

EDWARDS
ANGELL
PALMER &
DODGE

TAX-EXEMPT
ORGANIZATIONS



REAL EXPERIENCE. REAL SOLUTIONS.

NONPROFITS IN 2011:

THE 10 THINGS YOU DON'T KNOW THAT CAN HURT YOU

JANUARY 12, 2011

ANDREW M. GRUMET
PARTNER

EDWARDS ANGELL PALMER & DODGE LLP

TABLE OF CONTENTS

	Page
I. Introduction.....	1
II. The Intersection of Federal and State Law	1
III. Advocacy	4
A. What Constitutes “Participating in, or Intervening”?	5
B. Lobbying	6
C. What Does Not Constitute Advocacy - What is Not Limited?.....	10
D. Other Restrictions	12
IV. Privacy	13
V. Conflicts of Interest.....	14
VI. Expense Reimbursement.....	15
VII. For-Profit Activities	16
VIII. Fundraising	17
A. Federal Disclosures	18
B. State Disclosures	21
C. Professional Fundraisers and Fundraising Counsel	21
D. Fundraising on the Internet	22
E. Do-Not-Call Lists.....	22

I. INTRODUCTION

Establishing and operating a charitable organization can be a complex undertaking. There are many laws and regulations at the federal, state and local levels applicable to charitable organizations. The purpose of this presentation is to alert those working with charitable organizations to a number of the common traps that exist which are often overlooked by those who do not work with charitable organizations on a daily basis.

II. THE INTERSECTION OF FEDERAL AND STATE LAW

Charitable organizations are defined by two bodies of law, federal and state law. While state law governs the legal existence of the organization (i.e., whether an organization is a not-for-profit corporation, trust, or some other type of association), federal law governs the federal tax status of the organization. This distinction is important and can best be illustrated by the following statement: an entity may be established as a not-for-profit corporation pursuant to the laws of a particular state and yet fail to be treated as a charity exempt from federal income tax if certain specific requirements set forth in the Internal Revenue Code are not satisfied. In other words, an organization established as a not-for-profit corporation or as a trust which purports to be charitable in nature, does not necessarily mean that the organization or entity will be treated as a tax-exempt charity for federal income tax purposes.

To be exempt from federal income tax, an organization must be described in Section 501(c)(3) of the Code. In order to be described by Section 501(c)(3) of the Code, the organization must meet two tests: the “Organizational Test” and “Operational Test”. The Organizational Test requires that the organization’s articles of organization: (i) limit the purposes of the organization to one or more exempt purposes¹, and (ii) do not expressly empower the organization to engage, other than as an insubstantial part of its activities, in activities which in themselves are not in furtherance of one or more exempt purposes. The Organizational Test also requires that upon the dissolution of the organization the assets of the organization must be

¹ Exempt purposes are: religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals.

distributed, by reason of a provision in the organization's articles or by operation of law, for one or more exempt purposes, to the federal, state or local government for a public purpose.

The Operational Test is met if: (i) the organization engages primarily in activities which accomplish one or more of the exempt purposes specified in section 501(c)(3) of the Code, (ii) no part of the net earnings inure to the benefit of any private shareholder or individual, (iii) no substantial part of the activities of the organization consist of carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in Section 501(h)), and (iv) the organization does 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.

If both the Organizational Test and the Operational Tests are satisfied, an organization will be treated as an organization described in Section 501(c)(3) of the Code. As a result, by reason of Section 501(a) of the Code, such organization will be exempt from federal income tax.

Although many organizations may be exempt from federal income tax by reason of being described by Section 501(c)(3) of the Code, there are basically five sub-classifications under Section 501(c)(3) in which an organization could be classified. All organizations are classified in one of these categories. The first two categories are generically referred to as public charities, the third category is generally referred to as a quasi-public charity or a supporting organization², the fourth category are organizations that conduct tests for public safety and the fifth category is referred to as a “private charity”, “private foundation”, “family foundation” or simply as a “foundation”.

With certain exceptions, public charities are organizations such as schools, hospitals, synagogues and organizations that receive a substantial portion of their revenue from the general

² Reference to quasi public charities is made only to recognize the existence of this type of entity. However, because the operational requirements applicable to these organizations (namely, that a substantial contributor cannot maintain control of the organization) are not likely to fit within your goals, no discussion of this type of entity has been included in this presentation.

public.³ Private charities, on the other hand, typically receive most, if not all, of their revenue from a small number of sources.

The importance of the differentiation between public charities and private foundations is essentially two-fold. First, unlike public charities, private foundations are subject to substantial rules and regulations with respect to: (i) with whom it may conduct transactions, (ii) the type of investments that may be made and/or owned by the organization (including assets that are gifted to the organization), and (iii) the type of expenditures/distributions that can be made. In addition, certain private foundations are subject to an excise tax on its income.

The second major difference between public charities and private foundations is the income tax deductions that a donor may receive as a result of contributions to the organization. For example, while a contribution of cash to a public charity may be utilized to offset up to 50% of the donor's adjusted gross income for the year, the same contribution to a private foundation will be limited to 30%. Similarly, contributions of appreciated capital gain property, such as marketable securities, to a public charity will be subject to a 30% limitation, while the same gift to a family foundation will be subject to a 20% limitation.

Due to the operational restrictions imposed upon private foundations, as well as the income tax limitations, it is usually preferable for a nonprofit to qualify as a public charity. However, due to the technical requirements applicable to public charities, qualification as such may be difficult to achieve.

In order for an organization to be treated as exempt from federal income tax under Section 501(a) of the Code as an organization described in Section 501(c)(3), an organization must make a formal request to the Internal Revenue Service for the issuance of a Determination Letter.⁴ The request is made by filing Form 1023, Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code. The application is generally filed within 15 months of the end of the month in which the organization was organized or incorporated.⁵

³ Organizations such as schools, hospitals, synagogues may be considered defacto public charities since their qualification as a public charity is based upon the activities they perform.

⁴ If the organization is a religious organization, such as a synagogue or a church, a formal request is not required.

⁵ However, if an organization fails to meet this requirement, an automatic extension may be obtained if the organization files within one year of the expiration of the fifteen month period.

When granted, so long as the application is made in a timely manner, exemption is retroactive to the date of formation.

The application, among other things, sets forth the prior, present and planned activities of the organization. The information provided is generally designed to provide the Internal Revenue Service sufficient information to establish the organization's compliance with the Organizational and Operational Tests. To the extent that an organization fails to accurately describe its activities, or the organization's change significantly from the information provided, the Determination Letter may not be effective for the organization.

III. ADVOCACY

Nonprofit organizations have a long history of participating in the legislative process in the United States. Although the Internal Revenue Code places numerous restrictions on the types of activities that can be conducted without jeopardizing an organizations tax exempt status, only a few specific types of activities are strictly prohibited.

All organizations that are exempt from federal income tax as an organization described in Section 501(c)(3) of the Code are subject to the following restriction:

“no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does 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”⁶

For purposes of this overview, we will refer to this rule, generally, as the “Advocacy Restriction”.

Thus, all Section 501(c)(3) organizations are absolutely prohibited from directly or indirectly participating in, or intervening in, any political campaign on behalf of (or in opposition to) any candidate for elective public office. This prohibition applies to all campaigns including

⁶ I.R.C. § 501(c)(3).

campaigns at the federal, state and local level. Violation of this prohibition may result in denial or revocation of tax-exempt status and the imposition of certain excise taxes.

A. What Constitutes “Participating in, or Intervening”?

Participating or intervening in a political campaign includes any activity conducted by an organization that either favors or opposes one or more candidates for public office. These activities would include making contributions, making statements of endorsement or opposition, distributing materials prepared by others that either endorse or oppose a candidate and permitting a candidate to use the organization (e.g., use of its facilities) without granting equivalent use to other candidates. More subtle and less obvious activities can also constitute participation or intervention. For example, when the executive director or other leader of an organization makes public comments about a candidates campaign, such statements, if viewed as being made on behalf of the organization, could constitute participation or intervention. For this reason, it is important that such statements be made with a clear delineation that the statement is being made by the individual in his or her individual capacity, and not as the leader of the organization.

Another situation that can give rise to a determination that a particular activity constitutes participating or intervening is in the context of specific issue advocacy. Although charities may take positions on public policy issues, including issues that divide candidates in an election for public office, a charity may not participate in issue advocacy that has the effect of political campaign intervention. Such could be the case where an organization makes one or more statements that clearly favor or oppose a particular candidate. In this context, all of the surrounding facts and circumstances must be considered in determining whether the statement being made is issue advocacy or campaign intervention. In making this determination, IRS has identified the following factors as campaign intervention:

- Whether the statement identifies one or more candidates for a given public office;
- Whether the statement expresses approval or disapproval for one or more candidates’ positions and/or actions;

- Whether the statement is delivered close in time to the election;
- Whether the statement makes reference to voting or an election;
- Whether the issue addressed in the communication has been raised as an issue distinguishing candidates for a given office;
- Whether the communication is part of an ongoing series of communications by the organization on the same issue that are made independent of the timing of any election; and
- Whether the timing of the communication and identification of the candidate are related to a non-electoral event such as a scheduled vote on specific legislation by an officeholder who also happens to be a candidate for public office.

It is the position of the IRS that a statement is particularly at risk of being considered campaign intervention when the statement makes reference to candidates or voting in a specific upcoming election.

B. Lobbying

Lobbying, for purposes of obtaining and maintaining an organization's tax exempt status as an organization described in Section 501(c)(3) of the Code, generally means the expenditure of money to influence specific legislation, including bills, resolutions, repeal proposals, referendums or similar items at the federal, state and local level, as well as specific proposals that have not yet been introduced in a legislative body.⁷ In this regard, there are two types of lobbying; direct lobbying and grassroots lobbying, each of which are discussed in paragraphs 4 and 5, respectively, below.

1. What does not constitute lobbying?

The following is a list of certain types of activities that do not constitute lobbying:

⁷ In the case of an organization that does not make an election under Section 501(h) as discussed in paragraph 3 below, lobbying will also include all attempts whether at a financial cost, or otherwise, to influence specific legislation.

(a) Contacts with executive branch employees or legislators in support of or opposition to proposed regulations is not considered lobbying.

(b) Lobbying by volunteers, unless the organization reimburses the employees for expenses or expends funds in some other way in connection with the volunteer's activities.

(c) Membership communications that do not contain a direct "call to action". For this exception, a member is some who contributes more than a nominal amount of time or money to the organization. If, however, the communication does contain a call to action, the communication will be treated as direct lobbying if the communication encourages members to contact legislators, and will be treated as grassroots lobbying if the communication encourages members to ask the general public to contact legislators.

(d) A response to a request from a legislative body giving technical advice on pending legislation is not lobbying. However, if the request is made from a single legislator, the activity could be considered lobbying. Such advice can take the form of a written document, or giving testimony before a panel.

(e) An organization may lobby legislators in an attempt of self-defense. This will occur any time a matter before a legislative body may affect the organization's existence, powers, tax exempt status, etc. The self-defense exception does not, however, include lobbying for funding/appropriations for the organization.

(f) Distribution of "nonpartisan analysis, study, or research". This exception will apply when the report includes a sufficiently full and fair exposition of the pertinent facts to enable the audience to form an independent opinion. The report may take a position and still be treated as "nonpartisan". The key to this exception is that the report fully and fairly presents the facts, make the material generally available, and does not include a call to action.

(g) Discussion and comment on issues of broad social, economic and other policy issues will not be treated as lobbying if the discussion and comment des not address the merits of specific legislation.

2. What 501(c)(3) organizations can lobby?

Only public charities can lobby. Private foundations are prohibited from lobbying. However, despite the prohibition against lobbying by private foundations, private foundations may provide grants to public charities that lobby, so long as the grant is not earmarked for lobbying by the public charity.

3. What are the lobbying limitations?

Public charities may lobby to the extent that the lobbying activities do not constitute a substantial part of the organization's activities. Public charities have two (2) choices for determining whether their activities will be considered as being a substantial part of the organization's activities. First, an organization can utilize the "Substantial Part Test". Under the Substantial Part Test an organization must make a factual assessment of its lobbying activities as compared against all of the organization's activities. Here there are no bright line rules for determining whether the organization's lobbying activities are "substantial". The determination is subjective.

Alternatively, an organization can elect to utilize the safe harbor provided under Section 501(h). This safe harbor permits organizations to utilize up to 20% of their total budget (with a maximum of \$1,000,000) on lobbying activities. When determining the amount that may be spent on lobbying, three variables are at issue; the organization's exempt purpose budget, the amount devoted to grassroots lobbying and the amount devoted to direct lobbying (what will constitute grassroots lobbying and direct lobbying is discussed in paragraphs 4 and 5 below, respectively).

Although the Regulations are much more technical, generally, exempt purpose budget is the amount actually spent by an organization in the accomplishment of the organization’s exempt purpose.⁸ Thus, the amount that can be spent on lobbying is a function of how much the organization spends in accomplishing its mission. These limits are as follows:

Col.	Amount of Exempt Purpose Expenditures (“EPE”)	Amount of Direct Lobbying Expenditures (“DLE”)	Amount of Grassroots Expenditures
1	Up to \$500,000	20% of EPE	¼ of DLE
2	\$500,000.01 - \$1,000,000	15% + Col. 1	¼ of DLE
3	\$1,000,000.01 - \$1,500,000	10%+ Col. 1 & 2	¼ of DLE
4	\$1,500,000.01 - \$17,000,000	5%+ Col. 1, 2 & 3	¼ of DLE
5	Over \$17,000,000	\$1,000,000	¼ of DLE

Note, the DLE must be reduced by the amount spent on grassroots expenditures.

4. What is “grass roots lobbying”?

Generally, grassroots lobbying is a call to action made to the general public. In other words, grassroots lobbying is any time an organization states its position to the general public and calls upon the general public to act by contacting legislators and other members of government seeking action on a specific legislative matter. Thus, in order for an act to be considered to be grassroots lobbying, the statement must be: (a) directed to the general public, (b) refer to specific legislation or a proposal, (c) state the organization’s position, and (d) promote the listener to act with respect to the legislation or proposal.⁹

⁸ Treas. Reg. § 56.4911-4(c).

⁹ Treas. Reg. § 56.4911-2(b)(2)(ii).

Note, however, that general “educational messages” (i.e., paid mass media announcements) that do not contain a “call to action” but do reflect a view on pending legislation that is highly publicized may also be treated as grassroots lobbying if the announcement appears within two (2) weeks of a vote on the legislation. In this context, legislation will be treated as being highly publicized if the legislation receives frequent media coverage within two (2) weeks of its voting, and, the general purposes, terms, and pending action of the legislative body must be known to a significant portion of the public in the area where the ad appears.

5. What is “direct lobbying”?

Direct lobbying occurs when an organization states its position on specific legislation to its members, a legislator or a government employee who is involved in the legislative process. Thus, an organization engages in direct lobbying any time it makes a statement to: (a) its members, legislators or an employee of a legislative body, (b) identifies specific legislation, and (c) states a position on the legislation.¹⁰

6. Lobbying and Federal Grants

Generally, public charities that receive federal grants may not utilize any portion of the grant funds for lobbying activities. This restriction can be found in the general accounting procedures administered by the Office of Management and Budget (OMB). Pursuant to OMB Circular A-122, federal grant recipients are required to ensure that no portion of grant funds are utilized for lobbying and certain other political activities.

C. What Does Not Constitute Advocacy - What is Not Limited?

Certain types of activities (hereinafter referred to as “Exempt Activities”) are not considered advocacy in the context of Section 501(c)(3). Thus, these activities may be conducted by an organization, to an unlimited extent, without jeopardizing its tax exempt status for violating the Advocacy Restriction. Exempt Activities include: activities to promote voter registration, encourage voter participation and provide voter education. Although certain activities may clearly fall within the definition of an Exempt Activity, in order to determine

¹⁰ Treas. Reg. § 56.4911-2(b)(1)(ii).

whether a particular activity will be an Exempt Activity, an analysis of all of the facts and circumstances surrounding the activity must be considered.

A charity may present public forums and publish of voter education guides if they are carried out in a non-partisan manner. Charities may also encourage people to participate in the electoral process through voter registration and get-out-the-vote drives if conducted in a non-partisan manner. On the other hand, voter education or registration activities that are conducted in a manner that favors (or opposes) one or more candidates is prohibited.

Charities may also sponsor public forums where several candidates for the same office are given the opportunity to speak. This activity may be an Exempt Activity if the forum is operated in an unbiased and nonpartisan manner. The IRS has stated that a charity that decides to hold a public forum ought to consider the following key issues in order to ensure that the activity is an Exempt Activity:

- Whether questions for the candidates are prepared and presented by an independent nonpartisan panel;
- Whether the topics discussed by the candidates cover a broad range of issues that the candidates would address if elected to the office sought and are of interest to the public;
- Whether each candidate is given an equal opportunity to present his or her view on the issues discussed;
- Whether the candidates are asked to agree or disagree with positions, agendas, platforms or statements of the organization; and
- Whether a moderator comments on the questions or otherwise implies approval or disapproval of the candidates.

During elections, many charities may prepare and/or distribute documents referred to as voter guides. These documents are usually comprised of charts comparing candidates by position on various issues. While the distribution and/or preparation of such documents may be permitted as an Exempt Activity, if the document is focused on a single issue or a narrow range of issues, or if the document is written in a manner that reflects a bias for or against one or more candidates, the voter guide will be construed as an impermissible

intervention in a campaign. This type of activity is one of the most controversial activities a charity can consider because the very nature of the document lends itself to the conclusion that the charity is biased for or against one of the candidates, particularly, if the voter guide is being distributed in close proximity to an election. In determining whether the preparation and/or distribution of a voter guide will be permissible, the IRS has identified the following factors to consider:

1. Whether the questions and any other description of the issues are clear and unbiased in both their structure and content;
2. Whether the questions posed provided to the candidates are identical to those included in the voter guide;
3. Whether the candidates are given a reasonable amount of time to respond to the questions. If the candidate is given limited choices for an answer to a question (e.g. yes/no, support/oppose), whether the candidate is also given a reasonable opportunity to explain his position in his own words and that explanation is included in the voter guide;
4. Whether the answers in the voter guide are those provided by the candidates in response to the questions, including whether the candidate's answers are unedited, and whether they appear in close proximity to the question to which they respond;
5. Whether all candidates for a particular office are covered; and
6. Whether the number of questions, and the subjects covered, are sufficient to encompass most major issues of interest to the entire electorate.

D. Other Restrictions

In addition to the limitations imposed by the Internal Revenue Code, other rules and restrictions may apply to an organization's advocacy activities. Before engaging in any advocacy, an organization should determine whether other laws, such as the federal Lobbying Disclosure Act¹¹, the Byrd Amendment¹² or the Hatch Act restrict or prohibit the organization's

¹¹ 2 U.S.C. § 1601, et seq.

ability to engage in the proposed activity. In addition, state and local laws may also restrict or prohibit the organization's ability to engage in the proposed activity.

IV. PRIVACY

Nonprofit organizations face the same privacy and data protection challenges and requirements that apply to any business. As compared with for-profit enterprises, nonprofits also must often face these challenges and meet these requirements with smaller budgets and fewer resources, and with staff that may not be experienced in addressing privacy and data protection issues. Moreover, in the event of a data breach, nonprofits may suffer even greater harm than some for-profit enterprises if they lose trust and confidence of current or prospective donors and other supporters.

In the past few years, nearly all U.S. jurisdictions and many foreign jurisdictions have imposed a variety of obligations on entities that collect, use and store "personal information," which generally is defined to include a person's name, together with a driver's license or other state-issued identification number, bank or credit card number, or financial account number. The federal government and some states have also adopted requirements designed to protect "personal health information," which is commonly defined to include any information about a person's physical or mental health condition, the provision of health care, or payment for health care services. In addition to these governmental regulations, the credit card industry also imposes numerous data security requirements on any entity that accepts or processes credit card payments.

Most nonprofits collect, use and store "personal information" concerning their patrons and donors, as well as their staff. Many also collect, use and store "personal health information," at least with respect to staff. And many also accept donations or payments made with credit cards. Such organizations now must have comprehensive, written information security programs, which include administrative, technical and physical safeguards for protecting the confidential information of employees, donors and others. In the event the privacy of such

¹² 31 U.S.C. § 1352, et seq.

information is compromised, the organization also must be prepared immediately to comply with the “data breach” laws that have been adopted by almost all states and some foreign jurisdictions.

V. CONFLICTS OF INTEREST

Directors are also charged with the duty of loyalty with respect to the organization in which he or she serves. This duty requires a director to refrain from using his or her position as a director to derive personal benefits which should otherwise inure to the organization. State laws which establish this duty are often found in the form of laws prohibiting and/or regulating conflicts of interest. Conflict of interest laws generally provide certain circumstances in which a nonprofit may void a contract or other agreement entered into by the organization with a director or some related party who has a material interest in the transaction. For an agreement to be fully enforceable, the interested director is usually required to disclose the material interest to the board of directors, and, upon the board’s vote, there needs to be enough directors voting in favor of the agreement without the interested director’s vote to approve the transaction. If either of these conditions are not met, a nonprofit can usually void the agreement unless it is proven that the agreement was fair at the time the agreement was approved.

In addition to state law, federal law includes several provisions which indirectly enforce a director’s duty of loyalty. The first such provision is contained in the Operational Test required under the Regulations to Section 501(c)(3) of the Code and the “private benefit doctrine”. The private benefit doctrine provides that an organization will not be regarded as operated exclusively for exempt purposes if more than an insubstantial part of its activities are not in the furtherance of its exempt purposes. To the extent that one or more directors operate a not-for-profit corporation in a manner that causes the organization to violate the private benefit doctrine, such directors will have breached their duties of loyalty.

Both quantitative and qualitative analyses are applied for the purpose of determining if an insubstantial amount of an organization's activities further a non-exempt and private purpose. When a private benefit is received by a director, the private benefit must be insubstantial, measured in the context of the overall tax-exempt benefit conferred by the activity. If a private party receives a benefit that is both quantitatively and qualitatively incidental, then the

organization's activities that further a non-exempt and private purpose will be treated as insubstantial. When conducting the quantitative and qualitative analyses, the questions to consider are whether the organization's exempt purposes can be accomplished without benefiting private persons and whether the private benefit is a mere byproduct of the organization's activity.

Certain federal laws also prohibit certain breaches of the duty of loyalty. These laws address excess benefits (which apply to public charities) and self-dealing (which apply to private foundations) between nonprofits and a "disqualified person".¹³ Any economic benefit provided by a public charity to a disqualified person that exceeds the value of benefits provided to the organization by such disqualified person will be treated as an excess benefit transaction. When an excess benefit transaction occurs, a penalty tax is imposed on the disqualified person in an amount equal to 25% of the excess benefit and 10% (limited, however, to \$10,000) on the director, officer or trustee who knowingly acted on behalf of the organization. If an excess benefit transaction is not corrected within certain specific time limits, the penalty tax on the disqualified person is increased to 200% of the excess benefit. The excess benefit transaction rules, however, do not apply to private foundations. Instead, the rules against self-dealing apply.¹⁴

VI. EXPENSE REIMBURSEMENT

As a general rule, amounts paid to a person as a reimbursement, advance or allowance will be treated as taxable income unless certain conditions are met. Examples include amounts paid as an automobile allowance, mileage payments, meal allowances and payments for costs and expense incurred for the benefit of the organization. There are several situations when these types of payments may not be treated as income to the recipient, such as payments made at an amount equal to or less than federal mileage per diem rates.

In order to guard against unintended inclusion of reimbursement, advances and allowances being included in a person's income, it is often advantageous to establish an "accountable plan".¹⁵ If an accountable plan is established, payments made in accordance with

¹³ Generally, individuals and entities who are related to or who are substantial contributors to the organization.

¹⁴ See IRC § 4941.

¹⁵ For more information See IRS Pub. 463.

the plan will, generally, not be includable in the recipient's income. In order for a plan to qualify, the plan must: (i) require that all expenses have a business connection – the expense incurred must have a relationship to the services being provided by the recipient for the benefit of the organization, (ii) the recipient must adequately account to the payor for each expense, and (iii) any excess payments received must be returned to the organization within a reasonable period of time.

VII. FOR-PROFIT ACTIVITIES

In general, organizations exempt from federal income tax under Section 501(c)(3) will be taxed, often referred to as “unrelated business taxable income” or “UBTI”, on income derived from a business it conducts that is not related to the accomplishment of its exempt purposes (this is not affected by the fact that the income so derived is *used* in the conduct of the organization's exempt purposes – rather, the conduct of the business itself must contribute importantly to the accomplishment of the organization's exempt purpose in order to avoid tax on the income derived from the business).¹⁶ Although there are numerous exceptions to the imposition of UBTI, such as dividends, interest, certain rental income, royalties, incurring UBTI can be problematic for an organization if the UBTI is substantial. If the amount of UBTI received by an organization is “substantial”, the organization may be unable to qualify (or, if qualified initially, to retain its status) as a tax exempt entity under the Code. The Code does not define what is substantial, but case law and rulings suggest that substantiality can often be determined in comparison to the amount of revenue that the organization receives that is not UBTI. Historically, IRS has employed a facts and circumstances test of each case, and, in reported rulings, the proportion has varied widely.

In addition to business activities engaged that are unrelated to an organization's exempt purpose, property acquired by a charitable organization that is debt-financed will also cause an organization to have UBTI. Property is debt-financed to the extent that the organization either (i) incurred debt in the acquisition or improvement of the property, (ii) incurred debt before the acquisition or improvement of the property if such debt would not have been incurred but for such acquisition or improvement, or (iii) incurred debt after the acquisition or improvement of

¹⁶ IRC §§ 511 through 515.

the property if such debt would not have been incurred but for such acquisition or improvement and the incurrence of the debt was reasonably foreseeable at the time of such acquisition or improvement. Income to the organization from such debt-financed property will be taxable in the same proportion (not to exceed 100%) as the average indebtedness incurred on account of such property during the taxable year bears to the average adjusted basis of the organization in such property during the period it is held by the organization during the taxable year.

Many of the problems discussed above can be overcome by use of what is often referred to as a blocker corporation. This is a C corporation that is, in effect, placed between the organization and an investment vehicle that would otherwise produce unrelated business income. The organization's portion of income from the ultimate investment is paid to the blocker corporation, which in turn (after paying its taxes on such income, since the blocker corporation is generally not itself a tax-exempt entity), pays dividends to the corporation. Since dividends are excluded from the definition of UBTI, income which otherwise would have been UBTI can be converted as long as the organization's investment in the C corporation is not debt-financed.

Several considerations are involved in making an investment through one or more blocker corporations. Among these are the effect of the tax paid by the blocker corporation on the ultimate return to the parent organization from the investment. Another consideration is whether the parent organization should create its own blocker corporation through which to make all of its problematic (i.e., debt-financed or otherwise taxable) investments.

VIII. FUNDRAISING

Federal and state law impose a number of rules which must be strictly complied with in connection with fundraising by a charitable organization. Failure to comply with any of these rules can subject the organization (as well as its directors or trustees) to substantial financial penalties.

A. Federal Disclosures

1. Tax Related Disclosures

There are numerous situations when a charity may engage in a transaction with a donor which both parties receive something of value from the transaction. These situations are generally referred to as “quid pro quo” contributions. For example, a donor may purchase tickets to a charity gala, purchase an item at a silent or live auction, or purchase services. In each of these cases, only the portion of the payment that exceeds the value of the goods or services received by the donor.

All charitable organizations must provide each donor who has: (i) contributed cash or other property in excess of \$75, and (ii) received property or services from the charitable organization, with a statement which sets forth for the following information:

(a) That the amount which is deductible is limited to the amount received by the charity over the fair market value of the property or services received by the donor; and

(b) A good faith estimate of the value of the goods or services received by the donor.

Failure to provide this information could result in a penalty of \$10 per contribution received by the charity, but is limited to a \$5,000 penalty.

In addition to the aforesaid disclosure, each donor who makes a contribution in excess of \$250 in any calendar year will be required to obtain from the charitable organization a written acknowledgement of the contribution. Each acknowledgement must set forth: (i) the name of the organization, (ii) the amount of any cash contribution, (iii) a description of any non-cash contribution, and (iv) a statement that no goods or services were provided, or, if goods or services were provided, a statement estimating the fair market value. If a donor fails to obtain the written acknowledgement by January 31st of the year following the year the contribution is made, the donor is not permitted to claim a charitable deduction for the gift.

2. Federal Trade Commission Rules

Pursuant to the Federal Trade Commission's (FTC) Telemarketing Sales Rule, telemarketers hired to conduct inter-state solicitations of charitable contributions by phone, must:

- (a) be made within the hours of 8 a.m. and 9 p.m.;
- (b) promptly identify the organization they represent and that the purpose of the call is to ask for a contribution;
- (c) not make misleading statements during their pitch to induce a donation; and
- (d) honor any request to be placed on a "do not call" list. Any further calls to that person may subject the telemarketer to a fine of up to \$11,000.

In order to comply with clause (b) above, the telemarketer must state the name of the charitable organization on whose behalf a charitable contribution is sought. The identity of the telemarketer, or person making the call, however, need not be disclosed. In addition, if the charitable organization commonly uses a fictitious name that is registered with appropriate state authorities, that name may be disclosed instead of the charitable organization's legal name.

Compliance with clause (b) also requires that in disclosing the purpose of the call, the telemarketer must make the disclosure promptly. The manner in which the purpose of the call is described or explained is up to the telemarketer, provided that the description or explanation is not likely to be misleading.

In the case of telemarketers that are employed to both fundraise and sell items on behalf of the organization, other than items of nominal value, the telemarketer must comply with sales disclosures applicable to all telemarketing sales (i.e., the rules applicable to telemarketing for a for-profit enterprise).

Examples provided by the FTC are as follows:

(i) “I am calling on behalf of [name of non-profit organization] to offer you a subscription to the organization’s newsletter, which [description of newsletter] and to ask for a donation to help support the work of [name of non-profit organization].”

(ii) “I am calling for [name of non-profit organization] to seek your support. For a donation of \$25 or more, [name of non-profit organization] will extend to you a one-year membership, which entitles you to [description of the membership]. Your donation will help us to continue the [non-profit organization’s] important work . . .”

In order to comply with clause (c) above (pertaining to misrepresentations), a telemarketer is prohibited from making any misrepresentation pertaining to the following:

(i) The Nature, Purpose, or Mission of the Entity on Whose Behalf the Solicitation is Made. Telemarketers are prohibited from misrepresenting the nature, purpose, or mission of any entity on whose behalf a charitable contribution is being solicited.

(ii) Tax Deductibility. Telemarketers are prohibited from misrepresenting, either expressly or by implication, that any charitable contribution is partly or fully tax deductible, or falsely implying that an organization on whose behalf a contribution is solicited is “tax exempt.”

(iii) Purpose of a Contribution. Telemarketers are prohibited from misrepresenting how the requested contribution will be used. This prohibition includes statements pertaining to how a donation will be spent, and the locality where the donation will be utilized.

(iv) Percentage or Amount of Contribution that Goes to the Charitable Organization or Program. Although telemarketers are not required to affirmatively disclose the amount of a contribution that will ultimately go to the charity, if asked by a donor, or a potential donor, Telemarketers are prohibited from misrepresenting the percentage or amount of the contribution that will go to a charitable organization or program.

B. State Disclosures

In addition to federal requirements, some states require certain disclosures to be made in written solicitations for contributions. For example, in the State of New York, any written solicitation for a contribution must include the following:

“A copy of the latest annual report of _____ [*insert name of organization*] may be obtained, upon request, from _____ [*insert name of organization*], _____ [*insert address to make a written request*] or from the New York Attorney General’s Charities Bureau, Attn: FOIL Officer, 120 Broadway, New York, New York 10271.”

Generally, a disclosure is required **any** time a solicitation is made. Often, the only exception is for donated airtime (radio or tv) or advertisement space (for print media).

C. Professional Fundraisers and Fundraising Counsel

In addition to individual state registration requirements with respect to charitable solicitations, most states also require charitable organizations to provide detailed information with respect to their relationships with paid fundraisers. These rules generally exempt individuals who are bona fide employees of the organization, as well as accountants, attorneys, volunteers and Board members.

1. Fee Arrangements

In most states, a charitable organization may negotiate any financial arrangement with a paid fundraiser. The substance of a financial arrangement with a paid fundraiser is an issue that has prompted heated debates. On one hand, many professional organizations specifically prohibit (within their code of professional ethics) any fee arrangement based upon a percentage of funds raised. On the other hand, such financial arrangements are regularly utilized throughout the county. Regardless of your particular point of view, the one important point to keep in mind is that most fee arrangements are or will become a matter of public record. As a result, anyone can usually find out what your financial arrangement is.

2. Written Contracts

While it goes without saying, that any charitable organization should always enter into a written contract when it hires a paid fundraiser, indeed, many states specifically require that a written contract be executed by the parties and a copy of such contract be filed with the Attorney General's Office of the particular state. Any states, such as New York, also have certain terms and provisions that must be included in any contract with a paid fundraiser. Failure to include such provisions is typically grounds for rejection of the filing.

D. Fundraising on the Internet

At present, no state explicitly addresses fundraising using the internet. Some states, however, will define a "solicitation" by including any request for support using "any medium". Such language leaves the internet (i.e., whether registration in every state is required) issue open for interpretation. At present, no single point of view seems to be controlling.

The prevailing point of view is embodied in something called the Charleston Principles. The Charleston Principles were written by the National Association of State Charity Officials, an association generally comprised of representatives from State Attorney General offices from around the country. Generally speaking, the Charleston Principles provide that any organization domiciled within a state must register with the state that it is domiciled. In addition, organizations will be required to register in other states where internet solicitations yield contributions on an "on-going" basis or where there are "substantial" contributions received from a particular state. The Charleston Principles, however, do not provide definitions for what will constitute on-going or substantial. Those terms are left to each state to define. The Charleston Principles also provide that registration of a non-domiciliary shall be required where the charitable organization specifically targets individuals in a particular state through its internet fundraising activities.

E. Do-Not-Call Lists

While many states, such as the State of New York, specifically exempt charitable organizations from statewide "Do Not Call" statutes, federal law does not provide a complete exemption. With the passage of the USA Patriot Act in 2001, charitable organizations became

subject to the federal “No Not Call” laws if the charity employs for-profit telemarketers to conduct fundraising activities on their behalf. These rules may be found in the Telemarketing Sales Rule (the “TSR”).

Pursuant to the TSR, telemarketers must: (i) make certain prompt disclosures in every outbound call (See Section VIII.A.2 above); (ii) get express verifiable authorization if accepting payment by methods other than credit or debit card; (iii) maintain records for 24 months; and (iv) comply with the entity-specific Do Not Call requirements, but are exempt from the National Do Not Call Registry provision.¹⁷

Telemarketers are also prohibited from: (i) making a false or misleading statement to induce a charitable contribution; (ii) making any of several specific prohibited misrepresentations; (iii) engaging in credit card laundering; and (iv) engaging in acts defined as abusive under the TSR, such as calling before 8 a.m. or after 9 p.m., disclosing or receiving consumers’ unencrypted account information, and denying or interfering with a consumer’s right to be placed on a Do Not Call list.

¹⁷ Individuals may register for the federal “Do Not Call” registry online at www.donotcall.gov or by calling toll-free, 1-888-382-1222 (TTY 1-866-290-4236), from the number you wish to register. Registration is free of charge.