

## **B. TAXATION OF REVOKED TAX-EXEMPT ORGANIZATIONS:**

### **THE SYNANON CASE**

#### 1. Background

When attorney Paul Morantz discovered the hard way that a four-foot rattlesnake was residing in his mailbox one day in October 1978, he had more pressing concerns than to wonder about the possible income tax implications of the event. Although he immediately might have suspected that his representation of two former Synanon members in a lawsuit against the Synanon Church, then recognized as an IRC 501(c)(3) organization, could have inspired retribution by the organization, he doubtless would not have foreseen, or at that moment much cared about, the subsequent administrative actions that resulted in the revocation of Synanon's exempt status, Synanon's legal attempts to regain that status, and its persistence throughout the entire period, both before and after revocation, in holding itself out to contributors as a charitable organization.

The rattlesnake incident was far from the only questionable activity of the Synanon Church, but it was certainly the one that most captured the attention of the police, the press, and the IRS. As detailed in Synanon Church v. U.S., 579 F.Supp. 967 (D.C., D.C., 1984), in a 1977 speech called "New Religious Posture", Charles Dederich, Synanon's founder, had warned "Don't mess with us. You can get killed dead. Physically dead." Groups were organized to carry on a "Holy War" against Synanon's enemies, and Synanon had been tied to a number of beatings and acts of physical violence. During the summer preceding the incident, while Synanon officials were in Italy, phone calls were made to the United States in an attempt to arrange Mr. Morantz' assassination. Dederich was ultimately convicted on a plea of nolo contendere, along with two other Synanon members, of conspiracy to murder Mr. Morantz.

When the IRS initiated an audit in March 1979 concerning Synanon's taxable years ending in 1977 and 1978, the principal issues were whether there was a corporate policy of terror and violence that would suggest that the organization was not organized exclusively for charitable purposes, and whether corporate resources had been diverted for the enrichment of individuals within the organization. Beginning in October 1978, and extending into 1980, at a time that was contemporaneous with the audit, Synanon apparently engaged in systematic destruction of most of its own tapes and computer inventory, and alteration of its

records. In Synanon Foundation, Inc. v. Bernstein et al., Superior Court of D.C., Civil Action No. 7189-78, a nontax case, the court found that the destruction was aimed at materials that were not only related to violence, "but also to money, to sexual subjects, to guns, and to other matters", and that the destruction was conducted with the knowledge and approval of Synanon's legal department.

On May 19, 1982, Synanon's IRC 501(c)(3) exempt status was revoked beginning with its 1977 taxable year. The fact that contributions to Synanon were no longer deductible was made known to the public in a news release of May 28, 1982, and in the Internal Revenue Bulletin of June 14, 1982. Synanon's subsequent attempts from 1982 to 1987 to have its exempt status reinstated by the courts were unsuccessful. Synanon Church v. U.S., 820 F. 2d 421 (D.C. Cir. 1987); Synanon Church v. U.S., 579 F.Supp. 967 (U.S.D.C., D.C., 1984); Synanon Church v. U.S., 557 F.Supp. 1329 (U.S.D.C., D.C., 1983).

At all times after the effective date of its revocation, from the beginning of its 1977 taxable year through at least the end of its taxable year in 1983, Synanon continued to maintain publicly that it was a charitable and religious organization that had a central purpose of rehabilitating persons who were substance abusers. It continued to solicit contributions during this period and at least gave the impression that donations were deductible. Synanon also carried on a number of business activities on a for-profit basis. Finally, Synanon distributed large payments to Charles Dederich during this period, and paid criminal defense expenses for him and for other Synanon members. This topic discusses the June 7, 1989 Tax Court decision with respect to the tax treatment of Synanon for those taxable years, The Synanon Church v. Commissioner, T.C. Memo. 1989-270 (Docket No. 20015-84).

## 2. Taxation of Contributions

In most circumstances, taxation of a formerly tax-exempt organization that has had its exemption revoked does not present major difficulties. Normal corporation taxation or trust taxation rules apply in the same manner as with any taxable corporation or trust. In the case of a gift to a taxable entity, the donor may be subject to gift tax under the provisions of IRC 2501; the entity itself is not be taxed on property received by gift under the provisions of IRC 102.

It is possible or even likely that a revoked IRC 501(c)(3) organization may receive substantial contributions after the date that revocation of its exempt status becomes effective. This may be particularly true of an organization whose exempt

status has been revoked retroactively and whose contributors therefore have no knowledge of the revocation during the sometimes lengthy period for which the revocation has retroactive effect. A donor is not subject to gift tax and has advance assurance of charitable deductibility under IRC 170 for amounts contributed to a revoked IRC 501(c)(3) entity prior to public notice of the revocation (such as in the Internal Revenue Bulletin, however, notice may occur in other ways, see Estate of Clopton v. Commissioner, 93 T.C. No. 25 (8-29-89)). Donations by individuals after public notice of revocation are not so protected, and such donations are subject to gift tax and are not deductible under IRC 170. In contrast, a revoked donee organization is not normally subject to income tax on a gift because IRC 102(a) excludes from gross income the value of property acquired by gift, bequest, devise, or inheritance.

In its 1989 Synanon decision, however, the Tax Court carved what appears to be a narrow exception to the IRC 102(a) rule that gross income does not include the value of gifts received. The court noted that in the period that was under consideration, taxable years 1977 through 1983, Synanon aggressively solicited contributions and bequests of cash, food, clothing, and other items from the public. In its published materials, public speaking engagements, and private meetings, heavy emphasis was placed on Synanon's addict rehabilitation work. Also emphasized was the tax deduction that could be received under IRC 170(e)(3) for food and clothing inventories donated by corporations. Under IRC 170(e)(3)(A)(iii), the donee is required to furnish the donor a statement that the use and disposition of the property will be solely for care of the ill, needy, or infants. This representation was made by Synanon.

The court noted that contributions of cash went into Synanon's general fund and that donated goods were in large part used by the Synanon residents. The clear inference, according to the court, was that donors were misled. While they believed they were giving to a charity they were in fact making donations to a "predominantly business, profit-seeking organization." The court held that under these circumstances, the contributions of cash and goods were gross income under IRC 61 and, therefore, taxable.

In reaching its conclusion, the court made an analogy to cases where a purported borrower receives money and falsely promises to repay to the lender, while actually intending otherwise. In a string of judicial decision, the "borrowed" amounts have been held to be taxable income. Although Synanon had argued that the donors' intent that the contributed amounts were to constitute gifts was

controlling, the court concluded that the intent of the donor was not relevant where the gifts were solicited by misrepresentation.

The significance of the Tax Court holding should not be overstated. It clearly does not apply to situations where the solicitations are undertaken by an organization in good faith, including cases where an organization later diverts cash or goods to private uses after originally soliciting the donations in good faith. The use of the Synanon rationale, in fact, is probably effectively limited to cases where it can be demonstrated that an element of fraud exists; e.g., where:

- (1) the organization represents that amounts or goods received will be used for charitable purposes; and
- (2) organizational records or other strong evidence exists that shows that the organization intended to use the gifts for noncharitable or for business reasons.

It is doubtful that there will be many cases where an intent to divert contributed amounts can be shown to have existed at the time of solicitation. Because the activities of Synanon were so clearly inconsistent with exempt status, and Synanon itself was responsible for the destruction of records that might directly bear on its activities (including, perhaps, records that might show its intent at the time contributions were solicited), the case was one where the facts were exceptionally unfavorable for the organization. The Service currently is studying other possible rationales for taxation of contributed amounts to revoked organizations in appropriate situations. In the meantime, however, use by the Service of the Synanon rationale should be exercised judiciously.

### 3. Taxation of Income from Activities that are not Profit-Oriented

A revoked tax-exempt organization, perhaps to a greater extent than other taxable entities, may be involved in activities that are not designed to generate a profit. This may be particularly true where the organization has been carrying on charitable programs or other programs related to its exempt purposes but has had exemption revoked due to, for example (in the case of an IRC 501(c)(3) organization), inurement, political activities, or substantial lobbying. Because tax-exempt status no longer shelters income received from its programs after the date of revocation, the organization is subject to taxation on its income derived from these programs.

While Synanon engaged in a wide variety of profit-oriented business activities, there were other income-producing activities that the Tax Court found not to constitute a trade or business. These included, for example, the Synanon Distribution Network (SDN). Through SDN, Synanon aggressively solicited donations of food and clothing from manufacturers and wholesalers. It incurred expenses of \$4,549,902 in carrying out this activity. Much of the food and clothing was consumed by Synanon residents and the remainder was passed on to IRC 501(c)(3) organizations. The court found that Synanon received gross income in the amount of approximately \$4,094,912 from the activity.

Synanon had argued that SDN was a for-profit activity in order to receive an IRC 162 deduction for the \$4,549,902 in expenses. Synanon claimed that these expenses were an ordinary and necessary component of its SDN trade or business. Because the court found that SDN was not motivated by profit, it ruled that Synanon was only entitled to deductions with respect to SDN to the extent of its income from the activity, i.e., \$4,094,912.

As can be seen from this example, revocation of exempt status can lead to a reversal of arguments with respect to an income-producing program. Synanon doubtless would not have claimed that SDN was a trade or business for profit if it had been seeking to retain its IRC 501(c)(3) exemption, and probably would have fought such a characterization. As a taxable entity, however, Synanon stands better if all of its activities, including SDN, are considered to be engaged in for profit. Where a revoked tax-exempt organization derives a loss from an activity, characterization of the activity as other than a trade or business is a potential issue for purposes of IRC 162.

Synanon also attempted to deduct under IRC 162 its expenses for the legal defense of three criminal charges against members, and its expenses for one civil action brought by Synanon. At issue were expenses for the defense of Arizona v. Dederich (illegally marketing securities); People v. Benjamin (kidnapping); and People v. Dederich (attempted murder; i.e., the rattlesnake incident); and for the litigation of Superior Court/Tulare (action by Synanon for return of items seized pursuant to search warrant issued in investigation of rattlesnake incident). The court held that these expenses were not deductible because the evidence did not show that the cases in question had their origin in any trade or business carried on by Synanon.

#### 4. Executive Compensation

Synanon had claimed deductions of \$3,645,504 for cash executive compensation paid to its officers and directors for taxable years 1977 through 1983. The Service had allowed \$548,987. The deductibility of the remaining \$3,096,517 was at issue.

IRC 162(a)(1) allows a deduction for the ordinary and necessary business expenses paid in carrying on any trade or business, including a reasonable allowance for salaries for personal services actually rendered. Excessive payments to Charles Dederich had been a basis for the Service's revocation of Synanon's exempt status, and the issue had now been transformed before the Tax Court into a question of deductibility under IRC 162 for those payments that had been a factor in the 1982 revocation, and for other payments to Dederich and Synanon insiders as well.

Synanon claimed that the entire \$3,096,517 was bonafide executive compensation for present and past services. The Service argued that, while in the form of a salary or bonus, the payments were actually a distribution of Synanon's assets.

The Tax Court noted that the officers and executives of Synanon, "rather than serving as fiduciaries of a charitable entity, acted as if they were the proprietary owners of Synanon". It also noted that Dederich had dominated and controlled Synanon's Board of Directors since the organization's inception in 1958, and that the directors had the power to set their own compensation. In such a case, as stated by the court, special scrutiny is warranted.

In the court's consideration of the evidence, it did not help Synanon that transcripts of directors' meetings showed that Dederich and other members discussed plans to have a for-profit corporation of their own creation purchase all of Synanon's assets. While the assets would be acquired ostensibly in an arm's-length transaction, they would be diverted in the form of salary payments. It especially did not help Synanon that the transcripts referred to the salaries that the directors would pay to themselves as "cutting up the swag".

The court stated that the evidence on the issue was unsatisfactory, but that the burden was on Synanon to show that the payments were compensation. There was no credible explanation, according to the court, why Dederich's salary was raised from \$75,000 to \$100,000 under a lifetime employment agreement that was amended in 1977. At the same time a \$500,000 pre-retirement bonus was also paid to Dederich. Using its judgment, and noting that the inexactitude was of Synanon's

own making due to its destruction of evidence, the court disallowed the \$500,000 bonus as a deduction, and also disallowed 10 percent of the cash paid to executives in each fiscal year in question as a deduction.

The court also stated Synanon could not claim an IRC 162 deduction for executive compensation allocable to Synanon's activities that the court had found not to be profit-motivated. The resulting deduction by the court's calculations was not greatly in excess of that originally allowed by the Service (\$752,735 compared to the Service's \$548,987).

## 5. Conclusion

The Service has under study additional issues concerning the taxation of revoked exempt organizations and the taxation of individuals who are insiders and principal officers of revoked organizations. As a general rule, the tax treatment of individuals who are principals of revoked exempt organizations is no different from that of individuals who are principals of taxable organizations. One possible issue is whether excessive executive compensation may be treated as a corporate dividend when the nonprofit charter of a corporation expressly forbids dividends.

At press time, the Synanon case was still subject to appeal.

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### 1990 UPDATE

Editor's Note: In late 1990 the IRS updated each topic that came out in early 1990 in its Exempt Organizations Continuing Professional Education Technical Instruction Program textbook for 1990. As a result, what you have already read contains the topic as it was set forth in early 1990; what you are about to read is the 1990 update to that topic. We believe combining each text topic with its update will both improve and speed your research.

## **B. TAXATION OF REVOKED TAX-EXEMPT ORGANIZATIONS**

### 1. Recent Developments

When this topic was first proposed in mid-1989, it was expected that the Service, by the time the 1990 CPE text was published, would have finalized a project concerning the circumstances under which the income of a retroactively

revoked organization would be taxed. This expectation turned out to be unduly optimistic. As a result, virtually the sole focus of the CPE text was the recently decided case The Synanon Church v. Commissioner, T.C. Memo. 1989-270, 57 T.C.M. (C.C.H.) 602 (filed June 7, 1989). Thus, the scope of the topic was much narrower than had originally been intended.

In March 1990, after the publication of the 1990 CPE text, G.C.M. 39813, Taxation of Funds of Revoked Organizations, was issued. This is the document that was meant to form the basis of the original CPE topic. While the Synanon decision is necessarily confined to a specific set of facts, the G.C.M. outlines the Service position on when and whether to impose tax on retroactively revoked IRC 501(c)(3) public charities in a variety of situations, including those of the Synanon case. This update sets forth the provisions of G.C.M. 39813. G.C.M. 39813 does not cover the taxation of revoked private foundations, nor does it cover the taxation of revoked exempt organizations that were not described in IRC 501(c)(3).

In the only other significant development since the publication of the CPE text, the Synanon decision was finalized by the court along virtually identical lines to that initially filed on June 7, 1989, except for a few minor changes to precise dollar amounts. The decision was not appealed by Synanon.

## 2. In General

When IRC 501(c)(3) exemption is revoked, the revocation is retroactive unless IRC 7805(b) relief is warranted. Such relief will not be warranted if the organization omitted or misstated a material fact in seeking exemption, or operated in a manner materially different from that originally represented. IRC 7805(b) relief is discussed in Rev. Proc. 90-4, 1990-2 I.R.B. 10, 20. Although a retroactively revoked organization is a taxable entity for the entire period for which the revocation is effective, the charitable deductions of contributors to the organization are protected until public announcement of the revocation is made. However, an exception may be made if a contributor knew of the actual or imminent revocation, or was responsible for or aware of the activities that resulted in the revocation. See Rev. Proc. 82-39, 1982-2 C.B. 759, 760.

Once a revocation is made, a threshold issue is the classification of the organization for tax purposes. As with all entities, the rules of IRC 7701 apply to determine whether an organization is to be classified as a corporation, trust, partnership, or sole proprietorship. G.C.M. 39813 notes that each case must be evaluated on its facts. While some revoked public charities are organized as trusts,

most have been organized under state nonprofit corporation laws and are likely to be treated as corporations under IRC 7701.

### 3. Taxable Income of the Organization

G.C.M. 39813 notes that different treatment is warranted depending on the source of the income received. It distinguishes between income from:

- a. business and investment activities; and
- b. contributions received.

#### A. Business and Investment Income (and Expenses)

The normal rules applicable to for-profit taxable entities are also applicable to the revoked organization. The organization would have gross income to the extent of receipts from trade or business activity, offset by reductions for related expenses and losses.

The important fact to note here is that for purposes of determining gross income, once revocation becomes effective there is no longer any significance as to whether a business activity is related to what was the organization's exempt function. Gross income would include amounts already taxed as unrelated trade or business income (UBI), but would also include amounts derived from business activities that were hitherto considered related to the organization's exempt function, as well as amounts that were not included in UBI because they were excepted from being treated as such under specific provisions of the Code. For example, an amount derived from an activity that was excluded from treatment as UBI because it was not "regularly carried on", or was carried on for the convenience of patients, would not become includible in gross income.

Likewise, gross investment income includes passive income hitherto excluded from UBI under IRC 512(b).

Once gross income has been determined, IRC 162 allows reductions for expenses and losses incurred in earning the income. Consequently, for business and investment activities, the net income is taxed. Where expenses exceed gross income from an activity, a net loss results that can be used to offset net income from other business and investment activities. As will be discussed below, different rules apply to activities that are not profit-motivated.

## B. Contribution Income

This was the principal issue in the Synanon case. As noted in the CPE text, a gift to a taxable entity does not ordinarily result in taxable income to the donee. While the donor may be subject to gift tax under IRC 2501, the recipient is not taxed on property received by gift under the provisions of IRC 102.

Unlike the situation where a donor knowingly makes a gift to a taxable entity, a donor giving in good faith to a revoked public charity during the retroactive period (and until notice of the revocation is published) is not subject to gift tax and will, in fact, be eligible for a charitable deduction. Extensively covered by G.C.M. 39813 is how the contributions received by a retroactively revoked organization are to be treated. After discussing several alternatives in substantial detail, the G.C.M. concludes that the only viable theory for treatment of contribution income by revoked organizations is to consider it to be excluded from gross income under IRC 102, with certain exceptions.

The general rule set forth in G.C.M. 39813 is that a contribution given in good faith--and solicited in good faith--would generally be excludible by the revoked organization under IRC 102. However, as in Synanon, in cases of misrepresentation or fraud, where it is clear that the organization intentionally misrepresented in its solicitations that it was validly tax-exempt or misrepresented that it would use the donations for exempt purposes, then IRC 102 should not apply. The G.C.M. sets forth the principle that in such a case the contributions are not the type of "gifts" contemplated by the statute.

The misrepresentation exception, in fact, appears to swallow the general rule in most cases involving revoked organizations. G.C.M. 39813 sets forth the presumption that misrepresentation exists when the facts show that an organization soliciting contributions was engaged in a pattern of activities inconsistent with the basis for its exemption. While the misrepresentation exception does not apply where the misrepresentation is not attributable to the organization itself, the actions of officers and agents may be imputed to the organization. Whether particular acts of officers or agents are imputed to an organization depends upon the particular facts of each case. The G.C.M. notes that in most cases the same factors that led to the loss of IRC 501 (c)(3) exemption will support a finding that the organization is acting on its own behalf and is soliciting contributions through misrepresentation, as an organization's exemption is not jeopardized by officers acting in their individual capacities. Thus the fact of revocation implies that the disqualifying acts

were authorized or ratified by the organization, and the taxpayer would have the burden of proving otherwise.

In most revocation cases, therefore, the pattern of activities that led to the revocation will also be presumed to constitute a misrepresentation by the organization that the contributions received by the organization were to be used for charitable purposes. This is a much harsher rule than the original CPE article offered in its interpretation of the significance of the Synanon decision.

G.C.M. 39813 notes some cases where the misrepresentation rule does not apply. It does not apply to cases where contributions were solicited in good faith and later diverted to nonexempt uses. But the G.C.M. draws this circumstance narrowly, and applies it to cases where the good faith solicitation was followed by a change of personnel who later diverted the assets to nonexempt purposes. The misrepresentation rule also does not apply to organizations that have not lost their tax-exempt status.

### C. Contribution and Other Exempt Activity Expenditures

In those cases where a revoked organization is found to have generated gross income from contributions received on the grounds that IRC 102 is not applicable, the organization's tax depends on which expenditures it can use to offset that income.

Because the conduct of a solicitation campaign for charitable causes will rarely be considered a profit-motivated activity, deductions under IRC 162 are generally not allowable for expenses incurred in obtaining contribution income. As an administrative practice, however, the Service and some courts have generally permitted a deduction of those costs of a taxable organization that are actually devoted to a nonprofit activity, but only to the extent of income from that activity. This was the result in Synanon.

While this administrative "income-offset" rule cannot be found in the Code except to a limited extent in IRC 183 and IRC 277 (barring the deduction of "hobby losses" as well as net losses by certain clubs), it serves to draw a relatively happy medium between the unduly harsh result of making nonprofit activity expenses completely nondeductible, and the Service's desire not to allow losses from nonprofit activities to offset gains from business and investment income.

G.C.M. 39813 also would permit a revoked organization's grants and contributions to other 501(c)(3) organizations to be set off in full, to the extent of contribution receipts for the particular year.

There are two major limitations on the "income-offset rule" set forth in G.C.M. 39813:

- a. Fundraising expenses are deductible against contribution income under the "income-offset" rule only to the extent that such income is actually spent on exempt purposes.
- b. The rule applies only to the extent expenses are attributable to contribution income received in the same tax year. It does not apply to charitable expenses that are attributable to other sources such as business and investment income, or to contribution income received in a different year.

#### D. Expenses for Nonexempt Purposes

Ordinary and necessary expenses incurred in carrying on business and investment activities are deductible under IRC 162. However, where a revoked organization has made payments for activities that are not profit-motivated, IRC 162 has no application. The Synanon court disallowed deductions taken by Synanon for expenses related to defending against criminal charges on the grounds that they were not rooted in any trade or business carried on by Synanon. G.C.M. 39813 discusses several situations where revoked organizations may have undertaken activities not in furtherance of their exempt purposes and that were not motivated by the prospect of financial gain.

##### a. Noncompensatory Payments to Principals

Amounts that represent reasonable compensation for services incurred in an organization's business or investment activities are deductible as salary. Amounts that represent reasonable compensation in an organization's charitable activities can be offset against contribution income. However, any amounts in excess of reasonable compensation or that are found not to be intended as compensation for services are deductible, and were accordingly disallowed in Synanon.

##### b. Political Activities

Expenses specifically disallowed by the Code may not be deducted. Thus, political campaign and grassroots lobbying expenses described in IRC 162(e)(2) may not be deducted. Neither could such expenses be offset against income contributed for exempt purposes, both because of the IRC 162(e)(2) restriction and because the contribution income cannot be attributed to nonexempt activities.

### c. Illegal Activities

Deductions are not permitted under IRC 162(c) for certain illegal bribes or kickbacks, but only if the payment itself is illegal. Thus, if the payment itself is legal, and the expenses are otherwise deductible under IRC 162, a deduction is allowable. In no case, however, could otherwise deductible expenses incurred in carrying on an illegal activity be offset against contribution income, since contributions for exempt purposes are not attributable to illegal activities. Further, it is not necessary for the activity to have been judicially determined to be illegal in order to disallow an offset.

### E. Other Issues

While not covering the issue in detail, G.C.M. 39813 provides a general rule that the basis of an asset acquired or held in periods during which the organization was exempt from income tax would be the original cost or other basis of the asset, reduced not only by the depreciation occurring while the organization was taxable, but also for depreciation that would have been allowable in periods during which the organization was exempt.

Finally, G.C.M. 39813 notes that for post-1987 taxable years, a revoked organization may be subject to excise tax under IRC 4912, which is imposed on certain IRC 501(c)(3) organizations that lose their tax exemptions because of excessive lobbying. An excise tax may also be imposed under IRC 4955 against IRC 501(c)(3) organizations whose exemption was revoked for participating in a political campaign.

## 4. Tax Treatment of Individuals

G.C.M. 39813 also contains various rules relating to the tax treatment of principals of a revoked organization.

In extreme cases, the facts may show that the organization is no more than a sham, dummy, or alter ego for an individual. In such a case, there would be no

entity-level tax, and all income and expenses would be attributed to the individual. The G.C.M. notes that this result is unlikely.

To the extent that principals obtained assets of the organization and are liable as transferees under state law, the Service would be able to assess and collect that liability under IRC 6901.

Where an individual receives a payment that results in the individual's dominion and control over an organization's funds, and is not acting as a borrower or agent, the individual is taxable on the payment, at least to the extent it does not represent a return of capital. Whether such control exists is a question of fact.

Likewise, where a revoked organization has made a payment to a third party for the benefit of an individual, the payment would constitute constructive income and be includible in the individual's gross income. The mere fact that the individual has or shares control over the organization is not determinative in itself of the taxable nature of the transaction. To be taxable to the individual, there must be a financial benefit to the individual. A nonfinancial benefit (such as a political benefit) will probably not suffice to render the individual taxable on the payment, although there is little authority on the point.

Payments received by principals from a revoked organization should be presumed to be taxable to the principals as ordinary income under IRC 61 as a general rule, even if the payments cannot be characterized as compensation for services or some other typical form of ordinary income. However, the possibility of treatment as dividend distributions cannot be ruled out. In unusual situations, a taxpayer may be able to overcome this presumption by showing that the payment is a return of capital, or capital gain, under the requirements of IRC 301 and 316.

For post-1987 taxable years, a manager who agrees to lobbying expenditures that cause an organization to lose its exempt status is subject to excise tax under IRC 4912. IRC 4955 imposes a similar tax on managers whose actions result in loss of exemption due to participation in a political campaign. In both cases the term "manager" is defined to include officers, directors, trustees, and responsible employees.