FEBRUARY 06, 1996

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

TO: Regional Directors
Child Nutrition Programs
Special Nutrition Programs

On October 10, 1995, we 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 here 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). The attachment repeats our questions to IRS and their response to those questions. We believe that IRS's answers are fairly straightforward, and we trust that this information will be helpful when answering common questions from current and prospective sponsors. If you have additional questions regarding the attachment, please contact Ed Morawetz or Norma Ball of my staff at (703) 305-2620.

/ORIGINAL SIGNED/

Frances F. Zorn
Acting Director
Child Nutrition Division

Attachment

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ATTACHMENT

The following are the initial questions we 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?

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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 pan 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 o 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?

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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 <u>may</u> receive exemption under a different section of the Code.

12. Question: Since child care <u>centers</u> 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

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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, although we have previously instructed States that 1099s are required and that CACFP reimbursement will be considered income to the provider unless the provider has records documenting the portion of the reimbursement used to purchase food for enrolled children. 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.]

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