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Marcus Schoenfeld

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# Federal Taxation and Non-Profit Organizations

Marcus Schoenfeld\*

IN ONE SENSE, I suppose the tax man has a distorted view of non-profit organizations. He seems to think that non-profit organizations were created solely to yield tax benefits. It's not completely true, but there's a good bit of truth as to causation. That is, but for the tax law, the overwhelming majority of non-profit organizations would not exist. Previous speakers have referred to "private means for public benefits"; but the way we get this is by appealing to greed. We give certain benefits to individuals or firms for doing something which we think is socially desirable—"public good"—but of course we do have the characteristics of private greed and private good mixed in with this.

I am going to talk about the federal tax aspects of non-profit organizations as it is today. Most of you are aware of potentially great changes presently before Congress, and I shall briefly comment on these proposals.<sup>1</sup> I don't think we need an outline because Congress has seen fit to give us one. It's called sec. 501 of the Internal Revenue Code and I will devote the first portion of my remarks to amplifying that section for you. For those of you not adept at note-taking, I refer you to two chapters of Professor Oleck's book<sup>2</sup> which I authored several years ago. The materials there cover the areas I intend to cover here. In addition, last spring, the Internal Revenue Service issued an addition to its Manual called *Exempt Organizations Handbook*.<sup>3</sup> While it does tend to give the Service's "party line," I will occasionally make reference to it and I commend it to you as a working primer in the area. For example, each paragraph of Sec. 503 (c) has a chapter devoted to it in the *Handbook*.

Section 501 (c) begins with a "general rule." Those of you familiar with the semantics of the Code know that "general rules" never are general, and rarely are rules. Normally the "definitions" and the "exceptions" are the real operative provisions. Section 501 (a) is very short; it says in essence that an organization described in sub-section (c) or (d) shall be exempt from taxation unless such exemption is denied

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\* Professor of Law, Villanova University, School of Law. [This article is part of the Symposium on Non-Profit Organizations.]

<sup>1</sup> The "proposals" resulted in the Tax Reform Act of 1969, P.L. 91-172, hereinafter cited as "1969 Act." Appropriate amendments have been made in the text of this address to reflect the new law. Because of the late enactment and the early deadline for publication, little more than a brief description of the changes are made.

<sup>2</sup> Oleck, *Non-Profit Corporations, Organizations and Associations* (2d Ed., 1965) (chapters 28 and 29). Much of this material appeared in somewhat different form in 10 Villanova L. Rev. 487 (1965) and in 9 Tax Counselor's Quarterly 391 (1965).

<sup>3</sup> Subsection (11) 671 of the Internal Revenue Manual. Hereinafter this will be cited as *Handbook*.

under sections 502, 503, 504.<sup>4</sup> Thus, for federal tax purposes, whether an organization is tax exempt, is determined by section 501(c) and (d). There are now 18 paragraphs of sec. 501(c) and one paragraph of sec. 501(d) each enumerating one type of tax exempt organization, and I'll breeze through to give you some idea of the kinds of organizations that are not subject to federal income tax. This is exclusively a federal matter regardless of whether or not the organization involved is tax exempt under state law. So it is perfectly possible for an organization to be tax exempt for federal purposes and not for state purposes, and vice versa. And remember that sec. 501 deals with whether or not the organization itself must pay tax on its income. It does not deal with the issue of whether a person making a contribution to that organization can claim a deduction for such payment from his own personal tax returns. There is not an exact correlation between sec. 501(c) which is the standard for tax exemption of the entity, and sec. 170 which covers deductibility for income tax purposes, sec. 2055 which covers deductibility for estate tax purposes, and sec. 2522 which covers deductibility for gift tax purposes. Many of the factors, however, are similar; but we will focus primarily on the exemption of the entity and will spend just a little time on qualification for deductibility for contributions. Later speakers will cover plans and "gimmicks" using tax law. I'm just going to give you the basics of the tax mechanics.

We will run down the list of types of tax exempt organization, many of which you will never see. But you should know that there are types other than charitable, educational, religious or scientific institutions. For example, sec. 501(c) (1) exempts corporations organized under an act of Congress if such corporations are exempted from federal income tax. Federal Reserve Banks are an example of that. Sec. 501(c) (2) talks about corporations organized for the exclusive purpose of holding title to property, collecting income therefrom, and then turning over the entire amount thereof less expenses to an organization which itself is exempt. In other words, it is perfectly possible for an organization which is exempt to have a subsidiary which is a passive collector of income and for the subsidiary to be exempt by paying all profits over to the parent. We'll skip sec. 501(c) (3) for the moment. Sec. 501(c) (4) exempts civic leagues, and organizations not organized for profit but operated exclusively for the promotion of social welfare, whatever that means. When I say "whatever that means," I'm merely referring you to the I.R.S. *Handbook* which does have several pages on this. It will tell you what is meant by "civic associations," which is meant by "social welfare" and so on. The next few paragraphs of subsection 501(c) exempt labor, agricultural or horticultural organizations; business

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<sup>4</sup> I.R.C. 501(a) (1954). Hereinafter all references to the "Code" refer to the Internal Revenue Code of 1954 (as amended).

leagues, chambers of commerce, real estate boards or boards of trade; clubs organized and operated exclusively for pleasure and recreation and other non-profit purposes; fraternal beneficiary societies, orders or associations operating under the lodge system; and voluntary employees beneficiaries associations also exempted. Teachers' retirement funds; benevolent life insurance associations; cemetery companies operated exclusively for the benefit of their members and not operating for a profit; credit unions; small mutual insurance companies and associations; these are a few of the other enumerated exempt organizations. Time forces us to slip back to the most important for most of our purposes to section 501(c) (3). Again I want to emphasize here that these organizations themselves may be exempt from tax, but if you make a contribution to a chamber of commerce or something else within sec. 501(c) that is not necessarily deductible for income tax purposes. We're talking about two completely separate things. In order for the contribution to be deductible we must deal with section 170. There are many, many more organizations which are tax exempt under section 501, than would be proper recipients for deductible contributions for the donor under section 170.

The simplest way to begin to understand sec. 501(c) (3) is to dissect it phrase by phrase. It begins, ". . . corporations and any community chest, fund, or foundation. . . ." We have no definition of any of these phrases (except corporation), but it is perfectly clear from this that there must be some type of formal organization. It need not be a corporation, but it may certainly be a corporation. At one time there was some doubt as to whether a trust could qualify, but today there is absolutely no doubt that "foundation" or "fund" includes a trust. The only problem is if there is no formal organization; an individual cannot be an "organization." And under section six of the Uniform Partnership Act, a partnership cannot be this kind of organization because the definition speaks of "business for a profit."

The next clause says, ". . . organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty of children or animals. . . ." "Organized and operated" has been held to create two separate tests. That is, in order to be exempt under section 501(c) (3) the organization must be both "organized" and also "operated" for particular purposes. The organization test is relatively easy to meet; a corporation charter, or a trust indenture, or whatever the instrument setting up the organization is called, must state that this organization shall be operated exclusively for a given purpose and that purpose must be one of the ones enumerated in the statute. This is a relatively easy test to meet, because all you have to do is take an appropriate form book and the I.R.S. *Handbook* and draft carefully. If there has been a

formal deficiency or something else wrong with the papers this can be amended and this can have retroactive effect. If, for example, the purpose clause is too broad so that the organization may engage in purposes which are not listed here because it does say operated *exclusively*, a formal refile, correcting the omission will meet the organizational test. The operational test is a *de facto* test; had in fact this organization been operated in the past in conformity with the statutory purposes. In a few minutes I'll talk about the procedures for applying for tax exemptions. You'll see the Revenue Service requires you file the charter or indenture and all papers which show what the purpose is, and whether you've met the organizational test; and also you must file all sorts of information so that they can see whether for the past history, if any, you have complied with the operational test.

The next clause says “. . . no part of the net earnings of which inures to the benefit of any private shareholder or individual. . . .” We've been talking about non-profit organizations. Obviously a particular individual may show a “profit” because of the operation of a non-profit organization. I assume that here at the University of Michigan, for example, professors are paid salaries. Clearly the individuals involved who are receiving salaries have benefited and have shown a private benefit from the operations of a non-profit organization. That is not what the statute is talking about. No part of the profits from the operations shall be distributed to the “owners” because they are “owners”; by analogy with a business corporation, no dividends shall be declared. But merely because one might not properly receive a “dividend,” it does not follow that that individual would be precluded from receiving a salary for his services merely because he also happens to be an “owner.”<sup>5</sup> The question is whether the compensation received was reasonable for the services rendered. And, of course, as most of us know, what is “reasonable” can be in a wide, wide range. Generally in these cases it means that it is not clearly unreasonable. And of course the individual recipients may be selected by the creator of the organization. There's nothing to prevent the creator of a foundation from naming himself as the director and paying himself some kind of fee. Of course, in effect he'd be taking money out of one pocket and putting it into the other; he'd be getting a tax deduction for the money he paid over to the foundation, but his salary would be compensation and included as income. The real tax use (and abuse) occurs if he names his son or his wife as an employee of this organization, and they receive compensation for their services. In effect some of his income is transferred to someone else. That is he gets a deduction in his high bracket, and the recipient is taxed at his bracket.

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<sup>5</sup> This, of course, may not be permitted under state law, but remember we are here speaking only of federal tax law.

On the other hand the foundation or the corporation or whatever may also do certain things which can cause an indirect inurement, and this is prohibited. For example, a business may set up an organization for the benefit of its employees. If its employees are benefited in such a way that it can be reasonably deemed to be for the business purpose of the parent organization, then there is an indirect benefit inuring to the employer and the organization cannot pass the inurement test of sec. 501(c) (3). "Inurement" is a very strange phrase; a "non-profit" organization can be non-profit in that no profits were distributed to owners, but in which the owners or their nominees received a substantial salary. Of course, part of the problem is that these things just aren't policed. Usually there is no check as to reasonableness of compensation for services. For example the Pearl Buck Foundation has made front page stories in the Philadelphia press, and possibly the national press. In this particular case an individual gained the confidence of Miss Buck and became president of the Pearl Buck Foundation. He used substantial sums to purchase a town house and furniture for use as the headquarters of the Foundation. The top floor was converted into an apartment for his personal use. And since the president of an impressive organization could not drive around in a beat up old auto, the Foundation rented a limousine with a chauffeur to drive him around. He wore custom made Italian shoes, \$300 custom made suits, and he didn't just have one or two of them. The Foundation ordered them because of course the president of this organization could not go around asking for money from substantial contributors looking like a bum. In one sense, this individual had what you might call substantial inurement; he was much better off as the president of the foundation than he had been as a dance teacher, which he had been beforehand. As I said before "inurement" is a strange test. The real problem is that there are no tests involving controls on expenses, or involving ultimate charitable disposition of the assets of the organization.

Inurement is a theoretical test. Surely people can benefit, but the big problem is no line is drawn, and possibly can never be drawn as to what is the proper amount of expenses to be borne by an organization. I can remember not too many years ago, soon after Damon Runyan died, Walter Winchell was instrumental in setting up something called the Damon Runyan Cancer Fund, and his boast was that 100%, 100 cents of every dollar contributed, went to cancer research. He himself took no salary for being president of this organization, and his newspaper underwrote the cost of all the staff, so that literally there was no expense. Obviously, there are very few organizations that can operate this way. But in many "charities" very little money trickles down to the ultimate charitable recipients. Much of the money goes for administrative expenses. I don't know if it's feasible for anyone to

say that there should be some kind of percentage limit on expenses, but clearly there are questions of abuse. A somewhat similar question arises with insurance companies as to administrative and other expenses. Less than 50% of the premiums paid to automobile casualty companies goes to the ultimate injured parties in auto accidents, whereas with Blue Cross about 95% of the premiums paid goes to pay the hospital and doctor costs. Some kind of administrative expenses are inevitable in any activity. But there is no standard as to amount. Very few foundations operate on the "Robert Hall" theory, with plain pipe-racks with low overhead. Possibly they shouldn't be forced to be economical. But clearly the inurement test fails to guarantee how much money gets through to the ultimate charitable recipient. So long as there is no private inurement, so long as the individuals who would be owners if this were a business, get no "dividends," they or others may get salaries for "reasonable" compensation for services.

Hospitals have provided all sorts of problems in this area. Is a hospital operated for the benefit of charitable patients, or is it operated for the benefit of the doctors who own it? It's a question of fact, with both elements present. If the doctors receive a percentage of the fees, it's probably private inurement to them. If the doctors can charge their own fees and use the hospital's facilities by paying the hospital then it's probably not.

Incidentally, it is perfectly possible for a given organization to qualify under more than one paragraph of section 501(c) and for its purposes it doesn't really care under which one it qualifies. If it qualifies under any paragraph, it's tax exempt. The only time it matters is if it is accepting contribution and the contributors want to deduct their payments. Then, generally speaking, those kinds of organizations which would meet sec. 501(c) (3) would also meet sec. 170, which is the test of deductibility.

To continue with section 501(c) (3), after the inurement part it says ". . . no substantial part of the activities of which is carrying on propaganda, or otherwise attempting to influence legislation, and which does not participate in or intervene in (including the publishing or distributing of statements) any political campaign on behalf of any candidate for public office." Please remember that this is part of the definition of what organizations are exempt. If you have an organization that meets every other test of sec. 501(c) (3) but which is an "action organization" the phrase the regulations apply to organizations violating this clause, it is not an exempt organization. The statute doesn't say that the organization shall have a penalty; it says it shall not be exempt from tax. This is a very drastic provision; very few organizations have lost tax exemption, because it was an action organization. The big problem in this area is that it's an "all or nothing" decision. If the organization has indulged in propaganda or "action," it is not exempt.

Once it loses its exemption, people who contributed to it cannot claim a deduction. And if it had been an "action organization" the revocation is retroactive. This retroactive revocation might not seem fair to people who in good faith relied on the Treasury's former ruling which had said the contributions were deductible for their own income tax purposes. Presumably the Commissioner would exercise his discretion under sec. 7805 (b) not to penalize the outside contributors.

CAVEAT: Be sure to read about the 1969 changes *infra*.

Now that we have completed our survey of what types of organizations are made tax-exempt by sec. 501(c), it's time to recall that sec. 501(a) says that such organizations are exempt ". . . unless such exemption is denied under section 502, 503."<sup>6</sup> Thus we must look at these sections before we can be certain of exemption.

Section 502 deals with "feeder organizations." A "feeder" is an organization which conducts a trade or business for a profit, and then passes these profits over to a tax-exempt organization. Congress felt that a "feeder" might have an unfair advantage over its taxpaying competitors. For an instance, take the leading case under prior law, *C. F. Mueller Co.*<sup>7</sup> New York University owned a spaghetti company and used all of the spaghetti profits for its educational activities. It was felt that the Mueller company would have an advantage over other tax-paying spaghetti companies in that it could plow back more earnings into expansion and therefore grow faster than its competitors. And in terms of tight money, when other firms might not be able to borrow to expand, Mueller's could grow on its own tax-free accumulations. In addition, Mueller's could cut its price (because its pre-tax rate of return would only have to match its competitor's after-tax rate of return) and drive its tax paying competitors out of business. In total effect, it was feared that in the long run *all* businesses might fall under the control of tax-exempt parents. In any case, it must be remembered that "feeders" are not exempt from tax at all; they must pay taxes the same as any other business. Note that there must be an active trade or business to involve Sec. 502. A mere passive owner may pass on profits to a tax-exempt organization and itself be exempt under sec. 501(c) (2).<sup>8</sup>

Before proceeding to section 503, I'd like to mention the tax on "unrelated business income" imposed by sec. 511. In one sense, it's similar to sec. 502 in that a business is operated and that business is taxable. In another sense, it's very different. Thus, sec. 511 applies only to organizations that are exempt under certain paragraphs of sec. 501(c). If sec. 511 applies the organization does not lose its exemption; rather

<sup>6</sup> This reflects the language as amended by the 1969 Act.

<sup>7</sup> 190 F. 2d 120 (3d Cir. 1951).

<sup>8</sup> The 1969 Act did not affect this discussion but did somewhat alter certain conditions of what is not a "trade or business" under sec. 502. See sec. 121(b)(7) of the 1969 Act.



it is taxable only on its income from the "unrelated" business.<sup>9</sup> Suppose, as an instance, that New York University itself entered the spaghetti business rather than by use of a subsidiary. Such business would be "unrelated" to the primary educational purpose, and the income from that business alone would be subject to tax. N.Y.U. would still be exempt as to all other matters. A business may be "related" and not subject the otherwise exempt organization to tax. For example, Cornell University runs a hotel in connection with its school of hotel management. Many of those operating the hotel are doing so in connection with their course of study. Assuming that this hotel operates at a profit, Cornell would not be subject to sec. 511, because the hotel, although a "business," is not "unrelated" to Cornell's exempt purpose—education. The term used is that the business is "incidental" to the primary purpose. Another example of an "incidental"—and therefore non-taxable—activity of a university is a model farm operated in connection with an agricultural school. Since the passage of the 1969 Act the coverage of sec. 511 has been broadened.<sup>10</sup>

### Effect of the Tax Reform Act of 1969

At this point this article must deviate from the talk delivered in August 1969 because the 1969 Act drastically affected the remainder of the topic discussed then. Many provisions of the 1969 Act affect non-profit organizations directly and indirectly and this most comprehensive of tax changes will generate much commentary. The primary changes affecting the subject matter of this talk involve those in the penalties for "prohibited" transactions which in turn leads into the new special rules applying to "private foundations."

Prior to the 1969 Act, sections 503 and 504 denied tax exemption to certain types of organizations if they engaged in certain "prohibited transactions." The only organizations subject to these provisions were certain pension plan trusts, employee unemployment benefit trusts, and profit sharing trusts, and also (with some enumerated exceptions) organizations ". . . described in section 501(c) (3). . . ." Under the 1969 Act, an amalgamation of old secs. 503 and 504 into a new section 503 applies only to those pension, profit sharing and unemployment benefit situations which are exempt under the present secs. 501 (c) (17), 401 (a), and 501 (c) (18); no section 501 (c) (3) organizations can be so disqualified under the new sec. 503.<sup>11</sup> However many sec. 501 (c) (3) or-

<sup>9</sup> I.R.C. sec. 501 (b) (1954).

<sup>10</sup> Sec. 121 (a) of the 1969 Act amended sec. 511 so that almost all tax-exempt organizations are subject to its provisions. Previously, churches and a few other organizations were not subject to sec. 511.

<sup>11</sup> See I.R.C. sec. 503 as amended by 1969 Act, secs. 101 (j) (3), and (j) (7) through (14) inclusive. Note that former I.R.C. sec. 504 relating specifically to sec. 501 (c) (3) organizations has been repealed, and all references to sec. 501 (c) (3) have been eliminated in sec. 503 as amended.

ganizations are now subject to new sanctions for violation of certain specific prohibitions. Since most participants in the symposium were primarily interested in the "charitable" organizations of sec. 501(c) (3) and since the greatest changes in the 1969 Act occurred in this area, the remainder of this paper will be devoted to a brief analysis of the new controls against abuse of sec. 501(c) (3) organizations.

The new rules are quite detailed and quite complex. Indeed, until regulations are issued much uncertainty will exist. However the general thrust of Congressional intent is obvious. First of all a new part II was added to subchapter F containing new sections numbered 507, 508, and 509.<sup>12</sup> Sec. 509 defines a new term for the Code: "private foundation." In general these are *all* sec. 501(c) (3) organizations *except* organizations contributions to which may be deducted to the extent of 50% (30% before the 1969 Act) of the contributor's income,<sup>13</sup> or broadly publicly supported organizations,<sup>14</sup> or organizations organized and operated exclusively for the benefit of one or more of the preceding two types of organizations,<sup>15</sup> or an organization organized and operated for testing for public safety.<sup>16</sup> Once an organization is deemed to be a "private foundation"—and it is presumed that *all* section 501(c) (3) organizations (even one which existed before the effective date of the 1969 Act) are such unless they are exempted under the Regulations<sup>17</sup>—it is subject to a series of excise taxes under a new chapter 42 of subtitle D.<sup>18</sup>

Sec. 4940 now imposes a tax of four percent of the net investment income (as defined in sec. 4940(c)) of the private foundation for the taxable year.<sup>19</sup>

Sec. 4941 imposes a possible three level dual tax whenever there is "self-dealing" as defined in sec. 4941(d). At the first level a tax is imposed on the "disqualified person" equal to 5% of the amount involved in self-dealing each year, and also a tax is imposed on the foundation manager equal to 2½% of the amount of the self-dealing each year.<sup>20</sup> If the self-dealing is not "corrected" <sup>21</sup> within 90 days after a deficiency

<sup>12</sup> 1969 Act, sec. 101(a).

<sup>13</sup> See sec. 509(a) (1) referring to sec. 170(b) (1) (A) (as amended by sec. 201(a) of the 1969 Act).

<sup>14</sup> Sec. 509(a) (2).

<sup>15</sup> Sec. 509(a) (3).

<sup>16</sup> Sec. 509(a) (4).

<sup>17</sup> Sec. 508(b) and (c).

<sup>18</sup> Added by sec. 101(b) of the 1969 Act.

<sup>19</sup> For details see Conference Report, No. 91-782 (hereinafter cited as Conf. Rep.), 278, Senate Finance Committee Report, No. 91-552 (hereinafter cited as Sen. Rep.), 27-28, and House Ways and Means Committee Report No. 91-413 (hereinafter cited as H.R. Rep.), Part I, 19-20, Part II, 2-4.

<sup>20</sup> Sec. 4941(a).

<sup>21</sup> As defined in sec. 4941(e) (3).

notice with respect to the self-dealing is issued,<sup>22</sup> then an "additional tax" is imposed by sec. 4941(b). This is 200% of the amount involved on the "disqualified person" and 50% of the amount on the foundation manager.<sup>23</sup> If there has been "wilful repeated" acts or a "wilful and flagrant" act giving rise to tax liability under chapter 42 (which includes sec. 4941), then under sec. 507(c) a tax is imposed equal to the lesser of either the value of all foundation assets or the total tax savings at *any* past time to anyone because of the tax exempt status of the private foundation. This latter *de facto* penalty may be "abated" under sec. 4941(g) if the private foundation distributed all of its assets to a public charity or if the evils are corrected pursuant to state law.<sup>24</sup> Thus the use of an "excise tax" which is rather small for inadvertent violations and is clearly penal if the self-dealing continues after notice is the control mechanism Congress has chosen.

Sec. 4942 differentiates between an "operating foundation," defined in sec. 4942(j)(3), and other private foundations. A tax equal to 15% of undistributed income for the year is imposed on all private foundations except "operating foundations," unless the failure to distribute was due to reasonable cause and is corrected by a "qualifying distribution" during an "allowable distribution period."<sup>25</sup> The minimum payout is the greater of adjusted net income (defined in sec. 4942(f)) or 6% of all foundation assets not directly used for its exempt purpose (defined in sec. 4942(e)). The 6% rate may be varied by the Treasury by administrative action (sec. 4942(e)(3)), however lower specific limits are set for pre-existing private foundations under sec. 101(a)(3) of the 1969 Act. Again there is a "second tier" or "additional tax" of 100% of the amount remaining undistributed after the permissible "correction period" has run<sup>26</sup> (sec. 4942(b) and (j)(2)).<sup>27</sup>

Sec. 4943 is a quite complicated excise on "excess business holdings." In general the combined voting power of the foundation and all "disqualified persons" together cannot exceed 20% of the voting stock of any business corporation. If, however, effective control exists in another group, then the foundation plus its disqualified persons may own up to 35% of the voting stock of a single business corporation.

<sup>22</sup> As defined in sec. 4941(e)(4). The self dealer may appeal to the Tax Court before assessment may be made, or the tax may be paid and contested in the District Court of the Court of Claims. See 1969 Act, sec. 101(f)-(i).

<sup>23</sup> Sec. 4941(b)(1) and (2) respectively.

<sup>24</sup> Self dealing is discussed in Conf. Rep. 278-81, Sen. Rep. 28-34, and H.R. Rep. Part I, 20-24, and Part II, 7-9.

<sup>25</sup> These terms are defined under sec. 4942(a)(2), (g), and (j)(4).

<sup>26</sup> Again this "correction period" is not over until a 90 day letter has been sent, and if a petition is filed, until the Tax Court decision is final. And contest may be made as in fn. 22 *supra*.

<sup>27</sup> For details of this new Code section see Conf. Rep. 281-82, Sen. Rep. 34-38, and H.R. Rep. Part I, 25-27, Part II, 9-12.

The Commissioner is empowered to issue Regulations which will apply similar rules to non-corporate businesses. Special relief provisions giving extra time for gradual divestiture by present foundations which violate the new rules are given in sec. 4943 (c) (4). The initial tax is 5% of the value of excess holdings (sec. 4943 (a) (1)); and there is an additional "tax" of 200% of such excess holdings (sec. 4943 (b)) if no correction is made within the usual 90-day letter "correction period."<sup>28</sup>

Sec. 4944 imposes the usual multi-level excise taxes on both the foundation and its management if the foundation invests in such a manner as to jeopardize the carrying out of its exempt purpose.<sup>29</sup>

Sec. 4945 imposes the multi-level taxes upon the foundation and also its management if it makes certain "taxable expenditures" (as defined in sec. 4945 (d)). These "taxable expenditures" are those which are: (1) for lobbying to influence legislation;<sup>30</sup> (2) to attempt to influence any specific election;<sup>31</sup> (3) individual study grants not meeting the limitations of sec. 4945 (g); (4) grants to any organization which is not a public charity<sup>32</sup> unless the grantor private foundation exercises "expenditure responsibility";<sup>33</sup> or "(5) for any purpose other than one specified in section 170 (c) (2) (B)."<sup>34</sup> The initial tax is 10% on the foundation, and 2½% on management under sec. 4945 (a). The second-tier "additional" tax under sec. 4945 (b) is 100% on the foundation and 50% on the management unless there is a "correction" within the "correction period."<sup>35</sup>

Section 4946 defines "disqualified person" for purposes of these new excise taxes on private foundations. The term is especially relevant to an understanding of sec. 4941 (concerning self-dealing) and sec. 4943 (concerning excess business holdings). These include: a "substantial contributor" to the foundation (defined in section 4943 (a) (2) as a person described in section 507 (d) (2)); the foundation manager (as defined in subsection (b) (1)); a 20% owner of an entity that is a "substantial contributor" to the foundation; various relatives (as defined in sec. 4946 (d)) of any persons described above; and various entities in which any of the persons described above holds a 35% interest. For

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<sup>28</sup> For details of this new Code section, see Conf. Rep. 282-83, Sen. Rep. 38-45, H.R. Rep. Part I, 27-31, Part II, 12-15.

<sup>29</sup> For details of this new Code section, see Conf. Rep. 283-284, Sen. Rep. 45-46.

<sup>30</sup> As spelled out in sec. 4945 (e).

<sup>31</sup> As spelled out in sec. 4945 (f).

<sup>32</sup> As defined in sec. 509 (a) (1), and (2), and (3).

<sup>33</sup> As defined in sec. 4945 (h).

<sup>34</sup> These are "religious, charitable, scientific, literary, or educational purposes or for the prevention of cruelty to children or animals."

<sup>35</sup> For details of this new Code section, see Conf. Rep. 284-86, Sen. Rep. 46-51, H.R. Rep. Part I, 31-35, Part II, 15-17.

certain purposes controlled private foundations and government officials may be "disqualified persons."<sup>36</sup>

Since the remaining sections of the new excise tax provisions are of rather limited interest, let us return to the new sections added to subchapter F (i.e., secs. 507, 508 and 509). The definition of a "private foundation" in sec. 509 has been discussed above and will not be further analyzed.

Section 507 deals with "termination" of private foundation status. Involuntary termination pursuant to sec. 507(a) (2) has been previously discussed as a *de facto* penalty third-level "tax" for willful violations of the excise tax provisions. This is because sec. 507(c) imposes a "tax" equal to the lesser of either: "(1) . . . the aggregate tax benefit resulting from the section 501(c) (3) status of such foundation, or (2) the value of the net assets of such foundation." Sec. 507(d) defines "aggregate tax benefit" as the sum of: all income, estate and gift taxes saved by all "substantial contributors"<sup>37</sup> because of such contributions since 1913; *plus* the income taxes saved by the organization since 1913 because of its prior tax exempt status; plus interest from the date on which such additional tax would have been due if it had not been for the section 501 exemption. Obviously, in most instances this "tax" would cause the entity to go out of existence because of the lack of any *res*. The only alternative to this confiscatory "tax" is an "abatement" under sec. 507(g).<sup>38</sup> Such "abatement" may take one of two forms. Under sec. 507(g) (1) the private foundation may distribute "all of its net assets" to one or more public charities<sup>39</sup> each of which has been operating for at least five years. Alternatively, under sec. 507(g) (2), if "corrective action" pursuant to state law has been initiated to insure that the assets of the private foundation are devoted only to proper sec. 501(c) (3) purposes, the Commissioner may abate the "tax" upon certification of the appropriate state official that the foundation's assets have been so preserved. Sec. 507(a) (1) provides for a voluntary termination (under Regulations to be issued), with the same consequences to the foundation as an involuntary termination.<sup>40</sup>

Section 508(a) requires certain filings of all potential sec. 501(c) (3) organizations organized after October 9, 1969. Until such organization has notified the Commissioner that it is applying for sec. 501(c) (3) status (pursuant to Regulations to be issued) it is not to be treated as a sec. 501(c) (3) organization. Sec. 508(b) creates a presumption

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<sup>36</sup> For details of this new Code section, see Conf. Rep. 279, Sen. Rep. 30-32, H.R. Rep. Part I, 21-22, Part II, 8, 17-18.

<sup>37</sup> Defined for this purpose by sec. 507(d) (2).

<sup>38</sup> This is provided by the last clause of sec. 507(a).

<sup>39</sup> As defined in sec. 170(b) (1) (A).

<sup>40</sup> For details of this new Code section, see Conf. Rep. 287-88, Sen. Rep. 53-56, H.R. Rep. Part I, 37-40, Part II, 3-4.

that all sec. 501(c) (3) organizations are private foundations—even if it was in existence before the effective date of sec. 508—unless it notifies the Commissioner that it is not a private foundation. Certain organizations are statutorily exempt from this requirement under sec. 508(c) (1); others will be exempted from this requirement under legislative regulations to be issued pursuant to sec. 508(c) (2). Sec. 508(e) in effect codifies the old organization test by requiring that the governing instrument of the organization specifically prohibit all acts which would subject the organization to any of the excise taxes imposed by secs. 4941 through 4945 inclusive. Organizations already in existence on January 1, 1970 have two years to amend their governing instruments to conform to the new rules.<sup>41</sup>

Various additional reporting requirements have been imposed by the 1969 Act. For example, section 101(d) of that Act amends I.R.C. sec. 6033 greatly expanding the annual information return required to be filed by most sec. 501 (c) (3) organizations. And a new Code sec. 6056 was added requiring every private foundation with at least \$5,000 in assets to file an annual report giving full information of its operations and condition during the year.<sup>42</sup> Such annual report is to be available for public inspection.<sup>43</sup>

## Conclusions

The Revenue Act of 1969 is one of the greatest overall changes in the revenue laws since the introduction of the federal income tax in 1913. Perhaps the most extensive changes were made in the area of tax-exempt organizations. Only some of these changes were within the scope of the topic of this presentation, and some of the other changes in the "charitable" area merit great discussion—for example charitable remainder trusts.<sup>44</sup> Even the topics discussed herein, of necessity were discussed briefly due to lack of time and Regulations. The full impact of the 1969 Act on non-profit organizations will not be apparent for quite some time. Perhaps then we may have another Symposium.

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<sup>41</sup> For details of this new Code section, see Conf. Rep. 288, Sen. Rep. 54-55, H.R. Rep. Part I, 38-39, Part II, 4-5.

<sup>42</sup> The contents of this report is listed in I.R.C. sec. 6056(b).

<sup>43</sup> I.R.C. sec. 6104(d) (added by 1969 Act, sec. 101(e) (3)).

<sup>44</sup> See I.R.C. secs. 170(f), 664, 2055(e), 2106(a), and 2522(c) (as added or amended by 1969 Act).