

Audit Technique Guide – Other 501(c)(3) Organizations

Introduction

This guide describes techniques for finding and developing issues in audits of scientific organizations and amateur athletic sports organizations. It doesn't contain detailed technical information. For in depth technical information on scientific and athletic organizations, read these Continuing Professional Education articles:

- 1979-L: Recent Issues under IRC Section 501(c)(6)
- 1980-E: Amateur Athletic Organizations
- 1982-H: Amateur Athletic Organizations
- 1987-E: Amateur Athletic Organizations
- 1993-A: Athletic Booster Clubs: Are They Exempt?
- 1993-C: Sports Organizations - Current Issues

Scientific Organizations

The term “scientific” is not easily defined. Many times you’ll encounter organizations claiming to have a scientific or educational purpose, or both. To consider research “scientific” per IRC Section 501(c)(3), make sure it’s carried on to further a scientific purpose.

It’s not enough to simply conduct scientific research for an organization to qualify for IRC Section 501(c)(3) status. The scientific research must be “in the public interest.” Distinguish between the ‘public interest’ and the ‘private interests’ of individuals or business enterprises. Scientific research is deemed “carried on in the public interest” if the research:

- Results are available to the public nondiscriminatorily.
- Is performed for the U.S., or any of its agencies or instrumentalities, or for a state or political subdivision thereof.
- Is directed toward benefiting the public.

Research is considered “directed toward benefiting the public” if it:

- Helps in the scientific education of college or university students.
- Obtains scientific information published in a treatise, thesis, trade publication, or in any other form available to the interested public.
- Discovers a cure for a disease.
- Carries on scientific research to help a community or geographical area by attracting new industry or by encouraging an industry to develop or stay in the community or area.

An organization may meet the requirements of IRC Section 501(c)(3) only if it serves a public rather than a private interest. See Rev. Rul. 68-373, 1968-2 C.B. 206, which describes an organization engaged in the clinical testing of drugs. Although the results of the research ended up being published in various scientific and medical journals, the testing primarily benefited the drug manufacturers rather than the public.

A scientific organization must engage in scientific research rather than commercial or industrial testing and may not engage in activities of a type ordinarily carried on as an

incident to commercial or industrial operations, such as the ordinary testing or inspection of materials or products or the designing or construction of equipment, buildings, etc.

Commercially sponsored research that otherwise qualifies as scientific research under IRC Section 501(c)(3) may constitute scientific research carried on in the public interest if all results (including all relevant information) are timely published in a form available to the interested public, even though performed per a contract under which the sponsor has the right to obtain ownership of the patent. (See Treas.Reg Section 1.501(c) (3)-1(d)(5)(iii) and Situation 1, Rev. Rul. 78-296, 1976-2 C.B. 141.)

If published research is withheld or delayed significantly beyond the time reasonably necessary to establish ownership rights, that research constitutes an unrelated trade or business per IRC Section 513, and is not “in the public interest.”

An example of research that doesn't qualify as scientific is when publication of commercially sponsored scientific research is unreasonably postponed or delayed so that the sponsor can establish patent or other ownership rights in the research results. This is typically done to accommodate the sponsor's business interest. This activity is the conduct of an unrelated trade or business under IRC 513. (See Treas. Reg. Section 1.501(c)(3)-1(d)(5)(iv) and Situation 2, Rev. Rul. 76-296, 1976-2 C.B. 141.)

Audit Guidelines for Scientific Organizations

Examine catalogues or lists of the organization's projects or plans to determine the kinds of research in which the organization engages.

Review the minutes, agreements, and other available documentation to determine if the organization owns (directly or indirectly) or controls more than an insubstantial portion of the patents, copyrights, processes, or formulae resulting from its research and doesn't make these patents, copyrights, processes, or formulae available to the public.

Examine corporate minutes to determine how the organization selects projects. If nearly all projects are performed for one firm, the organization may be serving a private rather than a public interest.

Review payments to identify sponsors. Review agreements and contracts with sponsors. Identify any private interests being served.

Interview officers and directors and determine if research is performed only for individuals who created (directly or indirectly) the organization.

Look for large and recurring donations by a particular firm. Determine if any payments were made for services rendered.

Check payroll records to determine if any non-qualified persons occupy well-paid positions, possibly a way to disburse the organization's funds for nonexempt purposes.

Inspect membership lists to determine:

- Rights or privileges members hold.
- What membership entitles members access to.
- Any committees and advisory boards staffed by members.

Review project contracts or grants to:

- Uncover any commercial firm grants. If so, determine if the project involves scientific research rather than commercial or industrial testing.
- Determine if the organization will make results of the scientific research available to the public in a nondiscriminatory manner. (See Rev. Rul. 76-296, 1976-2 C.B. 141.)
- Identify the standards the organization uses to differentiate scientific from nonscientific research projects.
- Examine the completed research materials for evidence of private ownership.

Examine the articles of organization, lease agreements, contracts, payroll records, bylaws, and minutes for possible relationships between the exempt organization and a commercial firm. Indications that a commercial firm controls the exempt organization include:

- Interlocking directorates (minutes, bylaws, etc.).
- Sharing staff and facilities (lease agreements, contracts, payroll records, indications of allocation of expenses between the exempt organization and the commercial firm).
- Large and recurring donations from a particular firm (financial records).

If the organization has any scientific research projects that clearly don't fall within the categories of "scientific research in the public interest," such as ordinary testing incident to commercial or industrial operations, determine if:

- The activity relates or doesn't relate to attaining the organization's exempt purpose.
- The activity constitutes a trade or business.
- The activity is regularly carried on.
- The income from the unrelated business activity is excluded from tax by the IRC Section 512(b) exceptions and exclusions.

Review sources of income to determine if the organization engages in research and whether they're exclusively scientific per IRC Section 501(c)(3). Determine if the activities carried on constitute unrelated business activities.

Amateur Athletic Sport Organizations

Amateur sports organizations may qualify under IRC Section 501(c)(3) in the following ways:

- The organization may be "educational" if it teaches sports to youth or is affiliated with an exempt educational organization. This educational organizations may also provide facilities and equipment;
- The organization is deemed "charitable" on the grounds that it combats juvenile delinquency or lessens the burdens of government;

- The organization is deemed organized and operated to foster national or international amateur sports competition, but doesn't provide athletic facilities or equipment; or
- The organization is deemed a “qualified amateur sports organization” under IRC Section 501(j)(2). See below.

The educational and charitable rationale constitutes a valid basis for exemption especially when the organization’s activities are directed at children or adolescents.

Qualified Amateur Sports Organization Under IRC Section 501(j)

A “qualified amateur sports organization” that otherwise satisfies the requirements of IRC 501(c)(3) qualifies as exempt regardless of whether it provides athletic facilities or equipment or whether it has a local membership. IRC Section 501(j)

“Qualified amateur sports organization” under IRC Section 501(j)(2) means any organization organized and operated exclusively to foster national or international amateur sports competition if organized and operated primarily to:

- conduct national or international competition in sports or
- support and develop amateur athletes for national or international competition in sports.

An organization meets IRC Section 501(c)(3) requirements if it draws a local or regional membership (IRC Section 501(j)(1)(B)). An organization of local amateur athletes who primarily play other local teams, occasionally schedules games with teams or organizations in another state, won't qualify for exemption unless it demonstrates that those games are part of some national competition. Similarly, even if the organization offers a regional tournament, it fails the requirements of IRC Section 501(j) unless it shows some link to national or international competition. The organization's membership in a national sports association could provide that link.

An organization's assertion that it is a training ground for collegiate, professional, and/or Olympic players, absent some evidence of a reasonable probability that the members will participate in national or international competition, wouldn't be enough to meet the requirements for exemption. However, prior participation in national or international competitions would constitute some evidence for favorable consideration if the organization could also show it is prepared to continue participating.

Audit Guidelines – IRC Section 501(j)

Review the minutes, brochures, and activities to determine if the organization links to national or international competition.

Review membership to determine if it is merely local. If so, determine whether it has participated in national or international competitions in the past.

National or International Amateur Sports

The organization must organize and operate exclusively to foster national or international amateur sports competition per IRC Section 501(j). This can be accomplished by either:

- Conducting national or international sports competitions.
- Supporting and developing amateur athletes for national or international competition.

The organization must show some evidence of a reasonable probability that the its members will participate in national or international competition, and can't simply assert that it operates a training ground for collegiate, professional and/or Olympic players.

Audit Guidelines: National or International Amateur Sports

Review programs, minutes of board meetings, newsletters, fund-raising solicitations, and other documents to verify that the organization promotes serious competition or training rather than social or recreational activities.

Obtain the criteria the applicable governing body used to determine “amateur” status to determine if the organization’s athletes qualify for national or international competitions. Consider these potentially relevant factors in determining whether an organization fosters national or international competition:

- Is the sport the organization supports an event in the Olympic or Pan-American Games?
- Are the athletes the organization supports in the age group from which Olympic-quality athletes get chosen?
- Do they welcome athletes of a caliber that makes them serious contenders for the Olympic or Pan-American Games?
- Do the athletes demonstrate a certain level of talent and achievement in order to receive support from the organization?
- Does the organization provide intensive, daily training, as opposed to sponsoring weekend events open to and attracting a broad range of competitors?
- Is the organization devoted to improving the performance of a small group of outstanding athletes or does it emphasize the improvement in health of the general public?
- Is the organization a member of the United States Olympic Committee?

Consider the following questions when dealing with the issues/documents identified below:

Issue/Document	Questions
Affiliation Contracts	Do they contract with a professional sports organization or other non-IRC Section 501(c)(3) entity which sanctions the event? If so, does that contract enable the entity to control key matters affecting the event like pricing, merchandising, selection of contractors to perform services, etc.?
Benefits Of The Actual	Once the events were operational, did the actual operations result in significant benefits to the contracted parties?

<p style="text-align: center;">Organization</p>	<p>Determine if concessions or arrangements with non-IRC 501(c)(3) entities are necessary for the event to take place.</p> <p>Example: Was conducting the particular event secondary to the distribution of funds to charity?</p>
<p style="text-align: center;">Board Composition</p>	<p>Determine if the board is controlled by parties having commercial interests that may conflict with those of the exempt organizations. Does the exempt organization's independent board actually control its activities?</p>
<p style="text-align: center;">Creation of Organization</p>	<p>Was the exempt organization created by parties having commercial interests adverse to its interests? What was the original purpose of the organization?</p>
<p style="text-align: center;">Management Contracts</p>	<p>Will the exempt organization bring in a professional sports organization or management company to operate the event? If so, what would they control?</p>