

**DESCRIPTION OF PRESENT-LAW RULES
RELATING TO TAX TREATMENT OF
CHARITABLE ORGANIZATIONS**

Scheduled for a Hearing
before the
SUBCOMMITTEE ON OVERSIGHT
of the
HOUSE COMMITTEE ON WAYS AND MEANS
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Prepared by
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INTRODUCTION

The Subcommittee on Oversight of the House Committee on Ways and Means has scheduled a hearing on the response by charitable organizations to the September 11, 2001 terrorist attacks on the United States.

This document,¹ prepared by the staff of the Joint Committee on Taxation, contains an overview of the present-law rules related to the Federal tax treatment of charitable organizations, the Federal tax treatment of contributions to charitable organizations, and the rules relating to recognition of tax-exempt status and the filing requirements of charitable organizations.

¹ This document may be cited as follows: Joint Committee on Taxation, *Description of Present-Law Rules Relating to Tax Treatment of Charitable Organizations* (JCX-77-01), November 8, 2001.

I. OVERVIEW OF PRESENT-LAW RULES RELATING TO THE TAX TREATMENT OF CHARITABLE ORGANIZATIONS

In general

At present, 25 different types of nonprofit organizations qualify for tax-exempt status under section 501(c) of the Internal Revenue Code (the “Code”).² However, only organizations described in section 501(c)(3) of the Code are considered “charitable.” Such charitable organizations are subject to organizational and operational restrictions not faced by other tax-exempt organizations.

A section 501(c)(3) organization must operate primarily in pursuance of one or more tax exempt purposes constituting the basis of its tax exemption.³ The Code specifies such purposes as religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster international amateur sports competition, or for the prevention of cruelty to children or animals. In general, an organization is organized and operated for charitable purposes if it provides relief for the poor and distressed or the underprivileged.⁴ Failure to operate primarily for exempt purposes may result in loss of tax exemption or imposition of excise taxes depending on the type and severity of the violation. In order to qualify as operating primarily for an exempt purpose, the organization must satisfy the following operational requirements: (1) the net earnings of the organization may not inure to the benefit of any person in a position to influence the activities of the organization;⁵ (2) the organization must operate to provide a public benefit, not a private benefit;⁶ (3) the organization may not be operated primarily to conduct an unrelated trade or business;⁷ (4) the organization may not engage in substantial legislative lobbying;⁸ and

² For example, certain title and real property holding companies (sec. 501(c)(2)), social welfare organizations (sec. 501(c)(4)), labor, agricultural or horticultural organizations (sec. 501(c)(5)), trade associations (sec. 501(c)(6)), social clubs (sec. 501(c)(7)), cemetery companies (sec. 501(c)(13)), and credit unions (sec. 501(c)(14)). In addition, other Code sections provide general tax-exempt status for other entities, such as political organizations (sec. 527) and qualified pension plans (secs. 401(a) and 501(a)).

³ Treas. Reg. sec. 1.501(c)(3)-1(c)(1).

⁴ Treas. Reg. sec. 1.501(c)(3)-1(d)(2).

⁵ Violations of the “private inurement” prohibition may result in the imposition of excise taxes (commonly referred to as “intermediate sanctions”) on certain persons who engage in “excess benefit transactions” with section 501(c)(3) (or section 501(c)(4)) organizations (other than private foundations), and on organization managers who knowingly approve such transactions. Sec. 4958. In particularly severe cases of private inurement, the IRS may revoke an organization’s tax exemption in addition to imposing intermediate sanctions.

⁶ Treas. Reg. sec. 1.501(c)(3)-1(d)(1)(ii).

⁷ Treas. Reg. sec. 1.501(c)(3)-1(e)(1). Conducting a certain level of unrelated trade or business activity will not jeopardize tax-exempt status; however, too much of such activity will result in loss of tax-exempt status. There are no clear arithmetic standards for determining how

(5) the organization may not participate or intervene in any political campaign.⁹ In meeting the public benefit standard, Treasury’s regulations provide that “it is necessary for an organization to 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.”¹⁰ Thus, an organization described in section 501(c)(3) generally must serve a charitable class of persons that is indefinite or of sufficient size. Private benefit is permissible if it constitutes merely an “insubstantial part” of an organization’s total activities in light of all the facts and circumstances of a particular case. Excessive private benefit will result in loss of an organization’s tax-exempt status.

As discussed in more detail below, within certain limitations, donors to section 501(c)(3) organizations are entitled to deduct their contributions for Federal income tax purposes (if they itemize their deductions) and for Federal estate and gift tax purposes. In turn, recipients of charitable assistance may exclude the assistance from income as a gift.¹¹ Section 501(c)(3) organizations also may use the proceeds of tax-exempt financing (also discussed in more detail below). In contrast, contributions to other nongovernmental, tax-exempt organizations generally are not deductible¹² and such organizations are eligible only for the exemption from Federal income tax. Section 501(c)(3) organizations also may qualify for exemption from State and local taxes, preferential postal rates, and, in certain cases, are exempt from some federal excise taxes (e.g., taxes on highway fuels used by section 501(c)(3) school buses).

much unrelated activity an organization may conduct without jeopardizing its tax-exempt status. Rather, the determination is made based on a series of facts and circumstances determinations.

⁸ Treas. Reg. sec. 1.501(c)(3)-1(c)(3). Violation of this limitation may subject a section 501(c)(3) organization to excise taxes and/or loss of tax-exempt status.

⁹ The political activities prohibition for section 501(c)(3) organizations is absolute. Thus, it is not necessary for such activities to constitute a substantial part of an organization’s activities before the organization’s tax exemption will be in jeopardy. The Code provides three penalties that may be applied either as alternatives to revocation of tax exemption or in addition to loss of tax-exempt status: an excise tax (sec. 4955), termination assessment of all taxes due (sec. 6852(a)(1)), and an injunction against further political expenditures (sec. 7409).

¹⁰ Treas. Reg. sec. 1.501(c)(3)-1(d)(1)(ii).

¹¹ Sec. 102.

¹² Exceptions to the general rule of non-deductibility include certain gifts made to a veterans’ organization or a domestic fraternal society. In addition, contributions to certain nonprofit cemetery companies are deductible for Federal income tax purposes, but generally are not deductible for Federal estate or gift tax purposes. Secs. 170(c)(3), 170(c)(4), 170(c)(5), 2055(a)(3), 2055(a)(4), 2106(a)(2)(A)(iii), 2522(a)(3), and 2522(a)(4).

Section 501(c)(3) organizations are classified as either “public charities” or “private foundations.”¹³ Private foundations are defined under section 509(a) as all organizations described in section 501(c)(3) other than an organization granted public charity status by reason of (1) being a specified type of organization (i.e., churches, educational institutions, hospitals and certain other medical organizations, certain organizations providing assistance to colleges and universities, or a governmental unit); (2) receiving a substantial part of its support from governmental units or direct or indirect contributions from the general public; or (3) providing support to another section 501(c)(3) entity that is not a private foundation. In contrast to public charities, private foundations generally are funded from one or a limited number of sources (an individual, family, or corporation) and are subject to a number of restrictions not applicable to public charities.¹⁴ In general, more generous charitable contribution deduction rules apply to gifts made to public charities than the rules that apply to gifts made to private foundations.

Section 501(c)(3) organizations generally are not subject to Federal income tax on contributions received, on income from activities that are substantially related to the purpose of the organization’s tax exemption, or on investment income; although private foundations are subject to a two percent excise tax on their net investment income, as well as excise taxes for certain acts of self-dealing, failure to make sufficient charitable distributions, excess business holdings, jeopardizing business investments, and taxable expenditures (generally, expenditures for certain purposes, including lobbying, political activities, grants to individuals (without prior IRS approval), grants to organizations other than public charities unless special procedures are followed, and expenditures for noncharitable purposes).¹⁵ If a section 501(c)(3) organization engages in business activities unrelated to its exempt purpose, the organization may be subject to unrelated business income tax.¹⁶

Unrelated business income tax

Section 501(c)(3) organizations (and other tax-exempt organizations) are subject to the unrelated business income tax on income derived from a trade or business regularly carried on by the organization that is not substantially related to the performance of the organization's tax-exempt functions.¹⁷ Certain types of income, however, are exempt specifically from the

¹³ Sec. 509(a). Private foundations are either private operating foundations or private non-operating foundations. In general, private operating foundations operate their own charitable programs in contrast to private non-operating foundations, which generally are grant-making organizations. Most private foundations are non-operating foundations.

¹⁴ Secs. 4940-4945.

¹⁵ *Id.*

¹⁶ Secs. 511-514.

¹⁷ Secs. 511-514. Tax-exempt organizations are taxed on their unrelated business taxable income at the regular corporate tax rates (sec. 511(a)). Charitable trusts and other generally tax-exempt trusts are subject to tax on their unrelated business taxable income under the rates generally applicable to taxable trusts (sec. 511(b)).

unrelated business income tax, such as dividends, interest, royalties, and certain rents, unless derived from debt-financed property or from certain 50-percent controlled subsidiaries.¹⁸ Other exemptions from the unrelated business income tax are provided for activities in which substantially all the work is performed by volunteers, for income from the sale of donated goods, and for certain activities carried on for the convenience of members, students, patients, officers, or employees of a charitable organization.¹⁹ In addition, special unrelated business income tax provisions exempt from tax certain activities of trade shows and State fairs, income from bingo games, and income from the distribution of certain low-cost items incidental to the solicitation of charitable contributions.²⁰

Tax-exempt financing

Section 501(c)(3) organizations have access to tax-exempt financing through State or local governments. Interest on State or local government bonds is tax exempt when the proceeds are used to finance activities of those governmental units or the bonds are repaid with governmental funds (e.g., taxes). State and local governments also may act as conduits to provide tax-exempt financing for limited activities conducted and paid for by nongovernmental entities or individuals. One permitted type of such private activity conduit financing is for the exempt activities of section 501(c)(3) organizations. This exception generally does not include financing for unrelated business activities of such organizations.

¹⁸ Sec. 512(b).

¹⁹ Sec. 513(a).

²⁰ Secs. 513(d), (f), and (h).

II. FEDERAL TAX TREATMENT OF CONTRIBUTIONS TO CHARITABLE ORGANIZATIONS

In general

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and the fair market value of property contributed to an organization described in section 501(c)(3) or a Federal, State, or local governmental entity.²¹ The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.²²

In the case of a charitable contribution of inventory or other ordinary-income or short-term capital gain property, the amount of the deduction generally is limited to the taxpayer's basis in the property. In the case of a charitable contribution of tangible personal property, the deduction is limited to the taxpayer's basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose. In cases involving contributions to a private foundation (other than certain private operating foundations), the amount of the deduction is limited to the taxpayer's basis in the property.²³

A payment to a section 501(c)(3) organization (regardless of whether it is termed a "contribution") in exchange for which the donor receives an economic benefit is not deductible, except to the extent that the donor can demonstrate that the payment exceeds the fair market value of the benefit received from the section 501(c)(3) organization. To facilitate distinguishing charitable contributions from purchases of goods or services from charities, present law provides that no charitable contribution deduction is allowed for a separate contribution of \$250 or more unless the donor obtains a contemporaneous written acknowledgement of the contribution from the charity indicating whether the charity provided any good or service (and an estimate of the value of any such good or service) to the taxpayer in consideration for the contribution.²⁴ In addition, present law requires that any section 501(c)(3) organization that receives a contribution exceeding \$75 made partly as a gift and partly as consideration for goods or services furnished by the section 501(c)(3) organization is required to inform the contributor in writing of an estimate of the value of the goods or services furnished by the section 501(c)(3) organization and that only the portion exceeding the value of the goods or services is deductible as a charitable contribution.²⁵

²¹ The deduction also is allowed for purposes of calculating alternative minimum taxable income.

²² Secs. 170(b) and (e).

²³ Sec. 170(e)(1)(B).

²⁴ Sec. 170(f)(8).

²⁵ Sec. 6115.

Contribution limits

Individual taxpayers

Under present law, total deductible contributions of an individual taxpayer to public charities, private operating foundations, and certain types of private nonoperating foundations may not exceed 50 percent of the taxpayer's contribution base, which is the taxpayer's adjusted gross income ("AGI") for a taxable year (disregarding any net operating loss carryback).²⁶ To the extent a taxpayer has not exceeded the 50-percent limitation, (1) contributions of capital gain property to public charities generally may be deducted up to 30 percent of the taxpayer's contribution base, (2) contributions of cash to private foundations and certain other charitable organizations generally may be deducted up to 30 percent of the taxpayer's contribution base, and (3) contributions of capital gain property to private foundations and certain other charitable organizations generally may be deducted up to 20 percent of the taxpayer's contribution base.²⁷

Contributions by individuals in excess of the 50-percent limit may be carried over and deducted over the next five taxable years, subject to the relevant percentage limitations on the deduction in each of those years.

In addition to the percentage limitations imposed specifically on charitable contributions, present law imposes a reduction on most itemized deductions, including charitable contribution deductions, for taxpayers with AGI in excess of a threshold amount, which is indexed annually for inflation.²⁸ The threshold amount for 2001 is \$132,950 (\$66,475 for married individuals filing separate returns). For those deductions that are subject to the limit, the total amount of itemized deductions is reduced by 3 percent of AGI over the threshold amount, but not by more than 80 percent of itemized deductions subject to the limit. Beginning in 2006, the Economic Growth and Tax Relief Reconciliation Act of 2001 phases-out the overall limitation on itemized deductions for all taxpayers. The overall limitation on itemized deductions is reduced by one-third in taxable years beginning in 2006 and 2007, and by two-thirds in taxable years beginning in 2008 and 2009. The overall limitation on itemized deductions is eliminated for taxable years beginning after December 31, 2009; however, this elimination of the limitation sunsets on December 31, 2010.

Corporate taxpayers

Under present law, a corporation is allowed to deduct charitable contributions up to 10 percent of the corporation's modified taxable income for the year. For this purpose, taxable income is determined without regard to (1) the charitable contributions deduction, (2) any net operating loss carryback, (3) deductions for dividends received, (4) deductions for dividends paid on certain preferred stock of public utilities, and (5) any capital loss carryback for the taxable

²⁶ Sec. 170(b)(1)(A).

²⁷ Sec. 170(b)(1)(B), (C), and (D).

²⁸ Sec. 68.

year.²⁹ Any charitable contribution by a corporation that is not currently deductible because of the percentage limitation may be carried over for up to five taxable years.

A transfer of property by a business to a charity might qualify as either a charitable contribution or a deductible business expense, but not both. No deduction is allowed as a business expense under section 162 for any contribution that would be deductible as a charitable gift were it not for the percentage limitations on the charitable contributions deduction.³⁰ Likewise, a business transfer made with a reasonable expectation of financial return commensurate with the amount of the transfer is not deductible as a charitable contribution, but may be deductible under section 162.

Contributions of inventory

A taxpayer's deduction for charitable contributions of inventory generally is limited to the taxpayer's basis (typically, cost) in the inventory. However, corporations³¹ may claim a deduction in excess of basis for certain charitable contributions, including, in general, contributions of inventory to the ill, the needy, or infants, contributions of scientific property used for research, and contributions of computer technology and equipment for educational purposes. Sec. 170(e). This augmented deduction is equal to the lesser of (1) basis plus one-half of the item's appreciated value or (2) two times basis. To be eligible for an enhanced deduction, the taxpayer must establish that the fair market value of the donated item exceeds basis.

²⁹ Sec. 170(b)(2).

³⁰ Sec. 162(b).

³¹ The augmented deduction for inventory applies only to corporations organized under subchapter C of the Code, not to corporations organized under subchapter S. The augmented deduction for scientific property and computer technology and equipment is generally available to corporations except for S corporations, personal holding companies (sec. 542), and service organizations (sec. 414(m)(3)).

III. RECOGNITION OF TAX-EXEMPT STATUS AND FILING REQUIREMENTS

In general

In 1969, Congress required that section 501(c)(3) organizations (with certain exceptions) seek formal recognition of tax-exempt status by filing an application with the IRS (Form 1023).³² In response to the application, the IRS issues a determination letter or ruling either recognizing the applicant as tax-exempt or not.³³ Certain organizations are not required to apply for recognition of tax-exempt status in order to qualify as tax-exempt under section 501(c)(3) but may elect to do so. These organizations include churches, certain church-related organizations, organizations (other than private foundations) the gross receipts of which in each taxable year are normally not more than \$5,000, organizations (other than private foundations) subordinate to another tax-exempt organization that are covered by a group exemption letter, and for certain purposes only, charitable trusts described in section 4947(a)(1) that were organized before October 9, 1969.

Application process

A favorable determination by the IRS on an application for recognition of tax-exempt status (Form 1023) will be retroactive to the date that the section 501(c)(3) organization was created if it files a completed Form 1023 within 15 months from the end of the month it was formed.³⁴ If the organization does not file Form 1023 or files a late notice, it will not be treated as tax exempt under section 501(c)(3) for any period prior to the filing of an application for recognition of tax exemption.³⁵ Contributions to section 501(c)(3) organizations that are subject to the requirement that the organization apply for recognition of tax-exempt status are not deductible from income, gift, or estate tax until the organization receives a determination letter from the IRS.³⁶

Information required on Form 1023 includes: (1) information about previously filed Federal income tax and exempt organization returns; (2) a statement of receipts and expenditures

³² Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code.

³³ Internal Revenue Manual 7751, Exempt Organizations Handbook, sec. 111.

³⁴ Pursuant to Treas. Reg. sec. 301.9100-2(a)(2)(iv), organizations are allowed an automatic 12-month extension as long as the application for recognition of tax exemption is filed within the extended, i.e., 27-month period. The IRS also may grant an extension beyond the 27-month period if the organization is able to establish that it acted reasonably and in good faith and that granting relief will not prejudice the interests of the government. Treas. Reg. secs. 301.9100-1 and 301.9100-3.

³⁵ Treas. Reg. sec. 1.508-1(a)(1).

³⁶ Sec. 508(d)(2)(B).

for the current year and the three preceding years (or for the number of years of the organization's existence, if less than four years); (3) a balance sheet for the current year; (4) a detailed statement of actual and proposed activities; (5) a description of anticipated receipts and contemplated expenditures; (6) a copy of the articles of incorporation, trust document, or other organizational or enabling document; and (7) organization bylaws (if any).

A determination letter issued by the IRS will state that the application for recognition of tax exemption and supporting documents establish that the organization submitting the application meets the requirements section 501(c)(3) and will classify the organization as either a public charity or a private foundation. An organization that has received a favorable tax-exemption determination from the IRS generally may continue to rely on the determination as long as "there are no substantial changes in the organization's character, purposes or methods of operation."³⁷

An organization can request that the IRS expedite a determination letter application. Under the Internal Revenue Manual, requests for expedited treatment must be made in writing and contain a compelling reason why a case should be worked ahead of its normal date order. In general, expedited treatment is granted in the following circumstances: (1) when a grant to the applicant is pending and the failure to secure the grant may have an adverse impact on the organization's ability to continue operations; (2) when the purpose of the newly created organization is to provide disaster relief to victims of emergencies such as flood and hurricane; (3) when there have been undue delays in issuing a determination letter caused by problems within the IRS; and (4) in any other situation where the Division Chief or his or her delegate feels expedited service is warranted. The IRS has established a special expedited review and approval process for new organizations seeking tax-exempt status to provide relief to the victims of the September 11, 2001 attacks on the United States. Such new organizations should apply for tax-exempt status by filing Form 1023 and writing at the top of the form "Disaster Relief, September 11, 2001" and the IRS will give such applications immediate attention.³⁸

A ruling or determination letter may be revoked or modified by (1) notice from the IRS to the organization to which the ruling or determination letter was originally issued; (2) enactment of legislation or ratification of a tax treaty; (3) a decision of the United States Supreme Court; (4) issuance of temporary or final Regulations by the Treasury Department; or (5) issuance of a revenue ruling, a revenue procedure, or other statement in the Internal Revenue Bulletin.³⁹ An organization's tax exemption will not be terminated if it becomes inactive for a time so long as

³⁷ Treas. Reg. sec. 1.501(a)-1(a)(2).

³⁸ IRS News Release No: IR-2001-82 (Sept. 18, 2001).

³⁹ Rev. Proc. 90-27, 1990-1 C.B. 514; IRS Pub. No. 557 at 4.

the organization does not cease to be a legal entity under the laws of the State in which it is organized.⁴⁰

Upon revocation of tax-exemption or change in the classification of an organization (e.g., from public charity to private foundation status), the IRS publishes an announcement of such revocation or change in the Internal Revenue Bulletin.⁴¹ Contributions made to organizations by donors who are unaware of the revocation or change in status ordinarily will be deductible if made on or before the date of publication of the announcement.⁴²

Annual filing requirements for section 501(c)(3) organizations

Section 501(c)(3) organizations generally are required to file an annual information return with the IRS. An organization that has not received a determination of its tax-exempt status, but that claims tax-exempt status under section 501(a), is subject to the same annual reporting requirements and exceptions as organizations that have received a tax-exemption determination.

Section 501(c)(3) organizations that are classified as public charities must file Form 990 (Return of Organization Exempt From Income Tax) and an additional form, Schedule A, which requests information specific to section 501(c)(3) organizations. An organization that is required to file Form 990, but that has gross receipts of less than \$100,000 during its taxable year, and total assets of less than \$250,000 at the end of its taxable year, may file Form 990-EZ instead of Form 990. Private foundations are required to file Form 990-PF rather than Form 990.⁴³

On the applicable annual information return, organizations are required to report their gross income, information on their finances, functional expenses, compensation, activities, and other information required by the IRS in order to review the organization's activities and operations during the previous taxable year and to review whether the organization continues to meet the statutory requirements for exemption. Examples of the information required by Form 990 include (1) a statement of program accomplishments, (2) a description of the relationship of

⁴⁰ An inactive organization, however, is required to file an annual information return unless it is covered by one of the exceptions to the filing requirements described below. IRS Pub. No. 557 at 11.

⁴¹ Rev. Proc. 82-39, 1982-2 C.B. 759.

⁴² *Id.*

⁴³ Form 990-PF requires, among other things: information about the foundation's gross income for the year; information about expenses attributable to such income; information about disbursements for exempt purposes; information about total contributions and gifts received, and the names of all substantial contributors; names, addresses, and compensation of officers and directors; an itemized statement of securities and other assets held at the close of the year; an itemized statement of all grants made or approved; and information about whether the organization has complied with the restrictions applicable to private foundations (secs. 4941-4945).

the organization's activities to the accomplishment of the organization's exempt purposes, (3) a description of payments to individuals, including compensation to officers and directors, highly paid employees and contractors, grants, and certain insider transactions and loans, (4) disclosure of certain activities, such as expenses of conferences and conventions, political expenditures, compliance with public inspection requirements, and lobbying activities.

Any organization that is subject to the unrelated business income tax and that has \$1,000 or more of gross unrelated business taxable income must file Form 990-T. An organization described in section 501(c) must file Form 1120-POL for any year in which it has net investment income and expends any amount to influence the selection, nomination, election or appointment of any individual to office, unless either the amount of such expenditures or the organization's net investment income does not exceed \$100 for the taxable year. Public charities that make an election under section 501(h) regarding permitted lobbying expenditures and that incur tax for excess lobbying expenditures must also file Form 4720. Section 501(c)(3) organizations generally must file reports and returns applicable to taxable entities with respect to Social Security taxes but not with respect to Federal unemployment taxes.

The requirement of filing an annual information return does not apply to churches, their integrated auxiliaries, and conventions or associations of churches; certain organizations (other than private foundations), the gross receipts of which in each taxable year are normally not more than \$25,000; the exclusively religious activities of any religious order; an interchurch organization of local units of a church; certain mission societies; and certain church-affiliated elementary and high schools.⁴⁴

⁴⁴ Sec. 6033(a)(2)(A); Treas. Reg. sec. 1.6033-2(a)(2)(i); Treas. Reg. sec. 1.6033-2(g)(1).