Criteria for Sponsoring Organizations under the Child and Adult Care Food Program (CACFP) Exempt Organizations Handbook, Section 34 (14)

STATE AGENCY DIRECTORS
(Child Nutrition Programs)

- Colorado DPHE, Iowa, Kansas, Missouri DH,
  Montana DPHHS, Nebraska ED, North Dakota,
  South Dakota, Utah and Wyoming

On October 10, 1995, Food and Consumer Service Headquarters transmitted questions to the Internal Revenue Service (IRS) regarding concerns raised by State administrators of the CACFP and re-emphasized by the State and Federal representatives at the September 1995, CACFP Initiative Task Force meeting held at Headquarters. These concerns related to the recent revision to the criteria for granting tax exemption to sponsoring organizations of family day care homes from the IRS's Exempt Organizations Handbook (EOH) Section 34(14) (pages 7751-59, 7751-60, and 7751-60.1 attached). The attached questions and answers are a result of the response from IRS and should be helpful when answering common questions from current and prospective sponsors.

If you have any questions regarding the attachments, contact my staff at (303) 844-0359.

Darlene Sanchez

ANN C. DEGROAT
Regional Director
Child Nutrition Programs

Attachments
The following are the initial questions that were asked IRS regarding the Exempt Organizations Handbook (EOH) Section 34(14), USDA Child and Adult Care Food Program (CACFP) and the responses from IRS.

1. **Question:** Paragraph 4 states that "provider-dominated sponsoring organizations (SOS) are not operated exclusively for exempt public purposes", and that such organizations would not be eligible for tax exemption under the new criteria. Can you provide us with a definition of what IRS considers to be "provider domination" of a SO?

   **Answer:** A "provider" dominated SO would normally be an SO that has a Board of Directors a majority of which is made up of paid employees of an SO and/or family members of the paid employees. [Note: IRS appears to be using the term "provider" to denote the SO, which is the provider of the exempt service.]

2. **Question:** Paragraph 6(a) states that the governing body of tax-exempt SOS "should be composed primarily of members of the community who are not financially interested in its activities ... or related parties." Can you provide us a definition of "primarily"? Can you provide us with a definition of "related parties"?

   **Answer:** This criteria is not unique to determinations involving SOS. This criteria has long been applied to a variety of organizations seeking recognition of exemption under Internal Revenue Code (IRC) 501 (c)(3). For example, requiring that an SO be governed by a board of directors representative of the community served, rather than "insiders" with a financial interest in the organization's activities, is consistent with published precedents requiring that health care providers and similar organizations have a "community board" rather than a governing body dominated by financially interested individuals. "Primarily" generally means having a board that consist of over 50% of members of the community rather than of "insiders". "Related parties" are consider to be the Founder, family members of the Founder, Directors, Director's family members, and employees. Related parties would also include corporations which are owned by the Founder, Directors, their families, and/or employees and who also do business with the SO.
A major problem in this area is SOs that have been organized as sole proprietorships. IRC 501 (c)(3) provides exemption only to certain "corporations," or a "community chest, fund, or foundation," organized and operated exclusively for certain purposes. A sole proprietorship, being nothing other than the form through which an individual conducts business, cannot be recognized under IRC 501 (c)(3).

3. **Question:** Paragraph 6(d) states that "No person receiving compensation for services under CACFP may receive compensation for services from any other SO". Do you intend to exclude from tax-exempt status any SOs which employ on a part-time basis monitors, nutritionists, data processing consultants or other professionals who provide services to other SOs?

**Answer:** Generally no. However, if it is determined that an SO is organized and operated for the private benefit of such an individual, then the SO would fail to qualify for tax exemption.

4. **Question:** Paragraph 6(e) states that SOs "should accept any qualified day care provider" consistent with the SO's capacity to provide service, and paragraph 5 states that SOs are not qualified for tax-exempt status if they refuse to sponsor licensed or approved providers due to the provider's income or educational levels. Does IRS have examples of the type of constraints (e.g., staffing, travel limitations, language barriers) which would legitimately cause an SO to refuse additional providers?

**Answer:** We do not have any specific examples of the type of constraints which would legitimately cause an SO to refuse additional providers. We have seen some organizations that have been created to sponsor particular day care homes controlled by the individuals controlling the sponsoring organizations. Others have refused to sponsor economically disadvantaged providers. In some instances, multiple sponsoring organizations have been created to manipulate reimbursement under the CACFP per home schedule. For example, one SO with 350 homes might manipulate the reimbursement payment system by separating into two SOs with 175 homes each, thereby increasing their administrative payments.

5. **Question:** Are the new EOH criteria being uniformly implemented by all regional offices of IRS and, if not, what attempts will national IRS make to ensure uniform implementation of these criteria across the nation?
Answer: These are not new criteria. However, the criteria as summarized in the Internal Revenue Manual (IRM) should be applied uniformly as the IRM was published in August 1994 and training given to Service personnel during November 1994. The criteria outlined in the IRM were developed to prevent abuses, without undermining the Congressional goal in enacting and expanding CACFP, of ensuring that children and adults in day care receive nutritious meals.

6. Question: Based on previous discussions, it was Food and Consumer Service's understanding that IRS intended to apply these criteria to new applicant SOs only, and that existing SOs would be given training and time to come into full compliance with the new standards. However, we have been told that an IRS regional office has asked a State agency administering CACFP to employ these criteria in their review of existing CACFP SOs who have had tax-exempt status for many years. Does this reflect a new decision on the part of IRS to apply these criteria retroactively?

Answer: As stated above, the criteria as stated in IRM 34(14)11 are not new or unique to IRC 501 (c)(3) organizations. As stated before, the IRM was prepared in response to questions raised by Service personnel and to ensure uniformity in processing applications.

7. Question: If this is not the case, does IRS still plan to operate a training program for existing SOs and, if so, on approximately what schedule?

Answer: IRS has no plan to initiate a training program for existing SOs. IRS has participated in local/State training programs for SOs on an availability basis and will continue, when possible, to do so if requested by the State.

8. Question: Are SOs now receiving tax exemption being informed that their approval is only in effect for a certain number of years and, if so, is this consistent with the way other, non-CACFP organizations are being treated by IRS?

Answer: Tax-exempt status is not approved for a limited number of years. Organizations that are granted tax-exempt status under IRC 501 (c)(3) also must be classified as either a private foundation or not a private foundation. An organization's foundation status may be periodically reviewed and changed at the end of its advance ruling period but this has no bearing on its tax-exempt status. If an organization requires additional clarification on "private foundation" or "non-private foundation" status, please contact your local IRS.
9. Question: Will existing SOs now be subject to regular re-review of their tax exempt status? If so, on approximately what schedule, and is this consistent with the way other, non-CACFP organizations are being treated by IRS?

Answer: There presently is no special program nationally that identifies SOs for special emphasis. An SO's exempt status is subject to review in the same manner as other tax-exempt organizations.

10. Question: Are IRS officials asking SOs to provide the names and social security numbers of the SO's providers and whether providers are themselves non-profit? Since neither Section 17 of the National School Lunch Act (which authorizes CACFP) nor the program regulations require day care providers to be non-profit, such a request would not appear to be relevant.

Answer: For review of an SO's request for tax-exempt status this information would normally not be requested. However, if an organization were under a tax examination, this type of information would be pertinent to determine if proper filing had occurred and the correct taxes paid. Such a request could also involve a review of the Form 1099's in determining if the providers have correctly shown all income and related expenses on their own tax returns.

11. Question: Will all CACFP SOs be given tax exempt status under Section 501(c)(3) of the Internal Revenue Code (IRC) of 1986, or will some receive exemption under another part of Section 501(c) or an additional part of the IRC?

Answer: If an organization's sole function is to operate as an SO, it would normally qualify under section 501 (c)(3) of the Code. Thus if an SO performs other community services, it may receive exemption under a different section of the Code.

12. Question: Since child care centers wishing to participate in CACFP frequently ask State administering agencies for information concerning IRS tax exemption, would it be possible for you to provide our office with a brief summary of the requirements for child care centers to gain tax exemption?

Answer: Child care organizations requesting recognition under section 501 (c)(3) are subject to the same requirements for exemption and foundation status classification as other 501 (c)(3) organizations. Exemption for these organizations is specifically covered in section 501 (k). Substantially all of the care provided by the organization must be for the purpose of enabling individuals to be gainfully employed and
the services provided by the organization must be available to the general public. Generally such organizations may not limit enrollment to a particular employer. Such an organization may not be a sole proprietorship.

13. **Question:** We have been told that IRS regional offices are still inconsistent in their instructions to SOs regarding the distribution of Form 1099 to their home providers. Apparently, some sponsors are still being told that they are not required to distribute Form 1099 to all of their day care providers. We recommend either that these forms be issued by the sponsors, due to the apparently inconsistent application of these provisions by different IRS regional offices, or to contact the IRS regional office that has jurisdiction over the State. Is your office aware of any inconsistencies among regional offices in their implementation of this policy, or has IRS changed its policy on 1099s for providers?

**Answer:** In general, IRC 6041(a) of the Code requires that an information return (Form 1099) be made with respect to certain "fixed or determinable" items of income. Payment by sponsoring organizations to sponsored day care providers consists of two elements (food cost reimbursement and compensation for services), only one of which is income to the payee. The taxable amount is the amount by which the payment exceeds food costs. The general rule of thumb is that a sponsoring organization need not report on Form 1099 payments distributed solely to reimburse food costs unless the organization has direct knowledge that the amounts paid to a provider in a taxable year exceeds the provider’s cost by $600 or more. [Note: IRS and USDA are still exploring some issues related to the 1099’s and the income to the payee, i.e., the day care home provider.]
tion. Thus in Rev. Rul. 74–14, 1974–1 C.B. 125, a public housing authority incorporated under a State statute conferring upon it the power to conduct examinations and investigations, to administer oaths, issue subpoenas, and make its findings and recommendations available to appropriate agencies was held not to qualify under IRC 501(c)(3) since its powers were deemed to be regulatory or enforcement powers. Compare, however, Rev. Rul. 74–15, 1974–1 C.B. 126, in which a public library organized as a separate entity under a State statute, without power to impose taxes for its operation but whose funds are obtained by certification of a tax rate needed for its operation to the rate making authority, was held to qualify for exemption under IRC 501(c)(3). In that case it was determined that the power regarding the tax rate was not a regulatory or enforcement power since it merely involved the determination subject to specified limits, of a tax rate necessary to support the library’s operation.

(3) The power of eminent domain is not considered a governmental power. Therefore, a public hospital with the power to acquire property by eminent domain may qualify for exemption. Rev. Rul. 67–290, 1967–2 C.B. 183.

34(13) (5–12–82) Financial Support of Other Organizations

(1) Many charitable foundations do not engage in active charitable undertakings themselves, but rather assist the work of religious, charitable, educational, or similar organizations by contributing money to them. The foundation’s funds may be dedicated to purposes as broad as, but no broader than, the purposes set out in IRC 501(c)(3). These foundations are charitable in the broad sense of that word.

(2) Some charitable foundations, whose names and work are widely known, have very large endowments and dispose of millions of dollars annually. There are, in addition, many foundations controlled by corporate and individual taxpayers who use them as channels for their charitable contributions. This form of indirect support of charity is itself a charitable activity justifying exemption. Rev. Rul. 67–149, 1967–1 C.B. 133.

(3) Similarly, an organization that owns and leases a building to the member agencies of a community chest may be exempt. Since the rentals are at rates substantially below fair rental value, it is a form of indirect support of charitable activities and is therefore exempt. Rev. Rul. 69–572, 1969–2 C.B. 119.

(4) Charitable organizations may make distributions to nonexempt organizations. The funds must be used for specific projects that further the purposes of the charitable organization. Also, the charitable organization must retain discretion and control over the use of the funds and maintain records establishing that the funds are used for charitable purposes. Rev. Rul. 68–489, 1968–2 C.B. 210.

34(14) (8–9–84)
United States Department of Agriculture Child and Adult Care Food Program (USDA CACFP)

34(14)10 (8–9–84) Background

(1) Section 17 of the National School Lunch Act, as amended, at 42 U.S.C. § 1766, authorizes the U.S. Department of Agriculture (USDA) to carry on the Child and Adult Care Food Program (CACFP). The CACFP provides assistance to states through grants-in-aid and other means to initiate, maintain, and expand nonprofit food service programs for children or adult participants in nonresidential programs that provide care. In most states, the CACFP is administered by state agencies under USDA guidelines.

(2) The CACFP is available to public institutions, private entities exempt under IRC 501(c)(3), and proprietary family day care providers. However, non-exempt family day care providers may participate in the program only under the sponsorship of a “sponsoring organization” that is tax-exempt, or “moving towards that status” by filing an application for recognition of exemption with the Service.

(3) The “sponsoring organization” is responsible for:
   (a) submitting applications for participation or renewal in CACFP on behalf of sponsored day care providers;
   (b) accepting final administrative and financial responsibility for program operations with respect to sponsored day care providers;
   (c) monitoring the program at all facilities under its sponsorship;
   (d) maintaining records required by USDA; and

MT 7751-93 34(14)10
IR Manual
(e) acting as “fiscal intermediary” for food service funds between the state agency and the sponsored day care provider.

(4) The “sponsoring organization” must:
(a) conduct pre-approval visits to each provider;
(b) verify that the proposed food services do not exceed the providers capability;
(c) provide training for the providers in their responsibilities under CACFP; and
(d) review operations to assess compliance with CACFP at least three times a year.

(5) Sponsoring organizations receive the following payments under the CACFP program:
(a) payment for meals (which they must pay over to sponsored providers) at a rate established by law;
(b) administrative payments, which may be the actual expenditures for cost of administering the program or the amount of administrative costs approved by the state agency; and
(c) one-time start-up payments to develop or expand successful CACFP operations in day care homes.

34(14)11 (8–9–94) 7751
Requirements for Exemption for Sponsoring Organizations

(1) Based on the statutory recognition of the role played by the sponsoring organizations in administering CACFP, nonprofit organizations have been recognized as tax-exempt, on an individual basis, as organizations lessening the burdens of government.

(2) Rev. Rul. 81–276, 1981–2 C.B. 128, concludes that a professional standards review organization (PSRO) qualifies for exemption under IRC 501(c)(3), because it “lessens the burdens of government” and promotes health. The ruling reasons that the PSRO’s assume the government’s burden of reviewing the professional activities of health care practitioners and institutions to ensure they are appropriate for Medicare and Medicaid reimbursement. Similarly sponsoring organizations, by ensuring that only nutritionally appropriate meals are provided to eligible persons in the sponsored day care homes, promote the health of program beneficiaries; and, by assuming the government’s burden of reviewing the appropriateness of services provided under CACFP, lessen the burdens of government.

(3) A “sponsoring organization” does not qualify for exemption merely because its activities further exempt purposes. Such organizations must be organized and operated for public purposes rather than private benefit. Many “sponsoring organizations” applying for recognition of exemption are essentially one-person operations. The principal whose compensation is the organization’s primary expense is also its principal officer and director. Other board members and employees may be members of the principal’s family. Such organizations operate primarily for non-exempt private purposes, rather than exclusively for public purposes. See, e.g., Rev. Rul. 69–545, 1969–2 C.B. 177; compare Rev. Rul. 55–656, 1955–1 C.B. 262 (community nursing bureau qualified for exemption under IRC 501(c)(3)), with Rev. Rul. 61–170, 1961–2 C.B. 112 (private duty nurses; registry distinguished from community nursing bureau on basis that public control and support of latter demonstrated operation for public vs. private benefit).

(4) Sponsoring organization may also be created and controlled by the day care providers they sponsor, to enable the providers to participate in CACFP. Like employee-dominated sponsoring organizations, provider-dominated sponsoring organizations are not operated exclusively for exempt public purposes.

(5) Sponsoring organizations may not operate exclusively for exempt purposes, for other reasons. For example, organizations that refuse to sponsor state licensed or federally qualified day care providers who comply with program requirements, because of their income or education levels, are not operated exclusively to further exempt purposes. Also, some individuals have formed multiple sponsoring organizations in order to increase the amount of reimbursement received under CACFP, and such activities do not further exempt purposes.

(6) To qualify for exemption under IRC 501(c)(3), a sponsoring organization must meet the following criteria:
(a) Its governing body should be composed primarily of members of the community who are not financially interested in its activities (i.e., persons other than employees of the organization or sponsored day care providers) or related parties.
(b) Members of the governing body should not vote on decisions relating to their own compensation (or for a related party).
(c) Decisions about compensation of employees and other parties providing services to the organization should be made by the governing body.

(d) No person receiving compensation for services under CACFP may receive compensation for services from any other sponsoring organization; and

(e) Sponsoring organizations should accept any qualified day care provider, consistent with their capacity to provide services to sponsored providers.

(7) See text 428.3(6), IRM 7752, regarding the treatment of payments under CACFP for private foundation classification purposes.

(8) See IRM 7600 for paragraphs required for determination letters to sponsoring organizations.

350 (4-28-77) Scientific Organizations

7751

351 (4-28-77) General

(1) The term "scientific" is not one that can be defined with precision. Many pursuits may be described as either scientific or educational or both. An organization engaged in surveying scientific and medical literature and abstracting and publishing it free of charge was held to be exempt because it was engaged in the advancement of education and science. Rev. Rul. 66-147, 1966-1 C.B. 137.

(2) In another case, an organization carrying on research and disseminating knowledge in the field of the social sciences was held to be educational and scientific. It performed a substantial part of its research under contract from government agencies and devoted the proceeds to additional research. It performed no contract research for private individuals or organizations. Rev. Rul. 65-60, 1965-1 C.B. 231.

(3) An organization engaged in nonprofit research on human diseases, developing scientific methods for treatment, and disseminating its results through physicians' seminars was held to be exempt as an educational organization. It planned to make the results of its research, including patents, formulas, etc., generally available to the public. The organization derived its financial support primarily from the donations and registration fees of the participants in its seminars. Rev. Rul. 65-296, 1965-2 C.B. 163.