THE TAX EXEMPT TOOL KIT

These materials were produced in connection with ABA Section of Taxation continuing legal education programs, and was designed as a resource for nonprofit organizations, their boards of directors, officers, volunteers, and other nonprofit staff. They represent the statements and views of the authors and do not necessarily represent the official policies or positions of the American Bar Association or the ABA Section of Taxation. The American Bar Association and the Section of Taxation do not accept responsibility for the accuracy of the information in these materials, nor for any interpretation or application by the reader of the information contained in this volume. These papers are not intended to be, nor should they be construed as constituting the opinion of, or legal or tax advice with regard to specific cases or transactions by the author, the Tax Section or the American Bar Association.

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Addendum to "The Tax Exempt Tool Kit"

Contains updates on the new IRS filing thresholds for the 2010 tax year for nonprofit organizations.

First off, if your organization's fiscal year is the calendar year (ends December 31st), you need to be sure to file the appropriate form 990 with the IRS. They will revoke your status if you do not file for 3 consecutive years, so don't let this due date pass.

There's good news for most nonprofits regarding filing your 990 forms for reporting your organization's revenue and expenses to the IRS. The new thresholds should mean simpler forms to file for many organizations.

The 990 filing thresholds for the year 2010 and later (filed in 2011 and later) have changed and are as follows for all organizations required to file a 990-series return:

Organizations with gross receipts normally < $50,000 must file Form 990-N (but may choose to file a complete Form 990 or Form 990-EZ). In prior years only organizations with gross receipts normally< $25,000 could file the Form 990-N ("e-postcard").

Organizations with gross receipts > $50,000 and < $200,000 and total assets < $500,000 must file Form 990-EZ or a complete Form 990.

Organizations with gross receipts > $200,000 or total assets > $500,000 must file Form 990.

Private foundations must file Form 990-PF; no exceptions.

As always, if you have any questions regarding this, please feel free to give us a call at 800-928-4161. We are happy to handle your tax exempt filings on behalf of your organization in almost all cases.

You can read more here at the IRS website:
http://www.irs.gov/charities/article/0,,id=184445,00.html

All the best,
Thomas Wrobel

This Tax Exempt Tool Kit began as a joint project of the American Bar Association Tax Section Diversity Committee, the American Bar Association Commission on Racial and Ethnic Diversity in the Profession, the American Bar Association Business Law Section Nonprofit Committee and the Asian and Asian American Studies Department of Loyola University, Chicago, IL. The first seminar was held at the American Bar Association annual meeting in August 2001. The materials were also placed on the American Bar Association Tax Section's web site at http://www.abanet.org/tax/. This seminar is being held in conjunction with the American Bar Association Tax Section's Fall Meeting. There are plans to continue the program at future American Bar Association Tax Section meetings. The Commission on Racial and Ethnic Diversity in the Profession plans to have the materials translated into several languages.

The Tax Exempt Tool Kit is designed to gives directors, executives, volunteers and others associated with small exempt organizations, a basic overview of the various laws and financial responsibilities that the average small exempt organization is faced with. The Tax Exempt Tool Kit will provide basic introductory information for smaller tax exempt organizations on a myriad of issues such as:

- How to start a tax exempt organization.
- Lobbying and political activities.
- Federal and state filing requirements.
- Fiduciary responsibilities for the board of directors.
- Unrelated business activities.
- Intermediate sanctions.
- Employment issues.
- Accounting issues.
- Public disclosure requirements.
- Internet activities.
- Charitable contribution vs. business expenses.
- Basic contract law.
- Copyright and trademark issues.
- Bibliography of helpful websites and much more.

The toolkit is not a treatise or a comprehensive explanation on any one issue. Thus, for specific questions, readers should consult with competent legal counsel and/or an accountant. The primary focus will be on public charities exempt under Section 501(c)(3) but there will be some information geared towards Section 501(c)(4) organizations and trade association or business leagues exempt under Section 501(c)(6).

All references in this outline to a Code are to the Internal Revenue Code of 1986, as amended and the Treasury Regulations promulgated thereunder (hereinafter referred to as the "Code"). Unless otherwise noted, "Section" shall refer to sections of the Code. References to the IRS mean the Internal Revenue Service. Many references to Exempt Organizations are made using the abbreviated term "EO". Similarly, references to unrelated business taxable income after sometimes made using the abbreviated term "UBTI".

Section I. Tax Exempt Organizations[1]

This section will provide a general overview of the rules and restrictions governing the following tax exempt organizations:

501(c)(3) organizations – charities and private foundations

501(c)(4) organizations – social welfare organizations

501(c)(6) organizations – trade associations and business leagues

A. Section 501(c)(3) Charitable Organizations

Many nonprofit organizations qualify for exemption from federal income tax under section 501(c)(3) of the Code. To be exempt as a charitable entity, the organization must be both organized and operated for one of the below permissible purposes. The organization's articles of incorporation and bylaws must limit the purposes of the organization to one or more of the exempt purposes. Additionally, the organization's the may not engage in substantial lobbying, political activities or allow its assets to inure to the private benefit of any individual.

1. Organized and Operated for Exempt Purposes

An organization applying for recognition as a charitable organization under Section 501(c)(3) of the Code must be organized and operated for exempt purposes. These exempt purposes include: religious, charitable, scientific, literary, or educational purposes, testing for public safety, the prevention of cruelty to children or animals, or the promotion of national or international amateur sports competition. Most smaller charitable organizations are organized and operated for charitable, educational, scientific or religious purposes.

- **Charitable**

"Charitable" organizations are those whose purposes include one or more of the following: relief of the poor or underprivileged; advancement of religion; advancement of education or science; erection or maintenance of public building, monuments or works; lessening the burdens of government; and the promotion of social welfare by an organization designed to reduce neighborhood tensions, eliminate prejudice or discrimination, defend human or civil rights secured by law, or deter juvenile delinquency or community deterioration. Additionally, although Treasury Regulations do not contain any specific reference to it, the IRS and the Courts consider the promotion of health to be a charitable purpose.

- **Educational**

"Educational," for purposes of Section 501(c)(3) of the Code, includes both the instruction of individuals in order to improve their abilities and "the instruction of the public on subjects useful to the individual and beneficial to the community." The broad scope of this definition embraces conventional classroom instruction, the publication and distribution of written or recorded materials, public television and more. The IRS has issued guidance in Revenue Procedure 86-43, which focuses not on content but on the methods used by the organization to educate the public. To qualify as educational, an organization must "provide a factual foundation for the viewpoint or position being advocated" or "provide a development from the relevant facts that would materially aid a listener or reader in a learning process."

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[1] Portions of the materials in this section are being reproduced from *the Guidebook for Directors of Nonprofit Corporations* written by the Nonprofit Corporations Committee of the Business Law Section of the American Bar Association. Remaining portions were written by Alexis Neely and Shannon Nash

- **Scientific**

An organization has a scientific purpose if its research efforts are in the public interest. The IRS treats scientific research as being in the public interest if any one of the following conditions is satisfied:

1. The results of the research (including any intellectual property resulting from it) are made available to the public on a nondiscriminatory basis, or

2. The research is performed for a federal government agency, a state or a political subdivision of a state, or

3. The research is directed toward benefiting the public.

- **Religious**

An organization operating exclusively for religious purposes qualifies for exemption under Section 501(c)(3) of the Code. The IRS and the courts are reluctant to precisely define what is or is not a religious activity or organization due to the proscription against establishment of religion in the First Amendment of the United States Constitution. Consequently, federal tax law lacks a workable definition of the term. There are several categories of institutions that may be regarded as religious organizations, including churches, conventions and associations of churches, religious orders, schools, corporations, community chests, funds, or foundations.

The concept of a church is narrower than that of a religious organization. The IRS's position is that to be a church for tax purposes an organization must satisfy at least some of the following criteria: a distinct legal existence, a recognized creed and form of worship, a definite and distinct ecclesiastical government, a formal code of doctrine and discipline, a distinct religious history, a membership not associated with any other church or denomination, an organization of ordained ministers, ordained ministers selected after completing prescribed studies, a literature of its own, established places of worship, regular congregations, regular religious services, Sunday schools for the religious instruction of the young, and schools for the preparation of ministers. The IRS makes it clear that these criteria are not exclusive and are not mechanically applied; the analysis considers the totality of the facts and circumstances.

2. Prohibitions

Organizations recognized as tax-exempt under Section 501(c)(3) are subject to three basic prohibitions.

- **Private Benefit and Private Inurement**

The first prohibition protects the public nature and purpose of 501(c)(3) organizations by prohibiting private inurement and private benefit. The private inurement prohibition provides that no part of the organization's net earnings may inure to the benefit of any private individual. This is an absolute bar and a violation of the private inurement prohibition can result in the loss of tax-exemption. However, in 1996 Congress enacted Section 4958 of the Code, which imposes penalties on the insiders who receive excess benefits from their direct or indirect transactions with the organization. Although these intermediate sanctions are not in lieu of loss of exemption, the IRS will in many situation assert these sanctions first and give the organization a chance to remedy the problem.

The prohibition on private benefit provides that a 501(c)(3) organization may not be operated for the benefit of private interests. In contrast to the strict prohibition on private inurement, an incidental amount of private benefit is permitted. The incidental nature of a private benefit is examined both qualitatively and quantitatively. The qualitative element considers whether the private benefit to insiders is a necessary concomitant of the activity which benefits the public at large, meaning that the activity can be accomplished only by benefiting private individuals. The quantitative element considers whether the private benefit is substantial after considering the overall public benefit conferred by the activity.

- **Lobbying**

The second prohibition requires that no substantial part of an organization's activities attempt to influence legislation. An attempt to influence legislation can occur in two ways; 1) the organization contacts, or urges the public to contact, members of a legislative body for the purpose of proposing, supporting, or opposing legislation; or 2) advocates the adoption or rejection of legislation. A permissible amount of lobbying is allowed before an organization jeopardizes its tax-exempt status. Lobbying is discussed in Section IV of the outline.

- **Political Campaigns**

The third prohibition, prohibits organizations from participating in any political campaign. This, unlike the lobbying prohibition, is an absolute bar. The political campaign prohibition is triggered if there is participation or intervention by the organization in a political campaign with respect to an individual who is a candidate for a public office. All four elements must be met before the prohibition becomes effective. The political campaign prohibition is discussed in Section IV of the outline.

3. Private Foundations[2]

All organizations applying for recognition as tax-exempt under Section 501(c)(3) of the Code are presumed to be private foundations. This presumption is rebutted by establishing that the organization is a public charity, meaning that it is either a publicly supported organization or that it supports a publicly supported organization (a "public charity"). The public support test is discussed in Section III of the outline under the Form 1023 discussion. Smaller charitable organizations generally do not want to be treated as private foundations because such organizations are subject to the following stricter restrictions on their activities.

- **Charitable Contributions**

Deductions for contributions of appreciated assets to a private foundation are limited to the cost basis of the assets unless the contribution is of stock for which market quotations are readily available. This is a significant limitation as many donors are interested in donating appreciated assets to avoid incurring capital gains tax on a sale of such property. Also, contributions of cash are deductible only up to 30% of the donor's adjusted gross income; contributions of other assets are deductible only up to 20% of the donor's adjusted gross income.

- **Net Investment Income**

A private foundation must pay a tax of 2% of its net investment income. This 2% tax can be reduced to 1% if the organization makes additional qualifying distributions under section 4942 (see discussion below annual distribution of income).

- **Self Dealing**

A tax is imposed on acts of self-dealing, which include a direct or indirect sale or exchange between the private foundation and a disqualified person.

- **Annual Distribution of Income**

The failure to annually distribute an amount equal to 5% of the fair market value of the investment assets of a private foundation is subject to an excise tax.

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[2] The law relating to private foundations is beyond the scope of this article and, therefore, will not be discussed outside of this section.

- **Excess Business Holdings**

A private foundation is taxed on any business holdings in excess of 20% (or in some cases 35%) of a corporation's voting stock other equivalent interest in a business enterprise.

- **Jeopardizing Investments**

An excise tax is imposed on jeopardy investments, such as puts, calls, and straddles.

- **Taxable Expenditures**

Payments to persons or entities other than qualified public charities are taxed unless the foundation exercises expenditure authority over the payments.

- **Grant Restrictions**

Finally, the most important disadvantage of qualifying as a private foundation, rather than as a public charity, is that many grantmakers (themselves typically private foundations) are probably only willing to make grants to an organization that qualifies as a public charity. Therefore, it is very important that your organization comply with all the requirements necessary to maintain public charity status.

B. Section 501(c)(4) Organizations

1. Purposes

An organization applying for exemption under 501(c)(4) must be operated exclusively for the promotion of social welfare.

2. Prohibitions

A 501(c)(4) organization may not, as its primary activity, conduct a business with the general public in a commercial manner. Any earnings of such an organization must be devoted exclusively to charitable, educational, or recreational purposes.

3. Comparison to 501(c)(3)

Although the requirements of 501(c)(3) and 501(c)(4) appear to be similar, a corporation may more easily satisfy the requirements of 501(c)(4). First, it may benefit a smaller or more specific group or community than would qualify a corporation for charitable status under 501(c)(3). Second, a 501(c)(4) organization may engage in some social activities, some lobbying and some political activity.

Section 501(c)(3) status is preferable to 501(c)(4) status if tax-deductible contributions or tax-exempt financing is important to the organization. However, 501(c)(4) status may be advantageous if:

1. lobbying will be a substantial part of the corporation's activities,
2. freedom to support or oppose candidates for office is sought, or
3. the organization would be subject to the restrictions imposed on a private foundation if the organization were exempt under 501(c)(3)

However, if an organization was once exempt as a 501(c)(3) organization, but has lost its exemption because of lobbying or political campaign activities, it cannot then convert into a 501(c)(4) organization.

C. Section 501(c)(6) Organizations

1. Purposes

An organization applying for exemption under 501(c)(6) must be composed of persons having a common business interest and the organization must promote such interest. These organizations must improve the business condition of the industry in general rather than benefiting individual members by supplying such members with such things as management services or improving the economy and convenience of conducting individual businesses. The corporation may satisfy the requirement, if as a whole, it represents all components of an industry or line of business within a particular geographic area. The corporation generally may not, however, be in competition with another group within the same industry or line of business, although members within the corporation may compete with each other. Generally trade associations, professional associations and business leagues will qualify as section 501(c)(6) organizations.

2. Prohibitions

Section 501(c)(6) organizations are subject to a similar private benefit and private inurement prohibition. Although there is not an absolute prohibition against political activities, a section 501(c)(6) organization may not engage in political activities as its primary activity. However, these organizations may engage in lobbying as its primary activity without jeopardizing its tax exempt status.

D. Bibliography

www.irs.ustreas.gov/prod/bus_info/eo - IRS website providing general information for tax exempt organizations.

http://www.irs.ustreas.gov/prod/forms_pubs/index.html - IRS Publication 557 *Tax Exempt Status for Your Organziation.*

http://www.deathandtaxes.com/pub1828.htm – Publication 1828 *Tax Guide for Churches and Other Religious Organizations.*

Guidebook for Directors of Nonprofit Corporations, Chapter 4, "Taxation"(2nd ed., G. Overton and J. Frey, eds.; American Bar Association, 2002).

Section II. State Formation and State Tax Exemption Issues

This Section will briefly describe the primary legal issues and requirements relating to formation of a nonprofit corporation under state law and establishment and maintenance of tax-exempt status.

A. State Formation Issues[3]

Although some non-incorporated associations may qualify for tax-exempt status, the most well-known kinds of tax-exempt organizations, including 501(3) community and public benefit organizations, are commonly organized as nonprofit corporations under state law. Many states have separate nonprofit corporation statutes. However in some states nonprofits (sometimes referred to as "non-stock" corporations) are formed under the state's general corporations law.

1. Articles of Incorporation

To incorporate, an organization must file articles of incorporation (or other charter document depending on the state) that set forth the organization's purposes. Articles of EOs should contain language that affirmatively tracks the exempt purposes language contained in the Code and disavows use of the corporation's assets for private inurement and private benefit.

For 501(c)(3)s, the purposes language in the organization's articles should at a minimum state that:

- the organization is organized and operated exclusively for charitable purposes;
- none of its earning shall inure to the benefit of private individuals;
- no substantial part of the activities of the EO shall constitute the carrying on of propaganda or otherwise attempting to influence legislation;
- the EO shall not intervene in political campaigns;
- it is not a private foundation;
- (catch all phrase -) the EO shall not carry on any other activities not permitted to be carried on by an organization exempt from federal income tax under section 501(c)(3); and
- upon the dissolution of the EO, its assets shall be distributed for one or more exempt purposes within the meaning of section 501(c)(3) of the Internal Revenue Code or corresponding section of any future federal tax code, or shall be distributed to other 501(c)(3) organizations as are designated in the corporation's organizational documents, by the organization's board or member(s), or a local court, at the time of dissolution, or otherwise for a charitable or public purposes.

The articles of incorporation must be executed by an incorporator. In most states, the incorporator need only be an individual, at least 18 years of age. The incorporator(s) generally need not be an "organizer" or be a future director or officer of the new corporation. An attorney can and often does act as the incorporator by signing the initial articles of incorporation. Initial articles often include the names of the members of the initial board of directors. The articles of incorporation are then filed with the appropriate state agency (generally the Secretary of State's office) along with a filing fee. The EOs legal existence begins when the Secretary of State accepts the articles of incorporation for filing.

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[3] The Section was prepared by Jeannie Carmedelle Frey of the ABA Business Law Section's Nonprofit Corporation's Committee and Shannon Nash.

Although most nonprofit corporations incorporate in the State where their principal activity is located, nonprofit corporations may incorporate in any state, and then register as a "foreign" corporation doing business in the state(s) of their physical operation. This principle also applies to nonprofit corporations that operate primarily over the Internet. Although such Internet-based organizations may be deemed to be doing business in the state in which their server or any employees/volunteers are located, they can choose another state as their state of incorporation. Nonprofit organizers should be aware of a state's general regulatory regime as it applies to nonprofits before incorporation. If a nonprofit chooses to incorporate in a state in which it has no physical presence, it will need to pay someone -- such as a corporation service company – to serve as the corporation's registered agent in the state.

For "national" nonprofits (such as the United Way) with many local chapters, the organization may either incorporation in a single state and register as a foreign corporation doing business in each state in which a chapter is located, or may have each chapter separately incorporate. For liability purposes, many such national organizations choose the latter approach.

2. Bylaws

The EO's board must adopt Bylaws, which generally provide the internal governing procedures for the organization. The Bylaws typical include details on the following sections:

- Name of the EO;
- If a membership organization, details on the members, annual meetings, and member voting rights;
- Board of Directors - number, how chosen , duties, meetings and voting requirements;
- Officers – how appointed, duties;
- Committees of the Board of Directors – general or specific provisions for standing committees and ad hoc committees;
- Financial Management issues – such as fiscal year;
- Indemnification of officers and directors; and
- Miscellaneous other provisions, including amendment provisions.

3. Maintenance of Corporate Organization and Meeting Documents

The EO should maintain a corporate minute book containing all of its organization documents (Articles/Charter and Bylaws) and the corporate minutes taken at each meeting of the members and directors. The minute book serves as a record of actions taken by the corporation (through its Board and members). It thus serves as legal evidence of such actions and their due authorization. The minute book is also a good place to keep the EO's federal tax-exemption determination letter.

B. Board of Directors

1. Duties of Care and Loyalty

In carrying out their governance function as a board member, the board or directors act as fiduciaries in the corporation's behalf. As such, directors are subject to two primary obligations: a duty of care and a duty of loyalty. A third duty, the duty of obedience to a nonprofit corporation's purposes, is sometimes also said to apply to nonprofit directors. However, such duty may also be deemed to be included within the director's duty of care and the duty of loyalty.

2. Duty of Care

The Duty of Care requires a director to act in a reasonable and informed manner when taking part in board deliberations and activities. The director is generally expected to use the same degree of care as an ordinarily prudent person in a like position would believe appropriate under similar circumstances. At minimum, the director can fulfill this duty of care by reading board packet materials in advance; regularly attending board and committee meetings; and actively participating in board discussions. The director should also determine whether proper procedures are in place to assure that the corporation complies with applicable law.

The Duty of Care requires use of informed, independent judgment when participating as a member of the board. Thus directors should:

a. Understand and act in a manner that supports the corporation's mission and purposes.

b. Make sure the Board is receiving the level of information necessary to make informed decisions.

c. Reasonably rely on staff, Board committees, and outside experts, but avoid undue reliance on opinions of board members and executive management.

d. Ask questions; be persistent.

e. Understand the higher level of care that may apply to you if you have special training (lawyer, accountant, banker, insurance agent, etc.) or if you also serve as an executive of the organization

3. Duty of Loyalty

The Duty of Loyalty requires a director to place the corporation's interests above the director's personal interests. Duty of Loyalty issues may arise in the following situations:

- **Conflicts of Interest**

Directors may have interests in conflict with the EO. The "classic" conflict of interest situation occurs when a director or other insider has a material personal interest in a proposed transaction to which the EO may be a party. For example, the director may personally involved with a transaction , or may have an employment or investment relationship with an entity that the EO is dealing with (such as a bank or other vendor, or a prospective buyer or seller of property), or a family member may be involved in a proposed transaction. Conflicts of interest involving a director are not inherently illegal, nor are they to be regarded as a reflection on the integrity of the board or of the director. It is the manner in which the director and the board deals with a disclosed conflict which determines the propriety of the transaction. It is highly recommended that EOs have a written conflict of interest policy which sets forth requirements for annual and periodic disclosures of actual and potential conflicts of interests, and procedures for addressing conflicts that arise. A director's conflicts should be addressed by the following:

a. Disclosure – the conflict must be disclosed to the other members of the board, and

b. Informed Consideration – any transaction relating to the conflict generally may be approved by a majority of disinterested board members (or a committee thereof). Ideally (and as may be required by the organization's conflict of interest policy) the interested director should not be present during the discussion and vote on such transaction. The disinterested persons should determine if the transaction is in the best interests of the EO,

even if the interested director (or family member) receives benefits (but no more than fair market value). Some states, such as California, have stricter provisions than others relating to what factors must be present for a transaction involving an interested director to be valid, such as a board determination that the corporation could not have obtained a more advantageous arrangement with reasonable effort.

Also, a transaction between an insider (or family member) and the corporation may be subject to challenge by the IRS as an "excess benefit" transaction, under which both the insider and the organization directors or managers who approved the transaction could be required to pay certain penalties, as discussed in Section V of this Outline. In such cases the conflict should be dealt with by following the procedures for establishing a "rebuttable presumption of reasonableness," as referenced in Section V.

- **Competition; Usurpation of Corporate Opportunities**

Generally, a director or other EO insider may not compete with the organization without resigning his or her position. Similarly, an EO insider is prohibited under the duty of loyalty principles from taking advantage of a transaction that the insider should know would be of interest to the EO, without prior disclosure and giving the EO first opportunity to take advantage of the opportunity. Whether or not a transaction is regarded as a "corporate opportunity" depends on a number of factors, including how the insider found out about the opportunity

- **Confidentiality; Use of Corporate Assets**

A director should not disclose information about the EO's activities unless they are already known by the public or are of public record. Moreover, the director should not use the EO's proprietary information, or any other corporate asset, for personal purposes or benefit.

4. General Responsibilities of Directors

a. Varies with size of board, size of organization, and type of organization

b. In general, directors are expected to oversee ongoing operations and help define long-term direction and policies.

c. Fundraising

d. Representing corporation in community

e. Roles of "special purpose" director – identify expectations and hazards for: new board members; directors appointed by or as a "representative" of the organization's members or its beneficiaries; directors with special expertise (such as attorneys, financial managers, accountants, etc.)

5. Indemnification

Generally, a director's possible liability in litigation does not arise simply because the EO may be liable; it arises because the director is charged with some breach of duty owed either to the EO or to a specific party. In some cases the EO itself may be the party asserting the claim – generally, that the director has breached the duty of care or the duty of loyalty. The director should be informed regarding what indemnification and insurance is provided for directors, in the corporation's Bylaws and other documents. The director should also inquire about any statutory exoneration or other legal provisions that may limit the director's liability.

Further, the director (or prospective director) should review the level of indemnification available under the corporation's Articles, Bylaws and under State law. Is indemnification "to the maximum extent permitted by law" mandatory, or at the discretion of the board? Are indemnifiable expenses incurred payable in advance?

- **Director's and Officer's Insurance**

Even if the EO has expansive indemnification provisions in its articles of incorporation or bylaws, these assurances must be considered in light of the financial strength of the EO. Director's and officer's insurance may provide the extra protection that directors require to serve on the EO's board. The director should know if there is a D & O insurance in place, and if so, should understand what the policy does and does not cover.

- **Contractual Rights**

Consider contractual rights to indemnification – contracts with the corporation itself; and contracts with third parties that may provide indemnification of directors.

- **State and Federal Protection Statutes**

State and federal volunteer protection statutes may provide some protection from liability for non-management directors.

C. State Tax Exemptions and Filings

Once the EO receives federal exemption, it may apply from exemption from various state taxes.

1. State Income Tax

EOs must file a form with the appropriate state taxing to be exempt from income taxes. In some states this involves filing out a short form and attaching a copy of the IRS determination letter stating that the organization is exempt. Once granted, no income tax returns need to be filed unless the organization has UBIT. There is typically a small filing fee associated with this application.

2. Property Tax

In general, property owned by a charitable organization that is used in furthering its exempt purpose will qualify from exemption from state property taxes. In most states, this exemption is not automatic and the EO must file for exemption with the proper state entity. These applications may be time-consuming to prepare, depending on the size and nature of the property at issue. Generally the property tax affects real property owned – but in some states or localities there are also property taxes on tangible personal property (i.e., office furniture, computers, etc.). There is typically a filing fee associated with such applications. Some communities may be more stringent than others in granting property tax exemptions, due to budgetary concerns and taxpayer pressures.

3. Sales and Use Tax

The EO may also qualify for exemption from sales and use taxes on tangible personal property that it purchases. Again, in many states an application must be filed to receive this exemption. There is typically a small filing fee associated with this application. This exemption does not apply to sales taxes that may be levied on the tangible personal property that the EO sells to a third party. Thus, the EO may have the duty to collect a sales tax from a third party and remit such amounts to the appropriate state taxing authorities.

4. Federal Postage Reduction

EOs may apply for a reduced postal rate for their mailings through the US Postal Service. PS Form 3624, *Application to Mail at Nonprofit Standard Mail Rates*, must be completed and filed with the EOs local post office.

5. Charitable Solicitation License

Prior to soliciting any contributions in most states, charities exempt under section 501(c)(3) intending to solicit contributions must register with an appropriate state(s) agency (typically the state's Attorney General's office) to obtain a charitable solicitation license. There is typically a small filing fee associated with this license and then an annual fee generally based on the amount of solicitations. In some states certain organizations, such as churches, are exempt from this registration. Also, some states regulate solicitation made by professional fundraisers. In these states the professional fundraiser must register with the appropriate state agency and in often the actual contracts between the fundraisers and the charity must be filed with the state. If a charitable organization raises funds over the Internet, it may need to register under the charitable solicitation laws of other states and localities.

D. Bibliography

www.irs.ustreas.gov/prod/bus_info/eo – IRS website that provides information for tax exempt organizations and help in completing Form 1023.

http://www.irs.ustreas.gov/prod/forms_pubs/index.html – IS website with link to Publication 557 *Tax Exempt Status for Your Organization.*

www.nonprofit-info.org. – sample bylaws and articles.

http://www.mapnp.org/library/boards/boards – Sample articles of incorporation and bylaws for nonprofit corporations, and other information and samples useful to nonprofit boards and executives.

http://www.usps.gov – for a copy of PS Form 3624, *Application to Mail at Nonprofit Standard Mail Rates.*

Guidebook for Directors of Nonprofit Corporations (2nd ed., G. Overton and J. Frey, eds.; American Bar Association, 2002).

Nonprofit Governance and Management (V. Futter, et. al., eds., American Bar Association and American Society of Corporate Secretaries, 2002).

Section III. Federal Exemption

Section III will explore the process involved with seeking exemption from federal income taxes and provide a detailed analysis of IRS Form 1023 and Form 1024.

A. Internal Revenue Service Form 1023[4]

An organization that is applying for exemption under section 501(c)(3) must file IRS Form 1023, Application for Recognition of Exemption Under Section 501(c)(3). [5] This following is a part by part analysis of the Form 1023. It is recommended that before filling out a Form 1023, a copy of the instructions for this form be obtained and a tax advisor by consulted.

Part I - Identification of Applicant

In this section the organization must provide general background information such as its name, address, phone number and a contact person. Other notable information that must be provided in this part includes:

Line 2 - Employer identification number (EIN) - The organization must apply for an employer identification number ("EIN"). The EIN is a nine-digit number that can be obtained by filing IRS Form SS-4, Application for Employer Identification Number. In most districts, a director or officer of the organization can obtain this identification number immediately over the phone by calling the appropriate IRS office or by faxing the SS-4 directly to the IRS. Each IRS district has its own rules, thus individual districts should be consulted for their procedures. Contact numbers are available on the SS-4 instructions.

Line 4 - Month the annual accounting period ends - The organization must chose a month for its annual accounting period to end. Many charities chose a fiscal year that mirrors the calendar year. However an organization may consider choosing a month other than December where it operations dictate. For example, a charity may receive the majority of its funding from an annual event that takes place in June. Ending its fiscal year in August when most receipts are in from the event may be more fiscally sound.

Line 8 - Is this Organization required to file Form 990 (or Form 900 - EZ)? Nonprofit organizations are required to report their operations annually on a Form 990 or Form 990-EZ Return of Organization Exempt from Income Tax. If the organization's gross receipts are not normally more than $25,000 it will not be required to file a Form 990. Form 990-EZ is for use by organizations with gross receipts of less than $100,000 and total assets of less than $250,000 at the end of the year. See Section VIII of this outline for more information on Form 990 and Form 990EZ.

Line 10 – Checks the Box for the type of corporation and attach conformed copies of organizing documents - Most organizations will check the box as a corporation. Organizing documents for corporations will generally include articles of incorporation and by-laws. A conformed copy is one that is typically a photocopy of the original documents with a certification attached from a director or officer of the organization that the attached copy is a complete and accurate copy of the original document.

Part II - Activities and Operational Information

In this section, the charity provides the IRS with the information necessary to conclude that the organization meets the requirements of section 501(c)(3).

Line 1 - Provide a detailed description of all the activities of the organization - In this section it is important that the organization not just reiterate its purposes listed in the articles of incorporation. Details and descriptions of the organization's activities should be provided. For example, a theatrical group whose

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[4] The following discussion on was prepared by Shannon Nash and Alexis Neely
[5] Churches are not required to file form 1023.

purposes as provided in its articles include cultural and educational activities may discuss its schedule of performances in this section.

Line 2 – What are or will be the organization's sources of financial support? List in order of size. The organization should detail its primary sources of revenue, keeping in mind that as a public charity it should generate at least one-third of its support from the public, government funding and/or revenue generated from activities related to its exempt status. For example, A public charity formed to hold theatrical and cultural performances would list ticket sales as a source of funding.

Line 3 - Describe the organization's fundraising program. In this section the organization should detail how it plans to raise funds to support its' exempt activities. Many organizations will solicit funds through direct mailings. Copies of such mailings should be attached as an example to the Form 1023. Other organizations solicit funds through grant applications to the government and foundations. Copies of the grant applications should be attached. For organizations that solicit donations via their website, copies of these web pages should be provided. If the charity uses third party donation websites such as charity malls or internet retailers, details of the arrangements with the third party websites should be provided. See Section XIII of this outline for more information on internet fundraising.

Line 4b – Names, addresses, and titles of officers, directors, trustees, etc; annual compensation. The public charity should be careful when it provides compensation to its directors and officers in return for their governance services. To the extent that compensation arrangements are contemplated, the services should be valued at fair market value and not above. See Section V of this outline for a discussion of reasonable compensation and intermediate sanctions.

Line 4d - Are any members of the organization's governing body "disqualified persons"? In general, a disqualified person will be one who contributes more than $5000 to the public charity when such amount is more than 2% of the total contributions made to the public charity in that fiscal year. All family members of the substantial contributor are also themselves disqualified persons.[6] To the extent a public charity does have disqualified persons, such individuals should be listed and the public charity should explain.

Line 5 - Does the organization control or is it controlled by any other organization? Some public charities are outgrowths or offspring of other organizations. To the extent that the other organization continues to control the public charity, such relationship must be disclosed. In this section, the IRS is specifically looking for any special relationships that the public charity shares with another organization such as interlocking boards of directors or shared membership rolls, officers, or office space.

Line 6 – Does or will the organization directly or indirectly engage in certain transactions with any political organization or other exempt organization (non 501(c)(3) organization)? Similar to the information requested in Line 5, the IRS is looking for special relationships that the public charity may share with other non-charitable exempt organizations (i.e., a trade association) or a political organization.[7] In addition to probably listing the relationship under line 5, all financial transactions between the two organizations must also be detailed in this section.

Line 7 – Is the organization financially accountable to any other organization? Even if another organization does not "control" the public charity or the public charity does not engage in any financial transactions with non-charitable exempt organizations or political organizations, to the extent the public charity is financially accountable to another organization (i.e., it must report its income and expenses to another organization), such relationship must be disclosed.

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[6]Moreover, anyone who owns 20% or more of the total combined voting power of a corporation that donated more than $5000 to the public charity which again is more than 2% of the total contributions made to the public charity in a fiscal year, is also a disqualified person.

[7] For example, a public charity may be set up to be the philanthropic arm of a trade association.

Line 8 – What assets does the organization have that are used in the performance of its exempt function? All assets that the public charity owns, with the exception of cash, stocks, and other short-term marketable securities, must be disclosed. For many small public charities this will include listing the public charity's office equipment and furniture.

Line 10 – Will the organization's facilities or operations be managed by another organization under a contractual agreement? Is the organization a party to any leases? To the extent the public charity outsources a portion of its activities to another organization or individual, such relationship must be disclosed. For example, a public charity that hires a property manager to manage its properties must attach a copy of the contract and explain the relationship. Also, all lease arrangements that the public charity is a party to must be disclosed. Typically, the public charity will include information regarding its rental of office space or equipment under this section.

Line 11 – Is the organization a membership organization? For a membership organization, this section requires details about the members including (1) the membership requirements and membership fees, (2) a description of the methods used to attract new members including all promotional material and (3) the benefits that the members receive in exchange for their membership dues.[8]

Line 12 - Does the organization provide benefits, services or products? Are the recipients required to pay for them? Does the organization limit these benefits to specific individuals? For a public charity that derives all or a portion of its revenue from providing services (i.e., a theatrical group that generates revenues from ticket sales to its performances) a description of the services along with a fee schedule, must be provided. To the extent that the public charity subsidizes the services for certain individuals (i.e., the elderly pay a reduced fee) such limitations must also be disclosed.

Line 13 and 14 – Does or will the organization attempt to influence legislations or intervene in political campaigns? As provided in section 501(c)(3), a public charity cannot engage substantially in political and lobbying activities. To the extent lobbying activities are contemplated, they should be disclosed in this section. See Section IV of this outline for more information on lobbying and political campaign activities.

Part III - Technical Requirements

A newly formed organization must file its From 1023 within 15 months from the end of the month in which it was formed (i.e., incorporated). Lines 1 through 6 deal with the technical requirements of filing within the required time frame and provide exceptions. If the organization is filing within the 15-month period, it may skip lines 2 through 6 and proceed directly to line 7. Lines 7 through 14 address a very important issue for donors to charitable organizations - Is the organization a public charity or a private foundation?

Line 7– Is the organization a private foundation? In general, organizations that are exempt under section 501(c)(3), are presumed to be private foundations unless they qualify as a public charity under the provisions of Sections 509(a)(1) through 509(a)(4) of the Code (see line 9 below for these exceptions). In general, it is more advantageous for an organization to be treated as a public charity and not as a private foundation. As a private foundation, the organization is subject to detailed operating restrictions and potential excise taxes on the failure to comply with such restrictions. In addition, private foundations are subject to a 2% excise tax on investment income.

Moreover, from the donor's perspective, there are stricter limitations on the amount that can be deducted as a charitable contribution to a private foundation. Charitable contributions made to a public charity are deductible up to 50% of the donor's adjusted gross income. However, charitable contributions made to a private foundation are limited to 30% of the donor's adjusted gross income. In light of all these limitations, being treated as a public charity is desirable for a charitable organization. To answer line 7 the

[8] In recent years it is the third prong, the benefits description, that the IRS has focused on in determining whether benefits received by members who are not deemed full or regular members (i.e., associate members) of the public charity will be subject to taxation.

organization should refer to line 9 and ensure that it can meet one of the exceptions to private foundations status.

Line 9 - The organization is not a private foundation because it qualifies: Line 9 provides the exceptions to private foundation status as enumerated in Sections 509(a)(1) through 509(a)(4) of the Code. The majority of charitable organizations are excluded from private foundation status under section 509(a)(1) and section 509(a)(2) as a publicly supported organization. Box h and i provide the exceptions under sections 509(a)(1) and 509(a)(2) respectively.[9]

Under 509(a)(1), (box h), the public charity must either meet a strict one-third public support test or a looser facts and circumstances test. Under the one-third support test the public charity must receive at least one-third of its total support from the public including governmental units and/or the general public. Please note, that generally contributions from an individual (or entity) are treated as public support, provided that any amount contributed in excess of 2% of the public charity's total support is not treated as public support. Thus if most donations are relatively small (less than 2% of the total support), the public charity should have little trouble with the public support test.

If the public charity fails the public support test, it may still qualify under 509(a)(1) under a two prong facts and circumstances test. First, the public charity must receive at least 10% of its total support from the public including governmental units and/or the general public. Second, the organization must meet an attraction of the public support requirement. Under this test, the public charity must provide that it maintains a continuous and bona fide program for the solicitation of funds from the general public, community, or membership group involved, or it carries on activities designed to attract support from governmental units or other charitable organizations.

Under 509(a)(2), (box i), the public charity can also qualify as publicly supported if its satisfies a two prong test: (1) a one-third support test and (2) a not-more-than-one-third support test. The one-third support will be met if the organization receives at least one-third of its total support from any combination of: (1) gifts, grants, contributions or membership fees, and (2) gross receipts from admissions, sales of merchandise, performance of services, or furnishing facilities in any activity that furthers the charitable purposes of the organization. Under the not-more-than-one-third support test, the public charity cannot receive more than one-third of its support from gross investment income and the excess of any unrelated trade or business income over the tax imposed on such income. See Section VII of this outline for more information on unrelated business taxable income.

Generally, an organization that generates a majority of its revenue from services related to its exempt purposes instead of from contributions, will file for public charity status under section 509(a)(2). However, many organizations can meet the support requirements under both section 509(a)(1) and section 509(a)(2). In such a case, the organization is treated as qualifying under section 509(a)(1). If the organization cannot decide, it should check box j for 509(a)(1) and the IRS will determine the proper classification.

It is important to keep in mind that this entire section deals with whether or not the public charity will be treated as a public charity or a private foundation. To the extent the public charity cannot meet one of the aforementioned exceptions, it will be treated as a private foundation and thus subject to the stricter requirements mentioned in line 7 above.

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[9]Other organizations that are exempt from private foundation status under 509(a)(1) include: (1) churches or a convention or association of churches, (2) educational organizations such as schools or colleges, (3) hospitals or medical research organizations operated in conjunction with a hospital, (4) organizations operated for the benefit of certain state and municipal colleges and universities, and (5) governmental units. Under 509(a)(3), an organization that is operated solely for the benefit of another charitable organization that is itself exempt from private foundation status may in essence borrow that organization's public charity status. Also section 509(a)(4) exempts all public charities that are organized and operated exclusively for the testing of public safety. All of the aforementioned organizations are provided in boxes a through g of line 9 and all have corresponding schedules that must be completed. Such organizations are beyond the scope of this outline and a tax practitioner should be consulted for more information.

Line 10 - Has the organization completed by tax year of at least 8 months. Once the public charity decides that it is not a private foundation by virtue of 501(a)(1) or 509(a)(2), it must next determine whether it wants a definitive ruling or an advance ruling from the IRS. With a definitive ruling, the IRS is concluding that based on the information provided in the organization's Form 1023, the organization has definitively satisfied the requirements of section 501(c)(3) and is not a private foundation under 509(a)(1) or 509(a)(2).[10] To receive a definitive ruling the organization must have completed a tax year of at least 8 months. Organizations that are extremely confident that their operations to date can meet the public support tests will file for a definitive ruling.

Many newly formed organizations opt for an advance ruling because the organization has not received significant public support during its first or second year of operation. With an advance ruling the IRS gives the organization five years ("the advance ruling period") to prove that its operations meet the requirements of sections 509(a)(1) or 509(a)(2). During the advance ruling period, the organization is treated as a public charity. Thus, contributions to the organizations will be treated as charitable contributions, deductible under section 170 of the Code. At the end of the advance ruling period, the public charity will be required to prove that it was actually publicly supported based on its average public support ratio during the advance ruling period. If the organization is requesting an advance ruling, it need not answer lines 12 and 13.

Line 11 - Unusual grants. Unusual grants are substantial contributions and bequests from disinterested persons that are unexpected in amount and would, by reason of their size, adversely affect the organization's public charity status (i.e., the contribution is more than 2% of the organization's total support). A description of the unusual contribution including the name of the donor, the date and the amount, and the nature of the grant (i.e., one time donation vs. annual donation) is required. Also, the amount of the grant must be included on the Statement of Revenue and Expenses in Part IV, line 14.

Line 14 - Schedules. Schedules A - I are provided for certain types of section 501(c)(3) organizations. For example, Schedule A applies to a church organization.[11] It is important that the charity not forget to check "no" for each box listed in line 14. Neglecting to complete this line may delay the IRS's review of the entire 1023 application. Such mistakes or omissions can greatly prolong the organization's waiting period for a ruling on its exempt status.

Part IV - Financial Data

A. Statement of Revenue and Expenses -

Generally, a public charity must provide 3 to 4 years of financial information. For organizations already in existence this includes the current year and three years immediately before it. For organizations in existence less than 1 year, financial data for the current year and proposed budgeted information for the following 2 years must be provided.

Line 1 - Gifts, grants and contributions. - This amount should be the largest revenue source for charities that meet the public support test under section 509(a)(1). This line should not include amounts received by the charity in the performance of its exempt functions, such as ticket sales for an event. Such revenue should be included on line 9.

Line 2 - Membership fees received. For charities that are membership organizations, membership dues should be included on this line.

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[10] Note that a definitive ruling may only be given to a public charity that meets the requirements of section 509(a)(1) and (a)(2). Organizations that are exempt from private foundation status under 509(a)(3) or 509(a)(4) may skip this line.

[11] These special situations are beyond the scope of this outline and a tax advisor should be consulted for further information

Line 3 - Gross investment income. Charities that contemplate having net income at the end of a year on line 24 should include some amount on this line in the next year attributable to interest earned on the net income.

Line 4 – UBTI income. All income derived from unrelated business activities (i.e., after deducting all associated expenses) should be included on this line. Although listing an amount on this line is not per se detrimental to obtaining charitable status under section 501(c)(3), the IRS will be looking at the amount of unrelated business taxable income in relation to organization's other revenue. Too much unrelated business taxable income may cause the IRS to deny the organization charitable status. See Section VII of this outline for more information on UBTI.

Line 7 - Other Income. Included on this line are all other revenue sources not included on any other line.

Line 9 - Gross Receipts from admissions, sales of merchandise or services, furnishing of facilities in any activities that is not unrelated. This amount should be the largest revenue source for charities that meet the public support test under section 509(a)(2).

Line 11- Capital Gains. If the organization plans to sell a capital asset, such as publicly traded stock, any capital gain should be reported on this line.

Line 14 - Fundraising Expenses - The amount of fundraising expenses should be included on this line and should be consistent with scope of the charity's fundraising activities as they were described in Part I, line 3 of Form 1023.

Line 15 - Contributions/Gifts - As part of their charitable purpose, many charities make grants and contributions to individuals and other organizations. A schedule must be attached describing the purposes and the amount of the contribution.

Line 16 - Disbursements to or for the benefit of members. For membership organizations, amounts or benefits paid to members should be included on this line and detailed on an attached schedule.

Line 17 - Compensation of officers, directors and trustee - Amounts paid to officers and directors for compensation should be included on this line. This line does not include amounts paid to directors or officers that are non-compensation payments such as reimbursements for the charity's expenses (telephone, photocopying expenses, etc). Also a schedule detailing the name of the officer or director, the average amount of time devoted to the organization's affairs, and the amount of compensation paid must be attached.

The amount included on this line should be consistent with amounts that were disclosed in Part II line 4b of Form 1023. Typically, the amount paid to the charity's chief officer, often called the president or executive director, must be disclosed here. Board members of charitable organizations don't typically receive compensation for their services. The charity should be cautious in all compensation arrangements with its officers and directors and ensure that they are based on arms length negotiations and at fair market value. See Section V of this outline for a discussion of reasonable compensation and intermediate sanctions.

Line 18 - Other salaries and wages. Compensation paid to non-officers and board members, such as employees should be included on this line.

Line 20 - Occupancy - All amounts paid for renting or leasing the charity's office space should be included on this line. A copy of the actual rental or leasing contract should be attached to the Form 1023 as provided in Part II, 10b. Also other utility expenses, such as gas, electricity, water, etc. should be included on this line. If the organization owns its office space, mortgage interest and real estate taxes may be deducted on this line.

Line 22- Other expenses. All other expenses not included on any other line should be listed on an attached schedule with the total provided on this line.

B. Balance Sheet

As part of the required financial statements, the organization must also complete a balance sheet. The balance sheet information is a standard listing of cash, assets, and liabilities of the organization. Generally, the organization will complete a balance sheet on a date ending close to the filing of the Form 1023. However, this date may not be greater than 60 days from the filing of the form. Thus, the balance sheet is typically one of the last sections completed in finalizing the Form 1023. Failure to meet the 60 days requirement may delay the processing of the organization's Form 1023. .

The Form 1023 Submission Package

After the Form 1023 is completed, it must be mailed to the appropriate IRS key district office. This office is determined by the location of the organization's principal place of business or office. Form 8718, User Fee for Exempt Organization Determination Letter Request lists IRS key district offices. It is also is the form that the organization uses to select the user fee that must be paid to the IRS in connection with filing the Form 1023. For many organizations requesting an advance ruling on Form 1023, the cost will be $500.

In addition to including a Form 8718 in the Form 1023 submission package, the organization must also submit two copies of Form 872-C, Consent Fixing Period of Limitation upon Assessment of Tax Under Section 4940 of the Internal Revenue Code. Also, if the organization is working with an accountant, attorney, or other tax preparer, a Form 2848, Power of Attorney, must be completed and submitted. The organization should remember to attach a conformed copy of its articles of incorporation and bylaws to the Form 1023 application. Finally, any other attachments (i.e., additional information, copies of documents, etc) must contain the organization's name, address and employer identification number, as well as the part and line item number to which the attachment relates.

In the Form 1023 application package, the IRS includes a procedural checklist to make sure that the Form 1023 application is complete. The IRS also provides a list of the top ten reasons for delays in obtaining tax exempt status on their website (provided below in the bibliography section). Organizations should review both of these before sending in the Form 1023 submission package. Simple mistakes or omissions, such as forgetting to sign the first page of the Form 1023 application can delay review of the application and in severe cases cause the entire application to be mailed back to the organization; thereby causing the organization to incur an additional user fees when the Form 1023 Application is resubmitted.

The Waiting Game

For Form 1023 applications that are complete and do not require additional information from the organization, it will generally take up to 180 days for the IRS to rule on the organization's exempt status. However, in many cases response times have been less than 3 months. Delays, of course, can affect this timing and often are due to careless mistakes or omissions in the Form 1023 package or requests for more information from the IRS technical reviewer. In the mean time, the organization is in a limbo status. It cannot claim to be an exempt organization. Thus donors who contribute during the waiting period time should be told that their donations may not be deductible. Of course, once the organization receives a determination letter that it is exempt under section 501(c)(3), its exemption is retroactive to the date of its incorporation.

B. Internal Revenue Service Form 1024[12]

Internal Revenue Service Form 1024, Application for Recognition of Exemption Under Section 501(a), is used by organizations to apply for recognition of exemption from federal income taxation under Code section 501(a) as organizations described in several subsections of Code section 501(c), including:

- **Code section 501(c)(4)**: civic leagues, social welfare organizations and local associations of employees.

- **Code section 501(c)(6)**: business leagues and chambers of commerce.

When to File

An organization seeking exemption under any subsection of Code section 501(c) other than subsection (c)(3), (c)(9) or (c)(17) is not required to file an application with the IRS in order to be exempt from federal income taxation. If an organization meets the requirements for the specific subsection, it is automatically granted tax-exempt status without taking any affirmative action. Therefore, there is no deadline as to when an organization may file Form 1024. However, it is recommended that an organization confirm its exemption under Code section 501(c) by filing Form 1024.

Required User Fee

An organization must complete IRS Form 8718, User Fee for Exempt Organization Determination Letter Request, and enclose a required user fee, as follows:

1. **Gross Receipts Less Than $10,000:** An organization that has had during the previous four years or expects to have during the coming four years annual gross receipts averaging less than $10,000 must pay a user fee of $150.

2. **Gross Receipts of $10,000 or More:** An organization that has had during the previous four years or expects to have during the coming four years annual gross receipts averaging $10,000 or more must pay a user fee of $500.

Required Information: The applicant organization must complete Parts I through III of Form 1024. The questions in many of the Parts of Form 1024 are the same as or often very similar to the questions in IRS Form 1023, with the exception of certain questions posed in Part III that are directed toward member benefits. Thus the following analysis focuses on Part III.

Part III – Financial Data:

Statement of Revenue and Expenses:

- In general, the statement must be completed for the current year and each of the three immediately-preceding years (or the years the organization has existed, if less than four).

- For the current year, information must be provided for the period beginning on the first day of the organization's current fiscal year and ending on any day that is within sixty days of the date of Form 1024. If the date of Form 1024 is within 60 days of the organization's current fiscal year, no financial information is required for the current fiscal year.

- For organizations that have existed for less than one year, financial data must be provided for the current year and proposed budgets must be provided for the following two years.

[12] The following discussion on Form 1024 was prepared by Jennifer L. Franklin.

Balance Sheet:

- If the organization has no assets at the time of filing Form 1024, the Balance Sheet must be completed with "zero" entered on each line.

Schedules

Organizations seeking exemption under specific subsections of Code section 501(c) must file certain schedules, as follows:

Schedule B – Code section 501(c)(4) – To qualify under section 501(c)(4) as a civic league or social welfare organization, the applicant must show that is operated primarily to further the common good and general welfare of the people of the community. Therefore, if the primarily purpose of an applicant will be to conduct social activities, the applicant should attempt to obtain exemption under section 501(c)(7) as a social or recreational club instead. To qualify under section 501(c)(4) as a local association of employees, the applicant must show that its membership is limited to employees of a designated person or persons in a particular municipality and that the net earnings of the association will be devoted exclusively to charitable, educational or recreational purposes

Schedule D – Code section 501(c)(6) – An applicant seeking exemption under section 501(c)(6) as a business league, chamber of commerce, real-estate board, board of trade or professional football league must show that it is devoted to the improvement of business conditions of one or more lines of business as distinguished from the performance of particular services for individuals.

Attachments:

As with the discussion under the Form 1023 any attachments to the Form 1024 must contain the organization's name, address and employer identification number, as well as the part and line item number to which the attachment relates.

Where To File:

Regular Mail: If using regular mail, the application should be sent to the Internal Revenue Service at P.O. Box 192, Covington, Kentucky, 41012-0192. It is recommended to send the application by certified mail, return receipt requested.

Express Mail Services: If using an express mail service, the application should be sent to the Internal Revenue Service at 201 West Rivercenter Boulevard, Attention: Extracting Stop 312, Covington, Kentucky 41011.

C. Bibliography

www.irs.ustreas.gov/prod/bus_info/eo - This is the IRS website that provides information for tax exempt organizations and help in completing Form 1023.

http://www.irs.ustreas.gov/prod/forms_pubs/index.html - IRS Publication 557 *Tax Exempt Status for Your Organziation*, Form 1023 *Application for Recognition of Exemption Under Section 501(c)(3)*, Form 1024, *Application for Recognition of Exemption Under Section 501(a).*

http://www.irs.gov/bus_info/eo/tax-tips.html – IRS provides top 10 reasons for delays in processing form 1023 applications.

Section IV. Lobbying and Political Activities[13]

This section will provide a general overview of the prohibition against political campaign activities and the limits on lobbying activities. This section will generally apply to the activities of a Section 501(c)(3) organization.

A. Political Campaign Activity Prohibition

A Section 501(c)(3) organization must "not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office." A violation of this prohibition may disqualify the organization from tax-exempt status. A violation occurs if there is participation or intervention by the organization in a political campaign with respect to an individual who is a candidate for a public office. A candidate for public office is defined as an individual who offers himself or is proposed by others as a contestant for elective public office. An organization that contributes to the political campaign of a candidate or evaluates the qualifications of potential candidates and supports particular slates of candidates will be deemed to participate or intervene in a political campaign.[14] However, the following activities are generally excluded from political campaign activities.

1. Voter Education

Educational activities are distinguished from political campaign activities. Encouraging greater participation in government and political affairs or conducting forums at which a broad spectrum of political issues are debated, but not for the purpose of participating in political campaigns, are permissible activities by a Section 501(c)(3) organization. The organization must equitably distribute information regarding the issues and candidates without evidence of bias towards any particular issue or candidate. For example, an organization cannot distribute a voter guide that contains the voting records of candidates on selected issues that are important to the organization or send a questionnaire to candidates if the questions evidence bias on the issues. However, the organization can send an unbiased questionnaire to candidates and publish the answers or publish a voter guide with the voting records of all the Members of Congress on a wide range of legislative issues. The key to any voter education activity is to ensure that it is performed in a neutral and educational manner.

2. Judicial Appointments

A 501(c)(3) organization may attempt to influence the Senate's confirmation of a federal judicial nominee without jeopardizing its exempt status because federal judges aren't elected, but are instead appointed by the President. However, though the attempt to influence the Senate's confirmation is not prohibited campaigning, it is treated as legislative lobbying and as such must be within the permissible lobbying limitations, discussed below.

B. Lobbying

Section 501(c)(3) requires that "no substantial part" of an organization's activities involve carrying on propaganda, or otherwise attempting, to influence legislation. This does not mean that an organization should not engage in lobbying activities, but instead that an organization that is influencing legislation does so with the awareness of legal limitations. In determining what amounts to a substantial level of lobbying activities, the organization has two options. The organization may make an election pursuant to Section 501(h), which provides an objective method for measuring permissible lobbying expenditures. Alternatively, the organization may use a facts and circumstances test to determine whether more than a substantial part of its activities involve lobbying. Both methods are described below.

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[13] This Section was prepared by Alexis Neely and Shannon Nash

[14] Rev. Rul. 67-71, 1967-1 C.B. 125.

- **"Substantial Part" Test – Facts and Circumstances**

The facts and circumstances test is an imprecise measure of an organization's lobbying activities considering all the facts and circumstances of the organization's lobbying activities, including those that cost the organization nothing, such as lobbying by volunteers. Case law on this issue has suggested that an organization spending five percent of its time and effort on legislative activities does not exceed the lobbying limitation.[15] Other authorities suggest that spending 16 to 20 percent of an organization's time on legislative activities would be a substantial part; thereby exceeding the lobbying limitation.[16] An organization that spends less than five percent of its time on influencing legislation should not be concerned that its 501(c)(3) status will be jeopardized because a substantial part of its activities are spent on lobbying. As an organization gets closer to the line of using 16 percent of its resources to influence legislation, the organization should be aware of the danger of exceeding the lobbying limitation. Pursuant to the facts and circumstances test, organizations do not have certainty about which of their activities count towards the analysis; the organization should consider their lobbying activities as a whole, including volunteer activity, in the context of all of their organizational activities. The sanction for violating the lobbying limitation in the absence of a 501(h) election is revocation of the organization's exempt status. For organizations that are unwilling to rely on such an amorphous standard, charitable organizations, other than governmental units, churches, their integrated auxiliaries, and conventions or associations of churches, can obtain clarity by making an election pursuant to Section 501(h).

- **"Section 501(h) Expenditure" Test**

The Section 501(h) Expenditure test utilizes a mechanical test and sliding scale to measure the total amount of permissible direct and grassroots lobbying expenditures by an organization. See the discussion below for more information on direct lobbying and grassroots lobbying. The scale is determined by reference to declining percentages of the organization's total exempt purpose expenditures. The annual level of expenditures for direct legislative efforts is determined as follows: 20 percent of the first $500,000 of an organization's expenditures for an exempt purpose, plus 15 percent of the next $500,000, 10 percent of the next $500,000, and 5 percent of any remaining expenditures, with a total limitation on lobbying expenditures in any one year of $1,000,000. A separate limitation – amounting to 25 percent of the total lobbying expenditure limitation - is imposed upon grassroots lobbying. See the chart below.

Exempt-Purpose Expenditures	Total Lobbying Expenditures	Amount of Total Allowable for Grassroots Lobbying
Up to $500,000	20% of exempt-purpose expenditures	One-quarter
$500,000 - $1,000,000	$100,000 + 15% of excess over $500,000	$25,000 + 3.75% of excess over $500,000
$1,000,001 - $1,500,000	$175,000 + 10% of excess over $1,000,000	$43,750 + 2.5% of excess over $1,000,000
$1,500,001 - $17,000,000	$225,000 + 5% of excess over $1,500,000	$56,250 + 1.25% of excess over $1,500,000
Over $17,000,000	$1,000,000	$250,000

An organization seeking to make an election pursuant to Section 501(h) should file Form 5768 with the IRS. Although making the 501(h) election gives the organization more certainty as to the allowable amount of lobbying expenditures that it may incur, the electing organization will incur sanctions if it

[15] Seasongood v. Comm'r, 332 F.2d 907, 912 (6th Cir. 1995).
[16] Haswell v. United States, 500 F.2d 1133 (Ct.Cl. 1974).

exceeds the lobbying expenditure limitations. If the organization spends more on lobbying expenditures than is permissible under 501(h), a tax of 25% is imposed on the excess lobbying expenditures. Moreover, in extreme cases, an organization may lose its exempt status if its lobbying expenditures exceed the permitted amount by more than 50% over a four year period.

2. Direct Lobbying

As depicted in the chart above, organizations are permitted to spend more money on direct lobbying expenditures than on grassroots lobbying expenditures; thus, it is important that the organization be able to identify the characteristics of each. Direct lobbying communications generally include any attempt to influence legislation through communication with any member or employee of a legislative body or any other governmental official who participates in the formulation of legislation. All preparatory activities, such as research, planning, coordination, and decision to make a lobbying communication are direct lobbying communications if engaged in for the purpose of making a lobbying communication. If all the elements are there it's lobbying even if you are also educating legislators, providing technical advice or assistance to an individual legislator.

Urging the public to vote for or against a ballot initiative or referendum is direct lobbying because the public becomes the legislature. Urging the organization's members to contact public officials about legislation is also *direct* lobbying and, thus, subject to the higher lobbying expenditures limit. In contrast, if the organization encourages its members to urge the general public to contact legislators, that is grassroots lobbying and subject to the lower lobbying expenditure limitation. Members of an organization are defined as those who contribute more than a "nominal" amount of money or time to an organization, such as paying dues, making other contributions, or volunteering to work for the organization.

3. Grassroots Lobbying

Grassroots lobbying occurs when an organization attempts to affect the opinion of the general public, unless the general public is in the position of the legislature as in a ballot measure or referendum. A grassroots lobbying communication must refer to specific legislation, reflect a view on that legislation, *and* encourage the message recipient, other than a member of the organization,[17] to take action with respect to the legislation, called issuing a "call to action."

A communication encourages the message recipient to take action (issues a "call to action") if it communicates any of the following:

1. states the recipient should contact legislators,
2. states the address or phone number of a legislator or legislator's employee,
3. provides a convenient means of contacting a legislator, *or*
4. specifically identifies one or more legislators who will vote on the legislation as opposing the communication's view with respect to the legislation; being undecided with respect to the legislation; being the recipient's representative in the legislature; or being a member of the legislative committee or subcommittee that will consider the legislation. Naming the main sponsors of the bill for the purposes of its identification is not considered encouraging action.

This "call to action" requirement permits an organization to communicate its position on specific legislation without making a lobbying expenditure. Thus, so long as the communication is not a paid advertisement in the mass media as discussed below, an organization could send a message referring to

[17] Encouraging a member of the organization to contact their legislator is direct lobbying, not grassroots lobbying.

specific legislation and reflecting a view on that legislation without counting the expense of the message against its grassroots lobbying expenditure limitation because there is no call to action.

4. Paid Mass Media Advertisement

Even without a "call to action," an organization is subject to a rebuttable presumption that its communication is grassroots lobbying if the organization communicates its position regarding specific legislation in the mass media (television, radio, and general circulation newspapers and magazines)[18] within two weeks before a legislative vote on "highly publicized" legislation and either refers directly to the legislation or states a view on the legislation and urges the public to communicate with legislators about the subject. The advertisement can merely refer to the legislation and if the other publication requirements are met, the organization can be forced to allocate its expenses for the communication to grassroots lobbying.

Highly publicized legislation is legislation that has received so much publicity that its general terms, purpose, or effect are known to a significant element of the general public, not just to the particular interest groups directly affected. The lobbying presumption is rebutted if the organization can show that the advertisement is regularly made by the organization in the mass media in the customary course of its business or that the timing of the advertisement was unrelated to the upcoming legislative action.

For example, the National Organization for Motherhood places a television advertisement advocating support for the President's plan to provide six months of paid maternity leave, popularly known as "the President's Healthy Children Plan." The advertisement concludes: "SUPPORT THE PRESIDENT'S HEALTHY CHILDREN PLAN!" The plan is outlined by the President in a series of speeches and is drafted into proposed legislation. The President's plan and position are highly publicized during the two weeks before the Senate vote. The initiative is voted on by the Senate four days after the National Organization for Motherhood's advertisement. Although the advertisement doesn't encourage recipients to contact legislators or other government officials, it does refer to the legislation and reflect a view on the general subject of the legislation. The communication is presumed to be a grass roots lobbying communication. The presumption can be rebutted if the National Organization for Motherhood could show that it had placed this same ad weekly regardless of the pending vote and the placement of the advertisement was unrelated to the pending vote.

C. Activities Excluded from Lobbying

The following activities are excluded from lobbying expenditure limitations for the organization that makes a Section 501(h) election:

- Contacts with government officials in support of or opposition to proposed *regulations*.
- Lobbying by organization volunteers is only counted against the lobbying expenditure limitations to the extent that the organization incurs expenses.
- An organization's communication to its members is not lobbying as long as the organization does not encourage it members or others to lobby.
- A nonprofit's response to written requests from a *legislative body* for technical advice on pending legislation is not lobbying.
- Expenditures on lobbying legislators regarding matters that affect the organization's existence, powers, or tax-exempt status are not counted for the purpose of lobbying expenditure limitations.

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[18] See Section XIII of this outline covering the internet for a discussion of whether publication on the internet is mass media publication.

- Making available the results of nonpartisan analysis, study, or research on a legislative issue that presents a sufficiently full and fair exposition of the pertinent facts to enable the audience to form an independent opinion does not fall within the ambit of lobbying.

- An organization's discussion of broad social, economic, and similar policy issues for which resolution would require legislation is not considered lobbying so long as the discussion does not address the merits of specific legislation.[19]

D. Recordkeeping Requirements[20]

An organization that makes a 501(h) election must keep a record of its direct and grass roots lobbying expenditures for the tax year. The required records include the following:

1. amounts directly paid or incurred for direct and for grassroots lobbying;

2. the portion of amounts paid or incurred as current or deferred compensation for an employee's services for direct and for grassroots lobbying;

3. amounts paid for out-of-pocket expenditures incurred on behalf of the organization and for direct and for grassroots lobbying, whether or not incurred by an employee;

4. the allocable portion of administrative, overhead and other general expenditures attributable to direct and to grass roots lobbying; and

5. expenditures for publications, or for communications with members, to the extent the expenditures are treated as direct or as grass roots lobbying under the rules regarding membership communications.

E. Allocation of Expenses

There are fairly complex rules for allocating expenses among *mixed purpose* expenditures, which are expenditures on a single communication with both lobbying and nonlobbying purposes and *mixed lobbying* expenditures, which are those expenditures on both direct and grassroots lobbying communications. If the organization is making communications that include both direct and grassroots lobbying and making communications that include both lobbying and nonlobbying, it must devise a reasonable method of allocating the expenses to each category. For example, if the organization's administrative staff person works on a single communication that has both nonlobbying, direct lobbying, and grassroots lobbying elements, that staff person should allocate some of his/her time to all three categories.[21]

F. Practical Suggestions

1. Do not engage in any political campaigning.

   - If your organization plans on conducting any lobbying, make a section 501(h) election and keep clear records of your lobbying expenditures. By making a 501(h) election your organization will have certainty about how much lobbying it can engage in and any activities that do not cost the organization money, such as lobbying by volunteers, will not count against the lobbying limitation. Finally, if the

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[19] Most of these exceptions were taken from "The Nonprofit Lobbying Guide," 2nd. Ed.,Bob Smucker. This book and more detailed information about lobbying by nonprofits is available at http://www.independentsector.org/clpi/index.html.

[20] Treas. Reg. § 56.4911-6.

[21] A complete explanation of the allocation regulations is beyond the scope of this article and a tax advisor should be consulted for more information.

organization does exceed the lobbying limitations, sanctions are imposed first rather than revocation of exempt status.

- Allocate your expenses among direct lobbying, grassroots lobbying, and nonlobbying communications in a reasonable manner.

- Urge your members to contact their legislators, which will be considered direct lobbying, rather than grassroots lobbying, and subject to the higher lobbying expenditure limitations.

G. Lobbying and Political Campaign Activities of Section 501(c)(4) and 501(c)(6) Organizations

A Section 501(c)(6) organization may engage in lobbying as its primary activity without jeopardizing its tax exempt status. However, if the organization engages in lobbying it may be required to provide notice to its members regarding the percentage of their dues paid that are applicable to lobbying activities and hence not deductible as a business expense or the organization will be required to pay a proxy tax. Section 501(c)(6) organizations may also engage in some political activities. However, they will be subject to federal taxation on such activities under section 527(f) of the Code.

A Section 501(c)(4) organization may engage in lobbying activities and often such organizations are formed to do just that. Often a 501(c)(3) organization will form an affiliate 501(c)(4) organization to conduct the lobbying activities that are important to the 501(c)(3) and thereby avoid having to deal with the lobbying restrictions placed upon Section 501(c)(3) organizations. However, a 501(c)(3) organization that has lost its exempt status due to substantial lobbying activities may not then re-file for exemption under Section 501(c)(4). Again, as with 501(c)(6) organizations, the 501(c)(4) organization may have to notify its members regarding the percentage of their dues paid that are applicable to lobbying activities and hence not deductible as a business expense or the organization will be required to pay a proxy tax. Similarly, Section 501(c)(4) organizations may also engage in some political activities. However, they will be subject to federal taxation on such activities under Section 527(f) of the Code.

H. Bibliography

http://www.independentsector.org/clpi/index.html – This website provides a wealth of information on lobbying and political activities including: Bob Smucker, "The Nonprofit Lobbying Guide," 2nd Ed and a copy of the IRS lobbying letter mailed to nonprofits answering nine common question regarding lobbying activities.

http://www.afj.org/eadvocacy/index.htm - Elizabeth Kingsley, Gail Harmon, John Pomeranz, & Kay Guinane, "E-Advocacy for Nonprofits: The Law of Lobbying and Election Related Activity on the Net." Also see www.afj.org for the nonprofit advocacy project and other publications and information.

http://www.ombwatch.org/las/ - Let America Speak!

Section V. Intermediate Sanctions[22]

Section 501(c)(3) prohibits insiders from benefiting improperly from transactions involving charities. Until 1996, however, the IRS had only one remedy for public charity insider transactions: revoking the tax-exempt charitable status of the EO involved. Unfortunately, this remedy deprived the community of any benefit it may have received from the EO's activities, without reaching those who took advantage of their insider status to benefit improperly. Section 4958 of the Code (so called intermediate sanctions), adopted in 1996, allows the IRS to penalize those improperly benefiting from a public charity, without penalizing the public as well.

A. General[23]

Section 4958 imposes penalty taxes any time an "applicable tax-exempt organization" – that is, a Section 501(c)(3) charity that is not a private foundation, a Section 501(c)(4) social welfare organization, or an organization that would be described in either of those categories – pays an excess benefit to any person or organization that fits the definition of a disqualified person (defined below). These taxes do not apply to Section 501(c)(6) organizations. The taxes involved are paid by the disqualified person and by "organization managers" (officers, directors, trustees and other persons in the organization with similar powers or responsibilities) who knowingly approve or otherwise participate in the excess benefit transaction.

B. Excess Benefit Transactions

If an EO has directly or indirectly conferred an economic benefit on a disqualified person (as defined below) that exceeds the value of what the EO received in return, an excess benefit transaction has occurred. Compensation must be reasonable under all circumstances, i.e., only what would ordinarily be paid for like services by like enterprises under like circumstances. Compensation, employee benefits, and property transfers are likely to be the most common excess benefit transactions.

Excess benefits may also arise from revenue-sharing transactions, in which an economic benefit to a disqualified person is linked to the EO's revenues from a particular activity, if the disqualified person may receive additional compensation without proportional benefit to the EO. A revenue-sharing transaction will be an excess benefit transaction if it is structured so that the disqualified person benefits whether or not the arrangement is productive for the EO.

C. Disqualified Persons

A disqualified person is any person or organization that was in a position to exercise substantial influence over the affairs of the organization at any time during the five years ending on the date of the transaction in question. (There is no "qualified person" category). People and organizations that are deemed to have substantial influence include voting members of the EO's governing body; the president, chief executive officer, chief operating officer, treasurer and chief financial officer or anyone holding those powers or responsibilities, regardless of title; family members of a disqualified person; and an entity in which disqualified persons hold more than 35 percent of the control (i.e., voting power in the case of a corporation, profits interest in the case of a partnership, or beneficial interest in the case of a trust). Individuals and entities that do not fall into any of these categories may nevertheless be disqualified persons if the fact and circumstances show that they are in a position to exercise substantial influence. A person may be in such an influential position if the person:

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[22] Portions of this outline are being reproduced from The Rules of The Road, A Guide to the Law of Charities in the United States by Betsy Buchalter Adler and produced by the Council of Foundations. The remaining portions were written by Shannon Nash.

[23] See Treas. Reg. Sections 53.4958-1 through 53.4958-8 for the various rules discussed herein regarding intermediate sanctions.

- founded the EO,
- is a substantial contributor,
- is compensated on the basis of revenues derived from activities of the EO that the person controls,
- has authority to control or determine a significant portion of the EO's capital expenditures, operating budget or employee compensation,
- has managerial authority or is a key advisor to someone who does, or
- owns a controlling interest in a corporation, partnership or trust that is a disqualified person.

D. Presumption of Reasonableness

Ordinarily, the burden of proof in a tax dispute is on the taxpayer, because the taxpayer has unlimited access to its own records. This means that the EO and the disqualified person would have to prove that the transaction is reasonable. An EO may shift the burden of proof to the IRS—that is, it may force the IRS to demonstrate that a transaction is not reasonable—if the following three requirements are satisfied:

- the transaction is approved by the EO's governing body, or a committee of the governing body, and no member of the board or committee has a conflict of interest with respect to the transaction,
- the governing body or committee obtains and relies on appropriate data on comparability before approving the transaction, and
- the governing body or committee adequately documents the basis for its determination, concurrently with making the determination.

E. Decisionmaking Body

The IRS recognizes that a board is likely to include persons with a potential conflict of interest and that state corporate law may require board approval of particular transactions. If a director with a conflict of interest regarding a particular transaction meets with the other directors only to answer questions and otherwise leaves the room and does not participate in the debate or vote on the transaction, that director is not considered a member of the governing body for purposes of Section 4958. Thus, a board with one or more interested directors may invoke the presumption of reasonableness by following this procedure. This provision is stricter than the laws of most states dealing with conflicts of interests, which generally require an interested director to abstain from voting but do not expressly require the director to leave the room during the debate and the vote.

F. Appropriate Data

A board or committee has appropriate data on comparability "if, given the knowledge and expertise of its members, it has information sufficient to determine" whether the transaction is reasonable. Examples of appropriate data include:

- compensation paid by similar organizations, both taxable and tax-exempt, for "functionally comparable positions,"
- information on whether similar services are available in the EO's geographic area,

- "independent compensation surveys compiled by independent firms,"
- actual written jobs offers from similar institutions competing for the person in question, and
- independent appraisals of the value of property involved in the transaction.

EOs with annual gross receipts of less than $1 million may avail themselves of a safe harbor designed to enable them to avoid the significant expense of commissioning an independent salary survey. The board or committee is considered to have obtained appropriate data if it gathers compensation data from three comparable organizations in similar communities for similar services.

G. Adequate Documentation

To benefit from the presumption of reasonableness, the EO must document its decision concurrently; it is not possible to gain the presumption of reasonableness retroactively. At a minimum the documentation should include:

- records of the decision and the date approved,
- who participated in the debate and voted in the decision,
- what information the directors relied on and how it was obtained, and
- records of the actions of interested directors or others having a conflict of interest.

The documentation must be prepared by the next meeting of the approving body after the meeting where final action is taken (or 60 days after the final actions of the approving body). Moreover, the body must approve them as "reasonable, accurate and complete within a reasonable time period thereafter."

H. Failing the Rebuttable Presumption

Some EOs will not be able to qualify for the rebuttal presumption of reasonableness. Fortunately, the IRS has made it clear that this is not fatal. Failing to qualify for the presumption does not create an inference that the transaction is an excess benefit transaction. It simply means that the EO must prove to the IRS, if questioned, that the transaction was reasonable.

I. Penalties for Violation

Section 4958 penalizes the wrongdoers, not the organization. A disqualified person who receives an excess benefit is subject to a tax equal to 25 percent of the excess benefit amount. If the disqualified person does not correct the excess benefit transaction promptly, there is an additional tax of 200 percent of the excess benefit amount. In addition, any "organization manager" (a director, officer, trustee or other person with similar responsibilities or powers) who knowingly approves or otherwise participates in an excess benefit transaction is subject to a tax of 10 percent of the excess benefit amount, up to a total tax of $10,000 per transaction. However, organization managers who relied on a reasoned written opinion of legal counsel, an opinion of an accountant, or the opinion of certain valuation experts, in approving a transaction are not subject to this tax, even if the transaction later proves to have been excessive.

J. Practical Guidance

Steve Miller, the Director of the IRS Exempt Organization's Division, has written a helpful explanation of the intermediate sanction rules as they apply to using the rebuttable presumption to determine reasonable compensation. A copy of Mr. Miller's suggestions may be obtained in their entirety on line (see the website link below under the bibliography section). Mr. Miller provides a rebuttable presumption checklist

that can be used by directors when they are attempting to satisfy the rebuttable presumption. Although Mr. Miller's checklist only applies to compensation arrangements that may be deemed excess benefit transactions, a similar checklist can be used for other types of transactions (i.e., property transaction between the EO and a disqualified person).

K. Bibliography

http://www.nptimes.com/sanctions.pdf – A copy of the final intermediate sanction regulations, as published in the Federal Register, can be found on this website. The regulations became effective January 23, 2002.

http://www.irs.ustreas.gov/pub/irs-utl/m4958a2.pdf – A free copy of Steve Miller's practical suggestions for intermediate sanction rules may be obtained from this website.

http://cof.org – Council on Foundations website for information on obtaining The Rules of The Road, A Guide to the Law of Charities in the United States by Betsy Buchalter Adler

Section VI. Employment Issues[24]

This Section will provide an overview of the various employment concerns that face a small exempt organization. It is not meant to be in depth description of the various employment and benefits issues that may arise. When faced with complex issues competent advisors should be obtained. The section will cover:

- the differences between employees and independent contractors,
- employee and volunteer liability issues,
- payroll and withholding taxes,
- a brief overview of employee benefits
- and an example of standard employment policies found in human resource manuals.

Determining reasonable compensation for employees will be covered in Section V of the outline.

A. Employee v. Independent Contractor

Every organization must make the basic decision – will its operations by run by employees, independent contractors or a combination of both. The answer may make a big difference on the type of taxes that the organization pays and the type of benefits that it will offer. Many small EOs will have a few employees. Others may only be able to hire independent contractors.

People such as lawyers, contractors, subcontractors, public stenographers, and auctioneers who follow an independent trade, business, or profession in which they offer their services to the public, are generally not employees. However, whether such people are employees or independent contractors depends on the facts in each case. The general rule is that an individual is an independent contractor if the payer has the right to control or direct only the result of the work and not the means and methods of accomplishing the result.

The following is a list of factors used by the IRS in determining whether a given worker is an "employee" or an "independent contractor." However, the final determination is made on a case-by-case basis.

1. 20 Factor Test:

1. Instructions: An employee must comply with instructions about when, where and how to work. Even if no instructions are given, the control factor is present if the employer has the right to control how the work results are achieved.

2. Training: An employee may be trained to perform services in a particular manner. Independent contractors ordinarily use their own methods and receive no training from the EO.

3. Integration: An employee's services are usually integrated into the business operations because the services are important to the success or continuation of the business. This shows that the employee is subject to direction and control.

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[24] This section was prepared by Diana Salmann, Shannon Nash, Darius Bolling and Jeannie Carmedelle Frey.

4. Services rendered personally: An employee renders services personally. This shows that the employer is interested in the methods as well as the results.

5. Hiring assistants: An employee works for an employer who hires, supervises and pays workers. An independent contractor can hire, supervise and pay assistants under a contract that requires him or her to provide materials and labor and to be responsible only for the result.

6. Continuing relationship: An employee has a continuing relationship with an employer. A continuing relationship may exist even if work is performed at recurring although irregular intervals. The independent contractors relationship is determined under the terms of the contract. It usually ends when the services covered under the contract are deemed completed.

7. Set hours of work: An employee usually has set hours of work established by an employer. An independent contractor generally can set his or her own work hours.

8. Full-time required: An employee may be required to work or be available full-time. This indicates control by the employer. An independent contractor can work when and for whom he chooses.

9. Work done on premises: An employee usually works on the premises of an employer, or works on a route or at a location designated by an employer.

10. Order or sequence set: An employee may be required to perform services in the order or sequence set by an employer. This shows that the employee is subject to direction and control.

11. Reports: An employee may be required to submit reports to an employer. This shows that the employer maintains a degree of control.

12. Payments: An employee is paid by the hour, week or month. An independent contractor is usually paid by the job or on a straight commission.

13. Expenses: An employee's business and travel expenses are generally paid by an employer. This shows that the employee is subject to regulation and control.

14. Tools and materials: An employee is normally furnished significant tools, materials and other equipment by an employer.

15. Investment: An independent contractor has a significant investment in the facilities he or she uses in performing services for someone else.

16. Profit or loss: An independent contractor can make a profit or suffer a loss.

17. Works for more than one person or firm: An independent contractor is generally free to provide his or her services to two or more unrelated persons or firms at the same time.

18. Offers services to the general public: An independent contractor makes his or her services available to the general public.

19. Right to fire: An employee can be fired by an employer. An independent contractor cannot be fired so long as he or she produces a result that meets the specifications of the contract.

20. Right to quit: An employee can quit his or her job without at any time incurring liability. An independent contractor usually agrees to complete a specific job and is responsible for its satisfactory completion, or is legally obligated to make good for failure to complete it.

2. Form SS-8

Determination of employment status may be made by the IRS on Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding, with the IRS. Note that it not an anonymous form and once filed it becomes a part of IRS records.

3. Practical Suggestions

Small Eos generally require a lot of administrative support (i.e., secretaries or assistants) for day to day activities. They also often require professional help such as lawyers and accountants or fundraisers. The individuals running the day to day activities are generally employees (regardless of whether or not the are full-time or part-time). The other individuals that provide a professional service are typically independent contractors. The board of directors are typically unpaid volunteers and thus are neither employees or independent contractors. Officers may or may not be compensated. If they are compensated the will generally be deemed employees. In most instances the executive director will also be an employee.

B. Employee and Volunteer Liability

A significant percentage of lawsuits against nonprofit organizations relate to the activities of employees or volunteers. Directors of nonprofits may also be named as defendants in such suits.

A nonprofit corporation may be liable for employee or volunteer activities in two ways: (1) claims by third parties relating to acts or omissions of an employee or volunteers; and (2) claims by an employee or volunteer against the nonprofit organization.

1. Claims of Harm to Third Parties

An EO may be sued – or complained to – about the actions of employees or volunteers who have allegedly caused harm to third persons. For example, employees or volunteers operating motor vehicles (whether their own or the corporation's) for corporation purposes, or dealing with children, the elderly or other members of the public, may be charged with wrongdoing that is attributed to the corporation. In such circumstances, the employee or volunteer is viewed as the corporation's agent, and the corporation may be held liable for the agent's action. The corporation may be charged with direct liability for negligence in hiring or supervising an employee or volunteer.

2. Claims by Employees or Volunteers Against the Corporation

An EO also be sued by its own employees or volunteers, based on alleged wrongdoing of the EO itself or of other employee/volunteer agents of the corporation.

All corporations, whether for-profit or nonprofit, are subject to a host of laws related to employees. Some such laws also apply to volunteers. Many employment-related laws only apply if the corporation employs a certain minimum number of employees (often, 15 is the "magic number"). Such laws include the following:

1. Pregnancy Discrimination Act (covers discrimination based on pregnancy or childbirth);

2. Americans with Disabilities Act (covers discrimination based on disability);

3. Age Discrimination in Employment Act (covers discrimination against employees over 40 years old);

4. Equal Pay Act (covers discrimination in compensation based on gender);

5. Title VII, Civil Rights Act of 1963 (covers discrimination based on race, gender, national origin and religion; includes prohibition on sexual harassment as part of prohibition on gender discrimination; religious-based corporations are exempt from certain religious-based discrimination rules);

6. Family and Medical Leave Act (requires employers to provide eligible employees up to 12 weeks of unpaid leave for childbirth, adoption, care of an immediate family member or an employee's own serious health condition);

7. Occupational Health and Safety Act (requires compliance with mandatory safety and health standards);

8. Fair Labor Standards Act (requires payment of federal minimum wage and overtime pay for non-exempt employees working over 40 hours in one week);

9. Tax Withholding and Payroll Tax Laws (federal, state and local); and

10. Immigration Reform and Control Act of 1986 (prohibits employment of unauthorized aliens).

C. Payroll/ Withholding Tax Issues[25]

1. Employees

Although EOs are themselves exempt from income tax on their operations, they do have to withhold income tax (federal and state) from the pay of their employees. They also generally (with a few exceptions) have to withhold other payroll taxes such as social security, Medicare (Medicare and social security together are called FICA taxes). Federal unemployment (FUTA) and State unemployment (SUTA), though not withheld, must by the employer and is typically paid on the first $9,000 of wages. Thus, FUTA and SUTA are expenses borne completely by the employer. Also, employer's are subject to a FICA tax match, which is due for all FICA tax withheld from employees to cover Medicare and social security taxes.

- **Income tax**

The income tax is withheld from the wages of employees by the employer. The amount withheld is based on the number of exemptions claimed on the employee's Form W-4. This employment tax is withheld on many benefits in addition to wages paid.

- **FICA — Federal Insurance Contributions Act — Social Security tax and Medicare tax.**

FICA is a federal system of old age, survivors, disability and hospital insurance. The employer collects and pays the employee's part of these taxes. The employer must also pay a matching amount from its own funds. As of 1992-93 the rate for social security is 6.2 percent each for the employee and the employer (12.4 percent total). The tax rate for Medicare is 1.45 percent each for employers and employees (2.9 percent total).

[25] This Section does not cover the various rules and exemptions from withholding requirements for certain churches and religious organizations. Please consult IRS Publication 1828 for more information.

- **FUTA — Federal Unemployment Tax.**

Federal unemployment tax applies to all employees and is paid by the employer on Form 940.

- **SUTA – State Unemployment Tax**

State unemployment tax varies from state to state but generally provides for a credit when federal unemployment tax is paid. Thus, if the employer does not pay FUTA, the amount of SUTA paid will be higher.

2. Independent Contractors

Employers do not generally have to withhold or pay any taxes on payments to independent contractors. Independent contractors must pay their own ordinary federal and state income taxes, FUTA taxes, SUTA taxes and FICA taxes. Self-employed independent contractors also must estimate their individual income taxes for each year, then pay a quarter of the estimated amount owed to the federal and state government.

Independent contractors are required to fill out Form W-9, noting their name and address, social security or federal identification number (FEIN number). This form must be kept in the employer's files throughout the duration of the independent contractor's service. Independent contractors receive a Form 1099MISC at the end of the year. Like the Form W-2, this form reports to the IRS the amounts paid, but in the case of the report on Form 1099MISC there is no tax withheld. Form 1099MISC is required for payments over $600 per year, to individuals, partnerships, and other unincorporated entities. However, independent contractor, unlike employees, have the ability to deduct from gross income all legitimate business expenses including personal and fringe benefits. Form 1099MISC must be sent to the independent contractors by January 31st of the year after the tax year in questions. Failure to do this may result in penalties to the employer.

D. Employee Benefits

In additions to the salary paid to employees, the small EO must be concerned about what benefits it will provide to its employees (independent contractors do not get these benefits). Some possible benefits may include:

- Health Care
- Retirement/Pension Plans
- Insurance (Life, Accidental, Supplemental)
- Short and Long Term Disability

E. Human Resource Policies

EOs should also adopt get human resource manual covering various policies and procedures that apply to employees. The following is an example of various policies described in one EO's human resource manual.

- **Vacation Time**

a. All full-time employees shall accrue vacation at the rate of 1 day per month, 12 days per year total. All part-time employees shall accrue vacation at the rate equal to the percentage of full-time that each employee works. This time may be taken at the employees' discretion with the approval of the immediate supervisor. Employees are expected to take time off for vacation rather than receive payment instead of time off. If an observed holiday occurs during the vacation leave, an additional day of vacation shall

be granted. Part-time employees who work less than 20 hours per week are not entitled to paid vacation time.

b. After three years of service at the EO, all full-time employees accrue vacation at the rate of 1.25 days per full month worked, for a total of 15 days per year. After three years of service at the EO, all part-time employees accrue vacation at the rate equal to the percentage of full-time that each employee works.

c. All employees shall be entitled to vacation only after completion of their probationary period. Vacation time must be taken in the year in which it is earned or can be accrued up to two year's credit. Employees may elect to receive vacation pay for up to five days of unused vacation per year.

d. Prior to beginning any vacation leave, the employee shall determine the tasks to be completed, complete them and participate in arrangements for coverage of ongoing work during vacation leave.

- **Holidays**

The EO shall observe the following holidays:

1. New Year's Day
2. Martin Luther King Jr's Birthday
3. President's Day
4. Memorial Day
5. Independence Day
6. Labor Day
7. Thanksgiving Day
8. Thanksgiving Friday
9. Christmas Day

If the holiday falls on Saturday it will be observed on Friday. If the holiday falls on Sunday it will be observed on Monday.

- **Sick Leave**

All full-time employees shall be entitled to earn sick leave at a rate of one day per month, (twelve days per year). Employees are able to accrue any unused sick days beyond each anniversary year up to a maximum of 50 days. Accumulated sick leave shall not be used as additional vacation time. Part-time employees who work at least 20 hours per week will be entitled to earn sick leave at a rate of 1/2 day per month (six days per year). Upon employment, employees are entitled to use sick leave as it accrues. For absences of more than three days or recurrent absences, a physician's statement is required. Unused sick leave is forfeited at the time of termination, however, two bonus days will be granted if no sick leave was requested or taken during the previous twelve month period. Any employee taking a sick day must notify the office at the beginning of the work day. If an employee is absent from work due to personal illness and there is insufficient sick leave accumulated to enable regular payment of salary, the time may be charged to other leave categories such as vacation, compensatory time, personal business day, etc., provided the employee is eligible for such leave.

- **Personal Leave**

All full-time employees shall be granted two personal leave days per contract year. Personal leave days shall not be accumulated and must be taken in the year earned.

- **Family Death Leave**

In case of serious illness or death in the immediate family of the employee, spouse, parents, parents-in-law, brother, sister, child, grandparents, the supervisor can authorize a maximum of three days leave with pay.

- **Jury Duty**

In the event that an employee is called for jury duty or for service as a witness in a court of law, EO shall pay the regular salary of the employee. The employee is required to turn into the EO the pay received for jury duty or services as a witness. An employee is expected to report to work if jury duty or services as a witness does not require full-time service. Sick time and vacation days continue to accrue during jury duty leave.

- **Medical Leave**

Full-time employees shall be granted medical leave, with a letter from the employee's physician, provided that such leave does not exceed one month in length. The employee may elect to use all accrued sick, vacation and compensatory time at the commencement of this leave. Vacation and sick leave shall accrue during such leaves. The employee may return to the previously held position or a comparable position at the end of this leave.

- **Family Leave**

Employees eligible under the Family and Medical Leave Act (effective August 5, 1993) are entitled to up to 12 workweeks of unpaid leave, under the terms of the Family and Medical Leave Act.

- **Other Leaves of Absence**

The employee may take other leaves up to six months maximum (i.e., education, etc.) upon permission from the Executive Director or in the case of the Executive Director, the Board of Directors. Vacation and sick leave will not be accrued at this time. The staff member's position will not be filled during his/her leave of absence, although temporary arrangements may be made to cover the workload. The employee may return to the previously held position or a comparable position at the end of this leave. To be eligible for a leave of absence, the employee must have completed a minimum of two year's service with the EO. The staff may continue membership with the EO's group plan for medical care and life insurance, but at his/her own expense. Payments to Social Security, Worker's Compensation and Unemployment Compensation will be suspended because taxable wages are not being paid during the leave of absence.

Paternity leave may be given to an employee after the birth of their child or after adopting a child. Education leave may be given to an employee to attend classes to further their education.

F. Bibliography

http://www.irs.ustreas.gov/prod/forms_pubs/index.html - IRS publications and forms, including Publication 505, *Tax Withholding and Estimated Tax*; Form SS-8, *Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding*; Publication 15, *Employer's Tax Guide*, Publication 1976, *Employee or Independent Contractor*; Form W-2, *Wage and Tax statement*; Form W-9, *Request for Taxpayer Identification* Number; and Form 1099MISC, *Miscellaneous Income*.

http://charitychannel.com/ - charityChannel provides an on-line professional community that exceeds 45,000 nonprofit-sector professionals. The site has many discussion forums on various topics of interests to EOs, including a human resources discussion forum called CharityHR.

http://www.employers.gov - This website is called Firstgov for Employers and is a joint effort among the Department of Labor, Internal Revenue Service, Small Business Administration, Social Security

Administration, Treasury, States, and Simplified Tax and Wage Reporting System. The site provides resources and cross-agency information for employers, as well as new and established businesses. It provides helpful information on hiring employees, including links to forms and explanations of payroll taxes.

www.noacentral.org. National Organizers Alliance, a non-profit group with 1,000 members that represents the interests of people who work in "social justice " fields as disparate as homelessness, race relations, the environment, and labor activism. NAO formed a coalition in 1992 to form a joint pension plan for many small nonprofit organizations that could not afford to do so on their own. Non-profit organizations that join must contribute at least 5 per cent of employees' total annual salary to the retirement plan, and workers must have at least one year's employment at a social-justice organization to be eligible.

http://www.deathandtaxes.com/pub1828.htm - Tax Guide for Churches and Other Religious Organizations (not yet issued by the IRS)

Guidebook for Directors of Nonprofit Corporations, Chapter 7, "Volunteers" and Chapter 8, "Employees" (2nd ed., G. Overton and J. Frey, eds., American Bar Association 2002).

Section VII. UBTI[26]

EOs are, by definition, exempt from income tax. This is true for donations and revenues from the performance of exempt functions—that is, from conducting the activities for which the entity was organized. Revenues from other sources, however, are income from the conduct of an unrelated trade or business, and they are subject to tax under Sections 511 through 514 of the Code unless they are specifically excluded from taxation by law. This tax is known as the unrelated business income tax.

The unrelated business income tax rules focus on the activity that generates the income, not on how the EO uses the income. A section 501(c)(3) charity that operates a restaurant in order to teach job skills to homeless and unemployed people, for example, is not taxed on any income generated by the restaurant, because the activity itself serves a charitable purpose entirely apart from how the income is used. However, a section 501(c)(3) charity that operates a restaurant only to generate income for its other charitable activities is taxed on that income. This is true even though the income in the second example was applied exclusively to charitable purposes.

The unrelated business income tax rules contain numerous exceptions and exclusions. This chapter focuses first on the general rules and then on the exceptions.

A. General Rules And Definitions

Section 512 of the Code defines unrelated business taxable income in language that is almost as convoluted as the definition of a charitable organization under Section 501(c)(3). Put more simply, unrelated business taxable income is the gross income (less allowable deductions) that an EO derives from any activity that is (1) a trade or business, (2) regularly carried on by the EO, and (3) not directly causally related to achieving the EO's exempt purposes. For the income to be taxed, all three elements must be present. Thus, if the trade or business is regularly carried on but its conduct is related to the organization's exempt purposes, as with the restaurant example, the income from that activity is not taxed. Similarly, an unrelated trade or business that is not regularly carried on (such as a food booth at a county fair, operated one week per year) will not generate taxable income. It is, therefore, important to understand the elements of the definition.

1. Trade or Business

For this discussion, a trade or business is an activity that involves the sale of goods or services to produce income. It is not necessary to compete with for-profit enterprises, although the existence of competition is likely to influence the IRS or a reviewing court; the key is whether the EO conducted the activity with the intent to make a profit.

2. Regularly Carried On

An activity is "regularly carried on" by an EO if it is conducted with the same frequency and continuity as if it were operated by a nonexempt organization. An EO that presents a concert by a popular performer once a year to raise money, for example, cannot be equated with an impresario who presents concerts year-round. Thus, the facts and circumstances are likely to be decisive in determining whether an activity is regularly carried on.

3. Relationship to Exempt Purposes

If the conduct of a trade or business is substantially causally related to the achievement of the EO's exempt purposes, the income generated by that activity is not subject to taxation. The test focuses on the activity

[26] Portions of this outline are being reproduced from "The Rules of The Road, A Guide to the Law of Charities in the United States" by Betsy Buchalter Adler and produced by the Council of Foundations. The remaining portions were written by Shannon Nash.

itself, not on how the EO uses the income. The fact that all proceeds are used to support exempt-purpose activities does not make an unrelated activity into a related activity.

What, then, qualifies as related? In practice, if the actual conduct of the activity makes an important nonfinancial contribution to the nonprofit's exempt-purpose program, the IRS will consider the activity related, and the income that it generates is tax-free. This means that the facts and circumstances determine the result. Consider these examples:

- An art museum uses its auditorium during regular hours for lectures on art history. In the evening its shows films of general interest. Admission fees for the film series are income from an unrelated business.

- The museum store sells reproductions of works of art, some from its own collection and some from other similar collections. The museum store also sells jewelry and recorded music. Income from the sale of reproductions and similar items is considered related because it educates the public about art of the type presented at the museum, but the jewelry and music do not accomplish the goal. Therefore, income from the sale of those items is taxable.

B. Debt-Financed Income

EOs, like other entities, sometimes borrow money to acquire income-producing property. They may also receive encumbered property through a gift or bequest. Section 514 of the Code provides that income from debt-financed property is taxable in the proportion that the EO's acquisition indebtedness bears to its equity in the property. The taxable proportion of the income diminishes as the debt is paid off. If the property is sold while indebtedness remains, however, the capital gains on the property are taxed proportionately.[27] Please note that these rules override the exceptions, modifications and exclusions discussed below. Thus, rental income that would otherwise be excluded from tax is taxable in part if the rental property is debt-financed.

1. Sales of Merchandise or Goods

EOs that sell goods or merchandise may be subject to UBTI on the income derived from such activity. The IRS uses an item by item analysis. Items that are related to the EO's exempt purposes will not be subject to UBTI (i.e., an arts organization that sells reproductions of artistic works). However, certain convenience items such as (souvenirs, food, etc) may be subject to UBTI. Please note the sale of donated goods by the EO will not be subject to UBTI.

2. Advertising

Advertising payments will generally be subject to UBTI. Advertising includes:

- Messages containing qualitative or comparative language, price information or other indications of savings or value,

- endorsements, or

- inducements to purchase, sell or use the sponsor's products or services.

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[27] The intricacies of the debt-financed income rules are beyond the scope of this outline and thus a competent tax adviser should be consulted for further questions.

Advertising does not include the use or the mere acknowledgment of a sponsor. Those payments are treated as corporate sponsorship and are discussed in more detail below. The use of promotional logos and slogans or the distribution or display of the sponsor's products (whether free or for remuneration) is also not considered advertising.

3. Associate Member Dues

There is another category of income that may be subject to UBTI and is of particular concern for Section 501(c)(6) organizations. Associate member dues will be subject to UBTI where the principal purpose of such dues is to raise income for the EO. These associate members typically have very little in common with the regular members of the EO. Moreover, the benefits received by these associate members are typically very general in nature and have very little relationship to the purposes of the EO. For example, an EO that creates an associate membership category solely to allow these members to purchase insurance through the EO, will generally be subject to UBTI on these dues. Associate members dues will not be treated as UBTI if they are less than the annual limit, which is determined yearly. For 2000 the annual limit was $112.

C. Exceptions and Exclusions

Although some income-generating activities are clearly not related to accomplishing an EO's exempt purposes, they are nonetheless excluded from the definition of an unrelated trade or business. Income from these excluded activities is not subject to UBTI. The most frequently encountered exclusions apply to:

- any activity in which volunteers perform substantially all of the work;
- activities that are conducted primarily for the convenience of the organization's members; and
- the sale of donated merchandise.

Section 513 of the Code also contains special rules for the treatment of income from certain categories of the activities. Among these are the operation of trade shows, state fairs and conventions, the sale or exchange of mailing lists and the provision of "commercial-type" insurance.

Section 512(b) of the Code contains numerous modifications to the definition of unrelated business income. The modifications that EOs are most likely to encounter include investment income, royalties, and rent.

1. Investment Income

Dividends, interest, rents, royalties, capital gains and similar passive investment income are generally excluded from the reach of the unrelated business income tax except in two circumstances; if they are derived from debt-financed property, in which case the funds are partially taxable, or if they are paid by an organization controlled by the EO. Control, for this purpose, means a 50 percent interest.

2. Royalties

Section 512(b)(2) of the Code excludes "all royalties (including overriding royalties) whether measured by production or by gross or taxable income from the property and all deductions directly connected with such income." As with interest and annuities, royalties from debt-financed property or from controlled organizations are treated as unrelated business income.

In recent years, the IRS has begun to look closely at whether an exempt organization is being paid for the use of intellectual property (a tax-free royalty) or for services provided to another entity (a taxable fee for services). Payments for the use of an EO's mailing list have been the subject of much litigation, most recently in the context of affinity credit cards—that is, credit cards bearing the EO's logo and marketed by

the issuing bank to the EO's supporters through the EO's mailing list. The IRS continues to argue that unless the parties on both sides of the transaction are EOs, the transaction is not a tax-free royalty but a taxable payment for services. This is because, as the IRS sees it, the owner of the mailing list is actively involved in maintaining the list and, thus, providing services for which it is being paid.

This argument has not fared as well in court as the IRS would have liked. In several recent decisions, courts have ruled that bank payments to the Sierra Club (a Section 501(c)(4) organization) in connection with its participation in an affinity credit card program were payments for intangible intellectual property—that is, the Sierra Club's name, logo and mailing list—and, thus, tax-exempt royalties.[28] The IRS continues to argue that an EO's provision of any service in connection with a mailing list (such as sorting members' names by donation size or preparing mailing labels) converts the transaction from a tax-free royalty arrangement to a joint venture with a for-profit enterprise.

3. Rent

Section 512(b)(3) of the Code excludes income received from the rental of real property (land and buildings). However, there are numerous exceptions to this general rule. If the rent is from a controlled organization, as discussed above, it is considered unrelated business income. If the rent is derived from debt-financed property, part of the rent is taxable. Income from the rent of personal property (such as office equipment or furniture) is taxable unless the personal property is leased with real property and the rent attributable to the personal property is no more than 10 percent of the total rent from all the property leased.

Rent may be based on a fixed percentage of sales or receipts. But if the rent amount depends wholly or partly on the income or profits derived by any person from the leased property, the rental income is taxable.

An EO's landlord may provide normal maintenance services. However, if the EO provides services beyond what landlord usually provide in the circumstances, the rent exception does not apply and the income is taxable. An EO's landlord may provide utilities, collect trash and clean public areas without rendering its rental income taxable, but provision of maid service with the rental of living quarters is beyond normal maintenance services and would subject the rents to the unrelated business income tax.

An EO's income-generating transactions can often be structured to avoid the unrelated business income tax. If no exception or modification applies, however, that does not necessarily mean that an EO should avoid the transaction. As long as the EO's exempt-purpose activities are commensurate with its income and its primary purpose remains the conduct of those activities, the receipt of taxable income from unrelated business activities will not imperil the EO's tax-exempt status.

4. Corporate Sponsorship

Unlike advertising payments, qualified corporate sponsorship payments are not subject to UBTI. With these payments the sponsor does not receive a substantial benefit from the EO other than the use or acknowledgement of the sponsor's name, logo or product line.

D. Calculating the Tax

UBTI is taxable at regular corporate income tax rates. In calculating the amount of UBTI that an EO is taxable on, deductions directly connected with carrying on the unrelated trade or business may be taken. Thus, on its unrelated business taxable income, the EO is treated just like a regular corporate tax paying

[28] Sierra Club, Inc., 103 TC 307 (1994): affirmed in part, Sierra Club, Inc. v. Commissioner, 86 F.3d 1526 (9th Cir. 1996).

entity.[29] The UBTI tax is reported and paid on Form 990-T. See Section VIII of the outline for more information on Form. 990-T.

E. Bibliography

http://www.irs.ustreas.gov/prod/forms_pubs/index.html - IRS Publication 598, *Tax on Unrelated Business Income of Exempt Organizations.*

[29] The intricacies of corporate taxation are beyond the scope of this outline and thus a competent tax advisor should be consulted for further questions.

Section VIII. Internal Revenue Service Form 990s[30]

This Section will provide an overview of the federal tax forms that EO's may be required to file.

A. Form 990, Form 990-EZ and Form 990-PF

1. General Filing Requirements

Every EO must file an annual information return on either:

- IRS Form 990, Return of Organization Exempt From Income Tax;
- IRS Form 990-EZ, Short Form Return of Organization Exempt From Income Tax; or
- IRS Form 990-PF, Return of Private Foundation or Section 4947(a)(1) Nonexempt Charitable Trust Treated as a Private Foundation.

2. Organizations with Exemption Pending

An EO that claims to be exempt under Section 501(c)(3) but whose application on IRS Form 1023 has not yet been filed or is still pending must still file Form 990, Form 990-EZ or Form 990-PF, as the case may be, and may be subject to penalties for not doing so. If the EO's application is pending with the IRS, the EO should indicate this by checking the "application pending" box on page 1 of the applicable form.

3. Exceptions for Small Exempt Organizations

A small EO (other than a private foundation) having annual gross receipts that normally are not more than $25,000 will generally be exempt from filing a Form 990. An EO's annual gross receipts are considered to normally not be more than $25,000 if:

- The EO is up to one-year old and has received, or donors have pledged to give, $37,500 or less during its first taxable year;
- The EO is between 1 and 3 years-old and averaged $30,000 or less in gross receipts during each of its first 2 taxable years; o
- The EO is 3 years-old or more and averaged $25,000 or less in gross receipts for the immediately preceding 3 taxable years, including the year for which the return would be filed.

Gross receipts are equal to the total amount the EO received from all sources during its annual accounting period, without subtracting any costs or expenses.

An EO that normally receives annual gross receipts of $25,000 or less should probably still file Form 990 or 990-EZ for the following reasons:

- The EO will most likely need to furnish copy of Form 990 or 990-EZ if it is applying for grants from other EOs, particularly private foundations.
- The EO may be required to or may be able to (depending on the particular state statute) use Form 990 or Form 990-EZ to satisfy certain annual state reporting requirements. See Section IX of this outline for the various annual state filing requirements.

[30] This Section was prepared by Victoria Bjorklund and Jennifer Franklin

- The EO may need to file Form 990 or Form 990-EZ to be included in IRS Publication 78 and Guidestar's on-line database of EOs. (See bibliography below for a link to Guidestar's website which contains a database of all Section 501(c)(3) charities that submit Form 990 to the IRS and is often the starting point for a donor who is considering making contributions to an EO).

4. Other Exceptions from Filing a Form 990

The following EOs are also exempt from filing Form 990:

- Churches and church-affiliated organizations, including schools below college level and mission societies,

- State institutions whose income is excluded from gross income under Section 115,

- Corporations exempt under Section 501(c)(1) as corporations organized under an Act of Congress and instrumentalities of the United States,

- Foreign organizations described in Section 501(a) (other than private foundations) that normally do not receive more than $25,000 in annual gross receipts from sources within the United States and have no significant activities in the United States.

5. Which Form Must Be Filed?

- Form 990: Used by EOs exempt from federal income taxation under Section 501(a), which have annual gross receipts that are normally more than $25,000. EOs exempt under Section 501(c)(3) must also file Schedule A to Form 990. All EOs must file Schedule B to Form 990 to disclose the information regarding contributors that is required on Line 1(d) of Form 990, unless they certify that they do not meet the filing requirements of Schedule B by checking the box in Item L of the heading of the form.

- Form 990-EZ: Filed in lieu of Form 990 by EOs exempt from federal income taxation under Section 501(a) which have annual gross receipts of less than $100,000 and total assets at the end of the taxable year of less than $250,000. Again, EOs exempt under Section 501(c)(3) must also file Schedule A to Form 990-EZ. All EOs must file Schedule B to Form 990-EZ to disclose the information regarding contributors that is required on Line 1 of Form 990-EZ, unless they certify that they do not meet the filing requirements of Schedule B by checking the box in Item L of the heading of the form.

- Form 990-PF: Must be filed by all private foundations exempt from federal income taxation under Section 501(a), regardless of the amount of their annual gross receipts. How are gross receipts calculated for these purposes? An EO's gross receipts are equal to the total amount the EO received from all sources during its annual accounting period, without subtracting any costs or expenses.

6. When and Where Should Form 990, Form 990-EZ or Form 990-PF Be Filed?

Time of Filing: Form 990, Form 990-EZ or Form 990-PF must be filed by the 15th day of the fifth month after the EO's taxable year ends. If the regular due date falls on a Saturday, Sunday or legal holiday, the applicable form can be filed on the next business day.

Extension of Time to File: An EO can file IRS Form 8868, Application for Extension of Time to File Exempt Organization Return, to request an automatic 3-month extension of time to file Form 990, Form 990-EZ or Form 990-PF. An EO can use the same form (Form 8868) to request an additional (not automatic) extension of time to file by showing reasonable cause for the need for additional time.

Where to File: The applicable form should be mailed via either certified mail, return receipt requested or a private delivery service approved by the IRS to the Internal Revenue Service Center, Ogden, UT 84201-0027.

7. What are the Penalties for Not Filing?

An EO that is required to file Form 990, Form 990-EZ or Form 990-PF but fails to do so will be subject to a penalty of $20/day for each day the failure continues, up to a maximum penalty (for any one annual information return) equal to the lesser of $10,000 or 5% of the EO's gross receipts for the taxable year (plus interest). An EO that has gross receipts of over $1 million for the taxable year but fails to file Form 990 or Form 990-PF will be subject to a penalty of $100/day, up to a maximum of $50,000 (plus interest).

8. Reporting Excess Benefit Transactions

Under the IRS's intermediate sanctions rules, organizations that are exempt under Code sections 501(c)(3) and 501(c)(4) must report on their Form 990s whether any excess benefit transaction involving a director, executive officer or other insider (a "disqualified person") occurred during the fiscal year covered by the Form 990.

B. Form 990-T, Exempt Organization Business Income Tax Return:

1. Who Must File IRS Form 990-T?

Section 501(c)(3), 501(c)(4) and 501(c)(6) organizations that generate more than $1000 in gross income from unrelated businesses (or UBTI) must file Form 990-T. See Section VII of this outline for more information on UBTI.

2. When and Where is Form 990-T Filed?

- When To File: Form 990-T must be filed by the 15th day of the fifth month after the EO's taxable year ends. If the regular due date falls on a Saturday, Sunday or legal holiday, Form 990-T can be filed on the next business day.

- Extension of Time to File: A corporation can file IRS Form 7004, Application for Automatic Extension of Time to File Corporation Income Tax Return, to request an automatic 6-month extension of time to file Form 990-T. A trust, on the other hand, may request an extension of time to file Form 990-T by filing IRS Form 2758, Application for Extension of Time to File Certain Excise, Income, Information and Other Returns, but such a request will not be automatically granted.

- Where to File: Form 990-T should be mailed via either certified mail, return receipt requested or a private delivery service approved by the IRS to the Internal Revenue Service Center, Ogden, UT 84201-0027.

3. How is the Tax Calculated and How is it Paid?

Calculation of Tax: An EO will be subject to federal income tax at regular graduated rates applicable to for-profit corporations on its "unrelated business income." See Section VII of this outline for a discussion of the unrelated business income tax.

4. Estimated Tax Payments:

An EO must make estimated tax payments if it expects its unrelated business income tax to be $500 or more.

5. When Due:

Estimated tax payments are generally due by the 15th day of the fourth, sixth, ninth and twelfth month of the EO's taxable year. If the regular due date falls on a Saturday, Sunday or legal holiday, the payment will be due on the next business day.

6. How Calculated:

An EO can base its required estimated tax payments on 100% of the tax show on its return for the preceding year (unless no tax was shown) but only if its taxable income for each of the three preceding taxable years was less than $1 million. If an EO's taxable income for any of the preceding three years was $1 million or more, the EO can base only its first required estimated tax payment on its tax for the prior year. An EO should use Form 990-W, Estimated Tax on Unrelated Business Taxable Income for Tax-Exempt Organizations, to calculate its estimated tax payments.

7. What are the Penalties for Not Filing?

Penalty for Late Filing of Form 990-T: An EO that fails to file its return when due is subject to a penalty of 5% of the unpaid tax for each month or part of a month the return is late, up to a maximum of 25% of the unpaid tax (plus interest). The penalty may be abated upon a showing of reasonable cause for the delay. The minimum penalty for a return that is more than 60 days late is the smaller of the tax due or $100 (plus interest).

Penalty for Late Payment of Tax: Any tax due with Form 990-T must be paid in full when the form is filed, but no later than the date the return is due (determined without taking into account any extensions). An EO who does not pay its tax when due will be subject to a penalty of ½ of 1% of the unpaid tax for each month or part of a month the tax is unpaid, up to a maximum of 25% of the amount due (plus interest).

Estimated Tax Penalty: An EO that fails to make estimated tax payments when due may be subject to an underpayment penalty (plus interest). Generally, an EO will be subject to this penalty if its tax liability is $500 or more and the EO did not make estimated tax payments of at least the smaller of the tax shown due on the return or 100% of the prior year's tax.

C. Bibliography

http://www.irs.gov/pub/irs-pdf/p557.pdf - IRS Publication 557 *Tax Exempt Status for Your Organziation* . IRS Publication 598, *Tax on Unrelated Business Income of Exempt Organizations*, Form 990, Form 990-EZ, Form 990-PF, Form 990T may all be found on this website.

http://www.irs.gov/exempt/display/0,,i1%3D3%26genericId%3D6903,00.html – IRS provides filing tips for Form 990.

http://www.guidestar.org -- Guide star has complied a database of all 501(c)(3) charities that submit 990 forms to the IRS.

http://www.wiley.com - This website provides information on the following publications which are for sale: Jody Blazek, Tax Planning and Compliance for Tax-Exempt Organizations: Forms, Checklists and Procedures, John Wiley & Sons, Third Edition, 1999, Jody Blazek 990 Handbook: A Line-by-Line Approach, John Wiley & Sons, 2000, Jody Blazek, Tax Planning and Compliance for Tax-Exempt Organizations: Forms, Checklists and Procedures, John Wiley & Sons, Third Edition, 1999.

http://www.nonprofitfinancial.org - Nonprofit Financial Center is a nonprofit financial resource organization formed to help nonprofit organizations develop sound financial management. NFC also gives loans to Illinois nonprofits and provides valuable links for Illinois nonprofits.

http://www.990accountant.com - A guide to form 990s and other IRS nonprofit related forms.

http://www.qual990.org/links.htm – This site provides information about the Form 990, nonprofit accountability, and other accounting/tax issues.

http://www.form990.org - This site is a prototype of an electronic or magnetic filing system that when enabled will allow the user to complete a Form 990 and submit it to the appropriate agencies. Additionally the site will enable the public to view any Form 990 on record. The form 990 will be a smart form and will signal the user when calculation, ratio, and omission errors are made.

Section IX. State Tax and Other Yearly Filings[31]

A. State Taxes

A nonprofit corporation may have to pay state income or other taxes if exemptions for such taxes are not obtained. An EO may be subject to taxes in more than one state depending on the nature of its activities and its location. For example, an EO located close to the border of another state may have this issue. This section gives a general overview of the state taxes that may apply to an EO.

1. Income Tax

Although the EO may be generally exempt from state income taxes, just as with its federal exemption, the EO will continue to be subject to taxation on any unrelated business income or UBTI. For more on UBTI please refer to section VII of this outline.

Whether income is unrelated business income for federal income tax purposes depends on whether the activity is "substantially related" to the organization's exempt purposes and "contributes importantly" to the accomplishment of such purposes. In determining whether income should be treated as UBTI, all of the rules and exclusions discussion in Section VII of the outline continue to apply.

2. Sales Tax

The EO will be required to pay state sales taxes on its purchases if it did not file for exemption from state sales tax or if the exemption was denied. As with income tax, the state sales tax exemption may not apply to all of the EO's activities, so even with an exemption, state sales tax may still apply on certain purchases.

3. Property Tax

An EO's properties may or may not qualify for exemption from property tax (see the discussion in Section II of this outline), depending on the kind of activities engaged in, the kind of 501(c) organization, and the extent to which the property is used to further the organization's exempt purposes). In some locations, continued property tax exemption may not be assured after a planned transfer to another EO, such as in a reorganization.

4. Other Local Taxes and Assessments

Some states and localities have local assessments and business licenses that apply to EOs. Also, as states' tax bases erode, some states have begun to begun to look for other ways to raise funds from EOs. For example in some areas, EOs are subject to special energy taxes (assessed on utility bills) or "head taxes" (based on number of employees).

B. Corporate Filings

Annual/bi-annual corporate reports are usually filed with the Secretary of State, in a form prepared by the State. Such forms typically require identification of the current officers and directors, the organization's principal location, and other general information. In some states, filing a copy of the organization's Federal Form 990 may be required. There is generally a fee associated with this filing. Such annual or bi-annual corporate report forms are mailed to whomever is listed as the organization's registered agent. The corporation should make sure that the person currently serving as its registered agent will complete such forms on a timely basis.

[31] This section was prepared by Jeannie Carmedelle Frey and Shannon Nash

C. Charitable Solicitation Requirements

As mentioned in Section II of the outline, the EO will also have a yearly filing responsibility to keep it's charitable solicitation license current.

D. Bibliography

The following is a list of state agency (typically the Secretary of State or Attorney General's office) where EOs may find helpful information and links on these filing requirements.

http://www.law.state.ak.us/consumer/charities.html – Alaska Attorney's General Charity website

http://www.sosaz.com/Business_Services/Charities.htm – Arizona Secretary of State Charity website

http://www.ago.state.al.us -Alabama Attorney General website

http://www.ag.state.ar.us - Arkansas Attorney General website

http://caag.state.ca.us/charities - California Attorney General Charity website

http://www.sos.state.co.us – Colorado Secretary of State website

http://www.cslib.org/attygenl/mainlinks/tabindex8.htm – Connecticut Attorney General website

http://www.state.de.us/attgen – Delaware Attorney General website

http://www.dcpsc.org/index.html – District of Columbia Public Service Commission

http://legal.firn.edu - Florida Attorney General website

http://www.sos.state.ga.us – Georgia Secretary of State website

http://www.cpja.ag.state.hi.us - Hawaii Attorney General website

http://www2.state.id.us/ag - Idaho Attorney General website

http://www.ag.state.il.us/charitable/charity.html – Illinois Attorney General charity website

http://www.state.in.us/attorneygeneral – Indiana Attorney General website

http://www.state.ia.us/government/ag/index.html - Iowa Attorney General website

http://www.kssos.org/main.html – Kansas Secretary of State website

http://www.law.state.ky.us/cp/charity.htm - Kentucky Attorney General website

http://www.ag.state.la.us - Louisiana Attorney General website

http://www.state.me.us/ag – Maine Attorney General website

http://www.sos.state.md.us/sos/charity/html/cod.html#other – Maryland Secretary of State Charity website

http://www.ago.state.ma.us/charity.asp – Massachusetts Attorney General website

http://www.ag.state.mi.us – Michigan Attorney General website

http://www.ag.state.mn.us/charities/Default.htm – Minnesota Attorney General Charity website

http://www.sos.state.ms.us – Mississippi Secretary of State

http://www.ago.state.mo.us/index.htm – Missouri Attorney General website

http://sos.state.mt.us/css/index.asp – Montana Secretary of State website

http://www.nol.org/home/SOS – Nebraska Secretary of State website

http://ag.state.nv.us – Nevada Attorney General website

http://www.state.nh.us/nhdoj/CHARITABLE/char.html – New Hampshire Attorney General Charity website

htt://www.state.nj.us/lps/ca/ocp.htm – New Jersey Consumer protection website

htp://www.sos.state.nm.us – New Mexico Secretary of State website

http://www.oag.state.ny.us/charities/charities.html – New York Attorney General Charity website

http://www.secretary.state.nc.us/sls/default.asp – North Carolina Secretary of State Charity website

http://www.state.nd.us/sec – North Dakota Secretary of State website

http://www.ag.state.oh.us – Ohio Attorney General website

http://www.sos.state.ok.us – Oklahoma Secretary of State website

http://www.doj.state.or.us/ChariGroup/welcome2.htm – Oregon Attorney General Charity website

http://www.dos.state.pa.us/charities/charities.html – Pennsylvania Department of State Charities website

http://www.dbr.state.ri.us – Rhode Island Department of Business Regulation

http://www.scsos.com – South Carolina Secretary of State website

http://www.state.sd.us/attorney/index.html - South Dakota Attorney General website

http://www.state.tn.us/sos/charity.htm – Tennessee Secretary of State Charity website

http://www.oag.state.tx.us - Texas Attorney General website

http://attygen.state.ut.us – Utah Attorney General website

http://www.state.vt.us/atg – Vermont Attorney General website

http://www.vdacs.state.va.us/consumers/oca-regulatory.html – Virginia Office of Consumer Affairs Charity website

http://www.secstate.wa.gov – Washington Secretary of State website

http://www.state.wv.us/sos/charity/default.htm – West Virginia Secretary of State Charity website

http://www.doj.state.wi.us – Wisconsin Attorney General website

http://soswy.state.wy.us/index_1.htm – Wyoming Secretary of state website

Section X. Accounting Issues[32]

Accounting standards and rules govern how the EO keeps its internal financial books. They are often used by the board of directors and required by outside donors (i.e., big foundations). Thus, it is prudent for even a small EO to get in the practice of keeping sound internal accounting records. Moreover, the information in the financial records is often helpful in preparing the annual federal and state tax returns.

A. Financial Statements

The EO must have a set of financial documents that its board of directors can use to govern its affairs and plan for its future. They should be provided at each meeting of the board of directors and should be adopted by the board. Also, it may be prudent to have financial documents prepared on a yearly basis by an independent accountant. Sometimes these financial statements may actually may need to be reviewed or audited and will often depend on the parameters imposed donors. The following is a list of typical financial statements.

B. Statement of Revenue and Expenditures

The statement of revenue and expenditures shows the financial performance of the EO over a period of time.

C. Balance Sheet

The balance sheet reflects the assets and liabilities of the EO on a particular date.

D. Cash Flow Statement

The cash flow statement shows the cash inflows and outflows of the EO over a period of time. This is especially helpful in developing budgets for the EO as it gives an indication of all the cash issues that the EO is having.

E. FAS 116 and 117

Financial Accounting Standards are promulgations adopted by the Financial Accounting Standards Board. FAS 116 governs the recognition and valuation of contributions to the EO. FAS 117 governs the statement of cash flows and requires the EO to identify net assets as unrestricted, temporarily restricted or permanently restricted.

F. Fund Accounting

1. General

Many EO use a system of accounting commonly referred to as fund accounting. Fund accounting requires separate funds to be keep for assets donated to the EO which are subject to restrictions imposed by the donor. Thus, assets are grouped into funds – in there presentation on the balance sheet. The typical funds include:

2. General Fund

This category is for assets with no restrictions such as cash. The assets in this fund are generally used by the EO in carrying out its activities.

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[32] This section was prepared by Darius Bolling and edited by Shannon Nash.

3. Restricted Fund

The restricted fund contains assets that the EO may only use for a restricted purpose(s).

4. Endowment Fund

The endowment fund covers assets that are restricted in that only the income earned from such assets can be used by the EO.

5. Fixed Asset Fund

The fixed asset fund is a special fund designed to track an account for capitalized assets that usually cost over $500. Fixed assets can include significant repair costs, therefore an EO should establish a company policy covering the threshold of both asset cost and capitalized repairs.

G. Bibliography

http://www.990accountant.com - A guide to Form 990s and other IRS nonprofit related forms

http://www.nonprofitfinancial.org - Nonprofit Financial Center is a nonprofit financial resource organization formed to help nonprofit organizations develop sound financial management. NFC also gives loans to Illinois nonprofits and provides valuable links for Illinois nonprofits.

http://www.qual990.org/links.htm - provides information about the Form 990, nonprofit accountability, and other issues that NACs may tackle.

Section XI. Public Disclosure Rules[33]

Section 501(c)(3), 501(c)(4) and 501(c)(6) organizations must make copies of their informational tax returns and exemption applications readily available to the public.[34] This section will provide an overview of the information required to be disclosed and the manner in which they should be made available.

A. Information Required to be Disclosed

1. Annual Tax Returns

Upon request, EOs must provide copies of their three most recent annual informational tax returns (i.e., Forms 990, 990-EZ, 990-BL and Form 1065), including all attachments and schedules. This will result in the disclosure of the names and addresses of all individuals on the EO's board of directors and compensation information for officers, directors and key employees. EOs need not make available for public inspection nor for photocopying Form 990-T (dealing with unrelated business income). In addition, EOs that are public charities need not make available the portion of an informational return that identifies names and addresses of contributors.

2. Application for Exemption

Upon request, EOs must provide copies of their tax-exempt applications (i.e., Form 1023 or Form 1024) along with all schedules, attachments and documents, including the EO's organizational documents such as articles and bylaws. This disclosure only applies to applications that have been approved by the IRS. EOs waiting for their exempt status to be approved by the IRS need not comply. The disclosure rules also do not apply to exemption applications that were filed before July 15, 1987, unless the EO actually possessed a copy of the application on that date.

B. Public Inspection

EOs must show copies of their annual informational returns and exemption application to anyone who requests them during regular business hours at the EO's principal office, or in some cases its regional or district offices. However, where an EO does not have a principal office (as is the case with many start-up EOs), the EO may either choose a reasonable location or mail the requester a copy of the documents, all within two weeks of the request. During a public inspection, the EO may have an employee present in the room.

C. Requests for Copies

The EO has 30 days to fulfill requests for copies made in writing. A request for copies of documents made in person must be honored on the same day that the request is made. However, where unusual circumstances exist that prevent the EO from fulfilling the request on the same day, the EO will have up to five business days to respond to the request. Examples of unusual circumstances include the following: requests received shortly before the end of regular business hours, a significant volume of requests received on the same day, or requests received when the EO's administrative staff is busy conducting special duties (e.g., all-day office training, off-site meeting, etc.). The EO may not charge a fee for providing these documents, except for reasonable reimbursements for copying and/or actual postage costs incurred. A reasonable fee for copying cannot exceed the fee that the IRS charges the public for copies of tax-exempt organization tax returns and related documents. That fee is currently $1 for the first page and 15¢ for each additional page.

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[33] This Section was prepared by Shannon Nash.

[34] Treas. Reg. §§ 301.6104(d)-3 through 301.6104(d)-5; T.D. 8818 (April 18, 1999).

D. Internet Exception

An EO need not furnish a copy of its documents if they are widely available to the public such as by posting them on the internet. This posting can be done on the EO's web site or as part of a database of similar documents of other tax-exempt EOs maintained by another entity. The web site must inform users of the documents' availability and provide instructions for downloading the documents. A document must be posted in a format that, when downloaded, exactly reproduces the document as originally filed with the IRS. Anyone with Internet access must be able to download the documents without special computer hardware or software (other than software that is readily available to members of the public without payment of any fee). Portable Document Format (PDF) or Adobe Acrobat files will fulfill these formatting requirements.

Neither the EO nor any entity maintaining the web page may charge a fee for downloading and viewing the documents. The EO must provide the web site address immediately to a person requesting documents in person and within seven days of receiving a request in writing. Keep in mind that this internet exception only absolves the EO from furnishing copies of its documents. The EO must still make its returns and exemption applications available for public inspection at its offices.

E. Penalties

An EO that fails to comply with these public inspections and requests for information returns may be subject to a $20 per-day penalty for every day that it is in violation, subject to a maximum penalty of $10,000 per return. Failure to comply with the disclosure rules with respect to exemption applications subjects the EO to a $20 per-day penalty, with no maximum. There is an additional penalty of $5,000 for the "willful" failure to adhere to any of these disclosure rules.

F. Harassment Campaigns

EOs need not fulfill requests for copies of documents when the purpose is meant to disrupt the operations of the EO. EOs may disregard a request as being harassment motivated, when more than two requests per month or four requests per year are made by a single individual or from a single address. Otherwise, the EO must file an application for harassment campaign determination within 10 days of the purported harassment. Harassment campaigns may exist where the EO notices a sudden increase in the number of requests, an extraordinary number of requests made through form letters, or requests that contain language hostile to the EO. If the IRS denies the harassment campaign application, the EO may still be subject to the penalties for failure to comply with the disclosure rules. Realizing that in certain situations it may be appropriate to mitigate the EO's exposure to these penalties, the IRS is drafting a revenue procedure that will provide additional details on harassment campaign determination procedures and the imposition and mitigation of penalties.

G. Outsourcing the Burden

EOs may outsource the responsibility of fulfilling requests for copies of documents. However, the duty to comply with the law is still borne by the EO. Thus, if the EO's agent fails to process a request made in writing within the required 30 day time limit, the EO will remain subject to the penalty provisions. Moreover, the 30 day response period commences when the EO receives the request, and not when its agent is notified.

An agent may also be used to process requests for documents made in person.. The agent must be located within reasonable proximity of the EO's office. Again, the duty to comply with the law is still borne by the EO. If the agent fails to process the request in the same business day, unless there are unforeseen circumstances, the EO may be subject to penalties.

H. In Practice

Posting the information returns and exemption applications on the Internet is a viable option for complying with the regulations, especially if the EO already maintains a website. However, for smaller EOs, the time and expense involved in creating a website may be too burdensome. These EOs may want to consider outsourcing the burden to another entity.

I. Bibliography

http://www.irs.gov/pub/irs-utl/topico00.pdf – For IRS Continuing Professional Education article on disclosure of information returns and exemption applications.

http://www.guidestar.org -- Guide star has complied a database of all 501(c)(3) charities that submit Form 990s to the IRS.

Section XII. Deductions[35]

This section will provide an overview of the two type of deductions available for contributions made to section 501(c)(3) organizations – the charitable contribution deduction and the business expense deduction. There will also be a discussion of the type of records that taxpayers must keep in order to substantiate these deductions on their personal federal income tax returns. The section will provide a comparison of the two deductions and conclude with a bibliography listing other helpful sources on this topic.

A. Charitable Contribution Deduction

1. General Rules

Contributions to section 501(c)(3) organizations will often qualify for the charitable contribution deduction. Section 170 of the Code allows a deduction for charitable contributions. For individuals this deduction is taken on Schedule A of the Form 1040. However, the amount of the actual charitable contribution deduction is subject to certain limitations. The deduction is limited to 50 percent of an individual's adjusted gross income. Also as an itemized deduction, charitable contributions are further limited in that they can only be taken if the individual itemizes. Generally, an individual will itemize only if the total amount of the itemized deductions exceeds the standard deduction, which for 2001 was $4,550 for single taxpayers and $7,600 for married taxpayers filing jointly.

2. Substantiation Rules

Even if a contribution is made to a charity, failure to obtain the required substantiation of such deduction may result in denial of the contribution deduction[36].

- **Contributions in General**

The general substantiation requirements provide that the donor keep proof of the donation by way of a cancelled check, receipt or some other form that shows:

- the donee's name,
- the date of the contribution, and
- the amount of the contribution.

- **Gifts of $250 or More**

A donor who contributes money or property valued at $250 or more must substantiate the contribution by a contemporaneous written acknowledgment that includes the following information:

- the amount of the contribution and a description of any property,
- a statement of whether or not the charity provided any goods or services in consideration, in whole or in part in exchange for the contribution ("quid pro quo benefits"), and
- a description and good-faith estimate of the value of any quid pro quo benefits.

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[35] This section was prepared by Shannon Nash.

[36] Please note the substantiation rules being discussed generally apply to contribution made in cash. The substantiation rules for contributions of other types of property see IRS Publications 526 and 1771.

- **Quid Pro Quo Rule - Gifts of $75 or More**

If the donor receives a benefit in return for making a contribution to the charity in excess of $75, the charity must provide the donor with a written statement that includes the following information:

- the donor may only treat as a tax deductible charitable contribution, the amount by which the total contribution exceeds the fair-market value of the benefits provided by the charity, and

- a good faith estimate of the fair-market value of the quid pro quo benefits.

written records to substantiate this deduction. (See IRS Publication 526 Charitable Contributions for more information on the substantiation requirements).

4. Practical Tips

- **Quid Pro Quo Benefits less than $75**

Even if the quid pro quo benefit is given in connection with a donation of less than $75, the actual donation is still limited to the amount the donor gave less the benefit received in return. Thus the charity should be in the practice in its form thank you letter of describing the net gift.

- **Mailing of written acknowledgments**

A written acknowledgment is contemporaneous if it is obtained prior to the earlier of: (1) the date the donor files his or her original tax return in the year in which the contribution was made, or (2) the due date, including extensions for filing the donor's original tax return. Thus, for each tax year written acknowledgements should be sent to donors by January or the next tax year but at least before April 15th of the next tax year.

- **Aggregation**

There is no aggregation requirement. Also, there is no requirement that contributions by a particular donor to a single charity be aggregated in determining if the $250 threshold is met. Thus, a donor can contribute $249 daily to a single charity and never be required to obtain this written acknowledgment (assuming quid pro quo benefits are not received that would trigger the quid pro quo rule).

- **Penalties for failing to Provide Substantiation**

The Section 501(c)(3) organization faces a $10 penalty per contribution for each failure to provide the required written statement to a donor who receives quid pro quo benefits. There is a maximum penalty of $5000 per contribution. This penalty may be avoided if the organization can show that the failure was due to reasonable cause. Also the organization may be subject to penalties if it knows or has reason to know of a falsity in its written substantiation to donors.

- **EOs record retention**

How long should charity keep copies of the substantiation records? As a general rule donors need only keep their copies of acknowledgments for 3 years. Depending on the resources of the EO, it may be prudent (and certainly helpful for the donors) to keep copies of acknowledgements for a longer period (i.e., 6 years).

- **Be wary of stock contributions**

As previously mentioned, contributions of stock have become increasing popular because the donee gets a fair market value deduction without recognizing any gain on the stock. But accepting this stock can be fraught with issues. Small charities with few resources to help them deal responsibly with illiquid or restricted stock may be better off turning down gifts like shares in family-owned businesses and other unmarketable securities.

- **IRS Form 8283 Noncash Charitable Contributions**

Form 8283 must be completed by donors who make noncash contribution over $500 and the form must be attached to their Form 1040. The taxpayer must fill out section A of Form 8283 for noncash contributions less than $5000.

charitable contribution. Conversely, with a business expense the taxpayer is typically expecting a return that bears some relationship to his or her trade or business. In practice it is often hard to distinguish between the two motives. For example, take the case of an artist who is in the business of selling his or her art work. This artist makes a donation to become a member of a public charity whose purpose is to further artistic and cultural endeavors. Did the artist make this donation with or without the expectation of commensurate financial return? This is a factual decision and will depend on the circumstances of the particular individual and the charity.

D. What's the Big Deal?

The business expense deduction has several advantages over the charitable contribution deduction. To qualify for deduction, charitable contributions have to be substantiated by written receipts requiring certain information. Although taxpayers generally must be able to substantiate business expenses, there is no specific form language that must be obtained from a charity (but note Section 501(c)(6) and 501(c)(4) organizations must provide some cautionary language). Moreover, business expense deductions by themselves are not subject to the charitable contribution percentage limitations or the overall itemized deduction limitations.

However, from a practical standpoint, for most individuals the actual amount of the deduction is the same. Keep in mind, charitable contributions are limited to 50% of the taxpayer's adjusted gross income. Thus, individuals may deduct contributions up to half of their salary, wages and other earned income. Most individuals do not make contributions quite that large and, in practice, deduct the full amount of their charitable contributions. Moreover, many individuals are not engaged in a trade or business and, thus, cannot take a business expense deduction.

E. Bibliography

http://www.irs.ustreas.gov/prod/forms_pubs/index.html - for IRS Publications and Forms.

http://www.irs.ustreas.gov/prod/bus_info/eo/index.html – for IRS Exempt Organization general information.

http://www.irs.ustreas.gov/prod/bus_info/eo/contrib.html - for links to information regarding penalties to 501(c)(3) organizations for not providing written acknowledgments for quid pro quo contribution or for knowingly providing false substantiation to donors.