AMERICAN SOCIETY OF ASSOCIATION EXECUTIVES

2002 DC LEGAL SYMPOSIUM

Exempt Organization Tax Issues
Compliance and Risk Avoidance in 2002

September 25, 2002

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I. Introduction

This outline addresses new developments in three areas of the tax law: (1) political activities; (2) IRS audits and other activities; and (3) controlled subsidiaries. Other issues that will be discussed in this session of the Symposium are covered by materials prepared by Paula Cozzi Goedert.

II. Political Activities

A. Overview of Current Developments

There are several recent developments of significance in the laws and regulations governing political activities of exempt organizations. One of these developments, the passage of the Bipartisan Campaign Finance Reform Act of 2002, which amended The Federal Election Campaign Act ("FECA"), is covered in another session of this Symposium and will not be covered here. This handout covers the tax rules governing political activities. The most important developments in the tax area are:

- New disclosure rules applicable to Section 527 political organizations, legislative efforts to amend these rules, and the recent decision in *National Federation of Republican Assemblies v. United States*, No. 00-0759-RV-C (S.D. Ala. Aug. 27, 2002), holding much of the disclosure rules unconstitutional.

- Announcement 2002-87 requesting comments on possible changes to Form 990, which includes changes affecting Section 501(c) organizations and Section 527 Organizations.

- IRS Fiscal Year 2002 Continuing Professional Education ("CPE") Text, which contains a lengthy section on election year issues. The CPE is an internal training document and is not precedential guidance. Nevertheless, it

is an excellent indicator of the Service's current thinking on election year issues. It can be found on the IRS website, www.irs.gov.

B. Basic Rules Governing Political Activities of Tax-Exempt Organizations

The tax rules governing political activities of tax-exempt organizations are somewhat complex. In general the applicable rules vary, depending upon the section of the Internal Revenue Code under which an organization is recognized as exempt.

1. Section 501(c)(3) Organizations

Section 501(c)(3) organizations are prohibited from participating in or intervening in political campaigns. Although there is a great deal of published guidance from the IRS with respect to the activities that fall within this prohibition, there are often questions and controversies as to the definition of participating or intervening in political campaigns. In addition, even if an activity does not constitute participation or intervention in a political campaign, it may still be prohibited if it provides more than an insubstantial private benefit to any person, including a candidate for political office or a political party. *American Campaign Academy v. Commissioner*, 92 T.C. 1053 (1989). The penalty for a Section 501(c)(3) organization that engages in prohibited political activities is revocation of exempt status. However, a Section 501(c)(3) organization that is formed for the purpose of engaging in a particular political campaign may not be deterred by the threat of revocation of its exempt status, which would not likely take place before the election took place. To provide a deterrent to such organizations, Section 4955 imposes monetary penalties and Section 7409 gives the Service authority to seek an injunction.

2. Section 501(c)(4) and (c)(6) Organizations

Organizations exempt under Section 501(c)(4) (social welfare organizations) and Section 501(c)(6) (business leagues) may participate in political campaigns as long as such activities are not their primary activities. *See* GCM 34233; Rev. Rul. 81-95, 1981-1 C.B. 332. However, because gifts to Section 501(c)(4) and (6) organizations are subject to gift tax, they are not desirable for organizations engaging in fundraising.

Membership dues, to the extent allocable to political campaign activities, are not deductible as business expenses. Code § 162(e)(3). Section 501(c)(4) and (c)(6) organizations that engage in political activities are required to provide notice to their members setting forth the percentage of dues that are estimated to be applicable to political activities. Section 6033(e)(1)(A)(ii). Alternatively, such organizations may pay a proxy tax at the highest corporate rate (currently 35 percent) on these amounts.

Organizations exempt under Sections 501(c)(4) and (c)(6) that make expenditures for political activities are taxed under Section 527(f) of the Code on the lesser of their investment income or the amount of their political expenditures, unless the expenditures are made through a separate segregated fund. These organizations must disclose information about their political activities on Form 990, Return of Organization Exempt from Income Tax.

3. Separate Segregated Funds of Section 501(c) Organizations

Organizations exempt under Section 501(c) (other than Section 501(c)(3) organizations) may establish and maintain separate segregated funds to receive contributions and make expenditures in political campaigns. Treas. Reg. § 1.527-6(f). These funds are treated as organizations separate from the Section 501(c)(4) or (c)(6) organizations. If the separate segregated fund meets the requirements for a political organization under Section 527(e)(1), discussed below, then its "exempt function" income (generally funds raised for political activities) less its "exempt function" expenses (generally expenses used for political purposes), is exempt from federal income tax. Section 527(c). If it does not meet the requirements of a political organization, then it is subject to tax under general tax principles.

In order to be treated as a separate organization, the fund must be established and maintained by the organization separate from the assets of the organization. Treas. Reg. § 1.527-2(b)(1). The amounts in the fund must be dedicated for use only for political campaign activities. *Id*. The organization maintaining a segregated fund must keep records that are adequate to verify receipts and disbursements of the fund and identify the political campaign activity for which each expenditure is made. Treas. Reg. § 1.527-2(b)(2). Separate segregated funds do not need to be separately incorporated but can be as simple as a separate bank account.

Transfers of funds from an organization's general treasury to a separate segregated fund are likely to be treated as political expenditures of the Section 501(c)(4) or (c)(6) organization and thus may subject the organization to the Section 527(f) tax. However, amounts collected by a Section 501(c)(4) or (6) organization that are designated for the separate segregated fund and are promptly and directly transferred to such fund are not treated as political expenditures by the exempt organization and thus do not subject the organization to the Section 527(f) tax. Treas. Reg. § 1.527-6(e). A Section 501(c)(4) or (6) organization may pay indirect expenses (such as overhead and record keeping) that are necessary to support the political campaign activities engaged in by the separate segregated fund without incurring the Section 527(f) tax. *See* TAM 9433001 (Jan. 26, 1994).

4. Section 527 Political Organizations

a. Tax Treatment

The essence of Section 527 is that organizations that qualify as a "political organization" are treated as tax-exempt organizations on income from dues, contributions, and fundraising used for political campaign activities and are taxed on other income such as investment income. By establishing a separate segregated fund that meets the definition of a political organization under Section 527, an organization can limit its tax liability on investment income to investment income earned by the separate fund.

Contributions to Section 527 political organizations are not subject to gift tax. Code § 2501(a)(5).

b. Definition of political organization

Section 527 defines the term "political organization" to mean a party, committee, association, fund, or other organization (whether or not incorporated) organized and operated primarily for the purpose of accepting contributions or making expenditures for an "exempt function." Code § 527(e)(1).

The term "exempt function" (referred to in this outline as exempt political campaign activities) includes:

- influencing or attempting to influence the selection, nomination, election, or appointment of an individual to any Federal, State or local public office or office in a political organization, whether or not such individual is selected, nominated, elected, or appointed;

- influencing or attempting to influence the election of Presidential or Vice-Presidential electors, whether or not such electors are elected; and

- making expenditures related to one of the offices just described if such expenditures, if incurred by an individual, would be allowable as a deduction under Section 162(a) of the Code.

Code §§ 527(e)(1); (e)(2). Political campaign activities may qualify as exempt regardless of whether they support or oppose a particular candidate. The determination of whether a particular activity qualifies as a tax-exempt political campaign activity is based on facts and circumstances. Note that nonpartisan voter education activities -- which can be engaged in by Section 501(c) organizations, including Section 501(c)(3) organizations -- do not qualify as tax-exempt political campaign activities for Section 527 Political Organizations.

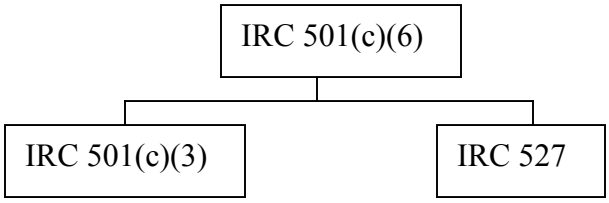
In order to be taxed only as a political organization, an organization must be both organized and operated *primarily* for exempt political campaign activities. Treas. Reg. §§ 1.527-2(a)(2); 2(a)(3). In addition, the organization's dues, contributions and fundraising income must be set aside in a segregated fund (or a number of segregated funds) for use only for political campaign activities. Code § 527(c)(3); Treas. Reg. § 1.527-2(b)(1). Non-segregated funds are included in the organization's taxable income when received. The organization may make an insubstantial amount of expenditures from a segregated fund for non-exempt activities without adverse tax consequences, provided that such expenditures (i) are not illegal; (ii) do not finance an illegal activity; and (iii) do not financially benefit the organization. Treas. Reg. § 1.527-2(b)(1). If the organization's expenditures for non-exempt activities from a segregated fund are more than insubstantial, the entire amount in the segregated fund must be included in the organization's taxable income. *Id*. However, the organization's status as a Section 527 organization will not necessarily be affected. Because a political organization is not prohibited from engaging in non-exempt activities, provided that such activities are not primary, the organization may make substantial expenditures for non-exempt activities from a particular segregated fund without jeopardizing its Section 527 status or the tax-exempt status of its other segregated funds. An organization that loses its Section 527 status is subject to tax under general tax principles.

A Section 527 organization need not be terminated once a candidate's political campaign ends. The organization's excess funds may be held in reasonable anticipation of future exempt use. Treas. Reg. § 1.527-5(c)(1). For example, the organization's excess funds may be held if the candidate intends to run again. If the organization determines that its excess funds are not needed for future political campaign activities, the organization must transfer such excess funds within a reasonable period of time to another Section 527 organization, a public charity, or the general fund of the U.S. Treasury or any State or local government. Code § 527(d). Excess funds that are not needed for future exempt use and not transferred as provided in Section 527(d) are treated as diverted for the personal use of the candidate and are included in the candidate's gross income. *Id*.

C. Affiliated Organizations

Many Section 501(c) organizations have a related Section 501(c)(3) organization. Because Section 501(c)(3) organizations are absolutely prohibited from engaging in political campaign activities, a Section 501(c) organization with an affiliated Section 501(c)(3) organization must ensure that its political campaign activities are not attributed to its Section 501(c)(3) affiliate. As long as the organizations are separately incorporated and maintain adequate records to show that tax-deductible contributions are not used to support the lobbying and/or political activities of the Section 501(c) organization, those activities will not be attributed to the related Section 501(c)(3) organization and will not jeopardize the Section 501(c)(3) organization's tax exempt status. *See Regan v. Taxation with Representation of Washington*, 461 U.S. 540 (1983); *Branch Ministries v. Rossotti*, 211 F.3d 137 (D.C. Cir. 2000).

For example, the following structure is permissible, provided that the organizations maintain their separate existence:



The 2002 CPE text contains a detailed discussion of the use of affiliated organizations in the context of political activity and several examples.

D. New Disclosure Rules

1. Overview

Pub. L. 106-230, which was signed into law on July 1, 2000 and became effective immediately, imposed three reporting and disclosure requirements on Section 527 organizations: (1) an initial notice; (2) periodic reports on contributions and expenditures; and (3) modified annual returns. The target of the new rules is so-called "new Section 527 organizations," i.e., organizations that qualify as political organizations under Section 527 but claim not to be subject to the requirements of FECA on the grounds that they do not engage in "express advocacy," the

term used under FECA to define organizations subject to its provisions. Prior to the enactment of these rules, such organizations were able to operate in complete secrecy.

2. Summary of Reporting Requirements

a. In General

To give organizations some relief from the immediate effective date, in May 2002, the IRS announced a voluntary compliance program that gave political organizations until July 15, 2002 to comply with the new reporting and disclosure requirements. *See* Notice 2002-34. Under the voluntary compliance program, the IRS would not assert any tax, penalty or interest that arose solely because a political organization failed to file or filed an incorrect form, provided that the form was filed or corrected by July 15, 2002. The program expired on July 15, 2002. The IRS has also issued Rev. Rul. 2000-49, 2000-44, I.R.B. 430 (Oct. 30, 2000) to provide organizations with guidance on the reporting requirements.

b. Initial Notice

Under the new law, a political organization must file with the IRS within 24 hours of its creation an initial notice on Form 8871 electronically and in writing. The organizations will not be treated as tax exempt until the notice is filed. The notice requirement applies to all political organizations, except:

a) organizations that are required to report under the FECA as a political committee;

b) organizations that reasonably anticipate that they will not have gross receipts of $25,000 or more for any taxable year; and

c) organizations described in Section 501(c) of the Code (such as public charities or business leagues) that are subject to tax under Section 527(f) by reason of making political campaign expenditures.

Code § 527(i)(6). Political organizations that file reports with state or local election agencies are not exempt from the notice requirement under Section 527(i). Organizations that are exempt from the notice requirement by reason of having gross receipts of less than $25,000 must give notice if they in fact receive $25,000 or more in any taxable year.

c. Periodic Reports on Contributions and Expenditures

Political organizations that are required to file the Initial Notice on Form 8871 (other than state and local candidate committees, and state and local committees of political parties) are also required to file Form 8872 with the IRS reporting contributions to the organization and expenditures made by the organization. Code § 527(j).

Each periodic report must include: (1) the name, address and, in the case of an individual, the occupation and employer, of any person that contributes in the aggregate $200 or more in a calendar year and the amount of such contribution; and, (2) the name, address and, in the case of an individual, the occupation and employer, of any person to whom expenditures are

made that aggregate $500 or more in a calendar year and the amount of such expenditures. Code § 527(j)(3). A political organization that fails to file a Form 8872 report or fails to include all the information required on Form 8872 is subject to tax, at the highest corporate rate, on the amount not disclosed on the return. Code § 527(j)(1).

Expenditures aimed at electing or defeating a clearly identified candidate for federal office that are made without cooperation or consultation with the candidate or any authorized committee or agent of such candidate, and which are not made in concert with, or at the request or suggestion of, any candidate for federal office, or authorized committee or agent of such candidate are not subject to the reporting requirement. Rev. Rul. 2000-49, Q&A-38.

Political organizations that are subject to the reporting requirement may elect to file reports on a monthly schedule in all years, or may file on a semi-annual schedule in non-election years (i.e., any odd-numbered year) and a quarterly schedule in election years (i.e., even numbered years). In any year in which a regularly scheduled general election is held, political organizations that accept contributions or make expenditures with respect to an election for federal office must also file a pre-election Form 8872 report (containing information through the 20th day before the election) twelve days before the general election and a post-election Form 8872 report no more than thirty days after the general election (containing information through the 20th day after the election). The term "election" for this purpose means a general, special, primary, or runoff election for a Federal office; a convention or caucus of a political party with authority to nominate a candidate for Federal office; a primary election to select delegates to a national nominating convention of a political party; or a primary election to express a preference for the nomination of individuals for election to the office of President. Code § 527(j)(6).

d. Modified Annual Returns

Prior to 2000, a political organization was required to file an annual return on Form 1120-POL only if its taxable income was greater than $100. For taxable years beginning after June 30, 2000, however, a political organization is required to file Form 1120-POL even if it has no taxable income, provided that its gross receipts are $25,000 or more in any taxable year. Code § 6012(a)(6). In addition, for taxable years beginning after June 30, 2000, political organizations (except for organizations with gross receipts of less than $25,000) are required to file annual information returns on Form 990. Code § 6033(g).

e. Public Disclosure

Forms 8871 and 8872 are open to public inspection at the IRS National Office and on the IRS website. Code § 6104(a), (b). In addition, the organization is required to make a copy of any Form 8872 available for public inspection on request. Code § 6104(d)(1). For taxable years beginning after June 30, 2000, Forms 1120-POL and Forms 990 filed by political organizations must be available for public inspection for a 3-year period after filing. Code § 6104(b).

3. Current Issues: Legislative and Constitutional Attacks on the Disclosure Rules

a. Legislative Efforts

Several bills have been introduced in the Senate and the House that would amend the disclosure rules in various ways. See S. 744, S. 2078, H.R. 1676, H.R. 4180, and H.R. 3993. These bills include amendments:

- to eliminate the duplicate electronic and written filing requirement for Form 8871 (S. 2078; H.R. 1676; H.R. 4180; H.R. 3993) ;
- to give the Commissioner of Internal Revenue the authority to waive taxes imposed on organizations that fail to file Form 8871 or 8872 in a timely manner (S. 744; S. 2078; H.R. 4180; H.R. 3993);
- in the case of state and local political organizations, to require Form 1120-POL only for organizations with gross receipts in excess of $100,000 (H.R. 1676; H.R. 4180);
- to require Form 1120-POL only for organizations that have taxable income (S. 2078; H.R. 4180; H.R. 3993).;
- to require state and local organizations to file Form 990 only if they have gross receipts of $100,000 or more (S. 744; S. 2078) ;
- to exempt state and local political organizations from filing Form 990 (H.R. 3993);
- to give the Commissioner authority to waive the requirement to file Form 990 if he concludes that the form is not necessary for efficient administration of the tax laws (H.R. 3993);
- to exempt state and local candidate committees from the initial notice requirement (S. 744);
- to exempt state and local political organizations from filing Forms 8871 and 8872 if the organization is required to report by state or local law and such reports are made public (S. 527, H.R. 527); and
- to exempt state and local political organizations from filing Forms 1120-POL and 990 if the organization is required by state or local law to report contributions and expenses, and such report is made public (S. 744, S. 527, H.R. 527).

As of this writing, none of these bills has been passed.

b. Constitutional Challenge

In *National Federation of Republican Assemblies v. U.S.*, No. 00-0759-RV-C (S.D. Ala. Aug. 27, 2002), Judge Richard Vollmer of the U.S. District Court for the Southern District of Alabama struck down as unconstitutional the reporting requirements of Pub. L. 106-230 "to the extent [they require] disclosures of contributions and expenditures in connection with state and local electoral advocacy and to the extent [they require] disclosures of expenditures." Judge Vollmer reasoned that political organizations subject to the reporting requirements of Pub. L. 106-230 are not sufficiently different from other exempt organizations engaged in electoral advocacy to justify their different treatment under Pub. L. 106-230. Judge Vollmer ruled, however, that the provisions of Pub. L. 106-230 requiring disclosures of contributions for federal electoral advocacy are constitutional.

III. Audit and Compliance Issues

A. FY 2002 EO Implementing Guidelines

The EO Guidelines for FY 2002, which are on the IRS website, www.irs.gov, indicate the EO function strategies and priorities for the fiscal year ending September 30, 2002. New guidelines should be issued in October.

B. Market Segment Studies Include Section 501(c)(6) Business Leagues

1. EO Compliance Council and Market Segment Approach

In FY 2001, the Director of EO Examinations formed an EO Compliance Council to integrate, develop and recommend compliance activities within EO. In recognition that the exempt organizations community is comprised of widely diverse organizations, the Compliance Council was asked to identify market segments within the exempt organization community, to collate all available information, including compliance information for each segment, and identify and analyze the compliance risks associated with each segment. The Compliance Council preliminarily identified 35 market segments and began market segment studies to collect information on six market segments. One of the six market segments to be studied is Section 501(c)(6) business leagues. These market studies will result in a profile of a market segment containing information on its: a) characteristics; b) geographical location; c) compliance levels with technical requirements under the Code and the regulations and procedural requirements for completeness and accuracy of the return filed; and, (d) examination coverage.

Each study will measure compliance with all requirements applicable to that segment. Non-compliance identified through the market segment studies will be assessed for the level of associated risk, and compliance improvement projects and educational activities will be designed to address areas of non-compliance identified through the risk assessment process.

2. Checklists

Organizations are chosen at random for the study, which will be conducted by IRS agents in connection with audits of selected organizations. The Service has published the checklist that

will be used for the initial six market studies on its website at www.irs.gov. All checklists must be submitted by March 31, 2003. Section 501(c)(6) organizations should review the published checklist and make sure they are in compliance with the areas covered. Some of the questions on the auditor's checklist for Section 501(c)(6) organizations are:

- Whether the organization has a website and, if so, whether it reveals any noncompliance;
- Whether the organization's articles of incorporation or bylaws have been amended since the organization received its determination letter and, if so, whether it notified the Service;
- Whether the organization had any nonmember source income, i.e., unrelated business taxable income ("UBTI") such as debt-financed rental income, rental income with provision of personal services, sales of merchandise, fee for services, advertising;
- Whether the organization has UBTI losses;
- Whether the organization has filed Form 990-T reporting UBTI;
- Whether the organization has filed employment tax returns and, if not, why not;
- Employment tax issues such as officers' personal use of organizations' vehicles, non-accountable travel plans, incorrect treatment of fringe benefits, misclassifications of workers;
- Whether the organization has provided services to members such as registry services, referrals, advertising, use of organization property;
- Whether the organization engages in political activities and, if so, whether it uses a separate segregated fund or a PAC; and
- Whether the organization filed Form 8871 and, if not, why not.

C. Compliance/Education Projects

1. General

The IRS has designated several compliance/education projects for FY 2002. The purpose of these projects is to address concerns or known areas of non-compliance. Several of these may be of interest to members of ASAE.

2. Disclosure Requirements of Section 527 Organizations

One of these projects will examine Forms 8871 and 8872 filed by Section 527 organizations for inconsistency and will contact the organizations whose Forms 8871 and 8872

are inconsistent. The project will address consistencies of filings, accuracy of information reported on the returns and non-filers. Examinations will be based on a nationwide statistically valid sample. Due to the fact that some Section 527 organizations dissolve quickly, Forms 8871 and 8872 that are selected for examination will generally be less than six months old. The project is expected to be completed within a short period of time. Referrals of non-compliant taxpayers in this area will receive priority.

3. Debt-financed Rental Property

Although rental income is generally excluded from UBTI, it is taxable to the extent that it is debt-financed. The Service has noticed that significant numbers of Forms 990 report exempt rental income and also report a mortgage payable, suggesting that debt-financed rental income is not being reported on Form 990-T.

4. Political Contributions Made by Section 501(c)(3) Organizations

Individual states have published lists of entities making political contributions. These lists include a number of Section 501(c)(3) Organizations that are prohibited from making political contributions. A task group will be formed to develop a strategy to address this area of noncompliance.

5. Private Inurement and Intermediate Sanctions

The Service announced that it intends to establish one or more projects in this area and that it had established a task force to develop an overall strategy relating to these rules.

D. Service Requests Comments on Possible Changes to Form 990

On September 4, 2002, the IRS released Announcement 2002-87, which describes recent changes to Form 990 and other changes that the Service is considering. The announcement requests comments on or before January 28, 2002 (sic). Several proposals may be of interest to ASAE members.

1. Fundraising Reporting

The Service has made changes to the Form 990, which include: clarifying that an organization must report the gross amount raised by outside fundraisers and not just the net amount. Fundraising expenses must be reported separately and cannot be reported as program expenses.

Currently Section 501(c)(3) and (c)(4) organizations and certain trusts are required to report their expenses as falling in one of three categories: program service expenses, management and general expenses, and fundraising expenses. State regulators have expressed an interest in having this information for other organizations such as Section 501(c)(5) and (c)(6) organizations. The Service is considering adding this requirement because many organizations use the Form 990 to meet state filing requirements.

2. Section 527 Political Organizations

The Service indicates that some concern has been raised about affiliations and potential transfers of funds between Section 527 organizations and other exempt organizations. The Service is considering the following changes:

- Requiring Section 501(c)(4), (c)(5) and (c)(6) and Section 527 Organizations to complete Parts I and II of Schedule A showing compensation paid to five highest paid employees and five highest paid independent contractors for professional services, and Part VII concerning relationships and transactions with exempt organizations other than Section 501(c)(3) organizations;

- Adding a new section for reporting fund transfers and transactions among Section 501(c)(4), (5) and (6) organizations and Section 527 Organizations; and

- Moving part VII of Schedule A (dealing with relationships with Section 501(c) organizations other than Section 501(c)(3) organizations) to the Form 990 and requiring all Section 501(c)(3), (4), (5) and (6) organizations to complete it.

3. Foreign Grants

The Service is considering requiring a separate schedule of grants to foreign organizations and requiring domestic charities conducting foreign activities to provide more specific information about the flow of funds involved in these activities and about the recipients of these funds.

4. Corporate Responsibility

Referring to the recent debates and legislation concerning ethical standards in reporting for public companies, the Service suggests it may be argued that the need for veracity in reporting by exempt organizations is just as great because contributors and others rely on information in the Form 990 in making decisions. The Service is considering:

- Requiring exempt organizations to disclose whether they have adopted conflicts of interest policies or have independent audit committees; and

- Requiring non-charitable exempt organizations to disclose information about transactions with substantial contributors, officers, directors, trustees and key employees.

IV. Taxation of Income From Controlled Entities

A. Basic Rules

1. Prior to Taxpayer Relief Act of 1997

As a general rule, interest, rents, royalties and annuities, generally referred to as "passive income," are not taxable as UBTI to exempt organizations. However, Section 512(b)(13) provides that exempt organizations are taxed on such income if it is paid to the organization by a controlled subsidiary. Prior to the enactment of the Taxpayer Relief Act of 1997, these rules were easily avoided. They applied only if the exempt parent directly owned 80 percent or more of the stock of the subsidiary. Thus, the rules could be avoided by having a second-tier subsidiary pay the passive income to the parent or by having another party hold more than 20 percent of the stock.

2. Changes Made in 1997

In 1997, the definition of control was lowered from 80 percent to 50 percent, and attribution rules were added to the statute so that ownership interests of related parties are taken into account in determining whether there is a 50 percent controlling interest. Consequently, it is no longer possible to avoid these rules by having a second-tier subsidiary or other related party be the payor of the passive income.

B. Legislative Efforts to Amend Section 512(b)(13)

1. Policy Reasons for Proposed Amendment

Exempt organizations have objected to the 1997 amendments on the ground that Section 512(b)(13) is overly broad in that it penalizes an exempt organization that enters into a legitimate arms length transaction with a subsidiary when that same transaction would not be penalized (or rearranged under Section 482) if it were between the exempt organization and an unrelated third party.

These organizations argue that the 1969 legislative history indicates that these rules were intended to prevent abusive transactions where exempt organizations had their controlled subsidiaries pay inflated amounts of passive income to the parent. Such amounts were deducted by the subsidiary, leaving the subsidiary with little or no taxable income, and were tax-exempt to the parent, thus enabling the parent to operate an unrelated business without incurring any substantial tax liability.

2. Proposed Amendment

A coalition of tax-exempt organizations has proposed a modification to Section 512(b)(13) to provide that "passive income" is taxable to the parent only if payments by the subsidiary to the parent are not arms-length under Section 482.

3. Current Status

a. This modification was included in the Financial Freedom Act of 1999, but the bill was vetoed by President Clinton for reasons totally unrelated to this issue.

b. In the current session of Congress, two bills have been introduced that contain the modifications sought by exempt organizations:

-- The Tax Empowerment and Relief for Farmers and Fishermen (TERFF) Act, S. 312, Section 6, introduced by Sen. Grassley (R-Iowa), Ranking Minority Member of the Senate Finance Committee; and

-- The CARE Act of 2002, H.R. 7, Section 302, as reported by the Senate Finance Committee on June 18, 2002.

As of this writing, neither of these bills has been enacted.