# THE IRS AND NONPROFIT MEDIA:
## TOWARD CREATING A MORE INFORMED PUBLIC

COUNCIL on FOUNDATIONS

**REPORT OF THE NONPROFIT MEDIA WORKING GROUP**

2013

Knight Foundation
*Informed & Engaged Communities*

# THE IRS AND NONPROFIT MEDIA
## Toward Creating a More Informed Public

Report of the
Nonprofit Media Working Group

*Council on Foundations*

*John S. and James L. Knight Foundation*

*2013*

COUNCIL *on* FOUNDATIONS

The Council on Foundations is a national nonprofit association of more than 1,700 grantmaking foundations and corporations. As the leading advocate for philanthropy, we strive to increase the effectiveness, stewardship, and accountability of our sector while providing our members with the services and support they need to advance the common good.

1255 23rd Street NW, Suite 200

Washington, DC 20037

*www.cof.org*



---

## Council on Foundations Nonprofit Media Working Group Members

Steven Waldman, Chair
Columbia Journalism School

Clark Bell
Program Director
Robert R. McCormick Foundation

Jim Bettinger
Director
John S. Knight Fellowships for Professional Journalists
Stanford University

Kevin Davis
Chief Executive Officer
Investigative News Network

Cecilia Garcia
Chief Executive Officer
Benton Foundation

John Hood
President and Chairman
John Locke Foundation

James T. Hamilton
Director, DeWitt Wallace Center for Media and Democracy
Duke University

Joel Kramer
Editor and Chief Executive Officer
MinnPost

Juan Martinez
Chief Financial Officer and Treasurer
John S. and James L. Knight Foundation

Jeanne Pearlman
Senior Vice President of Programs
Pittsburgh Foundation

Calvin Sims
Program Officer – Journalism
Ford Foundation

Vince Stehle
Executive Director
Media Impact Funders

Knight Foundation Representative: Eric Newton, Senior Adviser to the President

Legal Counsel: Marc Owens and Sharon Nokes, Caplin & Drysdale

Project Directors: Janne Gallagher and Shelton Roulhac, Council on Foundations

*(See Appendix B for member biographies)*

# Table of Contents

# Executive Summary

The Federal Communications Commission issued a report in 2011 concluding that accountability reporting, especially at the local level, has contracted dramatically, with potentially grave consequences for communities, government responsiveness, and democracy.[1] Moreover, it determined that nonprofit media needs to play an increasingly significant role to help meet the educational needs of citizens. Finally, it found that there was confusion about the IRS approach to nonprofit media. This approach, which has not been updated for the digital age, risks discouraging nonprofit media innovation and undermining the odds of its success.[2]

The report recommended that a group of tax and journalism experts gather to study these issues more carefully and make recommendations for further action. Supported by a generous grant from the John S. and James L. Knight Foundation, the Council on Foundations convened such a group from leaders of the foundation and tax-exempt media world. It has been meeting for the past year.

The group confirmed that there have indeed been lengthy delays and even rejections of tax-exempt status for organizations seeking to produce local news and disseminate information in the public interest, as the IRS applies an antiquated and counterproductive standard to a dynamic sector. The group has concluded that the IRS approach needs to be modernized. Specifically, in deciding whether to grant an organization tax exempt status, we recommend that the IRS shift its focus from operational distinctions between nonprofits and for profits that have been made irrelevant by developments in communications technology. Instead, the IRS should evaluate whether the media organization is engaged primarily in educational activities that provide a community benefit, as opposed to advancing private interests, and whether it is organized and managed as a nonprofit tax-exempt organization. In this report, the group makes a series of specific recommendations that maintains essential distinctions between for-profit and nonprofit media yet also removes obstacles from the types of innovation that are desperately needed to fill the gaps in nonprofit news, especially accountability journalism.

---

[1] Waldman, S. & the Working Group on Information Needs of Communities (2011, July). ***The information needs of communities.***

[2] Although the authors recognize that many different kinds of organizations are nonprofits under state law, this report uses the term nonprofit to refer only to media organizations that have qualified, or seek qualification, as organizations that are exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code and are eligible to receive deductible contributions under section 170.

# Nonprofit Media Working Group Report

The American media landscape is changing rapidly. The digital age promises great opportunity, yet, the transition to digital communications has disrupted traditional media delivery systems. Over the past five years, the ranks of local, professional journalists—primarily daily newspaper journalists—have experienced a historic drop.

Echoing the concerns of previous studies[3], the Federal Communications Commission (FCC) issued a report last year, *The Information Needs of Communities: The Changing Media Landscape in a Broadband Age*, concluding that accountability reporting, especially at the local level, has contracted dramatically, with potentially grave consequences for communities, government responsiveness, and democracy. The commercial news systems, heavily dependent upon advertising, are continuing to shrink even as the recession eases.

Because self-government does not work well without a healthy flow of news and information, many players are attempting to address these weaknesses. Social entrepreneurs are trying new digital models. Journalism schools are reinventing themselves to better serve their communities by providing local digital content and training those who create it. Public broadcasting is using multiple distribution platforms. And citizens have created a variety of volunteer-based models.

The FCC report recognized these trends and concluded that tax-exempt, nonprofit media would need to play an increasingly significant role. However, it found that there is confusion about the IRS's approach to tax-exempt status for media, and stated that the IRS's approach risked discouraging media innovation and undermining the odds of success. The FCC report recommended that a group of nonprofit tax and journalism experts gather to analyze this topic and make recommendations. Utilizing a grant from the John S. and James L. Knight Foundation, the Council on Foundations convened such a group from leaders of the foundation and nonprofit media world. The group's members are identified in Appendix B.

The experts concurred that there have been some worrisome actions by the IRS, which flow from the agency's application of an antiquated analytic approach to a very dynamic sector. For example, one provision in the IRS framework requires that "the manner in which the distribution (of nonprofit media) is accomplished must be distinguishable from ordinary commercial publishing practices." This requirement is inappropriate for the Internet age, in which the distribution methods for all forms of media, whether for-profit or nonprofit – newspapers, magazines, television, radio, charitable, and private—have converged and may be identical. The application of an outdated regulatory framework and other IRS actions have created delays and uncertainty among nonprofit media organizations seeking tax-exempt status in order to facilitate the dissemination of important news. Though they receive less national attention than the mainstream outlets, these nonprofit organizations are improving news and information dissemination in communities across the nation and have often plugged specific, serious gaps in news coverage.

This working group has concluded that the IRS approach needs to be updated. As applications for tax-exempt status from media organizations are submitted to fill the void in accountability journalism, the current policy present serious and unnecessary obstacles to critical innovation.

---

3 *See* The Knight Commission on the Information Needs of Communities in a Democracy (2009). *See also*, Informing communities: Sustaining democracy in the digital age, Washington, DC: Aspen Institute; Downie, Jr, L., & Schudson, M. (2009); The reconstruction of American journalism, Columbia *Journalism Review*, Pew Project for Excellence in Journalism (2009); The state of American news media 2009: An annual report on American journalism, Pew Project for Excellence in Journalism (2010). The state of American news media 2010: An annual report on American journalism, Pew Project for Excellence in Journalism (2011); The state of American news media 2011: An annual report on American journalism, Pew Project for Excellence in Journalism (2012); The state of American news media 2012: An annual report on American journalism.

## Journalism: Investigation and Reporting on Events and Issues as a Public Good

Hearings and workshops held by Congress, the FCC, the Federal Trade Commission, and numerous private groups all point to the declining ability of many daily newspapers to cover their communities. This waning coverage is driven significantly by a sharp decrease in advertising revenue. Between 2000 and 2010, total newspaper print advertising plummeted by more than 50 percent. This led to a reduction in the number of daily newspaper newsroom employees from 56,400 to 41,600—about the level of staffing before the Watergate scandal[4]. While online advertising grew by $207 million in 2011 relative to 2010, this increase did little to offset the lost revenue from print advertising. It plunged by $2.1 billion, yielding a ratio of losses to gains of about 10 to 1.[5] In response, newspapers have cut staff, reduced publication schedules, and, in some cases, shut down. Local TV news has not been able to fill the reporting gaps.[6] Yet most communities still depend upon these pre-existing news organizations to provide the preponderance of local news.

The FCC's 2011 report, *The Information Needs of Communities: The Changing Media Landscape in a Broadband Age,* traced how the content of local news outlets has been affected by alterations in advertising markets, the technology of content delivery, and the limited ability of firms to charge for information. Local newspapers once offered a highly profitable bundle of information and advertising. The digital revolution, starting with cable and expanding to the Internet, unbundled content. People seeking national news could read nationally targeted newspapers online, postings about products or jobs migrated to free sites on the web, and news about entertainment and sports became ubiquitous and current on mobile devices. The ongoing migration of classified and display advertising to low-cost or free Internet ads severely restricted the ability of local newspapers to cover their communities because of shrinking revenues. This reduced coverage affected all aspects of community life. Specifically, the FCC report detailed what this reduction in community reporting resources has meant to democratic government—fewer journalists at the state house, less coverage of local public affairs, and insufficient resources dedicated to labor intensive, civically-valuable reporting.

According to the FCC report: "Journalistic institutions do not need saving so much as they need creating. The 2007 Newspaper Association of America count of daily newspapers in the United States was 1,422. At the same time, there are 3,248 counties, encompassing over 19,000 incorporated places and over 30,000 'minor civil divisions' having legal status, such as towns and villages. It follows that hundreds, if not thousands of American communities receive only scant journalistic attention on a daily basis, and many have none."

Social science research indicates that public affairs coverage by local media outlets educates voters.[7] The positive effects of news media coverage demonstrated by academic research include increases in voter turnout, more informed public opinion, and changes in public policy as a result of investigations conducted by media outlets. When local journalists reveal hazardous pollution, unsafe streets, or public health system failures, these issues can be a matter of life and death. The decline in resources devoted to local accountability beats at newspapers means that there will often be ignorance of many public institutions and affairs at the local level.

Here, in economic terms, is how one analyst explains why civic news and information is neglected by the marketplace, despite its positive value:

> "Coverage of public affairs is not highly demanded by voters, even though it can have a large impact on the operation of government. At least four problems generate a low expressed demand for news about government despite its obvious importance: information in general is a public good; news about government feeds into the creation of other public goods, such as holding officials accountable; the low probability of an individual's political action having an impact means that information costs will often outweigh benefits; and the positive spillovers that you generate for others by casting an informed vote don't often factor into your decision

4 Waldman, S. & the Working Group on Information Needs of Communities
5 Pew Project for Excellence in Journalism, 2012
6 Waldman, S. & the Working Group on Information Needs of Communities
7 Hamilton, James T. (2011) Measuring spillovers in markets for local public affairs coverage.

> to become informed. In the language of economics, problems of public goods and positive externalities mean that many people won't seek out news about the city council. This means local media outlets cannot monetize many of the effects their coverage has on government, which leads them to under invest in public affairs stories."[8]

What types of issue coverage involve "positive spillovers," yet are not well supported by commercial systems? Education, environment, health, and local government accountability are cited in popular and academic accounts of what is missing.

Public affairs coverage is especially challenged. The types of stories that involve high costs include:

- Investigative pieces that require lengthy documents and records searches.
- Stories where government officials actively resist the disclosure of records and information.
- Stories that involve knowledge best gained through beat reporting, since understanding some policy areas involves spending time observing a set of institutions and issues.
- The creation of new software applications that make government data more accessible to the public
- The time-consuming nature of this work renders it more vulnerable to elimination as newspapers contract.
- Local accountability journalism is of great civic importance and value, but does not generate significant consumer demand to fuel healthy media business models.

The importance of such accessible media is not a new concept. During debates in 1787 over postal subsidies for newspapers, Benjamin Rush noted that newspapers are "not only the vehicles of knowledge and intelligence, but the sentinels of the liberties of our country."[9]

Arguing in favor of the postal subsidy, Thomas Jefferson said:

"The way to prevent these irregular interpositions of the people is to give them full information of their affairs thro' the channel of the public papers, and to contrive that those papers should penetrate the whole mass of the people. The basis of our governments being the opinion of the people, the very first object should be to keep that right; and were it left to me to decide whether we should have a government without newspapers, or newspapers without a government, I should not hesitate a moment to prefer the latter. But I should mean that every man should receive those papers and be capable of reading them."[10]

Over the last five years, myriad small, online startups began to fill the vacuum in public affairs coverage left by commercial media. These operations often have sought to become tax-exempt, nonprofit entities. The tax-exempt, nonprofit structure provides many economic benefits. It signals to donors that the reporters are more interested in providing essential civic information than generating an audience or income. This status attracts donors whose gifts are tax deductible. Excess revenues can be reinvested in content generation, rather than distributed to shareholders. And, the burden of supporting the public goods of education and accountability can be shared with many people. The topics covered by the tax-exempt media are often costly to investigate and report, important to democracy, but unprofitable.

8 Hamilton 2011

9 Rush, Benjamin (1787). The Defects of the Confederation. Speech in favor of postal subsidies for newspapers, Philadelphia, PA

10 Jefferson, Thomas. (1787, January). Amendment I (Speech and Press). Thomas Jefferson to Edward Carrington.

The precise number of new nonprofit news organizations considered tax-exempt, or seeking that status, is not known. The available information suggests they number between sixty and ninety. A database maintained by the *Columbia Journalism Review* includes 84 new nonprofits created since 2006.[11] The Investigative Reporting Workshop at American University found 75 nonprofit news organizations, but that list includes old and new nonprofits, other than public broadcasting.[12] The Investigative News Network, a relatively new membership organization, has 64 nonprofit members.

Those who started these organizations often cite a similar concern about the reduced availability of critically important information to the public. John Hood, the CEO of the John Locke Foundation, created the *Carolina Journal* as an activity of the tax-exempt foundation because the number of statehouse reporters had plummeted. "In North Carolina, several TV stations had reporters (covering the state). None has a bureau now. We were responding to changes in the market," he explained to researchers for the FCC's *Information Needs of Communities* report. "When you get to the state and local level, the collapse of the traditional business models imperils the delivery of sufficient public interest journalism—and we do believe that donor-driven journalism can be a very important model."[13]

Foundations have been providing financial support to these start-ups and to existing news media. J-Lab, an organization that studies local digital innovation, found that 180 community, family, and other foundations have contributed nearly $128 million to scores of U.S. news and information projects since 2005.[14] Some of the projects no longer exist. In a national survey, community foundations expressed a desire to increase funding for local news and information projects.[15] The foundations felt that their work is becoming harder due to a lack of coverage of the issues they cared about and the nonprofit community. Despite this support, philanthropy alone cannot sustain a vibrant news sector and foundations are encouraging nonprofit news media to seek alternate sources of financial support.

Even though nonprofit online news outlets fulfill critical civic education needs, current IRS policy guidelines and decisions have resulted in uncertainty about which outlets will gain tax-exempt status. Applying sometimes archaic federal tax precedents and guidelines developed for the mass media environment of 40 years ago to today's nonprofit, digital media outlets presents a significant challenge to the IRS as it processes applications for tax-exempt status from these organizations. In view of the increasing departure of commercial media from the market, each unwarranted denial or rejection of an application from a nonprofit media outlet deprives the community of the kinds of news and information people need to run their governments and their lives. Both applicants for tax-exempt status and the IRS agents charged with reviewing those applications would benefit from clear, published guidelines that reflect the changes that have occurred in media publication and distribution.

## Problems with the Current IRS Approach

For several decades, the IRS approach worked well from the government's perspective, and, for a time, it also worked well for nonprofit media. In decades past, many nonprofit media entities were created, and many obtained tax-exempt status and thrived, serving important educational functions in many communities. More recently, however, the approval of applications for exemption from nonprofit media have stalled.

Federal tax rules have focused on protecting the Treasury from groups intent on exploiting the tax code for commercial gain, an appropriate and necessary goal. But in the media context, the IRS approach for discerning

11 *CJR's* Guide to Online News Startups. *Columbia Journalism Review.*
12 Butts, B., Lewis, C., Musselwhite, K. (2012, August 31). A Second Look: The New Journalism Ecosystem. Investigative Reporting Workshop
13 Waldman, S. & the Working Group on Information Needs of Communities
14 Schaffer, J. (2009). New Media Makers
15 Kania, J.,Mack, K., Martin, E., Pol Longo, M., Preskill, H. (2011). 2011 Reports from the field: Place-based foundations and the Knight Community Information Challenge.

the boundary between taxable and tax-exempt entities is not working. This is largely because its framework for analyzing whether information dissemination is "educational," and thus entitled to exemption from tax, has not been significantly updated since the 1970s. Not surprisingly, it has been challenging for IRS decision makers to assess new digital media organizations while applying an outdated framework designed for print media.

It is difficult to determine how many nonprofits or potential organizations have been affected by having applications for exemption delayed or denied. The IRS does not compile and release reports summarizing the categories of applications that are denied or required to be materially modified nor the factors deemed significant in that process. The National Taxonomy of Exempt Organizations (NTEE) coding system developed by the National Center for Charitable Statistics during the 1980s, and used by the IRS, contains a code, A33, covering printing and publishing organizations, including newspapers. However, databases, like GuideStar have not developed ways to easily find nonprofits using this code, this could be because of consistency or other issues related to the assignment of NTEE codes.[16] With support from the Knight and Ford Foundations, the Foundation Center and GuideStar are collaborating to conduct comprehensive research about the universe of tax-exempt organizations working in media and the foundations supporting them. The information from this study will be made available on an interactive web-based portal, utilizing data visualization tools.[17]

Despite these deficiencies, there is significant anecdotal evidence that the IRS has delayed the approval of nonprofit media, potentially slowed the development of those already created, and harmed communities by leaving them without essential coverage, due to the application of archaic standards. These are complex issues, and we have no doubt the IRS is conscientiously attempting to address them. It is important that they develop and apply a clear strategy before they inadvertently create a less vibrant nonprofit media sector.

## 1. Tax-Exempt Status Approvals are Being Provided Inconsistently and, Given the Crisis in Journalism, are Taking too Long to Approve

There have been numerous reports that, when our communities urgently need tax-exempt media, the process for application review and approval has become more inconsistent and appears to have slowed, in some cases taking as long as three years.

The *San Francisco Public Press*, a nonprofit newspaper targeting low income and underrepresented communities, was founded in response to the collapse and hollowing of the commercial newspaper industry. It received tax-exempt status in September 2012—more than 32 months after applying in January 2010. While the application was pending, the organization could only accept grants through a fiscal sponsor and had to pay a seven percent fee to that sponsor to support oversight of the grants. Further, the *Public Press*'s

---

16 Stehle, V. (2012, September 25). Telephone interview. One GuideStar search showed 186 nonprofit media organizations over the past five years, but that list is not accurate because it only reflects those that identified an activity code on the IRS Form 990. In tax years 2010 and 2011, organizations were not required to list activity codes and many did not. A different search shows more than 500 tax-exempt organizations with "journalism" in the name, and more than 18,000 with the word media, but they could be many things—journalism schools, media critics, etc. Because there are different definitions of what constitutes nonprofit media and a media grant, a major 2010 study by Grantmakers for Film and Electronic Media (now known as Media Impact Funders) study could not be conclusive about how many media grants existed. Vince Stehle, President and CEO of Media Impact Funders, noted that during their annual meeting in June 2012, the most well attended session focused on understanding which funders are supporting media and how to further engage them. Stehle believes this is a testament to the growing awareness of the importance of nonprofit media.

17 The project seeks to establish a baseline figure for media funding in America by identifying grantmakers and grant recipients, including where grants are being made and for what purpose. The project team is currently developing a framework that describes different types of media funding. Using this information, the Foundation Center will create a dynamic web-based portal that will allow users access to information through a map interface and view profiles of funders and nonprofits working in media, as well as descriptions of specific grants. The portal, which will be hosted on the website of Media Impact Funders, is scheduled to launch in early 2013.

managers report that many funders gave smaller grants or no grants at all because of the organization's lack of tax-exempt status. According to the *Public Press*' executive director, Michael Stoll, the IRS expressed concern about the organization making political endorsements. Even though they noted in their original application that they would not make any, they had to sign redundant documents affirming that they would not make such endorsements.[18]

*The Arlington Mercury*, an online newspaper, reports on policies that impact the neighborhoods of Arlington, Virginia. It has been awaiting a decision by the IRS on its tax-exempt status since August 2011, and was recently told to expect a response by February 2013. The *Mercury*'s publisher, Steve Thurston, indicated that the uncertainty regarding the organization's status effectively prevents them from successfully soliciting funds from foundations.[19]

*The Chicago News Cooperative* was formed in October 2009, to offer coverage of city institutions and public affairs. It never received tax-exempt status and went out of business in February 2012.[20]

When El Paso's *Newspaper Tree* failed as a commercial operation, local leaders hoped to resuscitate it as a tax-exempt nonprofit to cover the city, which shares a border with Ciudad Juarez, Chihuahua, Mexico. *Newspaper Tree* was founded in 2003 to provide the El Paso/Juarez community with policy-focused and investigative reporting, including coverage of a wide-ranging public corruption investigation in which over 30 people have pled guilty. *Newspaper Tree* applied for recognition of tax-exempt status in April of 2011 and, to date, its application has not been approved. While the IRS has not noted any specific issues with *Newspaper Tree*'s application, it did ask for additional information on the paper's revenue streams. Eric Pearson, CEO of the El Paso Community Foundation, believes the organization would succeed if recognized as tax-exempt by the IRS. Pearson also noted that not only is El Paso being deprived of an independent, investigative eye, but the entire nation is, as well, since the *Newspaper Tree* could provide valuable information on key US/Mexico border issues, including the drug war, immigration, national security, international trade, and culture.

Another organization currently awaiting IRS approval is the *San Diego News Room*, founded to fill the void of in-depth, substantive content on public policy. The organization's editor, David King, also cited the declining volume and quality of local news as a reason for establishing the paper. The *News Room* applied for exempt status in January 2011, and has received various reasons from the IRS about the delay, from "too little manpower" to "new rules."[21] King further noted that without tax-exempt status, the organization cannot raise the money needed to hire professional journalists to provide meaningful content to the San Diego area.

In November 2009, *The Lens* in New Orleans was launched to fill some of that city's critical reporting gaps. This mission has become even more critical given the recent decision of the *New Orleans Times Picayune* to limit its printed edition to three days per week and lay off hundreds of employees.[22] *The Lens* employs dedicated reporters who specialize in labor-intensive, investigative and accountability reporting. They uncover corruption and inappropriate police behavior, resulting in prosecutions and changes in policy. *The Lens* applied for tax-exempt status in October 2010 and was not approved until December 2012. Its leaders say that the delays likely cost them funding.

These outlets either still seek or sought to disseminate news and information to millions of Americans. Kevin Davis, Investigative News Network's (INN) executive director, and Brant Houston, chair of the INN board, have stated publicly that IRS delays are harming nonprofit media outlets, and that some outlets have lost grants as a result of not having tax-exempt status.[23]

---

18 Stoll, M. (2012, September 13). Telephone interview.

19 Thurston, S. (2012, September 11). Telephone interview.

20 Banchero, S. and Belkin, D. (2012, February 17). Chicago News Cooperative to halt operations. *The Wall Street Journal, pp. A5.*

21 King, D.(2012, September 14). Telephone interview.

22 Carr, D. and Haughney, C. (2012, March 24). New Orleans newspaper scales back in sign of print upheaval. *The New York Times*, pp. A1.

23 Waldman, S. & the Working Group on Information Needs of Communities

## 2. The IRS Approach Appears to Undervalue Journalism

Especially frustrating to professional journalists is an IRS position, expressed in several cases, that civically-important journalism is not educational. Under current federal tax regulations, educational is defined as "the instruction of the public on subjects useful to the individual and beneficial to the community." It would obviously be beneficial for taxpayers to know if city officials are stealing public money by paying themselves exorbitant salaries.

Yet after waiting for two years, the INN, a consortium of nonprofit journalism outlets, received tax exemption from the IRS on the condition—among others—that it remove the word "journalism" from the "purpose" clause in its articles of incorporation. This seems quite odd to journalists. What the INN members do is not only journalism, the investigation and reporting to the public on events, issues and trends, but journalism of the highest order. While this may be a mere semantic point to journalists, it identifies one of the challenges facing media organizations seeking tax-exempt status. Specifically, that the IRS must verify that the purposes set forth in an applicant's articles of incorporation are no broader than those Congress specified in section 501(c)(3) of the Internal Revenue Code, for example, the advancement of education. Good journalism is independent of the tax status of the publisher. As the product of a profession, it can be the means to the success of either commercial or tax-exempt media organizations. Nonprofit media outlet members of the INN, such as ProPublica, the Center for Public Integrity, and the Center for Investigative Reporting—organizations that the IRS has determined do qualify as tax exempt—have been responsible for publicizing misuses of hundreds of millions of dollars in public expenditures, exposing everything from police misconduct to a lack of earthquake safety in schools, to misdiagnosis of returning war veterans. These outlets routinely win awards from the Investigative Reporters and Editors and other top honors.

Yet the editor of the *Johnston Insider*, an online news site in Rhode Island, reported that the IRS recently wrote: "While most of your articles may be of interest to individuals residing in your community, they are not educational."[24] The San Francisco Public Press was told by an IRS representative that a nonprofit producing journalism would be more easily approved if it had grown out of a university or a community education center. In other words, journalism itself is not by itself sufficiently educational but could be tolerated if associated with an organization that was.[25] Journalists object to such notions because good journalism is profoundly important public education. For a century, America's newspapers have been recognized as being the "schoolhouse of the masses." When territories applied for statehood, they noted the number and type of newspapers that existed, as these were seen as essential to civilized society. The press is specifically protected in the First Amendment because the Founders deemed the presence of an independent voice as crucial for self-governance. Journalism has enormous public benefits. Americans rely upon tax-exempt nonprofit media ranging from *Mother Jones* to *Consumer Reports*, from *National Geographic* to the *PBS NewsHour*. All provide journalism of tremendous educational value. As the federal tax rules are currently being interpreted, however, educational news and information qualifies for tax-exempt status, but regular "journalism," standing alone and without context, does not.

The IRS has, at least implicitly, agreed with this notion in the past. Prior to the recent stagnation, more than 500 nonprofits with the word "journalism" in their names, as distinct from the language in the corporate purpose clauses of the same organizations, had been recognized by the IRS as tax-exempt under section 501(c)(3).[26]

---

24 Wayland-Seal, E. (May 2012). A Message from the executive director. *Johnston Insider. September 14, 2012. From http://www.johnstoninsider.com/.*

25 Email exchange with Michael Stoll of San Francisco Public Press, February 8, 2013.

26 Source: Guidestar (August 2012), *at* http://www.guidestar.org. Some of these organizations may focus on journalism education; some may provide direct reporting. What is clear, though, is that in these cases the IRS did not view the term "journalism," at least as used in the organization's name, as inherently incompatible with an educational mission.

## 3. The IRS Approach Appears to Inhibit the Long-Term Sustainability of Tax-Exempt Media Organizations

Particularly troubling is the standard followed by the IRS since the 1970s requiring that "the manner in which the distribution (of nonprofit media) is accomplished must be distinguishable from ordinary commercial publishing practices." On the Internet, media distribution—newspaper, magazine, television, radio, charitable, and private—is identical.

As a result, IRS agents have focused on what tax-exempt, nonprofit media calls "earned revenue," income sources beyond philanthropy, such as advertising, as an indicator of ordinary commercial publishing. We agree that nonprofits should not accumulate "large profits . . . [and] profits from sales activities which are greatly in excess of the amounts expended for educational [purposes]."[27] But that is not what the IRS agents appear to be concerned about in recent cases. In these cases, all advertising revenue appears to be questioned, and in at least one instance, an applicant was told directly to fund an organization through foundation grants.

Funders who want to help nonprofit news entities sustain long-term operations are concerned about the imposition of such requirements in free-standing, tax-exempt media organizations. Indeed, this philanthropy-only approach contrasts with the successful funding models used by America's oldest and most successful tax-exempt, nonprofit media. These models have relied on earned revenue, including advertising revenue, and have long been approved by the IRS. Moreover, an enduring view in the philanthropic world is that institutions that have diverse sources of revenue tend to be more vibrant and sustainable.[28]

For example, while it does not carry advertising in its publications, *Consumer Reports* relies on its subscribers for support. Public broadcasting counts on "viewers like you," and, increasingly, on sponsorship income, a category of promotional communications that Congress specifically excluded from the definition of advertising. *Mother Jones* earns half of its budget each year from "earned revenue," including advertising and product sales. Reports by the Knight Foundation and others, on tax-exempt media sustainability, emphasize a diversified revenue stream. The tax-exempt media too heavily dependent on foundations are the first to go out of business.[29]

Further, foundations increasingly require their nonprofit grantees to have "earned revenue" strategies, in the hope that these organizations will eventually be able to operate independently. Thus, nonprofits find themselves in a Catch 22. Philanthropists say they will only fund groups that avoid dependence on philanthropy, while the IRS appears to be saying that the same groups can have tax-exempt status only if they do depend on philanthropy.

A straightforward reading of the IRS rules indicates that the tax-exempt media must avoid using earned revenue to *make a profit for distribution to private persons*. We have no problem with this. Nonprofit entities should use revenue to sustain operations and, if excess revenue is produced, it should be reinvested into advancing the public service mission. But in some evaluations of nonprofit media organizations, the IRS goes further by questioning certain types of revenue generation, even when the revenue in question is only used to keep the nonprofit solvent. For instance, the IRS has discouraged revenue generation by offering subscriptions or services for a fee, unless the fee is set at an amount that is "substantially below cost," rather than simply evaluating whether the activity generating the revenue is related or unrelated to the organization's exempt purposes, and imposing tax on any unrelated revenues. Such practices make tax-exempt media organizations dependent on significant funding from foundations. Many successful organizations have found that model to be a death sentence.

In a paper for the working group, Marcus Owens, a member in Caplin & Drysdale's Washington, D.C. office and former director of the Exempt Organizations Division of the Internal Revenue Service, noted

27 IRS General Counsel Memorandum 38845 (May 4, 1982).

28 McLellan. M. and Patel, M. 2011. Getting local: How nonprofit news ventures seek sustainability.

29 McLellan. M. and Patel, M. 2011.

that in 1977, in Revenue Ruling 77-4,[30] "the Service denied exemption to a nonprofit corporation whose sole activity was the publication and distribution of a weekly newspaper that presented local, national, and world news…. The Service emphasized that the newspaper's paid staff had 'no special skills and abilities other than those that are generally found on the staff of any other newspaper'—suggesting that the method of publication was commercial, rather than educational." In its denial of tax-exempt status to the newspaper, the Service also noted that "[t]his organization's only activities are preparing and publishing a newspaper, soliciting advertising, and selling subscriptions to that newspaper in a manner indistinguishable from ordinary commercial publishing practices" and, thus, did not qualify for exemption under section 501(c)(3).

In other previous guidance, the IRS has said that an entity is deemed overly commercial if it is:

: "Engaging in the publication and distribution of literature as its sole activity"

: "Making its literature available to the general public . . . by 'regular' paid subscriptions at 'regular' subscription rates"

: "Actively soliciting the purchase of its materials through such means as commercial mailing lists and radio and newspaper advertising"

: "Pricing its materials competitively with other commercial publications"

: "Publishing its materials almost exclusively for sale with only a de minimis amount of material donated to charity"[31]

In today's era of media convergence, it's important to note that these operational similarities could rule out a tax-exempt media organization determination even if that organization was otherwise fundamentally different in its mission or financial structure from a commercial enterprise. Consider this illustration from a different industry. Both tax-exempt and proprietary hospitals provide healthcare to the public in a manner that is essentially indistinguishable. Are they the same? They are both hospitals. Both will charge for medical services, so yes, they are methodologically the same. Yet they could not be more different because of their respective organizational structures. One is fundamentally focused on the healthcare of the community, the other on maximizing profits for the owners of the enterprise.

Furthermore, government policy has, in the past, recognized that tax-exempt organizations fulfill important, unmet community needs, even if the techniques of operation are similar to those of the commercial sector. In setting up the public broadcasting system, Congress did not require that children's programming avoid using skilled production personnel just because commercial TV did. Instead, they focused on the provision of educational programming not being provided by the commercial sector. A commerciality standard also is inconsistent with the reality that there has never been a time when all of America's governmental entities were covered by the existing commercial news system.[32]

If the goal is to educate citizens on the activities of its government, the commercial news system simply does not solely provide sufficient news and information, and it never has. Since digital transformation is accelerating traditional media's contraction, the IRS should not hold to an obsolete 1977 standard. This standard predates the digital revolution, and the dawn of the Internet, and was written in the early age of mass media, when newspapers and commercial TV were robust.

30 Rev. Rul. 77-4, 1977-1 C.B. 141

31 Gen. Couns. Mem. 38845 (Dec. 8, 1980) (discussed below),

32 The Knight Commission on the Information Needs of Community in a Democracy noted in 2009 that there has never been a time when all America's governmental entities were covered by the existing commercial news system.

At times, the IRS' approach conflicts with the spirit of the nonprofit law, which was designed to encourage the reporting of civically important educational content for public mission rather than private gain.

### 4. Confusion May be Inhibiting Nonprofit Entrepreneurs Trying to Address the Information Needs of Communities

The IRS focus on similarity in business practices has led to confusion even among those with tax-exempt status. The operator of the *Oshkosh Community News Network*, University of Wisconsin professor, Miles Maguire, shut the organization down after running it for five years, in part because of tax law uncertainty. Maguire told researchers at the Federal Communications Commission that he feared that increasing revenue would cause the IRS to revoke the organization's nonprofit status.

### 5. The IRS Approach Does Not Sufficiently Recognize the Changing Nature of Digital Media

The digital revolution has upended both commercial and nonprofit business models. For instance, in theory, tax-exempt print publications could generate sufficient revenue for survival by offering a subscription as a benefit of membership. But "pay walls" (online or other digital subscriptions) have been far less successful on the Web because consumers can instantly see if the same material is being offered for free. This undermines one method through which tax-exempt media has survived in the past. Further, many foundations and philanthropists stipulate that their funded content be disseminated to the broadest possible audience in order to generate the most impact, and maximize the educational benefit to the public.

A criterion for determining tax-exempt status should not be whether or not an entity resembles a commercial operation. In the past, the distribution of a paper for free might have been deemed proof of an organization's public service mission, since few commercial newspapers did that. Now most newspapers and broadcasters offer their news and public affairs content over the Web for free. The ability of a printing operation to reach innumerable people in the past, might have been a sign of commerciality. That advance is now within the reach of anyone with a personal computer.

Due to the information age, the ways in which nonprofits gather and distribute information increasingly resembles the methods used by the for-profit sector, just as tax-exempt hospitals use the same technology to cure the sick as proprietary hospitals.

The working group also became concerned about a problem potentially arising in IRS decision-making if adjustments are not made. That problem is that the IRS rules do not grasp the consequences of new modes of disseminating information. Mobile applications, social media feeds, and online communities are all part of the media ecosystem. Nonprofit media, attempting to educate on matters of interest to the public, may do so through labor-intensive accountability reporting, but this can also be accomplished by drawing together community members for online discussion, by enlisting citizens to report about their community, or by other techniques. These approaches could prove to be just as valuable as traditional forms at meeting important educational goals. Therefore, many traditional organizations will adopt them.

In light of the confusion surrounding the process by which nonprofit media organizations obtain tax-exempt status, the Knight-Council partnership could not be more opportune. Over the course of the last six months, the working group has reviewed and discussed what tax changes or clarifications could better enable tax-exempt media to meet the information needs of communities, and issued this report with recommendations about how to implement such changes.

## Principles for a New IRS Approach

We recognize that tax-exempt media entities are indeed different from commercial entities, and should be held to rigorous standards in order to receive the tremendous benefit of being tax exempt. With that in mind, we suggest:

Because "convergence" of previously different media practices is the norm in the digital age, the IRS methodology for analyzing whether a media organization qualifies for exemption should not take into account whether operational practices of nonprofits resemble those of for-profits, much as its process for analyzing whether a nonprofit hospital qualifies for exemption ignores operational similarities to for-profit hospitals. Society has a shared interest in allowing tax-exempt media to have earned revenue sources, so they can survive and become self-sufficient and to collect and distribute information in the same ways proprietary media do. This will enable them to efficiently disseminate news and information, especially accountability journalism, in the public interest.

Instead of focusing on meaningless operational distinctions, the IRS should evaluate whether the media organization is engaged primarily in educational activities that provide a community benefit, as opposed to advancing private interests, and whether it is organized and managed as a nonprofit, tax-exempt organization. The "private interests" concept is fundamental to exempt organizations' tax law. Indeed, the federal tax regulations provide that an organization must "serve a public rather than a private interest" to qualify as a tax-exempt charity. The notion that an organization can serve a public interest by satisfying a "community benefit" standard is also familiar to the IRS. These criteria make sense as guiding principles for tax-exempt nonprofit media as well.

Factors indicating an organization is pursuing educational rather than private purposes might include:

: In determining its editorial strategy, the organization uses as its primary criterion whether its content directly or indirectly furthers purposes that are educational as defined by section 501(c)(3) of the Internal Revenue Code.

: The organization provides information on important public issues or the performance of public institutions.

: The organization has procedures in place to ensure that editorial decisions or content are not determined by private interests.

: Exhortations to purchase unrelated or third-party goods or services do not constitute most of the organization's content or communications.

: The organization has a governing board that is independent of private interests and generally representative of the community it serves. This standard has been used by the IRS for many years. We are not suggesting any changes in approach to how they make that determination.

: No part of the earnings of a tax-exempt, nonprofit media entity should inure to the benefit of any private shareholder or individual.

: The organization must not officially endorse or oppose any candidate for public office.

: In addition, the working group believes the IRS currently is considering factors that, while appropriate originally, are now obsolete when determining whether an entity is qualified for tax-exempt status. Following are factors that should *not* be part of an IRS determination.

- The overall *manner or medium,* by which the editorial content is gathered, collected, displayed, or disseminated.

- Whether or not a fee or other payment is required. Any fee to access the editorial content should be reasonable and not set at a level intended to restrict public access. A tax-exempt media organization should be free to experiment with earned revenue models, as long as it simultaneously adheres to its broad educational purpose. While advertising revenue generated by a nonprofit might be taxable as unrelated business income, it should not be cause to deny the organization tax-exempt status. Similarly, a subscription to a nonprofit media entity is not tax deductible—but the use of a subscription model by a tax-exempt organization should not be considered evidence that that an entity is overly commercial.

- Whether or not an organization is supported by grants. Tax-exempt organizations should be able to develop a diverse set of revenue sources. They should not be compelled to exhaust all traditional philanthropic income sources before generating earned revenue.

The content published by the organization may or may not be similar to the content published by a taxable, news organization. If a tax-exempt nonprofit produces an article comparable to one found on a for-profit venue, it should not result in a penalty for the nonprofit.

The working group wholeheartedly agreed that nonprofit media organizations do have significant obligations.

To earn tax-exempt status, a nonprofit media organization should be "educational." This means it publishes general news, or other information beneficial to the community, allowing individuals to make informed decisions about the issues that affect their lives. We accept the current regulatory guidance that the term "educational" relates to the instruction or training of the individual for the purpose of improving or developing his capabilities; or the instruction of the public on subjects useful to the individual and beneficial to the community. Nonprofit journalism conducted in a free-standing, tax-exempt organization fits the second definition above.

Under the current definition, an organization may be educational even though it advocates a particular position or viewpoint, as long as it presents a sufficiently full and fair exposition of the pertinent facts as to permit an individual or the public to form an independent opinion or conclusion. An organization also may qualify as educational if it provides an open forum for the audience to discuss issues of public importance. An organization is not educational if its primary function is the presentation of unsupported opinion, or the marketing of unrelated products or services on behalf of a third party, even if the marketing effort also conveys an educational message.[33]

The principles we have suggested would change the way the IRS views the differences between for-profit and nonprofit media entities. We believe this shift is both sensible and reflects the reality of how the new media world operates. But there remain important distinctions between nonprofit and for-profit entities, and we embrace the idea that to be worthy of nonprofit status, and the special benefits entailed, nonprofit news organizations need to accept important limitations and restrictions that for-profit entities do not. Key differences between the two include their financial structure, their organization and their governance.

For example:

- For-profit organizations can attract investors by offering them a share of the company's profits or making them owners (e.g., shareholders). Nonprofits are barred from doing so and are also barred from sharing their profits with organization managers, members of their boards of directors, and other insiders. Only the community can be allowed to gain from the nonprofit's success.

---

[33] The latter principle was articulated by the Supreme Court in its 1975 decision, *United States v. American College of Physicians.*

- A for-profit can engage in unlimited lobbying for legislation it prefers, at the local, state, or national level, sometimes on policies directly benefiting the finances of the company. A nonprofit's ability to lobby, by contrast, is appropriately limited.

- A for-profit can endorse candidates. A nonprofit may not—and if it does it risks loss of its tax-exempt status and excise taxes against the company and its managers.

On a general level, a nonprofit cannot base its decisions on benefiting a private interest, but rather must primarily be geared toward advancing an educational mission. For-profit entities, of course, can also choose to advance educational purposes, but they are also fully free to make decisions for commercial reasons—entirely, mostly, or partly, at their discretion.

In short, while for-profits *can* provide public educational benefits, a nonprofit *must* provide public educational benefits, and be solely organized for the achievement of that mission.

***

We believe that the approach embodied in these principles would further the broad and essential goals of sensible past tax policy, safeguarding taxpayer money, and insuring that nonprofit groups embody a genuine public service mission.

Modernizing the procedures to better fit the nature of today's world would remove obstacles to tax-exempt entities' innovation, making it more likely that tax-exempt, nonprofit media can play a profoundly important role in helping to ensure that citizens get critical civic information.

## Additional Recommendations

The working group additionally recommends that:

- Appropriate stakeholders in the philanthropic sector and the tax-exempt, nonprofit media sector engage Treasury and the IRS in a discussion about modernizing the rules according to these principles.

- As an interim, immediate step, concerned foundations should consider funding the creation of more accessible guides to the use of current rules. Existing guides are text-heavy, unclear, and not as accessible as digital technologies allow.

- As a further interim step, we encourage foundations to continue to support and increase their investment in nonprofit media. In doing so, we request that foundations consider and embrace the principles enunciated in this report.

- Further work needs to be undertaken in at least three areas.

It is difficult for for-profit newspapers or traditional media companies to convert to tax-exempt organizations without donating the business to a university or other educational institution. Converting a for-profit organization to a tax-exempt organization can create significant tax liability for the for-profit/converting entity because the conversion is treated as a "deemed sale" under section 337(d) of the Internal Revenue Code. Changing this would require legislation pertaining to both tax, and possibly, bankruptcy law. Although beyond the purview of this group, we do believe that the conversion process *should be made easier.*

Some have argued that low-profit, limited liability companies ("$L^3Cs$") could provide an alternative structure to help encourage double-bottom line innovation in the media space. We would like to see more evidence and analysis of this intriguing subject.

We wholeheartedly believe in restricting tax-exempt, media organizations from lobbying, and prohibiting them from endorsing candidates for public office. However, the Internet has raised new scenarios regarding institutional attribution that must be addressed. If a private citizen endorses a candidate on a message board hosted by a media organization, should the media organization be held accountable? We believe it should not be. If a website hosts op-eds from a variety of viewpoints, should that count as endorsement? We do not believe so. In other areas of law, for example, campaign finance law, sites are generally not held legally responsible for such comments. The IRS and other policymakers should reassess this area in a way that upholds the restriction on organizations advocating on behalf of candidates or legislation, while also allowing for the paramount function of providing a forum for community discussion of politics and public affairs.

* * *

Nonprofit media plays a crucial role in helping communities get the information they need. These organizations will need to play an even greater role in the future. It is therefore essential that tax policy not inadvertently place unnecessary or inappropriate obstacles in their path to tax-exempt status. The working group believes that the steps recommended within this document would help preserve the essential principles of taxpayer protection that have guided the IRS in the past, and maintain significant distinctions in the treatment of nonprofit vs. for-profit entities, while modernizing the approach to accommodate new technologies, and community needs.

# References

Banchero, S. and Belkin, D. (2012, February 17). Chicago News Cooperative to halt operations. *The Wall Street Journal*, pp. A5.

Butts, B., Lewis, C. , Musselwhite, K. (2012, August 31). A second look: The new Journalism Ecosystem.

Investigative Reporting Workshop

Carr, D. and Haughney, C. (2012, March 24). New Orleans newspaper scales back in sign of print upheaval. *The New York Times*, pp. A1.

Downie, Jr, L., & Schudson, M. (2009). The reconstruction of American journalism, Columbia *Journalism Review* .

Edmonds, R., Guskin, E., & Rosentiel, T. (2012, April 11). *Newspapers: Building digital revenues proves painfully slow*. Retrieved from http://stateofthemedia.org/2012/newspapers-building-digital-revenues-proves-painfully-slow/

Federal Trade Commission Staff (2010). *Potential policy recommendations to support the reinvention of journalism*. Retrieved from http://www.ftc.gov/opp/workshops/news/jun15/docs/new-staff-discussion.pdf

Hamilton, James E. (2011). *Measuring spillovers in markets for local public affairs coverage*. Retrieved from http://dewitt.sanford.duke.edu/wp-content/uploads/2011/11/Hamilton-Spillovers.pdf.

Jefferson, Thomas. (1787, January). *Amendment I* (*Speech and Press*). Thomas Jefferson to Edward Carrington.

Joint Economic Committee Hearing (2009, September 24). *The future of newspapers: The impact on the economy and democracy*. Retrieved from http://jec.senate.gov/public/index.cfm?p=Hearings&ContentRecord_id=ce03ce4d-5056-8059-76f2-8b02fccb18e3&ContentType_id=14f995b9-dfa5-407a-9d35-56cc7152a7ed&Group_id=6d8935b0-4db8-4fc0-991e-3613943b7e4f
http://www.c-spanvideo.org/program/285745-1

Kania, J.,Mack, K., Martin, E., Pol Longo, M., Preskill, H. (2011). 2011 Reports from the field: Place-based foundations and the Knight Community Information Challenge. Retrieved from http://www.cfgnh.org/Portals/0/Uploads/Documents/Public/Community%20Knowledge%20Articles/Knight_Community_Information_Challenge.pdf

King, D.(2012, September 14). Telephone interview.

The Knight Commission on the Information Needs of Communities in a Democracy (2009). Informing communities: Sustaining democracy in the digital age. Washington, DC: Aspen Institute. Retrieved from http://www.knightcomm.org/wp-content/uploads/2010/02/Informing_Communities_Sustaining_Democracy_in_the_Digital_Age.pdf

McLellan. M. and Patel, M. 2011. Getting local: How nonprofit news ventures seek sustainability. Retrieved from http://www.knightfoundation.org/media/uploads/publication_pdfs/13664_KF_NPNews_Overview_10-17-2.pdf

McChesney, Robert W. & Nichols. John (2010, January 5). The death and life of *American journalism: The media revolution that will begin the world again*. Retrieved from http://books.google.com/books/about/The_Death_and_Life_of_American_Journalis.html?id=E3Sh7PGpWJ4C

Pearson, E. (2012, September 14). Telephone interview.

Pew Project for Excellence in Journalism (2009). The state of American news media 2009: An annual report on American journalism. Retrieved from http://stateofthemedia.org/2009/

Pew Project for Excellence in Journalism (2010). The state of American news media 2010: An annual report on American journalism. Retrieved from http://stateofthemedia.org/2010/

Pew Project for Excellence in Journalism (2011). The state of American news media 2011: An annual report on American journalism. Retrieved from http://stateofthemedia.org/2011/

Pew Project for Excellence in Journalism (2012). The state of American news media 2012: An annual report on American journalism. Retrieved from http://stateofthemedia.org/2012/

Rush, Benjamin (1787). The Defects of the Confederation. Speech in favor of postal subsidies for newspapers, Philadelphia, PA.

Schaffer, J. (2009). New Media Makers.

Stehle, V. ( 2012, September 25). Telephone interview.

Stoll, M. (2012, September 13). Telephone interview.

Thurston, S. (2012, September 11). Telephone interview.

Waldman, S. & the Working Group on Information Needs of Communities (2011, July).

*The information needs of communities*. Retrieved from http://www.fcc.gov/info-needs-communities

# Appendix A

As background for the working groups deliberations, the Council on Foundations requested a detailed analysis of the history of the tax rules involving nonprofit media. That analysis was authored by Marcus Owens and Sharon Nokes, of Caplan and Drysdale, both recognized authorities in this field.

Overview of the Federal Tax Rules Affecting the Formation, Operation, Funding, and Structure of a Tax-Exempt Newspaper

Marcus S. Owens
202.862.5020
mowens@capdale.com

Sharon W. Nokes
202.862.7839
snokes@capdale.com

Caplin & Drysdale, Chartered
One Thomas Circle, NW
Washington, DC 20005
http://www.capdale.com

TABLE OF CONTENTS

## Overview of the Federal Tax Rules Affecting the Formation, Operation, Funding, and Structure of a Tax-Exempt Newspaper

Marcus S. Owens
202.862.5020
mowens@capdale.com

Sharon W. Nokes
202.862.7839
snokes@capdale.com

Caplin & Drysdale, Chartered
One Thomas Circle, NW
Washington, DC 20005
http://www.capdale.com

## Introduction

The newspaper industry is caught in a perfect storm. Over the past five years, a rapidly-expanding Internet, decline in circulation and advertising, increase in production costs, and intense market pressures have caused this once-profitable industry to decline rapidly.[34] The recent economic recession accelerated this decline, prompting once-profitable papers to reduce staffing, curtail production, or shut down entirely. Faced with an uncertain future, community newspapers—as well as their stakeholders and supporters—are becoming more entrepreneurial, exploring whether different organizational structures and funding mechanisms may be deployed to preserve our legacy of a free and independent press.

One option that has gained traction is the nonprofit news organization. In recent years, an increasing number of nonprofit media entities have formed and applied to the IRS for tax-exempt status. Some have been recognized by the IRS as tax-exempt status as public charities that operate for educational purposes. The process has been far more protracted for other organizations, which have yet to receive a determination letter more than one year after filing their applications.

This paper aims to provide the Nonprofit Media Working Group with a robust overview of the federal tax rules that affect the formation, structure, operation, and funding of a tax-exempt newspaper. A few overarching principles bear mention at the outset:

The definition of "educational" under section 501(c)(3) is quite broad and includes not only traditional educational activities (teaching, disseminating research, etc.) but also, the "unconferences" offered by Journalism That Matters, the investigations conducted and published by ProPublica, and the news stories published by MinnPost.

In evaluating whether an organization qualifies for exemption the IRS focuses on whether its activities have a for-profit analogue, and the agency historically has worked to police a bright line between tax-exempt activity and ordinary commercial activity. With regard to organizations engaged in publishing activities, the IRS has developed standards that focus on the methodology by which the educational message is crafted, the manner in which it is disseminated and the nature of its financing. The greater the degree of overlap with commercial publishing, the greater the likelihood of a denial or revocation of tax-exempt status.

---

34 By one estimate, publicly-traded newspapers had an average profit margin of 26.6% in 2000. *See Merrill Lynch, Newspaper Industry Primer (8th ed. 2004).*

For some newspapers, the broad sweep of limitations on lobbying and the prohibition against political campaign activity may force a difficult choice between pursuing an historic role as the Fourth Estate of democracy, and pursuing exemption from tax.

What follows is not a substitute for legal advice, but rather an overview of the state of the law for tax-exempt educational organizations and newspapers in particular.

## Overview of Section 501(c)(3).

Section 501(a) of the Internal Revenue Code (the "Code") exempts from federal income tax the 28 different types of organizations listed in Section 501(c). Section 501(c)(3) describes the category of tax-exempt organizations that are organized and operated exclusively for charitable, educational, scientific, literary, religious or other purposes described in that section.

## Threshold Requirements for Qualifying for Exemption Under Section 501(c)(3)

For an entity to qualify as tax-exempt under section 501(c)(3), it must satisfy two basic tests, which are defined in the Treasury Regulations.

***Organizational Test.*** First, the entity must be "organized exclusively" for one or more exempt purposes—that is, its organizing documents (e.g., its articles of incorporation) (a) must limit its purposes to one or more exempt purposes; and (b) must not expressly empower the organization to engage, as more than an insubstantial part of its total activities, in activities that are not in furtherance of one or more exempt purposes.

***Operational Test.*** Second the entity must be "operated exclusively" for one or more exempt purposes—that is, it must "engage primarily" in activities that accomplish one or more exempt purposes specified in section 501(c)(3).

## Types of Section 501(c)(3) Organizations

Charitable organizations exempt under section 501(c)(3) are classified under Section 509(a) of the Code, as either private foundations or public charities.

In general terms, private foundations receive a significant portion of their funds from investment income or contributions from private sources (including wealthy individuals, corporations or other private foundations). Public charities, on the other hand, qualify as such by virtue of the nature of their activities (***e.g.***, churches, schools, hospitals, governmental units), because they actively support another public charity,[35] or by satisfying a "public support test."

***Broad-Based Public Support.*** One method of calculating public support—established by section 509(a)(1) of the Code—is designed for organizations primarily supported by grants and contributions from the public.

---

[35] These organizations, called "supporting organizations" are described in section 509(a)(3) of the Code.

***Public Support Plus Exempt Activity Income.*** A different method—established by section 509(a)(2)—is designed for organizations primarily supported by receipts from the performance of their exempt activities.

A newspaper seeking exemption from federal income tax as a public charity would likely do so by satisfying one of these public support tests. A detailed description of each is enclosed as Attachment 1 to this outline.

## Restrictions on Section 501(c)(3) Organizations

Even if an entity is organized for exempt purposes, and operates in furtherance of exempt purposes, it will not qualify for exemption under section 501(c)(3) if it engages violates any of these restrictions:

***No Private Inurement.*** To maintain tax-exempt status under section 501(c)(3), an entity must be organized and operated so that "no part of its net earnings inures to the benefit of any private shareholder or individual,"[36]—***i.e.***, someone with a personal and private interest in the organization's activities and who can control or influence an organization's activities because of his relationship with the organization.[37] Courts and the IRS have interpreted this inurement proscription broadly to apply to any "insider" of the organization.[38]

In essence, the private inurement prohibition is designed to "prevent anyone in a position to do so from siphoning off any of a charity's income or assets for personal use"[39] and ensure that, unlike their for-profit counterparts, tax-exempt entities do not pay dividends or their equivalent to stakeholders. However, the IRS and the courts recognize that there are other ways a supposedly charitable organization can confer advantages on its insiders. Thus, the ban on private inurement also prohibits paying excessive compensation, making interest-free or below-market loans to insiders, or otherwise engaging in transactions in which the insider gets a "disproportionate share of the benefits of exchange."[40]

***No Private Benefit.*** In addition to complying with the inurement proscription, section 501(c)(3) organizations must be organized and operated to "serve[] a public rather than a private interest."[41] Thus, to qualify for exemption, the entity must "establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests."[42] If a section 501(c)(3) organization more than incidental private benefits, the mere fact that it conducts a wide range of permissible charitable activities will not insulate it from the loss of its tax exemption.[43] However, "[o]ccasional economic benefits flowing to persons as an incidental consequence of an organization pursuing exempt charitable purposes will not generally constitute prohibited private benefits."[44]

---

36 Treas. Reg. § 1.501(c)(3)-1(c)(2).
37 Treas. Reg. § 1.501(a)-1(c)(2).
38 *See, e.g., Orange County Agricultural Society, Inc. v. CIR*, 893 F.2d 529, 534 (2d Cir. 1990).
39 Gen. Couns. Mem. 39862 (Dec. 2, 1991).
40 With regard to compensation paid to, and transactions with, insiders of a public charity, the IRS generally enforces the prohibition on private inurement primarily through section 4958 of the Code. Under this provision, the charity's officers, directors, and certain related parties ("disqualified persons") are subject to excise taxes on any transaction in which the disqualified person receives more than fair market value from the organization (an "excess benefit transaction"). Organizational managers who knowingly approve an excess benefit transaction may be liable for an additional tax. However, no tax is imposed on the charity.
41 Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii).
42 Id.
43 *Id.; see also* Goldsboro Art League, Inc. v. Commissioner, 75 T.C. 337 (1980).
44 American Campaign Academy v. Comm'r, 92 T.C. 1053, 1066 (1989) (emphasis added). For example, in Revenue Ruling 70-186, the Service considered a section 501(c)(3) organization that worked to improve the condition of the water in a lake to enhance its recreational features and concluded that the private benefits derived by the lakefront property owners who helped finance the organization did not "lessen the public benefits flowing from the organization's operations"; such benefits were incidental to the accomplishment of the organization's charitable purpose.

Whether a private benefit is "incidental" is measured both *qualitatively* and *quantitatively.* In general, to be considered qualitatively incidental, a private benefit must be a "necessary concomitant" of an activity that benefits the public—*i.e.*, the benefit to the public must not achievable without conferring an ancillary benefit on private individuals.[45] For example, in the course of serving public purposes, an organization may also benefit private parties, for instance by employing them or educating them. These qualitatively incidental benefits do not threaten a charitable organization's status. To be quantitatively incidental, the private benefit must be insubstantial when measured against the overall public benefit conferred by the particular activity.[46]

***No Substantial Lobbying.*** Federal tax law restricts the degree to which section 501(c)(3) public charities may engage in attempts to influence legislation.[47] Charities have the option of choosing between two quite different versions of this restriction. Under the default regime, a charity is subject to the so-called "no substantial part test," taken directly from the text of section 501(c)(3), which provides simply that no substantial part of an organization's activities may be "carrying on propaganda, or otherwise attempting, to influence legislation." Alternatively, certain public charities can make an election under section 501(h) to be subject to bright-line rules defining the portion of its charitable expenditures that can be devoted to lobbying activities. A detailed explanation of both tests can be found at Attachment 2 to this outline.

***No Campaign Intervention.*** Though Section 501(c)(3) organizations may engage in limited lobbying, they are prohibited from participating, directly or indirectly, or intervening in (including the publishing or distributing of statements), any political campaign on behalf of or in opposition to any candidate for public office.[48] While the prohibition against partisan campaign intervention is absolute, charities are permitted to engage in and fund strictly *nonpartisan* activities in connection with elections. There are therefore many activities that charities can support, including nonpartisan voter identification activities, get-out-the-vote efforts, voter education campaigns and, subject to certain restrictions, voter registration drives. However, charities may not support voter education efforts that involve explicit or implicit support or opposition for any particular candidate, such as, endorsements of candidates, other statements supporting or opposing a particular candidate, publication of a candidate scorecard that "rates" or "grades" candidates, publication of a biased candidate questionnaire or redistribution of any candidate's campaign literature.

***No Substantial Nonexempt Activities.*** As noted above, an entity will be regarded as organized and operated exclusively for exempt purposes only if it engages primarily in activities which accomplish one or more exempt purposes. Conversely, an organization will not be so regarded if "more than an insubstantial part of its activities" is not in furtherance of an exempt purpose.[49] Thus, an organization generally will cannot be described in Section 501(c)(3) if nonexempt activities—that is, activities that do not serve purposes described in section 501(c)(3)—are a "substantial part" of their total activities.[50]

The courts and IRS have steadfastly refused to set a definite percentage threshold for how much nonexempt activity qualifies as "substantial," insisting that "a percentage test . . . obscures the complexity of balancing the organization's activities in relation to its objectives and circumstances."[51]

---

45 Gen. Couns. Mem. 37789 (Dec. 18, 1978).

46 *See id.*

47 Private foundations, by contrast, are prohibited from engaging in, or funding, any lobbying.

48 I.R.C. § 501(c)(3); Treas. Reg. § 1.501(c)(3)-1(b)(3)(ii).

49 Treas. Reg. § 1.501(c)(3)-1(c)(1); Better Business Bureau v. United States, 326 U.S. 279, 283 (1945) ("[T]he presence of a single. . . [nonexempt] purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly . .. [exempt] purposes . . . .").

50 *See Treas*. Reg. § 1.501(c)(3)-1(c)(1).

51 *Haswell v. Comm'r*, 500 F.2d 1133 (Ct. Cl. 1974) (citing *Christian Echoes Nat. Ministry, Inc. v. United States*, 470 F.2d 849 (10th Cir. 1972)).

Noting that "[e]ach case must be decided upon its own unique facts and circumstances,"[52] the IRS has cited the "the percentage of the budget dedicated to a given activity" as "one type of evidence of substantiality."[53] Others include the "amount of volunteer time devoted to the activity, the amount of publicity the organization assigns to the activity, and the continuous or intermittent nature of the organization's attention to it."[54]

The highest percentage of an organization's budget devoted to a given activity that we have found a court to approve as "less than substantial" (and consistent with exempt status) is 10%.[55] The IRS, however, has stated that 10% would be "unjustifiably high" and recommended 5% as a "much better rule of thumb for use as a threshold for further examination."[56] The lowest percentage of an organization's budget devoted to a given activity that we have found a court to deem substantial is 15%.[57]

## Exempt Educational Organizations Under Section 501(c)(3)

As noted above, for an entity to qualify for exemption under section 501(c)(3), it must be organized and operated for one of the purposed listed in that section. In the case of a media entity, such as a newspaper, it is most likely that a successful public charity applicant would be organized for "educational" purposes.

## Background: What is Educational?

The term "educational" is defined in the federal tax regulations as including "the instruction of the public on subjects useful to the individual and beneficial to the community."[58]

## Examples of Educational Activities

Given the broad definition of "educational," it is not surprising that the IRS has recognized a wide range of activities as "educational" for purposes of section 501(c)(3). For example:

***Professional/Vocational Training.*** The IRS has ruled on numerous occasions that organizations or programs that instruct individuals to improve their business or professional capabilities are educational.[59]

---

52 *Church in Boston v. Comm'r*, 71 T.C. 102, 108 (1978); *see also The Nationalist Movement, a Mississippi Nonprofit Corporation*, 102 T.C. 558, 589 (1994); *Manning Ass'n v. Comm'r,* 93 T.C. 596, 610–11 (1989); Gen. Couns. Mem. 36148 (Jan. 26, 1975) ("[T]he Service should not adopt a percentage of total expenditures test for the substantiality of nonexempt activities conducted by exempt organizations.").

53 Gen. Couns. Mem. 36148 (Jan. 26, 1975).

54 *Id.*

55 *World Family Corp. v. Comm'r,* 81 T.C. 958 (1983) (holding that the organization's research activity, although for a nonexempt purpose, constituted an insubstantial amount of overall activity based upon the fact that only 10% of expenditures were used in the funding of this activity).

56 Gen. Couns. Mem. 36148 (Jan. 26, 1975).

57 *Best Lock Corp*, 31 T.C. 1217 (1959) (ruling that disbursements of approximately 15% of an organization's total expenditures for personal purposes were, in this sense, substantial). Other cases in which percentage thresholds were cited in holdings regarding substantiality include *Baltimore Reg'l Joint Bd. Health & Welfare Fund v. Comm'r*, 69 T.C. 554 (1978) (holding that the expenditure of 24% of an organization's total expenditures for improper [nonexempt] purposes was substantial); *Church in Boston v. Comm'r*, 71 T.C. 661 (1978) (revoking an organization's exempt status because the percentage of grants paid out for nonexempt purposes when compared to total contributions and gifts to the organization was 34.5, 24.6 and 14.5 in three consecutive years); and *Policeman's Benevolent Ass'n of Westchester County, Inc. v. Comm'r*, T.C.M. 1981-679 (ruling that 12% and 22%of total expenditures in 1977 and 1978 respectively for nonexempt purposes was a substantial part of organization's activities).

58 Treas. Reg. § 1.501(c)(3)-1(d)(3).

59 Rev. Rul. 65-298, 1965-2 C.B. 163 (presenting seminars and lectures to train physicians); see also Rev. Rul. 74-16, 1974-1 C.B. 126 (managing credit unions training for individuals in developing nations); Rev. Rul. 68-504, 1968-2 C.B. 211 (conducting an educational program in banking-related subjects for bank employees).

***Community Information Projects.*** The IRS also has long recognized that educational activity can involve community information projects or the provision of personal services that benefit the general public.[60]

***Publishing the Results of Investigations.*** Significantly for newspapers seeking exemption, the IRS has repeatedly held that organizations further educational purposes within the meaning of section 501(c)(3) by publishing the results of their investigations and analyses.[61] More specifically, the Service has ruled that publishing investigations and analyses with the purpose of achieving higher standards in journalism furthers an educational purpose.[62] It has also repeatedly held that the dissemination of publications that reveal discrimination against subordinated groups qualifies as educational.[63]

Applying these principles, the IRS routinely grants exemption to numerous organizations that disseminate information to the public in a variety of ways. For example, an organization formed to research human diseases; develop scientific methods for their prevention, diagnosis, and treatment; and disseminate the research to medical professionals and the public through seminars qualified as an educational organization under section 501(c)(3).[64] Similarly, a nonprofit organization that provided information to the public about the public's right of access to the broadcast media and objectively evaluated the performance of local broadcasters in fulfilling their public service obligations was found to be operated exclusively for charitable and educational purposes.[65] And an organization that was formed to educate the public as to the quality of radio and television programs and to encourage radio and television stations to fulfill their obligations to better serve the public interest through, *inter alia*, publishing newsletters, articles and pamphlets relating primarily to the television industry qualified for exemption under section 501(c)(3).[66]

## Policy Advocacy As an Exempt Educational Activity

In addition to qualifying as "educational" because it provides training or disseminates information, the IRS has ruled that that an organization "may be educational even though it advocates a particular position or viewpoint," provided that "it presents a sufficiently full and fair exposition of the pertinent facts as to permit an individual or the public to form an independent opinion or conclusion" and does not constitute the "mere presentation of unsupported opinion."[67] While this provision remains part of the section 501(c)(3) Regulations to this day, it was the subject of controversy and constitutional challenge.

***Big Mama Rag.*** In *Big Mama Rag, Inc. v. Commissioner,* the United States Court of Appeals for the District of Columbia Circuit ruled that the definition of "educational" in the section 501(c)(3) Regulations—in particular, its "full-and-fair-exposition" requirement—was so vague as to violate the First

---

[60] *E.g.*, Rev. Rul. 66-255, 1966-2 C.B. 219 (nonprofit organization which through meetings, films, forums, and publications educates the public in a particular method of painless childbirth is entitled to exemption).

[61] *See, e.g.* Rev. Rul. 74-615, 1974-2 C.B. 165 (publication of the results of investigations and analyses of the policies and practices of newspapers furthers an educational purpose); Rev. Rul. 72-228, 1972-1 C.B. 148 (publication of the results of investigation and examination of sex discrimination in employment furthers an educational purpose); Rev. Rul. 68-438, 1968-2 C.B. 209 (publication of the results of investigations and research on discrimination against minority groups furthers an educational purpose); Rev. Rul. 66-255, 1966-2 C.B. 210 (disseminating publications on a particular method of painless childbirth furthers an educational purpose).

[62] Rev. Rul. 74-615, 1974-2 C.B. 165.

[63] Rev. Rul. 72-228, 1972-1 C.B. 148; Rev. Rul. 68-438, 1968-2 C.B. 209.

[64] Rev. Rul. 65-298, 1965-2 C.B. 163,

[65] Rev. Rul. 79-26, 1979-1 C.B. 196.

[66] Rev. Rul. 64-192, 1964-2 C.B. 136. The Service noted that the organization's objectives were "achieved by educational means through various publications, teaching people to be discriminating in their viewing and listening habits, and teaching people to 'think' and to have sound reasons for their choice of programs and to make their feelings known to broadcasters so that they, in turn, may improve programs in the public interest." *Id.*

[67] Treas. Reg. § 1.501(c)(3)-1(d)(3)(i).

Amendment, and thus void, because failed to explain "which applicant organizations are subject to the standard" and also failed to articulate the standard's "substantive requirements."[68]

***National Alliance.*** The IRS did not acquiesce in the appellate court decision in *Big Mama Rag.* However, in a subsequent case in the same court, *National Alliance v. United States,* IRS set forth a four-part methodology test for determining whether activities were educational:

Whether a significant portion of the communication consisted of "viewpoints unsupported by a relevant factual basis";

Whether the facts relied on are "distorted";

Whether the organization "makes substantial use of particularly inflammatory and disparaging terms, expressing conclusions based more on strong emotional feelings than objective factual evaluation", and

Whether "the approach to a subject matter is aimed at developing an understanding on the part of the addressees, by reflecting consideration of the extent to which they have prior background or training."[69]

Although the *National Alliance* court did not rule on whether this test cured the vagueness found by the Big Mama Rag court, it did find that "[t]he test reduce[d] the vagueness found by the Big Mama Rag decision."[70]

***"Educational Methodology" Revenue Procedure.*** After these two cases, the IRS, in Revenue Procedure 86-43 (discussed below), adopted the four-part methodology test of *National Alliance* as its criteria for determining whether activities are educational within the meaning of Section 501(c)(3).

## Publishing as an Exempt Educational Activity

While newspapers and other media concerns do not automatically qualify for exemption, the IRS has, on numerous occasions, ruled that news organizations qualify as "charitable" where they further educational purposes within the meaning of section 501(c)(3). As the IRS explained in Revenue Ruling 67-4, a publication will qualify as "educational" if its content and operations satisfy four criteria.[71] The first two criteria focus on whether the substance of the publication is "educational." The third and fourth criteria focus on whether the publication and distribution of the publication are designed to further charitable, rather than commercial purposes.

**First Requirement: Content Must Be Educational.**
For a publication to qualify as tax-exempt, its content must be "educational." The content of a publication qualifies as educational when its articles contribute to the general public's "sum total knowledge on . . . substantive issues of public policy, the arts, and the humanities,"[72] thereby creating "a more interested and informed" public.[73] Further, as noted above, content that advocates a

---

[68] Big Mama Rag, Inc. v. United States, 631 F.2d 1030 (D.C. Cir. 1980).
[69] National Alliance v. United States, 710 F.2d 868, 874 (D.C. Cir. 1983).
[70] *Id.* at 875–76.
[71] *See* Rev. Rul. 67-4, 1967-1 C.B. 121. Revenue Ruling 67-4 involved an organization that was "formed to encourage basic research in specific types of physical and mental disorders, to improve educational procedures for teaching those afflicted with such disorders, and to disseminate educational information about such disorders, by the publication of a journal containing current technical literature relating to these disorders."
[72] *See* Gen. Couns. Mem. 38845 (May 4, 1982).
[73] Gen. Couns. Mem. 38587 (Dec. 8, 1980) (ruling that a magazine which provided editorial content concerning public affairs, science, education and the arts qualifies as an educational publication because it "enables the public to have sound reasons for their choice").

particular position or viewpoint may qualify as educational provided that it fairly presents the facts supporting both sides of an issue, thereby allowing the public to form an independent opinion or conclusion, and does not merely present the "unsupported opinions."[74]

**Second Requirement: Method of Publication Must Be Educational.**
To qualify as exempt, the publication must be prepared in accordance with methods traditionally accepted as "educational," rather than commercial. Applying the "full and fair exposition" standard from the Regulations, the IRS suggested that a publication method is educational where it ensures the selection of content based on educational value rather than "popular mass appeal."[75]

***Educational Methodology Revenue Procedure.*** Following its loss in *Big Mama Rag*, the IRS published Revenue Ruling 86-43 (discussed above), and further elaborated on this criteria, explaining that "[t]he method used by the organization [to prepare its content] will not be considered educational if it fails to provide a factual foundation for the viewpoint or position being advocated," in the case of an editorial, "or if it fails to provide a development from the relevant facts that would materially aid a listener or reader in a learning process," in the case of an editorial or news article.[76]

***Illustration.*** Applying this standard, the IRS has ruled that news and other programming on public broadcasting stations is educational because it informs the public "on subjects that are beneficial to the community . . . with a full and fair exposition of pertinent facts" supporting both viewpoint-neutral and editorial articles.[77]

**Third Requirement: Distribution Must Advance the Organization's Exempt Purposes.**
For a publication to qualify as an exempt activity, its distribution must be necessary or valuable in achieving the organization's exempt purposes. This requirement is met where the "the use or distribution" of the publication is "distinctly required to accomplish [the organization's charitable or educational] purposes,"[78] and where "there is a public benefit derived from the distribution."[79]

**Fourth Requirement: Manner of Distribution Must Differ from Commercial Publications.**
Finally, for a publication to qualify as an exempt activity, the manner in which it is distributed must be distinguishable from ordinary commercial publishing practices. To determine whether this requirement is met, the IRS and courts focus primarily on whether the financing of the publication is demonstrably different from commercial publications.

***No Profit Motive.*** Whether the publication is distributed "without regard to the realization of a net profit as important evidence that the publishing process is being used as a vehicle for accomplishing [educational] purposes."[80] While the existence of large profits does not compel the conclusion that the organization is non-charitable, such profits are "at least some evidence indicative of a commercial character.[81]

***Advertising is Permitted.*** It bears emphasis that in analyzing the fourth factor, the Service has been careful to underscore that the "solicitation of commercial advertising" will *not* prevent a publication from "being recognized as a section 501(c)(3) organization.[82] Indeed, Regulations interpreting the

---

[74] Treas. Reg. § 1.501(c)(3)-1(d)(3).
[75] *See* Gen. Couns. Mem. 38845 (May 4, 1982).
[76] *See* Rev. Proc. 86-43, 1986-2 C.B. 729.
[77] Rev. Rul. 66-220, 1966-2 C.B. 209
[78] *See* Rev. Rul. 60-351, 1960-2 C.B. 169.
[79] *See* Rev. Rul. 67-4, 1967-1 C.B. 121.
[80] Gen. Couns. Mem. 38845 (May 4, 1982).
[81] Gen. Couns. Mem. 34340 (Sept. 4, 1970) (discussed in Gen. Couns. Mem. 38845).
[82] Gen. Couns. Mem. 38587 (Dec. 8, 1980).

unrelated business income tax provisions of the Code (discussed below)—the enactment of which post-dated Revenue Procedure 67-4—make it clear that "activities of soliciting, selling, and publishing commercial advertising" will not automatically disqualify an organization from exemption.[83] Further, these Regulations provide no bright-line limitation on the amount of advertising content that may appear in a publication.

***Elaboration by IRS Chief Counsel.*** In Revenue Ruling 67-4, the IRS explained that the distribution of publications was distinguishable from ordinary commercial publishing practices where "[t]he charges for the publication recover only a portion of the costs" of publication[84]—a situation that is increasingly common for newspapers today. The IRS Chief Counsel elaborated on this concept in subsequent guidance that "[p]ractices which have been considered to reflect a purpose to engage in publishing operations for ordinary commercial gain are:

: making its literature available to the general public . . . by "regular" paid subscriptions at "regular" subscription rates;

: actively soliciting the purchase of its materials through such means as commercial mailing lists and radio and newspaper advertising;

: pricing its materials "competitively" or to return a "profit" or conducting the enterprise in a manner in which all participants expect to receive a monetary return;

: publishing its materials almost exclusively for sale, with only a de minimis amount of material donated to "charity";

: engaging in the publication and distribution of literature as its sole activity; and

: accumulating amounts resulting from its sales activities which are greatly in excess of the amounts expended for educational programs.[85]

: More than twenty years later, the IRS Chief Counsel expanded its list of criteria that indicate whether an organization's publishing activities are commercial in nature. Publishing activities that indicate commerciality include:

: Conducting as the organization's only activity publishing activities using standard commercial techniques that generate ongoing profits;

: Pricing its materials competitively with other commercial publications or to return a profit;

: Conducting an enterprise in a manner in which all participants expect to receive a monetary return;

: Publishing its materials almost exclusively for sale with only a de minimis amount of material donated to charity; and

: Creating or accumulating large profits and accumulating profits from sales activities greatly in excess of the amounts expended for educational purposes.[86]

---

83 Treas. Reg. 1.513-1(b).

84 Rev. Rul. 67-4, 1967-1 C.B. 121; *see also Elisian Guild v. United States*, 412 F.2d 121 (1st Cir. 1969) ("[W]e think that in this case the deficit operation reflects not poor business planning nor ill fortune but rather the fact that profits were not the goal of the operation.").

85 Gen. Couns. Mem. 34340 (Sept. 4, 1970).

86 *See* Gen. Couns. Mem. 38845 (Dec. 8, 1980) (discussed below),

***Contrary Judicial Authority.*** General Counsel Memorandum 38845 observes that the primary factor in demonstrating whether the organization is operated for an exempt purpose is that it distributes its publications without regard to realization of net profits. While courts consistently agree with the Service that a publishing concern cannot qualify for exemption if it operates for a primary commercial purpose,[87] it bears emphasis that case law does not support the Chief Counsel's view that the realization of net profits is determinative of whether a publishing concern is "commercial."

For example, in *Pulpit Resource v. Commissioner,*[88] the Tax Court ruled that the profit-motivated pricing, and realization of profits, by a religious periodical to clergy was not fatal to a religious publisher's exemption. The court observed that "[t]he fact that petitioner intended to make a profit, alone, does not negate that petitioner was operated exclusively for charitable purposes," noting a lack of evidence that the publisher was in competition with any commercial enterprise; "[t]he market for petitioner's product was so limited in scope that it would not attract a truly commercial enterprise." The court also viewed "the fact that [the publisher] dedicated all of its property and funds to [exempt] purposes [as] relevant evidence that petitioner's activity was not conducted for a commercial purpose."

Similarly, in *Presbyterian & Reformed Publishing Co. v. Commissioner,* the United States Court of Appeals ruled that a denial of exemption cannot be sustained solely because publishing organization derives profit from its activities.[89] In that case, a nonprofit religious publishing organization operated without profits for several years, depending on contributions to finance its operations. Thereafter, it began to earn substantial revenues from its publication of theological works by Jay Adams, which became unexpectedly popular. The organization intended to use its accumulated profits to expand its operations at a later point in time. The appellate court held that under the circumstances, the profits did not constitute evidence of a substantial nonexempt purpose, noting that "[t]he sudden popularity of an erstwhile obscure writer, such as Jay Adams, cannot, by itself, be the basis for stating that [the publisher] has departed from its professed purpose."

***Recent Applications for Exemption.*** It is our experience and understanding that, in reviewing recent applications for exemption by news organizations, the IRS has focused a great deal of attention on whether the applicant's manner of distribution and financing is different from that of a commercial newspaper.

## Authorities Analyzing Whether Periodicals Qualify For Exemption

The IRS has ruled on numerous occasions that publishing and distributing a periodical qualified as an exempt activity.

### Literary Magazine Qualifies as Educational.

In General Counsel Memorandum 38845, the IRS Chief Counsel applied the four-factor test in Revenue Ruling 67-4, to conclude that an nonprofit corporation that planned to acquire and publish a magazine (believed to be *Harper's* magazine) and conduct other educational programs qualified as tax-exempt under section 501(c)(3).

---

[87] *See, e.g.,* Scripture Press Found. v. United States, 285 F.2d 800 (Ct. Cl. 1961) (ruling that a publishing corporation that sold a large volume of religious literature, periodicals, and Sunday school supplies at a substantial profit was not exempt, where operating profits and accumulated earning were disproportionately large and there was no clear purpose to further any particular religious beliefs); Fides Publishers Ass'n v. United States, 263 F. Supp. 924 (N.D. Ind. 1967) (observing that "the publication and sale of religious literature at a profit," without more, cannot be an exempt purpose, or "every publishing house would be entitled to an exemption on the ground that it furthers the education of the public").

[88] Pulpit Resource v. Commissioner, 70 T.C. 594 (1978).

[89] Presbyterian & Reformed Publishing Co. v. Commissioner, 743 F.2d 148 (3d Cir. 1984)

***Content was Educational.*** First, the Service noted that the organization would serve educational goals through its publication of the magazine and through its "ancillary activities," and explained that the magazine's content was educational because "it will educate the public by adding to the sum total knowledge on . . . substantive issues of public policy, the arts and the humanities," and because the organization's "activities are geared to promoting . . . commentary on public questions."

***Method of Publication was Educational.*** Second, the Service observed that (i) the organization's governing body consisted of "leading experts in their respective fields"; (ii) articles would be selected by an independent Advisory board using a procedure that would "insure that articles [will focus] on . . . issues of public policy, rather than on articles of popular mass appeal; and (iii) many articles would be written by "leading authors, journalists, professors of English and educators." Thus, the Service concluded that the publication was developed using "methods, which, under the test of Rev. Rul. 67-4, are educational as opposed to commercial in character."

***Distribution was Necessary to Further Exempt Purpose.*** Noting that the corporation's stated purpose "includes the promotion . . . and development of public appreciation . . . 'relating to public policy questions, the arts and the humanities,' the Service observed that "[w]ithout the publication and distribution of the [magazine,] attainment of these goals would not be possible."

***Manner of Distribution was Noncommercial.*** Finally, the Service elaborated on the fourth criterion in Revenue Ruling 67-4, and concluded that the corporation's "publishing practices [were] in fact quite different from those of commercial" publications because it (i) devoted a "much lower percentage of its contents . . . to advertising than for-profit" publications; (ii) did not publish any articles on "topics of popular appeal"; (iii) had an "independent board of directors selected for their acknowledged stature in the field . . . who will select articles on the basis of [qualities other than] their commercial appeal"; (iv) priced the publication priced below-market and did not prioritize profit-generation; and (v) was and would be sustained primarily through grants and donations by the public. Thus, Chief Counsel concluded that the organization "does not have a substantial commercial purpose."

## Public Affairs Periodical Qualifies as Educational

In General Counsel Memorandum 38587, the IRS applied the four-factor test in Revenue Ruling 67-4 to rule that publishing a magazine containing articles focused on public affairs, science, education and the arts, as well as editorial content, was an exempt activity under section 501(c)(3). The publication was supported by loans, contributions, and receipts from the sale of advertising space "on both the national and local levels."

***Content and manner of preparation were educational.*** First, the Service explained that the "operations, the content of [the publication] and the manner in which it is prepared and presented appear to be 'educational' within the meaning of section 501(c)(3)" because it provided information on public affairs, science, education, and the arts, thereby creating an interested and more informed readership. The Service also noted that because its "editorial material provides information which enables the public 'to have sound reasons for their choice[,]' . . . the publication is useful to the individual and beneficial to the public in the section 501(c)(3) sense."

***Distribution was necessary to further the organization's exempt purpose.*** Second, the Service concluded that because the publication served as the "instrument for accomplishing its exempt educational purpose, it is apparent that distribution of the magazine is essential to the accomplishment of that purpose."

***Manner of publication was noncommercial.*** Observing that "the solicitation of commercial advertising" would not "prevent its being recognized as a section 501(c)(3) organization," the Service concluded that the publication was not distributed in direct competition with commercial publications and, thus, was distinguishable from a commercial publication.

## General News Newspaper Fails to Qualify For Exemption

In Revenue Ruling 77-4,[90] the Service denied exemption to a nonprofit corporation whose sole activity was the publication and distribution of a weekly newspaper that presented local, national, and world news. The pages of the newspaper were equally divided among community interest items of significance to the members of a certain ethnic group, national and international news articles of special interest to the members of the group, and commercial advertising. The newspaper also republished syndicated editorials. While the ruling presents little in the way of legal reasoning, the Service's recitation of facts suggests that the publication failed the second and fourth factors of the four-factor test in Revenue Ruling 67-1. Specifically:

***Method of publication was commercial.*** The Service emphasized that the newspaper's paid staff had "no special skills and abilities other than those that are generally found on the staff of any other newspaper"—suggesting that the method of publication was commercial, rather than educational.

***Method of distribution was commercial.*** The organization's income was derived solely from the sale of advertising and the sale of subscriptions to the general public; its primary expenses were the payment of wages and printing costs.

Although the newspaper had not realized a profit during any of its years in existence, the Service concluded that "[t]his organization's only activities are preparing and publishing a newspaper, soliciting advertising, and selling subscriptions to that newspaper in a manner indistinguishable from ordinary commercial publishing practices" and, thus, did not qualify for exemption under section 501(c)(3). This suggests that, for a general news newspaper to qualify for exemption, the organization would need to distinguish its manner of distribution and financing from its for-profit/commercial counterparts.

## Overview of Section 501(c)(4)

In addition to qualifying for exemption under section 501(c)(3) of the Code, organizations engaging in certain educational activities from taxation may also be recognized as tax-exempt as a "social welfare organization" under section 501(c)(4). Any organization that qualifies under 501(c)(3) may also qualify under section 501(c)(4); however, section 501(c)(4) organizations are permitted to engage in certain activities that section 501(c)(3) organizations are not.

## Advantages of a Section 501(c)(4) Organization

Section 501(c)(4) organizations offer a few significant advantages over section 501(c)(3) organizations:

***Increased Lobbying Capacity.*** Section 501(c)(4) organizations are permitted to engage in unlimited lobbying, at the federal, state, and local levels.

---

[90] Rev. Rul. 77-4, 1977-1 C.B. 141

***Permissible Partisan Political Campaign Activity.*** Section 501(c)(4) organizations are permitted to engage in partisan political campaign activity provided it is not their "primary" activity.[91] Whether an activity is secondary depends on all of the relevant facts and circumstances, but generally an activity will be a secondary activity if expenditures for it are 35% or less of total annual expenditures, and this limit could possibly rise as high as 49%. Section 501(c)(4) organizations are generally prohibited from engaging in express advocacy[92] or making contributions to candidates or political parties.

***Ability to Establish a Section 527 Fund.*** Section 501(c)(4) organizations can establish a section 527 fund to engage in certain political activities.

[91] Rev. Rul. 81-95, 1981-1 C.B. 332.

[92] The term "express advocacy" refers to communications that expressly advocate the election or defeat of a clearly identified federal candidate by using words such as "vote for," "vote against," "elect," "defeat," "support," or "oppose," regardless of whether the communication is coordinated with a candidate.

## Disadvantages of a Section 501(c)(4) Organization

Section 501(c)(4) organizations are subject to certain limitations and requirements:

***Contributions Not Tax-Deductible.*** Whereas contributions to a section 501(c)(3) organization are tax-deductible, section 501(c)(4) organizations are not eligible to receive tax-deductible contributions. Thus, a section 501(c)(4) organization might raise significantly less money than a section 501(c)(3) organization.

***Restrictions on Grants From Section 501(c)(3) Organizations.*** To the extent a section 501(c)(4) organization fundraises from section 501(c)(3) organizations, some donations—including grants from private foundations—will necessarily be restricted to prohibit their use for either lobbying or activities that are not considered charitable under section 501(c)(3), such as electioneering and fundraising for the section 501(c)(4) organization.

***Gift Tax Liability for Donors.*** Contributions from individuals in excess of $13,000 per year would likely be subject to the federal gift tax. The application of the gift tax to section 501(c)(4) organizations has been the subject of some controversy, and there are some lines of legal argument suggesting that the IRS would not prevail in court on this issue. Although this authority creates some uncertainty about the gift tax consequences, the IRS's current position is that such gifts are taxable.

***Election Law Filing Obligations.*** Section 501(c)(4) organizations that are "qualified nonprofit corporations" and engage in federal election activity also must file reports with the Federal Election Commission if annual expenditures for such activities exceed $10,000. These reports are published on the FEC's website and must identify certain donors who give $200 or more for the federal election activity. Likewise, to the extent that the organization engages in state election activity, there may be state registration requirements as well.

***State Tax Implications.*** Depending on the jurisdiction, a section 501(c)(4) organization may not be granted exemption from state tax obligations, including state income tax and property tax.

## Unrelated Business Income Tax

Organizations exempt under sections 501(c)(3) and 501(c)(4) are subject to tax at normal corporate rates on any net income derived from any "unrelated trade or business."[93] The imposition of unrelated business income tax ("UBIT") is intended "to eliminate a source of unfair competition" between exempt and non-exempt organizations that carry out the same activities by "placing [them] upon the same tax basis."[94] Thus, an activity will be considered an "unrelated trade or business," and thus subject to UBIT, if three criteria are met.

***The activity must constitute a "trade or business,"*** which is defined as any activity carried on for the production of income from the sale of goods or performance of services.[95] Courts have held that the existence of a profit motive is central to the determination that a particular activity is a trade or business.[96]

93 *See generally* I.R.C. §§ 511–513.
94 Treas. Reg. § 1.513-1(a).
95 Treas. Reg. §1.513-1(b).
96 *See, e.g.*, United States v. Am. Bar Endowment, 477 U.S. 105, 110–12 (1986).

***The activity must be "regularly carried on."*** [97] Generally, trade or business activities are deemed to be "regularly carried on" if they manifest a frequency and continuity, and are pursued in a manner similar to comparable commercial activities of nonexempt organizations.[98]

***The activity must not be "substantially related*** . . . to the exercise or performance" of the charitable or educational purpose that constitutes the basis for the organization's exemption from federal income tax.[99] This is a factual question that turns on the relationship between the income-producing activity and the accomplishment of the organization's exempt purpose.[100] Specifically, a substantial causal relationship must exist between the activity and the charity's exempt purpose—i.e., the activity must "contribute importantly to the accomplishment" of the exempt purpose, other than through the production of funds or the use the organization makes of profits from the activity.[101] In the words of the IRS, the "substantially related" question turns on whether the activity is conducted "as an end in itself or as the means by which [the organization] accomplishes a charitable purpose other than through the production of income."[102]

The UBIT rules modifications under which certain categories of unrelated business income are excluded from the calculation of unrelated business taxable income. The modifications include dividends, interest, annuities, royalties, certain rents, and capital gains.[103]

## The "Fragmentation Rule": Commercial Advertising as an Unrelated Business Activity

The UBIT rules provide that "an activity will not lose its identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization." This "fragmentation rule" requires parsing of the organization's activities into separate categories. Some activities may be considered "substantially related" to its exempt purposes and revenues from those activities would be exempt from UBIT. Other activities may be deemed "unrelated" and thus subject to UBIT.

This rule has been applied to find unrelated business income embedded in activities that, overall, may have a clear and substantial relationship to the organization's exempt purposes. Significantly for newspapers seeking exemption, the UBIT regulations provide that "activities of soliciting, selling, and publishing commercial advertising do not lose identity as a trade or business even though the advertising is published in an exempt organization periodical which contains editorial matter related to the exempt purposes of the organization."[104] Thus, the Supreme Court employed the fragmentation rule to distinguish between the sale of commercial advertising and the publication of editorial content in a journal published by a medical society.[105] The publication of editorial content was related to the society's educational purposes and, therefore, income from that activity was not subject to tax. In contrast, the Court found that the sale of ordinary commercial advertising, because regularly carried on and not related to the society's exempt purposes, was an unrelated business, subject to UBIT.

97 I.R.C. § 512(a)(1).
98 Treas. Reg. § 1.513-1(c)(1).
99 I.R.C. § 513(a).
100 Treas. Reg. § 1.513-1(d)(1).
101 Treas. Reg. § 1.513-1(d)(2).
102 Rev. Rul. 73-128, 1973-1 C.B. 222.
103 *See* I.R.C. § 512(b).
104 Treas. Reg. § 1.513-1(b).
105 *United States v. Am. Coll. of Physicians*, 475 U.S. 834 (1986).

## Corporate Sponsorships as a Related Activity

Whereas the sale of advertising by an exempt organization is almost always considered an unrelated trade or business,[106] section 513(i) of the Code provides a safe harbor excluding from the definition of "unrelated trade or business" the "activity of soliciting and receiving qualified sponsorship payments" ("QSPs").[107] QSPs are payments with respect to which there is no arrangement or expectation that the sponsor will receive a "substantial return benefit"—*i.e.*, any benefit other than the "use or acknowledgement" of the sponsor's name, logo, or product line in connection with the exempt organization's activities.[108]

***Acknowledgment vs. Advertising.*** A "use or acknowledgement" to which the QSP safe harbor applies may include any of the following: (i) the display of logos and slogans that do not contain qualitative or comparative descriptions of the sponsor's products, services, or company; (ii) a list of the sponsor's locations, telephone numbers, or Internet address; (iii) value-neutral descriptions, including visual depictions, of the sponsor's product-line or services; and (iv) the sponsor's brand or trade names and product or service listings.[109] By contrast, payments received in exchange for "advertising"—which includes qualitative or comparative descriptions of the sponsor or its products, price information, indications of savings, endorsements, or other inducements to purchase the sponsor's goods/services—do not qualify for the QSP safe harbor.[110] Advertising payments are taxed under the general UBIT rules; the income is taxed if the advertising activity is a regularly-conducted trade or business and no other exceptions from UBIT apply.[111]

***QSPs and Hyperlinks.*** The regulations contain two examples showing addressing whether hyperlinks to a sponsor's website confer a substantial return benefit on the sponsor. A hyperlink on an exempt organization's website to a sponsor's website, standing alone, is an acknowledgement, akin to a street address, and does not expose the organization to UBIT.[112] However, a hyperlink to a sponsor's website, where the sponsor's website also contains an endorsement by the tax-exempt entity, constitutes a substantial return benefit.[113] The IRS has followed this example in allowing a exempt organization to include non-endorsing hyperlinks to its corporate sponsors' websites as part of the its online acknowledgment of their sponsorship.[114]

## Limits on the Amount of Unrelated Business Activity

As discussed above, section 501(c)(3) organizations must be operated primarily for exempt purposes, and are not permitted to have any substantial nonexempt purposes—with the result that, as a general matter, any activities not furthering exempt purposes must be an insubstantial part of the organization's overall activities. However, a different and more lenient rule governs the degree to which an organization can operate an unrelated trade or business. Specifically, an organization may still meet

---

106 I.R.C. § 513(c).

107 I.R.C. § 513(i)(1).

108 *See* Treas. Reg. §§ 1.513-4(c)(1)-(2).

109 Treas. Reg. § 1.513-4(c)(2)(iv).

110 Section 513(i)(2)(A); Treas. Reg. § 1.513-4(c)(2)(v).

111 At times, a corporate sponsor may receive both acknowledgments and advertising in exchange for its sponsorship payment. Consistent with the fragmentation rule described above, the value of the acknowledgement (the QSP) and the advertising (subject to UBIT) are treated as separate payments. The exempt organization bears the burden of valuing the advertising benefit provided to the sponsor. If the organization is unable to prove that the value of the entire sponsorship payment exceeds the value of the advertising benefit, the entire amount of the payment could be subject to UBIT.

112 *See* Treas. Reg. § 1.513-4(f), Ex. 11; Priv. Ltr. Rul. 200303062 (non-promotional descriptions on exempt organization's website of services provided by sponsors to the organizations' members, together with hyperlinks to the sponsors' websites, were that did not give rise to UBIT). Private letter rulings are not precedential with respect to other taxpayers; however, they provide useful insight into how the IRS National Office has addressed the principle we are discussing.

113 *See* Treas. Reg. § 1.513-4(f), Ex. 12.

114 *See* Priv. Ltr. Rul. 200303062.

the requirements of section 501(c)(3) although it operates a trade or business as a substantial part of its activities, if (i) the trade or business is operated in furtherance of the organization's exempt purpose or purposes and (ii) the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business.[115]

Indeed, the IRS has recognized that unrelated businesses conducted as a substantial part of the organization's activity can still be "in furtherance of the organization's exempt purpose or purposes" by providing income to support that activity. Thus, it permits a tax-exempt organization to conduct substantial unrelated business activities, so long as the entity is "carrying on . . . a charitable program commensurate in scope with its financial resources, including the income provided by any unrelated trade or business."[116]

In applying this standard, the IRS has generally focused on the amount of resources and time that an organization spends on activities that serve its exempt purposes and not on the amount of income from unrelated trade and business activities.[117] Thus, the IRS Chief Counsel stated that an organization can receive substantially all of its income from unrelated trade or business activities and still be tax-exempt under section 501(c)(3), as long as its charitable activities are not substantially or significantly disproportionate to the income-producing activity. By contrast, an organization will fail to qualify for exemption "where the [exempt] function is incidental and subordinate to the conduct of a commercial trade or business for profit."[118] This line of authority has significance for aspiring tax-exempt newspapers, as it suggests that—contrary to the position taken by the IRS during its review of some new organizations' exemption applications—that a newspaper can derive a significant amount of its revenue from advertising and still qualify for exemption from tax.

There is, however, no numerical bright line prescribing what level of exempt activity is "reasonably commensurate" with an organization's financial resources and the ultimate determination turns on "the individual facts and circumstances of a particular case."[119] The IRS has suggested that facts indicating that an organization's level of charitable activity is not reasonably commensurate with its financial resources include (i) if the business activities fail over a substantial period of time to generate any positive returns that could be applied to charitable activities, or (ii) if the business activities have a positive return but the organization refuses for a substantial period of time to apply a significant part of that return to charitable activities.[120]

---

115 Treas. Reg. § 1.501(c)(3)-1(e)(1).

116 Rev. Rul. 64-182, 1964-1 C.B. 186; see also Gen. Couns. Mem. 38742 (reaffirming and elaborating on the "commensurate in scope" standard).

117 *See* Gen. Couns. Mem. 34682 (holding the presence or absence of purpose to accomplish a charitable end is determinative, "not a comparison of the 'amount' of one kind of purpose or activity with another").

118 Gen. Couns. Mem. 38742 (June 3, 1981) (discussing the circumstances under which "an organization [would] not qualify for exemption under I.R.C. § 501(c)(3) because it charges for goods or services that it provides in connection with its activities that would otherwise be considered to be in furtherance of charitable purposes."); *see also* Rev. Rul. 71-529, 1971-2 C.B. 234 (finding an arrangement wherein a section 501(c)(3) organization controlled by a group of exempt organizations provided substantially-below-cost management services to that group to be a charitable activity); *cf.* Rev. Rul. 72-369, 1927-2 C.B. 245 (ruling that an organization formed to provide management consulting services at cost to unrelated section 501(c)(3) organizations was not exempt because providing such services for a fee was a trade or business ordinarily carried on for profit and the fact that the services were provided at cost was not sufficient to render the activity "charitable"); Priv. Ltr. Ruls. 200830027 and 200830028 ("Under the facts presented, you are not providing services at substantially below your cost to charitable organizations, such as by charging 15 percent of your costs and subsidizing 85 percent of your costs incurred to deliver these services to the charitable organizations. Therefore, none of the services are substantially related to your exempt function on this ground because they are not provided at substantially below cost.").

119 *Id.*

120 Gen. Couns. Mem. 34682

## Other Issues That May Affect the Funding of a Tax-Exempt Newspaper

### The "Substantially Below Cost" Standard.

As discussed above, when evaluating whether a newspaper should qualify for exemption, one area of concern is whether the organization is "selling subscriptions . . . in a manner indistinguishable from ordinary commercial publishing practices."[121] Consistent with this concern, we understand that one issue raised by the Service in its recent review of exemption applications is whether a news entity plans to price its subscriptions at a rate that is "substantially below-cost." None of the newspaper authorities discussed above mandates a substantially-below-cost pricing model for subscriptions. However, the Service's suggestion that such pricing is appropriate comports with the position it has taken in the cases of charities that provide "essential" services (e.g., management services, or grant-making services) to other charities that an organization charging cost or above for goods or services has no valid claim to exempt status. Moreover, in the absence of other factors supporting exemption, we believe that an organization [accomplishing its exempt purpose] through the sale of commercially available goods or services should be recognized as exempt only if its sales are at prices substantially below its cost of operation. In such a case there will be no doubt that the organization is accomplishing its charitable purposes, and the competitive impact on commercial providers of the goods or services will be minimized.[122]

Indeed, we understand that the Service's recent grant of exemption to the Investigative News Network was based on the organization's representation that the services to members would be provided at a substantially-below-cost rate.

The IRS has not articulated the maximum amount a tax-exempt organization may charge for goods or services; however, it has ruled that charging 15 percent of cost is "substantially below cost."[123] Although the IRS has stated that charging "something significantly in excess of 15 percent would be acceptable" under certain circumstances,[124] it has not issued a ruling or other guidance describing those circumstances, nor has it approved fees that exceed 15 percent of cost.

### The Program-Related Investment Rules.

Congress has long recognized the value of private foundations investing their assets to support charitable projects and activities. This principle was codified nearly forty years ago, when Congress enacted a special exception to the excise tax regime that otherwise penalizes a foundation for making risky investments that jeopardize the carrying out if its exempt purposes[125] for certain high-risk investments that accomplish charitable purposes by providing financing for socially-beneficial projects. These permitted high-risk charitable investments are known as "program-related investments" ("PRIs").

To qualify as a PRI, a foundation's proposed investment must have three characteristics:

***Primary Charitable Purpose.*** The investment's primary purpose must be to accomplish one or more religious, charitable, scientific, literary, or educational purposes. An investment will satisfy this requirement if (a) it significantly furthers the accomplishment of the private foundation's exempt activities, and (b) the investment would not have been made "but for" the relationship between the investment and the accomplishment of the foundation's exempt activities.

---

[121] Rev. Rul. 77-4, 1977-1 C.B. 141.

[122] Gen. Couns. Mem. 37257.

[123] Rev. Rul. 71-529, 1971-2 C.B. 234.

[124] Gen. Couns. Mem. 37257, n.2 ("We are not suggesting that the 15 percent of cost fact in Rev. Rul. 71-529 be adopted as the standard for determining what is 'substantially below cost'. . . [but] are not prepared to suggest another percentage.").

[125] *See generally* I.R.C. § 4944. In essence, the jeopardizing investment rules are the federal codification of the "prudent investor" standard that is rooted in the common law of trusts.

***No Significant Profits Purpose.*** No significant purpose of the investment may be the production of income or the appreciation of property. To determine whether a proposed foundation investment satisfies this requirement, it is relevant whether investors solely engaged in the investment for profit would be likely to make the investment on the same terms as the private foundation.[126] However, the fact that an investment produces significant income or capital appreciation is not, by itself, conclusive evidence of a significant purpose involving the production of income or appreciation of property.

***No Lobbying or Political Purpose.*** No purpose of the investment may be to influence legislation or participate in local campaigns.[127]

In sum, PRIs are investments by private foundations, often into for-profit ventures, to support a charitable project or activity. PRIs may involve high risk, low return, or both, but are made anyway because they receive special treatment under federal tax law. For example, because they are considered to be used directly in carrying out the foundation's exempt purposes, PRIs are considered "qualifying distributions" in the year paid[128], and are not included in the calculation of a foundation's minimum investment return—the amount used to set the annual 5 percent payout requirement.[129] PRIs also are considered "grants" for purposes of the "taxable expenditure" rules.[130]

PRIs are typically structured as interest-free or below-market loans, loan participations or guarantees, letters of credit, and equity investments. Thus, in contrast to grants, which are not repaid, PRIs may enable a foundation to recover its charitable investment—and perhaps a return on its investment—and then re-deploy those funds in support of other charitable activities.

---

[126] Treas. Reg. § 53.4944-3(a).
[127] Treas. Reg. § 53.4944-3(a).
[128] Treas. Reg. § 53.4942(a)-3(a)(2)(i).
[129] Treas. Reg. § 53.4942(a)-2(c)(2)(v); see also Priv. Ltr. Rul. 9620039.
[130] *See* Treas. Reg. §§ 53.4945-4(a)(2), 53.4945-5(a)(2).

## Converting a Taxable Newspaper to Tax-Exempt

Generally, when a taxable organization converts into, or liquidates and distributes its assets to, a tax-exempt organization, it must pay taxes as if it sold its assets for fair market value to the nonprofit organization immediately before the transfer.[131] The nonprofit entity is not subject to tax. Thus, a for-profit newspaper would pay tax on any built-in gain upon a conversion to, or transfer of its assets to, a tax-exempt organization. Whether the financial statements of an organization reveal net profits in recent years, the entity may still have built-in gain to consider. In particular, if it owns intellectual property (e.g., the right to use its name), there could be difficulties in determining the value of this asset and potentially significant tax consequences.

However, if any of the assets are going to be used by the nonprofit in an unrelated trade or business (e.g., in advertising), gain or loss on those assets will not be subject to tax unless or until the nonprofit ceases to use them in an unrelated trade or business.[132]

## Some Options for Structuring a Tax-Exempt Newspaper

In addition to the myriad legal considerations discussed above, there are several legally viable options for structuring a tax-exempt newspaper. Below please find a few examples. We will explore these structures, and others, in greater depth in our next report to the Working Group.

## Independent Public Charity

The simplest structure would be to operate the exempt newspaper concern as a stand-alone public charity, organized for educational purposes and supported primarily by either grants and donations (a "section 509(a)(1)" organization) or by a mix of public support and receipts from its exempt activities (a "section 509(a)(2)" organization). This option is the most straightforward, structurally and has been used by several organizations that have been approved by the IRS in recent years (*e.g.*, ProPublica, MinnPost, Voice of San Diego, The Texas Tribune, and others) as well as longstanding news organizations, such as National Public Radio.

A significant advantage to public charity status is that it allows for the receipt of tax-deductible contributions and may facilitate the receipt of grants and program-related investments from private foundations. However, public charity status is not without its drawbacks. For example, a public charity newspaper would be barred from publishing endorsements of political candidates; may be constrained in the degree to which it comments on legislative efforts; and, if it enjoys significant advertising revenues will need to monitor its finances to ensure that amount of unrelated business income is commensurate with its financial resources.

## Through a Taxable Subsidiary

Rather than operating the newspaper directly, a public charity could establish a taxable subsidiary (either a corporation or a limited liability company) to operate the newspaper. Forming a taxable subsidiary is a common and well-accepted tax planning strategy for charitable organizations that wish to isolate activities that present liabilities or constitute unrelated trades or businesses. Perhaps the best-known example of this structure is the Poynter Institute's ownership of the *Congressional*

---

131 Treas. Reg. § 1.337(d)-4(a). An narrow exception exists for young organizations. Specifically, if a newly-formed taxable corporation becomes exempt (or files an application for recognition of tax-exempt status with the IRS) within 3 years of the close of the taxable year in which it was formed, it will not be liable for tax in connection with the conversion from taxable to tax-exempt. Treas. Reg. § 1.337(d)-4(a)(3)(i)(B).

132 Treas. Reg. § 1.337-4(b)(1).

*Quarterly* and Times Publishing Corporation (publisher of the *Tampa Bay Times*);

To accomplish this structure, the charity would make a capital contribution, in exchange for an ownership interest, in the form of stock, in the new entity. Federal tax law permits the charity to make capital contributions to a wholly-owned for-profit subsidiary without jeopardizing its exemption; however, the IRS has suggested in non-precedential rulings that such contributions are permissible because the organization has an "expectation of a financial return" on its investment.[133] These rulings suggest that the subsidiary's operations should, to a reasonable extent, reflect its "for profit" character.

The primary benefit of this structure would be that, if properly maintained, it should help to prevent the activities of the subsidiary—such as unrelated advertising—from being attributed to the public charity parent.[134] To establish that any subsidiary is not a mere agent of the charity, separate corporate formalities should be maintained—*e.g.*, the charity and its subsidiary should hold separate board meetings, maintain separate books and records, and establish separate bank accounts. In addition, the subsidiary should ideally be structured such that it has sufficient independent board members to approve transactions with the parent. However, parent and subsidiary may share some employees and facilities, so long as any shared costs are allocated proportionately between the two organizations and at fair market value.

## In Conjunction with a Section 501(c)(4) Affiliate

As noted above, one of the limitations on a public charity newspaper is its limited ability to engage in the political process. For example, it would not be able to weigh in on candidates for public office (through political endorsements) and would need to monitor its operations generally to ensure that its "lobbying" activities were appropriately circumscribed. One possible structure that would address this limitation on the "fourth estate" would be to establish two tax-exempt organizations—a section 501(c)(3) public charity and an affiliated section 501(c)(4) social welfare organization, wherein the former engaged in educational activities, but the latter operated the newspaper itself. The two organizations could have similar names and overlapping leadership, preserving a common direction and, subject to certain intellectual property limitations, a common "brand" identity for the two entities.

Both the courts and the IRS have ruled repeatedly that affiliation arrangements between section 501(c)(3) and 501(c)(4) organizations will not jeopardize the charity's tax-exempt status. However, in order to avoid attribution of the section 501(c)(4) entity's activities to the section 501(c)(3) entity, the two organizations would have to maintain all corporate formalities consistent with their independent legal existence. Hence, each entity would need to have its own bank accounts and financial records. The Board of each would be required to hold a separate meeting at least annually, and staff would have to be careful to hold themselves out to the public as representing the section 501(c)(4) entity when engaged in lobbying or any partisan political activities.[135]

There are two operational possibilities for structuring the tandem operations: through a grantmaking

---

[133] *Cf.* Priv. Ltr. Rul. 199941048 ("An exempt organization can invest its endowment and other funds without jeopardizing exemption. Whether investing through capital contributions or through guaranteeing debt or securing debt of a subsidiary, the activity is not changed into one which would jeopardize exemption, as it is still pledging assets in the expectation of a financial return."); Priv. Ltr. Rul. 9539014 ("Whether investing through capital contributions or through guaranteeing or securing the debt of Subsidiary the activity is not changed into one which would jeopardize exemption as it is still pledging assets in the expectation of a financial return."); Priv. Ltr. Rul. 9438041 (same).

[134] *See* Moline Properties v. Comm'r, 319 U.S. 436 (1943); Britt v. United States, 431 F.2d 227 (5th Cir. 1970).

[135] With regard to the political campaign prohibition for section 501(c)(3) organizations in particular, the IRS has indicated an increased interest in the interactions between a section 501(c)(3) organization and its section 501(c)(4) affiliate.

structure, in which the section 501(c)(3) entity would make grants to the section 501(c)(4) organization, or through a cost-sharing arrangement, in which each organization would pay its own share of the joint expenses. These alternatives, which are not mutually exclusive, are discussed below.

***Grantmaking Structure.*** In this kind of tandem structure, the section 501(c)(3) organization could maintain its current fundraising abilities and make grants to the section 501(c)(4) entity to fund those activities that it could have conducted itself under section 501(c)(3): education and a limited amount of direct and grassroots lobbying. Such grants are common between affiliated section 501(c)(3) and section 501(c)(4) organizations. These arrangements are perfectly legal, provided appropriate steps are taken to make sure that no section 501(c)(3) funds are used to pay for electioneering, excessive lobbying, or any other purpose prohibited under section 501(c)(3).

***Cost Sharing Structure.*** Alternatively, the section 501(c)(4) entity could enter a cost-sharing agreement with the section 501(c)(3) organization pursuant to which it would reimburse the section 501(c)(3) for the staff time, office space, and other goods and services it uses to conduct its activities. The section 501(c)(4) organization would not necessarily need to have any staff or offices of its own, but rather could obtain whatever resources it needs from the section 501(c)(3) through the cost-sharing arrangement.

Whether the section 501(c)(3) organization makes grants to the section 501(c)(4) entity to support section 501(c)(3)-permissible activities or the two organizations enter a cost-sharing arrangement, the organizations should be aware of a few administrative considerations. For instance, staff members would have to keep timesheets to track and record their work for each organization. Based on these records, the section 501(c)(3) organization would determine the proportion of each individual's salary and benefits that would be charged to the section 501(c)(4) entity. Overhead charges like rent and utilities would be apportioned between the two organizations according to their respective proportion of total direct costs.

## Through a Taxable "Hybrid" Entity

In recent years, venture philanthropists have developed new taxable "hybrid" structures that accomplish socially worthwhile purposes while generating returns for investors. Although these corporate forms are relatively new—indeed, a couple have been in existence for less than a year—they could provide an alternative structure for a newspaper, a structure that would not require filing an exemption application with the IRS approval process, and would not entail the restrictions on lobbying and political activity discussed above. It bears emphasis that none of these entities could receive tax-deductible contributions. However, a private foundation would not be precluded from making a program-related investment or expenditure responsibility grant to these for-profit entities, to fund charitable programs or activities.

Some of the better-known "hybrids" are described below. We will analyze the pros and cons of each in our next report.

***Benefit Corporation.*** The Benefit Corporation[136] is a new class of corporation that has been enacted in six states, most recently California. The Benefit Corporation is required by law to create general benefit for society as well as for shareholders. Benefit corporations must create a material positive impact on society, and consider how their decisions affect their employees, community, and the environment. Moreover, their boards and management are required by law to consider certain public

[136] The Benefit Corporation is distinct from the third-party certified "B-Corporation." To qualify as a B-Corporation, a public charity called B-Lab provides, for a fee, a certification to various forms of for-profit enterprises. To be certified by B Labs, a company must achieve a minimum score of 80 points to show "positive impact", pass a phone review, submit supporting documentation on a portion of their application, and be available for a possible on-site review.

benefits in corporate decision making and issue an annual "benefit report" on their social and environmental performances using established third-party standards.

***Low-Profit Limited Liability Company ("$L^3C$").*** The $L^3C$ is a type of limited liability company ("LLC") that has been adopted in 8 states, which possesses many characteristics of a typical LLC, such as a flexible ownership structure, free transferability of ownership interests, and limited liability for its members. However, there is one critical distinction between the $L^3C$ and the LLC. Although both are profit-making entities, the primary purpose of the $L^3C$ is not to earn a profit, but to achieve a socially-beneficial objective, with profit a secondary goal. Whereas a typical LLC may be organized and operated for any lawful business purpose, the $L^3C$ must also be organized and operated at all times to satisfy the three requirements for qualifying as a program-related investment, i.e.: it must significantly further the accomplishment of one or more "charitable" or "educational" purposes; no significant purpose may be the production of income (though it may earn a profit); and it must not be organized to accomplish any political or legislative purposes.[137]

As a type of LLC, the $L^3C$ enjoys a flexible ownership structure. Its members may include for-profits, nonprofits, foundations, government entities, and individuals—each with distinct investment goals and tolerance for risk. Because members are not required to invest equally, the $L^3C$ may be funded by two or more tiers of capital, each bearing a different level of risk and potential return.

The junior tier—the capital most at risk—comes from PRIs. Because foundations are willing to accept a below-market return and have the last claim on the assets of an $L^3C$ upon dissolution, the junior tier of PRI capital provides the financial backbone of the $L^3C$ and positions it to attract substantial additional capital from other investors.

The most senior tier of capital comes from investors that need to receive market returns. With the PRI capital in place, $L^3C$s can offer market returns at acceptable levels of risk to individual and institutional investors.

An $L^3C$'s capital structure also may include intermediate or "mezzanine" tiers designed for socially-conscious investors. Mezzanine investors are willing to forego market returns and accept part of their "return on investment" in the form of enhanced social welfare.

***Flexible Purpose Corporation.*** A flexible purpose corporation ("FPC") is a new class of corporation, approved by the California Legislature late last year, which allows its directors to pursue broader objectives than the narrow focus of maximizing financial return for shareholders. Each FPC must specify at least one "special purpose" in its charter, such as promoting environmental sustainability or minimizing adverse effects on the community. In exchange, the directors of the FPC can avail themselves of a new "safe harbor" (in addition to the business judgment) that insulates them from liability for violating their fiduciary duties to the corporation. Specifically, boards and management are protected from shareholder liability when they weigh their special purpose(s) against shareholder value—both in the ordinary course of business and in change of control situations. The FPC is distinguished from the $L^3C$ and Benefit Corporation in that it is primarily intended for use by for-profit companies seeking traditional capital market investment.

The FPC differs from the traditional corporate form in the following ways:

**Qualifying Special Purpose.** The FPC has one or more social and/or environmental purpose(s) agreed upon between management and shareholders, and included in the charter. The FPC is not permitted to change its purpose without a two-thirds vote of each class of voting shares.

---

137 *See I.R.C. § 4944(c).*

**Protection from Liability.** The FPC provides protection from liability for directors and management who make decisions on the basis of the agreed special purpose(s).

**Conversion of Other Forms.** An existing public or private corporation (LLC, partnership, or other entity) can convert into an FPC with two-thirds vote of each class of voting shares, with dissenter's rights.

**Reporting.** The FPC is required to publish regular reports with objectives, goals, measurement, and reporting on the impact or "returns" of social/environmental actions.

**Enforcement.** As fiduciary duties include the special purpose(s), shareholders have traditional enforcement rights with respect to the special purpose(s) (removal of directors and/or legal action); other "stakeholders" will not have enforcement rights.

# Attachment 1

This memorandum discusses the different methods for calculating public support under sections 509(a)(1) and 509(a)(2) of the Internal Revenue Code.[138]

## Type of Public Charity—Section 509(a)(1) vs. 509(a)(2).

All organizations that qualify for charitable tax exemption under section 501(c)(3) are, in turn, classified by section 509 as either "private foundations" or "public charities." "Public charity" is the preferred classification for most organizations because private foundations are subject to much more stringent regulation. Section 501(c)(3) organizations may qualify for public charity status either by virtue of the nature of their activities (*e.g.*, churches, schools, hospitals) or by satisfying a "public support test."

One method of calculating public support—established by section 509(a)(1)—is designed for organizations primarily supported by grants and contributions from the public.

A different method—established by section 509(a)(2)—is designed for organizations primarily supported by receipts from the performance of their exempt activities (*e.g.*, museum admission charges, child care fees).

When an entity applies to the IRS for recognition of exemption as a public charity, it will need to indicate whether it is applying for classification as a private foundation or a public charity and, if the latter, whether it expects to qualify as a public charity under section 509(a)(1) or 509(a)(2). It is important to note, however, that if the IRS recognizes the organization as a section 509(a)(2) public charity, the organization will not be precluded from qualifying as a public charity under section 509(a)(1) if the nature of its revenues changes over time. If the organization is ultimately supported primarily by grants and contributions, such that it satisfies the section 509(a)(1) public support test, the organization will automatically be treated as a 509(a)(1) public charity.[139]

---

[138] All section references herein are to the Internal Revenue Code of 1986, as amended (the "Code" or "I.R.C.") or to the Treasury Regulations promulgated thereunder ("Regulations").

[139] *Cf.* Treas. Reg. § 1.509)(a)-6 ("If an organization is described in section 509(a)(1) and also in another paragraph of section 509(a), it will be treated as described in section 509(a)(1).").

### *1. Similarities between the section 509(a)(1) and 509(a)(2) public support tests.*

Both the section 509(a)(1) and 509(a)(2) public support rules require the organization to compute (albeit under very different rules) the percentage of an organization's total support that qualifies as "public support." This percentage is commonly referred to as the public support fraction. Both tests are applied on the basis of a five year moving average, and if an organization satisfies either test for a given five-year period, it automatically qualifies for public charity classification for the subsequent tax year.[140]

A new organization will be treated as a public charity for its first five taxable years if it can "reasonably be expected to meet the requirements of" the relevant public support test during that period.[141] The charity will report its sources support to the IRS on its annual information return (IRS Form 990), but will not be required to calculate a public support fraction until Year 6. Starting in its sixth year, the organization will have to satisfy a public support test in order to continue to qualify as a public charity. For the sixth year, the IRS rules permit the organization to qualify as a public charity based on its support in either its first through fifth or second through sixth taxable years.[142] For each succeeding year, public support will be calculated using a five-year moving average (i.e., the average support during the year of the return and the four previous years).

Finally, both the section 509(a)(1) and 509(a)(2) public support calculations provide for the exclusion from both the numerator and denominator of the public support fraction of so-called "unusual grants"—that is, very large grants that are unlikely to recur.[143]

### *2. Differences in calculating public support under each test.*

Beyond these basic similarities, the section 509(a)(1) and 509(a)(2) public support calculations diverge dramatically with regard to their rules regarding the types of financial support that constitute "public support" (the numerator of the public support fraction), and the types of support are included in "total support" (the denominator of the fraction). The respective rules, to the extent relevant to the Concert Hall, are summarized in the following table:

| | **509(a)(1)** | **509(a)(2)** |
|---|---|---|
| | **Numerator** | **Numerator** |
| ***Gifts from substantial contributors*** | ***Yes, subject to 2% limit*** | ***No*** |
| ***Grants from "disqualified persons"*** | ***Yes, subject to 2% limit*** | ***No*** |
| ***Grants from private foundations*** | ***Yes, subject to 2% limit*** | ***Yes, no % limit (unless the foundation is a substantial contributor)*** |
| ***Grants from government sources*** | Yes, no % limit | Yes, no % limit |
| ***Grants from section 509(a)(1) orgs.*** | Yes, no % limit, if grantor is publicly supported | Yes, no % limit, if grantor is publicly supported |
| **Grants from section 509(a)(2) orgs.** | **Yes, no % limit** | **No.** |
| **Grants from section 509(a)(3) orgs.** | **Yes, subject to a 2% limit** | **No.** |
| Unusual grants | No | No |

140 Treas. Reg. §§ 1.170A-9T(f)(4); 1.509(a)-3T(c).

141 Treas. Reg. §§ 1.170A-9T(f)(4)(v)(A); 1.509(a)-3T(d)(1). "In determining whether an organization can reasonably be expected . . . to meet the requirements of the [applicable] public support test during its first five taxable years, the basic consideration is whether its organizational structure, current or proposed programs or activities, and actual or intended method of operation are such as to attract the type of broadly based support from the general public, public charities, and governmental units that is necessary to meet such tests." Treas. Reg. §§ 1.170A-9T(f)(4)(v)(B); 1.509(a)-3T(d)(2).

142 Treas. Reg. §§ 1.170A-9T(f)(4)(v)(A); 1.509(a)-3T(d)(1).

143 Treas. Reg. §§ 1.170A-9T(f)(6)(ii); 1.509(a)-3T(c)(3).

| | | |
|---|---|---|
| ***Receipts from exempt activities*** | ***No*** | ***Yes, subject to $5,000/1% limit*** |
| Net income from unrelated business | No | No |
| Gross investment income | No | No |
| Rents | No | No |
| Royalties | No | No |
| | **Denominator** | **Denominator** |
| Gifts from substantial contributors | Yes | Yes |
| Grants from private foundations | Yes | Yes |
| Unusual grants | No | No |
| Grants from publicly supported orgs. | Yes | Yes |
| ***Receipts from exempt activities*** | ***No*** | ***Yes*** |
| Net income from unrelated business | Yes | Yes |
| Gross investment income | Yes | Yes |
| Rents | Yes | Yes |
| Royalties | Yes | Yes |

As the table indicates, the two tests treat of contributions and receipts from exempt activities quite differently.

### a. Gifts, grants, contributions.

Under both provisions, all gifts, grants, and contributions (other than unusual grants), are included in full in the denominator of the support fraction, but they are treated differently for purposes of the numerator.

Under section 509(a)(1), contributions from government sources and public charities are included in the numerator in full, while all other gifts, grants, and contributions are included in the numerator up to an amount equal to 2% of the organization's "total support" received during the applicable four year base period.[144]

Under section 509(a)(2), contributions from so-called "substantial contributors"[145] and other "disqualified persons" are excluded entirely from the numerator, while all other gifts, grants, and contributions are included in full.[146]

In general, a donor is considered a "substantial contributor" if, at any point in the life of the organization, the cumulative contributions of the donor and his spouse exceed 2% of the organization's cumulative total support. A charity's "disqualified persons" include its officers, directors, persons who own more than 20% of an entity that is a substantial contributor, family members of these persons, and entities that are more than 35% controlled by disqualified persons.

---

144 Treas. Reg. §§ 1.170A-9T(f)(6).
145 *See* IRC § 4946(a)(2) (defining "substantial contributor" and cross-referencing IRC § 507(d)(2)).
146 IRC § 509(a)(2)(A); Treas. Reg. § 1.509(a)-3(a)(2).

**b. Receipts from exempt activities.**

Gross receipts from exempt activities are also treated differently under sections 509(a)(1) and 509(a)(2).

Under section 509(a)(1), gross receipts from exempt activities are excluded entirely from both the numerator and denominator of the section 509(a)(1) public support fraction.[147]

Under section 509(a)(2), gross receipts from exempt activities, including "*admissions*, sales of merchandise, performance of services, or furnishing of facilities," are included in full in the denominator of the section 509(a)(2) support fraction.[148] Such amounts are also included in the numerator, subject to the limitation that payments from any single payor during a given year are included only up to the greater of $5,000 or 1% of the organization's total support during the year.[149]

### *3. Differences in required levels of public support under each test.*

The section 509(a)(1) and 509(a)(2) rules also differ markedly with regard to the amount of public support an organization must attain in order to qualify as a public charity. Under both provisions, organizations with a public support percentage equal to or greater than 331/3% will automatically qualify for public charity status.[150] However, section 509(a)(1)—but not 509(a)(2)— contains an alternative test under which an organization may qualify as a public charity with as little as 10% public support, provided that it is organized and operated to attract new and additional public support on a continuous basis, and possesses other, non-financial attributes indicative of a "public" organization.[151] The principal factors considered under this "10% facts and circumstances test" are whether the organization has multiple sources of support (as opposed to receiving all of its support from related parties), has "a representative governing body" comprised of individuals with appropriate qualifications to lead the organization (as opposed to a board comprised of individuals related to the principal donors), and makes its services broadly available to the public.[152]

In addition, an organization described in section 509(a)(2)—but not 509(a)(1)—may not receive more than one-third of its support in its each taxable year from the sum of gross investment income and net after-tax unrelated business taxable income ("UBIT"). This limitation is absolute, *i.e.*, an organization that exceeds it will no longer qualify as a public charity under section 509(a)(2).[153]

---

147 Treas. Reg. § 1.170A-9T(f)(7).
148 Treas. Reg. § 1.509(a)-3T (emphasis supplied).
149 Treas. Reg. § 1.509(a)-3(b)(1).
150 Treas. Reg. §§ 1.170A-9T(f)(2); 1.509(a)-3T(a)(2).
151 Treas. Reg. § 1.170A-9T(f)(3).
152 Treas. Reg. § 1.170A-9T(f)(3)(iii)(B)–(D).
153 IRC § 509(a)(2)(B); Treas. Reg. § 1.509(a)-3T(a)(3).

# Attachment 2

This memorandum discusses the rules governing lobbying by public charities that are exempt under section 501(c)(3) of the Internal Revenue Code.[154] Section I addresses the relevant federal tax rules applicable to charities that have made a valid election under section 501(h). Section II discusses applicable requirements of the Lobbying Disclosure Act, 2 U.S.C. § 1601, *et. seq.* (the "LDA").

## Tax Law Lobbying Rules

As you know, the federal tax law restricts the amount organizations exempt under section 501(c)(3) of the Internal Revenue Code may spend on attempting to influence legislation. Public charities have the option of choosing between two quite different versions of this restriction. Under the default regime, they are subject to the so-called "no substantial part test" of section 501(c)(3), which provides simply that no substantial part of an organization's activities may be "carrying on propaganda, or otherwise attempting, to influence legislation." Alternatively, charities can elect under section 501(h) of the Code to abide by clear rules that specify the portion of its charitable expenditures that can be devoted to lobbying activities.

For the overwhelming majority of public charities, electing to follow the section 501(h) rules offers three major advantages. First, the section 501(h) rules establish a much more precise and considerably narrower definition of "lobbying" than applies under the "no substantial part" rules. Second, the 501(h) rules replace the vague requirement that lobbying not be "substantial" with a clear expenditure test under which an organization is permitted to spend a specified portion of its total expenditures on lobbying. Third, whereas the sanction for substantial lobbying under the "no substantial part" rules is loss of tax-exempt status, the primary sanction for lobbying expenditures in excess of the section 501(h) lobbying expenditure limits is a penalty tax on excess lobbying expenditures.

## Lobbying Expenditure Limits

The section 501(h) lobbying rules establish specific limits on an organization's lobbying expenditures. As the attached table illustrates,[155] the overall lobbying expenditure ceiling equals 20% of the first $500,000 of the organization's charitable budget[156] and declines as exempt expenditures rise, reaching a maximum allowance of $1 million per year. Further, only 25% of this amount may be devoted to socalled "grassroots" lobbying.

For purposes of illustration, assume that a charity has an estimated charitable operating budget of $3 million. As indicated in the table presented in Appendix 1, in this bracket, the formula for determining a charity's total allowable lobbying expenditures is $225,000 plus 5% of any excess over $1.5 million. Thus, the charity's ceiling would be $225,000 plus $75,000, or **$300,000.** Moreover, only 25% of this ceiling amount (i.e., **$75,000**) could be spent on "grassroots" lobbying activities.

---

[154] All section references herein are to the Internal Revenue Code of 1986, as amended (the "Code" or "I.R.C.") or to the Treasury Regulations promulgated thereunder ("Regulations").

[155] See attached Appendix 1.

[156] To be precise, the base against which a charity must compute its expenditure ceilings is its "exempt purposes expenditures." This is a highly technical term, which is defined in Appendix 2 of this memo.

## Penalties for Excessive Lobbying

If a charity exceeds either the overall lobbying expenditure ceiling or the grassroots lobbying ceiling during any tax year, it will be subject to a penalty tax equal to 25% of the excess expenditures. Excess lobbying expenditures will not result in revocation of the organization's taxexempt status unless it exceeds either the overall or grassroots lobbying expenditure ceiling by more than 50% over a fouryear period.

## The Definition of "Lobbying"

Under the rules for organizations that make the section 501(h) election, an activity is "lobbying" only if it involves either a "direct lobbying communication" or a "grassroots lobbying communication." Both of these terms have quite narrow, but rather technical definitions. In brief, "grassroots lobbying" is the attempt to influence legislation by influencing the general public, as distinguished from "direct lobbying," which is the attempt to influence legislation by communicating directly with legislators and certain other government officials.

### *Direct Lobbying*

**Communications with legislators or legislative staff**. An organization engages in "direct lobbying" when it makes a communication with a legislator (federal, state, local, or foreign) or legislative staff member that:

: refers to **specific legislation** (which includes proposals that recommend or require a specific legislative solution, even if the policy solution is not in an active or proposed bill); and

: takes a position on that legislation.

**Communications with Executive branch officials**. Most communications with executive branch officials are not lobbying for purposes of the tax rules. A communication with an executive branch official is direct lobbying only if:

the communication refers to and takes a position on specific legislation (executive branch enforcement or interpretive action are not covered); and its principal purpose is to influence legislation.

**Referenda or ballot initiatives**. Communications with the general public that both refer to and take a position on referenda or ballot initiatives also count as direct lobbying.

**Some examples** of direct lobbying include:

: meeting with legislators or their staff to discuss specific legislation;

: drafting or negotiating the terms of a bill;

: discussing the potential contents of legislation with legislators or staff;

: meeting with executive branch officials to influence testimony on a legislative proposal for increasing a specific appropriation; and

: urging a Presidential veto.

## *Grassroots Lobbying*

**"Call to action" communications.** Grassroots lobbying is defined as a communication with the public that:

: refers to specific legislation; and

: takes a position on that legislation; and

: includes a "**call to action**."

: A communication includes a **call to action** if it does any of the following:

: urges the recipient to contact a legislator or staffer (*e.g.*, "Tell Congress what you think" or "Call your Representative")

: provides the address, telephone number, or similar contact information for a legislator;

: provides a petition, tear-off postcard, etc., addressed to a legislator; or

: identifies a legislator as opposing the legislation, as being undecided, as being a member of the committee considering the legislation, or as being the recipient's representative (though identifying the legislation's sponsor does *not* count as a call to action).

**Paid mass media advertisements on highly publicized legislation.** The one circumstance in which communications with the general public may be treated as lobbying communications even if they do not contain a call to action involves paid mass media advertisements on **highly publicized legislation.** The tax regulations establish a presumption that such paid communications are lobbying if the communication:

: occurs within two weeks before a legislative vote;

: reflects a view on the general subject of the legislation; and

: either refers to the highly publicized legislation or encourages the public to communicate with legislators on the general subject of the legislation.

Legislation is **highly publicized** if:

: the legislation receives frequent coverage on television and radio, and in general circulation newspapers, during the two weeks preceding the vote by the legislative body or committee; and

: the pendency of the legislation or its general terms, purpose, or effect are known to a significant segment of the general public (as opposed to the particular interest groups directly affected) in the area in which the paid mass media advertisement appears.

**Some examples** of grassroots lobbying include:

: an action alert urging recipients to contact their legislators about a pending bill; and

: attending a coalition meeting to help plan a grassroots lobbying communication addressing a pending bill.

*Exceptions to the Definition of Lobbying*

There are four significant exceptions to the definition of lobbying:

**Nonpartisan analysis and research**. Making available materials that present a sufficiently full and fair exposition of public policy issues to allow readers to form their own conclusions does not constitute lobbying, even if the materials both refer to and take a position on a specific legislative proposal. In general, this exception is intended to include substantial analyses of public policy issues; the prototypical example of nonpartisan analysis would be a GAO report or a RAND report. To qualify for this exception, the material must not explicitly encourage recipients to contact legislators (although it may identify legislators as holding a particular position on the legislation) and it must not be distributed only to persons interested in one side of the issue addressed.

**Technical assistance**. Oral or written responses to written requests for technical assistance from a legislative committee, subcommittee, or other governmental body likewise do not constitute lobbying for tax purposes. In order to qualify for this exception, the written request must be from the committee or subcommittee, not from an individual member asking on his own behalf.

**Discussions of broad social issues**. Communications addressing broad social, economic, and similar issues are excluded from the definition of lobbying, even if the issues discussed are the subject of pending legislation.

**Self-defense**. Finally, communications with government officials involved in the legislative process do not constitute lobbying for tax purposes if they concern legislation that could affect an organization's existence, powers, duties, tax-exempt status, or right to receive tax-deductible contributions.

## Determining the Costs of Lobbying Communications

In general, all costs related to the preparation and distribution of a lobbying communication must be treated as lobbying expenditures. This includes all direct costs—including an appropriate share of the current and deferred compensation of all participating personnel—of researching, drafting, reviewing, copying, publishing, mailing, or otherwise distributing the lobbying communication. It also includes an allocable share of overhead costs.

Research costs must be treated as lobbying costs only if the research is undertaken for the primary purpose of using the research results in the lobbying communication. Research will not be viewed as undertaken primarily to support lobbying activities if an organization can demonstrate that it made substantial nonlobbying use of the research prior to, or simultaneously with, the lobbying use.

Consider the following example: If a charity hires a researcher to conduct a study on an environmental issue, and if the charity makes a substantial nonlobbying distribution of the study—for example, by publishing and distributing the research results in a format that does not include a "call to action" with respect to specific legislation—then the simultaneous use of the research in lobbying communications does not transform the research costs into lobbying expenditures. In addition, even if the charity did not make a substantial nonlobbying distribution of the research results, it would be required to include as lobbying expenditures only those research costs incurred less than six months before the first use of the research results in a lobbying communication.

## Making the section 501(h) election.

An eligible public charity may elect to follow the section 501(h) rules at any time by filing IRS Form 5768, a copy of which is attached to this letter. The election is retroactive to the beginning of the tax year in which the election is made. A public charity that has made the section 501(h) election may revoke the election, also by filing IRS Form 5768.

## Implications for Dealing with Private Foundations

In contrast to public charities, private foundations may not make any expenditures to fund lobbying activities. There is no equivalent to the lobbying ceilings for private foundations; any expenditure by these organizations that supports lobbying is subject to penalty. Consequently, most foundations are very careful to make sure that their grants will not fund lobbying activities. With this in mind, if a charity intends to solicit private foundation funding in the future, it should note the following aspects of the private foundation rules that can help ease foundations' concerns about supporting a public charity-grantee's policy-related work.

### *Foundations Use the Same Tax Law Definition of Lobbying*

Private foundations can use the definition of lobbying described above in determining whether their grants violate the prohibition against foundation lobbying. Hence, in preparing grant applications to foundations, it is extremely helpful to describe the proposed project in a manner that clearly explains why certain activities will not be lobbying. For example, when describing a public education campaign, you could state explicitly that communications with the public will not include a call to action, or that communications with legislators will not refer to specific legislation. Such representations will give foundations a firm basis for determining that they can fund these activities without incurring any penalty.

### *Foundations Can Fund Projects that Include Some Lobbying*

Obviously, many projects will include a mix of activities—some of which are lobbying under the tax law definition and some of which are not. The tax rules allow foundations to support such projects so long as the amount of the foundation's grant is less than the amount budgeted for the project's nonlobbying activities. In other words, the foundation rules apply a "first dollar to nonlobbying activities" approach for determining whether a foundation's project grant would support lobbying activities.

Significantly, a foundation may only take advantage of this rule if the grantee charity provides a project budget that clearly identifies the nonlobbying activities as such and specifies the cost of these activities. Accordingly, if a charity wants a foundation-supported project to include some lobbying, its grant proposal/application should include both a project description that distinguishes lobbying from nonlobbying activities (using the tax law definition discussed above) and a project budget that allocates costs between the two categories. A budget that simply identifies generic cost categories, such as salaries, printing, travel, and the like will not suffice.

### *General Support Grants Are Not Lobbying Expenditures*

Finally, the private foundation rules provide that a general support grant to a public charity will not be a lobbying expenditure unless the general support grant is "earmarked" for lobbying. A grant will be treated as earmarked for lobbying if there is an agreement, oral or written, that the grant funds will be used to support lobbying. In the absence of such an agreement, a grant to support a charity's general operations and not subject to any restrictions as to the specific activities for which the grant funds may be used will not create a lobbying problem for the foundation. Accordingly, although foundations generally do not favor unrestricted grants, you should not overlook general support grants as a possible means of obtaining foundation support for policy-focused work that may involve lobbying.

## Requirements of the Lobbying Disclosure Act (the "LDA")

### Overview

Under the Lobbying Disclosure Act (the "LDA"),[157] self-employed lobbyists, lobbying firms, and organizations employing in-house lobbyists must register with the Clerk of the House of Representatives and the Secretary of the Senate within 45 days of qualifying as a federal lobbyist, being retained to lobby, or employing an individual who qualifies as a lobbyist. Once registered, these lobbyists, firms, and organizations (collectively referred to herein as "registrants") must file lobbying reports on a quarterly basis. Additionally, registrants *and* all individuals registered as federal lobbyists must file semiannual contribution reports.

### LDA Registration

#### *Lobbying Contacts*

Federal lobbyists are individuals who, on behalf of a client or employer: (1) make two or more "lobbying contacts" (at any point); *and* (2) spend 20% or more of their time during a three month period engaged in "lobbying activities." Self-employed lobbyists must register with the Clerk of the House of Representatives and the Secretary of the Senate within 45 days of meeting the two criteria necessary to qualify as a lobbyist. Lobbying firms and organizations employing in-house lobbyists must register within 45 days of an employee being retained to act as a lobbyist or qualifying as a lobbyist. Self-employed lobbyists and lobbying firms that represent clients must file separate registration statements for each client represented.

To qualify as a lobbyist on behalf of a charity, a charity employee or representative must make two or more lobbying contacts.[158] Subject to the exceptions listed further below, the LDA defines lobbying contacts as oral or written communications with covered executive or legislative branch officials (made on behalf of a client) regarding:

- The formulation, modification, or adoption of Federal legislation;
- The formulation, modification, or adoption of a Federal rule, regulation, executive order, or any other program, policy, or position of the Federal Government;
- The administration or execution of a Federal program or policy (including the negotiation, award, or administration of a Federal contract, grant, loan, permit, or license); or

---

157 2 U.S.C. § 1601 *et seq.*

158 Public charities that make the 501(h) election and organizations reporting their taxes under section 162(e) of the Internal Revenue Code may use an alternate method for determining whether they trigger LDA registration requirements. In brief, when using the tax reporting method, organizations will rely on LDA definitions to analyze whether an employee has made a legislative branch lobbying contact or has engaged in legislative branch lobbying activities; and they will rely on the Internal Revenue Code definitions to analyze whether an employee has made an executive branch lobbying contact or has engaged in executive branch lobbying activities.

: The nomination or confirmation of a person for a position subject to confirmation by the Senate.

: Executive and legislative branch officials covered by the LDA are:

: The President;

: The Vice President;

: Officers and employees of the Executive Office of the President;

: Officials serving in an Executive Level I-V position;

: Members of the uniformed services serving at grade 0-7 or above;

: Employees serving in a confidential, policy-determining, policy-making or policy-advocating position ("Schedule C employees");

: Members of Congress;

: Elected officers of either House of Congress; and

: Congressional employees.

: The following communications do not qualify as lobbying contacts[159]:

: Communications made by a public official acting in his official capacity;

: Communications made by media representatives if for the purpose of gathering and disseminating news and information to the public;

: Speeches, articles, publications, or other materials that are distributed publicly or through mass communication;

: Communications made on behalf of a government of a foreign county or a foreign political party that are disclosed under the Foreign Agent Registration Act;

: Administrative communications like requests for meetings or inquiries regarding the status of an action (does not include attempts to influence the covered official);

: Communications made in the course of participation in an advisory committee subject to the Federal Advisory Committee Act;

: Testimony given before a committee, subcommittee, or task force of the Congress, or submitted in the public record for a hearing;

: Information provided in writing in response to an oral or written request by a covered executive or legislative branch official;

: Communications required by subpoena, civil investigative demand, or otherwise compelled by statute, regulation, or other action of the Congress or an agency;

[159] Because these communications do not qualify as lobbying contacts, they are not counted toward the registration threshold of two or more lobbying contacts.

- Communications made in response to a notice in a publication soliciting communications from the public and directed to the agency official specifically designated in the notice to receive such communications;
- Communications not possible to report without disclosing information, the unauthorized disclosure of which is prohibited by law;
- Communications made to an official in an agency regarding judicial proceedings, law enforcement inquiries, investigations, or proceedings;
- A filing or proceeding that the government is specifically required by statute or regulation to maintain or conduct on a confidential basis;
- Communications made in compliance with an adjudication;
- Written comments filed in the course of a public proceeding or other communications made on the record in a public proceeding;
- Written petitions for agency action disclosed as part of the public record pursuant to agency procedures;
- Communications made with certain covered officials on behalf of an individual concerning that individual's personal matters;
- Communications protected by law;
- Communications made by a church or religious order; and
- Communications between officials of self-regulatory organizations (as defined in the Securities Exchange Act) that are registered with or established by the SEC or the CFTC and the SEC or CFTC, relating to the organization's regulatory responsibilities.

### *Lobbying Activities*

In addition to making more than one lobbying contact, to qualify as a lobbyist, a person must spend 20% or more of his or her time during a three month period engaged in lobbying activities for a client or employer.[160] Lobbying activities include all lobbying contacts and any other activities in support of lobbying contacts. Activities in support of lobbying contacts include preparation and planning activities, drafting of position papers, research, and background work that is intended, at the time performed, for use in connection with lobbying. As such, if a policy paper is drafted for purposes unrelated to lobbying and later used in connection with a lobbying contact, the time related to the initial research and drafting of the paper does not count as a lobbying activity.

Lobbyists and lobbying firms earning less than $3,000 in lobbying income during a calendar quarter are exempt from the registration requirement. Similarly, organizations that employ in-house lobbyists but incur less than $11,500 in expenses for lobbying activities during a calendar quarter are exempt from the registration requirement.[161]

---

[160] As discussed above in Footnote 9 and *infra*, certain organizations may choose to analyze their employees' lobbying activities using the tax reporting method.

[161] Organizations that qualify to use the tax reporting method may calculate their lobbying expenses using either the LDA method or the tax method. If an organization's lobbying expenses are less than $11,500, as calculated using either the LDA method or the tax method, the organization is exempt from LDA registration.

## B. LDA Reporting

### *Quarterly Lobbying Report*

LDA registrants must file lobbying reports on a quarterly basis using form LD-2. The reports are due April 20, July 20, October 20, and January 20, and cover the preceding calendar quarter.[162] Quarterly lobbying reports disclose:

A good faith estimate of the income earned by lobbying firms or the expenses incurred by organizations employing in-house lobbyists for lobbying activities. Organizations may choose to calculate their lobbying expenses using the LDA method or using the Internal Revenue Code tax method. If an organization chooses to report using the tax method, it must use that method consistently for all reports filed during a calendar year.

The specific issues lobbied, including legislation, rulemaking, decisions, and nominations;

The Houses of Congress and Federal Agencies contacted (and *not* the individual covered official or department contacted);

The name of each lobbyist who engaged in lobbying activity and any "covered positions" held by the lobbyist during the prior 20 years (any new lobbyists must be identified); and

The identity of any interested foreign entities.

### *Semiannual Contributions Report*

Only LDA registrants must file quarterly lobbying reports. In contrast, both LDA registrants *and* individuals registered as federal lobbyists must file contribution reports on a semiannual basis using form LD-203. The reports are due July 30 and January 30, and cover the preceding semiannual period.[163] Contribution reports must include:

- A certification that the LDA registrant or individual lobbyist (1) has read and is familiar with the congressional gift rules; and (2) has not given a gift or provided travel that is improper under the gift rules;
- The name and employer of the LDA registrant or lobbyist;
- The name of all political committees controlled by the LDA registrant or lobbyist;
- A list of the following contributions valued at $200 or more made during the reporting period:
- Contributions to federal officeholders, candidates, leadership PACs, and political party committees; and
- Contributions to presidential library foundations or inaugural committees;
- A list of contributions (in any amount) made to or for any of the following during the reporting period, unless otherwise reported to the Federal Election Commission:

---

[162] If the report due date falls on a weekend or holiday, the report is due the next business day.
[163] If the report due date falls on a weekend or holiday, the report is due the next business day.

- Events to honor or recognize covered legislative or executive branch officials;
- Entities named for a covered legislative branch official;
- Persons or entities in recognition of a covered legislative branch official;
- Entities designated, established, financed, maintained, or controlled by covered legislative or executive branch officials; and
- Meetings, retreats, conferences, or other similar events held by, or in the name of, a covered legislative or executive branch official.

***Reporting by Charities Making the Section 501(h) Election***

A public charity that makes the 501(h) election may use an alternate "tax method" to calculate its lobbying expenditures for purposes of LDA reporting. One advantage of this option is administrative efficiency—an organization electing to report its total lobbying expenses using the tax law definition can simply copy the lobbying expenditure figures reported on the annual return it submits to the IRS (the Form 990).

There are significant differences between the LDA's definition of "lobbying activities" and the definition of "influencing legislation" under sections 501(h) and 4911 of the Internal Revenue Code. For example:

The LDA applies only to federal lobbying efforts, while the tax law definitions include state and local lobbying as well.

The LDA excludes any "grassroots" lobbying, which is included in the tax definition.

The LDA's definition applies to certain activities that are not covered by section 4911, including self-defense lobbying, lobbying on matters that are not yet "specific legislative proposals," and attempting to influence federal agency actions that do not involve legislation.

A charity electing to use the "tax method" to calculate its lobbying expenses must also use a hybrid approach that employs a mix of the tax and LDA definitions for other LDA purposes, including: (i) determining whether an employee has made a lobbying contact, (ii) determining whether an employee has met the 20% registration threshold, and (iii) determining the list of agencies lobbied and the bills and policy areas with respect to which lobbying occurred.

When using this "tax method," communications with legislative branch covered officials will qualify as lobbying contacts if they meet the definition of lobbying contact set forth in the LDA. At the same time, communications with executive branch employees will qualify as lobbying contacts only if they meet the definition for "influencing legislation" set forth in the Internal Revenue Code. In other words, organizations using the tax method will use LDA definitions when analyzing whether an employee has made a legislative branch lobbying contact or has engaged in legislative branch lobbying activities, while they will use Internal Revenue Code definitions when analyzing whether an employee has made an executive branch lobbying contact or has engaged in executive branch lobbying activities.

# Appendix 1

## LOBBYING EXPENDITURE CEILINGS

**for 501(h) electing charities**

| **Exempt Purpose Allowable** | **Total Allowable** | **Amount of Total** |
|---|---|---|
| **Expenditures Lobbying** | **Lobbying Expenditures** | **for Grassroots** |
| Up to $500,000 | 20% (i.e., up to $100,000) | 5% (i.e., up to $25,000) |
| $500,000 to | $100,000 + 15% | $25,000 + 3.75% |
| $1,000,000 | of excess over $500,000 | of excess over $500,000 |
| $1,000,000 to | $175,000 + 10% | $43,750 + 2.5% |
| $1,500,000 | of excess over $1,000,000 | of excess over $1,000,000 |
| $1,500,000 to | $225,000 + 5% | $56,250 + 1.25% |
| $17,000,000 | of excess over $1,500,000 | of excess over $1,500,000 |
| Over $17,000,000 | $1,000,000 | $250,000 |

# Appendix 2

**Definition of**

**EXEMPT PURPOSE EXPENDITURES**

An organization's "exempt purpose expenditures" constitute the base against which the organization's permitted lobbying expenditures are determined. Generally, exempt purpose expenditures include any amounts paid to advance a charitable purpose, plus lobbying expenditures and fundraising expenditures other than as noted below. On the other hand, exempt purpose expenditures do not include investment management expenses, expenses related to the conduct of any unrelated trade or business, amounts paid for outside fundraising services, and expenses related to a "separate fundraising unit" within the organization, defined as a group of two or more employees devoting a majority of their time to fundraising activities.

Expenditures that must be treated as capital expenditures under applicable tax rules may not be treated as exempt purpose expenditures, but an organization may claim a reasonable depreciation allowance with respect to capital assets used in exempt purpose activities as exempt purpose expenditures.

# Appendix B

Nonprofit Media Working Group Members

**Steven Waldman,** *Chair*
Waldman is the former senior adviser to the chairman of the Federal Communications Commission (FCC). At the FCC he was the lead author of June 2011 FCC report, “Information Needs of Communities: The Changing Media Landscape in a Broadband Age.” Waldman currently serves as a visiting senior media policy scholar at Columbia University’s Graduate School of Journalism. He was founder and CEO of Beliefnet.com and a correspondent for *Newsweek.*

**Clark Bell**
Bell is a program director at Robert R. McCormick Foundation. He serves as a member of the Accrediting Council on Education in Journalism and Mass Communications, and is also chairman of the Northwestern Integrative Medicine Advisory Council.

**Jim Bettinger**
Bettinger is director of the John S. Knight Fellowships Program at Stanford University. He previously worked as a reporter, editorial writer, and editor at the *Riverside (California) Press-Enterprise,* and at the *San Jose Mercury News,* where he was city editor/AM.

**Kevin Davis**
Davis is CEO and executive director of the Investigative News Network (INN), a consortium of 60 nonprofit newsrooms producing nonpartisan investigative and public interest journalism. He has more than 16 years of experience in strategic development and growth at news and media organizations. He was responsible for operations at Los Angeles-based news organizations Variety.com and TheWrap.com.

**Cecilia Garcia**
Garcia is executive director of the Benton Foundation. She previously served as a press secretary for a member of the U.S House of Representatives and a communications director for a national Latino nonprofit organization. She has also produced and directed public and community affairs programming at WTVS, Detroit’s public television station.

**James T. Hamilton**
Hamilton is the Charles S. Sydnor Professor of Public Policy at Duke University, as well as a professor of economics and political science. He also serves as the director of the DeWitt Wallace Center for Media and Democracy. His scholarly work and numerous publications reflect his interests in the media, environmental policy, the economics of regulation, and political economy. Hamilton joined Duke’s faculty in 1991 after receiving a Ph.D. in economics from Harvard University.

**John Hood**
Hood is president and chairman of the John Locke Foundation. He is also a syndicated columnist for the *Winston-Salem Journal, High Point Enterprise, Gaston Gazette, Durham Herald-Sun,* and newspapers in 50 other North Carolina communities. He is a regular radio commentator and a weekly panelist on “N.C. Spin,” a discussion program that is broadcast on 16 television stations in Charlotte, Raleigh, Greensboro, Greenville, Wilmington, Asheville, and elsewhere.

**Joel Kramer**
Kramer is CEO and editor of MinnPost. He became editor of the *Star Tribune* in 1983. He then became publisher and president in 1992, serving until 1998. He was involved in editing two investigative projects that won Pulitzer Prizes, one at *Newsday* and one at the *Star Tribune.*

**Juan Martinez**
Martinez is the vice president/chief financial officer and treasurer at the Knight Foundation. He is a partner in the development and implementation of the foundation's strategy. He is also responsible for directing all of the foundation's financial management, reporting, and regulatory compliance, and oversees the investment portfolio and partners with program staff in the development of grants and program related investments.

**Jeanne Pearlman**
Pearlman is senior vice president for programs and policy at The Pittsburgh Foundation. She carries out the foundation's grantmaking to foster sustainable communities in the Pittsburgh region, oversees the foundation's public education grants portfolio, and serves as convener of the Fund for Excellence in Public Education, a funder/educator collaborative created to support education reform in Pittsburgh.

**Calvin Sims**
Sims is a program officer at Ford Foundation and focuses on the development of a free and responsible press worldwide. He previously spent two decades at the *New York Times*, where he was a director, producer, and foreign correspondent and played a central role in the newspaper's expansion into television, documentaries, and the Web.

**Vince Stehle**
Stehle is the executive director of Media Impact Funders. Previously, he was program director for nonprofit sector support at the Surdna Foundation, where he oversaw critical support to innovative public and independent media projects, as well as leadership support in the development of the field of nonprofit technology.

**Eric Newton,** *Knight Foundation Liaison to the Working Group*
Newton is senior adviser to the president at the Knight Foundation. He previously was founding managing editor of the Newseum. He also edited California newspapers, becoming managing editor of the *Oakland Tribune* when the paper won 150 awards, including a Pulitzer Prize.

**Marc Owens,** *Legal Counsel*
Owens is a member in Caplin & Drysdale's Washington, D.C., office. Before that, he was employed by the Exempt Organizations Division of the IRS for his entire professional career and served as the division's director for the last 10 years. In that capacity, he was the chief decision maker regarding design and implementation of federal tax rulings and enforcement programs for exempt organizations, unrelated business income tax, private foundation excise taxes, hospital reorganizations, college and university guidelines, political organizations, and tax-exempt bonds.

**Sharon Nokes,** *Legal Counsel*
Nokes is an of counsel in Caplin & Drysdale's Washington, D.C., office, where she counsels a wide range of tax-exempt organizations on tax, corporate governance, transactional, and compliance issues and represents them in matters before the IRS and state attorneys general. Prior to joining Caplin & Drysdale in 2008, Nokes practiced in the tax department of a major international law firm, where she advised large for-profit and tax-exempt organizations on a variety of tax issues and represented them in controversies before the IRS.

**Janne Gallagher**
Gallagher recently retired after 13 years at the Council on Foundations, including 10 years as senior vice president and general counsel. Before joining the Council in 1999, she spent 17 years in the private practice of law, most recently at the Washington, D.C., law firm of Caplin & Drysdale, where she specialized in the representation of tax-exempt organizations. The author of numerous articles, Gallagher speaks frequently on legal issues affecting private foundations and other grantmaking institutions. She is a member of the District of Columbia Bar.

**Shelton Roulhac,** *Project Director*
Roulhac is senior policy analyst at the Council on Foundations. He is responsible for compiling and commissioning research to advance the Council's legislative agenda, and for reviewing and analyzing legislation, regulations, and studies to determine the impact on the philanthropic sector. Prior to joining the Council, Roulhac served as a legislative aide to Rep. Sheila Jackson-Lee (D-Texas) and as a policy analyst at the Mortgage Bankers Association.

# Appendix C

Nonprofit Media Working Group Meetings

**March 1, 2012** - Teleconference

**April 5, 2012** - Teleconference

**April 30, 2012** - Council on Foundations Annual Conference, Los Angeles, California
(Panel discussion and reception)

**May 1, 2012** - Council on Foundations Annual Conference, Los Angeles, California

**June 5, 2012** - Teleconference

**July 12, 2012** - Council on Foundations, Arlington, Virginia

COUNCIL on FOUNDATIONS

2121 CRYSTAL DRIVE, SUITE 700 • ARLINGTON, VA 22202 • 800-673-9036 • COF.ORG

Knight Foundation
*Informed & Engaged Communities*

JOHN S. AND JAMES L. KNIGHT FOUNDATION

200 SOUTH BISCAYNE BOULEVARD, SUITE 3300 • MIAMI, FL 33131-2349