Tax Exempt Organizations From Start to Finish

Advising on Operational Issues
Sarbanes-Oxley or SOX, enacted in 2002, requires public companies issuing stock and any other publicly-traded interest to adopt federal accounting reform and specific corporate responsibility principles.

Only parts of SOX applying by its terms to nonprofits are whistleblower protection and criminal provisions relating to destruction of evidence.

SOX suggest some corporate responsibility principles for exempt organizations, many of which are already required by Form 1023 and Form 990.

Elements are also implicit in state statutes setting forth standards of conduct for directors and officers.
Advising on Operational Issues
Strategies for Board Policy-Making

- Traditional role of board is planning strategically and setting policy
  - Best practices dictate that the board not micromanage
  - Elements common to best practices:
    - Effective governance
    - Strong financial oversight
    - Responsible fundraising
  - Effective governance
    - Regularly held meetings that are organized to promote participation, debate, decision-making and resolution or management of conflicts or problems

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Advising on Operational Issues
Strategies for Board Policy-Making (cont.)

- Regular communication with management so members are aware of potential issues and do not feel excluded
- Board evaluates how policies are being followed by management
- 3 types of decision-making that might be called strategic, tactical and operational
- Board makes strategic decisions – those that set a general direction and long-term goals
- Some boards consider decisions about significant investments to be policy issues

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If investments decisions delegated to finance or investment committee, there should be a clearly articulated policy on how important financial decisions are made and when the full Board should be involved.

Board decides whether new activities fit within the organization’s mission and reinforce its goals.

Tactical decisions are more in the nature of planning how to implement a board’s strategic decisions.

Often undertaken by board or committee, usually with input from management.
One tactical decision all boards deal with is developing a budget and allocating resources for achievement of its mission and specific goals.

- Generally, finance committee will gather facts, discuss with management and make recommendations to board.
- Finance committee also monitors alignment of actual revenues and expenses with budgeted ones.
- Typically reported at each board meeting and any significant departures from budget are discussed.
Advising on Operational Issues
Strategies for Board Policy-Making

- Operational decisions are daily decisions that run the organization
  - Fairly immediate impact and usually lower cost and lower risk than strategic and tactical decisions
  - Responsibility of management (hiring, firing, supplies)
  - Board exercises general oversight to ensure that operational decisions support and further board’s policies and goals
Advising on Operational Issues
Strategies for Board Policy-Making

- All Boards should ask variations of certain fundamental questions when facing major decisions:
  - What can the organization afford?
  - What are the potential consequences of making or not making a particular decision?
  - What will be the impact on employees, members if any, and community the organization serves?
Additional issues to consider

- Whether new or foreign grantee or donor may be involved in activities the U.S. Government or the UN has designated as either terrorist or terrorist-affiliated
- Compliance with the Foreign Account Tax Compliance Act (FATCA) reporting
  - Any organization with offshore account(s) having an aggregate value of $10,000 must file a Report of Foreign Bank and Financial Accounts (FBAR), Form TD F 90-22.1, for the organization and all U.S. citizens with signature authority for the account(s)
- Area of current interest for the IRS
Advising on Operational Issues
Advising Directors on Mission “Drift”

- A mission statement should provide clarity for everyone: board, employees, donors, volunteers and community
  - Organization may move away from stated mission because of expanding activities
  - Mission may be evolving as organization becomes more settled and experienced
  - Needs of community being served may be changing or have already changed and organization is trying to catch up
    - Often subtle and confusing
    - Donors, volunteers, employees may not understand where the organization is going
Advising on Operational Issues
Advising Directors on Mission “Drift” (cont.)

- Potential donors may also cause mission drift by offering substantial contribution if organization will do X
  - Even if related to mission, should be thoroughly discussed by board
  - Board may be afraid to leave significant money on the table
  - Board must consider impact on all stakeholders and whether change is worth it
Advising on Operational Issues
Advising Directors on Mission “Drift” (cont.)

- Generating unrelated business taxable income can sometimes fuel mission drift
  - Tangentially related activity become so successful that it can cause the organization to drift far from its mission
  - If activity becomes substantial part of organization’s activities, it can lead to loss of exemption

- Cost of mission drift
  - May function less efficiently and have difficulty implementing programs
  - Employees, donors and others don’t understand why certain activities are being undertaken

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Advising Directors on Mission “Drift” (cont.)

- Intentional and unintentional mission drift should result in similar actions
  - All stakeholders should be brought into discussion
  - Can be done by surveys and discussions with each constituency
  - If there is no buy-in from stakeholders, change in mission will be extremely difficult to achieve
- Strategic plan that is followed and re-evaluated at specific intervals is best guard against mission drift
  - Requires board to determine whether mission, goals, programs and services are aligned
Advancing on Operational Issues
Investment Considerations

- Other than for employee plans, 2 statutory schemes governing investment: corporate standard of care and Uniform Prudent Management of Institutional Funds Act (“UPMIFA”)
  - Corporate standard of care
    - Directors and officers must discharge duties in good faith, in best interest of organization and with care exercised by ordinarily prudent person in similar circumstances
    - Primary requirement is good faith
    - Acting only in best interest of organization requires avoiding conflicts of interest
• If your organization receives or applies for funding from Public Health Service or its constituent agencies, the organization must also comply with changes to already complex conflict of interest regulations. 42 C.F.R. Part 50, Subpart F and 45 C.F.R. Part 94.
  • Published August 25, 2011 with compliance required by August 24, 2012
  • According to the president of one college, there are rumors it will not be long before these regulations will affect every organization receiving funds from the U.S. Department of Education.
Advising on Operational Issues
Investment Considerations (cont.)

- **UPMIFA**
  - Directors and officers do not guarantee performance of investments but manage them with standard of care applicable to investment management
    - **Provisions applicable to all types of investments**
      - Formal investment policy must track UPMIFA
      - Helps avoid mistakes that could endanger charity’s ability to meet financial goals
• A charity must consider certain factors when making investments:
  • Context of specific charitable purposes of organization and purposes of the funds being invested
  • Compliance with duty of loyalty imposed by state law
  • Whether decisions are being made in good faith with care an ordinarily prudent person would exercise in similar situation
  • Whether individual decisions are being made in context of overall portfolio and investment strategy
Factors to be considered if relevant relate to economic conditions, inflation/deflation, tax consequences, expected return, need for distributions, value of asset to charitable purposes

Organizations may invest in any type of property as long as it is prudent

- Most states require some diversification of investments consideration of which should be documented
- Georgia’s diversification provision is unique and allows more latitude in decision-making

Organization may only incur costs appropriate and reasonable in relation to assets and exempt purposes
Advising on Operational Issues
Investment Considerations (cont.)

- If investment decisions are delegated to outside managers, the board must use prudence in selecting advisors, set specific limitations on scope and terms of their authority, and periodically review and supervise the manager.

- Rules applicable to endowments: funds that, under the terms of a gift instrument, are not wholly expendable by the organization on a current basis.

- Although organization may spend as much as it deems prudent, subject to donor intent, Board should adopt procedures for endowment spending.

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Majority of states have solicitation and fundraising laws
Over half accept the Unified Registration Statement ("URS") – subject to some differences

- Always check what the state in which you are interested requires
- Georgia requires registration before solicitation while Virginia does not accept registration until an organization has raised a certain amount within the state
- Benefit to using the URS is once registration statement is complete, it may be used for registrations in multiple states
Advising on Operational Issues
Solicitation and Fundraising Activities (cont.)

• General statutory framework:
  ▪ Registration and renewal for charities
    ▪ Unless an organization is registered in a state, it is illegal to solicit or accept charitable contributions in that state
  ▪ Exemptions common to many states:
    ▪ Nonprofit educational institutions and related organizations
    ▪ Nonprofit organizations that only solicit their members
    ▪ Persons soliciting for relief of named individual, with specific requirements
Advising on Operational Issues
Solicitation and Fundraising Activities (cont.)

- Charity not using a paid solicitor and having annual revenues less than $25,000
- Religious organizations
- Political parties, candidates for federal or state office, and political action committees

- Grounds for denial, loss of privileges and imposition of penalties: misrepresenting the identity of the charity or use to which funds raised will be dedicated
- Enforcement may include cease and desist orders, censure of paid solicitors, prohibiting charities or individuals from associating with a paid solicitor, imposition of civil money penalties, and additional court sanctions
Advising on Operational Issues
Solicitation and Fundraising Activities (cont.)

- Use of professional fundraisers/paid solicitors
  - Most states require professional fundraisers to register with the state, file annual financial statements and keep specific records
  - Relevant to charitable organizations because it is responsibility of an organization contracting with a paid solicitor to make certain the individual has a current registration
Solicitation and Fundraising Activities (cont.)

- **Raffles**
  - Illegal in some states
  - Only organizations that may legally hold a raffle in Georgia are charities that have registered with the sheriff of the county in which the organization is located

- **Georgia subjects solicitation to two other areas of regulation:**
  - Fair Business Practices Act of 1975
  - Charitable solicitations by telephone unless the organization has registered with the Secretary of State
Advising on Operational Issues
Lobbying and Political Campaign Activities

• Paragraph of § 501(c) under which an organization is exempt determines its restrictions
  ▪ Most restrictions placed on 501(c)(3) organizations/charities to which contributions are deductible
  ▪ Charity may not engage in any political campaign activities or attempt to influence legislation if the activity is substantial
  ▪ Non-tax considerations of federal election laws
    ▪ Lobbying and Disclosure Act of 1995
    ▪ Truth in Lobbying Act
    ▪ Federal Election Campaign Act of 1971 ("FECA")
Advising on Operational Issues
Lobbying and Political Campaign Activities (cont.)

- FECA prohibited corporations, federal contractors, trade associations and labor unions from making contributions from their general treasuries in connection with federal election campaigns predicated on their having resources allowing them to disproportionately influence the political process
  - May solicit contributions from associated individuals for “separate segregated funds” (PAC’s) and PAC’s may contribute to federal election campaigns
  - Corporate restrictions significantly loosened in last 5 years
Advising on Operational Issues
Lobbying and Political Campaign Activities (cont.)

- FECA changed substantially by *Citizens United v. Federal Election Commission* and now by the first of its progeny *McCutcheon v. Federal Election Commission*
  - *Citizens United* invalidated parts of § 203 of the Bipartisan Campaign Reform Act to allow corporations and unions to make independent political expenditures for the purpose of engaging in electioneering communications
    - Electioneering communications expressly advocate the election or defeat of a candidate
    - Court did not invalidate restrictions on campaign contributions or disclosure requirements for sponsors of ads

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Advise on Operational Issues
Lobbying and Political Campaign Activities (cont.)

- **McCutcheon v. FEC (4/2/14)** invalidated § 441 of FECA, imposing biennial aggregate limits on individual contributions to national political parties and federal candidate committees.

- Do Citizens United and McCutcheon change anything for exempt organizations?
  - For unions and non-charitable nonprofits, yes. For other exempt organizations probably not.
Advising on Operational Issues
Lobbying and Political Campaign Activities (cont.)

- Organization is not organized exclusively for exempt purposes if its articles allow it (1) to devote more than an insubstantial part of its activities to attempting to influence legislation or (2) to participate or intervene in any political campaign
  - Theoretically, any involvement should cause loss of exemption
  - Practically, if IRS thinks violation is inadvertent, it is corrected and procedures adopted to prevent reoccurrence, may not seek sanctions or impose excise tax
1 main area of ambiguity is voter education v. advocacy

- If conducted in non-partisan manner may not be political activity: public forums where all legally qualified candidates participate may not be political activity if conducted in neutral manner

- Educational activity must be objective, include a full and fair exposition of facts and may not include unsupported opinions

- IRS very skeptical of alleged non-partisan activities

- IRS voter guide attached at the end is very useful in determining whether activity is non-partisan
Whether activities are substantial relates only to lobbying – both direct and grassroots

- Direct includes contacting federal/state/local legislators and members of their staffs if principal purpose is to influence legislation
- Indirect or grassroots is urging public to contact members of a legislative body with respect to federal/state/local legislation
- Substantial lobbying means more than insubstantial amount
  - As a guideline, this is less than useful
• Uncertainty over meaning and application of substantial led to addition of section 501(h)
  • Allows educational institutions, hospitals and medical research organization, support orgs for governmental schools, publicly supported charities and support orgs for governmental units and publicly supported charities to elect compliance with specific limits
• Organization passing expenditure test will not be disqualified even if it would otherwise violate substantial part test
  - If organization exceeds either direct or indirect lobbying ceiling amount, there is a **25% tax on the excess**
  - Grassroots expenditure ceiling = 25% of lobbying nontaxable amount to maximum of $250,000
  - Lobbying ceiling amount = 150% of lobbying nontaxable amount to maximum of $1 million
  - If both lobbying and grassroots expenditures exceed nontaxable amount, tax imposed on larger of the two
Advising on Operational Issues
Lobbying and Political Campaign Activities (cont.)

- Nontaxable amounts are amounts below which excise tax is not imposed – determined on sliding scale
  - Organization may spend 20% of 1st $500,000 of exempt purpose expenditures +
  - 15% of next $500,000 exempt purpose expenditures +
  - 10% of next $500,000 exempt purpose expenditures +
  - 5% of all exempt purpose expenditures over $1.5 million – subject to a $1 million lobbying expenditure cap
• Organization “normally” exceeding 150% of applicable lobbying and grassroots lobbying nontaxable amount loses its exemption
  • Calculated on 4-year rolling average
Advising on Operational Issues
Lobbying and Political Campaign Activities (cont.)

- Social welfare organizations classified under § 501(c)(4) must be “primarily engaged in promoting” the common good and general welfare of the community
  - Unlimited amount of lobbying as long as it is related to organization’s exempt purpose
  - May not participate directly or indirectly in political campaigns but will not lose exemption due to limited amount of involvement in a campaign
    - Amount is taxable
    - All exempt organizations other than PAC’s taxed on campaign expenditures
In 2013, IRS issued proposed regs to define “candidate-related political activity” for § 501(c)(4) organizations

- Candidate-related political activity of organizations to which grants are made will be attributed to donor organization
- If and when these regs become final, exempt organizations should require grantees to certify they do not engage in and will not use grant funds for candidate-related political activities
  - Grantor may rely on certification
- IRS considering amending proposed regs to apply to §§ 501(c)(5) and (c)(6) organizations
Labor organizations created under § 501(c)(5) subject to same limited political campaign activity as social welfare organizations

- Engage in unlimited lobbying activity as long as it is related to exempt purposes
- May not contribute to a federal campaign other than through a PAC
Advising on Operational Issues
Lobbying and Political Campaign Activities (cont.)

• Business leagues and professional associations
  ▪ Commonly involved in issue advocacy and both direct and indirect lobbying
  ▪ For dues to be deductible, may not be used for lobbying
  ▪ In last few years, these organizations more sensitive to and careful not to cause potential tax issues for members by not separating out amounts to be used for lobbying

• Social clubs’ major requirement is to disclose that dues and contributions are not tax deductible
Advising on Operational Issues
Lobbying and Political Campaign Activities (cont.)

• Organizations providing health, retirement, unemployment or legal services benefits to members
  ▪ Only lobbying allowed is when it is self-protective

• Mutual and cooperative organizations
  ▪ May lobby for self-protection
  ▪ *E.g.*, rural electric power cooperative may own interests in nuclear power plants and may lobby in connection with that interest and other types of energy

• Fraternal lodges and cemetery companies
  ▪ Donors may not take charitable deduction if entity lobbies or intervenes in political campaigns
Veterans’ organizations

- No federal tax restrictions on lobbying as long as in furtherance of exempt purposes
- Part of “settled policy” of providing compensation to those who have served the country
Proxy tax

- Organizations supported largely by dues are required to estimate amount to be spent on lobbying annually so that members do not deduct that portion of dues payments.
- If organization does not provide notice of estimated lobbying expenditures, organization pays what is known as a proxy tax.
  - Tax makes up for tax benefit members received by being able to deduct full amount of dues payment.
  - Equal to highest section 11 rate for the year or 35%.
  - Underreporting lobbying also subject to § 6652(c) daily penalty for filing incomplete or inaccurate return.
Advising on Operational Issues
Lobbying and Political Campaign Activities (cont.)

• Political intervention via website
  • May inadvertently get into serious trouble by not paying sufficient attention to what is on website
    • Charitable organization found to have intervened in political campaign because it included web pages from a related § 501(c)(4) that included candidate questionnaires and endorsements
  • Same problem may occur with links to other organizations