

distinguish from amounts received as gross receipts from carrying on exempt activities.

In distinguishing the term **gross receipts** from the term **grants**, the term **gross receipts** means amounts received from an activity that is not an unrelated trade or business, if a specific service, facility, or product is provided to serve the direct and immediate needs of the payor rather than primarily to confer a direct benefit on the general public. In general, payments made primarily to enable the payor to realize or receive some economic or physical benefit as a result of the service, facility, or product obtained will be treated as gross receipts by the payee.

For example, a profit-making organization, primarily for its own betterment, contracts with a nonprofit organization for a service from that organization. Any payments received by the nonprofit organization (whether from the profit-making organization or from another nonprofit) for similar services are primarily for the benefit of the payor and are therefore gross receipts, rather than grants.

Research leading to the development of tangible products for the use or benefit of a payor generally will be treated as a service provided to serve the direct and immediate needs of the payor, while basic research or studies carried on in the physical or social sciences generally will be treated as primarily to confer a direct benefit upon the general public.

Medicare and Medicaid payments are gross receipts from the exercise or performance of an exempt function. The individual patient, not a governmental unit, actually controls the ultimate recipient of these payments. Therefore, Medicare and Medicaid receipts for services provided each patient are included as gross receipts to the extent they are not more than the greater of \$5,000 or 1% of the organization's total support for the tax year.

**Membership fees distinguished from gross receipts.** The fact that a membership organization provides services, admissions, facilities, or merchandise to its members as part of its overall activities will not, in itself, result in the classification of fees received from members as gross receipts subject to the \$5,000 or 1% limit rather than membership fees. However, if an organization uses membership fees as a means of selling admissions, merchandise, services, or the use of facilities to members of the general public who have no common goal or interest (other than the desire to buy the admissions, merchandise, services, or use of facilities), the fees are not membership fees but are gross receipts.

On the other hand, to the extent the basic purpose of the payment is to provide support for the organization rather than to buy admissions, merchandise, services, or the use of facilities, the payment is a membership fee.

**Bureau defined.** The term **any bureau or similar agency of a governmental unit** for determining amounts subject to the \$5,000 or 1% limit means a specialized operating unit of the executive, judicial, or legislative branch of government in which business is conducted under certain rules and regulations. Since the term bureau refers to a unit functioning at the operating, as distinct from the policy-making, level of government, it normally means a subdivision of a department of government. The term would not usually include those levels of govern-

ment that are basically policy-making or administrative, such as the office of the Secretary or Assistant Secretary of a department, but would consist of the highest operational level under the policy-making or administrative levels.

Amounts received from a unit functioning at the policy-making or administrative level of government are treated as received from one bureau or similar agency of the unit. Units of a governmental agency above the operating level are combined and considered a separate bureau for this purpose. Thus, an organization that has gross receipts from both a policy-making or administrative unit and an operational unit of a department will be treated as having gross receipts from two bureaus. For this purpose, the Departments of Air Force, Army, and Navy are separate departments and each has its own policy-making, administrative, and operating units.

**Example 1.** The Bureau for Africa and the Bureau for Latin America are considered separate bureaus. Each is an operating unit under the Administrator of the Agency for International Development, a policy-making official. If an organization had gross receipts from both of these bureaus, the amount of gross receipts from each would be subject to the greater of \$5,000 or the 1% limit.

**Example 2.** A bureau is an operating unit under the administrative office of the Executive Director. The subdivisions of the bureau are Geographic Areas and Project Development Staff. If an organization had gross receipts from these subdivisions, the total gross receipts from these subdivisions would be considered gross receipts from the same bureau and would be subject to the greater of \$5,000 or the 1% limit.

**Grants from public charities.** For purposes of the one-third support test, grants received from a section 509(a)(1) organization (public charity) are generally includible in full in computing the numerator of the support fraction for that tax year.

However, if the amount received is considered an indirect contribution from one of the public charity's donors, it will retain its character as a contribution from the donor, and if, for example, the donor is a substantial contributor to the ultimate recipient, the amount is excluded from the numerator of the support fraction. If a public charity makes both an indirect contribution from its donor and an additional grant to the ultimate recipient, the indirect contribution is treated as made first.

An indirect contribution is one that is expressly or impliedly earmarked by the donor as being for, or for the benefit of, a particular recipient rather than for a particular purpose.

**Method of accounting.** An organization's support is determined solely on the cash receipts and disbursements method of accounting. For example, if a grantor makes a grant to an organization payable over a term of years, the grant will be includible in the support fraction of the grantee organization only when and to the extent amounts payable under the grant are received by the grantee.

**Gross receipts from a related activity.** When the charitable purpose of an organization described in section 501(c)(3) is accomplished

through furnishing facilities for a rental fee or loans to a particular class of persons, such as aged, sick, or needy persons, the support received from those persons will be considered gross receipts from a related exempt activity rather than gross investment income or unrelated business taxable income.

However, if the organization also furnishes facilities or loans to persons who are not members of a particular class and furnishing the facilities or funds does not contribute importantly to accomplishing the organization's exempt purposes, the support received from furnishing the facilities or funds will be considered rents or interest and will be treated as gross investment income or unrelated business taxable income.

**Example.** X, an organization described in section 501(c)(3), is organized and operated to provide living facilities for needy widows of deceased servicemen. X charges the widows a small rental fee for the use of the facilities. Since X is accomplishing its exempt purpose through the rental of the facilities, the support received from the widows is considered gross receipts from a related exempt activity. However, if X rents part of its facilities to persons having no relationship to X's exempt purpose, the support received from these rentals will be considered gross investment income or unrelated business taxable income.

## Section 509(a)(3) Organizations

Section 509(a)(3) excludes from the definition of private foundation those organizations that meet all of the three following requirements.

1. The organization must be organized and at all times thereafter operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified organizations (which can be either domestic or foreign) as described in section 509(a)(1) or 509(a)(2). These section 509(a)(1) and 509(a)(2) organizations are commonly called **publicly-supported organizations**.
2. The organization must be operated, supervised, or controlled by or in connection with one or more of the organizations described in section 509(a)(1) or 509(a)(2).
3. The organization must not be controlled directly or indirectly by disqualified persons (defined later) other than foundation managers and other than one or more organizations described in section 509(a)(1) or 509(a)(2).

Section 509(a)(3) differs from the other provisions of section 509 that describe a publicly-supported organization. Instead of describing an organization that conducts a particular kind of activity or that receives financial support from the general public, section 509(a)(3) describes organizations that have established certain relationships in support of section 509(a)(1) or 509(a)(2) organizations. Thus, an organization may qualify as other than a private foundation even though it may be funded by a single donor, family, or corporation. This kind of funding ordinarily would indicate private foundation status, but a section 509(a)(3) organ-

stantial identity of interests has developed between the organizations.

If a supporting organization is operated, supervised, or controlled by, or is supervised or controlled in connection with, one or more publicly-supported organizations, it will not fail the test of being organized for the benefit of specified organizations solely because its articles:

1. Permit the substitution of one publicly-supported organization within a designated class for another publicly-supported organization either in the same or a different class designated in the articles,
2. Permit the supporting organization to operate for the benefit of new or additional publicly-supported organizations of the same or a different class designated in the articles, or
3. Permit the supporting organization to vary the amount of its support among different publicly-supported organizations within the class or classes of organizations designated by the articles.

See also the rules considered under the *Organizational test*, in the later discussion for organizations in *Category two*.

**Operational test — permissible beneficiaries.** A supporting organization will be regarded as operated exclusively to support one or more specified publicly-supported organizations only if it engages solely in activities that support or benefit the specified organizations. These activities may include making payments to or for the use of, or providing services or facilities for, individual members of the charitable class benefited by the specified publicly-supported organization.

For example, a supporting organization may make a payment indirectly through another unrelated organization to a member of a charitable class benefited by a specified publicly-supported organization, but only if the payment is a grant to an individual rather than a grant to an organization. Similarly, an organization will be regarded as operated exclusively to support or benefit one or more specified publicly-supported organizations if it supports or benefits a section 501(c)(3) organization, other than a private foundation, that is operated, supervised, or controlled directly by or in connection with a publicly-supported organization, or an organization that is a publicly-owned college or university. However, an organization will not be regarded as one that is operated exclusively to support or benefit a publicly-supported organization if any part of its activities is in furtherance of a purpose other than supporting or benefiting one or more specified publicly-supported organizations.

**Operational test — permissible activities.** A supporting organization does not have to pay its income to the publicly-supported organizations to meet the operational test. It may satisfy the test by using its income to carry on an independent activity or program that supports or benefits the specified publicly-supported organizations. All such support, however, must be limited to permissible beneficiaries described earlier. The supporting organization also may engage in fund-raising activities, such as solic-

tations, fund-raising dinners, and unrelated trade or business, to raise funds for the publicly-supported organizations or for the permissible beneficiaries.

**Absence of control by disqualified persons.** The third requirement an organization must meet to qualify as a supporting organization requires that the organization not be controlled directly or indirectly by one or more disqualified persons (other than foundation managers or one or more publicly-supported organizations).

**Disqualified persons.** For the purposes of the rules discussed in this publication, the following persons are considered disqualified persons:

1. All substantial contributors to the foundation.
2. All foundation managers of the foundation.
3. An owner of more than 20% of:
  - a. The total combined voting power of a corporation that is (during such ownership) a substantial contributor to the foundation,
  - b. The profits interest of a partnership that is (during such ownership) a substantial contributor to the foundation, or
  - c. The beneficial interest of a trust or unincorporated enterprise that is (during such ownership) a substantial contributor to the foundation.
4. A member of the family of any of the individuals just listed.
5. A corporation of which more than 35% of the total combined voting power is owned by persons just listed.
6. A partnership of which more than 35% of the profits interest is owned by persons described in (1), (2), (3), or (4).
7. A trust, or estate, of which more than 35% of the beneficial interest is owned by persons described in (1), (2), (3), or (4).

Remember, however, that foundation managers and publicly-supported organizations are not disqualified persons for purposes of the third requirement under section 509(a)(3).

If a person who is a disqualified person with respect to a supporting organization, such as a substantial contributor, is appointed or designated as a foundation manager of the supporting organization by a publicly-supported beneficiary organization to serve as the representative of the publicly-supported organization, that person is still a disqualified person, rather than a representative of the publicly-supported organization.

An organization is considered controlled for this purpose if the disqualified persons, by combining their votes or positions of authority, may require the organization to perform any act that significantly affects its operations or may prevent the organization from performing the act. This includes, but is not limited to, the right of any substantial contributor or spouse to designate annually the recipients from among the publicly-supported organizations of the income from his or her contribution. Except as explained under *Proof of independent control*, next, a sup-

porting organization will be considered to be controlled directly or indirectly by one or more disqualified persons if the voting power of those persons is 50% or more of the total voting power of the organization's governing body, or if one or more of those persons have the right to exercise veto power over the actions of the organization.

Thus, if the governing body of a foundation is composed of five trustees, none of whom has a veto power over the actions of the foundation, and no more than two trustees are at any time disqualified persons, the foundation is not considered controlled directly or indirectly by one or more disqualified persons by reason of this fact alone. However, all pertinent facts and circumstances (including the nature, diversity, and income yield of an organization's holdings, the length of time particular stocks, securities, or other assets are retained, and its manner of exercising its voting rights with respect to stocks in which members of its governing body also have some interest) are considered in determining whether a disqualified person does in fact indirectly control an organization.

**Proof of independent control.** An organization is permitted to establish to the satisfaction of the IRS that disqualified persons do not directly or indirectly control it. For example, in the case of a religious organization operated in connection with a church, the fact that the majority of the organization's governing body is composed of lay persons who are substantial contributors to the organization will not disqualify the organization under section 509(a)(3) if a representative of the church, such as a bishop or other official, has control over the policies and decisions of the organization.

**Category two.** This category includes organizations operated in connection with one or more organizations described in section 509(a)(1) or 509(a)(2).

This kind of section 509(a)(3) organization is one that has certain types of operational relationships. If an organization is to qualify as a section 509(a)(3) organization because it is operated in connection with one or more publicly-supported organizations, it must not be controlled by disqualified persons (as described earlier) and it must meet an organizational test, a responsiveness test, an integral-part test, and an operational test.

**Organizational test.** This test requires that the organization, in its governing instrument:

1. Limit its purposes to supporting one or more publicly-supported organizations,
2. Designate the organizations operated, supervised, or controlled by, and
3. Not have express powers inconsistent with these purposes.

These tests apply to all supporting organizations.

In the case of an organization that is operated in connection with one or more publicly-supported organizations, however, the designation requirement under the organizational test can be satisfied using either of the following two methods.

**Method one.** If an organization is organized and operated to support one or more publicly-supported organizations and it is oper-

want more than 5 members

In '78, P.L. 95-600, Sec. 520(a), substituted "2 percent" for "4 percent" in subsec. (a), effective for tax yrs. begin. after 9/30/77.

—P.L. 95-345, Sec. 2(a)(4), added "payments with respect to securities loans (as defined in section 512(a)(5)), after "rents" in para. (c)(2), effective for amounts received after 12/31/76 as payments with respect to securities loans (as defined in Code Sec. 512(a)(5)) and transfers of securities, under agreements described in Code Sec. 1058.

In '76, P.L. 94-455, Sec. 1901(b)(33)(N), substituted "capital gain net income" for "net capital gain" in para. (c)(1) and in para. (c)(4), effective for tax yrs. begin. after 12/31/76.

In '69, P.L. 91-172, Sec. 101(b), added Code Sec. 4940, effective for tax yrs. begin. after 12/31/69; Sec. 101(d)(8) provides as follows:

"(8) Certain redemptions—For purposes of applying section 302(b)(1) to the determination of the amount of gross investment income under sections 4940 and 4948(a) any distribution made to a private foundation in redemption of stock held by such foundation in a business enterprise shall be treated as not essentially equivalent to a dividend, if such redemption is described in paragraph (2)(B) of this subsection" [see note following Code Sec. 4941].

## Sec. 4941. Taxes on self-dealing.

### (a) Initial taxes.

(1) **On self-dealer.** There is hereby imposed a tax on each act of self-dealing between a disqualified person and a private foundation. The rate of tax shall be equal to 5 percent of the amount involved with respect to the act of self-dealing for each year (or part thereof) in the taxable period. The tax imposed by this paragraph shall be paid by any disqualified person (other than a foundation manager acting only as such) who participates in the act of self-dealing. In the case of a government official (as defined in section 4946(c)), a tax shall be imposed by this paragraph only if such disqualified person participates in the act of self-dealing knowing that it is such an act.

(2) **On foundation manager.** In any case in which a tax is imposed by paragraph (1), there is hereby imposed on the participation of any foundation manager in an act of self-dealing between a disqualified person and a private foundation, knowing that it is such an act, a tax equal to 2½ percent of the amount involved with respect to the act of self-dealing for each year (or part thereof) in the taxable period, unless such participation is not willful and is due to reasonable cause. The tax imposed by this paragraph shall be paid by any foundation manager who participated in the act of self-dealing.

### (b) Additional taxes.

(1) **On self-dealer.** In any case in which an initial tax is imposed by subsection (a)(1) on an act of self-dealing by a disqualified person with a private foundation and the act is not corrected within the taxable period, there is hereby imposed a tax equal to 200 percent of the amount involved. The tax imposed by this paragraph shall be paid by any disqualified person (other than a foundation manager acting only as such) who participated in the act of self-dealing.

(2) **On foundation manager.** In any case in which an additional tax is imposed by paragraph (1), if a foundation manager refused to agree to part or all of the correction, there is hereby imposed a tax equal to 50 percent of the amount involved. The tax imposed by this paragraph shall be paid by any foundation manager who refused to agree to part or all of the correction.

### (c) Special rules.

For purposes of subsections (a) and (b)—

(1) **Joint and several liability.** If more than one person is liable under any paragraph of subsection (a) or (b) with respect to any one act of self-dealing, all such persons shall be jointly and severally liable under such paragraph with respect to such act.

(2) **\$10,000 limit for management.** With respect to any one act of self-dealing, the maximum amount of the tax imposed by subsection (a)(2) shall not exceed \$10,000, and the maximum amount of the tax imposed by subsection (b)(2) shall not exceed \$10,000.

### (d) Self-dealing.

(1) **In general.** For purposes of this section, the term "self-dealing" means any direct or indirect—

(A) sale or exchange, or leasing, of property between a private foundation and a disqualified person;

(B) lending of money or other extension of credit between a private foundation and a disqualified person;

(C) furnishing of goods, services, or facilities between a private foundation and a disqualified person;

(D) payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person;

(E) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation; and

(F) agreement by a private foundation to make any payment of money or other property to a government official (as defined in section 4946(c)), other than an agreement to employ such individual for any period after the termination of his government service if such individual is terminating his government service within a 90-day period.

(2) **Special rules.** For purposes of paragraph (1)—

(A) the transfer of real or personal property by a disqualified person to a private foundation shall be treated as a sale or exchange if the property is subject to a mortgage or similar lien which the foundation assumes or if it is subject to a mortgage or similar lien which a disqualified person placed on the property within the 10-year period ending on the date of the transfer;

(B) the lending of money by a disqualified person to a private foundation shall not be an act of self-dealing if the loan is without interest or other charge (determined without regard to section 7872) and if the proceeds of the loan are used exclusively for purposes specified in section 501(c)(3);

(C) the furnishing of goods, services, or facilities by a disqualified person to a private foundation shall not be an act of self-dealing if the furnishing is without charge and if the goods, services, or facilities so furnished are used exclusively for purposes specified in section 501(c)(3);

(D) the furnishing of goods, services, or facilities by a private foundation to a disqualified person shall not be an act of self-dealing if such furnishing is made on a basis no more favorable than that on which such goods, services, or facilities are made available to the general public;

(E) except in the case of a government official (as defined in section 4946(c)), the payment of compensation (and the payment or reimbursement of expenses) by a private foundation to a disqualified person for personal services which are reasonable and necessary to carrying out the exempt purpose of the private foundation shall not be an act of self-dealing if the compensation (or payment or reimbursement) is not excessive;

(F) any transaction between a private foundation and a corporation which is a disqualified person (as defined in section 4946(a)), pursuant to any liquidation, merger, redemption, recapitalization, or other corporate adjustment, organization, or reorganization.

oses of this section—  
 section. The terms "correction" and "correct" with respect to any taxable expenditure, (A) recovery or all of the expenditure to the extent recovery is made, and where full recovery is not possible such corrective action as is prescribed by the Secretary, or (B) in the case of a failure to comply with subsection (h)(2) or (h)(3), obtaining or making good in question.  
 able period. The term "taxable period" means, with respect to any taxable expenditure, the period beginning on the date on which the taxable expenditure occurs and ending on the earlier of—  
 (1) the date of mailing a notice of deficiency with respect to the tax imposed by subsection (a)(1) under section 6212; or  
 (2) the date on which the tax imposed by subsection (a)(1) is assessed.

Sec. 4946. Definitions and special rules.

(a) Disqualified person.

- (1) In general. For purposes of this subchapter, the term "disqualified person" means, with respect to a private foundation, a person who is—
- (A) a substantial contributor to the foundation,
  - (B) a foundation manager (within the meaning of subsection (b)(1)),
  - (C) an owner of more than 20 percent of—
    - (i) the total combined voting power of a corporation,
    - (ii) the profits interest of a partnership, or
    - (iii) the beneficial interest of a trust or unincorporated enterprise,
 which is a substantial contributor to the foundation,
  - (D) a member of the family (as defined in subsection (d)) of any individual described in subparagraph (A), (B), or (C),
  - (E) a corporation of which persons described in subparagraph (A), (B), (C), or (D) own more than 35 percent of the total combined voting power,
  - (F) a partnership in which persons described in subparagraph (A), (B), (C), or (D) own more than 35 percent of the profits interest,
  - (G) a trust or estate in which persons described in subparagraph (A), (B), (C), or (D) hold more than 35 percent of the beneficial interest,
  - (H) only for purposes of section 4943, a private foundation—
    - (i) which is effectively controlled (directly or indirectly) by the same person or persons who control the private foundation in question, or
    - (ii) substantially all of the contributions to which were made (directly or indirectly) by the same person or persons described in subparagraph (A), (B), or (C), or members of their families (within the meaning of subsection (d)), who made (directly or indirectly) substantially all of the contributions to the private foundation in question, and

P.L. 100-647, Sec. 1001(d)(1)(B), amended para. (g)(1), effective for tax yrs. begin. after 12/31/86, but only in the case of partnerships and fellowships granted after 8/16/86.  
 to amendment, para. (g)(1) read as follows:  
 the grant constitutes a scholarship or fellowship grant which is subject to the provisions of section 117(a) and is to be used for an educational organization described in section 170(b)(1)(A)(ii)."  
 6, P.L. 99-514, Sec. 122(a)(2)(B), substituted "section 74(b) out regard to paragraph (3) thereof" for "section 74(b)" in (g)(2), effective for prizes and awards granted after 12/31/86.  
 4, P.L. 98-369, Sec. 302(b), amended para. (d)(4), effective for grants made after 12/31/84, in tax yrs. end. after 12/31/84.  
 to amendment, para. (d)(4) read as follows:  
 4) as a grant to an organization (other than an organization described in paragraph (1), (2), or (3) of section 509(a)), unless the foundation exercises expenditure responsibility with respect to such grant in accordance with subsection (h), or  
 80, P.L. 96-596, Sec. 2(a)(1)(F), substituted "taxable period" for "correction period" in para. (b)(3), and Sec. 2(a)(2)(E), amended (1)(2), effective as provided in Sec. 2(d) of this Act which reads as follows:

Effective dates.—  
 (1) First tier taxes.—The amendments made by this section with respect to any first tier tax shall take effect as if included in the Internal Revenue Code of 1954 when such tax was first imposed.  
 (2) Second tier taxes.—The amendments made by this section with respect to any second tier tax shall apply only with respect to taxes assessed after the date of the enactment of this Act [12/24/80]. Nothing in the preceding sentence shall be construed to limit the assessment of a tax in a case to which, on the date of enactment of this Act [12/24/80], the doctrine of res judicata applies.

(3) First and second tier tax.—For purposes of this section, the terms "first tier tax" and "second tier tax" have the respective meanings given to such terms by section 4962 of the Internal Revenue Code of 1954.

or to amendment para. (1)(2) read as follows:  
 (2) Correction period. The term "correction period" means, with respect to any taxable expenditure, the period beginning with the date on which the taxable expenditure occurs and ending 90 days after the date of mailing of a notice of deficiency with respect to the tax imposed by subsection (b)(1) under section 6212, extended

(A) any period in which a deficiency cannot be assessed under section 6213(a), and  
 (B) any other period which the Secretary determines is reasonable and necessary to bring about correction of the taxable expenditure (except that such determination shall not be made with respect to any taxable expenditure within the meaning of paragraph (1), (2), (3), or (4) of subsection (d) because of any action by an appropriate State officer as defined in section 6104(c)(2))."

1976, P.L. 94-455, Sec. 1901(b)(8)(H), substituted "educational organization" described in section 170(b)(1)(A)(ii) for "educational

- (1) only for purposes of section 4941, a government official (as defined in subsection (c)).
- (2) Substantial contributors. For purposes of paragraph (1), the term "substantial contributor" means a person who is described in section 507(d)(2).
- (3) Stockholdings. For purposes of paragraphs (1)(C) and (1)(E), there shall be taken into account indirect stockholdings which would be taken into account under section 267(c), except that, for purposes of this paragraph, section 267(c)(4) shall be treated as providing that members of the family of an individual are the members within the meaning of subsection (d).
- (4) Partnerships; trusts. For purposes of paragraphs (1)(C)(ii) and (iii), (1)(F), and (1)(G), the ownership profits or beneficial interests shall be determined in accordance with the rules for constructive ownership of stock provided in section 267(c) (other than paragraph (4) thereof), except that section 267(c)(4) shall be treated as providing that the members of the family of an individual are the members within the meaning of subsection (d).