

E. CONDUIT ORGANIZATIONS - CHARITABLE DEDUCTIBILITY AND EXEMPTION ISSUES

by

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When computing one's tax return, most Americans know that they cannot count tuition payments as a charitable deduction, even though the check is made out to the section 501(c)(3) educational institution. In addition, most taxpayers know that their tuition payments are still not deductible if they are paid to a community foundation or other public charity with instructions to forward the funds to the appropriate college or university.

Unfortunately, far too few donors and charitable institutions apply the same logic to other similar circumstances. In too many communities, it is generally accepted that when grants or gifts cannot be made directly all one must do is "launder" the money through a convenient "fiscal agent" which is frequently the local community foundation or some other well established public charity.

John A. Edie, "Use of Fiscal Agents: A Trap for the Unwary," Council on Foundations (1989).

1. Introduction

Mr. Edie's comments are particularly applicable to this discussion of conduit organizations, which covers both charitable deductibility under IRC 170(c) of the Code and exempt status under IRC 501(c)(3) when the conduit aspect is a dominant, if not primary, element in the operations of a particular organization. His comments are also relevant to Donor Directed Funds, Topic M in this EOCPE textbook, and Topics K in the 1994 EOCPE textbook (p. 150 *et. seq.*) and O in the 1995 EOCPE textbook (p. 282 *et. seq.*) regarding Community Foundations and Private Foundations.

2. IRC 170(c) Deductibility

A. Background

To analyze the exemption issue, we must first consider the issue of

deductibility under IRC 170. After reviewing deductibility in the context of tuition payments and general contribution principles, we will look at the effect of conduit transactions on tax exemption.

B. Revenue Ruling 83-104

(1) General

Rev. Rul. 83-104, 1983-2 C.B. 46, provides six fact situations that illustrate the distinction between qualified charitable contributions and tuition payments. In each situation, the donee is an IRC 170(c) organization that operates a private school, and a parent of a student at the school makes a payment to the school that equals or exceeds the cost of tuition.

(2) Discussion

In the first three situations, parents are required to make "contributions" or pay tuition in the amount suggested by the school for each child enrolled. In Situation 1, parents are required to contribute \$400x for each child enrolled, or else pay tuition of \$400x. In Situation 2, the school states that no tuition is charged. However, solicitation for contributions from parents of applicants are made during enrollment of students or while the application is pending, and children of parents who do not make or pledge a "contribution" in the specified amount are not accepted. In Situation 3, the organization admits or readmits a significantly larger percentage of applicants whose parents made contributions than applicants whose parents have not made contributions. The parents in Situations 1 through 3 are not entitled to a charitable deduction for the payments to the educational institutions because "contributions" are not voluntary. Rather, they are paid with the expectation of having their children admitted to the school.

In Situation 4, a society for religious instruction operates a school providing both secular and religious instruction for which it charges no tuition. The school is funded through the society's general account. However, a significant amount of funds come to the society from parents on a regular established schedule. The school treasurer also solicits contributions from parents according to their financial ability. Parents are not entitled to a charitable contribution deduction to the society because the school is economically dependent on the parents' payments, contributions are made on an established schedule, and the treasurer's pressure for contributions indicates that contributions are not voluntary.

In Situation 5, organization W operates a private school that charges tuition of \$300x per student. In addition, it solicits contributions from students' parents during periods other than enrollment or application. The solicitation material includes a report on W's cost per student to operate the school. W suggests amounts of contributions based on an individual ability to pay. Many parents do not contribute. The taxpayer made a \$100 contribution in addition to the tuition payment. Under these circumstances the Service will generally conclude that the taxpayer is entitled to claim a charitable contribution deduction of \$100 to W. The fact that parents are singled out for a solicitation will not in itself create an inference that future admissions or any other benefits depend on a contribution from the parent, as charitable organizations normally solicit contributions from those known to have the greatest interest in the organization.

In Situation 6, church X operates a school providing secular and religious education. Children of members and nonmembers of X attend. X receives contributions from all its members, which are placed in X's general operating fund and expended for all church activities. A substantial portion of X's activities and a major portion of its expenses are not related to the school. Most members of X do not have children in the school. X's methods of soliciting contributions from members with children at the school and members without children at the school are the same. X has full control over the use of the contributions it receives. Members with children at the school are not required to pay tuition for their children, but tuition is charged for the children of non-members. Taxpayer, a member of X whose child attends X's school, contributed \$200x to X during the year for X's general purposes. With these facts, the Service will ordinarily conclude that the taxpayer is allowed a charitable contribution deduction of \$200x to X. The facts indicate that X's school is supported by the church, that most contributors to the church are not parents of children enrolled in the school, and that contributions from parent members are solicited in the same manner as contributions from other members. The taxpayer's contribution will be considered a charitable contribution and not a tuition payment, unless there is a showing that contributions by members with children in X's school are significantly larger than those of other members. The absence of a tuition charge is not determinative in view of the facts.

(3) Important Factors in Deductibility Determinations

Rev. Rul. 83-104 sets out factors, the presence of one or more of which create the presumption that payment to an organization that operates a school is not a charitable contribution deductible under IRC 170. The factors are:

- a. The existence of a contract under which a taxpayer agrees to make a "contribution" and which contains provisions ensuring the admission of the taxpayer's child.
- b. A plan allowing taxpayers to either pay tuition or to make "contributions" in exchange for schooling.
- c. The earmarking of a contribution for the direct benefit of a particular individual.
- d. The otherwise unexplained denial of admission or readmission to a school of children of taxpayers who are financially able, but who do not contribute.

(4) Additional Factors

Rev. Rul. 83-104 further states that several other factors may suggest that a payment is not a charitable contribution especially when more than one is present. When these factors are present, both economic and non-economic pressures placed upon parents must be evaluated. Such factors include:

- a. The absence of a significant tuition charge.
- b. Substantial or unusual pressure to contribute applied to parents of children attending the school.
- c. Contribution appeals made as a part of the admissions or enrollment process.
- d. The absence of significant potential sources of revenue for operating the school other than contributions by parents of children attending the school.
- e. Other factors suggesting that a contribution policy has been created as a means of avoiding the characterization of payments as tuition.

C. Important Court Cases

Court cases that illustrate the distinction between deductible charitable contributions and nondeductible tuition payments include the following:

- a. In S.E. Thomason v. Commissioner, 2 T.C. 441 (1943), the taxpayer paid an educational institution the tuition and maintenance of a particular individual, who was the ward of a public charity, and claimed a charitable deduction. The court held that the taxpayer was not entitled to the deduction because the contributions were for the benefit of a particular individual.
- b. In Tripp v. Commissioner, 337 F.2d 432 (7th Cir. 1964), the court held that payments made to an educational institution and earmarked for the educational expenses of a particular individual were not deductible because they were neither made to the college for use as it saw fit nor made for the benefit of an indefinite number of persons, as, for example, a scholarship fund.
- c. In Graves v. Commissioner, T.C.M. 1994-616, the Tax Court held that amounts paid by the taxpayers to the Owl Foundation, which in turn paid their childrens' tuition to educational institutions, were not contributions within the meaning of IRC 170(c). This case, as well as others, will be discussed in greater detail in Part 4 of this article.

D. Summation

Generally, contributions earmarked by a donor for a particular individual are treated as gifts to the designated individual and are not deductible. However, a deduction will be allowed if it is established that the gift is intended by the donor for the use of the charitable organization. The test is whether the organization has full control of the donated funds, and discretion as to their use, to ensure that they will be used to carry out the charitable organization's functions and purposes. See Revenue Ruling 62-113, 1962-1 C.B. 10.

Situations similar to the "tuition" cases arise in a variety of other circumstances where funds are set up to help designated individuals or families. For example, in emergencies, funds are often set up to help individuals, such as a fund to help pay for an organ transplant or to help a particular family rebuild a

home destroyed by a tornado. Similar issues are also raised by religiously motivated programs to support designated missionaries. The general principles applied to the "tuition" cases also apply to other circumstances, which we will discuss later in this topic.

We will now discuss IRC 170(c) deductibility principles in detail.

3. Principles Governing Deductibility of Contributions

A. General

IRC 170(a) provides that there shall be allowed as a deduction, subject to certain limitations, any charitable contribution, as defined in IRC 170(c), payment of which is made within the taxable year. IRC 170(c) defines charitable contribution, in part, to include a contribution or gift to or for the use of a corporation organized and operated exclusively for religious, educational or other charitable purposes no part of the net earnings of which inures to the benefit of any private shareholder or individual.

The term "charitable contribution," as used in IRC 170, has been held to be synonymous with the word "gift." Channing v. U.S., 4 F. Supp. 33(D. Mass. 1933), aff'd per curiam, 67 F.2d 986(1st Cir. 1933). A gift for purposes of IRC 170 is a voluntary transfer of money or property that is made with no expectation of commensurate financial benefit in return for the transfer. Reg. 1.170A-1(c)(5), H.R. Rep. No. 1337, 83rd Cong., 2d Sess. A44 (1954); S. Rep. No. 1622, 83rd Cong., 2nd Sess. 196 (1954). To qualify as a gift, the payment or transfer of property must be made as an act of detached or disinterested generosity and not for an anticipated benefit to the payor. Commissioner v. Duberstein, 363 U.S. 278 (1960). To the extent the transferor receives or can expect to receive, for the money or property transferred, a financial or economic benefit, as distinguished from the incidental benefit that inures to a donor as a member of the general public, then no deduction is allowable. When substantial benefits are derived from a contribution supplying the donor with a quid pro quo, the charitable nature of the donation is destroyed. Singer v. U.S., 449 F.2d 413 (Ct.Cl. 1971). If a transaction is structured in the form of a quid pro quo, where it is understood that the taxpayer's money will not pass to the charitable organization unless the taxpayer receives a specific benefit in return, and where the taxpayer cannot receive the benefit unless he pays the required price, then the transaction does not qualify for the deduction under IRC 170.

B. "To or for the use of"

(1) General

A contribution is not considered made "to" a charity if the facts and circumstances show that the charity is merely a conduit to a particular person. If contributions to a fund are earmarked by the donor for a particular individual, they are treated as gifts "to" the designated individual rather than "to" the charitable organization. See Rev. Rul. 62-113, supra. Rev. Rul. 68-484, 1968-2 C.B. 105, provides that for purposes of determining that a contribution is made to or for the use of an organization described in IRC 170 rather than to a particular individual who ultimately benefits from the contribution, the organization must have full control of the use of the donated funds and the contributor's intent in making the payment must have been to benefit the charitable organization itself and not the individual recipient. In Tripp v. Commissioner, supra, the taxpayer made earmarked payments to a college for a particular student's tuition. The Tax Court opinion stated that there was nothing in the record that indicated that the college ever at any time awarded the student a scholarship or was in any manner obligated to provide the student with tuition or other expenses out of its scholarship funds or other funds. If a "scholarship" was involved, it was one the taxpayer, not the college, awarded the student. The court concluded that the payments were for the sole benefit of one specified person rather than gifts to the college for the benefit of an indefinite number of persons. The payments made were not to a general scholarship fund to be used as the college saw fit.

In Thomason v. Commissioner, supra, a taxpayer paid tuition and expenses for a particular individual, who was the ward of a public charity, and claimed a charitable deduction for such expenses. The Service disallowed the deductions. In upholding disallowance, the court concluded that the payments were not charitable contributions, as they were earmarked from the beginning not for a group or class of individuals, not to be used in any manner seen fit by the public charity, but for the use of a single individual. The payments may have relieved the charity of providing its ordinary services, but it did not follow that such payments were made "for the use of" the public charity. The court cites Russell v. Allen, 107 U.S. 163, stating, "Charity begins where certainty in beneficiaries ends, for it is the uncertainty of the objects and not the mode of relieving them which forms the essential element of charity."

(2) Control

Indefiniteness is an essential element of a charity. Earmarking or designating individual donees does not create an uncertain object of charity and therefore lacks this essential element. The requirement of indefiniteness is satisfied if the charitable organization retains control of the funds. The taxpayer in Thomason v. Commissioner argued that because the child was a ward of a charitable orphanage, funds designated for the child should be regarded as "for the use of" the organization. The court found that the Service has long (since 1943), construed the phrase "for the use of" to mean "right of exclusive appropriation or enjoyment of the thing donated," rather than the purpose or mode of use, and as intended to convey a meaning similar to "in trust for." The court states that the taxpayer's donations, intended for the benefit of one individual, secured special privileges and advantages for him that the orphanage otherwise would not have furnished. The sums were paid by taxpayer for the benefit of a designated individual, and were thus gifts to or for the benefit of the particular child, not to the organization.

In Davis v. United States, 495 U.S. 472 (1990), the Supreme Court held that funds transferred by the taxpayers to their two sons while they served as full-time, unpaid missionaries of the Church of Jesus Christ of Latter-day Saints (Church) did not qualify as a charitable contribution made "for the use of" the Church in absence of evidence that funds were transferred "in trust for" the Church. The Supreme Court affirmed the lower courts and concluded that because the taxpayers did not donate the funds "in trust for" the Church, or in a similarly enforceable legal arrangement for the benefit of the Church, the funds were not donated "for the use of" the Church for purposes of IRC 170.

It was evident in this case that the missionary sons, not the Church, had true control over the funds in question. Funds contributed were placed directly in the missionaries' personal bank accounts by their parents. The missionaries made use of such funds as they saw fit.

We will revisit Davis in Part 4 of this topic.

(3) Other Significant Cases

In Graves v. Commissioner, *supra*, the court held that no portion of payments made by the taxpayers to a private foundation that solicited funds from parents of children in private schools for the purpose of paying their tuition constituted charitable contributions. The taxpayers earmarked the funds for their children's tuition. They knew that their children would not have received

"scholarships" had they not paid the tuition amount plus fifteen percent to the Foundation.

In Peace v. Commissioner, 43 T.C. 1 (1964), acq., 1965-2 C.B. 6, the Tax Court held that amounts paid by the taxpayer were contributions "to and for the use of" the Sudan Interior Mission (Mission), an exempt charitable organization, and were not personal gifts to four designated missionaries. Therefore, the amounts were deductible as charitable contributions under IRC 170(c) of the Code.

The Mission operated various hospitals in Africa and had clinics at most of its 200 missionary sites. The Mission estimated the cost of a missionary's yearly support. Mission policy was that each missionary obtain promises from donors to equal the amount of his or her annual support. However, contributions were placed in a common pool and were disbursed based on the needs of each missionary. Therefore, the actual support provided to each missionary could be more or less than the amount contributed. In its "Missionary Maintenance" pamphlet, the organization stated that "[t]here are missionaries accepted by the Mission who are waiting to set sail but who need financial support. Perhaps God would have you share the burden by undertaking partial or full support of one of these, to be your personal gospel representative in Africa."

The court concluded that the Mission had exclusive control, under its own policy, of both the administration and distribution of the funds donated by the taxpayers. The court further concluded that based on "the totality of the facts and evidence it was clearly demonstrated that the taxpayers knew and intended that their funds would go into a common pool to be distributed only as the Mission itself determined." (Underlining added.)

We will return to the Graves and Peace cases in Part 4 of this topic.

In Estate of Otis C. Hubert, T.C. Memo 1993-482, the Tax Court allowed a charitable deduction for bequests to sub-trusts created to benefit the church's missionary work through two named missionaries. The court states that bequests were not life estates for the missionaries' benefit because the church controlled the funds, which were held in a trust against which the church could legally enforce its rights, and the decedent had no relationship with the missionaries except through the church. The court distinguished this case from Thomason and Davis by stating that "under Davis and Thomason the test is not whether the charitable organization has full control of the funds, but rather whether the charitable organization has a legally enforceable right to the funds. In neither Davis nor Thomason did the

charitable organization actually receive the funds either directly or in trust."

C. Bottom Line

The principle that emerges from case law is that whether a contribution is made "to" the individual or "to or for the use of" the charitable organization is determined by applying a control test. Does the organization have full control of the donated funds and discretion as to their use, to ensure that the funds will be used to carry out the charitable organization's functions and purposes? To answer to this question, we must consider the following factors:

- a. Whether contributions are earmarked for a particular individual.
- b. Whether there is a commitment or understanding, either oral or written, that such contributions will be used only for the designated beneficiary.
- c. Whether the contributor's intent in making the payment is to benefit the charitable organization itself and not the individual recipient.

The facts and circumstances of each case, such as the organization's activities, its mode of operation and the donor's knowledge and acceptance of such methods, must be considered to determine whether the charitable organization or the donor exercise control over the funds.

D. Disallowance of Deductibility to Contributors Who Make Contributions to Organizations Having Their IRC 501(c)(3) Status Revoked

(1) General

Rev. Proc. 82-39, 1982-1 C.B. 759, Reg. 1.509(a)-7 and IRC 7428(c) provide special rules for the disallowance of charitable contribution deductions made by contributors to organizations which have had their IRC 501(c) exempt statuses revoked. Generally, contributors have reliance on organization's IRC 501(c)(3) status until there has been public notice of the revocation. However, when the contributor has pre-publication knowledge of revocation or is a perpetrator of the events that caused the revocation, deductibility may be denied.

These rules may have special relevance to taxpayers who contribute to a revoked organization whose "raison d' etre" is to launder funds.

(2) Revenue Procedure 82-39

Revenue Procedure 82-39, 1982-1 C.B. 759, provides criteria for determining the extent to which contributors may rely on the listing of an organization in Publication No. 78, Cumulative List of Organizations Described in IRC 170(c), for purposes of deducting contributions under IRC 170 and for making grants under IRC 4945. Section 3.01 of the revenue procedure provides, in part, that where an organization ceases to qualify as an organization contributions to which are deductible under IRC 170 and the Service revokes a ruling or determination letter issued to it, contributions made to the organization by persons unaware of the change in status of the organization generally will be considered allowable if made on or before the date of an appropriate public announcement. However, the Service is not precluded from disallowing a deduction for any contribution made after an organization ceases to qualify under IRC 170, where the contributor (1) had knowledge of the revocation of the ruling or determination letter, (2) was aware that such revocation was imminent, or (3) was in part responsible for, or was aware of, the activities or deficiencies on the part of the organization that gave rise to the loss of qualification.

(3) Reg. 1.509(a)-7

Reg. 1.509(a)-7(a) provides that once an organization has received a final ruling or determination letter classifying it as an organization described in IRC 509(a)(1), (2) or (3), the treatment of contributions under IRC 170 will not be affected by reason of a subsequent revocation by the Service of the organization's classification under IRC 509(a)(1), (2) or (3) until the date on which notice of the change is made public (such as by publication in the Internal Revenue Bulletin). Reg. 1.509(a)-7(b) provides that an exception to this general rule occurs when the contributor (i) had knowledge of the revocation or (ii) was in part responsible for, or was aware of, the act, the failure to act, or the substantial and material change on the part of the organization which gave rise to the revocation of the ruling or determination letter.

(4) IRC 7428(c)

IRC 7428(c) provides for limited validation of charitable contribution deductibility for contributors during the pending of a declaratory judgement

proceeding involving the revocation of IRC 501(c)(3) status. Similar to the rules expressed in Reg. 1.509(a)-7 and Rev. Proc. 82-39, supra, this validation is not applicable to individuals who are responsible, in whole or in part, for the act (or failures to act) on the part of the organization which were the basis for the revocation. IRC 7428(c)(3).

We will further discuss the disallowance rules in the context of the Graves case, supra, in Part 4 of this topic.

E. Substantiation and Disclosure Rules of OBRA '93

IRC 501(c)(3) organizations must now comply with new rules involving substantiation and disclosure of contributions. The rules will have relevance to organizations and contributors where the transfer of funds involve a quid pro quo, for example, the payment made is partly, or entirely, for school tuitions. See the 1995 EOCPE Textbook, Topic J.

4. Deductibility Principles and Exempt Status Under IRC 501(c)(3) for Conduit Organizations

A. General

We have reached a point in this topic where we may confront exemption issues under IRC 501(c)(3). We will discuss court cases and PLRs involving educational organizations, churches and missionary organizations where the conduit element is so integral to the organization's operations that that is the primary activity and, depending on the facts and circumstances, inconsistent with IRC 501(c)(3) status.

We will see that these cases are highly fact driven.

B. Educational Organizations - The Graves Case

(1) General

Graves v. Commissioner, supra, is a classic recent example of "laundering" money through a convenient "fiscal agent" or intermediary organization. The organization, The Owl Foundation, can be characterized as a Non Exempt Conduit Organization (hereinafter "NECO") because its primary activity was to act as a conduit of funds to pay for predesignated tuitions. In December 1994 the Tax

Court held that no portion of payments made by a married couple to The Owl Foundation, which solicited funds from parents of children in private schools for the purpose of paying their tuition, constituted charitable contributions.

(2) Facts and Discussion

The couple in Graves contributed the exact amount of money that would pay for their children's tuition plus a 15 percent fee. They conceded that they were not entitled to charitable deductions for the portion of their payment that was used to pay tuition for their children. However, they argued that they were entitled to deduct as charitable contributions the 15 percent paid to the Foundation in excess of the tuition payments.

The court rejected the taxpayers' argument, holding that the 15 percent in excess of tuition was not a "contribution" within the meaning of IRC 170(c). The court also rejected the taxpayers' argument that the payments were made before the Foundation's exempt status was revoked, holding that the taxpayers had participated in the very activity that led to revocation.

The specific facts and circumstances of the case were discussed by the court as follows:

The Owl Foundation was created and operated by Mr. Richard Dryer on December 12, 1977. On March 15, 1979, the Service issued a determination letter stating that the Foundation was exempt from federal income tax under IRC 501(c)(3) and was classified as a public charity pursuant to IRC 509(a)(2). On July 6, 1989, the Service retroactively revoked the Foundation's tax exempt status because its "primary activity was to solicit funds from individuals for the ultimate purpose of paying for school tuition (and related costs) for their children," contrary to the activities listed on its exemption application. The organization was providing a commercial facilitator service operated for a substantial non-exempt purpose and private benefit, factors inconsistent with IRC 501(c)(3) status. Also, from the following facts gleaned from the court case, Owl and Mr. Dryer may have been operated contrary to public policy by aiding and abetting tax avoidance.

Mr. Dryer, the founder and President of the organization, attended social functions to solicit funds from potential contributors. He informed potential contributors that the Foundation would accept contributions for the amount of the tuition bill of the contributor's children, plus an additional 15 percent. He stated that upon receipt of the contribution, the Foundation would pay the tuition bill in

the form of a scholarship, and use the remaining 15 percent for overhead expenses and for scholarships for needy students. Mr. Dryer told potential contributors that they would be allowed to take the full amount contributed as a charitable deduction for federal income tax purposes.

When the Foundation received payments of the tuition amount plus the 15%, it made tuition payments for the donors' children directly to the school. The Foundation never refused to award a "scholarship" to any student whose parents contributed the amount of the student's tuition plus the 15 percent additional amount. However, the Foundation required that the contributor include the additional 15 percent before payments of tuition would be made.

The taxpayers' children did not fill out scholarship, grant, or any other type of education related application for the Foundation. The children were never interviewed by Mr. Dryer or other Foundation personnel. The taxpayers knew that their children would not have received the "scholarships" had they not contributed the additional 15 percent. The taxpayers informed the Foundation of the names of their children, the amounts of tuition to be paid and the schools to which checks were to be paid. The Foundation provided the taxpayers with a thank you letter for each payment listing the amount of the stated contribution as the amount the taxpayers paid to the Foundation. The taxpayers deducted the amounts in their entireties as charitable contributions.

In practice, the moneys in excess of tuition payments that the Foundation received did not go to needy students, but were used by Mr. Dryer for expenses of the Foundation and for personal purposes. The Foundation did not process any scholarship applications, nor did it ever award scholarships based on financial need, scholastic achievement, or athletic ability. The taxpayers had no actual knowledge that the Foundation performed other charitable acts, but they did receive letters from the Foundation that stated that scholarships had been given to needy students.

The taxpayers were educated individuals who should have realized that this arrangement was too good to be true. They knew that their children were not receiving scholarships based on any type of merit or financial need. They also knew that had they not contributed the amount of their children's tuition, plus the 15 percent fee, they would not have received tuition payments in return. Further, though they questioned their accountant as to whether contributions to the Foundation were deductible, they did not inform the accountant that part of such contributions paid for their children's tuition. The accountant merely verified the

Foundation's tax exempt status and informed the taxpayers that contributions to the Foundation were deductible. The accountant did not ask the taxpayers whether they had received anything in return for the contributions made.

(3) Bottom Line

The NECO was not a bona fide IRC 501(c)(3) organization and the "contributions" were nondeductible payments for non charitable purposes.

C. Peace v. Commissioner - A Missionary Organization

(1) General

Peace v. Commissioner was briefly cited in Part 3 with respect to the definition of "to or for the use of." The Tax Court in 1964 held that contributions paid by the taxpayers were "to or for the use of" the subject organization (hereinafter Mission) rather than personal gifts to the four designated missionaries. A look at the Mission's missionary program structure and operation, as described in the court opinion, will be particularly helpful in our review of fact patterns involving deductibility and NECOs.

(2) Facts

- a. The Mission is a charitable and religious organization exempt under section 501(c)(3) of the Code. It has some hospitals in Africa, including ten (10) leprosaria, and has clinics at most of its 200 missionary stations. At the time in question, it had between 1,200 and 1,300 missionaries.
- b. The Mission is dependent for its support entirely upon freewill offerings of individuals, groups, and churches.
- c. The Mission's fundraising program consists of visitations to churches, groups and individuals in the United States by missionaries on furloughs from their field work. The missionaries make known the Mission's needs for funds, in line with the Mission's policy of "full information and no solicitation."
- d. Each year the Mission estimates the cost of support for

each missionary. For example, for the years in question, 1959 - 1961, the estimated yearly cost for each missionary was \$1,600.

- e. The estimated costs for each missionary in any particular country are identical, although allowances might vary from one country to the next.
- f. The Mission receives funds in three categories: General-Undesignated-Funds, Funds-For-Support, and Special Funds. General-Undesignated-Funds are used to meet current expenses. Funds-For-Support are divided into three portions: 50% for the support pool; 20% for mission passage, which provides for missionaries' travel to and from furloughs; and 30% into a general fund used for missionaries' housing, medical, and administrative needs. Special Funds include gifts designated for special projects and personal transmission gifts sent directly to missionaries concerned.
- g. The Mission's policy, with regard to contributions and distribution of funds, is stated in a pamphlet entitled "Missionary Maintenance" as follows:

Contributions designated by the donor to a specific department of the work or to an individual are applied as designated. The general fund, from which the general administrative expenses are met, receives most undesignated and sundry contributions. It is the aim of the Mission that each missionary going forth have his full support promised. The money thus received is divided equally for Personal Allowance and Service Support. The Personal Allowance Fund is divided equally each month among all the missionaries and fluctuates in proportion to the amount available. This is the equivalent of the missionaries' "salary" and is for his personal use. The actual sum received varies slightly on different fields but the fund is shared in such a manner as to enable each one to enjoy as nearly as possible the

same purchasing power.

From the half that goes into Service Support, appropriate sums are set aside for passage and general maintenance requirements. At the end of each month, any balance in the general fund is transferred to the Allowance Fund and augments the amounts available for the missionaries' monthly allowances.

By sharing funds this way, with each member contributing his support funds to the general family welfare, the Mission is happily following the example of the early church.

There are missionaries accepted by the Mission who are waiting to sail but who need financial support. Perhaps God would have you share the burden by undertaking partial or full support of one of these, to be your personal gospel representative in Africa.

The Mission's policy is that each of the missionaries acquire pledges from donors in the amount of his or her annual support. Contributors measure their contributions in terms of the support of individual missionaries. Contributions are placed in a common pool used for missionary support and are disbursed in accordance with the policy of the Mission as set out in the "Missionary Maintenance" pamphlet. The taxpayers in the case measured their contributions in terms of partially meeting the support for four named missionaries.

(3) Court Decision and Analysis

The Tax Court concluded that the Mission had exclusive control, under its own policy, of both the administration and distribution of the funds donated by the taxpayers. The court further concluded that based on "the totality of the facts and evidence it was clearly demonstrated that the petitioners knew and intended that their funds would go into a common pool to be distributed only as the Mission itself determined." (Underlining added.)

The court viewed the following facts as favorable to deductibility and IRC 501(c)(3) status. The Mission conducts its own programs. The Mission determines the average expenses per missionary per year. Each missionary is responsible to

raise the amount for average expenses. The Mission deposits all amounts received into a general missionary support fund. The Mission distributes funds to missionaries based on their needs, which could be more or less than the total they had been promised by their donors. The Mission solicits funds for "missionaries who are waiting to set sail," but have no funds, thereby raising funds for selected missionaries who lack funds. A person responding to the solicitation and donating funds to the Mission for one of these missionaries is actually donating to a specific program. At any given time, a number of different missionaries can be working at a site. Therefore, the names appear to indicate association with a program rather than specific individuals. The Mission advertises its fundraising and disbursement policies to all contributors. Therefore, contributors are familiar with the Mission's policy of placing all contributions into a common pool administered by the Mission and distributed according to its stated policy.

The Tax Court concluded that the Mission has complete control of the donated funds and that the contributors' intend to benefit the Mission's charitable programs rather than particular individuals. Thus, funds are transferred "to or for the use of" the Mission.

Thus, the court held the contributions deductible. From this reading, Mission was not a NECO. And, as a postscript, the Service agreed that the facts were sufficient to support the court's finding by acquiescence. 1965-2 C.B. 6.

D. Davis v. United States

(1) General

In Davis v. United States, *supra*, the Supreme Court held that the transfer of funds did not qualify as a charitable contribution made "for the use of" the Church of Jesus Christ of Latter-day Saints (Church) in absence of evidence that funds were transferred "in trust for" the Church. A gift or contribution is "for the use of" a qualified organization when it is held in a legally enforceable trust for the qualified organization or in a similar legal arrangement. Contrary to the factual pattern in Peace, there are unfavorable factors in Davis, in respect to the deductibility of contributions.

There are no exemption issues raised in this case. The missionary program is significant, but constitutes only a small part of the church's overall operations.

(2) Facts

- a. The Church operates a worldwide missionary program involving 25,000 persons each year. Most of the missionaries are young men between the ages of 19 and 22. If the Church determines that a candidate is qualified to become a missionary, the President of the Church sends a letter calling the candidate to missionary service in a specified geographical location. A follow-up letter from the missionary department lists the items of clothing the missionary will need, provides specific information relating to the mission, and sets forth the estimated amount of money needed to support the missionary service.
- b. After accepting the call, the missionary candidates receive priesthood ordinances to serve as official missionaries and ministers of the Church. During the missionary service, the mission President (leader of the mission) controls many aspects of the missionaries' lives, including the manner of dress and grooming. Missionaries are required to conform to a daily schedule which calls for at least 10 hours per day of actual missionary work in addition to study time, mealtime, and planning time. Mission rules forbid dating, movies, plays, certain sports, and other activities. Missionaries are not allowed to take vacations or travel for personal purposes.
- c. Missionaries receive some supervision over their use of funds. The Missionary Handbook instructs missionaries that the money they receive is sacred and should be spent wisely. Missionaries submit weekly reports to their group leader listing the amount of time spent in Church service, the type of missionary work accomplished, and a report of the total expenses for the week and month to date. If a missionary begins to accumulate surplus funds, he is expected to take action to reduce the amount of donations sent to him. The mission President may alter his estimates of the amounts required each month to take into account changing circumstances.

- d. The missionary's parents generally provide the necessary funds to support their son or daughter during the period of missionary service. If they are unable to do so, the Church will locate another donor from the local congregation or use money donated to the Church's general missionary funds. The Church believes that having individual donors send the necessary funds directly to the missionary benefits the Church in several important ways. Specifically, "[i]t fosters the Church doctrine of sacrifices and consecration in the lives of its people," as well as reducing the administrative and bookkeeping requirements which would otherwise be imposed upon the Church.

- e. The taxpayers transferred certain amounts into their children's personal checking accounts. They claimed charitable contribution deductions for the amounts paid to their children during their missionary services. The Service disallowed their claim. The taxpayers argued that the payments made to support their children's missionary service were charitable contributions "for the use of" the Church.

(3) Supreme Court Decision and Analysis

The Supreme Court affirmed the lower courts and concluded that because the taxpayers did not donate the funds in trust for the Church, or in a similarly enforceable legal arrangement for the benefit of the Church, the funds were not donated "for the use of" the Church for purposes of IRC 170.

The court considered the following factors. Similar to Mission in Peace, supra, the Church had an established missionary program. The Church selected the missionaries and determined where they would serve. It also supervised the program closely. For example, it had a missionary President or leader for each mission who supervised missionaries' schedules, activities, behavior, dress, expenses, and made suggestions for changes in amounts of support needed when appropriate. However, in contrast to Mission, the Church did not receive the funds and, other than to advise as to the wise use of funds, the missionary President did not control how the missionaries expended funds. The Church expected the

parents of the missionaries to support their children's living expenses. (Therefore, it appeared to be the parents' personal responsibility and expense.) Parents deposited funds directly into their children's personal checking accounts for them to spend as they saw fit, although they were instructed to use the funds consistent with their missionary activities. It was also possible for a parent to deposit more funds than actually needed. However, in contrast to Peace, in which Mission received funds, commingled all funds received including contributions exceeding the average amount, and disbursed funds based on need, the Church did not receive such funds and had absolutely no control over their use.

Thus, the court resolved the case in favor of the Service holding that the contributions were not deductible. Under these facts, distinguishable from those in the Peace case, the missionary program, if it was independently established and not under the umbrella of the Church, would be a NECO.

(4) A "Peace" Remedy To The Davis Case

a. General

The Mormon church converted their missionary funding procedure into an Equalized Funding Program (hereinafter EFP) and contributions to the program are now fully deductible under IRC 170(c). A copy of the IRS News Release is included as Exhibit A at the end of this topic.

b. Restructured Program

Prior to selecting its missionaries, the organization determines the cost of operation of its missionary programs and the cost of maintaining its missionaries in different parts of the world. It then determines an average cost for all its missionaries. The funds collected go to a commingled general fund. The organization then distributes the funds to each mission where it is used as needed. By using this system, the parents and relatives will be donating more or less than the actual expenses of their son or daughter. They are donating to the missionary effort the average cost of supporting a missionary worldwide rather than the actual cost of supporting their child. The conduit or earmarking issue is thus effectively diluted. The parents, friends, and relatives are donating directly to the organization with the understanding that the organization will distribute funds as needed at the mission site. Also, missionaries, whose parents are unable or unwilling to provide support, will be supported.

In the way of Peace, the organization, in the EFP will control the funds. The funds are donated to the organization and are contributed without condition, the organization is given the discretion to use those funds as needed in the various mission placements of the organization, no commitment or understanding exists that the payments will be spent for the benefit of a particular missionary, and it is clear that the donor's intent is to benefit the organization rather than a particular missionary.

E. TAM 94-05-003 - A Recent Conduit Case

(1) General

TAM 94-05-003 dated November 12, 1992, held that the taxpayers' contributions to a religious ministry (Ministry) were not deductible under IRC 170 because the contributions were earmarked for a student and the Ministry did not have full control of the donated funds.

(2) Facts

- a. Ministry was formed for the purpose of promoting, encouraging, and supporting theological students while attending graduate school. Ministry was granted exempt status under IRC 501(c)(3) in 1970.
- b. Ministry solicits applications from seminary students to become its self-employed staff members. Ministry requires its applicants to affiliate with a local church, to engage in supervised Christian ministry for eight or more hours weekly, and to maintain an evangelical doctrinal stance.
- c. The staff members are responsible for soliciting contributions for their own support, but the contributions are sent to Ministry rather than to the student that solicited them. Ministry deducts an administrative charge for its services from each contribution.
- d. Each month Ministry sends a check to each staff member from the net contributions credited to each staff member's account. A compensation ceiling is calculated

based on marital status, family size, and local cost of living. Funds received in excess of the monthly ceiling are credited to the following month's account balance.

- e. A donor ordinarily gives a certain amount periodically for the support of a particular staff member. Literature published by Ministry states, in general, that donations to it qualify as charitable donations. Taxpayers are instructed that donations must be directed to Ministry, a check should not contain the name of the student for whom it is given but the student's name should be on the envelope or separate paper, and although the disposition of all contributions rests with the board of directors, Ministry honors the donor's designation whenever possible. Ministry's policy manual, available to student ministry contractors, states that Ministry takes donor's designation into account as a matter of accountability and integrity.
- f. Ministry records all contributions in a computer. Each donor is matched with the staff member by an assigned account number. Ministry sends a tax-deductible receipt to the staff member every month for each contribution received that month. The staff member forwards the receipt to the donor along with a return envelope, provided by Ministry, for the following month's contribution. Except for responses to inquiries, Ministry does not correspond directly with the donors.
- g. When staff members terminate from Ministry, they are instructed to notify their donors that they may receive no more than three additional checks. Any monies left in the staff member's account, after those post-termination checks are issued, are not returned to the donor and may be allocated by Ministry. From the \$1.7 million received in contributions in 1987, only \$8,202.00 was reallocated. In 1989, only \$6,992 was reallocated out of \$1.9 million.
- h. Contributors' son, Student, enrolled in a Master of Divinity degree program where field education and an

internship are part of the educational program. Student receives six hours of academic credit upon completion of the internship portion of the program. The Student serves as a student minister at two area churches for approximately 6 months each and participates in other ministry projects such as small group Bible studies for adults. These projects are supervised by the local churches and are approved by Ministry. The ministry projects require about 15 hours per week for which Student receives approximately \$1600.00 per month from Ministry.

- i. The Student also serves as a support consultant for Ministry, assisting other student ministers, whose ministries are also supported through Ministry.
- j. During the time in question, the taxpayers contributed \$16,000.00 to Ministry through regular monthly gifts. Taxpayers requested that their payments be used to support the ministry being conducted by their son. During this period, Student received \$16,243 from contributions credited to his account. Even though the taxpayers indicated they understood that Ministry was free to use their gifts for other purposes, they also stated that they would not have contributed to Ministry if their son had not been associated with Ministry.

(3) TAM Holdings

TAM 94-05-003 concluded:

- a. Ministry's program is set up to have contributions go to designated individuals.
- b. Contributions by the taxpayers to Ministry are earmarked for the Student by use of account numbers and envelopes with Student's name.
- c. Ministry will make every effort to use the contributions as the donor requests.

- d. The donors' intentions are to benefit the individual recipients not the Ministry.
- e. The taxpayers would not have made donations if they were not for the use of their son.

Consequently, TAM 94-05-003 held that Ministry does not have full control of donated funds and the taxpayers' contributions to Ministry are not deductible under IRC 170(c).

5. Conclusion and Service Development of NECO Cases

TAM 94-05-003, did not consider IRC 501(c)(3) exemption issues. To do so would require additional facts. In any case, Exempt Organizations Specialists should carefully scrutinize organizations whose activities involve serving as conduits in the manner described in this topic. The following factors should be considered.

- a. Whether there is evidence of inurement to recipients of the conduit organization because the recipients may be insiders using the organization to further their private and personal goals.
- b. Whether there is private benefit or inurement to contributors because the conduit organization is supporting selected recipients who have a commonality with the contributors through family, employment, or financial relationships.
- c. Whether there is a substantial nonexempt commercial purpose served by the organization that may be also providing private benefit or inurement to the organization's insiders, recipients, or contributors.
- d. Whether there is a substantial nonexempt purpose of serving private interests of an organization's creators and managers, contributors, and recipients by operating as a mechanism for tax avoidance.

- e. Whether, in the case of a quid pro quo activity that does not otherwise constitute a primary conduit element, the organization is complying with the Substantiation and Disclosure Rules of OBRA '93. See Topic J in the 1995 EOCPE textbook.

In circumstances where the organization is directing all, or close to all, donor contributions to the use of individuals specifically preferred by those donors, a review of the facts should be measured against those in the Peace, Graves, and Davis cases to determine whether the organization is in control of the funds. If control is not in the hands of the organization, it may be appropriate to refer the exemption applications to Headquarters pursuant to IRM 7664.1(a) and refer cases under examination to Headquarters pursuant to Technical Advice Procedures under Revenue Procedure 95-5, 1995-1 I.R.B. 132.