PART II

CURRENT DEVELOPMENTS

by
Toussaint Tyson and Thomas J. Miller

1. Announcements

Announcement 98-108, 1998-48 I.R.B. 11 (November 30, 1998)

This announces public hearings on the proposed regulations, REG-12168-97 (concerning the unrelated business income tax consequences of travel tours hosted by exempt organizations), which were held on February 10, 1999. These proposed regulations are more fully discussed under section 5 of this article.

Announcement 99-62, 1999-25 I.R.B. 13 (June 21, 1999)

This reminded tax-exempt organizations of the June 8, 1999, effective date for T.D. 8818, 1999-17 I.R.B. 3 (April 26, 1999), 64 Fed. Reg. 17279 (April 9, 1999), which requires exempt organizations other than private foundations to provide, on request, copies of the application for recognition of exemption and three most recently filed information returns.

2. Notices, Revenue Procedures and Revenue Rulings

Notice 98-58, 1998-49 I.R.B. 13 (December 7, 1998)

This notice contains a proposed revenue procedure providing procedures for issuers to request an administrative appeal of an adverse determination by the Employee Plans/Exempt Organizations Key District that interest on their debt obligations is not excludable from gross income under IRC 103. The revenue procedure would implement section 3105 of the Internal Revenue Service Restructuring and Reform Act, P.L. 105-206, 112 STAT. 685 (the Act), which directs the Service to modify its administrative procedures to allow issuers to appeal an adverse determination of the bond's interest excludablity.

The notice requested comments on the proposed revenue procedure and on the application of the early referral program to bond issues.

Notice 99-17, 1999-14 I.R.B. 6 (April 5, 1999)

This notice modifies Notice 98-20, 1998-13 I.R.B. 25, to reflect changes made to IRC 1(h) by the Tax and Trade Relief Extension Act of 1998, P.L. 105-277, 112 STAT. 2681. The changes affect the treatment of post-1997 distributions of certain capital gains properly taken into account in 1997 by an IRC 664 charitable remainder trust.

Notice 99-31, 1999-23 I.R.B. 1 (May 20, 1999)

This notice informed taxpayers that the deadline for special reformations of CRUT's provided for by section 1.664-3(a)(1)(i)(f)(3) of the Treasury Regulations has been extended to June 30, 2000. The notice also clarifies that the term "legal proceedings," used in that section of the Treasury Regulations, includes non-judicial reformations, if such reformations are valid under state law and if completed by June 30, 2000.

Notice 99-36, 1999-26 I.R.B. 1 (June 14, 1999)

This notice alerts taxpayers and organizations described in IRC 170(c) about certain charitable split-dollar insurance transactions that purport to give rise to charitable contribution deductions under IRC 170 or IRC 2522. Taxpayers and these organizations are notified that the such transactions will not produce the tax benefits advertised by the promoters and that parties undertaking these transactions may be subject to other adverse tax consequences, including paying penalties and excise taxes.

Rev. Proc. 98-62, 1998-52 I.R.B. 23 (December 28, 1998)

This revenue procedure updates Rev. Proc. 97-56, 1997-2 C.B. 582, and identifies circumstances under which the disclosure of a taxpayer's return position with respect to an item is adequate for the purpose of reducing the understatement of income tax under IRC 6662(d) (relating to the substantial understatement penalty) and the IRC 6694(a) preparer penalty. The revenue procedure addresses many items on an income tax return, including, at ' 4.01(1)(d), disclosure concerning contributions reported on lines 15 through 18 on the Form 1040. The revenue procedure also clarifies when Form 8283, *Noncash Charitable Contributions*, must be attached to the return and whether the IRC 170(f)(8) contemporaneous written acknowledgment must be attached.

Rev. Proc. 98-63, 1998-52 I.R.B. 25 (December 28, 1998)

This revenue procedure, at section 7, updates Rev. Proc. 97-58, 1997-2 C.B. 587, by providing optional standard mileage rates for employees, self-employed individuals, or other taxpayers to use in computing the deductible costs, paid or incurred on or after January 1, 1999, of operating an automobile for business, charitable, medical or moving expense purposes. The substantiation methods mentioned in this revenue procedure are permissible not mandatory.

3. Proposed and Final Regulations

REG-106177-97, 1998-37 I.R.B. 33 (September 14, 1998), 63 Fed. Reg. 45019 (August 24, 1998)

This document contains proposed regulations on qualified State tuition programs (QSTP's). These proposed regulations reflect changes to the law made by the Small Business Job Protection Act of 1996 and the Taxpayer Relief Act of 1997. The proposed regulations affect QSTP's established and maintained by a State or agency or instrumentality of a State, and individuals receiving distributions from QSTP's.

REG-246256-96, 1998-34 I.R.B. 9 (August 24, 1998), 63 Fed. Reg. 41486 (August 4, 1998)

This proposed regulation provides guidance on the excise taxes on excess benefit transactions under IRC 4958, which was added to the Code by Taxpayer Bill of Rights 2, P.L. 104-168, 110 Stat. 1452, and is generally effective for transactions occurring on or after September 14, 1995. The IRC 4958 excise taxes are imposed on certain transactions that provide excess economic benefits to disqualified persons of public charities and social welfare organizations. The proposed regulations clarify certain definitions and rules (including the "rebuttable presumption of reasonableness") contained in IRC 4958.

T.D. 8791, 1999-5 I.R.B. 7 (February 1, 1999), 63 Fed. Reg. 68188 (December 10, 1998)

This transmits final regulations under IRC 664, concerning charitable remainder unitrusts and charitable remainder annuity trusts, and under IRC 2702, concerning special valuation rules for transfers of interests to trusts. The final regulations contain: rules on the conditions under which the governing trust instrument may provide a change in the method of calculating the unitrust amount under IRC 664(d)(3); rules on the date by which the annuity amount or the

unitrust amount must be paid to the non-charitable recipient; rules concerning the appraisal of and definition of unmarketable assets; clarification on the application of IRC 2702 to certain charitable remainder unitrusts; and a prohibition on the allocation of precontribution gain to trust income and the prohibition on the treatment of the make-up amount as a trust liability.

T.D. 8791 obsoletes Notice 97-68, 1997-2 C.B. 330, as of December 10, 1998.

T.D. 8802, 1999-4 I.R.B. 10 (January 25, 1999), 63 Fed. Reg. 71591 (December 29, 1998)

This final regulation contains IRC 337 guidance to implement provisions of the Tax Reform Act of 1986 P.L. 99-514, 100 STAT. 2085, and the Technical and Miscellaneous Revenue Act of 1988, P.L. 100-647, 101 STAT. 3342, concerning the repeal of General Utilities. They generally affect a taxable corporation that transfers all or substantially all of its assets to a tax-exempt entity or converts from a taxable corporation to a tax-exempt entity in a transaction other than a liquidation, and generally require the taxable corporation to recognize gain or loss as if it had sold the assets transferred at fair market value.

T.D. 8818, 1999-17 I.R.B. 3 (April 26, 1999), 64 Fed. Reg. 17279 (April 9, 1999)

These final regulations provide guidance for tax-exempt organizations (other than private foundations) required to make their applications for tax exemption and annual information returns available for public inspection. In particular, these regulations provide guidance for tax-exempt organizations required to comply with written or in-person requests from individuals who seek copies of those documents. These regulations describe how a tax-exempt organization can make the documents "widely available" and, therefore, not be required to provide copies in response to individual requests. T.D. 8818 also addresses the standards that apply in determining whether a tax-exempt organization is the subject of a harassment campaign and provide guidance on the applicable procedures for obtaining relief from the requirement that copies of documents be provided in response to requests.

T.D. 8818 became effective June 8, 1999.

(Private foundations continue to be subject to the public disclosure requirements under IRC 6104(d) and (e), as in effect prior to the Tax and Trade Relief Extension Act of 1998, P.L. 105-277, 112 STAT. 2681).

4. Court Decisions

A. Exemption and Foundation Classification Cases

Anclote Pyschiatric Center, Inc. v. Commissioner, T.C. Memo 1998-273

The Tax Court found the Service had not improperly revoked Anclote's exemption, which revocation was based on Anclote's sale of its assets for less than fair market value.

The Service had the burden of proof because of an earlier unfavorable ruling on the burden of proof, Anclote Pyschiatric Center, Inc. v. Commissioner, 98 T.C. 374 (1992) (The Service had failed to rule on the request for a determination with respect to its continuing qualification for exemption within 270 days after the date the request was submitted.) Furthermore, the Service's evidence on valuation was ruled inadmissible.

The organization had received a 1982 private letter ruling that if a certain proposed asset sale to an investor group composed of board members was at fair market value, there would be no disqualifying inurement. The sale went forward and the organization was later examined. The court found that the sale price was based on a price for the assets which did not include approximately $1,000,000 worth of real estate; further the court found the sale price was $6,638,120, and that Anclote had received considerably less. The excess was considered fatal inurement sufficient to uphold the revocation.

Emmet Fields v. United States of America, 98-1 U.S.T.C. ¶ 50,361, 81 A.F.T.R.2d (RIA) 1625 (D.C.C. 1998)

The district court dismissed the plaintiff's case for lack of standing. Apparently, the plaintiff's organization's claim to exemption as a church had been denied by the Service. He filed the following three claims: that IRC 501(c)(3), "which establishes the criteria for an organization to receive tax exempt status", is unconstitutional; that the Kurtz fourteen-point test used to assist in determining whether an organization is a church, is unconstitutional; and that that individuals cannot achieve tax-exempt status is also unconstitutional. The court found the plaintiff lacks standing under Lujan v. Defenders of Wildlife, 504 U.S. 555 (1992) (concerning the Endangered Species Act of 1973), where the complained of harm is not particularized nor would any granted relief singularly benefit him. As to the plaintiff's substantive constitutional arguments, the court relied on a legion of cases supporting the constitutionality of the plaintiff's first and second claims. The court did not directly address the third claim concerning exemption for individuals.

Tate Family Foundation v. Commissioner, T.C. Memo 1999-165

The Tax court upheld the Service's adverse determination on the organization's application for exempt status.

The creators and a supermajority of the board and officers were of the same family. The organization filed the Form 1023, *Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*, but submitted vague answers in response to requests for clarifying information. The organization appealed the proposed adverse determination letter, but provided vague information here also. The final adverse determination stated that the organization did not meet the operational test under section 1.501(c)(3)-1 of the Income Tax Regulations.

The Tax Court citing to Bubbling Well Church of Universal Love, Inc. v. Commissioner, 74 T.C. 531, 535 (1980), *aff'd* 670 F.2d 104 (9th Cir. 1981), stated that the opportunity for abuse is present where the affairs of an organization are controlled by its creators who belong to the same family. In such a case, the Tax Court "require[s] an open and candid disclosure of all facts bearing upon the organization, its operations, and its finances so that [the court] may be assured that [it] is not sanctioning an abuse of the revenue laws by granting a claimed exemption."

Tamaki Foundation v. Commissioner, T.C. Memo 1999-166

The Tax Court upheld the Service's adverse determination on the organization's application for exempt status.

The creators were husband and wife, who also made up a majority of the board and officers. The organization filed the Form 1023, *Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*, claiming the organization's activities would include financial assistance to the poor, services to the aged, and aid to the handicapped; however, in response to repeated Service requests for clarifying information, the organization submitted vague uninformative answers. The organization appealed the proposed adverse determination letter, but provided vague information here also. The final adverse determination stated that the organization did not meet the operational test of section 1.501(c)(3)-1 of the Income Tax Regulations.

The Tax Court, citing Bubbling Well Church of Universal Love, Inc. v. Commissioner, 74 T.C. 531, 535 (1980), *aff'd* 670 F.2d 104 (9th Cir. 1981), stated that the opportunity for abuse is present where the affairs of an organization are controlled by its creators who belong to the same family. In such a case, the Tax Court "require[s] an open and candid disclosure of all facts bearing upon the organization, its operations, and its finances so that [the court] may be assured

that [it] is not sanctioning an abuse of the revenue laws by granting a claimed exemption."

Larry D. Bowen Family Foundation v. Commissioner, T.C. Memo 1999-149

The Tax Court sustained the Service's determination that the organization had failed to show that it met the operational test under section 1.501(c)(3)-1 of the Income Tax Regulations.

United Cancer Council v. Commissioner, 165 F.3rd 1173 (7th Cir. 1999) *rev'g* and *remanding* 109 T.C. 326 (1997)

The Seventh Circuit reversed the Tax Court's opinion, which had upheld the Service's revocation of United Cancer Council's (UCC) exemption under IRC 501(c)(3) on the grounds that UCC's earnings inured to the benefit of a fund-raiser, Watson & Hughey (W&H). The case was remanded for review of the Service's second ground for revocation, which is that UCC had conferred private benefit to W&H.

In 1984 UCC had entered into a five year mail solicitation fund-raising contract with W&H. UCC had no risk under the contract if the fund-raising contract went poorly, and enjoyed income if the fund-raising was successful. UCC paid very high fees for the creation of the mailing lists, which the Tax Court had found were controlled by W&H during the term of the contract. Most of the expenses resulting from generation of the mailing list were paid to W&H or one of its affiliates. Funds generated by the mail solicitations were deposited into an escrow account and disbursed only on instruction from W&H. UCC was dependent on these funds to avoid insolvency. Even though the contract was amended from time to time, W&H did not, during the term of the contract, release control of the mailing lists nor of the escrowed funds. Upon expiration, the contract was not renewed by UCC.

The Seventh Circuit reversed the Tax Court's findings that W&H was a UCC insider and its findings that the net earnings of UCC had inured to the benefit of W&H. However, the Seventh Circuit clarified that upon remand, the Tax Court may consider whether UCC had operated to confer private benefit on W&H by the board's violation, if any, of its corporate duty of care involving the dissipation of the charity's assets. (The Court clarified that this type of "private benefit" is different from the usual private benefit case "where charity had dual public and private goals.")

Matthew Fondel v. United States, 98-2 U.S.T.C. ¶ 50,530 (Ct. Cl. 1998)

The Court of Federal Claims dismissed Mr. Fondel's request for declaratory judgment on the exempt status of At Cost Services, Inc. Mr. Fondel filed suit for a declaratory judgment in his capacity as an individual director of the organization. The court, citing to IRC

7428(b)(1), found that it lacked jurisdiction to entertain Mr. Fondel's suit as he had filed the suit in his capacity as an individual, and not as a representative of the organization.

KJ's Fund Raisers, Inc. v. Commissioner, 98-2 U.S.T.C. ¶ 50,869 (2nd Cir. 1998), *aff'g* T.C. Memo 97-424

The Second Circuit affirmed the Tax Court's ruling that KJ's Fund Raisers, Inc., which was organized in 1992, was not described in IRC 501(c)(3). The organization raised funds, through the sale of lottery tickets, exclusively on the site of a lounge, viz., KJ's Place. The Tax Court had found that the lounge's owners controlled the organization and that the organization was operated for the substantial private benefit of KJ's Place and its owners.

On appeal, the organization argued that the Tax Court should have considered state law in its determination of whether the organization met the requirements of IRC 501(c)(3). The organization also argued that the Tax Court should not have considered the organization's pre-July 1, 1994, conduct, because the organization asked the Tax Court for a declaration of its exemption prospectively from July 1, 1994. The Second Circuit ruled that the organization's compliance with the state law is irrelevant to a consideration of compliance with IRC 501(c)(3), a federal law, and that, the pre-July 1, 1994, events and facts are, in fact, relevant to a determination of its actual operating purposes, and the progression, if any of those purposes over time.

Educational Athletic Ass'n v. Commissioner, T.C. Memo 1999-75

The Tax Court upheld the Service's determination that an organization described in IRC 501(c)(3) was a private foundation as all of its revenue was derived from unrelated business taxable income.

The organization was organized primarily to promote athletic education and its sole source of support for 1993, 1994 and 1995 was the sale of "pickle cards" to liquor establishments. On September 27, 1996, the organization submitted Forms 990-T, *Exempt Organization Business Income Tax Return*, for 1993, 1994 and 1995 and reported the "pickle card" receipts as unrelated business taxable income (UBTI). On January 28, 1998, the Service advised the taxpayer that as all of its revenue was from UBTI, the organization was not a public charity under IRC 509(a)(2). The organization argued its income was not UBTI (the filed Forms 990-T, notwithstanding).

The Tax Court ruled that as the "pickle card" sales were conducted continuously from 1993 through 1995, and the sales were conducted to generate a profit, and that such "pickle card" sales comprised a trade or business that was regularly carried on. Citing to the plain

language of IRC 513(a), the court rejected the organization's need for the profits derived from the sales as constituting a substantial relationship to the organization's purpose of promoting athletic education. Additionally, the court rejected the organization's argument that its pickle card sales do not unfairly compete with for-profit businesses; the court, citing to Clarence La Belle Post No. 217, VFW v. United States, 580 F.2d 270, 271 (8th Cir. 1978), found the argument was not significant to the analysis.

Branch Ministries, Inc., et al. . v. Commissioner, 40 F.Supp.2d 15 (D.D.C. 1999)

The District Court for the District of Columbia by summary judgment upheld the Service's revocation of Branch Ministries' exemption under IRC 501(c)(3).

The district court found that on October 30, 1992, the taxpayer had expressed its concern about the moral character of a candidate in the 1992 presidential elections. The expression was placed in two newspapers with wide national circulation.

By November 20, 1992, the Service had begun an IRC 7611 church tax inquiry, followed, in 1993, by an IRC 7611 church tax examination and a 1995 revocation of the organization's exemption retroactive to January 1, 1992. The taxpayer filed a timely action challenging the revocation as violative of IRC 501(c)(3), the Religious Freedom Restoration Act (RFRA), 42 U.S.C. section 2000bb, the First Amendment and the church's equal protection rights under the Fifth Amendment. The Service unsuccessfully challenged a taxpayer discovery motion. Branch Ministries, Inc. v. Richardson, 970 F. Supp. 11 (D.D.C. 1997).

Concerning the taxpayer's argument that the Service's revocation violated the Code, the taxpayer posited that IRC 7611 prevents revocation of exemption, once the Service determines a church is exempt under IRC 501(a), and described in IRC 501(c)(3) unless the Service first determines the organization is not a church. (The Service did not challenge taxpayer's claim that it's a church.)

The District Court tracing the skein of IRC 7611, 501(a) and 501(c)(3) explained that the Service may revoke a church's tax exempt status upon a determination that the organization is not a church exempt under IRC 501(a) which provides exemption for organizations described in IRC 501(c)(3); IRC 501(c)(3), in turn, describes organizations organized for religious purposes that do not politick. The court found that, as the Service had properly determined the organization did politick, it could properly determine the organization was not exempt under IRC 501(a).

Concerning the constitutional claims that it was the subject of selective prosecution because of its political and religious beliefs, the court clarified that the taxpayer had to make the Armstrong showing that the prosecutorial decision had a discriminatory effect or was undertaken with discriminatory intent. *See* United States v. Armstrong, 517 U.S. 456 (1996). The organization was unable to make a case for discriminatory effect where is could show no organizations, i.e., churches, that had placed similar advertisements in two national newspapers and not been revoked. The taxpayer's case for discriminatory intent was based on even less evidence.

Concerning, the taxpayers' free exercise claim, which are protected by the RFRA and the First Amendment, the district court required the plaintiffs to show that the government had substantially interfered with their exercise of religious. Then, under Weir v. Nix, 114 F.3d 817 (8th Cir. 1997), the government would be required to show that application of the burden to the affected persons (here, the plaintiffs) is (1) in furtherance of a compelling governmental interest, and (2) is the least restrictive means of furthering that compelling governmental interest. The court found that the plaintiffs had failed to establish that the revocation substantially burdened their right to freely exercise their religion where they could not show the plaintiffs had to violate their beliefs, *see* Thomas v. Review Bd. Of Indiana Employment Soc. Services Division, 450 U.S. 707 (1981), nor abandon a precept of their religion, Sherbert v. Verner, 374 U.S. 358 (1963). The court noted that revocation, and any consequent taxation merely reduced the taxpayer's disposable cash, but that this is constitutionally insignificant. *See* Bob Jones Univ. v. United States, 461 U.S. 574 (1983).

Finally, the court ruled that the taxpayers' content based discrimination claims - that such discrimination violates their Fifth Amendment right to equal protection, and their First Amendment right to free speech - merely mirrored their Fifth Amendment selective prosecution claim. The re-cast argument still, in the court's view, lacked factual support.

The Fund for Study of Economic Growth and Tax Reform v. Internal Revenue Service, 161 F.3d 755 (D.C. Cir. 1998)

The D.C. Circuit upheld the district court's sustaining the Service's determination that the Fund did not qualify for tax exemption because it operated as a Treas. Regs. 1.501(c)(3)-1(c)(3)(iv)(b) "action" organization.

The Fund's primary activity was to fund the National Commission on Economic Growth and Tax Reform, an organization which studied the merits of only one tax regime, which was advocated by one political party. The Service and the district court considered it appropriate to attribute the activities of the Commission to the Fund in analyzing the Fund's claim to tax-exemption as an organization described in IRC 501(c)(3). The District Court found that the Commission advocated a tax regime which could only be achieved through legislation. The district court also found that the Commission's effort could not be said to be purely non-partisan research where it assumed a conclusion and did not seriously consider any other tax regime.

Ronald M. Auen, Trustee v. United States of America, 83 A.F.T.R.2d ¶ 568 (9th Cir. 1999)

The Ninth Circuit upheld the Service's position that a certain pair of trusts is described in IRC 501(c)(3) and exempt under IRC 501(a) as private foundations and, therefore, liable for the IRC 4940 excise taxes. The Ninth Circuit agreed that both trusts were exempt despite one trust's obligation to "pay the estate taxes of the first trustor to die," which the court characterized as an insubstantial part of the trust's activities. (The trust had unsuccessfully argued they were IRC 4947(a)(1) non-exempt trusts.)

B. Unrelated Trade or Business Cases

Museum of Flight Foundation v. United States, 83 A.F.T.R.2d ¶ 99,474 (W.D.W. 1999)

The district court found that the Museum generated no unrelated business taxable income by its single two year lease of one of its display aircraft.

In 1998, Boeing retired a test aircraft, a Boeing 747 Jumbojet, and donated it to the Museum in an "as is - where is" condition, which was several miles from the museum's main facility. Shortly thereafter, Boeing leased the craft from the Museum to test engines for its forthcoming Boeing 777. Boeing paid the Museum $200,000 over 1991 and 1992, and, when finished, returned the plane, freshly painted and in an enhanced condition, to the Museum at its main facility.

The court ruled this case, unlike Cooper Tire & Rubber Co. Employee's Retirement Fund

v. Commissioner, 306 F.2d 20 (6th Cir. 1962)(which involved a ten year lease of twenty tire-manufacturing machines that were purchased specifically for the purpose of leasing) did not involve a regularly carried on trade or business. Additionally, the court found the test craft's second incarnation as a test craft enhanced its display value and added substantially to the organization's purpose to "acquire, restore, preserve and donate for public display airplanes . . . of present or historic value."

Sierra Club, Inc., v. Commissioner, T.C.Memo 1999-86, *rev'd and remanded by* 86 F.3d 1526 (9th Cir. 1996), *rev'g* 103 T.C. 307 (1994)(Sierra Club II).

The Tax Court ruled against the Service's determination that the amounts received by the Sierra Club from its affinity card program were consideration for services, and ruled that the amounts were royalties within the meaning of IRC 512(b)(2). Accordingly, Sierra Club would not be liable for unrelated business income tax. (In Sierra Club II, the Tax Court ruled, on summary judgment, that the income was royalty income. The Ninth Circuit reversed the Tax Court because payments under an affinity card program are not royalty income as a matter of law, and, therefore, the case could not be disposed of on summary judgment where there were genuine issues of material fact in dispute. The Tax Court was charged to make a factual determination, and did so in this 1999 iteration of the case.)

Common Cause v. Commissioner, 112 T.C. No. 23 (June 22, 1999)

Planned Parenthood Federation of America, Inc. v. Commissioner, T.C. Memo 1999-206

The Tax Court held that amounts paid (a) for the use the respective organizations' mailing lists and (b) certain "royalty-related activities" conducted by the organizations and other parties in connection with the mailing list rentals were not unrelated business income; the amounts were found to be IRC 512(b)(2) royalty payments. The court found the activities conducted by the mailing list brokers to be other than "royalty-related activities;" however, payments attributable to these activities were not held to be UBI. The court found that (a) such payments were not received by the organizations and (b) the brokers were agents of the parties renting the mailing lists - not agents of the organizations. Additionally, the court, relying on legislative history, rejected the Service's argument that the passage of section 1601(a) of the Tax Reform Act of 1986, P.L. 99-514, which added IRC 513(h)(excepting certain mailing list transactions from the definition of trade or business) suggested that other mailing list transactions, which do not fall within IRC 513(h), are the conduct of a trade or business.

C. Chapter 42 Case

Ronald M. Auen, Trustee v. United States of America, 83 A.F.T.R.2d 568 (9th Cir. 1999)

The Ninth Circuit upheld the Service's position that a certain pair of trusts is described

in IRC 501(c)(3) and exempt under IRC 501(a) as private foundations and, therefore, liable for the IRC 4940 excise taxes. The Ninth Circuit agreed that both trusts were exempt despite one trust's obligation to "pay the estate taxes of the first trustor to die," which the court characterized as an insubstantial part of the trust's activities. (The trust had unsuccessfully argued they were IRC 4947(a)(1) non-exempt trusts.)

D. Disclosure and Miscellaneous Cases

Markus Q. Bishop v. United States, 83 A.F.T.R.2d ¶ 99-815 (D.C.N.F. 1999)

The district court by summary judgment ruled the Service's IRC 7609 summons was proper against two church officers who had sought to quash a summons of church records pertaining to income tax liabilities of the officers.

The Service served an IRC 7609 summons on the church and two of its officers. The officers sought to quash the summons. The church intervened under IRC 7609(b), and also filed a petition to quash the Services summons on several grounds, including that the information sought was not relevant to the tax audit. According to the officers and the church, under IRC 7611, the Service was only entitled to payroll records and W-2 information. They also argued that other information under the summons was irrelevant to an income tax audit of the officers.

The court found that IRC 7611 was inapplicable to the analysis because IRC 7611(c)(2) clearly provides that IRC 7611 shall not apply to any inquiry or examination relating to the tax liability of any person other than a church. The district court ruled in favor of the Service on the other defenses as well.

Tax Analysts v. Internal Revenue Service, 83 A.F.T.R.2d 1278 (D.D.C. 1999)

The federal district court ruled on summary judgment that the Service properly withheld closing agreements from disclosure. Tax Analysts argued under the Freedom of Information Act that the closing agreements were disclosable, despite the general confidentiality rules of IRC 6103, because the documents were issued by the Service with respect to applications for exemption, which should be disclosable under IRC 6104(a)(1)(A). The Service failed to respond to the request. In response to the Tax Analysts' administrative appeal from the Service's effective denial of the request, the Service argued that the documents were not disclosable under IRC 6103(a). Tax Analysts filed an action to injoin the Service from withholding the documents.

The district court found that terms of closing agreements are the product of negotiation rather than factors in granting tax exemption. Accordingly, such documents are not issued by the Service, and, therefore, cannot be disclosable under IRC 6104(a). It followed that the IRC 6103 general disclosure proscription controlled, accordingly, the district court ruled the closing agreements are not disclosable.

Anita Schuloff v. Queens College Fdn. Inc, 165 F.3rd 183 (2d Cir. 1999)

The Second Circuit agreed with the defendant exempt organization and found that a requester has no right against an exempt organization to compel compliance with the public disclosure requirements of IRC 6104.

Affiliated Foods, Inc. v. Commissioner, 154 F.3rd 527 (5th Cir. 1998)

The Fifth Circuit ruled for Affiliated Foods, Inc. (AFI), a non-exempt cooperative of small grocery stores that challenged alleged tax deficiencies for taxable years 1989 and 1990. The Tax Court, in Affiliated Foods, Inc. v. Commissioner, T.C. Memo 1999-136, had found AFI had earned income through the management of certain advertising funds destined for its shareholders. AFI appealed. The Fifth Circuit ruled on the facts, not on the proper law to be applied.

The case involved two sets of monies, i.e., promotional account funds and food show funds, both of which were provided by the cooperative's vendors and commingled with the cooperative's general accounts. Concerning the promotional funds, in order to increase the retail sales of the cooperative's members, the vendors encouraged the members to promote the vendor's products. The Fifth Circuit found that the vendors discretionarily deposited funds with AFI to be released, in the amount and manner chosen by the vendor, to the members upon proof submitted to the vendor that the vendor's promotion was undertaken. Following precedent established by Seven-Up Co. v. Commissioner, 14 T.C. 965 (1950), the court ruled AFI never had a claim of right to the monies and, therefore, such monies were not properly includible income of AFI.

Concerning the food show funds, which were used during food shows, hosted by AFI, the vendors were required by AFI to provide special price discounts to AFI's members based on the amount of product bought. The Fifth Circuit, relying on Buckeye Countrymark, Inc. v. Commissioner, 103 T.C. 555 (1994) agreed with the Tax Court's finding that the members had received rebates based on the amount of product purchased *through AFI*, and that AFI was able to provide a patronage dividend without complying with the statutory requirements of Subchapter T (governing the taxation of cooperative income and related distributions). (At the Tax Court level, this failure resulted in the disguised patronage dividends being ineligible for deductibility under Subchapter T of the Code.)

5. Bills Introduced in the 106th Congress (1st Session)

H.R. 1469

This bill would amend IRC 1388 to clarify that marketing, for the purposes of IRC 521 (concerning farmers' cooperatives) and Subchapter T of the Code (concerning the tax treatment of cooperatives), includes feeding animals and selling such animals, and animal products. Additionally, this bill would extend the IRC 7428 declaratory judgement remedy to include the qualification or continuing qualification of organizations claiming exemption under IRC 521.

Generally, this bill would be effective for taxable years beginning after the date of enactment. The declaratory judgment provision would apply to pleadings filed after the date of enactment but only with respect to determinations (or requests for determinations) made after January 1, 1998.

HR 1525

A bill to amend IRC 7701(c) by providing simplified criteria, in lieu of the common law rules endorsed by section 530 of the Revenue Act of 1978 for determining whether a individual is an employee or an independent contractor. The bill's three point test would classify an individual as an independent contractor if he has a right to control and direct the manner of, **and "means used in,"** the service provider's performance of services for the service recipient; he makes similar services available to others and is not prevented from doing so while providing services to any service recipient; and he bears entrepreneurial risk.

Additionally, the bill would repeal section 530 of the Revenue Act of 1978 and includes transitional relief for any taxpayer currently eligible for the section 530 safeharbor. Amended IRC 7701(c) would become effective after September 31, 2000; regulations effected by the repeal of section 530 would not apply to services performed before January 1, 2001. (Current IRC 7701(c)(concerning definition of "include" and "including") would be inserted in a new IRC 7701(a)(33)).

H.R. 1640

This bill would restore and make permanent the exclusion from gross income for amounts received under qualified group legal services plan. The effective date, if passed in current form, would be date of enactment.

H.R. 1707

This bill would amend IRC 513, by creating IRC 513(f)(3), to provide that the conduct of certain games of chance shall not be treated as an unrelated trade or business if they are conducted under a state license available only to non profit or tax-exempt organizations, and the conduct of which does not violate state or local law.

Effective date is date of enactment.

H.R. 1914

This bill would amend IRC 1388(a) to permit cooperatives to pay dividends on stock without reducing the cooperatives' net earnings available for patronage dividends. The bill would be effective on the date of enactment.

H.R. 2101

This bill would extend the work opportunity tax credit to employment taxes of IRC 501(c)(3) organizations. The bill would apply to individuals who begin work for the employer after December 31, 1999.

S. 435

This bill would amend IRC 170(f)(8) to allow the Secretary of the Treasury to waive the IRC 170 substantiation rules. The bill would be effective for contributions made on or after January 1, 1994.

S. 490

Would amend IRC 513(f) to provide all legal games of chance the unrelated business income tax treatment presently accorded bingo, as defined in IRC 513(f). The effective date is date of enactment.

S. 997

A bill to assist states in providing an individual a credit against state income taxes or a comparable benefit for contributions to charitable organizations working to prevent or reduce poverty and to protect and encourage donations to charitable organizations, to prohibit discrimination against nongovernmental organizations and certain individuals on the basis of religion in the distribution of government funds, to provide government assistance and the distribution of such assistance, to allow such organizations to accept such funds to provide such assistance without impairing the religious character of such organizations, to provide for tax-free distributions from individual retirement accounts for charitable purposes, and for other purposes.

Provisions concerning the credit against taxes would be effective on January 1, 2000; provisions to prohibit religious based discrimination would be effective on the date of enactment; and provisions concerning IRA distributions would be effective for taxable years beginning after the bill's date of enactment.

6. Discussion:

PROPOSED REGULATIONS ON TRAVEL AND TOUR ACTIVITIES OF TAX EXEMPT ORGANIZATIONS

Proposed travel tour regulations were published on May 18, 1998. (REG-121268-97, 1998-20 I.R.B. 12.) The proposed regulations add Reg. 1.513-7, which provides that the determination of whether travel tour activities of tax exempt organizations are substantially related to an organization's exempt purposes is a question of facts and circumstances. To illustrate how the facts and circumstances test would apply, the proposed regulations include the following four examples:

Example 1. O, a university alumni association, is exempt from federal income tax under section 501(a) as an educational organization described in section 501(c)(3). As part of its activities, O operates a travel tour program. The program is open to all current members of O and their guests. O works with travel agencies to schedule approximately 10 tours annually to

various destinations around the world. Members of O pay $X to the organizing travel agency to participate in a tour. The travel agency pays O a per person fee for each participant. Although the literature advertising the tours encourages O's members to continue their lifelong learning by joining the tours, and a faculty member of O's related university is invited to join the tour as a guest of the alumni association, none of the tours includes any scheduled instruction or curriculum related to the destinations being visited. By arranging to make travel tours available to its members, O is not contributing importantly to the accomplishment of its educational purpose. Rather, O's program is designed to generate revenues for O by regularly offering its members travel services. Accordingly, O's tour program is an unrelated trade or business within the meaning of section 513(a) of the Code.

Example 2. N is an organization formed for the purpose of educating individuals about the geography and culture of the United States. It is exempt from federal income tax under section 501(a) as an educational and cultural organization described in section 501(c)(3). N engages in a number of activities to accomplish its purposes, including offering courses and publishing periodicals and books. As one of its activities, N conducts study tours to national parks and other locations within the United States. The study tours are conducted by teachers and other education professionals. The tours are open to all who agree to participate in the required study program. The study program consists of community college level course related to the location being visited by the tour. While the students are on the tour, five or six hours per day are devoted to organized study, preparation of reports, lectures, instruction and recitation by the students. Each tour group brings along a library of material related to the subject being studied on the tour. Examinations are given at the end of each tour and N's state board of education awards academic credit for tour participation. Because the tours offered by N include a substantial amount of required study, lectures, report preparation, examinations and qualify for academic credit, the tours clearly further N's educational purpose. Accordingly, N's tour program is not an unrelated trade or business within the meaning of section 513 of the Code.

Example 3. R is a section 501(c)(4) social welfare organization devoted to advocacy on a particular issue. On a regular basis throughout the year, R organizes a travel tour for its members to Washington, D.C. The tours are priced to produce a profit for R. While in Washington, the members follow a schedule according to which they spend substantially all of their time over several days attending meetings with legislators and government officials and receiving briefings on policy developments related to the issue that is R's focus. Bringing members to Washington to participate in advocacy on behalf of the organization and learn about developments relating to the organization's principal focus is substantially related to R's social welfare purpose. Therefore, R's operation of the travel tours does not constitute an unrelated trade or business.

Example 4. S is a membership organization formed to foster cultural unity and to educate

X Americans about X, their country of origin. It is exempt from federal income tax under section 501(a) and is described in section 501(c)(3) as an educational and cultural organization. Membership in S is open to all Americans interested in the X heritage. As part of its activities, S sponsors a program of travel tours to X. All of S's tours are priced to produce a profit for S. The tours are divided into two categories. Category A tours are trips to X that are designed to immerse participants in the X history, culture and language. The itinerary is designed to have participants spend substantially all of their time while in X receiving instruction on the X language, history and cultural heritage. Destinations are selected because of their historical or cultural significance or because of instructional resources they offer. Category B tours are also trips to X, but rather than offering scheduled instruction, participants are given the option of taking guided tours of various X locations included in their itinerary. Other than the optional guided tours, Category B tours offer no instruction or curriculum. Even if participants take all of the tours offered, they have a substantial amount of time free to pursue their own interests once in X. Destinations of principally recreational interest, rather than historical or cultural interest, are regularly included on Category B tour itineraries. Based on the facts and circumstances, sponsoring Category A tours is an activity substantially related to S's exempt purposes, and does not constitute an unrelated trade or business with respect to S. However, sponsoring Category B tours does not contribute importantly to S's accomplishment of its exempt purposes and is designed to generate a profit for S. Therefore, sponsoring the Category B tours constitutes an unrelated trade or business with respect to S.

At a public hearing held on February 10, 1999, representatives from both the for-profit and exempt organization sectors presented their views to the IRS on the proposed regulations. Although most of the speakers were of the opinion that the proposed regulations were fair, at least one speaker for the for-profit sector believed that the regulations fell short of providing meaningful reform and failed to offer objective factors for guidance. Some representatives of the commercial travel and tour businesses also contended that tax exempt organizations continue to engage in for-profit travel activities but are not paying income tax, which affords them a tremendous competitive advantage.

One speaker for the non-profit, tax-exempt sector was critical of the IRS's more traditional view of education and requested that the IRS expand its definition of education by looking at more current types of travel programs, such as programs that offer enrichment through experience rather than academic credit. The speaker also noted that the use of a "substantially all" test to quantify how much of a travel tour is educational is too harsh and suggested use of a "primarily all" test in the regulations.

Speakers also responded to the IRS's request for comments regarding whether it should specify the types of records that exempt organizations must keep to establish whether their trade or business activities further their exempt purposes. A number of speakers on both sides of the issue believed that the IRS should include a recordkeeping requirement. The speakers for the exempt organizations, however, cautioned that such a requirement should not be an administrative burden.

Final regulations on travel tours, as one of the items on the 1999 Treasury/IRS Business Plan, are expected to be published by the end of 1999.