Risk and Reward: Protecting Your Tax-Exempt Status

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Today's Program

• Introduction
• Review of Trends in Nonprofit Support/Enforcement
• Background on Exempt Status
• Protecting Exempt Status
  ➢ Governance and Policies
  ➢ Transactions and Ventures
  ➢ "Deal breakers"

Trends in Nonprofit Support and Enforcement

• Statistics show slow recovery in giving after 2007 peak
• Program service revenue equals 38% of income (followed by government grants, contributions, then other sources)
• 501(c)(3)s are looking for ways to replace downturn in contribution revenue

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Trends in Nonprofit Support and Enforcement

- IRS Exempt Organizations function continues aggressive push on examinations over the past two years
- UBIT on the work plan for 2012
- Policies inquired about on the Form 990 also on the work plan for 2012

Background on Exempt Status

- Basic requirements for 501(c)(3)—
  - Religious, charitable, scientific, educational, testing for public safety, literary, relieving the burdens of government, etc.
  - Organizational Test
  - Operational Test
- Private Inurement
- Political Activities
- Advocacy

Background on Exempt Status

- Unrelated Business Income Tax
  - Trade or business
  - Regularly carried on
  - Not substantially related
  - Exceptions—royalty, sponsorship, qualified conventions and trade shows, investment income
Background on Exempt Status

• Intermediate Sanctions
  - Excess benefit to a disqualified person
  - Beneficiary needs to return excess benefit
  - Potential excise tax on beneficiary (25%, but can go up to 200%)
  - Potential excise tax on organization managers (knowingly and willfully) (10%, capped at $20,000 per transaction)
  - Rebuttable presumption steps
    1. Recusal
    2. Comparability Data
    3. Contemporaneous Documentation

Protecting Exempt Status—Governance and Policies

• Governance questions on the Form 990:
  - Governing body
  - Management company relationships
  - Governing document changes
  - Diversions of Assets
  - Structure (membership rights vs. board rights)
  - Minutes

Protecting Exempt Status—Governance and Policies

• Governing Body:
  - Number of members; number of independent members
  - Relationships among directors
  - Is there a minimum total number of directors? A minimum number of independent?
  - Why is this important?
    • Close control, particularly by related persons, is cause for greater scrutiny according to courts, IRS
Protecting Exempt Status—Governance and Policies

• Policies:
  ➢ Control over chapters/affiliates?
  ➢ Copy of Form 990 provided to the voting members of the governing body before submitted?
  ➢ Conflict of interest policy (by the end of the tax year)?
  ➢ Annual disclosure or update required?
  ➢ Enforcement?

• Policies (continued):
  ➢ Whistleblower?
  ➢ Document retention?
  ➢ Compensation review for top management official?
    • Recusal of person with conflict
    • Use of valid comparability data
    • Contemporaneous documentation
  ➢ Joint venture?

• Policies (continued):
  ➢ Why are these important?
    • They work—effective policies in this arena manage an organization’s risk
    • IRS views failure to establish and adhere to such policies as increasing risk of non-compliance
    • FY 2012 Work Plan states that IRS will begin evaluation whether its theory on this point is correct
Protecting Exempt Status—Transactions and Ventures

• Program Service Revenue
  ➢ Educational programs, webinars, conferences
  ➢ Publications
  ➢ Merchandise
    • Logo-themed merchandise often subject to UBIT
    • Museum sales have a bit more leeway
    • Products used by members for their businesses—likely taxable

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Protecting Exempt Status—Transactions and Ventures

• Advertising, Sponsorship, and Royalty
  ➢ Traditional advertising revenue usually subject to UBIT
  ➢ But, note the exceptions:
    • Sponsorship safe harbor
    • Royalty exception

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Protecting Exempt Status—Transactions and Ventures

• Sponsorship
  ➢ Qualified Sponsorship Payments
    • Payments to a tax-exempt organization by a person engaged in a trade or business when there is no arrangement or expectation that the sponsor will receive a substantial return benefit other than the use or acknowledgment of the sponsor’s name or logo (or product lines) in connection with the exempt organization’s activities.

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Protecting Exempt Status—Transactions and Ventures

• Sponsorship
  ➢ Inapplicable to: contingent payments, periodicals, qualified conventions and trade shows
  ➢ Substantial Return Benefit
    ➢ Insubstantial value (2 percent cap)
    ➢ Advertising
    ➢ Webinks Issue

Protecting Exempt Status—Transactions and Ventures

• Royalties
  ➢Member benefits, “affinity” programs, mailing list rental
  ➢ Long battle in the courts on this issue
  ➢ General rule—royalty is a payment received for the right to use intangible property rights; does not include payment for services

Protecting Exempt Status—Transactions and Ventures

• Royalties
  ➢ Note
    ➢ “De minimis” services allowed
    ➢ Bifurcation option is there to manage tax risk
    ➢ IRS enforcement example
  ➢ Keys to success—solid contract language, watch how the program works in practice, guard against trademark misuse and potential tort liability
  ➢ Caution—difficult to have royalty income from a publishing relationship
Protecting Exempt Status—Transactions and Ventures

• Joint Ventures
  - Joint activities with other 501(c)(3)s
    - Not likely a tax/UBIT issues, but need to protect rights through contract
    - Ownership issues should be addressed
    - Keep term relatively brief
    - How will time be counted, other expenses
    - Separate entity?

Protecting Exempt Status—Transactions and Ventures

• Joint Ventures
  - Joint activities with non-501(c)(3)s
    - Same contractual issues apply
    - Tax concerns come into play—general rule from IRS and court precedent suggests that control must be given to the exempt organization in order to guard against tax exposure to income.
    - Ancillary vs. Whole

Protecting Exempt Status—Deal Breakers

• Political Activities and Lobbying
  - Lobbying
    - No substantial part
    - 501(h) Election
  - Political Activities

• Private Inurement
  - Similar to intermediate sanctions
  - Often focused on compensation, but that’s not all
Conclusion/Questions

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