar organizations, with which you might be familiar. ABC would, through a friendly local counsel, be happy to form such a legal organization for the benefit of its members, provided they have this desire, but ABC does not wish to force any person to join anything. If any educational, junior or senior member in this seminar does not wish to join this particular civic club he will not have to do so. ABC will provide the organization of the club and will help suggest ways and means for founding the club and accomplishing its initial desires, but ABC will not control the club in any way. The civic club will be considered an associate member of ABC for communication purposes only. If any of the class are interested in forming such an organization within your own ranks, then a local attorney will discuss the organization briefly with you now.

Distribute EXHIBIT #8 on civic club and attorney will explain details. Articles of incorporation will be drafted but other organization material will be left to a subsequent meeting. Suggest future projects to be undertaken by Civic Club.

* * * * *

EXHIBIT 8CIVIC LEAGUESOrganization

Civic leagues are tax-exempt organizations created under section 501(c)(4) of the Internal Revenue Code. This section defines the types of groups that are either employee organizations or social welfare organizations. Most people are primarily concerned with the second definition, social welfare organizations. Civic leagues formed for social welfare are usually created in the same way that corporate foundations are; that is, they are created through the formation of a non-profit corporation. The purpose clause of these civic league corporations, however, differs from that of a section 501(c)(3) private foundation. If the purpose clause of a non-profit corporation's articles of incorporation contain the word "welfare" or gives enough scope so that the organization can deal with social welfare outside of the limits of science, education, etc. (section 501(c)(3)), then the Treasury will usually consider the organization to be a civic league.

Differences Between a Private Foundation and a Civic League

Other than the purpose clause difference, the civic league is generally more flexible in terms of operation than the private foundation. A civic league may participate in most business activities without tax problems and a civic league may, to a limited extent, participate actively in politics. The rule concerning political action is: if legislation would affect the ultimate social purpose of the civic league, then the organization may lobby for or against that legislation or support candidates who tend to support the objective of the civic league. Private foundations, as you might know, are barred from such activities.

Civic leagues, however, cannot receive deductible charitable contributions; that is, an individual donating to a civic league may not deduct that donation from his income tax liability for that particular year. Civic leagues are not considered charities and are usually not controlled by any charitable trust acts.

Common Examples of Modern Civic Leagues

The following organizations have been found by the Treasury to be 501(c)(4) civic leagues:

1. American Legion
2. U. S. Lawn Tennis Association
3. An organization concerned with the suppression and punishment of crime

4. An organization to promote financially sound and economical government
5. An organization created for the purpose of assisting members in time of sickness or distress
6. An organization to rehabilitate unemployed persons over a stated age
7. An organization to encourage greater participation in governmental or political affairs
8. An organization formed for the purpose of giving aid and advice in connection with the location and construction of homes for sale to low and middle income families in an area where no adequate housing existed.

The following organizations were found not to be tax-exempt civic leagues:

1. A non-profit organization organized to provide low-cost cooperative housing to veterans and other eligible tenants through the purchase and operation of a housing project.
2. An organization formed to provide television reception to its members for a fee on a cooperative basis; in other words, a community antenna.
3. An organization formed to operate a semi-professional baseball club.
4. A non-profit organization that conducted social welfare activities but whose primary function was the operation of a summer home open to the general public at competitive rates.
5. An organization of women buyers of ready-to-wear accessories which carried on no community-oriented functions and used its annual income to service its members.

What a Civic League Can Do

Your civic league, if you should decide to form one with your fellow classmates or others, would be able to accomplish a great deal of good in your community without becoming a charitable organization. You could foster education, both of the members of the civic league and other persons in the community. You could promote legislation that would better your community or promote the repeal or defeat of legislation that would be detrimental to individuals and their freedoms. Your civic league would be a democratic society formed by those who wish to participate in it for the sole purpose of accomplishing community uplift. The precise details of any project could be worked out by the boards of directors involved.

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Your civic league could be a vehicle for providing benefits in terms of self-education and practicing foundation techniques without endangering or implicating your own private foundation.

Funding the Civic League

Since contributions to a civic league are not tax-deductible, it is recommended that those interested in funding a civic league loan money to the league on a low-interest or interest-free basis. Another alternative would be to charge membership dues on an annual basis and begin funding in this method. If a small capital fund could be created, subsequent investments and operations might increase this fund through earnings and provide a broader base on which to operate.

Principles of Civic League Management

This topic is scheduled to be discussed in great depth at a later seminar which is being developed at the present time. However, the general principles of private foundation management will apply in most cases to those of a civic club. Remember, however, that a civic league or civic club is not limited by unrelated business income, unreasonable accumulation of income, or the prohibited transactions that will be discussed in your foundation management education. These statutory laws only apply to section 501(c)(3) organizations and not to section 501(c)(4) civic leagues.

Starting Procedures

Your attorney is more than capable of creating a non-profit corporation based on section 501(c)(4). He would also be able to supply you with the proper bylaws and minutes to begin your organization. The following language, however, could be used for the bylaws of a civic league or civic organization. This language should, however, be discussed with an attorney before it is used to enable all the participants to understand the language in depth. These bylaws should never, in any case, be used as the bylaws for a private foundation.

BYLAWS OF A CIVIC LEAGUE

1. Name: The name of this club is _____
incorporated under the State of _____ under the
_____ law on the _____ day of _____, 1967.
2. Objects: Objects of this club shall be to protect and promote the best interests of the citizens of the nation, the state and this area, hereinafter set forth: to promote and strive for the improvement and betterment of all public facilities and services; to promote and encourage a better community and civic spirit and to foster good will and friendship between and among all the residents of said area, to cooperate

with county, town, village, state and federal officials and with other civic and public organizations for the general welfare of the entire community.

3. Membership: Membership may be of several classes as provided by the Board of Directors and shall be initially of one class.

(a) The initial class of members shall be those persons elected by the board of directors.

4. Dues: Annual dues may be assessed from each member equally by the board of directors.

5. Fiscal Year: The fiscal year of the club shall commence on the _____ day of _____ and end on the _____ day of _____.

6. Meetings:

(a) The annual meeting of the members shall be held on the _____ day of _____, of each calendar year for the express purpose of electing directors and officers and for conducting such other business as may come before the members at that time.

(b) Regular meetings of the members shall be held as per agreement and resolution of the members.

(c) Special meetings of the membership may be called by the president, whenever he shall deem the same necessary or whenever he shall be called upon to do so by two members of the board of directors or four members of the club.

(d) Notices of all such annual and special meetings shall be in writing given or mailed to each member not less than five nor more than ten days before the date set for any such meetings, but such notice may be waived in writing by agreement of 2/3 of the members at any such meeting. No notice is required for a regular meeting of the membership. Two-thirds of the members shall constitute a quorum of the membership. Voting shall be by a majority vote cast in person or by proxy. Proxies shall be in writing subscribed by the member and shall be presented by the presiding official of the meeting, to be qualified.

7. Directors: The affairs and business of this club shall be managed by a board of _____ directors elected by a plurality vote of the members present, at the annual meeting or such special meeting as may be called. Such directors shall serve for the ensuing year or until their successors have been elected and qualified.

Special or regular meetings of the board of directors shall be called by the president whenever he deems them necessary or whenever he is called upon to do so by two of the directors.

8. Officers: The officers of this club shall be four in number; a president, vice-president, secretary and a treasurer. No one person may hold more than one office. All officers must be members of the club.
 - (a) The president shall be the chief executive of the club, charged with the duty of supervising all of its functions subject to the orders of its board of directors. He shall be an ex-officio member of all committees.
 - (b) In the president's absence or in the event of his inability to act, the vice-president shall perform the duties of the president. He shall also perform such other functions as the board of directors may from time to time assign.
 - (c) The secretary shall conduct the correspondence of the club, issue notices and keep minutes of all meetings of the club, be custodian of the records, keep the roll of members and discharge such other duties as may be assigned to him by the board of directors or the president.
 - (d) The treasurer shall collect all dues and shall have the care and custody of all funds and property of this club, which shall be disbursed by him only upon the order of the board of directors or of the president. He shall submit a report for the preceding year at the annual meeting of the members and shall render special reports whenever requested to do so by the board of directors. He shall deposit all funds in the name of the club in such bank or banks as may be designated by the board of directors.
 - (e) Should any vacancy occur by death, resignation or otherwise, the same shall be filled without undue delay by the board of directors.
9. Committees: Committees shall be designated and appointed by the president or the board of directors as may be required.
10. Seal: The board of directors is empowered to design and accept a seal for the club and an impression thereof must be made at the margin of this page.
11. Amendments: Bylaws of this club may be amended or revised by the board of directors, by 2/3 vote of all directors and approval by the affirmative vote of a majority of the members present at the annual meeting or at any regular or special meeting, provided that notice of any such meeting contains a summary of the proposed amendment or amendments.

* * * * *

Section 3Foundation Income SourcesThe Operation of the Foundation

Under section 501 of the Internal Revenue Code an organization properly organized and operating is entitled to tax-exemption for federal income tax purposes. Up to now, we have referred to the principles and some of the documents involved in organizing a foundation for tax-exemption purposes. For the rest of this portion of the seminar we will consider methods applicable to proper operation of the foundation. Your local counsel will accomplish much of the work in organizing your foundation, using your ideas. But your counsel will not be able to operate your foundation. He will only be able to advise and guide you in the proper operation of the foundation. The greater knowledge of the operational methods of foundations that you have, the greater will you

potentially benefit the world and yourself as founder and executive director. The better you know how a foundation ought to operate the more chance there is that your foundation will significantly benefit mankind. Again I will welcome any questions on the material that we will discuss. Perfect understanding of these methods by you is an objective of ABC. We hope to answer every question. We will cover the following areas of management.

Instructor should refer to EXHIBIT #1

Normal Business Functions of the Foundation

Your foundation, as a legal structure, is only an alternate form of organization. Legally your foundation is no more special than a corporation, a partnership or a sole proprietorship. There are no particular mystical or magical business methods that apply to foundations which differ in any way from conventional responsible business management. You may, in fact, with very few differences, properly operate a foundation with the same business methods

that you use for a stock corporation. Our purpose, however, in spending the time in this seminar discussing operating methods is not to teach you conventional good business practices. Instead we would like to make you aware of certain applications of normal business practices that would be beneficial to the overall operation of the foundation either in terms of security from government regulations or the efficient production of benefits.

In each of our seminars we bring together individuals of a wide variety of backgrounds. Due to this availability of talent, I would like to conduct the management portion of this seminar on the basis that each of us contributed ideas to the others. That is, I do not have all the answers to questions of management, and perhaps some of you have ideas that would work within the framework of the foundation principles. I suggest that we go through the written material for each subject and then discuss some ideas of practical application of the general rules of thumb that are presented which might personally apply.

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Foundation Income Sources

The first order of management of any business is capitalization. Your foundation is no different. In other words, before your foundation can begin to operate it must have capital assets with which to finance the operations. These capital assets will come primarily from one or more of three sources. The sources are:

1. Contributions
2. Loans
3. Purchases

Contributions

The first tax-exempt source of income is capital gains, which will be briefly discussed in the section on "buying and selling property". A more familiar concept of capitalization, however, is from contributions. Contributions may be derived from many sources. It is recommended, however, that you do not create your foundation with intent to become a general solicitor. That is, ABC does not recommend that your foundation become a "tin cup" foundation. There is usually no reason for an operating foundation

to make general solicitations for contributions from the public at large. ABC does not recommend that a source of "charitable" activities, such as foundations should become the subject of charity. Your foundation should be dependent only upon its efficient operations and the energies and resources of its founders and employees. This is not to suggest, however, that ABC discourages foundations from receiving unsolicited endowments or from applying for special research grants from larger private and public sources. In addition, ABC also recommends that in some situations contributions from the founder to the foundation might be highly desirable to other parties. We will discuss contributions in this section only in terms of contributions to the foundation and we will reserve the procedures of contributions by the foundation to the section on grants and charity.

We recommend that your foundation begin its activities with borrowed money rather than contributions. This is a general statement and, of course, has exceptions. But our reasoning for this general

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statement is as follows:

You will start your foundation by placing some amount of money in your foundation's bank account. This money will either be from your private income or from your business income. In either case, it is recommended that a promisory note should be executed by the foundation to the lender. Technically your foundation has not yet been recognized by the U.S. Treasury as a qualifying organization to receive deductible contributions, and this original amount might not be recognized as a deductible charitable contribution. If these original funds are a loan then you will not be penalized in the event the amount is not recognized as a charitable deduction. This loan may or may not carry interest, may be short term or long term and may be converted into a contribution simply by marking the note "paid" and giving it back to the foundation. The foundation would then send a "thank you" note for the contribution as evidence of the transaction. Your foundation would then have capital to begin its operations.

Another reason for loaning money to the foundation at first rather than contributing to it is that

this technically cuts down paper work on the form 1023 application for exemption determination.

Section 170 (b) of the Internal Revenue Code governs normal contributions to a foundation. There are also other sections of the Internal Revenue Code which govern special contributions in terms of the Federal Gift Tax, the Federal Estate Tax, Membership and Club dues, and certain trust procedures. Section 170 (b), however, will govern most of your activities in terms of contributing to your foundation. Under section 170 (b) you, as an individual, are allowed to deduct up to 20 percent of your adjusted gross income for contributions made to private charities. You are allowed to deduct up to an additional 10 percent if the contributions were made to a church, school or hospital. This does not mean that you are not allowed to contribute more of your salary or income, but only that you are allowed to deduct these percentages above for income tax purposes. In other words, there is no limit on what you can give - only on what you can deduct.

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Corporations may contribute up to 5 percent of their adjusted gross income to any charity. It is recommended that corporations never exceed this limit in their gifts.

A mere pledge is not considered to be a contribution and a contribution must actually be paid to entitle the donor to a deduction. Gifts of appreciated property generally avoid a tax on the attributed capital gains appreciation. All types of property may be used as gifts - the most frequently used are stock, life insurance, bonds and other types of intangible interest.

Life insurance may be given where there is an irrevocable assignment of the policy and the foundation is also named as irrevocable beneficiary. A transfer of property to a foundation may also be both a sale and a gift simultaneously. Where property is sold at less than market value the difference between the actual sale to the foundation and market value might be directed as a charitable gift; because recent cases have criticized or questioned charitable gifts made to foundations with limitations or strings

attached, it is as a general rule recommended that gifts be made to a foundation without restrictive limitations. It must be pointed out, however, that it is quite permissible and sometimes desirable, to give property to a foundation or charity and retain a lifetime interest in that property; that is, upon your death the foundation or charity would gain outright control of the property, but you retain the income of the property while you live. You may deduct the value of the foundation's future interest in the property immediately upon the creation of such a contract.

It is recommended that in any unusual or complex contribution you refer this to a local attorney or a well qualified tax accountant. There are many special types of contributions that have been recognized by the Treasury as having tax consequences - some favorable and some unfavorable. Before completing a contribution transaction of an unusual nature or large amount, you should consult with an attorney. For small amounts you would keep a record in the same way

that you presently keep a record of a contribution to your church, college, or local charity.

Fees

The primary reason that your foundation may not need to solicit contributions from the general public is that it may earn most of its initial capital through fees for services actually rendered. In other words, your foundation may provide certain services to the community at large for which it will be paid fees. If your present vocation is that of a doctor of medicine or other member of the "healing arts", then you may continue this type of service through your foundation with a few changes in structure and record keeping. You would form a "clinic", whether you use this name or not. You might offer some of your services to the general public, or a special portion of the public, as you wish, and charge fees based upon the services rendered to these people by your foundation. These fees may be based on the ability of your patients to pay. This standard is the one used by the Mayo Clinic in Rochester, Minnesota, which is associated with the Mayo Brothers Foundation.

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Both of these organizations are foundations.

If you are an educator or a scientist, or some other type of "self-employed professional", some, if not all of your services, could be retained by your foundation and your expertise used to offer foundation services to the "general public". For example, if you are an expert in sales or distribution of products, you might offer research and development in sales communications or the science of transportation through your foundation. If any other business desired special research and development in these fields, they would contract with your foundation to provide them with answers to their questions. Your foundation would, however, have to make the results available on a non-discriminatory basis, and you should check with a local attorney who could help you decide if your proposed operations would qualify as a foundation activity.

We are simply suggesting that your foundation could offer services to the general public or some portion of the general public within the scope of the express purposes of the foundation. If your foundation

is created exclusively for education, science, religion and literary purposes, then you might offer services within these fields. This is the precise method of operation that Educational Testing Service, for example, offers standardized nationwide tests to enable students and institutions to judge the ability of any individual on a nationwide basis. ETS administers the College Board examination, which is offered to every high school junior and senior in the country for about \$12 to \$20 per examination. Nearly half of the students in the country take this exam during the course of their high school years. Obviously, Educational Testing Service, a foundation, does not need to solicit funds from the general public.

The one principle to remember in structuring the services that your foundation might offer to the public is that these services must be related to the exempt purposes of your foundation or the income from these services will not be tax-exempt under the Internal Revenue Service Code. Normally, activities outside of education, scientific research, health

care, or agricultural research are structured as pure basic research and development in the "science" of the subject matter most related to the interests of the foundation staff.

In structuring the exact amount for the fees, care should be taken to avoid direct competition with local commercial institutions. Indirect competition is permitted under the law. In other words, even though you may charge exactly the same fees as a local competitor for the services of your particular foundation, you might structure it as fees based upon the ability of the person to pay, or fees relating to the costs of the foundation (costs, of course, include the salaries necessary to pay foundation employees), or fees based upon the research value of the particular project for which the foundation contracted to study.

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Investment Securities, Mortgages, Rentals, and
Savings

We have covered briefly two sources of tax-exempt income for your foundation. These two sources are contributions and related fees. There are five other sources of tax-exempt income and these are:

1. Dividends
2. Most rents
3. Royalties
4. Interest
5. Short and long term capital gains.

These are the five "investment" sources of foundation income.

Your foundation may invest in any security program that is reasonably secure. That is, it may invest in any listed security or approved bond and it may deal in almost all of the major and minor securities in over-the-counter market. Probably the only rule of investment that should be kept in mind

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is that the foundation is barred from "endangering the capital assets of the tax-exempt organization." In other words, the Internal Revenue Code prohibits foundations from endangering the foundation funds through investment in extremely risky situations. It could be illegal for the foundation to invest in highly speculative transactions such as wildcat oil companies or penny stocks in exotic mineral rights. However, conventional speculative investments as well as growth and blue-chip income investments are quite permissible. Dividends, capital gains and interest from these normal security transactions are tax-exempt to your foundation under the Internal Revenue Code.

The foundation through it's officers or directors may personally administer these security transactions. The foundation is not required to hold any investment for any mandatory or minimum period of time. Many foundations, in fact, do regularly trade on the nation's stock exchanges. In the alternative, a foundation may create a security account with an established broker and have that broker administer

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the account or give advice on various transactions. When such accounts are opened and established, the broker usually requires a resolution from the board of directors authorizing the account and naming an agent to represent the foundation. This named agent is usually the president or the executive director of the foundation, and he is usually empowered to buy, sell or purchase securities and pledge them for loans.

Foundations may also invest in so-called unconventional investments. The average person believes that mortgages must be made either by savings and loan companies, banks or insurance companies. In fact, colleges and universities, churches and foundations execute and establish just as many mortgages as banks and savings and loan companies. Your foundation may properly "invest" in any mortgages, whether they be first, second or third mortgages, provided the security is sufficient to provide safety. You should consult an attorney about these transactions if you are not familiar with the proper papers or if the mortgage is unusually large. Remember foundations may both loan funds and take

mortgages as security and mortgage foundation property.

Your foundation might purchase time savings deposit certificates in large amounts. In addition, your foundation may have a normal savings account up to certain limits. The Treasury Department has indicated that they would frown on a foundation that had more than \$15,000 in an ordinary savings account. In other words, the Treasury seems to insist that foundations invest. To open a foundation "savings account" you would sign a corporate resolution similar to the one you used to open your foundation checking account. Banks usually provide their own corporate resolutions for the foundation.

EXHIBIT #9 Some examples of current foundation in investment activities should be discussed.

Buying and Selling Property

Your foundation will buy or sell property as part of either its initial or subsequent activities in exactly the same way as any corporation.

Your foundation may purchase property in its own

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EXHIBIT 9

FOUNDATION INVESTMENT

A foundation investment memo is being prepared by an informed stock broker with a nationally-known firm. At the time of this seminar this memo had not yet been prepared. It will be forwarded to you as soon as it is available.

* * * * *

name - that is the Smith Foundation will take title to land rather than Mr. Smith. Mr. Smith, however, as director or officer of the foundation, will sign the proper papers. Authorization for such a purchase from the board of directors, is usually necessary. The financing of such a purchase, where necessary, would be conducted in the same way as the financing for any purchase by any party.

The foundation, as a non-profit corporation, is empowered to borrow money and pledge as security foundation property. Thus any foundation may secure a real estate loan with the real estate purchased with the loan. The foundation may execute an ordinary automobile loan.

The foundation may purchase or sell property from or to the founder of the foundation or major contributors of the foundation. In these cases, however, all such transactions must be at or near fair market value. This rule is to comply with the "self-dealing" provisions of the Internal Revenue Code. It may be possible for your foundation to obtain exemption from state sales taxes; where local law

permits, your foundation should apply for and receive such exemption in order to enjoy significant savings. Such exemption is usually not automatic under the state law. Applications should be made through the State Treasurer, the Secretary of State or Attorney General, depending on local regulation. Please consult your associate counsel or write your State Attorney for the exact procedures applicable in your state.

Some major retail outlets or merchandise distributors allow a discount to certain types of non-profit organizations, generally related to educational, medical or welfare organizations. Nationwide concerns such as Montgomery Ward, Sears and large local distributors such as Macy's, Hudson, and Marshall Field have given small discounts to non-profit organizations of these types.

These discounts are private privileges offered by these companies and are not governed by any law. You would generally have to apply to the Credit Desk of the store or business in question before each purchase or series of purchases. If a store refuses

such a request do not feel outraged - this is their right. It is suggested that there should be no abuse of these privileges or they may be lost to all. Most foundations only take advantage of these discounts when they are engaged in non-income producing activities, such as youth projects, libraries, or welfare.

Your foundation may occasionally sell equipment or small items of foundation property without a special resolution of the board of directors, but such sales if regularly carried on, should be examined for possible unrelated business income, which is taxable, or for collection and payment of state sales taxes from the purchaser. Major sales, such as the conveyance of real estate, large amounts or pieces of depreciable equipment, or large holdings of securities or other investments should generally be authorized by either a special resolution or general resolution of the board of directors.

Careful records of capital gains on all sales and purchases should be kept for two reasons.

1. The foundation should have accurate records

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to reflect its economic status at any given time and

2. Such records are highly useful as protection in the event of Internal Revenue Service investigation.

In most cases, your foundation's purchases and sales will be made by officers rather than by the directors. If you are both an officer and director of your foundation, remember to sign bills of sale or contracts to purchase as an officer rather than a director. That is, sign John Smith, President, rather than John Smith, Director. Generally, the executive director, the assistant executive director, the president, the secretary and treasurer are usually empowered in normal practice to buy and sell corporate property. Often vice-presidents, assistant secretaries and treasurers are also empowered to sign contracts in a large business. The authorization of these other officers is generally made by express resolution of the board of directors.

Your foundation may grow rapidly through the proper buying and selling of property, because capital gains, both short term and long term, are tax-exempt sources of income and do not fall under any

distribution qualifications under federal law. Such income may be rapidly accumulated to increase the foundation's net worth and optional endowment fund. To review a few of the principles:

1. Make certain the foundation has authorized the purchase or sale of property through a proper resolution.
2. Use normal responsible business practices in completing any sale or purchase.
3. Investigate state tax advantages and disadvantages
4. Watch for self-dealing problems in transactions with donors or founders.
5. Use, but do not abuse, discount privileges offered by private concerns.

Other Property, Purchases, Leases and Management

Your foundation may execute leases with any other organization or individual. The only limitation on leases is that of self-dealing. In cases where the foundation leases from a contributor or the founder of a foundation, the lease must be at local market-value and may not be inflated. Just as sales contracts

and other normal business transactions are signed and executed by the officers, so will the leases.

Generally, foundations own and operate all property leasehold interests that they may acquire. However, it is not unusual nor improbable for a foundation to contract with a for-profit independent agency to manage certain foundation property. For example, a foundation may contract with a real estate management company to manage foundation rental property. The foundation would receive as rental income that portion of the rents after expenses and the management fee were deducted.

As stated earlier, a foundation has the power to borrow money and pledge its assets to secure that loan. The foundation, as a borrower, has certain advantages that other corporate or individual borrowers do not have. Because of its tax-exempt status, a lender knows that he will not be in danger of taking a back seat to a government lien for taxes. Because the foundation is tax-exempt, the lender knows that his debtor cannot dissipate its assets, and the lender's security, through large dividends or excessive salaries.

The foundation may borrow from its creator or officers. As stated earlier, this is frequently done to get the foundation under way and, because a deduction for contributions cannot be claimed until the IRS recognizes the foundation's exemption, the lender does not want to make a gift of the money. Such a loan should be shown by a simple note or memorandum signed by the foundation. If made at not more than fair interest, there will be nothing wrong with such a loan.

If a third party is asked to loan money, he will be mainly concerned about two questions:

1. Whether the person seeking to make the loan is authorized to act on behalf of the foundation, and
2. Whether the loan will be repaid.

When a person deals with any corporation, he must be concerned with whether the person who seeks to make a contract (in this case a loan) binding the corporation has power to do so. For this reason, the form resolutions prepared by banks include an optional resolution authorizing some person or persons

to borrow in the corporation's name. In many of the foundation's initial dealings with such potential creditors as banks, brokers, savings and loan, and certain other large commercial institutions these organizations may ask for a corporate resolution, so that they can be sure that the foundation is really going to be liable on the credit they are asked to advance.

Since these resolutions are for their own protection, the creditors or lenders will usually provide their own forms which the foundation will merely fill out and sign.

In most cases, especially for small amounts or with persons familiar with the creator or officer seeking to open the account in the foundation's name, nothing will be asked.

On the foundation's part, it should authorize certain of its officers to incur debts in the name of the foundation to carry on the foundation's business. This will usually be done by a resolution of the board of directors at their first meeting. Like all such resolutions, the attorney will prepare it

ahead of time in exactly the form desired. There may be as many people authorized by the foundation as desired by the creator.

A potential creditor's second consideration is whether he is likely to get his money back. For this reason he may ask the foundation to execute a mortgage or pledge assets. This can be done either by a resolution of the directors or by some officer authorized by them and is done in exactly the same way as any similar corporation.

In addition, since the foundation may not have a great deal of equity to secure a loan, the lender may ask for additional security or a personal obligation from one of the officers or directors. Once again there is nothing unusual or unique about such an arrangement in normal business practice.

Most experienced business people undoubtedly have enough personal skill to execute and administer small loans. It is recommended, however, that in all cases that involve large amounts of funds, complex transactions, significant purchases of real estate or

major items of personal property (such as diamond mines or major items of depreciable business equipment) that you consult with an attorney.

A foundation may, under most state laws, own anything and everything that is ownable in the world. Once a foundation owns the world it may sell it. A foundation may also manage or use any properties that it owns or leases. Some rental transactions or leases, however, may involve taxable consequences to the foundation. These situations will be discussed later in this seminar.

* * * * *

Section 4Legal Restrictions on Foundations

There are three areas of government regulations which are limitations and restrictions on foundation management. These three areas are:

1. Prohibited transactions.
2. Unrelated business income or taxable income.
3. The unreasonable accumulation of income or distribution requirements.

Prohibited transactions are divided into three areas:

1. Political activities.
2. Endangering foundation funds
3. Self-dealing

The first two are relatively clear and simple to understand. The third, that of self-dealing, is much more complex and will require more detailed explanations.

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A. Political activities

Your foundation is prohibited from political activities. Your foundation is prohibited by law from supporting any public candidate for office. Your foundation is prohibited by law from influencing legislation. If you desire to participate in politics, you may do so as an individual, even though you are an officer or director, but if your foundation participates in political action, it will lose your tax-exemption. In other words, you cannot support political activities through a 501 (c) (3) organization.

Education of the public about political ideas, however, is permitted. In other words, you may educate the public on political economics, political science, jurisprudence or legislation, provided that it is education material and not propaganda.

EXHIBIT # 10 The article on political propaganda vs political education from the 1957 conference on trusts might be included as an exhibit.

EXHIBIT 10

POLITICAL ACTION

Propaganda v. Political Education

An organization qualifying for tax-exempt status under section 501(c)(3) of the Internal Revenue Code may not participate in political activity. Tax exemption is granted by the Internal Revenue Code only to an organization where no substantial part of the activities carried on by the foundation is concerned with political propaganda to influence legislation or to influence any political campaign on behalf of any candidate for public office. This includes a prohibition against publishing or distributing statements that may have effect on legislation or a political campaign.

In addition, both the Treasury Department and the federal courts have found that indirect contacts with individuals to influence legislation is also political activity. In other words, your foundation may not influence its contributors or members or customers to write their Congressmen. There is nothing wrong with these persons writing to their Congressmen, but the influence for the letter may not be derived from activities of the foundation.

Legislation has been defined to include action by Congress, any state legislature, any local governing body or the public in a referendum, initiative, constitutional amendment or other similar procedure.

Under the Internal Revenue Code political activity must be substantial in order to bar an organization from exempt status, but since this is a question of fact, no legal guidelines can be given as to what is substantial or what is insubstantial. There have been no cases to date defining what is substantial or insubstantial political activity.

The term "propaganda" has also never been defined clearly by the courts. It would seem that the legal definition of the word is much less general in scope than the dictionary meaning. However, a general guideline could be that propaganda is matter that is disseminated or distributed not primarily to benefit the individual receiving the information, but to accomplish the purpose or purposes of the person who instigated the propaganda.

A 501(c)(3) organization, on the other hand, may be formed to accomplish political education. An early court case involved an institution that was organized and operated for the purpose of advocating good municipal government and opposing measures of detrimental nature to the municipality. This organization was found to be a political action organization. However, when this case was

(over)

decided it was stated that if there was some element of education in the dissemination of information through the organization's publications that at least this portion was valid. The organization was the Civic Fund of the City Club of New York and they were found not to be tax-exempt or educational. The courts, however, found that a foundation organized for the purpose of teaching, expounding and propagating the ideas of a particular philosopher was a tax-exempt organization. Exemption was granted to the League for Industrial Democracy even though it encouraged definite social doctrines because it had no legislative program which it advocated. Exemption was also granted to the World League Against Alcoholism because it had no legislative program and worked against alcoholism, which was defined as the abuse or disabuse of alcohol.

The general guidelines that should be considered in political education is that if the material that is distributed or the persons involved in the seminar present both sides of a political issue so that an individual may reach his own conclusion from a fair hearing of the information, then this is considered to be education rather than propaganda. The fine line is not too clear. What, to some people, may be propaganda would to others present both sides of the story fairly.

DUE TO THE GENERAL CRITICISM OF POLITICAL ACTIVITY ACCOMPLISHED BY FOUNDATIONS WE RECOMMEND THAT NO POLITICAL ACTIVITY OF ANY NATURE BE ACCOMPLISHED BY A FOUNDATION.

This would not bar a foundation from creating a library of politically-oriented books nor would it prevent the foundation from making this library available or even distributing books, such as the Making of the President, or Profiles in Courage, but no foundation activity should mention or indirectly advocate any legislation, and in no case should any reference be made to a current political campaign, either for or against any candidate. (additional material on this subject may be distributed in the future.)

* * * * *

The text of the material must present the facts of an issue in a fair way so that the reader might reach an independent conclusion based on fair information. This type of material is considered educational and not political propaganda. Any other type of political material will endanger the tax-exempt status of the foundation.

The National Rifle Association has for years distributed literature which educates the public on the pros and cons of the statutory regulation of rifles. The literature is "objective" and presents both sides of the story. And yet few readers can conclude that rifle legislation is good after reading the literature. Perhaps the truth alone is the convincing factor. I hope so.

Due to recent Treasury criticism (which has strong legal basis) of politically active foundations, it is not recommended that foundations participate in any political activity which might lead to harassment or litigation.

B. Endangering Foundation Funds

A foundation may lose its tax-exempt status if it

uses it funds in such a way as to seriously endanger their application to proper tax-exempt purposes. This would include unsecured loans, risky investments, and unwise overall planning and structure of investments.

The prohibition against endangering foundation funds is an unusual prohibition which seems to indicate that, by law, a foundation may not go bankrupt. Of course there is no indemnity guarantee - it merely means that if you do go bankrupt you become taxable. The prohibition against endangering foundation funds was created to discourage foundations from entering high risk ventures. The courts, however, have all but nullified this prohibition by consistently finding that if a venture is successful, it could not have been risky. If your investment in mineral rights turns out to be highly profitable, how could it have possibly been dangerous? If your foundation's investment in growth securities of a perpetual motion machine makes millions, how could it have been risky? In other words, the courts have used hindsight to determine the risk of a venture.

A few years ago the Internal Revenue Service attacked a foundation that had invested in securities in such a way and with such a risk that a 15 percent drop in the price of the securities would have wiped out the foundation investment. The 15 percent drop did not occur and the foundation made a healthy return on its investment. The courts found that the foundation had not endangered the funds of the foundation and that its tax-exemption would stand.

This rule should only caution you against considering risks that are extremely unusual or even shady. The rule would not prevent you from investing in any security on the stock exchange, nor from investing in any bond of any registered company, nor from investing in mortgages of any nature where security was sufficient, nor from investment into research and development of an unusual character. Endangering foundation funds is essentially a caution sign against irresponsible activity.

C. Self-dealing

The most complex area of prohibited transactions is self-dealing. We have briefly discussed some of the issues in prior sections of this class but perhaps we should review the rule in detail and even repeat ourselves to make the distinction clearer.

The term "self-dealing" is misleading. The term does not mean that a foundation is barred from dealing with individuals who are closely related to it, but only that the foundation is barred favoring these individuals or sacrificing foundation funds. The rule against self-dealing simply states that a foundation is barred from entering into certain transactions with the founder of a foundation, the directors of a foundation, the contributors to a foundation, and their relatives, and, in some cases, the officers of the foundation, in such a way as to give preference

to these individuals or to cause the foundation to suffer a substantial loss in the transaction.

To be specific, all of these individuals may sell or buy property from the foundation or borrow from or loan to the foundation, lease to or from the foundation, or exchange properties with the foundation, provided that the terms of the transaction are within the scope of the normal market values of a similar transaction. A contributor to the foundation may borrow money from the foundation provided that the contributor pledges adequate security for the loan, pays a reasonable interest and promises to return the loan by a specific date.

Conversely, a director of the foundation may loan money to the foundation and ask security and charge a reasonable interest, but may not charge an exorbitant interest outside the bounds of ordinary financing sources nor ask double or treble normal security.

A foundation may not be used by a contributor or officers as a vehicle for personal gain - that is, an officer may not sell securities to the foundation

at prices in excess of reasonable market valuation nor may an officer, through the foundation, purchase valuable securities or properties and have the foundation sell them to himself at substantially less than reasonable market value.

In all cases of foundation transaction or dealing with officers, directors, founders or contributors an arm's length status must be maintained. That is, the foundation must deal with these individuals in the same way that it might deal with unrelated individuals.

Some examples should help illustrate the rule. An officer of the foundation may sell or buy securities to or from the foundation, but he may not purchase penny stocks today and sell them for \$20.00 a share tomorrow unless, of course, their values have risen that rapidly in the established market exchanges. In the same way, an executive director of the foundation cannot have the foundation purchase blue chip securities, like General Motors, and then buy them from the foundation for a few dollars

a share.

The officers, directors, employees and creators may borrow some of the foundation funds but they must provide security for the loan, sign proper papers illustrating the debt, pay a reasonable interest and pay the loan back by a set termination date. If the foundation borrows from a contributor, the contributor cannot charge an unreasonable amount of interest nor insist on double security. These related persons are not allowed to manipulate foundation mortgages so that individuals gain ownership of foundation property at substantially less than market value.

The foundation may not prefer one of these related individuals in its activities - that is, although founders, contributors, directors and officers may win grants or awards generally they must do so as if they were in competition with unrelated individuals. The same standards and qualifications for any grant or award must be maintained where a "related" individual is an applicant or competitor.

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If a better qualified individual unrelated to the foundation applies in competition with an employee of the foundation, the employee should not be given overriding preference. (In such cases the employee may always be trained as part of a training program of the foundation rather than awarded a specific grant). In other words, the same arm's length status must be maintained in grant or charity programs as it is in other financial transactions.

These prohibitive activities only underscore the requirement that you consider your foundation as an independent person. Your foundation is not the same as yourself. Others may confuse the identity of your foundation and yourself, but you should avoid this confusion.

For example, when the Ford Foundation gives a major grant, most people think of the gift as coming from the Ford family. There is nothing wrong with this attitude, but the Ford Foundation maintains complex separate records that are completely independent of the Ford family.

In the same way your foundation records and files should be kept completely ~~apart~~ from your personal files. Your foundation is under your control and usually accomplishes your beneficial and philanthropic desires, but it is not you yourself and should not be considered so.

Your foundation would deal with you in the same way that it would deal with any other individual. As long as this internal relationship is kept clean and clear, it does not matter if the rest of the world believes that every gift from your foundation is a gift from you. In other words, evidence must be maintained to prove that your non-profit corporation is not confused with your personal existence. You are a taxable person - your foundation is a tax-exempt person. If your records and your foundation's records are confused your foundation loses its tax-exemption.

The rules against self-dealing are really good guides to prevent this confusion. No bona fide benefits are lost through complying with the rules against the existing prohibitive transactions.

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Distribute EXHIBIT #11.

Distribution Requirements

The Internal Revenue Code does require distribution of income by a foundation. The rule is called "the unreasonable accumulation of income prohibition". The rule is a foundation may lose its tax-exempt status from accumulating an unreasonable amount of income within a certain period of time without using, disbursing or dedicating the funds for an exempt purpose. This is the rule that seems to say that a foundation must give all of its earnings away each year. This is not true. An examination of the various terms used within the rule in the light of the Treasury definitions and court decisions should be made.

First, the term "accumulation" means that the funds in question must be surplus after expenses and uses. A foundation might earn a million dollars, but if it accumulates only \$100,000 out of a million

EXHIBIT 11WHAT FOUNDATIONS CAN AND CAN'T DO

Being a corporation, the foundation normally will have all the rights and powers enjoyed by similar corporate organizations under State law and there is no need to enumerate them other than to say that they are almost invariably wide enough to allow any act desired by the directors. For example, the Illinois General Not-For-Profit Corporation Act provides "Each corporation shall have power:...to have and exercise all powers necessary or convenient to effect any or all of the purposes for which the corporation is organized." IGNEPCA, § 5(n).

For our purposes here, a more relevant question is: what acts should not be performed in order to preserve the foundation favorable tax status.

1. A foundation is prohibited from entering into the following transactions with a substantial donor or his family.
 - (a) lending any part of its income or corpus, without the receipt of adequate security and a reasonable rate of interest;
 - (b) paying any compensation, in excess of a reasonable allowance for salaries or other compensation for personal services actually rendered;
 - (c) making any part of its services available on a preferential basis;
 - (d) making any substantial purchase of securities or any other property, for more than adequate consideration in money or money's worth;
 - (e) selling any substantial part of its securities or other property, for less than an adequate consideration in money or money's worth;
 - (f) engaging in any other transaction which results in a substantial diversion of its income or corpus to such person.
2. The foundation is further prohibited from performing any of the following acts:
 - (a) accumulating an unreasonable amount of income;
 - (b) using its income to a substantial degree for purposes unrelated to its exemption.

- (c) investing its income in such a way as to jeopardize its ability to carry out its purposes. (Note: these last three prohibitions apply only to income and not to corpus (c.g. gifts or donations received) and in practice present no particular problem with good counseling.
3. A foundation may not endorse a particular political candidate or advocate passage of a particular piece of legislation. It may, however, advocate a particular point of view. E.G., a conservation group could advocate the desirability of conservation but could not advocate approval of a particular law to achieve conservation.

These are general descriptions of the activities which will imperil a foundation's tax exempt status and are found in section 501 to 504 of the Internal Revenue Code.

Unrelated Business Income

There is a situation in which a foundation may be subject to income tax on certain of its earning without affecting its exempt status. This is called a tax on unrelated business income. Although there are a good many limitations on this tax, the general rule is that an exempt organization is taxable at corporate rates on the income from a trade or business regularly carried on by the organization, the conduct of which is not substantially related to the performance of the organization's exempt purpose.

For example, a tax-exempt clinic would pay no tax on its fees from patients but might be taxable on the income of a restaurant operated by the clinic in its building which served the public. Of course, since income from investments is generally untaxed, the clinic could incorporate the restaurant, own all the stock, and pay no tax on the dividends received from the restaurant corporation.

This tax on unrelated income does not apply to income from interest, dividends, royalties, most rents, and passive investments generally. The only problem with rents may arise under certain types of leases on property which is subject to a debt incurred in purchasing it.

The unrelated business tax is apparently not a major item in the tax treatment of exempt organizations. During the year 1962, for example, only 1,648 report forms (990-T) were filed with the Internal Revenue Service.

* * * * *

dollars, then only \$100,000 is subject to the rule and not the \$900,000 that was earned and disbursed.

Second, the term unreasonable amount is entirely dependent upon the size of the foundation. One million dollars of accumulation might be unreasonable for your foundation, but it would be a mere drop in the bucket for the Ford Foundation and could not be considered unreasonable. The term reasonable time has been construed to mean from one to ten years, so even if you were to accumulate a large amount of income you would still have, according to some court rulings up to ten years to use, disburse or dedicate the funds.

The term "income" also has a special definition. Income does not include earnings or gains from short or long term capital gains or contributions. In other words, if you receive funds as contributions or make capital gains earnings, these funds are not subject to this rule. Only income earned from rents, dividends, interest, royalties and related or unrelated sources are considered income.

Finally, if you do use or disburse the funds

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within a reasonable time (1 to 10 years) the funds are no longer subject to criticism. You may also dedicate the funds to a specific purpose.

For example, let us state that you wish to accumulate \$2,000 a year to an educational fund for educational purposes. The funds may be accumulated for as long as the board of directors desire or the fund may be periodically drawn upon to finance educational activities. The board of directors under present law is not required to use the funds for educational purposes. The board of directors may rededicate the funds to another exempt purpose. It is not recommended that such rededication be accomplished without bona fide consideration and good intent. It is recommended that if the foundation wishes to dedicate funds for accumulative purposes that it explore a valid and serious dedication purpose prior to the dedication. It is also suggested that the foundation have an idea for what the funds will be used prior to the dedication. Every time you remove funds from a dedicated purpose without using

them for the purpose, the foundation becomes liable to criticism under the unreasonable accumulations rule.

Since the reality of your foundation's long-range dedication programs is relevant to the validity of a large dedication, care should be taken to choose projects that truly require a large amount of money to succeed. Building funds, giant, specific scientific projects, and the creation of schools are some conventional ideas. Libraries, museums, or large non-profit facilities are some other ideas. Special funds, such as the educational accumulation fund, tend to grow rapidly due to the exemption from taxation. Nothing is wrong with this provided that the funds are later used for a good purpose. The Ford Foundation has more than doubled its endowment since it was founded. This has been in spite of the rule against accumulations and in spite of its substantial charitable activities. The Mott Foundation has grown nearly a thousand times since its founding 30 years ago. Accumulation of income is allowed within the limits that have been stated. As long as

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the foundation board of directors maintains a proper attitude no questions should be raised.

The growth of your foundation and its endowment to permit greater flexibility, and to provide greater benefits to mankind, is not discouraged by the Treasury, nor prohibited by the Internal Revenue Code. Your foundation may accumulate large amounts of funds.

It is recommended that if you do not disburse accumulated income to other foundations, that you dedicate the funds to a specific realistic purpose. It is also recommended that you review this fund periodically for possible use or change of dedication.

It is also recommended that the funds be used for that purpose, at least in part, within the lifetime of any particular set of board of directors.

Distribute EXHIBIT #12.

Taxable income

Not all income to the foundation is tax-exempt.

EXHIBIT 12

UNREASONABLE ACCUMULATION OF INCOME

Section 504(a) of the Internal Revenue Code states that a section 501(c)(3) organization shall be denied exemption if the amounts accumulated out of income during the taxable year or any prior taxable year and not actually paid out by the end of the taxable year are unreasonable in amount or duration in order to carry out the charitable, educational or other purpose or function constituting the basis for exemption under section 501 of the Internal Revenue Code.

This language seems to indicate that unless you spend, use or give away all your money during any particular year, you will lose your tax exemption. This is not so. We will analyze in the following paragraphs each of the elements of this rule to explain in detail what the rule says, what must be done under the rule; and what might be done to avoid the rule.

(a) Income - The Internal Revenue Code has several definitions of income. Each of these definitions apply in different situations. The definition of income to a tax-exempt organization organized under section 501(c)(3) of the Internal Revenue Code is as follows:

Income shall include all unrelated business income, rents, royalties, dividends, interest and fees received related to the purpose of your organization.

Income does not include contributions or capital gains. The term "income" then does not include all the sources of funds or earnings that your foundation might enjoy. Only those monies or properties that could be classified as income under the above definition are subject to the distribution requirements of the rule against unreasonable accumulation of income.

(b) Unreasonable Amount - The amount of income accumulated in any year must be unreasonable. The term unreasonable is viewed in two lights. First, unreasonable in relation to the size of the foundation. Five thousand dollars is certainly a great deal of money. To many foundations, \$5,000 would be an unreasonable amount if accumulated in a one-year period. However, \$5,000 would be a drop in the bucket to the Ford or Rockefeller Foundations. The amount must then be measured against the size and scope of the foundation in question. Second, an unreasonable amount must be unreasonable by other standards. The court standards used to date have indicated that \$500,000 might not be an unreasonable amount. The Treasury has claimed that amounts as low as \$330,000 have been unreasonable accumulations of income. The courts have disagreed and have usually defined unreasonable accumulation violations only in terms of amounts exceeding \$1,000,000.

The actual limits of what "unreasonable" might be can only be determined on a case-by-case situation-by-situation basis. There are no arbitrary or clear standards in the law.

(c) Unreasonable Time - If your foundation should earn a large amount of income within a single year it is given a reasonable time in which to do something with it. What is a reasonable time? Courts have construed this to be as much as ten years. We recommend, however, that consideration of the proper use of the funds, particularly in terms of dedication to a long-range purpose which will be discussed later, be accomplished within two to three years after the funds have been earned.

(d) Use, Disbursement, and Dedication of Income - If a large amount of income is earned in any year, it is not subject to the rule against unreasonable accumulation of income unless it is actually accumulated. To avoid accumulation, a foundation must either use the funds or distribute the funds to other 501(c)(3) organizations or dedicate the funds to a proper long-range purpose.

Most people understand what present use of income means and this will not be discussed in detail in this section. There should also be no problem with understanding the concept of distribution to other charitable organizations. In other words, your foundation would simply give the money away.

The dedication of large amounts of income, however, is a technical procedure and should be discussed in some detail. A foundation may actually dedicate large amounts of income to a long-range purpose and accumulate the funds until it has enough to accomplish that purpose. A famous example occurred when the Hulman Foundation dedicated funds amounting to over \$3,000,000 over a period of several years toward building a racing museum at the Indianapolis "500" Race Track. The Treasury Department didn't think this was a proper purpose but the courts did. The Hulman Foundation won its case for accumulation of income.

One principal guideline should be mentioned in dedicating funds. The dedication must be for a purpose that is realistically long-range, feasible, and practical. The Treasury has strenuously objected to ethereal dedications or long-range dedications for short-term projects. Secondary guidelines to be considered for dedicating funds for future purposes are:

- (a) The funds should be kept in a separate account. (This will enable the funds to be used for investment purposes apart from the other investment programs or savings programs of the foundation.)
- (b) The dedication should be stated clearly in a minute of the board of directors of the foundation and may even be communicated to the bank or securities dealer where the foundation account is kept. This is not required, however.

Conclusion

As you can see, the rule against the unreasonable accumulation of income is not as strenuous as it first seems. You do not have to give away all your money every year nor do you need dedicate it unless you feel the amount itself is unreasonable. Today, because the courts and the Treasury have never considered relatively small amounts to be unreasonable, it is safe to assume that accumulation up to a quarter of a million dollars could be accomplished without question, even without dedication.

* * * * *

Some of the income of your foundation may be taxed at corporate rates. This income is called unrelated business income and is usually derived from sources outside of the seven tax-exempt sources.

To review, the seven tax-exempt sources of income are:

1. Related Fees
- 2.. Royalties
3. Most rents
4. Capital gains
5. Contributions
6. Dividends
7. Interest

Unrelated business income is income that is not derived from the exempt activities of the foundation. The Treasury defines "unrelated trade or business" as income from any business activity regularly carried on that is not derived from an activity directly related to tax-exempt purpose. Since this definition might include your foundation's operations we must look to the meaning of "unrelated". Unrelated business

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activity or trade is trade or business not substantially related to the organization's performance of its exempt functions, where the trade or business is regularly carried on by the organization. We should break down the meaning of this definition in detail.

First of all, the unrelated business activities must be carried on regularly by the foundation. The periodic sale of real estate by a foundation will not necessarily make the foundation a real estate broker, unless the activities are carried on regularly. In other words, if the foundation sells a piece of property, this sale would be a trade or business activity, but it is not a regular activity. There must be a frequency and continuity with which the activities productive of the income are conducted, and a regular manner in which they are pursued.

Specific business activities of an exempt organization will be considered to be "regularly carried on" if they occur frequently and may be compared to commercial activities of non-exempt organizations. But these business activities will only be taxable,

if they are unrelated to the exempt purposes of the organization. For example, the regular sale of drug supplies to the general public by a hospital pharmacy is not taxable since the hospital merely furnishes supplies in accordance with its exempt purposes. In the same way, sales of books by a college book store to students or sales of goods, where the exempt function of the organization involved the sale of goods, would not be unrelated business activity. If the trade or business is substantially related to the exempt purpose there is no tax liability. The Treasury states that where the production or distribution of the goods or the performance of services does contribute importantly to the accomplishment of the exempt purpose of the organization, the income from the sale of the goods or the performance of the service is a related trade or business, but the relationship is a matter of fact in each case and the Treasury has refused to lay down substantial standards of relation. They have chosen instead to review each case as it occurs. The Treasury is

unable to set out clear standards due to the variety of permissible foundation activities.

Where questions have occurred in the past, special rulings have been requested and obtained by other organizations. Considerable pressure was placed upon the Treasury for favorable rulings in these cases. It is suggested that the standards set by the Treasury, regulations are ambiguous and vague and, therefore, may allow unreasonable arbitrary action by the Treasury.

The Treasury, however, has given some examples and a few rules which may be helpful in determining relation of a business activity to your foundation's exempt purpose.

In one example the Treasury stated that where a school existed for training children in the performing arts, such as acting, singing and dancing, that income derived from admission charges for the performances of its students were tax-exempt and related, since the students' participation in the performance was an essential part of their training. In the same

way, the sale of products and articles produced by handicapped persons being rehabilitated by a foundation was considered to be related income, since the sale in the production contributed importantly to the accomplishment of the rehabilitation of the handicapped.

In the case of an experimental dairy herd maintained for scientific purposes by an organization described in section 501 (c) (3) foundation income from the sale of milk and cream produced in the ordinary course of operation would not be gross income from unrelated sources of income. On the other hand, the Treasury stated that if the organization were to manufacture ice cream, pastries and the like, that the sale would be considered income from these products and would be unrelated trade or business income.

The Treasury is constantly attempting to reduce the scope of related business income. In one of their recent attempts they revised the regulations on unrelated business income to include advertising revenue derived by tax-exempt magazines. The

National Geographic, Nation's Business, and Journal of American Medical Association are three of the largest magazines affected. If the regulation is upheld as being proper then the organization involved will probably obtain special rules to exempt them from the regulations.

This tends to show the sometimes arbitrary nature of the Treasury's regulations and rules. Special rulings may be obtained to exempt any person from any regulation proposed or used by the Treasury.

Probably the most common situation which your foundation might encounter is the so-called "business lease". Briefly stated, the business lease is a lease for longer than five years on property owned by an exempt organization which is subject to a debt incurred in its acquisition. In such a "business lease" situation, a portion of the rental received by the exempt organization is taxed as unrelated business income. While this rule may seem a bit arbitrary, its purpose is to discourage foundations from trading on their tax-exemption and "empire building" by

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securing real estate purchases with long term leases.

Your foundation, however, may conduct unrelated business activities without endangering or affecting the foundation's exempt status, if

1. the unrelated business activity does not constitute an overwhelming or primary part of the foundation's activities
2. the foundation reports and pays corporate taxes on the unrelated income by March 15 following every calendar fiscal year.

This unrelated business income is reported and the taxes are paid on form 990-T provided by the Internal Revenue Service.

We do not have the time to discuss details of taxation of unrelated business income. It is recommended that if you propose business activity that you consult with counsel to determine the tax status and reporting methods that are required. Your foundation has an automatic \$1,000 exemption from unrelated business income, and since it is taxed at corporate rates on the rest of its unrelated business income, your foundation may also take advantage of all of the conventional corporate tax deductions and

advantages. These deductions would include normal business expenses, capital losses, depreciation and any and all other normal business deductions. Your attorney should be able to advise you on what portions of your foundation's expenses might be used to offset taxation of unrelated business income. The Treasury regulations are quite liberal in what they allow and quite often all or most of taxable unrelated business income can be offset by business deductions.

Distribute EXHIBIT #13.

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EXHIBIT #13

Proposed Rule Making

DEPARTMENT OF THE TREASURY

Internal Revenue Service

[26 CFR Part 1]

TREATMENT OF INCOME FROM UN-RELATED TRADE OR BUSINESS

Notice of Proposed Rule Making

Notice is hereby given that the regulations set forth in tentative form below are proposed to be prescribed by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury or his delegate. Prior to the final adoption of such regulations, consideration will be given to any comments or suggestions pertaining thereto which are submitted in writing, in duplicate, to the Commissioner of Internal Revenue, Attention: CC: LR: T, Washington, D.C. 20224, within the period of 30 days from the date of publication of this notice in the *FEDERAL REGISTER*. Any person submitting written comments or suggestions who desires an opportunity to comment orally at a public hearing on these proposed regulations should submit his request, in writing, to the Commissioner within the 30-day period. In such case, a public hearing will be held, and notice of the time, place, and date will be published in a subsequent issue of the *FEDERAL REGISTER*. The proposed regulations are to be issued under the authority contained in section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805).

[SEAL] SHELDON S. COHEN,
Commissioner of Internal Revenue.

In order to clarify the meaning of the terms "unrelated business taxable income" and "unrelated trade or business" as they relate to certain exempt organizations, the Income Tax Regulations (26 CFR Part 1) under sections 513 and 514 of the Internal Revenue Code of 1954 are amended as follows:

PARAGRAPH 1. Paragraphs (b) and (c) of § 1.513-1 are respectively redesignated as paragraphs (e) and (f), and § 1.513-1 is otherwise amended to read as follows:

§ 1.513-1 Definition of unrelated trade or business.

(a) *In general.* As used in section 512 the term "unrelated business taxable income" means the gross income derived by an organization from any unrelated trade or business regularly carried on by it, less the deductions and subject to the exceptions, additions and limitations provided in section 512. Section 513 specifies with certain exceptions that the phrase "unrelated trade or business" means, in the case of an organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related

(aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational or other purpose or function constituting the basis for its exemption under section 501 (or, in the case of an organization described in sec. 511(a) (2) (B), to the exercise or performance of any purpose or function described in sec. 501 (c) (3)). (For certain exceptions from this definition, and a special rule for certain publishing businesses, see paragraphs (e) and (f) of this section. For a special definition of "unrelated trade or business" applicable to certain trusts, see sec. 513(b).) Therefore, unless one of the specific exceptions of section 512 or 513 is applicable, gross income of an exempt organization subject to the tax imposed by section 511 is includible in the computation of unrelated business taxable income if (1) it is income from trade or business, (2) the conduct of such trade or business is not substantially related (other than through the production of funds) to the organization's performance of its exempt functions and (3) such trade or business is regularly carried on by the organization.

(b) *Trade or business.* For the purposes of section 512 the term "trade or business" has the same meaning it has in section 162, and generally includes any activity carried on for the production of income from the sale of goods or performance of services. The term "trade or business" thus is not limited to integrated aggregates of assets, activities and good-will which comprise businesses for the purposes of certain other provisions of the Internal Revenue Code. Activities of producing or distributing goods or performing services from which a particular amount of gross income is derived do not lose identity as trade or business merely because they are carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization. Thus, for example, the regular sale of pharmaceutical supplies to the general public by a hospital pharmacy does not lose identity as trade or business merely because the pharmacy also furnishes supplies to the hospital in accordance with its exempt purposes. Similarly, activities of soliciting, selling, and publishing commercial advertising do not lose identity as trade or business even though the advertising is published in an exempt organization periodical which contains editorial matter related to the exempt purposes of the organization.

(c) *Regularly carried on.* (1) *General principles.* In determining whether trade or business from which a particular amount of gross income derives is

"regularly carried on," within the meaning of section 512, regard must be had to the frequency and continuity with which the activities productive of the income are conducted and the manner in which they are pursued. This requirement must be applied in light of the fundamental purpose of the unrelated business income tax to place the business activities of exempt organizations upon the same tax basis as commercial endeavors with which they compete. Hence, for example, specific business activities of an exempt organization will ordinarily be deemed to be "regularly carried on" if they manifest a frequency and continuity, and are pursued in a manner, generally similar to comparable commercial activities of nonexempt organizations.

(2) *Application of principles.* (i) *Normal time span of activities.* Where income producing activities are of a kind normally conducted by nonexempt commercial organizations on a year-round basis, the conduct of such activities by an exempt organization over a period of only a few weeks does not constitute the regular carrying on of trade or business. For example, the operation of a sandwich stand by a hospital auxiliary for the 2-week period of an annual state fair would not be the regular conduct of trade or business. However, the conduct of year-round business activities for one day each week would constitute the regular carrying on of trade or business. Thus, the operation of a commercial parking lot on Saturday of each week would be the regular conduct of trade or business. Where income producing activities are of a kind normally undertaken by nonexempt commercial organizations only on a seasonal basis, the conduct of such activities by an exempt organization during a significant portion of the season ordinarily constitutes the regular conduct of trade or business. For example, the operation of a track for horse racing for several weeks each year would be considered the regular conduct of trade or business because it is usual to carry on such trade or business only during a particular season.

(ii) *Commercial attributes of intermittent activities.* In determining whether or not intermittently conducted activities are regularly carried on, the manner of conduct of the activities must be compared with the manner in which commercial activities are normally pursued by nonexempt organizations. In general, exempt organization business activities which are engaged in only discontinuously or periodically will not be considered regularly carried on if they are conducted without the competitive and promotional efforts typical of commercial endeavors. For example, the sale of advertising in programs for

Sports events or music or drama performances would not ordinarily be deemed to be the regular carrying on of business where no systematic endeavors are made to develop and promote this class of business in the manner of a commercial publication. Similarly, where the exempt function of an organization involves the sale of certain types of goods or services to a particular class of persons (as, for example, sales of books by a college bookstore to students), casual sales in the course of such activity, which are not related to the exempt function involved, do not generally constitute the regular conduct of unrelated trade or business. On the other hand, where the organization systematically and consistently caters to a customer class unrelated to its exempt functions or sells products unrelated to the performance of such functions, the unrelated selling activities meet the section 512 requirement of regularity.

(iii) *Occasional or sporadic activities.* Income producing activities undertaken only occasionally or sporadically generally will not be regarded as trade or business regularly carried on. For this purpose, an income producing or fund raising event lasting only a short period of time will not be regarded as regularly carried on merely because it is conducted on an annually recurrent basis. Accordingly, income derived from the conduct of an annual dance or similar fund raising event for charity would not be income from trade or business regularly carried on.

(d) *Substantially related.*—(1) In general. Gross income derives from "unrelated trade or business," within the meaning of section 513(a), if the conduct of the trade or business which produces the income is not substantially related (other than through the production of funds) to the purposes for which exemption is granted. The presence of this requirement necessitates an examination of the relationship between the business activities which generate the particular income in question—the activities, that is, of producing or distributing the goods or performing the services involved—and the accomplishment of the organization's exempt purposes.

(2) *Type of relationship required.* Trade or business is "related" to exempt purposes, in the relevant sense, only where the conduct of the business activities has causal relationship to the achievement of exempt purposes (other than through the production of income); and it is "substantially related," for purposes of section 513, only if the causal relationship is a substantial one. For the conduct of trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is granted, the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes. Where the production or distribution of the goods or the performance of the services does not contribute importantly to the accomplishment of the exempt pur-

poses of an organization, the income from the sale of the goods or the performance of the services does not derive from the conduct of related trade or business. Whether activities productive of gross income contribute importantly to the accomplishment of any purpose for which an organization is granted exemption depends in each case upon the facts and circumstances involved.

(3) *Size and extent of activities.* 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 which they purport to serve. Thus, where income is realized by an exempt organization from activities which are in part related to the performance of its exempt functions, but which are conducted on a larger scale than is reasonably necessary for performance of such functions, the gross income attributable to that portion of the activities in excess of the needs of exempt functions constitutes gross income from the conduct of unrelated trade or business. Such income is not derived from the production or distribution of goods or the performance of services which contribute importantly to the accomplishment of any exempt purpose of the organization.

(4) *Application of principles.*—(i) *Income stemming directly from performance of exempt functions.* Gross income derived directly from the performance of exempt functions does not constitute gross income from the conduct of unrelated trade or business. The following examples illustrate the application of this principle:

Example (1). * M, an organization described in section 501(c)(3), operates a school for training children in the performing arts, such as acting, singing, and dancing. It presents performances by its students and derives gross income from admission charges for the performances. The students' participation in performances before audiences is an essential part of their training. Since the income realized from the performances derives from activities which contribute importantly to the accomplishment of M's exempt purposes, it does not constitute gross income from unrelated trade or business. (For specific exclusion applicable in certain cases of contributed services, see section 513(a)(1) and paragraph (e)(1) of this section.)

Example (2). N is a trade union qualified for exemption under section 501(c)(5). To improve the trade skills of its members, N conducts refresher training courses and supplies handbooks and technical manuals. N receives payments from its members for these services and materials. However, the development and improvement of the skills of its members is one of the purposes for which exemption is granted N; and the activities described contribute importantly to that purpose. Therefore, the income derived from these activities does not constitute gross income from unrelated trade or business.

Example (3). O is an industry trade association qualified for exemption under section 501(c)(6). It presents a trade show in which members of its industry join in an exhibition of industry products. O derives income from charges made to exhibitors for exhibit space and admission fees charged

patrons or viewers of the show. The show is not a sales facility for individual exhibitors; its purpose is the promotion and stimulation of interest in, and demand for, industry's products in general, and conducted in a manner reasonably calculated to achieve that purpose. The stimulation of demand for the industry's products in general is one of the purposes for which exemption is granted O. Consequently, the activities productive of O's gross income from the show—that is, the promotion, organization and conduct of the exhibition—contribute importantly to the achievement of an exempt purpose, and the income does not constitute gross income from unrelated trade or business.

(ii) *Disposition of product of exempt functions.* Ordinarily, gross income from the sale of products which are a direct result of the performance of exempt functions does not constitute gross income from the conduct of unrelated trade or business if the product is sold in substantially the same state it is in on completion of the exempt functions. Thus, in the case of an organization described in section 501(c)(3) and engaged in a program of rehabilitation of handicapped persons, income from sale of articles made by such persons as a part of their rehabilitation training would not be gross income from conduct of unrelated trade or business. The income in such case would be from sale of products, the production of which contributed importantly to the accomplishment of purposes for which exemption is granted the organization—namely, rehabilitation of the handicapped. On the other hand, if a product resulting from an exempt function is utilized or exploited in further business endeavor beyond that reasonably appropriate or necessary for disposition in the state it is in upon completion of exempt functions, the gross income derived therefrom would be from conduct of unrelated trade or business. Thus, in the case of an experimental dairy herd maintained for scientific purposes by an organization described in section 501(c)(3), income from sale of milk and cream produced in the ordinary course of operation of the project would not be gross income from conduct of unrelated trade or business. On the other hand, if the organization were to utilize the milk and cream in the further manufacture of food items such as ice cream, pastries, etc., the gross income from the sale of such products would be from the conduct of unrelated trade or business.

(iii) *Dual use of assets or facilities.* In certain cases, an asset or facility necessary to the conduct of exempt functions may also be employed in a commercial endeavor. In such cases, the mere fact of the use of the asset or facility in exempt functions does not, by itself, make the income from the commercial endeavor gross income from related trade or business. The test, instead, is whether the activities productive of the income in question contribute importantly to the accomplishment of exempt purposes. Assume, for example, that a museum exempt under section 501(c)(3) has a theater auditorium which is specially designed and equipped for showing of educational films in connection

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with its program of public education in the arts and sciences. The theater is a principal feature of the museum and is in continuous operation during the hours the museum is open to the public. If the organization were to operate the theater as an ordinary motion picture theater for public entertainment during the evening hours when the museum was closed, gross income from such operation would be gross income from conduct of unrelated trade or business.

(iv) *Exploitation of exempt functions.* In certain cases, activities carried on by an organization in the performance of exempt functions may generate good will or other intangibles which are capable of being exploited in commercial endeavors. Where an organization exploits such an intangible in commercial activities, the mere fact that the resultant income depends in part upon an exempt function of the organization does not make it gross income from related trade or business. In such cases, unless the commercial activities themselves contribute importantly to the accomplishment of an exempt purpose, the income which they produce is gross income from the conduct of unrelated trade or business. The application of this subdivision is illustrated in the following examples:

Example (1). U, an exempt scientific organization, enjoys an excellent reputation in the field of biological research. It exploits this reputation regularly by selling endorsements of various items of laboratory equipment to manufacturers. The endorsing of laboratory equipment does not contribute importantly to the accomplishment of any purpose for which exemption is granted U. Accordingly, the income derived from the sale of endorsements is gross income from unrelated trade or business.

Example (2). V, an exempt university, has a large regularly enrolled student body. During the school year, V sponsors the appearance of professional theater companies and symphony orchestras which present drama and musical performances to the students. V advertises these performances to its students, provides a university theater building for their presentation, and supervises advance ticket sales at various university facilities, including the cafeteria and the university bookstore. V derives gross income from the conduct of the performances. However, the presentation of drama and music events contributes importantly to the overall educational function of the university. Therefore, the income which V receives does not constitute gross income from the conduct of unrelated trade or business.

Example (3). W is an exempt business league with a large membership. Under an arrangement with an advertising agency, W regularly mails brochures, pamphlets, and other commercial advertising materials to its members, for which service W endorses the agency an agreed amount per enclosure. The distribution of the advertising materials does not contribute importantly to the accomplishment of any purpose for which W is granted exemption. Accordingly, the payments made to W by the advertising agency constitute gross income from unrelated trade or business.

Example (4). X, an exempt organization for the advancement of public interest in classical music, owns a radio station and operates it in a manner which contributes importantly to the accomplishment of the purposes for which the organization is granted exemption. However, in the course

of the operation of the station the organization derives gross income from the regular sale of advertising time and services to commercial advertisers in the manner of an ordinary commercial station. Neither the sale of such time nor the performance of such services contributes importantly to the accomplishment of any purpose for which the organization is granted exemption. Notwithstanding the fact that the production of the advertising income depends upon the existence of the listening audience resulting from performance of exempt functions, such income is gross income from unrelated trade or business.

Example (5). Y, an exempt university, provides facilities, instruction and faculty supervision for a campus newspaper operated by its students. In addition to news items and editorial commentary, the newspaper publishes paid advertising. The solicitation, sale, and publication of the advertising are conducted by students, under the supervision and instruction of the university. Although the services rendered to advertisers are of a commercial character, the advertising business contributes importantly to the university's educational program through the training of the students involved. Hence, none of the income derived from publication of the newspaper constitutes gross income from unrelated trade or business.

Example (6). Z, an exempt trade association, publishes a monthly journal. The publication of the articles and other editorial content of the journal contributes importantly to the accomplishment of purposes for which exemption is granted the organization. Income from the sale of subscriptions to members and others in accordance with the organization's exempt purposes, therefore, does not constitute gross income from unrelated trade or business. In connection with the publication of the journal, Z also derives income from the regular sale of advertising space and services to commercial advertisers. Neither the publication of advertisements nor the performance of services for commercial advertisers contributes importantly to the accomplishment of any purpose for which exemption is granted Z. Therefore, notwithstanding the fact that the production of income from advertising utilizes the circulation developed and maintained in the performance of exempt functions, such income is gross income from unrelated trade or business. That result follows even though the advertising is of products and services within the general area of professional or business interest of the members and other readers.

(e) . . .

(f) . . .

PAR. 2. Section 1512(a)-1 is amended to read as follows:

§ 1512(a)-1 Definition.

(a) *In general.* Section 512 defines "unrelated business taxable income" as the gross income derived from any unrelated trade or business regularly carried on, less those deductions allowed by chapter 1 of the Code which are directly connected with the carrying on of such trade or business, subject to certain exceptions, additions and limitations referred to in § 1512(b)-1. To be deductible in computing unrelated business taxable income, therefore, expenses, depreciation, and similar items not only must qualify as deductions allowed by chapter 1 of the Code, but also must be directly connected with the carrying on

of unrelated trade or business. Except as provided in subparagraph (2) of paragraph (d) of this section, to be "directly connected with" the conduct of unrelated business, for purposes of section 512, an item of deduction must have proximate and primary relationship to the carrying on of that business. In the case of an organization which derives gross income from the regular conduct of two or more unrelated business activities, unrelated business taxable income is the aggregate of gross income from all such unrelated business activities less the aggregate of the deductions allowed with respect to all such unrelated business activities.

(b) *Expenses attributable solely to unrelated business.* Expenses, depreciation and similar items attributable solely to the conduct of unrelated business are proximately and primarily related to that business and therefore qualify for deduction to the extent that they meet the requirements of section 162, section 167, or other relevant provisions of the Internal Revenue Code. Thus, for example, salaries of personnel employed full-time in carrying on unrelated business are directly connected with the conduct of the unrelated business and are deductible in computing unrelated business taxable income if they otherwise qualify for deduction under the requirements of section 162. Similarly, depreciation of a building used entirely in the conduct of unrelated business would be an allowable deduction to the extent otherwise permitted by section 167.

(c) *Dual use of facilities or personnel.* Where facilities or personnel are used both to carry on exempt functions and to conduct unrelated trade or business, expenses, depreciation, and similar items attributable to such facilities or personnel (as, for example, items of overhead) shall be allocated between the two uses on a reasonable basis. The portion of any such item so allocated to the unrelated trade or business is proximately and primarily related to that business, and shall be allowable as a deduction in computing unrelated business taxable income in the manner and to the extent permitted by section 162, section 167, or other relevant sections of the Internal Revenue Code. Thus, for example, assume that X, an exempt organization subject to the provisions of section 511, pays its president a salary of \$20,000 a year. X derives gross income from the conduct of unrelated trade or business. The president devotes approximately 10 percent of his time during the year to the unrelated business. For purposes of computing X's unrelated business taxable income, a deduction of \$2,000 (\$20,000 times 10 percent) would be allowable for the salary paid to its president.

(d) *Exploitation of exempt functions—(1) In general.* In certain cases, gross income may be derived from unrelated trade or business which exploits an exempt function. Except as specified in subparagraph (2) of this paragraph, in such cases expenses, depreciation and similar items attributable to the conduct of the exempt function are not

deductible in computing unrelated business taxable income. Since such items are incident to a function of the type which it is the chief purpose of the organization to conduct, they do not possess proximate and primary relationship to the unrelated trade or business. Therefore, they do not qualify as directly connected with that business.

(2) *Allowable deductions.* Where unrelated trade or business is of a kind carried on for profit by taxable organizations and where the exempt activity exploited by the business is a type of activity normally conducted by taxable organizations in pursuance of such business, the expenses, depreciation, and similar items which are attributable to the exempt activity qualify as directly connected with the carrying on of the unrelated trade or business to the extent that:

(i) The aggregate of such items exceeds the income (if any) derived from or attributable to the related activities; and

(ii) The allocation of such excess to the unrelated activities does not result in a loss from such unrelated trade or business.

Under the rule of the preceding sentence, expenses, depreciation and similar items paid or incurred in the performance of an exempt function must be allocated first to the exempt function to the extent of the income derived from or attributable to the performance of that function. Furthermore, such items are in no event allocable to the unrelated business activities to the extent that their deduction would result in a loss carryover or carryback with respect to the particular conduct of trade or business involved. Similarly, they may not be taken into account in computing unrelated business taxable income attributable to the conduct of unrelated trade or business not exploiting the same exempt activities.

(3) *Examples.* The provisions of this paragraph are illustrated by the following examples:

Example (1). W is an exempt business league with a large membership. Under an arrangement with an advertising agency W regularly mails brochures, pamphlets and other commercial advertising materials to its members, charging the agency an agreed amount per enclosure. The cost of the advertising materials does not contribute importantly to the accomplishment of the purpose for which W is granted exemption. Accordingly, the payments made to W by the advertising agency constitute gross income from unrelated trade or business. In computing W's unrelated business taxable income, the expenses attributable solely to the conduct of the business are allowable as deductions in accordance with the provisions of section 162. Such deductions include the costs of handling and mailing, the salaries of personnel used fulfilling in the unrelated business and an allocable portion of the salaries of personnel used both to carry on exempt functions and to conduct the unrelated business. However, costs of developing W's membership and carrying on its exempt activities are not deductible. Those costs are necessary to the maintenance of the intangible asset exploited in the unrelated business—W's membership—but are incurred primarily in connection with W's fundamental status and functioning as an exempt organization. As a consequence, they do not have proximate and primary relationship to the conduct of the unrelated business, and do not qualify as directly connected with it.

Example (2). Z, an exempt business league, publishes a monthly journal which it sells by subscription to members and others. The articles and other editorial content of the journal contribute importantly to the accomplishment of Z's exempt purposes. Therefore, the subscription income does not constitute gross income from unrelated trade or business. In connection with the publication of the journal, Z derives income from the sale of advertising space to commercial advertisers. Since the provision of commercial advertising space does not contribute importantly to the accomplishment of Z's exempt purposes, Z's income from advertising constitutes gross income from unrelated trade or business.

In computing Z's unrelated business taxable income, allowable deductions would (subject to the rules provided in section 162 and other relevant sections of the Internal Revenue Code) include the specific costs of the advertising activity, such as advertising copy and mechanical costs, advertising sales commissions and similar expenses. Also allowable would be items of deduction (such as general overhead expenses and depreciation) allocable to the advertising activity in accordance with the rule of paragraph (c) of this section. In addition, since expenses, depreciation, and similar items related to the production and distribution of the editorial content of the journal are costs generally incurred by taxable organizations publishing journals with advertising, such items will be treated as directly connected with the conduct of the unrelated trade or business. Thus, subject to the limitations of subdivisions (i) and (ii) of subparagraph (2) of this paragraph, they would be allowable as deductions in computing Z's unrelated business taxable income to the extent provided in section 162, section 167, and other relevant sections of the Internal Revenue Code.

[P.R. Doc. 67-4206; Filed, Apr. 13, 1967; 11:16 a.m.]

SECTION 5Foundation Operation GuidesGrant program and Charity

The most significant distinction between the foundation as an alternate business form and other business forms is in the area of use of funds for non-income-producing purposes. A foundation, by definition, has a wide variety of reasons for which it may use its funds. The foundation may be active

in the broadest application of the terms religion, education, science, charity and literature. All forms of human progress and activity may be encouraged or investigated by the foundation.

In order to avoid questions from the Internal Revenue Service or Congress as to the propriety of the disbursement of funds, proper procedures should be employed in a consistent fashion. In other words, although any reasearch development, inquiry, investigation, educational material, lectures, charity, welfare or philosophy may be promoted by a foundation. There are established methods for promoting these things that are accepted today as a matter of course by governments and others in this country. It is generally known that if activities are carried on in such a way as to avoid direct competition with the commercial world, or to avoid foundation funds inuring to the benefit of any individual, such procedures are approved.

First, we should explore a few of the things you might accomplish through a proper grant structure or

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charity structure. We will then discuss how these things are accomplished.

The most obvious foundation activities occur in the field of education. Foundations give scholarships and grants to students and educational institutions in great amounts. Any student of a bona fide educational institution may be awarded a scholarship to pay tuition, books, fees and expenses incidental to that educational experience. The institution itself may, in fact, receive a grant or endowment for its general fund or for a particular purpose.

In the same way, other educational experience may be supported, such as seminars and short courses in various subjects. The building or financing of an educational institution, the creation of a library in church, school, hospital or other institution, or the gathering together of notable people in any field to correlate information on that field for educational purposes are all educational projects. Grants may be given to accomplish research and/or development in all areas of human endeavor. We are all aware of grants for scientific purposes, particularly

in the medical field, but other subjects may be supported with equal flexibility. Social science has been recognized as a valid science. This field includes economics, history, political science, business relations, financial management, conservation and psychology, both academic and applied among the subjects.

Scientific tax-exempt grants have also been given to research methods for discovering oil or other valuable minerals, for developing higher yields of grain, fatter cattle, for developing a new metal alloy for a particular purpose or finding use for a particular plastic.

Foundation grants have been used to preserve dying or dead cultures, for establishing and preserving historical landmarks, for researching methods of preventing the extinction of certain animals or plants, and of course, for pursuing basic research in all accepted sciences.

We have briefly discussed what foundations have done to place you in a frame of mind to consider

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what your foundation might do in terms of grants, scholarships or charity programs consistent with your personal desires, hobbies or academic interests.

Develop possible outline for conducting a short discussion of not more than $\frac{1}{2}$ hour on possible foundation programs. Primarily Objectives. This might also be tied in with the possible programs of the civic club or with an association of several foundations to accomplish a large project. The instructor should stress the complete freedom of this field, perhaps using numerous examples or discussing complex structures. The possibility that this group might continue to meet four, five, or six times a year to continue this discussion might also be explored.

Having discussed what the foundation can do and what your foundations want to do, our next step is to discuss in detail how foundations accomplish these things. Fortunately the basic structure for all of these complex programs may be created through a simple step-by-step framework that seldom needs to be varied (only the details and the words used within each step need be changed to reflect the specific activity).

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Distribute EXHIBIT #14.

The Treasury Department has very minimal standards to judge the propriety of grant procedures. The Treasury requires only four types of information to be maintained for evidence of foundation grant activity. Grant programs do not have to be submitted to the Treasury for approval prior to their creation or operation. But if the Treasury should review a foundation's activities it would require four types of information about each grant. The Treasury requires;

1. The name and address of the recipient
2. The amount of the grant
3. The purpose of the grant disbursement
4. The relation, if any, of the recipient to persons who granted or contributed to the foundation.

Just as it is not illegal for a foundation to

EXHIBIT 14

GRANTS AND SCHOLARSHIPS

The records which the Treasury requires of grantors:

- (a) Name and address of recipient
- (b) Amount of grant
- (c) Purpose of this disbursement
- (d) Relation, if any, to persons who created or controlled foundation

In addition to these skeletal records, good practice would suggest a procedure for processing grants by the foundation. Such procedures will both serve to assure the Treasury that you are operating a bona fide program (and this may be prudent since the initial recipients of your philanthropy may tend to be children and relations, if not you, yourself) and to make things easier in your relations with strangers whom you might want to consider helping (i.e., it can make it more impersonal and easier to say no).

Mr. Harvey B. Matthews, Jr., of the Ford Foundation, speaking at New York University's Conference on Charitable Foundations, suggested these steps for processing grants:

- (1) A stated program containing some sort of guidelines for determining what sort of grants will be considered (e.g., tuition scholarship for college students).
- (2) Application - require some written application which makes clear that the person is applying for a grant and not just making an inquiry. The application should make clear what the money is wanted for so that the foundation can tell whether it falls within the foundation's program and corporate purposes.
- (3) Action Control - Mr. Mathews suggests that a piece of paper be attached to the application to record everything that is done regarding the application.
- (4) Preliminary screening and review. At this stage the foundation compares the request with its program to see whether or not the request falls within the grant program.
- (5) Final consideration. The merits of a proposed grant are compared against the availability of funds and a judgment made whether it is really worthwhile or desirable on the part of the foundation.

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As a matter of form, the initial screening should be done by one officer who then refers those he considers worthwhile to the directors or some committee of directors who make the final decision on the grant and its terms.

- (6) The person in charge of the grant program notifies the recipient of the acceptance or rejection of his application by letter.
- (7) There should be in addition a follow-up on the grant, a formal closing out of the terms of the grant, and an evaluation of the benefits derived from the foundation's use of its money in this particular instance.

As it was alluded to before, the test of the propriety of a grant is whether it is in furtherance of the foundation's exempt purpose. A child, spouse, or relative of a donor or foundation officer may properly receive such a grant (and, of course, in those cases, adherence to form is more important). With proper planning, the grant may be made in such a way as to result in no taxable income to the recipient. See Section 117, Internal Revenue Code. Of course, since this is a grant rather than an expense account, the complicated rules relative to expense accounts have no application.

Following are some illustrative forms to aid you in developing your foundation's clerical work and necessary language to properly manage your foundation's grant and scholarship program:

SAMPLE APPLICATION FOR GRANT TO STUDENTS
FOR SPECIAL TRAINING

THE R O A B FOUNDATION

APPLICANT'S NAME _____

ADDRESS: _____

AGE _____ OCCUPATION _____ U.S. CITIZEN _____

GRANT FOR THE STUDY OF _____

INSTITUTION WHERE STUDY IS TO BE MADE _____

PREVIOUS GRANTS, AWARDS _____

If student, complete the following:

PRESENT SCHOOL _____

MAJORING IN _____

OTHER COURSES OF STUDY IN RELATED FIELD _____

Complete in own words, reason for request for grant and why you are qualified to receive special training.

THIS FORM IS ONLY TO BE USED FOR ILLUSTRATIVE PURPOSES. INDIVIDUAL FORMS FOR INDIVIDUAL GRANT PROGRAMS SHOULD BE DRAFTED.

Recommendation of Present Teacher (If student) _____

SAMPLE CORPORATE FOUNDATION RESOLUTION TO AUTHORIZE GRANT
AND SCHOLARSHIP PROGRAM

"BE IT RESOLVED: That to further the purposes of the foundation that a program of grants, gifts, and endowments be instituted by the foundation.

That said grants and endowments be awarded only for such projects as serve to advance the stated purposes of the foundation which are research, development and education in agriculture.

That preference be given students in agriculture or related fields but in no case shall such grants be for purposes other than scientific, education, religious or literary.

That such grants may be received by any citizen, person or governmental unit of the United States.

That the Vice-President be appointed as Chairman of the Committee on Grants, with the recommendation that other members be chosen from business or the professions, to serve at the Chairman's discretion. Said committee shall prepare forms and information for prospective applicants and screen all such applicants and recommend prospective applicants to the board of directors as the committee feels will best serve to further the purposes for which the foundation was created.

That upon approval of such application, by the board of directors, the chairman of the committee on grants may proceed to administer such grant on such terms as are calculated to maximize the benefits of the foundation's expenditure.

That the board of directors or the committee on grants reserve at all times the right to modify, withdraw or cancel any part of any grant not paid out.

That the chairman of the committee on grants shall require an accounting from each recipient on terms he thinks appropriate regarding the expenditure of all grant monies and evidence of the results accomplished.

That in the case of grants, gifts, or endowments not amounting to more than \$50 each, nor aggregating more than \$1,000 per fiscal year, such disbursements may be made solely on the authority of the chairman of the committee."

ANOTHER SAMPLE APPLICATION

THE _____ FOUNDATION

A Non-Profit Institution for Agricultural
Research and Education

APPLICATION FOR SCHOLARSHIP

To the Applicant: Please answer the following questions as fully as possible, using the reverse side if necessary. Type or print legibly.

Hoover Scholarships are available to any serious student, with preference being given to students working in the field of agriculture.

1. Name _____ Age _____
2. Purpose of Scholarship
(This form is provided for educational purposes only)
3. Amount needed to supplement applicant's own funds _____
(Note: Scholarships may be available only for fixed sum).
4. Applicant's qualifications and past educational experience.
5. Has applicant ever worked in agriculture? _____
If so, explain.
6. Give names of two persons, not relatives, who can testify to applicant's character and ability.

_____	_____
(Name)	(Address)
_____	_____
(Name)	(Address)

Applicant understands that any grant made may be subject to such terms as the foundation may provide to insure the maximum usefulness of the funds awarded and that any funds awarded but not actually paid out are subject to cancellation or reduction by the foundation in its sole discretion.

Date _____ (Signed) _____ (Applicant)

SAMPLE PUBLICITY RELEASE

A PROGRAM OF GRANTS AND SCHOLARSHIPS

The _____ Foundation was established to further research, development, and education in agriculture, and in furtherance of that goal has instituted a program of grants and scholarships.

Grants and scholarships are intended primarily to assist students working in the field of agriculture but will also be available to students in the other sciences and the humanities where qualified applicants are not found in agricultural studies.

Who May Apply:

Grants and scholarships may be awarded to any person evincing a serious interest in education. It is not necessary that the applicant be in financial need although this factor will be considered.

Criteria for Awards:

Grants and scholarships are to be awarded to those students or for those projects which, in the opinion of the foundation, most satisfactorily serve the purposes for which this foundation was created.

Terms of Awards:

Grants and scholarships shall be awarded on such terms as the chairman of the committee on grants determines to be most likely to maximize the usefulness and benefit of the foundation's expenditures. Such terms may include among other things, periodic payments of grants, accounting for expenditures and evidence of work accomplished. All grants and scholarships are subject to revision or cancellation with respect to any monies not as yet paid out to the recipient.

Amount of Awards:

Grants and scholarships may be made either in fixed sums allocated by the committee on grants or may be adjusted to the individual financial need.

When and Where to Apply:

Applications may be made at any time although a 60-day delay for processing should be expected. Applications should be addressed to:

Chairman, Committee on Grants
The _____ Foundation
(Address)

SAMPLE REFERENCE FORM

THE _____ FOUNDATION

A Non-Profit Institution for Agricultural
Research and Education

REFERENCE FORM

To the Applicant: Fill in items 1-3. Then give a copy of this form to each of the persons whom you have listed on your application.

1. Name of Applicant _____
2. Home Address _____
3. School now attending _____ Class _____

To person filling out this form:

The above-named student has applied for a scholarship from the _____ Foundation. We will appreciate your assistance in assessing this student's character and qualifications. All information will be held in confidence.

(This form is provided for educational purposes only).

4. How long have you known the applicant?
5. In what capacity have you known applicant?
6. What comments can you make regarding applicant's character and qualifications?
7. Any additional statement regarding applicant's suitability for a foundation scholarship would be appreciated.

(Signature)_____
(Address)_____
(Position)

FOLLOW-UP EVALUATION OF GRANT PROGRAM

Dear :

We of the Foundation hope you have been successful in your chosen project or studies. To judge the effectiveness of our program of grants and scholarships, we would appreciate your completing your obligation under this award and giving us your comments on the value of your grant.

1. What did you accomplish through your grant?
2. Were you satisfied with the handling of this grant and have you had any suggestions for improvement?

(This form is provided for educational purposes only)

Please include with this report any additional material under the terms of your grant.

Yours very truly,

THE FOUNDATION

Chairman, Committee on Grants

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sell property to a contributor or founder of a foundation, it is also not illegal or improper for a foundation to award a grant to these persons or their relatives, provided that a clear set of standards for awarding the grant was established prior to the application and these standards were met by the winning applicant. In other words, if your foundation creates a grant program with established standards and purposes, and your child applies under these standards and meets them, it is not improper or illegal if the board of directors of your foundation should declare the child a winner.

Among the major foundations in this country, there are nearly as many different methods of grant programs and procedures as there are foundations, because of the minimal and ambiguous Treasury requirements. Foundations, in line with good business practices, usually create grant procedures that are much more complex than the Treasury requirements. Of the many foundations that exist and their equally many variations of grant programs, we have found that

the Ford Foundation (the world's largest funded foundation) has perhaps the grant program that could be best applied to smaller foundations. We recommend that, if any foundation uses the methods suggested by the Ford Foundation, such a grant program would meet little or no questioning from any regulating government. In your Exhibit you will find the seven steps that are recommended by the Ford Foundation in establishing the proper processing of a grant program. We will discuss each of these steps in detail.

1. A detailed stated program for the grant should be created by the executive director and approved by the board of directors. This program may be very broad or very limited depending upon the desires of the board of directors. We suggest that a broad program provides more flexibility and less red tape.

Several examples of existing grant programs, both of members and non-members, should be included as an exhibit and perhaps a "model" grant program might be drafted.

Your application for grants which are available through the grant program may be as detailed or simple as you desire. The application is evidence that the person involved is applying for funds and not merely making an inquiry as to the availability of funds.

Your application may be 10 pages long and filed in triplicate or be one page long and filed in a single copy. That is, it may be as simple or complex as your board of directors desires. The application should realistically apply to the situation, that is, the more complex the grant program is the more extensive the application should be to meet the standards of the program. The information required by the Treasury should be a part of every application, but the application should also reasonably provide enough information so that the board of directors can intelligently determine if the applicant meets the standards of the program. For example, an application from a student for a scholarship should include where the student went to school, where he intends to go to school, copies of transcripts of prior education,

references by teachers, what the student intends to study, time of study and statements or mater showing why the student believes he should receive the award. In other words, the application should not be ambiguous or facetious or overly complex for its purpose. You would, for example, not require that an application for a \$17.00 scholarship to a YMCA weekend youth conference include a 50 page essay or be 10 pages long. It would also be inappropriate if your foundation awarded a \$15,000 research grant on the basis of a one page application.

2. It is highly recommended that a third-party reference or references be required of all applicants for whatever portion or nature your grant program might cover. That is, a student would be required to submit references or names of teachers or prominent friends. In the same way, a scientist or researcher would be required to submit references who would be able to verify the applicant's qualifications for the grant and/or the ability of the applicant to accomplish the proposed pesearch. Third-party references serve

three purposes:

1. They establish valid information to make a proper determination on the application by the board of directors.
2. They lend credence to the actual award and lend status to your foundation's activities.
3. They publicize your foundation's grant program without cost.

In fact, many subsequent applications are made through such third-party references once these references discover that the grant program exists.

3. Action Control - This part of your grant's procedures depends entirely upon your need for "crutches" in completing procedures. In this case, action control procedures include a check list of proper steps concerning every grant application. This check list would be attached to every file and application. The applicant's papers would be considered by the proper persons in the proper order, and notations would be made on every activity or action taken

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regarding application. It is only good business practice to keep close records of all ideas or letters sent to your foundation. In some cases your foundation may receive unsolicited applications from unrelated third-parties. Many of these applications might include original ideas created by the applicant. To avoid potential copyright, patent or other infringements, action or actions for negligence, great care should be taken in the handling of all letters and applications regarding grants. In order to provide consistency the same care should be taken for all grant applications, even though the applications may be from persons closely related to the foundation. It is recommended that correspondence be maintained with all persons who apply regardless of the final determination of the board of directors; that is, that a "thank you" note should be sent to all losers and all original material should be returned unless a grant is awarded.

If your foundation is small and has only a limited endowment and limited desire to give away money, it is recommended that publicity about

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your grant program be limited. Foundations that get into newspapers are often subjected to hundreds of unsolicited applicants - most of these will be serious and wellmeaning, some will be humorous, some may have great potential and some may have no potential whatsoever. In any case, the time spent in processing these applications is considerable, and even though the evidence is desirable, the expense in time and funds may not justify the work. It is recommended that your foundation continue its grant program by the recommended methods, personally solicit applicants in specified areas, or inform a select group of students, if your program includes college scholarships.

There are no Treasury requirements for publicity and we recommend that unless you wish a great number of applicants you do not publicize through an extensive, formal public relations program. The word will be passed fast enough by the people who write the references for your original applicants, regardless of any public relation activity on your part.

4. The foundation should now begin preliminary

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screening and review. That is, the directors or officers should consider all the applications. They should see:

1. Whether the applications fall within the purpose of the foundation.
2. Whether the applications are covered by the existing grant program.
3. Whether the standards of the grant program are met.
4. Whether applicant both qualifies for the grant and looks like a good recipient.

5. One officer or director usually chooses the best or the best of the applicants for final screening by the board of directors. The board of directors reviews the recommendations of the president or other officers. A decision to grant or not to grant is then made.

6. A person in charge of the grant program should then notify the winners and the losers by letter. The winner should be informed of the next procedures to be taken, depending upon the nature of the grant program.

7. After all the applicable procedures relating to the actual grant itself and the accomplishment of the grant itself, there should be a closing out of the grant. This formal closing should include one or more of the following elements:

1. It is highly recommended that a complete accounting of the use of the grant funds be submitted by the winner.
2. It is highly recommended that a review of the grant program be made by one or more of the following persons: the officer in charge of the grant program, the recipient of the grant, or a third party reference who would have knowledge of the grant and who would be qualified to make such an appraisal, such as a dean of students, when a scholarship is awarded, or an expert scientist unrelated to the project, where an appraisal of original research has to be made.
3. Except in cases of general scholarships, a detailed report by the grant recipient of the grant concerning the results of the grant is, of course, highly recommended, as evidence of proper foundation activity.