BUSINESS LAW TODAY

Five Tax Traps for Business Lawyers Advising Nonprofit Clients

By Cynthia R. Rowland and Deborah K. Tellier

Many business lawyers are often called upon to advise nonprofit organizations, such as their kids' schools and sports leagues, soup kitchens and homeless shelters, museums and cultural institutions, community foundations, and the occasional private foundation set up by a good client. While much of the legal work for established nonprofits is the same as for any other business clients, the tax exempt status of these entities brings with it a host of income, property, and sales tax rules that are not necessarily obvious. This article highlights the most likely tax issues to arise for nonprofit organizations, typically corporations, that are described in Internal Revenue Code Section 501(c)(3). Similar traps exist for other common kinds of nonprofits – for example "social welfare" organizations, trade associations, and social clubs – but other special rules that apply to those types of entities are beyond the scope of this article.

Just Because it's Tax Exempt, Doesn't Mean No Income Taxes Are Due

Nonprofits are subject to federal (and sometimes state) income tax on their "unrelated business taxable income," commonly referred to as UBTI. The policy behind these rules is that nonprofits should not take advantage of their tax exempt status and undercut the prices charged by taxable businesses that carry out the same or similar business activities. For example, operating a fitness club for youth may well be charitable and educational, but if it is operated as commercial competition to for-profit fitness clubs, why should it have the competitive advantage of operating tax free?

Net income from an activity operated by a charitable organization will be taxable if the activity:

- Is a trade or business,
- Is regularly carried on,
- Is unrelated to the organization's exempt function, and
- Is not covered by an exception or statutory "modification."

Note that occasional activities are not going to be caught in the snares of the unrelated business income tax; the high school drama department's car wash may well compete with the local gas station car wash, but if it is just one Saturday each year, it is not "regularly carried on."

Sometimes an organization is best advised to go ahead and generate revenue from a taxable trade or business. The structural issues to consider in that case are nicely covered by "Taking Care of Business: Use of A For-Profit Subsidiary by a Nonprofit Organization" (in this issue of *Business Law Today*).

There are also several exceptions, termed "modifications," to UBTI. These exceptions cover passive activities that generate income from rents, royalties, interest, and dividends, as well as capital gains on investment income, but here again there is another exception. Any income (other than exempt function income) that is financed by acquisition indebtedness will also be subject to UBTI, in the same proportion as the debt bears to the acquisition cost. And of course there is an exception to the exception, for indebtedness on the property when it was contributed to the charity, provided that the debt is more than 10 years old.

Another common UBTI trap is sprung when a nonprofit accepts corporate sponsorships in order to promote the organization's mission and raise funds for the organization. Charitable organizations must understand the differences between nontaxable corporate sponsorships on the one hand, and payments that are taxable advertising

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income on the other hand. Fortunately, the IRS has created safe-harbor regulations regarding the tax treatment of corporate sponsorship payments. These regulations permit the charity to accept a payment from a corporate sponsor as long as the sponsor does not receive a "substantial return benefit," such as advertising, endorsements, exclusive-provider arrangements, or other benefits.

So what can charities provide the sponsor without running afoul of the IRS' safe harbor? The charity can:

- Use, acknowledge, or publish the sponsor's name, phone numbers, Internet address locations, logos, and slogans in print media or on the charity's website, as long as the acknowledgment does not also include descriptions of the company's products or services, links to the sponsor's website, or similar benefits.
- Display a sponsor's products or services, or distribute free samples of a sponsor's products at a nonprofit's event, although the charity cannot do anything to endorse the product/service.
- Provide a single Internet website link to route the viewer only to the sponsor's home page, but not pages where the product or service is marketed, sold, or advertised.

However, the charity cannot:

- Include any messages or materials that promote or advocate for a sponsor's business, services, or products; include pricing or savings information; or make comparisons with other businesses.
- Provide a message that includes both corporate sponsorships and advertising.

In short, a charity can fundraise by seeking corporate sponsorships without having to pay taxes on this income, but it should be clear with the sponsor about what the charity can and cannot offer in return. A written sponsorship agreement that describes return benefits that fit within the safe harbor should be carefully drafted to avoid the UBTI trap.

Beware Employment and Withholding Taxes

Nonprofits (other than churches, which have some special rules) are subject to the same employment and withholding obligations as for profit businesses. Because of cost pressures, nonprofits often are tempted to push the boundaries of treating service providers as independent contractors rather than employees, and sometimes are tempted to pay interns stipends that may violate minimum wage laws. Nonprofits should also be careful when compensating the president or chief financial officer as independent contractors; these are statutory employees for purposes of federal wage withholding rules. The rules are nicely and succinctly stated on the IRS website.

On a related note, volunteer officers are too frequently a by-catch of the responsible person penalties. Certain officers are "responsible persons" who have the duty to perform, or the power to direct, the act of collecting, accounting for, or paying over employment trust fund taxes. Just as is the case with for profit entities, if such "responsible person" fails to ensure that the organization pays over the withholding taxes, the IRS can collect the amount due from the volunteer personally. Of course, the organization's insurance is unlikely to protect the volunteer director or officer who is stuck with this liability.

Advocacy and Lobbying Can Spell Trouble Under the Internal Revenue Code

As the 2014 election season approaches, many charities and foundations will face important opportunities to advance their mission in the political arena. Both are subject to specific and numerous prohibitions on participating in campaigns for elected office – running afoul of those rules could trigger a deadly trap for the nonprofit. Specifically, charities and foundations must not do any of the following:

- Endorse a candidate for public office
- Urge the public to vote for or against a specific candidate
- Contribute money or anything of value to an election campaign
- Form or support a political action committee (PAC)
- Provide mailing lists to candidates
- "Score" or "grade" candidates
- Provide campaign workers to campaigns for public office
- Support or oppose political party platforms
- Provide website or social media links to any candidate, party, or PAC website

Candidate appearances at events sponsored by a nonprofit that involve incumbent office holders running for reelection are permissible in some circumstances, but check Internal Revenue Code rules and regulations before sanctioning any candidate activity involving a nonprofit. Similarly, voter registration drives are permissible if properly managed within the rules so as to be entirely nonpartisan.

On the other hand, policy advocacy and limited legislative lobbying activities are permissible for public charities up to certain limits. However, private foundations are prohibited from influencing legislation, and may risk losing their tax exempt status by doing so. This prohibition for private foundations includes both grassroots lobbying (e.g., attempts to influence legislation through an attempt to affect the opinions of the general public), and direct lobbying (e.g., communication with any member or staff of a legislative body, or any governmental official that refers to a specific piece of legislation). In addition, every "call to action" where the foundation encourages the public to contact a legislator is prohibited.

Advocating for policy changes that are within the organization's mission, and that address broad social, economic, and similar issues will be perfectly acceptable for both public charities and private foundations, as long as the advocacy is not merely propaganda, and does not use code or buzz words to oppose or support a candidate. Furthermore, foundations and public charities may engage in nonpartisan analysis, study, and research as long as it does not advocate the

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adoption of legislation or legislative action to implement its findings.

Although these activities are prohibited for private foundations, public charities are allowed to engage in both grass roots and direct lobbying, so long as the activity is not "substantial." There are two tests for substantiality: the "facts and circumstances" test that considers all facts as well as the amount of money spent, and the objective test that applies to public charities that have made the election under Internal Revenue Code Section 501(h). The lobbying rules are complex, but the IRS provides a good overview of the rules on its Tax Information for Charitable Organizations website.

The best protection against inadvertently falling into a tax trap and becoming embroiled in impermissible political activities is to ensure that the organization has a policy in place that clearly describes for staff and board members the parameters of permissible advocacy. The policy should also prohibit the use of the organization's assets for any candidate activity, and require staff to report any potential issues to the organization's executive director or the board. Of course, staff can individually participate in candidate and advocacy activities on their own time, but they should never use the organization's resources, including e-mail, conference rooms, or paid time to engage in these activities. The policy should clearly state that employees must use their private addresses and networks, and personal time, when it comes to political activism relating to candidates.

Compensating Insiders for Goods and Services Requires Attention to Detail

Just because an individual works for a charity does not mean that person must donate all or part of his or her time to the organization. In fact, many service providers to nonprofits are paid. Tax traps frequently arise when insiders and management are paid too handsomely for their services to the organization.

Aside from the public relations dilemma that many charities face, the Internal Revenue Code includes no-kill traps that penalize the self-dealing insider and management, without harming the nonprofit itself. Treasury Regulations set forth the rules that a nonprofit organization must follow in order to avoid punitive excise tax penalties that may apply to excessively-compensated insiders, and the board members who approve the compensation arrangement. In order to avoid the penalties that apply to "excess benefit transactions" in the case of public charities or "self-dealing transactions" in the case of private foundations, the compensation arrangement must be "reasonable" and should be documented very carefully in the minutes of a board of directors' meeting (or, if necessary, by a board committee meeting) or by unanimous written consent. The following process should be followed in every instance of insider compensation, as well as any increase in salary or benefits:

- The transaction must be approved in advance by the board, or a committee that is permitted by state law to act on its behalf,
- The board members approving the transaction may include only individuals who do not have a conflict of interest with respect to the transaction, and all conflicted individuals should recuse themselves,
- The board must obtain and rely upon appropriate comparability data (explained below) prior to making its determination, and
- The board must properly document the basis for its determination concurrently with making the determination.

Adequate documentation of such compensation arrangements should include the following:

- The board's knowledge of the material facts and the director's interest in the transaction,
- That the organization is entering into the transaction for its benefit,
- That the transaction is fair and reasonable to the organization,
- The specific terms of the transaction (e.g., annual salary, benefits, etc.) and the date it was approved,
- A complete list of the board members who were present during the debate and who voted on it,
- Comparability data and a description of how the data was obtained, and
- The actions taken by the board with respect to consideration of the transaction by anyone who had a conflict of interest.

In order to document properly any reasonable compensation arrangement for an insider, the board should gather and evaluate data regarding comparable salaries ordinarily paid for like services by similar organizations in similar regions. The data may be derived from independent industry surveys, documented compensation of persons holding similar positions in similar organizations in the same geographic region, expert compensation studies, or other evidence of comparability. The board should review and attach to the resolution approving compensation a comprehensive job description of the position, a current resume of the insider, the insider's qualifications for the position, and the salary, including all benefits and perquisites provided.

For other types of transactions, such as the purchase or leasing of property, independent appraisals are the best evidence of reasonableness, and keep in mind that private foundations generally cannot enter into any sale or lease transactions with insiders, regardless of how fair and reasonable the arrangement may be.

The All Important IRS Form 990 Tells the Public the Whole Truth, Every Single Year

In the charitable world, there is perhaps no document as important and scrutinized as the organization's annual tax return, which is IRS Form 990. Every organization exempt from federal taxes must file the IRS Form 990 return, although private foundations file a variant of the 990, referred to as the 990PF. A number of other noncharitable exempt organizations such as chambers of commerce, labor unions, and social clubs also must file the 990. Smaller organizations may qualify to file the shorter 990-EZ Form, and the smallest (with an-

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nual gross receipts normally $50,000 or less) need only file an electronic 990N, the "e-Postcard." Beware, however, that an organization that fails to file its 990 for three consecutive years will find itself trapped in an *automatic revocation* of its exempt status. Although the revocation can in many cases be reversed, it is a huge hassle to get out of this trap unscathed, so prompt annual filing should be a high priority for every nonprofit that wants to remain tax exempt.

As the charitable sector has moved toward providing greater transparency into its operations over the past decade, the IRS and several independent organizations have made accessing an organization's tax status and current filings free and increasingly easy. However, donors and funders of nonprofits who fail to conduct their due diligence on an organization's exempt status may find themselves unexpectedly making donations to an organization that will not qualify as tax exempt. Accordingly, private foundations and public charities routinely rely on the Internal Revenue Service's online tool, EO Select Check, to verify tax exempt status. EO Select Check allows anyone with Internet access to search all exempt organizations listed with the IRS to find out information about an organization's tax exemption type (e.g., public charity or private foundation, social welfare organization). It is a combination of three databases:

- Organizations eligible to receive tax-deductible charitable contributions (Pub. 78 data)
- Organizations for which the federal tax exemption was automatically revoked for not filing a Form 990-series return or notice for three consecutive years
- Form 990-N (e-Postcard) filers and filings

In addition, several websites, including Guidestar and Charity Navigator, provide the public (and regulators) with access to every nonprofit's Form 990 or Form 990-PF (free) and financial information (usually for a fee). In a matter of minutes, interested parties can review details about an organization's revenue, expenditures, names and addresses of board members, and public support test calculations.

Because the Form 990 provides a powerful looking glass into an organization's mission, operations, governance, employees, and board members, organizations need to be more thoughtful than ever in preparing the Form 990. This may require the skills of accountants, tax advisors, and public relations specialists, and will most definitely require a careful review by the organization's leadership and its board members.

Schedules for Form 990

Schedule A (Form 990 or 990-EZ), Public Charity Status and Public Support

Schedule B (Form 990, 990-EZ, or 990-PF), Schedule of Contributors

Schedule C (Form 990 or 990-EZ), Political Campaign and Lobbying Activities

Schedule D (Form 990), Supplemental Financial Statements to report donor advised funds, conservation easements, certain art and museum collections, escrow accounts and custodial arrangements, endowment funds, and supplemental financial information.

Schedule E (Form 990 or 990-EZ), Schools

Schedule F (Form 990), Statement of Activities Outside the United States

Schedule G (Form 990 or 990-EZ), Supplemental Information Regarding Fundraising or Gaming Activities

Schedule H (Form 990), Hospitals

Schedule I (Form 990), Grants and Other Assistance to Organizations, Governments and Individuals in the U.S.

Schedule J (Form 990), Compensation Information for certain officers, directors, individual trustees, key employees, and highest compensated employees, and information on certain compensation practices.

Schedule K (Form 990), Supplemental Information on Tax Exempt Bonds

Schedule L (Form 990 or 990-EZ), Transactions With Interested Persons

Schedule M (Form 990), Noncash Contributions

Schedule N (Form 990 or 990-EZ), Liquidation, Termination, Dissolution, or Significant Disposition of Assets

Schedule O (Form 990 or 990-EZ), Supplemental Information to Form 990 to provide responses to specific questions, and to explain their operations or responses to various questions.

Schedule R (Form 990), Related Organizations and Unrelated Partnerships to provide information on related organizations, on certain transactions with related organizations, and on certain unrelated partnerships through which they conduct significant activities.

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The IRS takes good governance seriously, and in 2008 it published a collection of good governance initiatives. The IRS believes, as do many in the nonprofit sector, that good governance increases an organization's compliance with tax laws and helps protect its charitable assets, which enables nonprofits to best serve their charitable beneficiaries. Although the IRS does not have the legal authority to require charities to put governance and management policies and measures in place, the IRS has made it very clear that it will review an organization's application for exemption and its annual 990 returns to determine whether the organization has practices and policies that:

- Establish periodic review the organization's mission
- Establish organizational documents that provide the framework for the organization's governance and management
- Establish written governance and management policies, such as a conflict of interest policy, investment policy, compensation policy, record retention policy, code of ethics, fundraising policy and whistleblower policy

In addition to the expected financial information, the Form 990 includes questions in several detailed schedules (Schedules A through R) that touch on the traps discussed above. Unrelated trade or business activities are disclosed on the 990T. See the sidebar for a complete list of Schedules to the 990.

Conclusion

The Internal Revenue Code and Treasury Regulations are replete with tax traps for the unwary nonprofit. Since the consequences of missing one of these issues can include audits, penalties, and bad press for an organization, and in the very worst case, the loss of the organization's tax exempt status, business lawyers should be extra cautious when stepping into the role of tax counsel to a nonprofit organization. Avoiding income tax on funds raised, making sure that all employment taxes are paid when due, steering clear of impermissible candidate and lobbying activities, justifying reasonable compensation, and reporting on all of the above accurately on the annual Form 990, are fundamental compliance matters of which every counsel to a nonprofit must be aware.

Cynthia R. Rowland and Deborah K. Tellier are partners with Farella Braun + Martel, LLP in San Francisco.

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