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The *Operated Exclusively* Test for Section 501(c)(3) Organizations

Basic Rules

An organization qualifies for exempt status under IRC Sec. 501(c)(3) only if it is *operated exclusively* for religious, charitable, scientific, testing for public safety, literacy, or educational purposes (charitable activities). The regulations interpret this test to mean that an organization must engage *primarily* in activities that accomplish one or more of these purposes [Reg. 1.501(c)(3)-1(c)(1)]. Conversely, an organization will not satisfy the operated exclusively test if more than an *insubstantial part* of its activities *does not* further an exempt purpose. The presence of a single substantial purpose that is not described in IRC Sec. 501(c)(3) prevents exemption as a Section 501(c)(3) organization regardless of the number or importance of the charitable activities conducted by the organization [*Better Business Bureau*, 34 AFTR 5 S Ct. (1945)].

Recent Examples

***Giving Hearts, Inc.* [TC Memo 2019-94 (2019)].** Giving Hearts, Inc. (GHI) was organized exclusively for IRC Sec. 501(c)(3) exempt purposes, including the purpose of making distributions to other Section 501(c)(3) organizations.

One of its organizers and president of GHI was the spouse (S) of the owner (C) of Window Plus, Inc. (WPI), a for-profit entity specializing in the sale of replacement windows and other home improvement services to residential customers.

As a charitable organization, GHI was permitted to make solicitation calls to phone numbers registered on the national "Do-Not-Call Registry." WPI could not legally do so.

GHI set up a corporate sponsorship program to provide telemarketing opportunities to help businesses generate leads and "give back to a charity." S and C entered into an agreement between GHI and WPI, respectively, authorizing WPI employees to make telemarketing calls on behalf of GHI. The telemarketer would state that the call was made on behalf of GHI to raise funds for local children's charities. The telemarketer would then explain that WPI would make a donation to GHI for every homeowner that accepted a product demonstration. The

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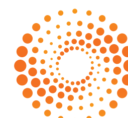

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telemarketer would then launch into a sales pitch for WPI. WPI was obligated to make a contribution to GHI only when a potential customer agreed to an in-home product demonstration.

The Tax Court upheld the IRS's retroactive revocation of GHI's exempt status. The Court carefully noted that the Internal Revenue Code does not prevent the use of a taxable entity to solicit donations. However, in this instance the sponsorship agreement was by design intended to permit WPI "to invoke GHI's name as part of a telemarketing pitch intended, first and foremost, to generate sales leads and revenues." In other words, although telemarketing calls are made on [GHI's] behalf, the real purpose of the calls is to promote business. This is neither an exempt purpose within the meaning of IRC Sec. 501(c)(3) nor related to an exempt purpose. The Court observed that the primary factor of the operational test is the purpose of an organization's activities, not the nature of such activities. Although activities may be "wholesome and commendable," they must be undertaken to further a charitable purpose.

Ltr. Rul. 201934008. The organization (X) seeking exemption under IRC Sec. 501(c)(3) was incorporated exclusively for charitable and educational purposes. Its primary activity was the operation of a coffeehouse with the dual purposes of (1) raising funds for local nonprofits; and (2) acting as a community launch point and gathering venue featuring local art and music. X's hours of operation would be typical for a coffeehouse in its area. Menu prices for food and beverages would be comparable to those of other coffeehouses in the area. Besides operating the coffeehouse, X planned to conduct various types of community building programs.

The IRS ruled that X's primary activity was the operation of a commercial coffeehouse in competition with for-profit coffeehouses. X's primary activity was deemed to be the operation of an unrelated trade or business, which precludes exemption under the operational test.

Ltr. Rul. 201931012. Organization Y was formed to support the development of young professionals working in the public sector in a particular area. Y's activities included professional development training and non-partisan advocacy. Although it was a membership organization aimed at young, nonprofit professionals, Y's activities were open to the public and no membership fee would be charged.

Professional development would include training to improve skill sets advantageous for individuals in nonprofit sectors. It would also help advance members' careers by providing assistance with resumes and skill training presentations. Networking and social events would be held to foster connections among members. The professional and social networking activities generally would be held monthly.

The IRS ruled that Y failed the operational test. Although it conducted educational activities, the social and networking activities were a substantial part of Y's activities and did not promote an educational purpose.

Ltr. Rul. 201904015. The organization in this ruling had lofty charitable purposes, including the following:

- Develop and promote community oriented and charitable programs that enrich and uplift the socio-economic well-being of its members.
- Integrate and assimilate into the body politic of the U.S.

Specific activities prior to the exemption application involved requests to professional and business owners in the organization's area to provide services and/or products for free or at discounted prices to the organization's 16 members.

Reg. 1.501(c)(3)-1(d)(1)(ii) provides that an organization is not organized or operated exclusively for one or more charitable purposes unless it serves a public rather than a private interest. Therefore, an entity must not be organized or operated for the benefit of private interests, such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by those private interests. Because the entity was organized and operated for the private benefit of its members, it did not meet the operational test and did not qualify for exemption.

Practical Consideration:

Too often organizations waste time and money seeking exempt status without properly evaluating whether their activities satisfy the operational test. In other instances, failure occurs when an organization changes its activities.

Court Schools IRS on Meaning of Educational Organization

Background

For the unrelated debt-financed income rules of IRC Sec. 514(a), the term *acquisition indebtedness* does not include indebtedness incurred by an educational

organization (EDU) in acquiring or improving any real property [IRC Sec. 514(c)(9)(C)].

An EDU is defined as an organization that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at the place where the educational activities are regularly carried on [IRC Sec. 170(b)(1)(A)(ii)].

According to the regulations, an organization can qualify as an EDU only if, among other requirements, its primary function is the presentation of formal instruction [Reg. 1.170A-9(c)(1)]. Therefore, an organization engaged in both educational and non-educational activities is not an EDU unless the latter are merely incidental to the educational activities. This regulation was the subject of recent litigation [*Mayo Clinic*, 124 AFTR 2d 2019-5448 (DC MN, 2019)].

The Facts

The Mayo Clinic (M) is the parent organization of several hospitals, clinics, and the Mayo Clinic College of Medicine and Science. M was seeking a refund in unrelated business income tax paid on debt-financed income from real estate. The IRS concluded that M was entitled to the refund if it met the requirements of IRC Sec. 170(b)(1)(A)(ii) during the tax years in question.

The IRS argued that M did not pass the "primary function" and "merely incidental" tests in the regulations since its primary function was health care, not education; and even if that were not so, that M's healthcare activities were not merely incidental to its education activities.

A Matter of Statutory Construction

The Court focused on the validity of the regulations *primary-function* and *merely incidental* tests. It concluded that the regulations were invalid because the IRS had exceeded its statutory authority by the addition of those requirements. Consequently, M was awarded the tax refund.

The Court observed that the Supreme Court has promulgated a two-step analysis to determine a regulation's validity:

- If the intent of Congress is clear, the IRS and the judiciary must give effect that unambiguously expressed intent.
- If a statute is silent or ambiguous concerning a specific issue, the question for a court is whether the IRS's answer is based on a permissible construction of the statute [*Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.,* 467 U.S. 837 (S. Ct. 1984)].

The Court determined that Congress's intent was clear when it did not include the primary-function and merely-incidental tests in IRC Sec. 170(b)(1)(A)(ii). A persuasive factor was that Congress *did* include the primary-function requirement in Sec. 170(b)(1)(A)(iii) when it referenced "principal purpose or function." Although Congress used the adjective "principal" and the IRS used "primary," the Court deemed these terms interchangeable. Therefore, if Congress uses specific language in one part of a Code section [e.g., IRC Sec. 170(b)(1)(A)(iii)] but not another [e.g., IRC Sec. 170(b)(1)(A)(ii)], then there is clear intent that Congress did not want the specific language in the other part. It is a clear and unambiguous omission.

The Court added that the *primary function test* and the *merely-incidental test* are essentially one test. If an organization's primary function is education, then all other activities will necessarily be incidental. Since the IRS improperly included the primary function requirement in the regulation, it was also improper to include the merely-incidental requirement.

Practical Consideration:

As of now, the IRS has not indicated whether it will modify Reg 1.170A-9(c)(1) or continue to litigate the matter in other jurisdictions.

Tax Brief

REV. PROC. 2018-38 INVALIDATED. As we discussed in the September 2018 issue of *The PPC Nonprofit Newsletter*, Rev. Proc. 2018-38 (2018-31 IRB 280) revised reporting requirements for Schedule B of Form 990 or 990-EZ to provide that exempt organizations other than Section 501(c)(3) organizations and Section 527 political organizations would not be required to report donors' names and addresses (for tax years ending on or after December 31, 2018).

However, a Montana district court has invalidated Rev. Proc. 2018-38 because the IRS did not provide notice to the public and allow public comments prior to issuance [*Bullock*, 124 AFTR 2d 2019-5354 (DC MT, 2019)]. In response, REG-102508-16 was released, reflecting the revised reporting requirement set out in Rev. Proc. 2018-38. Additionally, the proposed regulation asks for public comments. Notice 2019-47 (2019-39 IRB) provides penalty relief for those organizations that did not report the information because they relied on the Revenue Procedure.

Proposed Delay in Three Big Standards

On August 15, 2019, a large sigh of relief could be heard throughout the nonprofit organization community when the FASB issued a proposed Accounting Standards Update (ASU). That ASU proposes to delay the effective date of the standards related to leases, hedging, and current expected credit losses (CECL) for private companies, nonprofit organizations, and some small public companies and introduces a new philosophy on effective dates.

New Approach to Effective Dates

The FASB heard very clearly that the significant new accounting standards recently or about to be implemented were more than many private companies and nonprofit organizations could handle. The FASB's plan to address this problem is to expand the gap between the implementation date for large public companies and the implementation date for all other entities (private companies, small public companies, nonprofit organizations, and employee benefit plans). This would give those other entities more time to learn from the hurdles the larger, frequently more adequately resourced, public companies faced in their implementation of the standards. Thus, for a major accounting standard, large public companies would implement the standard first and all other entities would implement the standard at least two years later. The FASB expects to continue to allow early implementation of new standards.

New Effective Dates

As proposed, the revised effective dates for most nonprofit organizations would be as follows:

- ASU 2016-02, *Leases (Topic 842)*, and related ASUs would be effective for fiscal years beginning after December 15, 2020.
- ASU 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*, and related ASUs would be effective for fiscal years beginning after December 15, 2020.
- ASU 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, and related ASUs would be effective for fiscal years beginning after December 15, 2022.

For nonprofit organizations that are conduit bond obligors, the effective date for leases remains for fiscal years beginning after December 15, 2018.

Practical Consideration:

The FASB is accepting comments on the exposure draft until September 16, 2019. Interested parties may make comments using a form on the FASB website and follow the status of the project at **www.fasb.org**.

New Data Collection Form

In June 2019, The Federal Audit Clearinghouse (FAC) issued the 2019 Form SF-SAC, also known as the Data Collection Form (DCF). The 2019 DCF is to be used for audits covering fiscal periods ending in 2019, 2020, and 2021. We had reported on the proposed changes in the November 2018 edition of this newsletter and, as it turned out, many of those changes were adopted in the final DCF. Following are highlights of the final changes to the 2019 DCF.

Notes to the Schedule of Expenditures of Federal Awards (SEFA)

The notes to the SEFA are now be included in Part II, Item 2 of the DCF, including:

- A description of the significant accounting policies used in preparing the SEFA.
- Whether the auditee elected to use the de minimis cost rate.
- Any additional notes included in the reporting package, excluding charts, tables, or footnotes.

Text of Audit Findings

The full, detailed text of audit findings exactly as they appear in the Schedule of Findings and Questioned Costs (SFQC), excluding charts, tables, or footnotes, are to be included in Part III, Item 5 of the DCF.

Corrective Action Plan (CAP)

The full, detailed text of the corrective action plan exactly as it appears in the auditee's Corrective Action Plan (CAP), excluding charts, tables, or footnotes, are to be included in Part IV of the DCF.

Referencing Charts, Tables, or Footnotes from the SEFA Notes, Audit Findings, or CAP

Regarding charts and/or tables within text of the SEFA notes, audit findings, or CAP, the instructions state that you should enter "See the Notes to the [SEFA, SFQC, or CAP, as applicable] for chart/table." Similarly, for notes within text, enter "See Notes to [SEFA, SFQC, or CAP, as applicable] for footnote."

Auditee Certification Statement

The auditee certification statement in Part V, Item 1, now references the data in the DCF, rather than the DCF itself. This may seem strange at first, but this change is to facilitate the fact that the FAC may present data provided on the DCF in different formats to allow users of the data to perform analytics.

Auditor Statement

The auditor statement in Part V, Item 2, was revised to update the references to the revised DCF.

Final Note

Certain changes to the Form that had previously been proposed by the FAC were not adopted. One of the proposed changes that was not included in the final DCF relates to management letter comments. Originally, it was proposed that the text of management letter comments for issues that were not audit findings, but that warranted the attention of management, would be included in the DCF. Also, auditees will not be required to input the date the full, complete report was received from the auditor into the IDES so that federal agencies can track the 30-day aspect of the Uniform Guidance FAC submission due date requirement.

Practical Consideration:

The 2019 DCF and instructions are available at **https://harvester.census.gov/facides/InstructionsDocuments.aspx**.

AICPA Comment Letter on the 2019 Compliance Supplement

In last month's issue of this newsletter, we had an article on the release of the 2019 Compliance Supplement. On August 5, 2019, the AICPA and the Governmental Audit Quality Center (GAQC) issued a 16-page comment letter to the OMB discussing errors, other items that need additional clarification in the 2019 Compliance Supplement, and comments on the process used to finalize the Compliance Supplement. Auditors and other users of 2019 Compliance Supplement should be aware of errors and other issues that exist in the OMB's 2019 Compliance Supplement.

The AICPA's letter has three main sections:

- Concerns needing immediate action for 2019 audits,
- Other comments and suggestions for the 2020 Compliance Supplement, and
- Attachments.

Auditors and other users will especially want to look closely at the first section, which is discussed in more detail below.

Practical Consideration:

The AICPA's comment letter can be found at **www.aicpa.org/content/dam/aicpa/interestareas/governmentalauditquality/resources/singleaudit/uniformguidanceforfederalrewards/downloadabledocuments/aicpacommentletteron2019csupplement.pdf**.

Concerns Needing Immediate Action

The AICPA has identified numerous errors or other changes in the 2019 Compliance Supplement that raise interpretative questions, which are included in the first section, *Concerns Needing Immediate Action*, of the AICPA's comment letter. The items include the following:

- Inconsistencies between compliance requirements listed in Part 2, *Matrix of Compliance Requirements*, and

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Part 4, *Agency Program Requirements*, for individual programs.

- Programs incorrectly identified as new or deleted.
- The cross-cutting sections included in Part 4, *Agency Program Requirements*, have several problems, including that they provide requirements details for certain compliance requirements that are not subject to audit.
- Certain programs in Part 4, *Agency Program Requirements*, include requirements details for compliance requirements identified as not subject to audit.
- Certain programs in Part 4, *Agency Program Requirements*, do not include requirements details for compliance requirements that are subject to audit.
- Federal agencies have identified certain requirements *not subject to audit* that, in the past, have been direct and material to the program, which has led to questions about whether errors have been made. (However, this is not surprising in that federal agencies had to limit the number of compliance requirements subject to audit.)
- A single program was identified as a cluster.
- Several "other cluster" issues and questions.
- Issues noted with the testing and new required communication in the Student Financial Assistance cluster (SFA cluster) in Part 5, *Clusters of Programs*.
- Part 6, *Internal Control*, the illustrative controls contain errors. (The AICPA notes that the errors appear to have occurred when files were converted from Excel to Word.)

The AICPA is concerned that the errors could cause confusion and inconsistency in practice and could increase the risk of audits not meeting the expectations of the Uniform Guidance.

Other Items Communicated

Other Comments and Suggestions for 2020. The comments and suggestions for the 2020 Compliance Supplement address the update process and several other topics, including comments or suggestions relating to the following:

- A better quality-review process with more oversight.
- An alternative approach to the six-requirement mandate.
- Changes to the six-requirement mandate if the OMB decides to retain a mandate.
- Challenges related to the rotation of requirements going forward.
- Sampling tables included in the SFA cluster in Part 5, *Clusters of Programs*.
- Issues in Performance and Special Reporting Sections included in Part 4, *Agency Program Requirements*.
- Requirement for auditors to test and provide opinion-level assurance on whether the corrective actions have been adequately implemented for CFDA 11.611.

Attachments to the Comment Letter. Attachments to the comment letter contain a detailed list of errors and issues and include a—

- List of specific errors and inconsistencies by CFDA number, and
- Questions related to the SFA Cluster.

Practical Consideration:

The GAQC has issued Alert No. 385 (available to GAQC members on the GAQC website) relating to the comment letter sent to OMB. Auditors should be alert for additional guidance and developments about these issues.