Compliance Guide for Nonprofit Organizations

Legal and Tax Materials for Nonprofit Administration

Compiled by

Judah I. Kupfer, Esq.

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Biography

Judah I. Kupfer, Esq.

is an in-house counsel and compliance officer at Citigroup, Inc. Mr. Kupfer previously served as staff counsel in the legal and government affairs department at Agudath Israel of America. He has a broad range of experience advising a variety of nonprofits regarding issues of tax, nonprofit law, bank/regulatory, civil liability, and criminal law matters. He coordinated and presented at more than a dozen CLE/CPE accredited seminars in cities across the United States on behalf of organizations including Agudath Israel, the National Council of Young Israel, Torah Umesorah (The National Society for Hebrew Day Schools) and COPE Educational Services. Mr. Kupfer is a regular contributor of legal and tax articles featured in *The Nonprofit Quarterly* and the *Hamodia* newspaper. He continues to serve on the administrative board of Agudath Israel of America Legal Support Services LLC.

Before joining Agudath Israel's legal team, he clerked at the U.S. Attorney's Office for the Eastern District of New York and practiced law as an associate at the law firm of Allen & Overy LLP in each of their white-collar criminal defense and banking & finance groups.

Mr. Kupfer earned an LL.M. in taxation from New York University School of Law. He obtained his Juris Doctor, *magna cum laude,* from Brooklyn Law School where he served as Notes and Comments Editor for the *Brooklyn Journal of International Law,* and earned his Bachelor of Arts, *summa cum laude,* from Touro College.

Mr. Kupfer is licensed to practice law in New York and New Jersey and is admitted to appear before the U.S. Tax Court, the U.S. District Courts for the Southern and Eastern Districts of New York and the District of New Jersey. Mr. Kupfer can be reached via email at jkupfer1@gmail.com.

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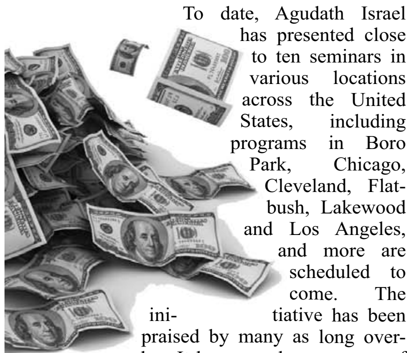
Is Your Donation Deductible?

An Orthodox Jew's Guide to the Laws of Charitable Giving - Part One

By Judah I. Kupfer, Esq.

Over the past several months, Agudath Israel of America has initiated the Dina D'Malchusa Dina series of legal seminars project. Responding to the timely need in the Orthodox Jewish community for substantive guidance regarding a range of legal and tax-related issues faced by yeshivos, shuls, gemachs and the general public, Agudath Israel stepped up to fill that need by coordinating this initiative.



To date, Agudath Israel has presented close to ten seminars in various locations across the United States, including programs in Boro Park, Chicago, Cleveland, Flatbush, Lakewood and Los Angeles, and more are scheduled to come. The initiative has been praised by many as long overdue. It has served as a means of educating the greater Orthodox community regarding the intricacies of complicated and often misunderstood legal concepts and has brought about a keen awareness of pertinent rules and laws vital to ensure that organizations and individuals act in compliance with state and federal law. The deductibility of charitable contributions from income tax is one such topic. Below is an article that seeks to clarify the rules of charitable contributions and many of its applications and nuances.

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INTRODUCTION

A feeling of satisfaction accompanies charitable giving. That feeling is amplified when it comes with actual savings in the form of a tax deduction. Last year, charitable giving in the United States was estimated to be in excess of $300 billion and it is safe to say that the deductibility of charitable contributions has played a key role in increasing the amount people give. By allowing a tax deduction for charitable contributions, the government indirectly subsidizes private philanthropy. While some critics have argued against the idea of the government providing such a subsidy, many people regard activities of charities as socially desirable and appreciate this tax incentive.

It is important to note, however, that not just anything given to further a charitable purpose qualifies for a tax deduction. Congress along with the courts and the Internal Revenue Service have articulated rules regarding which contributions will be deductible. What follows is a synopsis of the elements required for a deductible charitable contribution and some common applications to Orthodox Jews in the context of schools, *shuls*, *kollelim*, *gemachs* and other charitable organizations. Next week, Part Two will follow with additional illustrations of these principles.

As many of the illustrations are very fact-specific and can change with variations of the smallest details, the reader is cautioned to seek out professional tax advice in connection with his or her specific circumstances, to ensure the proper application of these rules and to be apprised of the many additional rules and nuances that didn't make it into this article.

Do you need the deduction?

Much value is placed on whether one can deduct a charitable contribution. Often, though, a donor won't end up utilizing that deduction. When calculating taxable income, while certain deductions are available to all, others are limited to taxpayers who elect to itemize their deductions instead of taking the standard deduction. The taxpayer generally chooses whichever method saves him more. The charitable contribution deduction is an example of an itemized deduction (also referred to as a "below-the-line" deduction). For 2010, the taxpayer's itemized expenses for the year need to exceed $11,400 on joint returns ($5,700 for single persons) for it to be worthwhile to itemize. Last year, it is estimated that nearly 70% of all taxpayers in the U.S. elected the standard deduction instead of itemizing. Thus, one is encouraged to review past tax returns to gain perspective and consider whether a deduction will be useful.

What constitutes a deductible charitable contribution?

At the outset, it is important to recognize certain key elements that are required for a contribution to be deductible. First, the donor must make the donation with "donative intent." As it sounds, the donor must intend to make a donation.

Second, the donor may neither *receive* a benefit in return for his donation *nor may he even expect to receive one*. The courts have said that donations must be made with "detached and disinterested generosity" - meaning, a donation may not be given in exchange for a past benefit nor with the expectation of a future benefit. To the extent that the donor does in fact receive a benefit in return for his donation, the value of the benefit may not be deducted. (There are exceptions for religious and incidental benefits which will be explained below.) Thus, if the value of the benefit received is equivalent to the donation, the donor may not deduct that donation at all.

Third, a deductible donation is one that is given to a "qualified charitable organization." Most *shuls* and 501(c)(3) organizations are considered qualified charitable organizations. Through this requirement, Congress has consciously decided to exclude donations made to individuals, no matter how worthy the individual's situation may be. Additionally, a qualified charitable organization must be a domestic U.S. organization, i.e., an organization organized under the laws of the United States. With some limited exceptions to donations made to organizations recognized under the laws of Israel, Canada and Mexico, foreign organizations do not qualify. The details of donating directly to foreign organizations in those countries will not be explored in this article, and may be subject to further restrictions, so please consult a tax advisor if you wish to make such donations.

Donations that do not fit these requirements may be made - but they do not qualify for a tax deduction. In such cases, the donor may not deduct them on his federal tax return and the donee may not issue a receipt. Should the donor nonetheless request a receipt, any receipt provided should be clearly marked as "not tax deductible." If an organization decides to issue a tax-deductible receipt for a donation it knows not to be deductible (and makes no such notation), the organization exposes itself to serious civil and criminal sanctions.

What are some examples of deductible and non-deductible contributions?

Deductible donations in a *shul* setting include donations to cover the costs for general *shul* expenses (such as the sponsorship of *ner lama'or*, which covers electricity costs). As donors have the option to donate cash or property, a sponsorship of *shul* furniture can consist of writing a check to the *shul* and the *shul* making the purchase. Alternatively, the donor may purchase the furniture directly from the store. In such an instance, the donation would consist of property, i.e., the furniture, and as with any donation of property, the receipt issued to the donor should not assess a value, but rather merely acknowledge receipt of and describe the donated property. The donor would substantiate his deduction through a combination of the *shul* receipt, showing a description of the donated property, and his store receipt, showing the value of the donated property. (The requirements for donating property are complex and the reader is urged to see IRS Publication 526 for additional information.) The merits of donating certain types of property will be discussed below.

Some common examples of non-deductible payments include tuition payments (even for the portion allocated exclusively to religious studies), value of time or services, a "mandatory contribution," and a deposit, i.e., money that the donor expects to get back and/or actually gets back.

If an employer decides to pay the tuition for a child of its employee, absent payments made as part of a Qualified Tuition Reduction Plan (under Internal Revenue Code §117(d)), such payments would ordinarily be considered taxable compensation to the employee. The employer, thus, may not deduct such payments as a charitable contribution, since the employer thereby receives a benefit in exchange for its donation - i.e., the work of the employee (but a business expense deduction for such payments may be available).

Are there any benefits to donating property?

Certain types of property carry an added tax advantage when donating the property directly to the organization instead of selling it first and thereafter donating the proceeds. For example, let's say a person purchases publicly traded corporate stock for $5,000 which grows in value to $25,000. If the owner were to sell the stock and then turn around and contribute the proceeds, he would realize a taxable gain of $20,000. By donating the stock as is, assuming he had owned the stock for more than a year, the donor may obtain a tax deduction for the full $25,000 and need not pay tax on any of the gain in value. Note that contributions of this sort are limited to 30% of the taxpayer's adjusted gross income for the year, to be discussed in more detail in Part Two.

Is the value of volunteer work deductible?

The value of time or services is not deductible. Thus, the value of volunteer work is not deductible even when provided to help a qualified charitable organization. Some out-of-pocket expenses that the volunteer spends may be deductible - those that are: unreimbursed, directly connected with the services, expenses the donor accumulated only because of the services he provided, and expenses that are not personal living or family expenses. But the donor may not deduct the cost for child-care or any lost income due to volunteering. (The volunteer would be required to substantiate the unreimbursed expenses by obtaining a receipt from the organization acknowledging the volunteer service and whether any goods or services were provided to the volunteer in exchange.)

May payments made to a school ever be deductible?

While tuition payments are not deductible, payments made to a school separate from tuition, such as a building fund donation, may be deductible under certain circumstances. First, the donation must be made completely voluntarily. The IRS considers various factors to determine the voluntariness of a contribution, including whether the child would have been denied admission to the school had the contribution not been made, whether the enrollment materials imply the contribution to be required, whether the solicitation was made as part of the enrollment process, and whether the parents were under a contractual obligation to make the donation. Additionally, if the donor seeking the deduction is the parent of a student, for such a donation to be deductible it must be clear that the amount of tuition being charged by the school was adequate to support the costs of the child's education. (For donors who do not have children attending the school, the adequacy of tuition rates would not be relevant.) Clearly, calling tuition by another name will not transform non-deductible tuition payments into a deductible donation. Payments made to schools will be scrutinized to determine whether they were in fact non-deductible tuition payments in disguise.

To illustrate, let's assume a school claims not to charge tuition but instead requires a "voluntary" contribution from parents to cover the costs of the educa-

tion. Whether stated explicitly or implicitly, if the policy is such that those who fail to make the "voluntary" contribution are denied admission to the school, the contribution will be deemed not to be a contribution at all but rather non-deductible tuition. Alternatively, should a school require, for example, $6,000 as tuition and request a $1,500 voluntary building fund contribution - assuming the $1,500 is indeed voluntary - such payment would likely be deductible. However, as the IRS considers contributions requested as part of the enrollment process a negative factor in determining voluntariness, the better practice is to conduct the building fund drive at a different time of the year and not as part of the enrollment process so not to give the impression that such funds were part of non-deductible tuition. For additional information on this issue, please refer to IRS Revenue Ruling 83-104 which provides many useful examples of both deductible and non-deductible contributions in the school context.

On the topic of tuition payments, the practice of two sets of parents agreeing that each will pay the other's child's tuition so that each may receive a tax deduction does not work. Such payments to the school are not being made with "detached and disinterested generosity," but are rather part of a scheme to disguise tuition payments as deductible donations. Additionally, as will be explored in Part Two, this scenario raises issues associated with designating a contribution for a specific purpose or individual.

What if a donor receives a benefit in exchange for his donation?

When a benefit is provided in exchange for a donation (known as a "quid pro quo" contribution), the fair market value of the benefit received may not be deducted. Take, for example, one who attends a *yeshiva* dinner. Assuming the dinner fee was $180 and the fair market value of the dinner was estimated at $50, the donor may deduct $130. (Please note: the fair market value of the benefit is not deductible, no matter the cost of the benefit to the donee.) In such an instance (and in any instance where a donor contributes $75 or more and a benefit of any kind is provided in exchange), the *yeshiva* is required to provide a receipt which assesses an estimated value for the dinner and a notice alerting the donor that the value of the dinner may not be deducted.

Whereas the general obligation to substantiate donations is on the taxpayer, in a scenario where a benefit is provided in exchange for a donation of $75 or more, the donee organization has an affirmative obligation to issue a receipt in accordance with the above requirements. In our case, sample language can read, "The estimated value of the goods or services received is $50. Only the amount of your contribution in excess of $50 is tax deductible."

In the above example, should the donor respond that he will not be attending the dinner but nonetheless encloses a donation of $180, the full $180 may be deducted. If instead, the donor initially responded affirmatively to the dinner invitation and then decides not to attend (or if he attends and does not eat), the value of the dinner remains non-deductible. To be deductible in this case, the donor must take affirmative steps before the dinner to reject the benefit by indicating to the *yeshiva* his intention not to attend.

One additional point to mention about dinners: Even if the entire dinner were to be sponsored by an individual, each attendee must nonetheless subtract the fair market value of the dinner portion received, since the issue is not the cost to the organization but the benefit to the donor. The sponsor of the dinner should obtain a tax deduction for his donation with the exception of his benefit (i.e., the fair market value of his dinner portion).

What is an incidental benefit?

The entire amount of the donation may be deducted when the only benefit provided in exchange is incidental. An incidental benefit is something of "token value," which is estimated currently to be valued at no more than $9.60 (this number changes over time as it is adjusted for inflation) when the donor makes a minimum donation of $48. This typically takes the form of a coffee mug or key chain with the charity's logo. Alternatively, if the benefit received is equal to or less than 2% of the donation, the entire donation may be deductible so long as the benefit does not exceed $96 (adjusted yearly for inflation).

What is an intangible religious benefit?

An intangible religious benefit is defined as "any intangible religious benefit which is provided by an organization organized exclusively for religious purposes and which generally is not sold in a commercial transaction outside the donative context." Examples of such benefits include the cost for purchasing *shul* seats and dues, the purchase of an *aliyah* and the sponsorship of a *parsha* in a new *Sefer Torah*. More questionable cases include whether the money paid to use a *mikvah* may be deducted and whether the cost for purchasing a *lulav* and *esrog* directly from a *shul* may be deducted (on the one hand, the benefit received is religious, yet commercial vendors sell these items).

Examples where the amount paid will likely not be deductible include payments made to a *shul* to purchase wine and *matzoh* for *Pesach* (as these are ordinary consumer goods sold outside the donative context) and the rental cost for a *shul* hall (as the donor receives an ordinary benefit in exchange) unless the cost charged to rent the hall is exaggerated beyond market price. In such an instance, the amount paid beyond market price may be deductible if the donor made the payment with the intent of making a donation. (On that note, the organization should consult with a tax professional to determine if it is required to pay unrelated business income tax on the rental proceeds.)

At the present time, it is well settled that tuition payments made for religious education do not qualify for a charitable deduction, even though the benefit received in exchange can conceivably be seen as an intangible religious benefit.

What are the substantiation requirements?

In order to deduct any contribution, at the time of filing his tax return, the donor/taxpayer must be able to "substantiate" his contribution. The substantiation requirements differ based on the amount and the form of the donation. For cash contributions, a receipt is always needed regardless of the amounts. For a donation in the form of a check of under $250, a canceled check or bank record showing the amount of the donation and the organization name would suffice. For amounts of $250 or more, a receipt is needed.

The receipt must be a written acknowledgment of the donation that includes the amount of cash or description of non-cash property donated, the date of the contribution, the name of the recipient organization and whether it has provided any goods or services to the donor. If goods or services have been provided, a description and good faith valuation of such goods or services must be included. If the donor received an intangible religious benefit, the receipt must include a statement that the only benefit received was an intangible religious benefit.

Part Two In Next Week's Paper

Part Two will address issues of designated/targeted donations, limits to deductible amounts, donor advised funds, rabbi's discretionary funds, the deductibility of raffles tickets and state registration requirements for charitable solicitation of funds.

Other Resources

Helpful resources published by the IRS regarding charitable contributions include: IRS Publications 526 (Charitable Contributions), 1771 (Substantiation and Disclosure), 561 (Determining the Value of Donated Property), 4302 (A Charity's Guide to Vehicle Donations), 4303 (A Donor's Guide to Vehicle Donations), and 597 (Information on the United States - Canada Income Tax Treaty).

Other helpful resources published by the IRS regarding tax-exempt issues include: IRS Publications 1828 (Tax Guide for Churches and Religious Organizations), 4221-PC (Compliance Guide for 501(c)(3) Public Charities), 4220 (Applying for 501(c)(3) Tax-Exempt Status), 557 (Tax-Exempt Status for Your Organization), and 598 (Tax on Unrelated Business Income of Tax Exempt Organizations).

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Judah I. Kupfer, Esq. is a staff counsel at Agudath Israel of America. He previously practiced as an associate at the law firm of Allen & Overy LLP in New York. Mr. Kupfer is a summa cum laude graduate of Touro College, a magna cum laude graduate of Brooklyn Law School and an LL.M. taxation candidate at New York University School of Law. To contact the author, email ykupfer@agudathisrael.org. Questions and comments are welcome.

Is Your Donation Deductible?

An Orthodox Jew's Guide to the Laws of Charitable Giving - Part Two

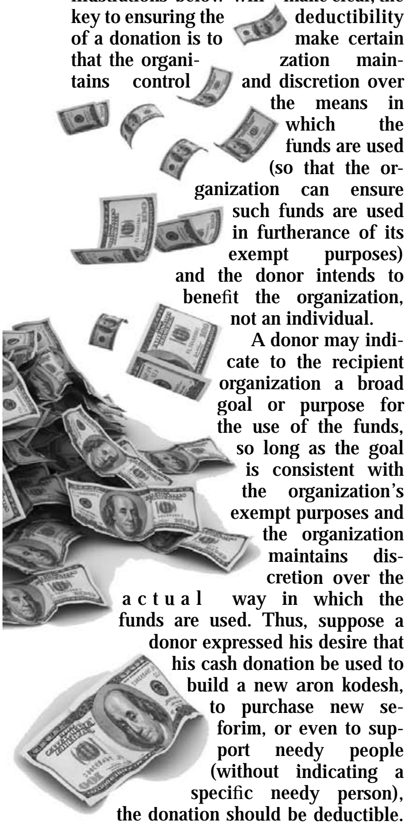
By Judah I. Kupfer, Esq.

INTRODUCTION

This is a sequel to Part One, published last week, which outlined the basic elements of charitable contributions and substantiation requirements, and discussed some examples of deductible and non-deductible donations. Also addressed in Part One were the benefits of donating property, the deductibility of volunteer work and of payments made to schools, the effect of receiving benefits in exchange for donations, and when the benefits received are incidental or intangible and religious in nature. Part Two, below, continues this theme with specific application to various common scenarios. As this article is the second of a two-part series, the reader is strongly urged to first read Part One before proceeding further.

May a donor designate a contribution for a certain purpose or individual?

The ability to designate a donation is likely the least understood and most legally challenging area within the laws of charitable giving. The U.S. Supreme Court has stated, "Charity begins where the certainty in beneficiaries ends, for it is the uncertainty of the objects and not the mode of relieving them which forms the essential element of charity." As the illustrations below will make clear, the key to ensuring the deductibility of a donation is to make certain that the organization maintains control and discretion over the means in which the funds are used (so that the organization can ensure such funds are used in furtherance of its exempt purposes) and the donor intends to benefit the organization, not an individual.



A donor may indicate to the recipient organization a broad goal or purpose for the use of the funds, so long as the goal is consistent with the organization's exempt purposes and the organization maintains discretion over the actual way in which the funds are used. Thus, suppose a donor expressed his desire that his cash donation be used to build a new aron kodesh, to purchase new seforim, or even to support needy people (without indicating a specific needy person), the donation should be deductible. (The organization should be sure, however, that its organizational documents authorize it to engage in these activities.)

A more difficult scenario is where the donor requests that his donated funds be used to benefit a specific individual. To be sure, if the donor would thereby receive a benefit, the donation would not be deductible. Thus, let's say a grandfather donates money to a school with the stipulation that the donation be credited toward his grandchild's tuition. The donation should not be deductible, since the grandfather is assumed to benefit from the education that is provided to his relative which he is helping to fund. The same rule would apply to a donor who makes a donation to an organization and stipulates that his donation be provided to support his son who at the time is studying in a kollel. Once again, the support provided to the son is deemed to benefit the donor, which makes it non-deductible.

What, though, if the donor receives no benefit in return, yet designates a specific individual as the recipient?

Say the donor requests from his shul that his donation be provided as charity to his needy neighbor. In considering this issue, recall the requirement that donations be made to organizations, not individuals. The rule is that funneling money through an organization to be provided to an individual cannot transform funds that otherwise would not be deductible into deductible contributions. The funds must be given to the organization with the intent to benefit the organization (and purposes in which the organization supports) and the organization must possess control and discretion over how the funds are to be used. The organization may very well decide to benefit the individual with charitable funds, but that decision must belong to the organization and may not be imposed on it by a donor.

To sum it up, in application, a targeted donation to an organization specifying an individual beneficiary when the donor is not benefiting may be deductible so long as certain requirements are met: First, the donor's input must be limited to a mere "recommendation" and nothing more. Second, the organization must maintain full control over the donated funds and discretion as to their use. This discretion must be real and substantial and not simply a rubberstamp of the recommendation given by the donor. Third, the donor must understand that the recommendation is advisory and that the organization retains full control, including the authority to accept or reject the donor's recommendation. Fourth, the donor must intend to benefit the organization, not an individual.

The organization should have a policy informing potential donors of the limits to which donor recommendation will be followed. A benevolence fund should consider adopting language of the following policy:

"[Organization], in the exercise of its religious and charitable purposes, has established a benevolence fund to assist persons in *fi*nancial need. [Organization] welcomes contributions to the fund. Donors are free to suggest bene*fi*ciaries of the fund or of their contributions to the fund. However, such suggestions shall be deemed advisory rather than mandatory in nature. The administration of the fund, including all disbursements, is subject to the exclusive control and discretion of the [organization] board. The [organization] board may consider suggested donations, but in no event is it bound in any way to honor them, since they are accepted only on the condition that they are merely nonbinding suggestions or recommendations. As a result, donors will not be entitled to a return of their designated contributions on the ground that the [organization] failed to honor their designations.

"Donors wishing to make contributions to the benevolence fund subject to these conditions may be able to deduct their contributions if they itemize their deductions on their federal tax return. The [organization] cannot guarantee this result and recommends that donors who want assurance that their contributions are deductible seek the advice of a tax attorney or CPA. Checks should be made payable to the [organization], with a notation that the funds are to be placed in the [organization] benevolence fund."

After all is said and done, however, even when clear notices are provided and the donee maintains the proper understanding, if an organization regularly honors its donors' recommendations, the IRS may find that the organization lacked the requisite control over the funds and disallow the deductions. Thus, there are ways to increase the likelihood of deductibility for certain designated contributions. However, any designation will be suspect and the outcome less than certain.

Oftentimes, organizations advertise seeking to raise funds to benefit a specific family or individual. If the organization decided to initiate the fundraising drive, targeted donations would be permitted. This is so because an organization may, on its own initiative, decide to collect funds to benefit a specific individual. Donations provided to such a fund would be deductible, as the organization is exercising its control and discretion in choosing the recipients. Said another way, a donor may not instruct an organization how to use donated funds or what causes such funds should support. Conversely, an organization may exercise its discretion and decide which causes, including individuals in need, to support.

It should be noted that an organization must be established with the authority to benefit a class of people and may not pre-select specific individuals to benefit. Once established, the organization may exercise its discretion to use donated funds in furtherance of its exempt purposes, including choosing to benefit specific individual beneficiaries who are part of the class.

As provided, there are times when organizations may desire to issue grants of charitable funds to individuals. If an organization desires to distribute such grants, it should be sure that it is in compliance with the following requirements: First, the organization must be authorized in its organizational documents to make grants to individuals. This usually means that authorization should be stated as one of its exempt purposes in the organization's certificate of incorporation (some professionals believe that including "charitable" as an exempt purpose in the certificate of incorporation would suffice). Second, if the organization files a year-end form 990, the recipients of such aid would need to be disclosed as required on Schedule I of that form. Third, as required by IRS Revenue Ruling 56-304, the organization must maintain adequate records and case histories to show: the name and address of each recipient of aid, the amount distributed to each, the purpose for which the aid was given, the manner in which the recipient was selected, and the relationship, if any, between the recipient and (a) members, officers, or trustees of the organization, or (b) a grantor or substantial contributor to the organization or a member of the family of either.

Are there any limits to the amount that may be deducted?

Charitable contributions may be deducted only during the calendar year that the donations were made. The tax code imposes limitations on the amount that may be deductible in a given year, generally based on the income of the taxpayer. Ordinarily, a person may deduct up to 50% of his Adjusted Gross Income (AGI) for the year. However, there are many exceptions when the limit will be tighter, including contributions of capital gain property which will be limited to 30% of AGI. (The rules regarding these limitations are complex and the reader is advised to seek professional guidance.)

Additional amounts may be carried over for up to five years, but the following year's limitation will also be based on the taxpayer's AGI for that year. Thus, let's assume A has an AGI of $120,000 for 2010. A may deduct up to $60,000 for donations contributed during 2010. If A contributes $75,000 during 2010, the additional $15,000 may not be deducted during 2010, but may be carried over to be deducted in 2011 (or any year up to and including 2015). However, the deductible amount permitted in 2011 will be limited to 50% of A's 2011 AGI.

When should a "donor advised fund" be used?

Given the yearly limitation on charitable contribution deductions, let's assume B earns a larger than ordinary gain in 2010 and thus has a larger AGI that year. His yearly limit for 2010 will be much greater than usual and carry with it the ability to deduct a greater amount of contributions. B may wish to have more time to choose the recipients of the charitable funds, while still claim a deduction of those funds during 2010. In such an instance, B should consider giving the funds to a donor advised fund (DAF). A DAF (not to be confused with "The Daf") is a special financial vehicle that allows a full deduction during one year, yet provides the donor the opportunity to make recommendations of recipients in future years (while the DAF has exclusive legal control over such assets and ultimate control). One important caveat is that DAFs may only make distributions to other qualified charitable organizations, not to individuals.

Various financial institutions, including Fidelity and Vanguard, offer their customers the opportunity to set up a DAF. (Agudath Israel of America also

offers this opportunity, called the "Special Tzedokah Fund"). Due to recent legislation affecting DAFs, it is imperative that one seeking to use a DAF consult a qualified tax advisor.

Are there any restrictions on a "rabbi's discretionary fund"?

any congregations have a dedicated fund, sometimes referred to as a "rabbi's discretionary fund," to which contributions are made and the rabbi maintains discretion to choose the recipients of the donated funds. Contributions made to this type of fund should be tax-deductible so long as the following conditions are met. At the outset, the three requirements to deduct any charitable contribution must be present: (1) the fund is a recognized charitable organization or being run under a recognized charitable organization (this can be a shul bank account that gives the rabbi signing authority), (2) the contribution is made with donative intent, and (3) no benefit is given in return to the donor.

Additionally, to ensure that the organization maintains proper discretion over the funds as required, the shul board must maintain administrative control over the use of the funds by reviewing distributions. The shul board should also only permit the rabbi to distribute in furtherance of certain approved purposes, e.g., needy people, based on the exempt purposes of the organization. Significantly, the rabbi may not possess authority to use the funds for himself or his immediate family. The mere availability of the funds for the rabbi's own personal use, even without actually using them, would require him to pay taxes on such funds due to the "constructive receipt" rule. A sample resolution to enact this restriction might look like this:

"The rabbi acts as agent of the synagogue in disbursing funds from their discretionary funds. These funds remain the property of the synagogue. The rabbi of the synagogue is authorized to use the monies contributed to the discretionary funds for needs and projects consistent with the religious, educational and charitable purposes of the synagogue. o monies from these discretionary funds shall be used or distributed for personal purposes of the rabbi or his family. The purposes for which discretionary funds have been used shall be reviewed annually by the then-president and or any delegates appointed by the then-president, including, should the president so choose, outside auditors."

Furthermore, if the rabbi intends on making grants to individuals (instead of only to other organizations), the procedures and record-keeping required to make grants to individuals must be maintained.

Are raffle tickets and hinese auctions ever deductible?

The IRS has stated that raffle tickets are not deductible, as the donor is considered to be purchasing a chance to win, which is deemed to be a benefit equal in value to the amount paid for the ticket. If the raffle maintains a policy that tickets are "no purchase necessary," some experts believe that payments made to the organization conducting the raffle to purchase tickets would be deductible up to the number of tickets that would be given for free if requested. (This assumes that the purchaser of the raffle tickets has in mind the requisite donative intent and that the organization conducting the raffle is a qualified charitable organization.)

One court that dealt with this issue hinted that there are times that raffle tickets may be deductible. The court in *oldman v. Commissioner*, 46 T.C. 136 (1966) *aff d* 388 F.2d 476 (6th Cir. 1967) stated, "it is possible to hypothesize a raffle ticket situation where the charitable nature of the gift would scarcely be debated, as where the purchase for $10 is one of one thousand chances and the prize a nosegay of violets." The court in that case ultimately concluded that the purchase of the raffle tickets could not be deducted, since the prizes offered by the charity were of substantial value and the taxpayer failed to establish that his chances of winning were sufficiently low to entitle him to a charitable deduction. However, this case indicates that raffle tickets might be deductible when either the value of the prizes are insubstantial or the chances of winning are very remote because of the number of tickets sold. Since there is no clear precedent when a deduction as such was allowed, an organization and taxpayer alike should seek the advice of a qualified tax advisor before adopting this position.

On the topic of raffles, under certain circumstances raffle prizes require reporting and withholding. Organizations must issue a Form W-2G if the value of the prize is $600 or greater and is at least 300 times the amount paid for the ticket. Additionally, organizations must withhold taxes on winnings in excess of $5,000. Such withholding should be funded by the prize winner (which may prove difficult to do when the prize is personal property and not cash). If an organization decides to pay the taxes due on the prize on behalf of the winner, since such payments would be considered additional taxable income to the winner, the organization will have to gross up, i.e., pay tax on the tax. (This process repeats itself down to a dollar and requires the organization to pay a substantially greater sum in taxes than had the taxpayer paid it himself.)

Some states require licensing and impose other state restrictions to conduct raffles or any kind of charitable gaming. For example, in New York, under many circumstances, an organization must obtain a license to conduct a raffle and the raffle would be subject to many state gambling laws. Details can be found at http://www.racing.state.ny.us/charitable/char.home3.htm. Organizations should consult the gambling laws in their states to ensure compliance with such requirements. Additionally, IRS Publication 3079 is a useful resource for more information about charitable games conducted by tax-exempt organizations.

Need one register to be able to solicit funds?

Most states impose a registration requirement in order to conduct charitable activities, such as soliciting contributions or holding charitable assets. Each state has different rules and registration requirements. For example, most organizations that engage in charitable activities in New York State (NYS) and/or solicit charitable contributions (including grants from foundations and government grants) in NYS are required to register with the NYS Attorney General's Charities Bureau. The organization must complete form CHAR410, submit various organizational documents and pay a fee. Details can be found at http://www.charitiesnys.com/faqs reg new.html.

In NYS, some organizations, including many religious organizations, are exempt from registration. Organizations that are exempt from registration must file a request for exemption, Schedule E to form CHAR410. NYS also requires registered charities to file an annual form CHAR500 and other states may impose similar annual filing requirements.

CONCLUSION

The charitable contribution deduction from federal income tax provides an important incentive to support worthy charitable causes. It is imperative, however, that the deduction be applied correctly and taxpayers and organizations alike obtain proper tax advice from a qualified tax advisor in both the planning stages as well as when questions arise.

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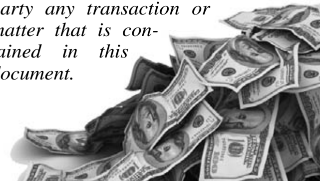

Rev. Rul. 67-246; 1967-2 C.B. 104

Advice has been requested concerning certain fund-raising practices which are frequently employed by or on behalf of charitable organizations and which involve the deductibility, as charitable contributions under section 170 of the Internal Revenue Code of 1954, of payments in connection with admission to or other participation in fund-raising activities for charity such as charity balls, bazaars, banquets, shows, and athletic events.

Affairs of the type in question are commonly employed to raise funds for charity in two ways. One is from profit derived from sale of admissions or other privileges or benefits connected with the event at such prices as their value warrants. Another is through the use of the affair as an occasion for solicitation of gifts in combination with the sale of the admissions or other privileges or benefits involved. In cases of the latter type the sale of the privilege or benefit is combined with solicitation of a gift or donation of some amount in addition to the sale value of the admission or privilege.

The need for guidelines on the subject is indicated by the frequency of misunderstanding of the requirements for deductibility of such payments and increasing incidence of their erroneous treatment for income tax purposes.

In particular, an increasing number of instances are being reported in which the public has been erroneously advised in advertisements or solicitations by sponsors that the entire amounts paid for tickets or other privileges in connection with fund-raising affairs for charity are deductible. Audits of returns are revealing other instances of erroneous advice and misunderstanding as to what, if any, portion of such payments is deductible in various circumstances. There is evidence also of instances in which taxpayers are being misled by questionable solicitation practices which make it appear from the wording of the solicitation that taxpayer's payment is a "contribution," whereas the payment solicited is simply the purchase price of an item offered for sale by the organization.

Section 170 of the Code provides for allowance of deductions for charitable contributions, subject to certain requirements and limitations. To the extent here relevant a charitable contribution is defined by that section as "a contribution or gift to or for the use of" certain specified types of organizations.

To be deductible as a charitable contribution for Federal income tax purposes under section 170 of the Code, a payment to or for the use of a qualified charitable organization must be a gift. To be a gift for such purposes in the present context there must be, among other requirements, a payment of money or transfer of property without adequate consideration.

As a general rule, where a transaction involving a payment is in the form of a purchase of an item of value, the presumption arises that no gift has been made for charitable contribution purposes, the presumption being that the payment in such case is the purchase price.

Thus, where consideration in the form of admissions or other privileges or benefits is received in connection with payments by patrons of fund-raising affairs of the type in question, the presumption is that the payments are not gifts. In such case, therefore, if a charitable contribution deduction is claimed with respect to the payment, the burden is on the taxpayer to establish that the amount paid is not the purchase price of the privileges or benefits and that part of the payment, in fact, does qualify as a gift.

In showing that a gift has been made, an essential element is proof that the portion of the payment claimed as a gift represents the excess of the total amount paid over the value of the consideration received therefor. This may be established by evidence that the payment exceeds the fair market value of the privileges or other benefits received by the amount claimed to have been paid as a gift.

Another element which is important in establishing that a gift was made in such circumstances, is evidence that the payment in excess of the value received was made with the intention of making a gift. While proof of such intention may not be an essential requirement under all circumstances and may sometimes be inferred from surrounding circumstances, the intention to make a gift is, nevertheless, highly relevant in overcoming doubt in those cases in which there is a question whether an amount was in fact paid as a purchase price or as a gift.

Regardless of the intention of the parties, however, a payment of the type in question can in any event qualify as a deductible gift only to the extent that it is shown to exceed the fair market value of any consideration received in the form of privileges or other benefits.

In those cases in which a fund-raising activity is designed to solicit payments which are intended to be in part a gift and in part the purchase price of admission to or other participation in an event of the type in question, the organization conducting the activity should employ procedures which make clear not only that a gift is being solicited in connection with the sale of the admissions or other privileges related to the fund-raising event, but also, the amount of the gift being solicited. To do this, the amount properly attributable to the purchase of admissions or other privileges and the amount solicited as a gift should be determined in advance of solicitation. The respective amounts should be stated in making the solicitation and clearly indicated on any ticket, receipt, or other evidence issued in connection with the payment.

In making such a determination, the full fair market value of the admission and other benefits or privileges must be taken into account. Where the affair is reasonably comparable to events for which there are established charges for admission, such as theatrical or athletic performances, the established charges should be treated as fixing the fair market value of the admission or privilege. Where the amount paid is the same as the standard admission charge there is, of course, no deductible contribution, regardless of the intention of the parties. Where the event has no such counterpart, only that portion of the payment which exceeds a reasonable estimate of the fair market value of the admission or other privileges may be designated as a charitable contribution.

The fact that the full amount or a portion of the payment made by the taxpayer is used by the organization exclusively for charitable purposes has no bearing upon the determination to be made as to the value of the admission or other privileges and the amount qualifying as a contribution.

Also, the mere fact that tickets or other privileges are not utilized does not entitle the patron to any greater charitable contribution deduction than would otherwise be allowable. The test of deductibility is not whether the right to admission or privileges is exercised but whether the right was accepted or rejected by the taxpayer. If a patron desires to support an affair, but does not intend to use the tickets or exercise the other privileges being offered with the event, he can make an outright gift of the amount he wishes to contribute, in which event he would not accept or keep any ticket or other evidence of any of the privileges related to the event connected with the solicitation.

The foregoing summary is not intended to be all inclusive of the legal requirements relating to deductibility of payments as charitable contributions for Federal income tax purposes. Neither does it attempt to deal with many of the refinements and distinctions which sometimes arise in connection with questions of whether a gift for such purposes has been made in particular circumstances.

The principles stated are intended instead to summarize with as little complexity as possible, those basic rules which govern deductibility of payments in the majority of the circumstances involved. They have their basis in section 170 of the Code, the regulations thereunder, and in court decisions. The observance of these provisions will provide greater assurance to taxpayer contributors that their claimed deductions in such cases are allowable.

Where it is disclosed that the public or the patrons of a fundraising affair for charity have been erroneously informed concerning the extent of the deductibility of their payments in connection with the affair, it necessarily follows that all charitable contribution deductions claimed with respect to payments made in connection with the particular event or affair will be subject to special scrutiny and may be questioned in audit of returns.

In the following examples application of the principles discussed above is illustrated in connection with various types of fund-raising activities for charity. Again, the examples are drawn to illustrate the general rules involved without attempting to deal with distinctions that sometimes arise in special situations. In each instance, the charitable organization involved is assumed to be an organization previously determined to be qualified to receive deductible charitable contributions under section 170 of the Code, and the references to deductibility are to deductibility as charitable contributions for Federal income tax purposes.

Example 1:

The *M* Charity sponsors a symphony concert for the purpose of raising funds for *M'* s charitable programs. *M* agrees to pay a fee which is calculated to reimburse the symphony for hall rental, musicians' salaries, advertising costs, and printing of tickets. Under the agreement, *M* is entitled to all receipts from ticket sales. *M* sells tickets to the concert charging $5 for balcony seats and $10 for orchestra circle seats. These prices approximate the established admission charges for concert performances by the symphony orchestra. The tickets to the concert and the advertising material promoting ticket sales emphasize that the concert is sponsored by, and is for the benefit of *M* Charity.

Notwithstanding the fact that taxpayers who acquire tickets to the concert may think they are making a charitable contribution to or for the benefit of *M* Charity, no part of the payments made is deductible as a charitable contribution for Federal income tax purposes. Since the payments approximate the established admission charge for similar events, there is no gift. The result would be the same even if the advertising materials promoting ticket sales stated that amounts paid for tickets are "tax deductible" and tickets to the concert were purchased in reliance upon such statements. Acquisition of tickets or other privileges by a taxpayer in reliance upon statements made by a charitable organization that the amounts paid are deductible does not convert an otherwise nondeductible payment into a deductible charitable contribution.

Example 2:

The facts are the same as in *Example 1,* except that the *M* Charity desires to use the concert as an occasion for the solicitation of gifts. It indicates that fact in its advertising material promoting the event, and fixes the payments solicited in connection with each class of admission at $30 for orchestra circle seats and $15 for balcony seats. The advertising and the tickets clearly reflect the fact that the established admission charges for comparable performances by the symphony orchestra are $10 for orchestra circle seats and $5 for balcony seats, and that only the excess of the solicited amounts paid in connection with admission to the concert over the established prices is a contribution to *M.*

Under these circumstances a taxpayer who makes a payment of $60 and receives two orchestra circle seat tickets can show that his payment exceeds the established admission charge for similar tickets to comparable performances of the symphony orchestra by $40. The circumstances also confirm that amount of the payment was solicited as, and intended to be, a gift to *M* Charity. The $40, therefore, is deductible as a charitable contribution.

Example 3:

A taxpayer pays $5 for a balcony ticket to the concert described in *Example 1.* This taxpayer had no intention of using the ticket when he acquired it and he did not, in fact, attend the concert.

No part of the taxpayer's $5 payment to the *M* Charity is deductible as a charitable contribution. The mere fact that the ticket to the concert was not used does not entitle the taxpayer to any greater right to a deduction than if he did use it. The same result would follow if the taxpayer had made a gift of the ticket to another individual. If the taxpayer desired to support *M,* but did not intend to use the ticket to the concert, he could have made a qualify-

ing charitable contribution by making a $5 payment to *M* and refusing to accept the ticket to the concert.

Example 4:

A receives a brochure soliciting contributions for the support of the *M* Charity. The brochure states: "As a grateful token of appreciation for your help, the *M* Charity will send to you your choice of one of the several articles listed below, depending upon the amount of your donation." The remainder of the brochure is devoted to a catalog-type listing of articles of merchandise with the suggested amount of donation necessary to receive each particular article. There is no evidence of any significant difference between the suggested donation and the fair market value of any such article. The brochure contains the further notation that all donations to *M* Charity are tax deductible.

Payments of the suggested amounts solicited by *M* Charity are not deductible as a charitable contribution. Under the circumstances, the amounts solicited as "donations" are simply the purchase prices of the articles listed in the brochure.

Example 5:

A taxpayer paid $5 for a ticket which entitled him to a chance to win a new automobile. The raffle was conducted to raise funds for the *X* Charity. Although the payment for the ticket was solicited as a "contribution" to the *X* Charity and designated as such on the face of the ticket, no part of the payment is deductible as a charitable contribution. Amounts paid for chances to participate in raffles, lotteries, or similar drawings or to participate in puzzle or other contests for valuable prizes are not gifts in such circumstances, and therefore, do not qualify as deductible charitable contributions.

Example 6:

A women's club, which serves principally as an auxiliary of the *X* Charity, holds monthly membership luncheon meetings. Following the luncheon and any entertainment that may have been arranged, the members transact any membership business which may be required. Attendance of the luncheon meetings is promoted through the advance sale of tickets. Typical of the form of the tickets is the following:

While the ticket does not specifically state that the amount is tax deductible, the characterization of the $5.50 price of the ticket as a "donation" is highly misleading in that it is done in a context which suggests that the price of the ticket is a charitable contribution and, therefore, tax deductible. On the facts recited, no part of the payment is deductible, since there is no showing that any part of the price of the ticket is in fact a gift of an amount in excess of the fair market value of the luncheon and entertainment.

Example 7:

In support of its summer festival program of 10 free public concerts, the *M* Symphony, a charitable organization, mails out brochures soliciting contributions from its patrons. The brochure recites the purposes and activities of the organization, and as an inducement to contributors states that:

"A contribution of $20 entitles the donor to festival membership for the season and free admission to the premiere showing of the motion picture * * * starring * * * and * * *.

Cocktails - 7:00 P.M. Curtain - 8:15 P.M.

This special premiere performance is not open to the public.

* * *

"Your contribution will benefit an important community function; it also entitles you to choice reserved seats for all summer festival concerts and events." 110

The envelope furnished for mailing in payments contains the following:

"Enclosed is my tax-deductible membership contribution to the *M* Symphony summer concert program in the amount of $ - . " Send me - tickets to the May 1 premiere performance. "I do not desire to attend the special premiere performance for festival members, butI am enclosing my contribution."

A taxpayer mails in a payment of $20, indicating on the envelope form that he desires a ticket to the premiere showing of the film.

No part of the payment is deductible as a charitable contribution. Payment of the $20 entitles an individual not only to the privilege of attending the cocktail party and the premiere showing of the film, but also the privilege of choice reserved seats for the summer festival concerts. Under the circumstances, no part of the payment qualifies as a gift, since there is no showing that the payment exceeds the fair market value of the privileges involved. Even if a "contributor" indicates he does not desire to attend the cocktail party and premiere showing of the film, it would still be incorrect for the organization to characterize the $20 payment as a deductible charitable contribution, since under these circumstances the fair market value of the privilege of having choice reserved seats for attending the concerts would, in all likelihood, exceed the amount of the payment. However, if the taxpayer wishes to support the *M* Symphony, and advises the organization that he does not desire the ticket to the premiere and does not want seats reserved for him, the amount contributed to *M* is deductible as a charitable contribution.

Example 8:

In order to raise funds, *W* Charity plans a theater party consisting of admission to a premiere showing of a motion picture and an after-theater buffet. The advertising material and tickets to the theater party designate $5 as an admission charge and $10 as a gift to *W* Charity. The established admission charge for premiere showings of motion pictures in the locality is $5.

Notwithstanding *W'* s representations respecting the amount designated as a gift, the specified $10 does not qualify as a deductible charitable contribution because *W′* s allocation fails to take into account the value of admission to the buffet dinner.

Example 9:

The *X* Charity sponsors a fund-raising bazaar, the articles offered for sale at the bazaar having been contributed to *X* by persons desiring to support *X′* s charitable programs. The prices for the articles sold at the bazaar are set by a committee of *X* with a view to charging the full fair market value of the articles.

A taxpayer who purchases articles at the bazaar is not entitled to a charitable contribution deduction for any portion of the amount paid to *X* for such articles. This is true even though the articles sold at the bazaar are acquired and sold without cost to *X* and the total proceeds of the sale of the articles are used by *X* exclusively for charitable purposes.

Example 10:

The members of the *M* Charity undertake a program of selling Christmas cards to raise funds for the organization's activities. The cards are purchased at wholesale prices and are resold at prices comparable to the prices at which similar cards are sold by regular retail outlets. On the receipts furnished to its customers, the difference between the amount received from the customer and the wholesale cost of the cards to the organization is designated by the organization as a tax-deductible charitable contribution.

The organization is in error in designating this difference as a tax-deductible charitable contribution. The amount paid by customers in excess of the wholesale cost of the cards to the organization is not a gift to the organization, but instead is part of the purchase price or the fair market value of the cards at the retail level.

Example 11:

In support of the annual fund-raising drive of the *X* Charity, a local department store agrees to award a transistor radio to each person who contributes $50 or more to the charity. The retail value of the radio is $15. *B* receives one of the transistor radios as a result of his contribution of $100 to *X.* Only $85 of *B*'s payment to *X* qualifies as a deductible charitable contribution. In determining the portion of the payment to a charitable organization which is deductible as a charitable contribution in these circumstances, the fair market value of any consideration received for the payment from any source must be subtracted from the total payment.

Example 12:

To assist the *Y* Charity in the promotion of a Halloween Ball to raise funds for *Y'*s activities, several individuals in the community agree to pay the entire costs of the event, including the costs of the orchestra, publicity, rental of the ballroom, refreshments, and any other necessary expenses. Various civic organizations and clubs agree to undertake the sale of tickets for the dance. The publicity and solicitations for the sale of the tickets emphasize the fact that the entire cost of the ball is being borne by anonymous patrons of *Y* and by the other community groups, and that the entire gross receipts from the sale of the tickets, therefore, will go to *Y* Charity. The price of the tickets, however, is set at the fair market value of admission to the event.

No part of the amount paid for admission to the dance is a gift. Therefore, no part is deductible as a charitable contribution. The fact that the event is conducted entirely without cost to *Y* Charity and that the full amount of the admission charge goes directly to *Y* for its uses has no bearing on the deductibility of the amounts paid for admission, but does have a bearing on the deductibility of the amounts paid by the anonymous patrons of the event. The test is not the cost of the event to *Y,* but the fair market value of the consideration received by the purchaser of the ticket or other privileges for his payment.

IRS Revenue Rulings

Code Sec. 170

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26 CFR 1.170A-1: Charitable etc. contributions and gifts; allowances of deduction.

Charitable contributions; private school operated by charitable organization. Factual situations illustrate the distinction between qualified charitable contributions and tuition payments made to an organization that operates a private school. Rev. Rul. 79-99 superseded.

REV. RUL. 83-104

ISSUE

Is the taxpayer entitled to a deduction for a charitable contribution under section 170 of the Internal Revenue Code in each of the situations described below?

FACTS

In each of the situations described below, the donee organization operates a private school and is an organization described in section 170(c) of the Code. In each situation a taxpayer who is a parent of a child who attends the school makes a payment to the organization. In each situation, the cost of educating a child in the school is not less than the payments made by the parent to the organization.

SITUATION 1. Organization S, which operates a private school, requests the taxpayer to contribute $400x for each child enrolled in the school. Parents who do not make the $400x contribution are required to pay $400x tuition for each child enrolled in the school. Parents who neither make the contribution nor pay tuition cannot enroll their children in the school. The taxpayer paid $400x to S.

SITUATION 2. Organization T, which operates a private school, solicits contributions from parents of applicants for admission to the school during the period of the school's solicitation for enrollment of students or while the applications are pending. The solicitation materials are part of the application materials or are presented in a form indicating that parents of applicants have been singled out as a class for solicitation. With the exception of a few parents, every parent who is financially able makes a contribution or pledges to make a contribution to T. No tuition is charged. The taxpayer paid $400x to T, which amount was suggested by T.

SITUATION 3. Organization U, which operates a private school, admits or readmits a significantly larger percentage of applicants whose parents have made contributions to U than applicants whose parents have not made contributions. The taxpayer paid $400x to U.

SITUATION 4. Organization V, a society for religious instruction, has as its sole function the operation of a private school providing secular and religious education to the children of its members. No tuition is charged for attending the school, which is funded through V's general account. Contributions to the account are solicited from all society members, as well as from local churches and nonmembers. Persons other than parents of children attending the school do not contribute a significant portion of the school's support. Funds normally come to V from parents on a regular, established schedule. At times, parents are personally solicited by the school treasurer to contribute funds according to their financial ability. No student is refused admittance to the school because of the failure of his or her parents to contribute to the school. The taxpayer paid $40x to V.

SITUATION 5. Organization W, operates a private school that charges a tuition of $300x per student. In addition, it solicits contributions from parents of students during periods other than the period of the school's solicitation for student enrollments or the period when applications to the school are pending. Solicitation materials indicate that parents of students have been singled out as a class for solicitation and the solicitation materials include a report of W's cost per student to operate the school. Suggested amounts of contributions based on an individual's ability to pay are provided. No unusual pressure to contribute is placed upon individuals with children in the school, and many parents do not contribute. In addition, W receives contributions from many former students, parents of former students, and other individuals. The taxpayer paid $100x to W in addition to the tuition payment.

SITUATION 6. Church X operates a school providing secular and religious education that is attended both by children of parents who are members of X and by children of nonmembers. X receives contributions from all of its members. These contributions are placed in X's general operating fund and are expended when needed to support all church activities. A substantial portion of the other activities is unrelated to the school. Most members of X do not have children in the school, and a major portion of X's expenses are attributable to its nonschool functions. The methods of soliciting contributions to X from church members with children in the school are the same as the methods of soliciting contributions from members without children in the school. X has full control over the use of the contributions that

it receives. Members who have children enrolled in the school are not required to pay tuition for their children, but tuition is charged for the children of nonmembers. Taxpayer, a member of X and whose child attends X's school, contributed $200x to X during the year for X's general purposes.

LAW AND ANALYSIS

Section 170(a) of the Code provides, subject to certain limitations, for the allowance of a deduction for charitable contributions or gifts to or for the use of organizations described in section 170(c), payment of which is made during the taxable year.

A contribution for purposes of section 170 of the Code is a voluntary transfer of money or property that is made with no expectation of procuring a financial benefit commensurate with the amount of the transfer. (See section 1.170A-1(c)(5) of the Income Tax Regulations and H.R. Rep. No. 1337, 83rd Cong., 2d Sess. A44 (1954).) Tuition expenditures by a taxpayer to an educational institution are therefore not deductible as charitable contributions to the institution because they are required payments for which the taxpayer receives benefits presumably equal in value to the amount paid. (See Channing v. United States, 4 F. Supp 33 (D. Mass), aff'd per curiam 67 F.2d 986 (1st Cir. 1933), cert. denied, 291 U.S. 686 (1934).) Similarly, payments made by a taxpayer on behalf of children attending parochial or other church-sponsored schools are not allowable deductions as contributions either to the school or to the religious organization operating the school if the payments are earmarked for such children. (See Rev. Rul. 54-580, 1954-2 C.B. 97.) However, the fact that the payments are not earmarked does not necessarily mean that the payments are deductible. On the other hand, a charitable deduction for a payment to an organization that operates a school will not be denied solely because the payment was, to any substantial extent, offset by the fair market value of the services rendered to the taxpayer in the nature of tuition.

Whether a transfer of money by a parent to an organization that operates a school is a voluntary transfer that is made with no expectation of obtaining a commensurate benefit depends upon whether a reasonable person, taking all the facts and circumstances of the case into account, would conclude that enrollment in the school was in no manner contingent upon making the payment, that the payment was not made pursuant to a plan (whether express or implied) to convert nondeductible tuition into charitable contributions, and that receipt of the benefit was not otherwise dependent upon the making of the payment.

In determining this issue, the presence of one or more of the following factors creates a presumption that the payment is not a charitable contribution: the existence of a contract under which a taxpayer agrees to make a "contribution" and which contains provisions ensuring the admission of the taxpayer's child; a plan allowing taxpayers either to pay tuition or to make "contributions" in exchange for schooling; the earmarking of a contribution for the direct benefit of a particular individual; or the otherwise-unexplained denial of admission or readmission to a school of children of taxpayers who are financially able, but who do not contribute.

In other cases, although no single factor may be determinative, a combination of several factors may indicate that a payment is not a charitable contribution. In these cases, both economic and noneconomic pressures placed upon parents must be taken into account. The factors that the Service ordinarily will take into consideration, but will not limit itself to, are the following: (1) the absence of a significant tuition charge; (2) substantial or unusual pressure to contribute applied to parents of children attending a school; (3) contribution appeals made as part of the admissions or enrollment process; (4) the absence of significant potential sources of revenue for operating the school other than contributions by parents of children attending the school; (5) and other factors suggesting that a contribution policy has been created as a means of avoiding the characterization of payments as tuition.

However, if a combination of such factors is not present, payments by a parent will normally constitute deductible contributions, even if the actual cost of educating the child exceeds the amount of any tuition charged for the child's education.

HOLDINGS

SITUATION 1.

The taxpayer is not entitled to a charitable contribution deduction for the payment to Organization S. Because the taxpayer must either make the contribution or pay the tuition charge in order for his or her child to attend S's school, admission is contingent upon making a payment of $400x. The taxpayer's payment is not voluntary and no deduction is allowed.

SITUATION 2.

The taxpayer is not entitled to a charitable contribution deduction for the payment to Organization T. Because of the time and manner of the solicitation of contributions by T, and the fact that no tuition is charged, it is not reasonable to expect that a parent can obtain the admission of his or her child to T's school without making the suggested payments. Under these circumstances, the payments made by the

taxpayer are in the nature of tuition, not voluntary contributions.

SITUATION 3.

The taxpayer is not entitled to a charitable contribution deduction for contributions to Organization U. The Service will ordinarily conclude that the parents of applicants are aware of the preference given to applicants whose parents have made contributions. The Service will therefore ordinarily conclude that the parent could not reasonably expect to obtain the admission of his or her child to the school without making the transfer, regardless of the manner or timing of the solicitation by U. The Service will not so conclude, however, if the preference given to children of contributors is principally due to some other reason.

SITUATION 4.

Under these circumstances, the Service will generally conclude that the payment to Organization V is nondeductible. Unless contributions from sources other than parents are of such magnitude that V's school is not economically dependent upon parents' contributions, parents would ordinarily not be certain that V's school could provide educational benefits without their payments. This conclusion is further evidenced by the fact that parents contribute on a regular, established schedule. In addition, the pressure placed on parents throughout the personal solicitation of contributions by V's school treasurer further indicates that their payments were not voluntary.

SITUATION 5.

Under these circumstances, the Service will generally conclude that the taxpayer is entitled to claim a charitable contribution deduction of $100x to Organization W. Because a charitable organization normally solicits contributions from those known to have the greatest interest in the organization, the fact that parents are singled out for a solicitation will not in itself create an inference that future admissions or any other benefits depend on a contribution from the parent.

SITUATION 6.

The Service will ordinarily conclude that the taxpayer is allowed a charitable contribution deduction of $200x to Organization X. Because the facts indicate that X's school is supported by the church, that most contributors to the church are not parents of children enrolled in the school, and that contributions from parent members are solicited in the same manner as contributions from other members, the taxpayer's contributions will be considered charitable contributions, and not payments of tuition, unless there is a showing that the contributions by members with children in X's school are significantly larger than those of other members. The absence of a tuition charge is not determinative in view of these facts.

EFFECT ON OTHER REVENUE RULINGS

The facts in Situation 4 are essentially the same as in the case of Oppewal v. Commissioner, 468 F.2d 1000 (1st Cir. 1972), on which Rev. Rul. 79-99, 1979-1 C.B. 108, was based. Certain facts were not stated in that ruling. First, the sole function of the organization was the operation of a school. Second, there was an absence of significant potential sources of revenue for operating the school other than contributions by parents. Third, funds normally came to the organization on a regular, established schedule. Fourth, when solicitations were made, parents were solicited on a personal basis by the school treasurer. Rev. Rul. 79-99 is hereby superseded.

Rev. Rul. 56-304, 1956-2 C.B. 306

Organizations privately established and funded as charitable foundations which are organized and actively operated to carry on one or more of the purposes specified in section 501(c)(3) of the Internal Revenue Code of 1954, and which otherwise meet the requirements for exemption from Federal income tax are not precluded from making distributions of their funds to individuals, provided such distributions are made on a true charitable basis in furtherance of the purposes for which they are organized. However, organizations of this character which make such distributions should maintain adequate records and case histories to show the name and address of each recipient of aid; the amount distributed to each; the purpose for which the aid was given; the manner in which the recipient was selected and the relationship, if any, between the recipient and (1) members, officers, or trustees of the organization, (2) a grantor or substantial contributor to the organization or a member of the family of either, and (3) a corporation controlled by a grantor or substantial contributor, in order that any or all distributions made to individuals can be substantiated upon request by the Internal Revenue Service.

Rev. Rul. 63-252, 1963-2 CB 101

SECTION 170.--CHARITABLE,. ETC., CONTRIBUTIONS AND GIFTS

26 CFR 1.170-2: Charitable deductions by individuals; limitations. Deductibility of contributions by individuals to a charity organized in the United States which thereafter transmits some or all of its funds to a foreign charitable organization.

[Text]

Advice has been requested as to the deductibility, under section 170 of the Internal Revenue Code of 1954, of contributions by individuals to a charity organized in the United States which thereafter transmits some or all of its funds to a foreign charitable organization.

Section 170 of the Code provides, in material part, as follows:

(a) ALLOWANCE OF DEDUCTION.--

(1) GENERAL RULE.--There shall be allowed as a deduction any charitable contribution (as defined in subsection (c)) payment of which is made within the taxable year. A charitable contribution shall be allowable as a deduction only if verified under regulations prescribed by the Secretary or his delegate.

-o-o-o-

(c) CHARITABLE CONTRIBUTION DEFINED.--For purposes of this section, the term "charitable contribution" means a contribution or gift to or for the use of--

-o-o-o-

(2) A corporation, trust, or community chest, fund, or foundation--

(A) created or organized in the United States or in any possession thereof, or under the law of the United States, any State or Territory, the District of Columbia, or any possession of the United States;

(B) organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes of for the prevention of cruelty to children or animals;

(C) no part of the net earnings of which inures to the benefit of any private shareholder or individual; and

(D) no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation.

A contribution or gift by a corporation to a trust, chest, fund, or foundation shall be deductible by reason of this paragraph only if it is to be used within the United States or any of its possessions exclusively for purposes specified in subparagraph {B) .

In determining whether contributions to or for the use of a particular corporation, trust, community chest, fund, or foundation are deductible, it must first be determined that the recipient organization was validly created or organized in the United States, a state or territory, the District of Columbia or a possession of the United States, as required by section 170(c) (2) (A) of the Code. If the organization does not qualify under section 170(c) (2) (A) of the Code--that is, it was not created or organized in the United States, etc.--a contribution thereto is not deductible under section 170 of the Code. Dora F. Welti v. Commissioner, 1 T. C. 905 (1943); Muzaffer ErSelcuk et al. v. Commissioner, 30 T. C. 962 (1958). It must further be found that the recipient was organized and operated exclusively for one of the

purposes stated in section 170(c) (2) (B) of the Code, namely, religious, charitable, scientific, literary, or educational purposes or for the prevention of cruelty to children or animals, and that it meets the remaining requirements of section 170(c) (2) of the Code.

Assuming that an organization otherwise meets the requirements set forth in section 170(c) (2) of the Code, a further problem arises where that organization is required to turn all or part of its funds over to a foreign charitable organization. As noted above, contributions directly to the foreign organization would not be deductible. The question presented here is whether the result should differ when funds are contributed to a domestic charity which then transmits those funds to a foreign charitable organization.

Prior to the passage of the Revenue Act of 1938 there were no restrictions as to the place of creation of charitable organizations to which individuals might make deductible contributions. (Section 102(c) of the Revenue Act of 1935, which first permitted a deduction for corporate charitable contributions, limited that deduction to contributions to "domestic" organizations which used such contributions within the United States.) The rule as to individual contributions was changed with the passage of the Revenue Act of 1938. Section 23(0) of that Act provided that contributions by individuals were deductible only if the recipient was a "domestic" organization. See discussion of that section in Ways and Means Committee Report, H.R. Report No.1860, Seventy-fifth Congress, Third Session, C.B. 1939-1 (Part 2) , 728, at 742. Section 224 of the Revenue Act of 1939 substituted for the requirement that a qualifying organization be "domestic," the requirement that it have been "created or organized in the United States or in any possession thereof," etc. In substantially the same form, this requirement was re-enacted as section 170(c) (2) (A) of the 1954 Code.

At the outset, it should be noted that section 170(c) (2) (A) of the Code relates only to the place of creation of the charitable organization to which deductible contributions may be made and does not restrict the area in which deductible contributions may be used. Compare the last sentence in section 170(c) (2) of the Code, which requires that certain corporate contributions be used within the United States. Accordingly, the following discussion should not be construed as limiting in any way the geographical areas in which deductible contributions by individuals may be used.

The deductibility of the contributions here at issue will be discussed in connection with five illustrative examples set out below. The "foreign organization" referred to in each of the examples is an organization which is chartered in a foreign country and is so organized and operated that it meets all the requirements of section 170(c) (2) of the Code excepting the requirement set forth in section 170(c) (2) (A) of the Code. The "domestic organization" in each example is assumed to meet all the requirements in section 170(c) (2) of the Code. In each case, the question to be decided is whether the amounts paid to the domestic organization are deductible under section 170(a) of the Code.

(1) In pursuance of a plan to solicit funds in this country, a foreign organization caused a domestic organization to be formed. At the time of formation, it was proposed that the domestic organization would conduct a fund-raising campaign, pay the administrative expenses from the collected fund and remit any balance to the foreign organization.

(2) Certain persons in this country, desirous of furthering a foreign organization's work, formed a charitable organization within the United States. The charter of the domestic organization provides that it will receive contributions and send them, at convenient intervals, to the foreign organization.

(3) A foreign organization entered into an agreement with a domestic organization which provides that the domestic organization will conduct a fund-raising campaign on behalf of the foreign organization. The domestic organization has previously received a ruling that contributions to it are deductible under section 170 of the Code. In conducting the campaign, the domestic organization represents to prospective contributors that the raised funds will go to the foreign organization.

(4) A domestic organization conducts a variety of charitable activities in a foreign country. Where its purposes can be furthered by granting funds to charitable groups organized in the foreign country, the domestic organization makes such grants for purposes which it has reviewed and approved. The grants are paid from its general funds and although the organization solicits from the public, no special fund is raised by a solicitation on behalf of particular foreign organizations.

(5) A domestic organization, which does charitable work in a foreign country, formed a subsidiary in that country to facilitate its operations there. The foreign organization was formed for purposes of administrative convenience and the domestic organization controls every facet of its operations. In the past the domestic organization solicited contributions for the specific purpose of carrying out its charitable activities in the foreign country and it will continue to do so in the future. However, following the formation of the foreign subsidiary, the domestic organization will transmit funds it receives for its foreign charitable activities directly to that organization.

It is recognized that special earmarking of the use or destination of funds paid to a qualifying charitable organization may deprive the donor of a deduction. In s. E. Thomason v. Commissioner, 2 T. C. 441 (1943), the court held that amounts paid to a charitable organization were not deductible where the contributions were earmarked for the benefit of a particular ward of the organization. Similarly, see Revenue Ruling 54-580, C.B. 1954-2, 97. These cases indicate that an inquiry as to the deductibility of a contribution need not stop once it is determined that an amount has been paid to a qualifying organization; if the amount is earmarked, then it is appropriate to look beyond the fact that the immediate recipient is a qualifying organization to determine whether the payment constitutes a deductible contribution.

Similarly, if an organization is required for other reasons, such as a specific provision in its charter, to turn contributions, or any particular contribution it receives, over to another organization, then in determining whether such contributions are deductible it is appropriate to determine whether the ultimate recipient of the contribution is a qualifying organization. It is well established in the law of taxation that "A given result at the end of a straight path is not made a different result because reached by following a devious path." Minnesota Tea Co. v. Helvering, 302 U.S. 609, at 613, Ct. D. 1305, C. B. 1938-1, 288; George w. Griffiths v. Helvering, 308 U.S. 355, at 358, Ct. D. 1431, C. B. 1940-1, 136. Moreover, it seems clear that the requirements of section 170(c) (2) (A) of the Code would be nullified if contributions inevitably committed to go to a foreign organization were held to be deductible solely because, in the course of transmittal to the foreign organization, they came to rest momentarily in a qualifying domestic organization. In such cases the domestic organization is only nominally the donee; the real donee is the ultimate foreign recipient.

Accordingly, the Service holds that contributions to the domestic organizations described in the first and second examples set forth above are not deductible. Similarly, those contributions to the domestic organization described in the third example which are given for the specific purpose of being turned over to the foreign organization are held to be nondeductible.

On the other hand, contributions received by the domestic organization described in the fourth example will not be earmarked in any manner, and use of such contributions will be subject to control by the domestic organization. Consequently, the domestic organization is considered to be the recipient of such contributions for purposes of applying section 170(c) of the Code. Similarly, the domestic organization described in the fifth example is considered to be the real beneficiary of contributions it receives for transmission to the foreign organization. Since the foreign organization is merely an administrative arm of the domestic organization, the fact that contributions are ultimately paid over to the foreign organization does not require a conclusion that the domestic organization is not. the real recipient of those contributions. Accordingly, contributions by individuals to the domestic organizations described in the fourth and fifth examples are considered to be deductible.

Pursuant to the authority contained in section 7805(b) of the Code, the principles stated herein will not be applied to disallow deductions for contributions made to a charitable organization prior to December 9, 1963, the date of publication of this Revenue Ruling, if those contributions otherwise would have been deductible under an outstanding ruling or determination letter.

Not-For-Profit/Exempt Organizations Blog

Posted at 7:00 PM on October 2, 2011 by Jacob I. Friedman

IRS Tutorial Explains the Special Rules for International Activities of U.S. Charities

The IRS presents webinars on a variety of subjects. In August, the IRS presented a webinar conducted by two IRS representatives on the special rules affecting charities that make grants to foreign organizations or engage in activities in foreign countries.

In a fairly comprehensive course, the following significant points were made:

1. A U.S. charity can do anything in a foreign country that it can do here, provided that the activity is consistent with the charity's exempt purposes.

2. For purposes of the rule that a charity may not devote a substantial part of its activities to legislative lobbying:

    a. lobbying includes action by the public in a referendum, ballot initiative, constitutional amendment or similar procedure;

    b. actions by executive, judicial or administrative bodies are not considered legislation;

    c. legislation includes foreign laws; and

    d. in certain countries ruled by authoritarian or theocratic regimes, it is questionable whether the governing body is a legislature or if a legislative process even exists.

3. A charity is prohibited from directly or indirectly participating in a political campaign of a candidate for a foreign public office, and may not make a contribution to any such campaign.

4. In a country ruled by a dictatorship, a charity's criticism of the regime in the course of advocating for democracy, the rule of law or human rights would not ordinarily be regarded as intervention in a political campaign.

5. The operation of a foreign school must meet the same non-discrimination requirements that are mandatory for domestic schools.

6. A charity must exercise reasonable care to ensure that its assets are used for charitable purposes. A charity can demonstrate that it exercised this care by:

   a. maintaining procedures for properly vetting a foreign grantee, such as requiring a written application from the grantee and conducting background checks;

   b. entering into an agreement with the foreign grantee that sets forth the purpose of the grant; and

   c. exercising oversight of the grant to ensure that the grant is used as intended.

7. Proper documentation may include periodic reports, accounting of expenses, copies of receipts, reports of on site visits by agents of the granting charity and photos and videos showing the charitable program.

8. The charity should review the reports and take corrective action, where appropriate.

9. A charity's exempt status can be revoked if the charity makes grants to foreign organizations and it cannot demonstrate that the grants were actually used for exempt purposes.

10. If a corporation makes a contribution to a charitable trust, the funds must be used within the United States in order for the contribution to be tax deductible.

11. Contributors may not earmark funds for the use or benefit of any specific organization or individual.

12. Contributors may designate their contributions to go to a specific purpose such as earthquake relief. A charity may also accept non-binding recommendations or advice from donors.

13. "Friends of" charities must exercise discretion and control over the funds they raise. The IRS looks at the following positive factors:

a. whether the charter provides that the board has discretion to allocate funds raised to any charity;

b. whether the bylaws provide that the board will review all requests for funds, require that the requests specify the proposed use of the funds and require a periodic accounting of funds granted;

c. whether the bylaws allow the charity to solicit funds for a specific project or purpose approved by the charity, but retain the charity's right to withdraw approval of the grant and use the funds for other purposes; and

d. whether the charity makes these policies known to donors upon request, and refuses to accept contributions earmarked so that they must go to the foreign organization.

14. A donor-advised fund may not make a grant to individuals or make any grant for non-charitable purposes.

15. A Type III supporting organization may not support an organization that is not organized in the United States.

16. A charity may distribute funds to foreign organizations that are not charities. The U.S. charity must be sure that the funds are used for specific projects that further its own exempt purposes. It must keep records and show it controls the distribution of the funds. The charity can demonstrate that it exercises such control by implementing the following procedures:

a. engaging in an independent decision-making process (with no requirement that the charity listen to the donor's direction) about whether it will provide funds to a foreign organization;

b. conducting a pre-grant inquiry to be reasonably sure that the grant will be used for exempt purposes;

c. entering into a written agreement with the recipient regarding the use of the funds; and

d. obtaining reports that the funds were used for approved exempt purposes.

17. Charities, in conducting their foreign activities and grantmaking, should be mindful of the sanctions programs of the Treasury Department's Office of Foreign Asset Control known as OFAC. OFAC has programs that ban a broad range of programs in or with certain countries. In some cases a charity may need to obtain a license from OFAC in order to conduct the activity.

18. OFAC has a program that forbids transactions with specific named individuals and organizations. A list of names is available on the OFAC website. Violations of these programs can lead to civil fines and criminal penalties.

19. The Commerce Department's Bureau of Industry and Security (BIS) also restricts export of certain equipment and technology to certain countries. Information in this program is available on the BIS website.

20. Charities that have foreign investments may have to file certain information returns (besides the 990) such as:

a. Forms 926 and 5471 relating to foreign corporations;

b. Forms 3520 and 3520-A relating to foreign trusts and foreign gifts;

c. Form 8621 relating to passive foreign investment companies and qualified electing funds; and

d. Form 8865 relating to foreign partnerships.

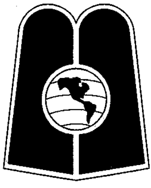
21. Under the income tax withholding rules, a charity that makes a payment to a nonresident alien or a foreign organization, such as compensation for services performed in the United States, may need to withhold tax on a portion of the payment and pay it over to the IRS.

22. If a charity has a financial interest in or signature authority over a foreign financial account, such as a bank account, brokerage account, mutual fund or trust and the aggregate value in the accounts exceeds $10,000 at any time, then the charity may be required to file Form 90-22.1, popularly known as FBAR.

23. Failure to file an FBAR when required to do so may result in civil penalties and criminal penalties. If a charity failed to file an FBAR for earlier years, it should file the delinquent reports and attach a statement explaining why the reports are late.

Comments (0) Read through and enter the discussion with the form at the end

Proskauer Rose LLP
Boca Raton 2255 Glades Road
Suite 421 Atrium
Boca Raton, FL 33431-7360
Phone: 561.241.7400
Boston One International Place
Boston, MA 02110-2600
Phone: 617.526.9600
Chicago Three First National Plaza
70 West Madison
Suite 3800
Chicago, IL 60602-4342
Hong Kong 36/F, Edinburgh Tower
The Landmark
Suites 3605-3607
15 Queen's Road Central
Hong Kong
Phone: 852.3410.8000
London Ninth Floor
Ten Bishops Square
London E1 6EG
United Kingdom
Phone: 44.20.7539.0600
Los Angeles 2049 Century Park East
32nd Floor
Los Angeles, CA 90067-3206
Phone: 310.557.2900
Newark One Newark Center
Newark, NJ 07102-5211
Phone: 973.274.3200
New Orleans Poydras Center
650 Poydras Street



AGUDATH ISRAEL OF AMERICA
COMMUNITY SERVICES
42 Broadway, New York, NY 10004 • (212) 797-9000 • Fax (646) 254-1600

REVISED VERSION
24 Teves 5770
January 10, 2010

MEMORANDUM

TO: Principals and Administrators

FROM: Mordechai Biser, Esq., Associate General Counsel

CC: Mrs. Deborah Zachai, Director of Education Affairs
Mr. Dovid Tanenbaum, Education Affairs Associate

RE: **Parsonage Payments**

We receive frequent requests from menahalim, rebbeim, rabbonim, accountants for yeshivos and shuls, and others to answer questions about parsonage allowances, which enable rabbonim and rebbeim to legally receive part of their salary in a way that is not subject to federal income tax. We have therefore prepared the attached memorandum to answer the most frequently asked questions.

You do not need a law or accounting degree to understand the parts of this memo (the part above the footnotes) that apply to you. The footnotes, however, are for the tax lawyers and accountants (and the legally curious) who may want to know the legal basis for our suggestions and conclusions.

This memo should not constitute legal or accounting advice. Indeed, we encourage you to consult with your own accountant or tax attorney. However, it has been prepared with the input of leading attorneys and accountants in the field, and we encourage you to share it with your tax advisor.

We hope that we have clarified and explained what is an often-misunderstood area of tax law. Most importantly, we hope that this memo will enable our community's rebbeim and rabbonim to make use of this tax break to the fullest extent allowable by law.

Agudath Israel of America

January 2010

PARSONAGE PAYMENTS--TAX BREAK FOR REBBEIM AND RABBONIM*

Contents

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2. What is the maximum that can be taken as a parsonage allowance?
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10. Is a homeowner eligible for parsonage payments?
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General Introduction

Pursuant to Section 107 of the Internal Revenue Code[1], under certain circumstances a member of the clergy does not have to pay federal income tax on the part of his income that he spends on housing. This means that a rabbi or rebbe can reduce his income tax bill by having part of his salary designated as a rental allowance (often called "parsonage payments"). Even if a rebbe owns his own home, he can still receive parsonage payments to cover his housing costs.

The requirements for parsonage payments are as follows:

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* Agudath Israel of America acknowledges and thanks attorney Kevin Babitz for researching and writing the first draft of this memorandum. We also thank attorneys Jacob I. Friedman and Amanda H. Nussbaum of Proskauer Rose, LLP, Yehuda Kupfer, Esq., staff attorney at Agudath Israel, and Chaim Aaron Levin, CPA, for reviewing this updated memo and offering their comments.

[1] For more details, see Treasury Regulations Sec. 1.107-1.

- **The parsonage allowance must be provided as payment for services that are ordinarily the "duties of a minister".** [2] One need not be the rabbi of a shul to take advantage of this provision. "Duties of a minister" includes "the ministration of sacerdotal functions and the conduct of religious worship, and the control, conduct, and maintenance of religious organizations."[3] The IRS has ruled that rebbeim teaching in yeshivos and day schools are eligible to receive parsonage allowances.[4]

- **The employer, as a general rule, should be a religious organization**.[5] However, if the rabbi or rebbe is performing religious worship or similar services, even if his employer is not a religious organization he is still entitled to receive parsonage payments.[6] Thus, a rabbi who works for a nursing home in a non-rabbinic capacity will not qualify for parsonage payments,[7] but if he gives shiurim, runs the shul, and counsels patients on religious matters, he is eligible for parsonage.

- **There needs to be an official action taken by the employer organization (the shul or the yeshiva) that designates the payment as a "rental allowance" under Section 107 of the Internal Revenue Code.** This designation can be made in an employment contract, in the minutes of a meeting of the Board of Directors of the employer, in an employer resolution, in a budget, or in any other appropriate document. The designation should specify how much of the rabbi's or rebbe's salary is to be a parsonage allowance. (See Appendix B for a suggested text of this designation.)

- **The parsonage allowance cannot be greater than the amount that the rabbi actually spends for housing costs, or the fair market rental value of the housing, whichever is less.** [8] Therefore, a shul or yeshiva cannot designate a rabbi's entire salary as a parsonage allowance, unless he actually spends his entire salary for housing. (See Appendix A for sample application form for rabbi or

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[2] Note that retired clergy can receive part of their pension benefits as parsonage payments.
[3] Treasury Regulations Sec. 1.1402(c)-5(b)(2).
[4] Private Letter Ruling 9126048 (April 02, 1991). What if a rebbe teaches secular subjects for a yeshiva? A member of the clergy who is assigned to perform even secular duties by his church may still be entitled to parsonage payments for his work. See Treasury Regulations Sec. 1.1402(c)-5(b)(2)(v). Whether a yeshiva by itself may "assign" a rebbe to teach secular studies and thus enable him to qualify for parsonage payments remains an open question. One could argue that, under the terms of these Treasury Department regulations, a rebbe who teaches secular studies for a yeshiva is performing services pursuant to an assignment by his "church" and thus still qualifies for the parsonage exclusion. However, there is a case in which parsonage payments to a professor of religion at a church-affiliated college were disallowed on the grounds that the college was not an "integral agency" of the church and because the professor was not performing "sacerdotal functions." Flowers v. United States of America, 1981 WL 1928 (November 25, 1981). Therefore, we recommend that this issue be dealt with on a case-by-case basis in consultation with a tax attorney.
[5] Revenue Ruling 68-68 (January, 1, 1968)
[6] Treasury Regulations Sec. 1.1402(c)-5(b)(2)(iii).
[7] Unless the nursing home is an 'integral agency' of a shul.
[8] IRC Sec. 107(2).

rebbe to submit to employer, to enable the employer make the appropriate parsonage designation.)[9]

Specific Questions and Issues

1. How does the yeshiva or shul make the "official designation"? Is it sufficient to type "parsonage allowance" on the employee's paystub?

A parsonage rental allowance must be designated as such pursuant to "official action" by the employer taken in advance of such payment.[10] This designation must mention the particular individual who will be receiving the payments, and it must be in writing, either in an employment contract, in minutes of or in a resolution by the Board of Directors of the employer's organization, or in any other appropriate document demonstrating such official action. Making the designation on a paystub alone is thus not likely to qualify as an official action taken in advance of the payment of the housing allowance. Without official designation, the parsonage allowance is not valid, and cannot legally be excluded from gross income.[11] The designation can state that it will remain in effect for the duration of the rabbi's or rebbe's employment, but since housing costs change often, we recommend that the designation be reissued each year. Attached as Appendix B is a suggested form of minutes for a Board of Directors meeting to make the parsonage designation, and as Appendix C is a suggested form of letter to give to the rabbi or rebbe after the designation has been approved. Even though the designation comes from the employer, the burden of providing proof of the designation to the tax authorities will almost always fall on the employee. As a practical matter the employee should therefore solicit a copy of the official designation from the employer at the beginning of the school year, or at the signing of his contract. The employee should also make certain that the designation is properly dated and is consistent with the information he provided to his employer.

Dependent on its governance structure an employer may find it more practical to have an authorized officer approve the application form (Appendix A). In that situation Appendices B and C need not be used. The employee should retain a copy of the signed approval. Attached as Appendix D is a worksheet which the employee can utilize in preparing the estimated housing expenses.

2. What is the maximum amount that can be taken as a parsonage allowance?

A parsonage allowance can be for the full amount (but not more than) the rabbi's or rebbe's actual housing expenses, as long as this does not exceed the fair market rental

[9] It is not the employer's responsibility to investigate whether the employee has accurately estimated his housing expenses for purposes of making parsonage payments.
[10] Treasury Regulations Sec. 1.107-1(b).
[11] This provision appears to be strictly enforced. In Mosley v. Comm'r, T.C. Memo. 1994-457(1994), a minister had taken a housing allowance for several tax years, but did not have any evidence of an official action for the earlier years. Even though the taxpayer was able to produce evidence of official action for the later years, no exclusion was permitted for the earlier years because of this lack of evidence of official action.

value of the housing.[12] See question 3 as to what can be included in calculating housing expenses.

3. What can be included in calculating housing expenses?

For purposes of a parsonage allowance, housing costs may include:

- ✓ rent,
- ✓ mortgage payments,
- ✓ down payments and other costs of buying a home,
- ✓ real estate taxes,
- ✓ homeowner's or renter's insurance,
- ✓ the actual cost of home improvements,
- ✓ maintenance expenses,
- ✓ repair costs, including appliance repairs,
- ✓ utilities (electricity, gas, water, sewer charges, garbage and snow removal charges, non-business phone line),
- ✓ furniture costs,
- ✓ appliances (including vacuum cleaner, garage door opener, lawn mower),
- ✓ household goods (dishes, cookware, linens, lawn care tools and supplies, cleaning supplies, light bulbs and fixtures, etc..) and
- ✓ home decorations (carpets, curtains, paint, wallpaper, pictures, mirrors, etc.).[13]

Please note that while all of the above may legally be included when calculating one's housing costs, a rabbi or rebbe should estimate his housing expenses as accurately as possible. If the expenses are over-estimated, the rabbi or rebbe may have additional taxable income. On the other hand, if the housing expenses are under-estimated it could result in the rabbi or rebbe paying additional income taxes.

4. Does a rebbe need smicha in order to receive a parsonage allowance?

We recommend strongly that all rebbeim in yeshivos who are receiving parsonage allowances have some form of formal certification of ordination from the yeshiva where they learned. While one doesn't need Yoreh Yoreh to claim the parsonage exclusion,

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[12] Even if the fair rental value of the home is greater than the actual housing expenses, only the actual expenses can be excluded from gross income. Reed v. Comm'r, 82 T.C. 208, 214 (1984). If the clergyman's actual housing expenses exceed the fair rental value of his home, he may only exclude from income the fair market rental value of his home. IRC Sec. 107(2), as amended by the "Clergy Housing Allowance Clarification Act of 2002", effectively overturning Warren v. Comm'r, 114 T.C. 343 (2000). Note that if a rebbe overestimated his housing expenses for a given year (e.g., he planned to make some home improvements and then decided not to), and already received parsonage payments based on his estimates, the difference between what he actually spent on housing and the amount of his parsonage payments must be reported as taxable income.

[13] See Treasury Regulations Sec. 1.107-1(c). There is generally a liberal view as to the scope of "furnishings," as the IRS is reluctant to "dictate the quality of a minister's quarters." GCM 34454 (March 15, 1971). The IRS has even ruled that seemingly "extraordinary or extravagant" expenses (such as fancy antique furniture) may be excluded from income. GCM 37820 (January 15, 1979).

possessing a "Rav u'Manhig" or some other sort of certificate or letter would definitely be advisable.[14]

5. Can women receive a parsonage allowance?

There is no clear precedent whether an Orthodox Jewish female teacher who has a bona fide certification (i.e., a certificate from a seminary or other Jewish program as described below) to teach Limudei Kodesh, and who is employed by a Jewish school for that purpose, is eligible to receive a parsonage allowance. We therefore cannot state with certainty that such payments would not be challenged by the IRS, which could affect the tax liability of the teacher and the school's withholding obligation. However, according to the legal experts with whom we have consulted, it should be reasonable for a school to pay a parsonage allowance to a female Limudei Kodesh teacher who is performing clearly religious functions (e.g., davening with students, teaching Limudei Kodesh, and providing religious counseling) and is appropriately commissioned or licensed. They advise that such commission or license should be in the form of a certificate from a seminary or other qualified Jewish program designed to prepare Limudei Kodesh teachers (and not from a board of education or other secular organization or school) and should certify that the recipient is authorized to perform those religious functions.

6. Is a parsonage payment totally tax-free income?

No. Parsonage payments are not included in one's federal gross income and therefore are not subject to federal <u>income</u> tax.[15] However, a recipient of parsonage payments is

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[14] The Internal Revenue Code does not define the phrase "minister of the gospel," nor does the statute's legislative history. The regulations list three sorts of duties that are considered to be those of a minister: (1) the performance of sacerdotal functions, (2) the conduct of religious worship, and (3) the performance of services in "control, conduct, and maintenance of religious organizations." Treasury Regulations Sec. 1.1402(c)-5(b)(2). However, case law has established that other important factors are whether the taxpayer was duly "ordained, commissioned or licensed", and whether the particular church or denomination recognized the taxpayer as a minister or religious leader. Knight v. Comm'r, 92 T.C. 199 (1989); Wingo v. Comm'r, 89 T.C. 922 (1987).

Based in part on their lack of rabbinical ordination, the IRS initially disallowed the exclusion for cantors. The Tax Court overruled the IRS position and has permitted cantors to claim the exclusion on the grounds that their duties and services are considered to be sufficiently ministerial (the IRS acquiesced and modified its earlier ruling). Yet it is important to note that in the Tax Court cases, the cantors had formal certificates from the appropriate organization indicating their qualifications to serve as cantors. Salkov v.Comm'r, 46 T.C. 190 (1966); Silverman v. Comm'r, 57 T.C.727 (1972). Furthermore, in a subsequent case, a shamash for a shul who gave bar mitzvah lessons and served as a witness at weddings was not permitted to claim the exclusion. Haimowitz v.Comm'r, T.C. Memo 1997-40 (1997). The Tax Court held that even though these duties were related to the Jewish religion, they were nevertheless more organizational than religious in nature, as they did not require performance from one who held ministerial authority. These factors, combined with the fact that the shamash was not ordained as a rabbi or certified as a cantor, led the Tax Court to conclude that he was not a "minister of the gospel" under section 107 and the accompanying regulations. Accordingly, we recommend that a rebbe who is taking the parsonage exclusion should have some form of formal ordination.

[15] In general, states and localities tend to simply base their income taxes on the adjusted gross income on one's federal tax return, so that parsonage payments would also not be reportable for state or local tax purposes either. However, some states require taxpayers to add back certain exclusions or deductions taken

subject to the rules governing self-employment tax (SECA) on the full amount of his salary (including his parsonage allowance). When filing his tax return, he must, therefore, include the full amount of his salary on the form for self-employment income (Schedule SE), and pay tax accordingly.[16] He is required to pay self-employment tax on the entire salary he receives for his duties as a member of the clergy, unless SECA taxes were already withheld from his pay, at his request.[17] See question 8 below.

7. Does the employer need to report parsonage payments on the employee's W-2 form?

No. Parsonage payments are not included in federal gross income and therefore should not be reported as taxable income on the year-end W-2 form. However, as noted above in the answer to question 6, the rabbi or rebbe who receives parsonage payments is required to pay self-employment tax on the full amount of his parsonage allowance. Therefore, the employer may indicate the total amount of the parsonage payments in box 14 of the rabbi or rebbe's W-2 form so that he will know how much he received in parsonage payments that year.[18]

8. May the shul or yeshiva withhold FICA taxes from the amount designated as parsonage allowance? Does the shul or yeshiva still withhold FICA taxes from the non-parsonage part of the rabbi or rebbe's salary?

Salary payments to a member of the clergy for services that are the duties of a clergyman are exempt from FICA withholding, when paid from a religious organization with exempt status under Section 501(c)(3) of the Internal Revenue Code.[19] The shul or yeshiva thus should not withhold any FICA taxes from the rabbi or rebbe's salary.[19a] The rabbi or rebbe is required to report his entire salary (including parsonage allowance) for his duties as a member of the clergy as income for self-employment tax purposes (SECA).[20] This is

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on one's federal return. We are not aware of any state or locality that denies the parsonage exclusion, but this needs to be checked with one's local accountant.

[16] IRC §1402(a)(8), Treasury Regulations Sec. 1.1402(a)-11(a), Flowers v.Comm'r, T.C. Memo. 1991-542(1991).

[17] For more information, including details on how those receiving parsonage should fill out Form SE, see IRS Publication 517, "Social Security and Other Information for Members of the Clergy and Religious Workers". Note that even if a shul provides the rabbi with a free home, he is still required to pay self-employment tax on the rental value of that residence. McFarland v. Comm'r, T.C. Memo. 1992-440 (1992).

[18] Although the rebbe's employer may choose to state the amount of the parsonage allowance in box 14 of the rebbe's W-2 form, this does not mean it needs to be reported to the IRS.

[19] IRC Sec. 3121(b)(8)(A); Treasury Regulations Sec. 31.3121(b)(8)-1(b).

[19a] A shul or yeshiva that has been paying the employer portion of FICA taxes on the non-parsonage payment and now decides to discontinue paying those taxes, should add an additional amount to the rabbi or rebbe's payments so that the rabbi or rebbe is not hurt by the change. This will ensure that the shul or yeshiva has acted consistently with the understanding about the amount the rabbi or rebbe will receive as net salary. If a shul or yeshiva does pay FICA taxes on the rabbi or rebbe's salary, the amount paid is considered additional taxable income to the rabbi or rebbe.

[20] IRC §1402(a)(8), Treasury Regulations Sec. 1.1402(a)-11(a), Flowers v.Comm'r, T.C. Memo. 1991-542 (1991).

reportable on Schedule SE of his tax return. He can request that the employer withhold SECA taxes from his salary.

9. Are members of the clergy required to receive a parsonage allowance? If not, is there ever an advantage to not receiving parsonage?

It is not mandatory that a member of the clergy receive any of his salary as a parsonage allowance. In some instances, it can actually be advantageous for a rabbi or rebbe to forego receiving parsonage. Each rabbi or rebbe should consult with a tax professional to determine whether or not he should receive parsonage payments. [21]

Parsonage Issues For Homeowners

10. Can a rabbi who owns his own home still receive a parsonage allowance?

Yes. The amount of his parsonage allowance may include his mortgage payments, real estate taxes, and other housing expenses (see question 3). It can also include the amount of his down payment and other purchase costs, but only during the tax year that he actually made such expenditures. The total amount of the parsonage allowance for any year may not exceed the annual fair market rental value of the home plus the cost of utilities.

11. Can a rabbi who owns his own home and receives a parsonage allowance still deduct mortgage interest payments and real estate taxes from his gross income?

Yes. Even though a parsonage allowance (which can include the cost of real estate taxes and mortgage interest payments) is excluded from gross income, a clergyman is nonetheless permitted to also deduct real estate taxes and qualified home mortgage interest from his total gross income.[22] A rebbe or rabbi who owns his own home thus gets, in effect, a double tax break.

12. What happens when a rabbi has completed paying his mortgage, or paid for his home in full and has no mortgage?

In such cases, the amount of his excludable parsonage allowance will only be his actual remaining housing costs.[23] Therefore, before prepaying a mortgage, a rabbi should consult with an accountant or tax attorney about the consequences.[24]

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[21] For example, the current tax rules provide for earned income credits and additional child tax credits, both of which are refundable even if the employee had no income tax withheld. These credits are based on the employee's taxable income. Therefore, in some instances, a rabbi or rebbe will lower the amount of his tax refund if he receives a parsonage allowance.

[22] IRC §265(a)(6); Rev. Rul. 87-32 (April 27, 1987).

[23] Swaggart v. Comm'r, T.C. Memo 1984-409 (1984).

[24] The IRS has explicitly ruled that, if a clergyman pays for his home in full in cash, or has already paid off his mortgage, he may not spread the purchase price over a number of years and claim the parsonage exclusion for each of those years. Similarly, he may not use the parsonage allowance to pay off a home equity line of credit, or use the allowance to pay off a loan secured by the paid-off home (unless the

13. When a rabbi buys a home, can he exclude as parsonage the down payment and other purchase-related costs?

Yes, provided that this exclusion is taken during the tax year that the down payment and costs were actually expended, and provided that the total amount of the parsonage allowance that year does not exceed the fair market rental value of the home plus the cost of utilities.

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refinancing was used for capital improvements on the home). Private Letter Ruling 9115051 (January 16, 1991).

APPENDIX A: SUGGESTED PARSONAGE ALLOWANCE APPLICATION FORM

Name of Employer: ____
Name of Applicant: ____
Ordination or Certification Received from*: _________________________________
Home Address: ____
My estimated housing expenses (plus utilities) for the [calendar year 20___] or [the school year ___ 20___- 20___] are as follows: $____________ **
The above is an estimate of my anticipated housing expenses. Should my housing expenses change significantly during the course of the year, I will promptly notify my employer and submit a new parsonage allowance request form.

Signature of Applicant ________________________
Printed Name of Applicant ____________________
Date ____

Approved by: ________________________
[Name and title of authorized officer]
Date ______________________________

*copy on file with the Employer
** Amount may not exceed fair rental value (for the calendar year) of the home, including furnishings and appurtenances, such as a garage, plus the cost of utilities.

APPENDIX B: SUGGESTED OFFICIAL DESIGNATION OF PARSONAGE ALLOWANCE

(A copy of this designation should be presented to the rabbi upon completion)

At a meeting of the Board of Directors of___________________ (the "Organization"), duly convened with proper notice, the Chairman of the Board advised that under Section 107 of the Internal Revenue Code, a qualified member of the clergy is not subject to federal income tax on the rental allowance paid to him as part of his compensation, to the extent used by him to rent or provide a home. Since Rabbi_____________ is duly ordained and engaged by the Organization to perform religious services as defined by the Internal Revenue Code and accompanying regulations, he is eligible to receive a designated housing allowance. After reviewing Rabbi ________________'s application for such housing allowance, which lists his estimated housing expenses, the following motion was moved, seconded, and unanimously adopted:

Resolved, that $__________ is hereby designated as Rabbi ______________'s annual parsonage allowance. Be it further resolved, that as long as Rabbi__________________ continues as an employee of the Organization in good standing, that the above amount of designated housing allowance shall apply to all future years unless and until modified. Rabbi _________________, in his parsonage allowance application, has pledged to inform the Board of Directors of any significant changes in his monthly housing costs.

In witness whereof, I, the undersigned, Secretary of the Organization, hereby certify that the above resolution was duly adopted at a meeting of the Board of Directors duly convened on___________________________(date).

____
Signature of Secretary

APPENDIX C: SUGGESTED LETTER TO RABBI DESIGNATING PARSONAGE ALLOWANCE

Dear Rabbi _________________,

Pursuant to your application for a housing allowance under Internal Revenue Code Sec. 107, the Board of Directors recently met and approved an annual housing allowance in the amount of $______________. Attached is the Board's official designation of your housing allowance.

This housing allowance is not reportable as taxable income on your federal tax return. However, you are required by the Internal Revenue Code to report it as self-employment income, and to pay self-employment tax accordingly. (Indeed, as a member of the clergy, you are required to pay self-employment tax -- reportable on schedule SE of your tax return -- on your entire salary, both your housing allowance and the rest of your salary. If you do not pay self-employment tax, you run the risk of substantial penalties if audited. Furthermore, you (or your family members) will not be able to receive the Social Security benefits to which you would otherwise have been entitled, since those benefits are based on what you paid in self-employment taxes.)

Should your housing costs change significantly during the course of your employment, please obtain a new parsonage allowance application from the office and submit it promptly.

Sincerely,

(Enclose a copy of Appendix B, the official designation of parsonage allowance)

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APPENDIX D: HOUSING EXPENSES WORKSHEET
Calendar Year 20___

Rent __________

Mortgage Payments (principal and interest) __________

Down Payments and other costs of buying house __________

Real Estate Taxes __________

Homeowner's or renter's insurance __________

Actual Cost of home improvements (new roof, room addition, pool, garage) __________

Maintenance and expenses __________

Repair costs, including appliance repairs __________

Utilities

- Electricity __________
- Gas __________
- Water __________
- Sewer charges __________
- Garbage and snow removal __________
- Non-business phone line (base charge only) __________

Furniture Costs __________

Appliances (including vacuum cleaner, garage door opener, lawn mower) __________

Household goods (dishes, cookware, linen, tools and supplies, cleaning supplies, light bulbs and fixtures) __________

Home decorations (carpets, curtains, paint, wallpaper, pictures, mirrors, etc.) __________

Lawn care __________

Notes

- The aggregate parsonage allowance may not exceed the fair market value of the home including furnishings (and garage) plus utilities. Excess amounts should be reported as income on your tax return.

- Only one home may be counted.

- All parsonage payments from all employers must be aggregated.

- Evidence of expenses should be kept in your files.

- Keep a copy of the formal approval of the parsonage amount. The approval must be made in advance of the receipt of the parsonage payment.

- Real estate taxes and interest on the mortgage may <u>also</u> be deducted on your Schedule A of Form 1040.

- Do not count maid service, labor, groceries, personal toiletries, clothing, toys, etc.

Feature

Demystifying the Parsonage Exclusion From Federal Income Tax

Over the past several months, Agudath Israel of America has initiated the Dina D'Malchusa Dina series of legal seminars project. Responding to the timely need in the Orthodox Jewish community for substantive guidance regarding a range of legal and tax-related issues faced by yeshivos, shuls, gemachs, and the general public, Agudath Israel has stepped up to fill that need by coordinating this initiative. To date, Agudath Israel has presented close to ten seminars in various locations across the United States, including programs in Boro Park, Chicago, Cleveland, Flatbush, Lakewood and Los Angeles, and more are scheduled to come. The initiative has been praised by many as long overdue. It has served as a means of educating the greater Orthodox community regarding the intricacies of complicated and often misunderstood legal concepts, and has brought about a keen awareness of pertinent rules and laws vital to ensure that organizations and individuals act in compliance with state and federal law. The parsonage exclusion from income tax is one such topic. Below is an article that seeks to clarify the rules of parsonage, the limits to the exclusion and some of its nuances.

By Judah I. Kupfer, Esq.

Introduction

No one likes taxes. Paying them, that is. However, people's ears generally perk up at the prospect of keeping more take-home pay and giving less to Uncle Sam. Some Orthodox Jews may legitimately be able to save on their income taxes by taking advantage of the "parsonage" housing-allowance exclusion from federal income tax.

The Internal Revenue Code provides that a "minister," or one who can be classified as a minister for purposes of the tax Code, may be able to exclude a portion of his or her income earned in the exercise of performing ministerial service that has been pre-designated and actually used for the minister's housing expenses that year. This income is excluded, and will thus not be reported for purposes of federal income taxes (and most state and local taxes too) but will still be subject to social security tax.

The parsonage exclusion clearly affords a huge tax break to a group that generally doesn't bring home all that much pay to begin with and can certainly use the extra cash. Although the parsonage exclusion has faced challenges over the years on constitutional grounds and continues to be challenged (notably, as recently as a May 21, 2010 decision from a California federal court that allowed such a challenge to move forward).

At the time of this writing, the parsonage exclusion is still the law, and, as long as it continues to remain the law, those who are eligible can take advantage of it. Outlined below are some of the basic concepts and procedures for how the parsonage exclusion works. It should be noted at the outset that it is important to seek professional guidance to ensure eligibility and to ensure that its requirements are being applied correctly.

Who is eligible?

The parsonage allowance may only be provided as payment for services that are the "duties of a minister." This includes "the ministration of sacerdotal functions, the conduct of religious worship, and the control, conduct and maintenance of religious organizations." This definition would include most shul Rabbanim, *rebbeim* in yeshivos who teach religious subjects, as well as yeshivah administrators.

One caveat is that the person must also be "ordained, licensed or commissioned." That would not necessarily require the rabbi to have formal *semichah,* but he should have a certificate or diploma from the yeshivah he attended attesting to his qualification to act in a rabbinic capacity, and that certificate should be on file with his employer.

Female teachers conducting ministerial services (e.g. *davening* or learning with children) can likely take advantage of this provision as well. Although they may not be "ordained," it would be sufficient for the female teacher to obtain a diploma or certificate from her seminary attesting to her qualifications to teach Jewish religious subjects.

Although, generally, the employer will be a shul or yeshivah, there is no requirement that the employer be a religious organization. For example, a rabbi working in a rabbinic capacity (e.g. conducting *shiurim*, running the shul, counseling patients on religious matters) at a nursing home or hospital would also qualify. If you are unsure whether you qualify, it is important to seek professional guidance before using the exclusion.

> *The parsonage exclusion clearly affords a huge tax break to a group that generally doesn't bring home all that much pay to begin with.*

What do you need to do?

The parsonage allowance, i.e. an estimate of how much of his salary the employee will use for housing expenses that year, must be designated by the employer, and that designation must happen prospectively, meaning before the income is earned, in order for an employee to take advantage of the tax break. The employee estimates his housing expenses for the year and submits the estimate to the employer for approval. The designation must be made by "official action" of the employer. Examples of "official action" include a designation within an employment contract, in the minutes of a board of trustees meeting, in an employer resolution — but really any other appropriate document will suffice. While a verbal designation would count (so long as such designation was made by "official action"), it isn't recommended, as it can cause evidentiary issues later on.

Parsonage is a matter of tax law, and thus, like most tax laws, it follows the calendar year — January through December. Since the expenses must be pre-designated, the designation should ideally take place each December, or earlier, for the following calendar year. (If based on the school year, care should be taken that the designations for the school years involved cover the entire calendar year.) When starting a new job mid-year, the designation should occur as soon as the employee starts working, if not before.

A designation can technically be made for future years, but because pre-designation of housing expenses should be as accurate as possible, a new designation would likely be needed at the beginning of each calendar year.

What kinds of items are considered "housing expenses"?

"Housing expenses" includes basically everything that has to do with housing. A non-exhaustive list includes various expenses in buying or owning a home such as the down payment on a home, closing costs, mortgage payments including interest and principal, home equity payments (as long as the loan proceeds were used for other housing expenses), real estate tax and property insurance. For those renting, rental payments are also considered housing expenses.

Other applicable housing expenses include the cost of utilities (e.g. electricity, heat, water, non-business telephone line, gas, sewer charges), cost of furnishings and appliances, household goods (including dishes, cookware, linens, lawn-care tools, cleaning supplies, electrical supplies), building repairs, remodeling and home improvements, yard maintenance, landscaping, pest control, snow removal, local calls on the home phone, and more.

With so many everyday items included, it's important to note some items that are deemed *not* to be housing expenses. Such items are the cost of purchasing food, personal toiletries such as toothpaste and shampoo, music CDs, computer software, automobile costs, as well as the cost for services such as housekeeping and babysitting.

Are there any limitations?

There are indeed limitations as to the amount of parsonage an employee may exclude. The employee is limited to the lesser of (a) the amount pre-designated by the employer, (b) the amount of housing expenses actually used that year, and (c) the fair rental value of a furnished home while adding the employee's actual cost of utilities incurred that year.

To illustrate how these limitations work, suppose a rabbi estimated in January that he would require $10,000 in housing expenses for the year and the school went through the process of pre-designating by official action that amount from his salary of $40,000. The school would pay the rabbi the entire $40,000, but the rabbi's W-2 would only show $30,000. (The parsonage amount of $10,000 may be detailed in Box 14 for "other income," but there is no requirement that this be done.) When tax time comes, assuming the rabbi actually used $10,000 on housing expenses during that calendar year, he will only report and pay federal income tax on $30,000 of his salary.

> *The parsonage exclusion merely applies to federal income tax.*

Let's say the rabbi only used $8,000 of the pre-designated $10,000 for housing expenses. He would be required to report and pay federal income tax on the leftover $2,000. Suppose the rabbi ended up using $12,000; he is limited to the pre-designated amount of $10,000 — and so the additional $2,000 of the rabbi's salary that went toward housing expenses but was not pre-designated is considered taxable income.

In this last example, should the rabbi notice during the year that his pre-designated amount will fall short, he may ask his employer to amend the designation to account for the additional amount, so long as the expenses used at that point have not yet exceeded the original pre-designated amount. To the extent they have, the amount that exceeded the pre-designated amount may not be part of parsonage as tax-free housing expenses.

To take a different example, suppose a rabbi was given the use of a home, rent-free, that was otherwise valued at $20,000. If not for the parsonage exception, that amount likely would need to be included in the rabbi's salary as a taxable benefit gained from his employer through the course of his employment. (Note that there are certain other limited exceptions when such fringe benefits would not have to be included as taxable income, but we won't explore those in this article.)

However, given the parsonage rules afforded a rabbi by the tax Code, the $20,000 gain will not be subject to federal income taxes. In such an instance, aside from not reporting the $20,000 gain, the rabbi may also desire to have his employer pre-designate a portion of his salary as a housing allowance so that other housing expenses used that year would also not be included in taxable income for federal income tax purposes.

Suppose a rabbi decided in January that this year will be the year that he purchases a home. Knowing his expenses for the year will be quite significant, he designates his entire salary of $85,000 toward his housing allowance. (As it turns out, actual housing expenses for the year may end up being even greater than his entire salary.) In this case, the fair-rental value limitation kicks in. The rabbi would need to evaluate the fair-rental value of a fully-furnished home such as his (let's say it is $35,000), and add to that his actual cost of utilities for the year (let's say it's $10,000), and the sum of those figures would be the maximum amount of parsonage he may take tax-free for that year, even though he pre-designated a larger amount and although he actually spent more. In our example, his parsonage amount is limited to $45,000. The additional $40,000 of his income ($85,000 – $45,000 = $40,000) would be taxable.

As far as designating one's entire salary, that, too, is fine. Just remember that the above limitations would apply.

Does the employee have to pay social security/Medicare tax on his income?

Here is the more troubling news. Indeed, the parsonage exclusion merely applies to federal income tax (as well as any local and state taxes that base their taxable income on the employee's federal "adjusted gross income"). Social security taxes are a different story. The employee is required to pay social security and Medicare tax on his entire income, both the parsonage as well as the non-parsonage amounts. Not only that, this burden of paying it falls completely on the employee — all 15.3% of it. If you're thinking it's strange — that's because it is.

The tax code classifies "ministers" with respect to ministerial services they perform as "dual-status employees." That means they are considered employees for all purposes (so they generally receive a W-2 at year's end from their employers), except when it comes to social security tax.

For social security purposes, ministers are considered "self-employed." The rule is that employees pay half their social security and Medicare obligations (also known as FICA, which stands for Federal Insurance Contributions Act) while employers are required to kick in the other half at their own expense, which will not be taxable to employees. Since ministers with respect to their ministerial services are exempt from FICA, there is no obligation for the employer to kick in half of the FICA. Indeed, should the employer decide to pay half regardless, such amount is considered additional taxable income to the employee.

Instead, ministers fall under the SECA system (which stands for Self-Employment Contributions Act), which requires them to pay the entire 15.3% of their entire salary themselves (parsonage and non-parsonage), just like any other self-employed person. The minister would also be required to make quarterly estimated payments towards the SECA obligation and report those payments on Schedule SE to the Form 1040. (Boxes 3 through 6 on the employee's W-2 should be left blank, as those apply only to FICA amounts, not SECA.)

One saving grace, perhaps, is that a self-employed person is allowed an adjustment on his Form 1040 of 7.65% of his entire salary (also known as an "above-the-line deduction").

If, prior to reading this, an employer had the practice of paying half of the rabbi's social security tax as though the rabbi were an ordinary employee, and now decides to no longer cover any of the rabbi's SECA obligation, to maintain the understanding between the employer and rabbi it is suggested that the employer increase the rabbi's salary by the 7.65% that the employer was previously paying, so that the rabbi is not left with a net loss.

One further thing to remember is that the social security ramifications just discussed are a by-product of a taxpayer being deemed a "minister," and do not vary based on whether the rabbi elects to accept parsonage. So long as the rabbi is deemed a minister who is conducting ministerial services and is thus eligible for parsonage, the social security rules discussed above will apply to him — regardless of whether he actually receives parsonage.

On that note, once we've mentioned a ramification of being classified as a "minister," another important ramification is that the employer of a minister is exempt from its obligation to withhold federal income tax, whether or not the rabbi is receiving parsonage. (If receiving parsonage, this would apply only to the non-parsonage amount, as the parsonage amount is already excluded from federal income tax.) In such a case, the rabbi would be required to pay quarterly estimated federal income tax on any non-parsonage amount, just as he must do for social security tax.

The rabbi may request that his employer voluntarily withhold federal income tax on his behalf (on any non-parsonage amount) so that he need not bother arranging and filing quarterly estimated federal income taxes.

One last note about social security tax: Besides being the law and thus obligatory, as a practical matter, paying into social security serves as a sensible long-term investment, as it allows the payer to receive income after retirement. Additionally, although there is the option for certain clergy members to opt out of social security, based on their opposition to public insurance for personal religious considerations, many tax professionals have serious questions about the availability of this exemption for Orthodox Jews.

May both a husband and wife claim parsonage?

Sure, keeping in mind that the above limitations apply: Actual (and pre-designated) housing expenses used that year that do not exceed the fair rental value of the home (including furnishings plus actual cost of utilities).

Thus, if a rabbi's entire salary won't cover all of his housing expenses, so long as the wife is also eligible to receive parsonage, her salary, too, may be pre-designated to cover the remainder of their housing expenses, keeping in mind the fair rental value limitation previously discussed.

May one claim parsonage for a summer home?

The parsonage exclusion may only be used to exclude housing expenses incurred for one home. However, should the rabbi incur expenses for more than one home, such expenses incurred while living in that other home may be treated as housing expenses for the parsonage exclusion. The catch is that during that time, any housing expenses incurred in connection with the rabbi's primary residence are taxable. A slightly different way of structuring this arrangement is by adding the total amount of expenses incurred for each home and multiplying each sum by the percentage of the year in which the rabbi occupied that home. Only the proportion of expenses incurred given the time spent living in that home may be considered tax-free expenses for parsonage purposes.

For social security purposes, ministers are considered "self-employed."

What about local and state income taxes?

Most local and state taxes base taxable income on the "adjusted gross income" reported on the employee's federal tax return. Since parsonage is an exclusion from gross income, it is not included in the employee's adjusted gross income. Thus, for most jurisdictions, the parsonage amounts would also be excluded from state and local taxes.

Should one who is eligible always elect to accept parsonage?

Not always, as accepting parsonage may affect whether the employee would be entitled to other tax benefits. Thus, an employee should be sure to check with a qualified tax advisor before electing to accept parsonage, to ensure that, given the totality of the employee's specific financial circumstances, accepting parsonage would be in his best financial interest.

Conclusion

Although parsonage amounts are not completely tax-free, they nonetheless provide a significant tax break to many families that may be eligible.

However, in actual practice, it is important to keep in mind the above principles and the need to seek guidance from a tax advisor to ensure the exclusion is applied correctly.

***

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Judah I. Kupfer, Esq., is a staff counsel at Agudath Israel of America. He previously practiced as an associate at the law firm of Allen & Overy LLP in New York. Mr. Kupfer is a summa cum laude graduate of Touro College, a magna cum laude graduate of Brooklyn Law School and an LL.M. taxation candidate at New York University School of Law. To contact the author, please email ykupfer@agudathisrael.org. Questions and comments are welcome.

Business News

Parsonage Rule Update:

U.S. Tax Court Rules Parsonage Extends to Non-Commercial Use of a Second Home

BY JUDAH I. KUPFER, ESQ.

On December 14, 2010, the United States Tax Court ruled in a divided decision, *Driscoll v. Commissioner* (135 T.C. No. 27), that a "minister" for tax purposes correctly excluded from gross income the pre-designated housing allowance he received as part of his compensation and which he actually used for the non-commercial use of *two* personal residences.

The petitioner in the case, Philip Driscoll, was a minister who owned more than one home, a primary residence and a summer home. Neither of the houses was used for rental or any commercial purposes at any point during the years at issue.

In each of the years, the ministry, a 501(c)(3) tax-exempt organization, pre-designated part of his compensation as a parsonage housing allowance to be used for the acquisition and maintenance of each of the homes. The petitioner excluded those amounts from his gross income that were pre-designated and actually used for housing expenses for each of his two homes.

The IRS determined that the petitioner owed additional taxes, the amount excluded from gross income that was used for the second home. The petitioner sought review by the Tax Court. The Tax Court held that under §107 of the Internal Revenue Code, the term "a home" is not to be interpreted as being limited to one home.

The court emphasized that the term 'home' does not extend to situations where "a minister, in additional to a home, rents, purchases, or owns a farm or other business property." Thus, it is clear that the exclusion under §107 applies only for the minister's *personal use* of the second home. The second home may not be rented or leased to a tenant or used for any commercial or business purposes.

What is unclear from the case is how the law would treat the personal use of a third home, fourth home, etc. The court merely decided the facts before it, which was a case involving two homes. It would seem that the reasoning should extend to more than two homes. Indeed, as the dissent notes, "[t]he majority decides today that, if a property is a dwelling house, then it is a 'home' for which an allowance is excludable, no matter the number of 'homes' a minister may claim." However, the court stopped short and left that determination for another day.

Moreover, it is also unclear how the "fair rental value" limitation would apply in a situation where the minister excluded housing expenses for two homes. Among other limitations, parsonage is limited to the fair rental value of a home that is fully furnished, plus the actual cost of utilities. Until now, it was clear that this limitation is for the fair rental value of one home. The court did not address whether fair rental value is for one home or two homes (presumably because fair rental value was not an issue in the facts of the case) and so the extent of the current limitation seems unclear in the situation where the minister excludes housing expenses for two homes.

It should be noted that the rule is not limited to situations where the minister *owns* a second home — if he *rents* a second home, that should qualify as well. The designation made by the minister's employer must be done in advance of both (i) earning the income, as well as (ii) spending on the housing-related expenses. Since the parsonage amounts must be pre-designated, this case may not be used to exclude additional amounts for the 2010 tax year.

For the 2011 tax year, those wishing to exclude the housing expenses for their second homes must be sure to pre-designate additional amounts of their compensation to cover those expenses to be used for the second home. If a designation has already been made for the 2011 tax year, it may be amended to increase the housing allowance, so long as those amounts have not yet been earned or expended on housing expenses.

Most importantly, while this case is a matter of first impression setting a new precedent in the law, given that the court was divided in its decision (meaning not all of the judges agreed with the decision), there remains a strong likelihood that the IRS will appeal the decision and that the law may change at some point in the future. Thus, you are urged to consult your own tax advisor before implementing any changes based on this court decision.

Judah I. Kupfer, Esq. is a staff counsel at Agudath Israel of America. For more information, please email ykupfer@agudathisrael.org.

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LEXSEE REV. RUL. 68-507

Revenue Ruling 68-507

Rev. Rul. 68-507; 1968-2 C.B. 485; 1968 IRB LEXIS 317

July 1968

[*1]

SUBJECT MATTER: SECTION 3402.-INCOME TAX COLLECTED AT SOURCE

APPLICABLE SECTIONS:

26 CFR 31.3402 (a)-1: Requirement of withholding. (Also *Sections 61*, *1401*; *1.61-1*, *1.1401-1*.)

TEXT:

Voluntary plans for withholding income tax from a minister's salary cannot be approved by the Revenue Service; further, amounts paid by a church toward its minister's personal tax obligations are includible in his gross income for income and self-employment tax purposes.

Advice has been requested whether a church may withhold Federal income tax from the salary of its minister, notwithstanding the fact that the withholding is not required under chapter 24, subtitle C, of the Internal Revenue Code of 1954 (Collection of Income Tax at Source on Wages). Advice also is requested whether amounts paid by the church to the minister to assist him in paying his self-employment tax (for social security) are includible in his gross income for purposes of Federal income tax and the self-employment tax.

Section 3402 of the Code requires the withholding of Federal income tax upon "wages" as defined in *section 3401 (a) of the Code*. Under the provisions of *section 3401 (a)*, certain types of remuneration and remuneration paid to certain classes of persons are excepted [*2] from the definition of the term "wages." Thus, the Code is specific as to the "wages" to which it is made applicable. Under the provisions of *section 3403 of the Code*, the employer is made liable for the payment of the tax required to be withheld. The employer is subject to penalties for failure to comply with the requirements for withholding, reporting, and paying over the tax. Under *section 31 of the Code*, the amount withheld under *section 3402* from an employee's "wages" shall be allowed as a credit against the Federal income tax imposed on the employee. The crediting is allowed in any case in which the tax has actually been withheld as required by *section 3402* even though the tax is not paid over to the United States Government by the employer.

In the instant case, the amounts paid by the church to the minister are excepted from "wages" by *section 3401 (a) (9) of the Code*, which excepts remuneration paid for services performed by a duly ordained, commissioned, or licensed minister of a church in the exercise of his ministry. For that reason, the church is not required by *section 3402 of the Code* to withhold Federal income tax from the amounts so paid. The Internal Revenue Service [*3] is without authority to approve any voluntary plan of Federal income tax withholding in this case or in the case of any other employee whose remuneration is not subject to the withholding.

Although the Internal Revenue Service is without authority to approve a plan for the withholding of Federal income tax by the church from the salary of its minister or to authorize withholding in any case not provided for by law, these provisions do not preclude any arrangement that the church may make privately with the minister for the setting aside of part of his salary for his use in meeting his personal tax obligations, including his payments of estimated income tax, provided that certain precautions are observed.

However, under any such arrangement, it should be made clear to the minister that the setting aside of money on his behalf is not a withholding of Federal income tax that the church is required to make, and that the Internal Revenue Service in no way authorized the arrangement. The church may not in any way make the United States Government a custodian of any part of the money by the use of a Federal Tax Deposit, Form 501, by the filing of a quarterly tax return on Form 941, or otherwise. [*4] No amount set aside from the minister's salary is to be reported by the church on a Wage and Tax Statement, Form W-2, as income tax withheld on wages. The minister may not claim on his income tax return that any amount set aside under the arrangement was withheld as Federal income tax. The minister should understand that he must file a declaration of estimated tax, and pay the estimated tax, if he meets the requirements relating thereto. The Internal Revenue Service will not intervene in any controversy that may result from the arrangement.

To the extent that the church pays any amount toward the minister's obligation for income tax or self-employment tax other than from the minister's salary, the minister is in receipt of additional income that is includible in his gross income and must be considered in determining his income tax and self-employment tax liability.

Agudath Israel of America
אגודת ישראל באמריקה

10 Shevat 5763
January 13, 2003

MEMORANDUM

TO: Those requesting information about qualified tuition reduction programs

FROM: Mordechai Biser, Esq., Associate General Counsel

cc: Deborah Zachai, Director of Education Affairs
Yehoshua Michaeli, Education Affairs Associate

RE: **Qualified Tuition Reduction Programs**

We receive occasional queries from menahalim, rebbeim, teachers, accountants for yeshivos, and others about how a school can pay all or part of the tuition for its employees' children such that the employees do not have to pay income tax on the amount of the tuition provided. This can be done under what is known as a "qualified tuition reduction program", the details of which are frequently misunderstood.

To clarify the matter, we asked Kevin Babitz, a tax lawyer at the Washington, DC law firm of Powell, Goldstein, Frazer & Murphy, to prepare the attached memorandum to answer the most frequently asked questions about this type of tax benefit (we thank Beryl Septimus, Esq. for doing some background research for this memo). You do not need a law or accounting degree to understand the part of the memo that is above the footnotes. The footnotes, however, are for the tax lawyers and accountants (and the legally curious) who may want to know the legal basis for the memo's conclusions.

This memo is not intended to constitute legal and accounting advice. Indeed, we encourage you to consult with your own accountant or tax attorney. However, it has been reviewed and approved by leading tax attorney Jacob I. Friedman, and his associate Shane Stroud, of the New York City firm of Proskauer Rose, LLP.

The law firm that Mr. Babitz works for requires that we provide you with the following disclaimer, with which we concur:

> *We have provided you with a copy of a Memorandum dated January 13, 2003, concerning qualified tuition reduction programs, that was prepared by Powell, Goldstein, Frazer & Murphy LLP. Powell Goldstein has given Agudath Israel of America permission to distribute this Memorandum to yeshivos, seminaries, and day schools. However, please be advised that this Memorandum contains confidential information and should not be forwarded to anyone outside your organization without*

Powell Goldstein's consent (you may, however, provide it to your organization's tax advisor, attorney, or others who are working on your organization's behalf). In addition, please note that Powell Goldstein did not represent you in connection with the issues in the Memorandum and you should not rely on the Memorandum for legal advice. If you wish to retain Powell Goldstein directly to represent your interests, we have no objection to you doing so, but you would need to contact them directly in this regard.

POWELL
GOLDSTEIN
FRAZER &
MURPHY LLP

ATTORNEYS AT LAW

ATLANTA GENEVA WASHINGTON

Date: January 13, 2003

MEMORANDUM

To: Mordechai Biser, Esq.
Associate General Counsel
Agudath Israel Of America

From: Kevin Babitz

Re: Qualified Tuition Reduction Programs

File #: 998001.00039

General Introduction

Pursuant to Section 117(d)(1) of the Internal Revenue Code, under certain circumstances an employee of an educational organization can receive from his employer a tuition reduction for his children's tuition such that the amount of the reduction does not constitute taxable income to the employee. This can be done if the employer provides the employee with a “qualified tuition reduction” (hereafter called a “QTR”) as part of a QTR program. A QTR is defined as a reduction in tuition provided to an employee of an educational organization[1] for education (below the graduate level) at that or another educational organization.

A QTR is a very attractive benefit for yeshivos, day schools and other Jewish educational institutions. When a school provides an employee with a tuition reduction, its cost is generally far less than the value of the reduction to the employee.

The requirements for providing a QTR are as follows:

- The QTR must be provided by an educational organization (defined below), for attendance at it or at another educational organization.
- The QTR must be part of a program in which similarly classified employees (defined below) receive substantially the same benefits. The program cannot discriminate in favor of owners or officers or certain other employees of the organization.
- The QTR must be a fringe benefit and not a payment in lieu of salary.

[1] As described in Code Section 170(b)(1)(A)(ii).

Specific Questions and Issues

1. What sort of educational institution is permitted to have a QTR program?

Only educational organizations may offer qualified tuition reduction programs. An employer is considered to be an educational organization if it meets all of the following conditions:

(1) its primary function is the presentation of formal instruction;
(2) it normally maintains a regular faculty and curriculum; and
(3) it normally has a regularly enrolled body of students in attendance at the place where its educational activities are carried on.[2]

If a school offers qualified tuition reductions for attendance at another institution, the other institution must also meet these requirements.

For most yeshiva katanas, yeshiva gedolahs[3], Bais Yaakov seminaries, and day schools, these requirements will not be difficult to satisfy. [4] A pre-school[5], an afternoon kiruv school, and the like would also appear to qualify. It appears that QTR payments may also be made to yeshivos and seminaries in Israel.[6] However, an organization such as a shul that runs a nightly beis medrash program cannot offer a QTR program, even to its full-time employees, since its primary function is not the presentation of formal instruction.

2. Who is entitled to receive a QTR?

A QTR can be provided to any person 'treated as an employee' according to the Internal Revenue Code. Individuals in the following categories are treated as employees:

(1) A current employee;
(2) A former employee who retired or left on disability;
(3) A widow or widower of an individual who died while an employee;
(4) A widow or widower of a former employee who retired or left on disability; or

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[2] Treasury Regulation § 1.170A-9(b).
[3] However, see question 11, which states that QTR payments for graduate education (such as kollel) are much more limited.
[4] The IRS has stated explicitly that religious schools are eligible to offer QTR programs. See PLR 200149030.
[5] A facts and circumstances test will apply to pre-schools to make sure they are sufficiently educational. In San Francisco Infant School, Inc. v. Commissioner, 69 TC 957 (1978), the court ruled that a preschool was indeed an educational organization, because it had qualified teachers and a formal curriculum. However, General Counsel Memorandum 38731 (1981) ruled that an institution for mentally handicapped children was not an educational organization because it did not have the proper indicia of education.
[6] While there is no direct authority on this point, Rev. Rul. 82-143 discusses a "foreign university described in 170(b)(1)(A)(ii)" in the gift tax context, thus indicating that foreign schools can be 170(b)(1)(A)(ii) institutions. See also PLR 9018068 and PLR 9510045.

(5) A dependent child or spouse of any person listed in (1) through (4).[7]

3. Does a school have to include all of its employees in its QTR program?

No. An employer has significant flexibility in designing a program that meets employees' needs while limiting its own costs. Thus, even though there is a very broad class of people who *may* be covered under a QTR program, an employer may decide to limit the covered group in order to keep costs down. However, in doing so, the employer cannot discriminate against individual employees within the same classification, as explained below in question 5.

> *Example: a school can choose to only provide QTR benefits to full-time employees who have been working for the school for three or more years, but having done so, it must make the benefits available to all of its full-time employees who have been with the school for three or more years.*

4. Can the QTR be an amount deducted from an employee's salary?

No. The QTR must be a fringe benefit provided by the employer to the employee and not a payment for services rendered by the employee.[8] In other words, the school must set a certain salary for each classification of its employees and then offer the QTR as a fringe benefit in addition to each employee's salary.

To the extent that different teachers in a school receive significantly different salaries, it would be highly advisable for all schools with QTR programs to maintain records that demonstrate the

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[7] Additionally, a child of deceased or divorced parents may also benefit from a QTR program. If both of a child's parents have died, but one of them qualified as an employee under (1) through (4) above, their child, if under the age of 25, can qualify to receive a tuition reduction from his or her parent's former employer. The child will then be permitted to exclude the amount of the QTR from his or her own income. A dependent child of divorced parents is treated as the dependent of both parents.

[8] Generally, all financial benefits are included in a taxpayer's gross income (Code Section 61 defines gross income as all income from whatever source derived). Fringe benefits are thus included as income unless they are specifically excluded under the Code, and Section 117(d) explicitly excludes qualified tuition reductions from an employee's taxable income. Treasury Regulations Section 1.132-1(f)(1) indicate that the 117(d) exclusion is considered to be a fringe benefit. The regulation states that the requirements of Section 132 (which deals with taxable fringe benefits) do not apply to particular fringe benefits that are expressly provided for in other sections. The Regulation specifically mentions the Section 117(d) QTR as an example of a fringe benefit not subject to the Section 132 rules because it is provided for by another section. A payment for services rendered, on the other hand, cannot be a fringe benefit. Therefore, if an institution were to deduct tuition payments it makes for an employee's children from the salary of the employee, this reduction will not constitute a fringe benefit, but taxable income to the employee. Additionally, even if the employee were to receive a discounted rate of pay, this would not constitute a reduction of tuition, but just an adjustment of the taxpayer's salary. This distinction was discussed by the Tax Court in 1994 in *Rasmussen v. Commissioner*, T.C. Memo. 1994-311, in which the Court approved a QTR program, stating that "the amounts [of the tuition reductions] were not subtracted from the petitioners' respective salaries." This statement implies that had the amount been deducted from employees' salaries, they would not have been permitted to exclude it from their income.

basis for their salary structure so that their QTR payments cannot be construed by the IRS as payments in lieu of salary.

> *Example: Rebbe A and Rebbe B both teach fourth grade for Yeshiva Y. If Rebbe A gets a $35,000 salary and no QTR (because he has no school-age children), whereas Rebbe B (who has four children enrolled in schools) gets a $25,000 salary and $10,000 in QTR payments to the schools his children attend, the QTR payments to Rebbe B are likely to be construed as taxable salary and not a tax-free fringe benefit. But if the school had a written salary policy, that is uniformly adhered to in practice, that all teachers who have five years or more seniority (such as Rebbe A) are paid $35,000, whereas newer teachers (such as Rebbe B) get $25,000, then the QTR payments for Rebbe B's children would be justifiable as a fringe benefit.*

5. Can different rebbeim or teachers receive different amounts of benefits under a QTR program?

QTR benefits must be made available on substantially the same terms to each member of a group of employees that is defined under a "reasonable classification" set up by the employer.[9] A classification will be reasonable if established under objective business criteria that identify the category of employees who benefit under the plan. Reasonable classifications include specified job categories, nature of compensation (i.e. salaried or hourly), geographic location, seniority, full-time vs. part-time status, and job description.[10]

Therefore, rebbeim or teachers who have greater seniority, or who teach a longer school day, can receive more QTR benefits than those with less seniority or those who are more part-time.

Once a school establishes its classification of employees for QTR purposes, it has considerable discretion as to the details of the QTR benefits it provides to each class of employees. For example, a school can establish a total dollar cap on QTR (e.g., we will pay up to $10,000 in tuition payments for the benefit of each full-time employee), a per child cap (e.g., we will pay up to $2,500 in tuition for every child of a full-time employee), a cap on the number of children or other dependents whose tuition will be paid, et cetera. As long as employees within each classification are eligible for substantially the same benefits, the QTR program will not be discriminatory.

6. May an employer, as part of a QTR plan, also pay tuition at other educational institutions?

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[9] Code Section 117(d)(3).
[10] Treasury Regulations Section 1.410(b)-4. See also PLR 200137041.

Yes. An employer may extend its QTR program to include other educational institutions. It should be noted, however, that this would likely cause the employer to incur additional costs, as it will need to pay full or partial tuition to the other institution. One way this additional cost can be abated is if the institutions enter into a reciprocal agreement, in which each institution agrees to provide a discounted tuition to children of employees at the other institution.

7. Can a QTR program offer full tuition payments for a school's employees?

Yes. While a QTR plan need not provide employees with full tuition assistance, the employer may provide a reduction ranging anywhere from 1 percent to 100 percent.[11]

8. What do the regulations mean when they say that a QTR program cannot be discriminatory?

A QTR program cannot discriminate in favor of "highly-compensated employees" [12], owners or officers.[13] This means that the organization must make available tuition reduction benefits to

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[11] Depending on the goals of the program, there are advantages and disadvantages to having a higher or lower reduction rate. A partial reduction program, if limited to the employer-institution, offers a significant potential monetary advantage to an institution. This is because such a program would not only encourage employees and their families to enroll at the institution, but also pay partial tuition to the school. Since the additional cost of extra students in a class is generally quite low, the employer-institution stands to gain from receipt of even partial tuition. If the benefit were extended to other institutions, the employer would not have to pay out as much as if it were providing full tuition. The benefit of a full reduction program, on the other hand, is that is would be more attractive to employees and prospective employees.

[12] "Highly compensated employee" (HCE) is defined in Code Section 414(q)(1) as an employee who either was a 5% owner at any time during the tax year or the preceding year; or for the preceding year had compensation exceeding $85,000 (in 2001, but adjusted for inflation in later years) and, if the employer so elects, the employee was in the top 20% in compensation in the organization. On the other hand, if the number of HCEs eligible for tuition reduction under the organization's plan is substantially higher than the number of eligible non-HCEs, then the HCEs must include in income the entire value of the benefit received (Letter Ruling 9041085). Even in these cases, however, the non-HCEs who receive a tuition reduction can still exclude the benefit from their own income, as this provision only applies to HCEs.

[13] The plan will need to satisfy one of two percentage tests set out in the Treasury Regulations at Section 1.410(b)-4(c)(2) and (3). However, even if these two tests are not satisfied, the IRS may still rule that a QTR plan is nondiscriminatory and therefore valid, if it believes that the number of eligible non-highly compensated employees is sufficient. See PLR 9621033; PLR 9710022.

The IRS illustrated the application of these provisions in PLR 9728017. In this ruling, the Service considered a university's QTR plan. The plan covered all faculty and staff employees who had five years of full-time service and part-time staff with six or more years of service. The IRS ruled that the plan satisfied the prohibition against discrimination in favor of highly compensated employees because the classification of the employees was based upon a combination of length of service, full-time employment and position. More recently, the IRS considered the validity of a plan that covered a more limited class of employees in PLR 200137041. This plan provided tuition reductions to eligible employees and their dependents for university degree-granting programs. To be eligible for

other employees on "substantially the same basis" as it does to highly compensated employees, owners, and officers, assuming that the other employees are in the same classification. In other words, the salary level of employees itself cannot be the basis for a classification.

9. What is the tax effect of a QTR for the employee? Does the value of the QTR need to be recorded on the employee's W-2 form?

An employee who receives benefits under a QTR plan is not required to include any amount of the value of the QTR in his gross income. The value of the benefit is not reported on the employee's W-2, and no withholding or other taxes are paid on the QTR.

This will be the case whether the employee himself or a member of his family derives the benefit of the QTR.

10. How should a school make tuition payments to other schools under a QTR program?

The school, after classifying its employees into categories and establishing a policy as to what QTR benefits it will provide to those within each category, should simply make tuition payments payable directly to the educational institutions that its employees' children attend. Of course, detailed records should be kept of these payments.

11. Can QTR's be used to pay for graduate level education?

A tuition reduction for graduate education can also be tax-free, but only under much more limited circumstances. The recipient of the reduction must be a graduate student who performs teaching or research activities for that institution. The QTR may only be for education furnished by the institution itself, not for any other school. It also may not represent payment for services rendered by the student.[14]

12. Can a volunteer worker qualify for QTR benefits?

Probably not. This is because any fringe benefit, such as a tuition reduction, must be offered to an employee *in addition* to salary and not *in lieu* of salary. Since a volunteer worker receives no salary, then any tuition benefit he or she receives will not be in addition to anything. The result of this is that the tuition break that the volunteer is receiving will really be in compensation for services provided, and this sort of compensation is generally considered to be income.

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this program, employees needed both to have completed five or more years of full-time service and also be active members of the employer-sponsored 401(a) or 403(b) retirement plans. The IRS ruled that these restrictions did not cause the plan to be discriminatory.

[14] IRC §117(d)(5).

In such cases, then, a tuition reduction that a school provides to a volunteer worker should be considered taxable income to the volunteer. The institution will thus need to include the volunteer on its payroll, provide him or her with a W-2, and make the appropriate withholding.

13. If a shul or other charitable organization runs a school in addition to engaging in other activities, may its employees who do not work for the school receive a qualified tuition reduction?

No. The IRS has recently ruled[15] that only actual school employees may benefit from a QTR. Other employees who work for the organization running the school cannot claim this tax benefit. This ruling will be relevant to congregations or other organizations that may run a school in addition to other activities. For example, all employees of a school run by a shul could receive a QTR (including secretarial, managerial, custodial, and other employees), but employees whose work is solely for the shul's office could not. While the organization is free to offer a tuition reduction to its other employees, the benefit would be a taxable fringe benefit for them.

14. Can a QTR program pay tuition for individuals not specified in the Internal Revenue Code as eligible for QTR benefits?

A school can pay tuition for others not listed (under question 2 above) as eligible for QTR benefits, such as other family members, relatives, or friends of the employee, but the amount of such tuition will constitute taxable income to the employee.[16]

[15] PLR 200149030.
[16] PLR 200137041.

Qualified Tuition Reduction Plans:
Fact & Fiction Regarding Using Pre-Tax Dollars for Your Child's Education

Judah I. Kupfer, Esq.

Introduction

As an Orthodox Jewish parent with children attending a yeshiva or *Bais Yaakov*, what is your single greatest financial expense? Presumably, tuition. Most families find the ever increasing cost of tuition to be their single greatest financial burden. It doesn't get any easier – as costs keep rising, so does tuition. To be fair, despite tuition hikes and various fundraising measures, yeshivos are suffering financially and literally struggle to survive.

The financial reality has led many parents to seek out ways to pay their tuition obligations while at the same time alleviating their financial burden. One means of obtaining this end has been the possibility of saving on one's tax liability by deducting tuition payments as charitable contributions – but this method has failed. Current law is clear that tuition payments, even for *limudei kodesh* studies alone, are not deductible.

Recognizing that rabbeim and teachers earn far less than what schools are able to pay, in attempt to assist their employees financially, many schools have adopted the practice of directing teacher compensation on a pre-tax basis toward the costs of tuition for their children, either at the same school by allowing children of employees to attend at a reduced rate, if not for free, or by writing checks directly to the institutions where such children attend. While there is a basis for this practice under current law, it is important to understand the confines of this doctrine, what is allowed and what is not.

At the outset, it is important for the reader to understand a tax rule that is simple in nature, yet seemingly unknown to many. Generally, payments in any form including cash, property or other benefits, made to an individual as compensation for services rendered (whether the person is working in the capacity as employee or as an independent contractor) are taxable to the individual regardless of whether the cash, property or benefits are paid directly to the employee or are directed elsewhere by the employee. It is, thus, irrelevant whether the employee actually receives the benefit or if he directs it to benefit someone else and never actually sees or benefits from the payment – in either case, the baseline is that this constitutes taxable compensation to the employee.

Given this rule, it should then be obvious that, generally, compensation earned by a teacher ought to be taxable to the teacher regardless of whether it goes directly to the teacher's bank account or whether the teacher directs such monies toward her mortgage, her grocery bill or to another school to pay for her child's tuition. In all cases, the general rule applies: such monies are taxable compensation to the employee.

If you are a teacher, you may be wondering how you may not be paying tax on the part of your salary that your school provides directly to pay for your child's tuition. The answer lies in whether your school is making such payments as part of, and pursuant to, a Qualified Tuition Reduction Plan. If you meet all of

Judah I. Kupfer, Esq. is a staff counsel at Agudath Israel of America. Mr. Kupfer received his B.A. from Touro College, his J.D. from Brooklyn Law School and LL.M. in taxation from New York University School of Law. To contact the author, please email ykupfer@agudathisrael.org. Questions and comments are welcome.

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the requirements set out by law, those payments may rightfully be tax-free. If not, prepare to write a larger check to Uncle Sam. This article seeks to clarify these requirements.

What is Qualified Tuition Reduction?

Let's first identify what it is we are talking about. Section 117(d) of the Internal Revenue Code allows for Qualified Tuition Reduction, or QTR for short. It is a program a qualified educational institution, such as a school, may adopt in which it agrees to pay a specified sum toward the tuition at the same or another educational institution, incurred by certain relatives of a designated class of employees which will be tax-free to the employees (for all federal, state and local taxes – including FICA) as a fringe benefit of employment. But, QTR may not be a payment in lieu of salary – it must be a fringe benefit of employment paid in addition to salary. That sounds like a mouthful – so let's take each of these requirements in turn.

Which institutions may have a QTR program?

Most employers are *not* eligible to institute a QTR program. For example, commercial businesses are not eligible. Rather, to be able to offer a QTR plan, the employer must be an educational institution that (a) has as its primary function the presentation of formal instruction, (b) normally maintains a regular faculty and curriculum, and (c) normally has a regularly enrolled body of students in attendance at the place where its educational activities are carried on.

Most *yeshiva katanas*, *yeshiva gedolahs* and day schools would meet this definition. Depending on how educational it is, a pre-school may also qualify. As for *batai medrashim* or *kollelim*, given the variety of structures these entities take on, each *bais medrash* and *kollel* interested in instituting a QTR plan should seek professional guidance to determine on an individual basis whether it meets this definition.

It is conceivable that teachers may send their children to the same school in which they are employed or to different schools. If the child attends a school other than the one in which the teacher is employed, both schools must meet the definition for educational institution. The recipient school, i.e. the school that the child is attending, may be located inside the U.S. or overseas – so payments given to yeshivos and seminaries in Israel (i.e. child of the teacher is studying in yeshiva or seminary in Israel) should qualify so long as those institutions meet the above definition as being an educational institution.

As an aside, it should be noted that if not for §117 of the Tax Code, allowing an employee's child to attend the same school for free or at a reduced rate would be a taxable benefit to the employee. Thus, QTR's applicability is equally in effect both when the employee's child attends the same school or a different school.

For whom may QTR be paid?

The education the QTR is funding must generally be for undergraduate studies, which includes elementary, high school and college (undergraduate) level. Graduate level classes may also qualify in the limited circumstance where the person whose tuition is being paid attends the same institution and is performing teaching or research activities for that institution and the QTR tuition amount is not payment for services rendered by the student.

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Who is Eligible to take part in a School's QTR Program?

Only an *employee* is eligible to take part in an employer's QTR program. Thus, a volunteer worker will not qualify. The school may allow for any employee to take part in its program – it is not limited to teachers or any other kind of employee. However, the school need not make its program available to all employees but may limit its program to a specific class or classes of employees so long as such classification is reasonable and not "discriminatory." Classification based on seniority, part-time vs. full-time, salaried vs. hourly, type of job e.g. teachers vs. secretaries, geographic location e.g. all teachers in a certain branch of the school – are all examples of reasonable classifications. The classification, however, may not be based on salary alone. For example, the school can choose to only provide QTR benefits to full-time employees that have been with the school for three years. But it may not choose, for example, to only include teachers earning above a certain salary or teachers whose relatives are school board members or large contributors.

The school can also choose to cap the maximum amount of benefits to allow per eligible employee. It may, for example, allow for the payment of full tuition or only a portion of tuition; it can pay for all children or only a certain number of children per employee; it can also cap the benefit at a certain dollar amount per employee. As long as employees within each classification are eligible for substantially the same benefits, the QTR program will not be unlawfully "discriminatory."

The school should be very clear as to who is eligible and the amount of the benefit for which such employees are eligible. The plan should be clearly written and made known to its employees. If schools find themselves making QTR payments to each other, the schools may find it helpful to create a reciprocal agreement with each other so that actual money may not need to change hands.

May QTR be part of salary or must it be in addition to salary?

The qualifications outlined thus far probably seem reasonable and even doable. The requirement that leads to the most errors is this next one. QTR is limited to payments made in addition to the employee's salary, not part of the employee's salary. In other words, part of the employee's salary may not be diverted to pay for QTR – a base salary must be set and any QTR benefits offered must be in addition to that salary. For example, if the agreement with the employee is that he will be paid $40,000, any QTR benefit offered must be given to pay tuition *in addition* to the $40,000. Once the salary is set, should the school offer to pay the teacher $30,000 with the additional $10,000 going toward tuition, the entire $40,000 is taxable income to the teacher as that $10,000 is not being given pursuant to a QTR program but is instead ordinary compensation which is taxable.

This requirement clearly reflects the IRS position as set forth in Publication 970: "You must include in your income any tuition reduction you receive that is payment for your services." Additionally, after the IRS claimed QTR payments made in lieu of compensation constituted taxable income, a court agreed with the IRS finding the salary reduction to be taxable income basing its conclusion on the treasury regulations, which states: "Any amount deducted by an employer from the remuneration of an employee is considered to be a part of the employee's remuneration and is considered to be paid to the employee as remuneration at the time the deduction is made." *Marquette University v. United States*, 645 F. Supp. 1007 (E.D. Wis. 1985). In addition to classifying the QTR payments as taxable income to the employee, the court in that case concluded that the college should have reported such amounts on the employee's W-2 as taxable wages and withheld taxes on the salary reductions.

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Moreover, a noted tax lawyer who has published extensively on tax issues relating to religious and educational institutions writes the following: "…can the employee pay for [QTR] with pretax dollars through a salary reduction arrangement? The answer is no. Salary reductions can reduce taxable income only if specifically authorized by law. For example, federal law specifically authorizes the payments of contributions to a 403(b) plan (tax sheltered annuity) or to a cafeteria plan to be made through salary reductions. No authorization is given to pay for tuition expenses through salary reductions." RICHARD R. HAMMAR, 2010 CHURCH & CLERGY TAX GUIDE 212 (2010). Furthermore, in *Rasmussen v. Commissioner*, T.C. Memo. 1994-311, the Tax Court approved a QTR program stating that "the amounts [of the tuition reductions] were not subtracted from the petitioners' respective salaries." The implication is that had the amount been deducted from employees' salaries, it would have been subject to income tax.

The practice of establishing a set salary and subsequently reducing the salary based on the desired amounts of QTR payments requested by the teacher violates this qualification. Alternatively, setting salaries with QTR in mind e.g. teacher would receive $40,000, but because s/he requests $10,000 of QTR, his/her salary for the year will be reduced to $30,000, is also problematic.

Certainly, employers possess the discretion to pay their employees different salaries. There is no requirement that all similarly situated teachers be paid the same amount. If, however, the disparity among the salaries of similarly situated teachers is apparent and the QTR benefit being received accounts for that discrepancy, it will be obvious to any auditor that the QTR benefit was, in fact, part of salary and, thus, should be taxable income. It is, therefore, incumbent on any school that maintains different salaries for its employees, to keep detailed records of its salary structure to be able to justify that any QTR benefit is not a payment in lieu of salary.

Based on the foregoing, it should be clear that while the QTR benefit a school offers may not cost it much in terms of out-of-pocket expense when the child of an employee attends the same school for free or at a reduced rate, it will most certainly cost the school when the child attends a different school – as that will require the school to draft a check to the other institution; money it would otherwise not be required to pay if not for this additional benefit it is providing.

One final note on this requirement: Although this appears to be the current status of the law and the IRS' position, a more aggressive tax position in this area that favors teachers has been articulated and some institutions have followed that position. Each institution would, thus, be well advised to rely on the professional advice of its own professional in advancing its QTR benefit program.

Are any taxes paid on QTR?

The amounts properly paid as part of a QTR benefit (assuming all requirements are met) are exempt from federal, state and local income taxes as well as payroll taxes such as FICA. The amounts of QTR do not belong on a form W-2, as they are exempt from taxes and are not included in gross income. They will also not be considered "earned income" for purposes of the earned income and child tax credits.

Payments to other institutions or the value of reductions in the same school's tuition that do not fall within the requirements for QTR as set out, should be reported as taxable income, listed on the employee's form W-2 and the employer should withhold taxes as required.

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Conclusion

While a QTR program provides a significant benefit to school employees, it is important to keep in mind the various requirements necessary to qualify for this benefit. These rules are not new but may seem novel due to misinformation and a lack of understanding of the requirements. These requirements place a significant cost on the school providing the benefit – a benefit that goes a long way to any employee on the receiving end, but at the same time is, no doubt, an additional cost to the school providing it. It is incumbent upon each employer eligible to offer a QTR program to recognize the true nature of the QTR rules in consultation with its own tax professional and consider the financial costs prior to implementing a QTR plan.

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Tax Feature / Judah I. Kupfer, Esq.

Does My Nonprofit Need to Pay Tax?
Understanding Unrelated Business Income Tax Part I

If there is one thing that people know about taxes, it is that tax-exempt organizations don't pay federal income tax. That seems simple enough. After all, if they had to pay tax, they wouldn't be "tax-exempt," right? Well, not always. While it is true that under most circumstances, tax-exempt organizations will not be subject to a corporate level income tax that their taxable entity counterparts are required to pay, there are times that they will be subject to income tax, in this context known as the Unrelated Business Income Tax, or "UBIT" for short.

Much to the dismay of business owners, corporations and trusts pay income tax at the corporate/trust level. To ensure that tax-exempt organizations aren't given an unfair advantage, Congress added the UBIT rules to force exempts to pay their fair share when engaged in commercial activity outside the scope of their exempt purposes (as well as on earnings utilizing borrowed funds).

The laws surrounding UBIT are very complex. This article is not meant to cover all scenarios but is intended to provide an overview and alert the reader to the potential UBIT issues. Competent tax counsel should be consulted for further detailed questions. In addition, IRS Publication 598 is a handy resource. In Part One, below, we describe the general rules and some application. In Part Two, published next week, we will see some exceptions to the general rules as well as additional examples of how the rules play out in everyday occurrences (so be sure to read both parts).

When Will an Organization Pay UBIT?

UBIT rules require a tax-exempt organization to pay income tax when the organization regularly carries on a trade or business that is not substantially related to the organization's exempt purposes. Let's discuss each of these elements separately.

To be subject to UBIT, first, the organization has to carry on a trade or business. This is pretty self-explanatory, but to be sure, trade or business will usually involve the sale of goods or services in exchange for money or something else of value for the purpose of making a profit. Next, the trade or business must be *regularly* carried on. This means it takes place frequently or on a continual basis similar to the way the activity would be carried on by a for-profit business. Even a seasonal business can be considered regularly carried on regardless of the large gaps of time in between sales. Third, the trade or business must not be substantially related to the organization's exempt purposes. In other words, the activity doesn't contribute importantly to accomplishing the organization's exempt purposes. What are its exempt purposes? This gets a bit more complex, so let's take a step back and understand some background.

At the time of formation, nonprofits file a certificate (or articles) of incorporation with the secretary of state in the state of incorporation (trusts execute a trust document). The founders of the organization choose from a short list of permissible purposes in which a nonprofit is permitted to engage and includes them in the certificate. Whereas a for-profit business is generally incorporated with the ability to conduct all lawful activity, nonprofits may only carry-on certain activities and in exchange receive certain benefits when they are recognized by the IRS as tax-exempt. (Note, a shul qualifying for "church" status is tax-exempt automatically, but other nonprofits need to formally apply for exemption.) These benefits include the ability to receive tax deductible contributions, income tax exemption, a property tax exemption, and preferred U.S. postal rates, among others.

While it is true that under most circumstances, tax-exempt organizations will not be subject to a corporate level income tax that their taxable entity counterparts are required to pay, there are times that they will be subject to income tax.

The most common exempt purposes are religious, charitable, educational, and scientific. While the tax regulations defining the activities which fall within each of these purposes are lengthy, suffice it to say that a shul's activities will likely fall within religious, charitable and perhaps even educational, and such purposes should have been listed in its formation documents. The nonprofit may only engage in activities that contribute importantly to those exempt purposes it is authorized to conduct — it becomes authorized by including them in its certificate. While a yeshivah's main purpose is educational, many of its activities will also fall within religious and charitable. The activities of most *tzedakah* organizations will fall within "charitable," but if they provide some educational element such as educating the public regarding issues of concern to the broader public, those activities would fall within "educational."

As an easy example, the charging of tuition by a yeshivah is, no doubt, a regularly carried on business. But it is related to its exempt purpose, since parents are paying for the education of their children, education being the name of the game. When business activity is related to the exempt purpose, it may be carried on even substantially, with the organization never having to pay UBIT. Similarly, another easy example is a shul charging its congregants fees for membership and seats. It is a regularly carried on business, but it is related to its exempt purpose — admission to the shul for *tefillah*, which falls squarely within a shul's religious purpose. From these examples we see an interesting point: there is no prohibition for a nonprofit to make money so long as it is doing so by carrying on an activity related to its exempt purposes. (Of course, the organization is restricted with what it may do with that money; generally, it may only use the money to pay reasonable compensation and necessary expenses. For more details on these restrictions, see *"Is Your Organization Paying Reasonable Compensation? How to Avoid Excess Benefit Penalties,"* Hamodia at B42, June 29, 2011 & at B36, July 6, 2011.)

In determining whether an activity is related, we look to the activity itself and not to where the profit from the activity may go. So if an activity itself does not contribute to the organization's exempt purposes, the act of applying the proceeds to fund the organization's exempt purposes does not make the activity related.

To illustrate, what if in an attempt to raise funds, the yeshivah started a retail clothing business located across the street where it sold clothing to the general public at market value. The retail sale of clothing does not fall within any of the yeshivah's exempt purposes, and so it is an unrelated regularly carried-on business activity. As noted above, it will be unrelated regardless of the fact that the proceeds go to benefit the yeshivah's core function of educating students. Once we have a regularly carried on trade or business that is *unrelated*, the next question to ask is whether it is substantial or insubstantial compared to all else the yeshivah does. If it is insubstantial, the yeshivah would be required to pay UBIT to the Internal Revenue Service. This is a tax at the current tax rate for the net profits the organization earns by running the unrelated business. If, however, the yeshivah's business really takes off and becomes substantial as compared to the rest of the activity the yeshivah as a whole conducts, in addition to being required to pay the UBIT, the yeshivah becomes at risk for losing its tax-exempt status since it would no longer be primarily engaged in its tax-exempt purposes as required by section 501(c)(3) of the Internal Revenue Code, the source for its tax exemption.

While weighing whether a trade or business is substantial or insubstantial is very subjective and depends on the specific details of the case at hand, one may want to think of it in terms of which activity is primary and which is secondary. Taking the organization as a whole, the question

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to ask is whether this is a yeshivah that happens to have a small clothing business or whether this is really a clothing business that also has a yeshivah. This can be measured by many factors including revenue, size and extent of the various activities; because it varies based on the specific case, it would be prudent to make this determination in consultation with a tax counsel. Although it never has been clearly defined, many practitioners agree that as a rule of thumb, an organization's net income generated from unrelated activity should not exceed 20% of its overall net income.

In addition to paying the tax, an organization with $1,000 or more of gross income from unrelated business is also required to file a Form 990-T (by the 15th day of the 5th month after the end of its tax year). Note, this filing is required regardless of whether the organization is otherwise required to file a Form 990 (so a shul would not be exempt from this filing). If the organization anticipates paying $500 or more of UBIT for the year, it is required to pay the tax in quarterly estimated payments.

Part Two Next Week: This article will continue and conclude with Part Two, published next week, which will provide exceptions to the general rules (so if you only read Part One, you will not get the full picture). We will also apply the rules to common scenarios and practices including: sales and rentals by *gemachs*, real estate rentals, *simchah* halls, earning interest and dividends, investments in partnerships, LLCs and S-Corporations, dinners, *melaveh malkas* and Chinese auctions, journal ads, renting parking spaces, sales of *sefarim* and *esrogim*, vending machines and cafeterias, and the lease of space for cell-phone towers/antennas.

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The author may be contacted via email at ykupfer@agudathisrael.org. Questions and comments are welcome.

Tax Feature / Judah I. Kupfer, Esq.

Does My Nonprofit Need to Pay Tax?
Understanding Unrelated Business Income Tax *Part II*

In Part One, published last week, we learned that there are times a nonprofit is required to pay income tax – namely, when it regularly carries on trade or business that is unrelated to the organization's exempt purposes. We noted that earning money from activities that contribute importantly to the organization's exempt purposes will not be subject to tax, even if conducted substantially. However, should the organization earn money by regularly carrying on business that is unrelated to its purposes, if the activity is insubstantial to all else the organization does, it is required to pay unrelated business income tax (UBIT) to the IRS. If, on the other hand, it is substantial, in addition to paying the tax, the organization is at risk of losing its tax-exempt status. We also noted that money earned through unrelated business does not become related simply by applying those funds to activities that further the organization's exempt purposes.

We continue with Part Two, below, where we list several exceptions to the general rule and provide additional examples regarding how the rules of UBIT are applied to real life scenarios. It can't be overemphasized that these rules are complex and specific tax advice should be sought.

Convenience Exception

There are several exceptions where unrelated and regularly carried on business activity will not be subject to UBIT. First, where the business is performed primarily for the convenience of its members, students, patients, officers or employees, UBIT will not apply. For example, a nonprofit hospital's cafeteria is obviously a regularly carried-on business. However, because it is there primarily for the convenience of the patients, employees and guests, its net income would not be subject to UBIT. To the extent it is used by the general public (i.e. those that have no connection to the hospital), its net income generated by outsiders would be subject to UBIT. Additionally, if it did more than necessary so that it can no longer be called a simple convenience, such as if a hospital were to open a five-star restaurant, the net income attributable to anything more than necessary for the convenience of its patients, staff and visitors would be unrelated. A laundry operated by a yeshivah is another example of a business operated for the convenience of its students and, thus, its net income would not be subject to UBIT. Additionally, a yeshivah's vending machines would fall within the convenience exception.

Items sold at a tax-exempt's gift shop are scrutinized on an item by item basis to determine whether the sale of each item is related to the exempt purposes of the organization. The Metropolitan Museum of Art (the "Met"), a tax-exempt organization, provides for an interesting case study. The Met has a gift shop and an on-line store, each of which do a substantial amount of sales, yet it infrequently pays UBIT. Items possess an imprint of art images which is seen as acting in furtherance of the museums educational purposes by making works of art more familiar to a broader segment of the public and, thus, considered to be related to the museum's exempt purposes. However, should souvenir items be sold such as T-shirts or mugs featuring the New York emblem or the Met logo, such items are considered to not contribute importantly to the accomplishment of the museum's exempt purposes and would be subject to UBIT.

Sale of Donated Property

A second exception: UBIT doesn't apply to the sale of donated property. Thus, sales by thrift shops or bake sales by a tax-exempt organization when the sale goods were donated would not be subject to UBIT. So, for example, if a tax-exempt *gemach* were to accept donations of wedding gowns and subsequently sold them to needy individuals, the net proceeds from such sales would not be subject to UBIT. (Note, if the *gemach* sold or rented the gowns at substantially below market/rental value to needy individuals, the proceeds from the gown sales/rentals would likely be considered related to the organization's "charitable" purposes and would not need this exception.)

If a tax-exempt organization received donated used cars and subsequently sold them to earn money to be applied toward the organization's mission, while the sale of the donated cars would be unrelated trade or business, it would fall within this exception. Applying this rule to our retail clothing store example from Part One, if the store sold only donated items it received, it would also fall within this exception. (It is important to note that the organization's sale of donated property creates limitations to the amount the donor may deduct from his taxes.)

Work Performed By Unpaid Volunteers

A third exception: work performed by unpaid volunteers is not considered an unrelated trade or business. Thus, in our example above, if substantially all of the work at the yeshivah's clothing store were accomplished through the work of unpaid volunteers, it would fall within this exception.

Passive Investments

A fourth exception is income derived from passive investments such as dividends, royalties, interest, and capital gains. Thus, if a tax-exempt company invested in publicly traded stock and received a dividend or sold the stock and realize a capital gain, such dividend/gain is not subject to UBIT. Similarly, if the organization earned interest on its bank account, the interest is not subject to UBIT.

Income derived from the rental of real estate is considered passive and falls within this exception so long as the organization only rented out the space and did not provide personal services (but note, passive income from the rental of personal property is subject to UBIT). Thus, if an organization derived income from renting hotel rooms, rooms in boarding houses or tourist homes, or space in parking lots or warehouses, this exception would not apply (and the net income would be subject to UBIT) because some element of personal service was provided in addition to the space.

So let's say an organization operated a parking lot for a fee (and assume it did not fall into the convenience exception), this activity would be considered unrelated. If, however, the organization leased a sizeable plot of empty space it owned to a company for a fixed fee to operate a parking lot (and the company handled everything and all the organization provided were typical services generally provided by a landlord), this would be considered passive rental income and would fall within this exception. If, however, the rental fee paid to the organization was tied to the success of the parking company, this would be a joint venture between the organization and the business. The rule is that a joint venture, where the rent or dividend is dependent on the success of the venture, is not considered to be passive. So if the amount paid by the rental company was tied to the success of the business, it would not fall within this exception and would be subject to UBIT.

Please keep in mind that even if one exception is not available, another may apply. To illustrate, if the parking lot were operated primarily for the convenience of the organization's guests and employees, it would fall within the convenience exception (or otherwise be considered related to the purposes of the organization as it may contribute importantly to the use of the organization's facilities). If, however, it were used by members of the general public who had no connection to the organization and simply sought to use the parking facility, the net income generated by them would be subject to UBIT.

To take a more relevant example, let's say an organization housed a hall used for weddings or bar mitzvahs. This is clearly unrelated and regularly carried-on business activity. The question is whether it fits within the rental income (passive investment) exception. The answer depends on the circumstances. If the caterer was a salaried employee of the organization, the net income from the hall should be unrelated and not within this exception since the organization is the one running the hall and so the income would not be passive. If, however, the caterer was not an employee of the organization but independent and paid a fixed rental fee to the organization for use of the hall, the net income would be considered passive, so long as the services provided by the organization were merely typical landlord services such as repairs, normal maintenance, heat and hot water, cleaning of public entrances, exits, stairways and lobbies, and the collection of trash. If, however, the organization provided such services as cleaning or laundry, it would not be considered passive income. If the arrangement was somewhere in the middle, for instance if the caterer was independent but paid the organization based on the amount the hall is used, it would be a joint venture and not within the exception. In either case, if the hall was owned by a yeshivah that rents it out for *shiurim* or other similar events, such events would, in certain circumstances, be considered related to its exempt purposes.

To illustrate the passive investment exception further, if the organization were a partner in a partnership (or LLC) engaged in unrelated business (even as a silent partner) or if it owned S-Corp stock (any S-Corp stock regardless of whether the business of the S-Corp was related to the purposes of the organization), it would have to report the income from its partnership and S-Corp holdings as unrelated taxable income. If however, the organization (or the partnership in which the organization was a partner) owned stock in a corporation and received a dividend, such dividend would fall within this passive investment exception.

The tax regulations explicitly state that the rental of space in a warehouse or storage garage does not fit within the passive investment exception and will be subject to the general UBIT rules. They also make clear that the income an organization generates by renting space on its building roof to cell-phone carriers, by placing cell towers or antennae, does not fall within the passive investment exception as the rules treat it as the rental of personal property, which we have seen, does not get the benefit of this exception.

It is important to note that this passive investment exception generally does not apply to any income from a passive investment that was acquired through debt financing, i.e. borrowed funds such as a mortgage. So if the organization borrowed in order to conduct unrelated passive investments, the net income earned from the investments would be subject to UBIT in proportion to the debt on the property, and if substantial, may risk the exempt status of the organization. (These rules in particular are complex and tax counsel should be consulted.)

Low Cost Items

Some organizations send to potential donors a low-cost item, such as a coffee mug or key chain, sporting the organization's logo to help induce people to donate. Under this exception, such a distribution will not be seen as a sale (when the donor ends up making a donation) if the donor did not request the distribution, the distribution is made without the express consent of the

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Does My Nonprofit Need to Pay Tax?

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recipient, and the item is accompanied by a request for a charitable contribution to the organization along with a statement that the recipient may keep the item regardless of whether he or she makes a contribution.

Some Additional Examples

The tax regulations make it clear that "income derived from the conduct of an annual dance or similar fundraising event for charity would not be income from trade or business regularly carried on." Thus, should an organization host an annual dinner, *melaveh malkah*, Chinese auction or similar event solely for fundraising purposes, the net income derived therefrom (as well as the income generated by journal ads) should not be subject to UBIT as they are not considered to be "regularly carried on." (Raffles conducted at more frequent intervals may be subject to more stringent rules.)

If a yeshivah were to publish and sell *seforim* with scholarly works of its *rabbeim* and students, such works would be considered related to the yeshivah's exempt purposes. There would, thus, be no issue if the yeshivah turned a profit on the sales, even if conducted substantially, and no UBIT would need to be paid. Similarly, if a yeshivah sold *seforim* to its students as needed for their studies, such sales would be related business activity.

If a shul sold *lulavim* and *esrogim* before *Succos*, such sales should be considered related to its exempt "religious" purposes. If, however, it sold matzah and wine before *Pesach*, since such items are sold by commercial retailers, such sales would be unrelated and subject to UBIT. To reiterate, the fact that the proceeds from the sales are used to support the exempt purposes of the shul is irrelevant and would not make an otherwise unrelated activity to be related.

If an organization sold its mailing lists or other data to an outside commercial entity, such sales would be unrelated and subject to UBIT. Similarly if the organization maintained a website or periodical, the advertising revenue it generated would generally be unrelated and subject to UBIT. (An exception exists, though, for "qualified sponsorships" — please seek addition guidance if this may apply to your situation.) However, advertising income generated by ads in a student-run yearbook would be considered related.

State Requirements

Thus far we discussed requirements to file and pay UBIT to the federal government. States also have their own requirements. For example, organizations that are subject to federal tax on unrelated business income are taxable under Article 13 of the New York State Tax Law, if they pursue those unrelated business activities in New York State. To report those taxes, the organization must file Form CT-13, *Unrelated Business Income Tax Return*. The rules of states vary and so specific state laws should be consulted to determine your organization's state tax liability.

Conclusion

To ensure that tax-exempt organizations aren't given an unfair competitive advantage over for-profit commercial entities, Congress added the UBIT rules to force exempts to pay their fair share when engaged in commercial activity outside the scope of their exempt purposes. When that activity is so substantial, however, organizations are at risk of also losing their tax-exempt status, since at that point, they no longer operate primarily in furtherance of their exempt purposes as required under Section 501(c)(3). The rules surrounding UBIT are complex. This article has outlined some of the key concepts, but specific advice should be sought from competent tax counsel.

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The author may be contacted via email at ykupfer@agudathisrael.org. Questions and comments are welcome. .

ARTICLE 5

A. Inurement of Income: "No part of the net earnings of the corporation shall inure to the benefit of, or be distributable to, its members, directors, officers or other private persons except that the corporation shall be authorized and empowered to pay reasonable compensation for services rendered."

B. Legislative or Political Activities: "No substantial part of the activities of the corporation shall be the carrying on of propaganda or otherwise attempting to influence legislation and the corporation shall not participate in or intervene (including the publishing or distribution of statements) any political campaign on behalf of any candidate for public office."

C. Operational Limitations: "Notwithstanding any other provisions of these articles, the corporation shall not carry on any other activities not permitted to be carried on (a) by a corporation exempt from Federal Income Tax under section 501(c)(3) of the Internal Revenue Code of 1954 (or the corresponding provision of any future United States Internal Revenue Law) or (b) by a corporation, contributions to which are deductible under section 170(c)(2) of the Internal Revenue Code of 1954 (or the corresponding provision of any future United States Internal Revenue Law)."

D. Dissolution Clause: "Upon the dissolution of the corporation, the Board of Directors shall, after paying or making provisions for the payment of all the liabilities of the corporation, dispose of all the assets of the corporation exclusively for the purposes of the corporation in such manner, or to such organization or organizations organized and operated exclusively for charitable, educational, religious, or scientific purposes as shall at the time qualify as an exempt organization or organizations under section 501(c)(3) of the Internal Revenue Code of 1954 (or the corresponding provision of any future United States Internal Revenue Law), as the Board of Trustees shall determine. Any such assets not so disposed of shall be disposed of by the Court of Common Pleas of the county in which the principal office of the corporation is then located, exclusively for such purposes or to such organization or organizations, as said court shall determine, which are organized and operated exclusively for such purposes."

Legal Feature / By Judah I. Kupfer, Esq.

Is Your Organization Paying Reasonable Compensation? A Guide to Avoid IRS Penalties *(Part I)*

As an executive director or president of a yeshivah, shul or *tzedakah* organization, have you ever wondered whether there are any restrictions on the amount you pay or method you use for compensating your employees? Your accountant may have mentioned something called "inurement" and that there are some restrictions on nonprofit compensation practices, but you figure that since your organization can't afford to pay that much, you have nothing to worry about. Right? Well, not exactly.

Clearly some of the wealthier nonprofits pay large salaries. Indeed, not a week goes by without reading about a nonprofit executive earning more than one would expect a "nonprofit" to be paying, especially one that relies on tax-deductible donations and government grants for support. Such news stories are generally critical of the generous compensation packages being paid and question the propriety of this practice. While this may be an issue at some of the larger nonprofits, the average organization struggles to meet its payroll obligations, even for the modest salaries it pays.

Current law imposes restrictions on the amount of compensation a nonprofit organization may pay its employees. Moreover, even providing modest compensation without following certain procedures may violate tax rules that can trigger a large additional tax to be imposed on the employee who receives such compensation and the organization managers who approve the conduct. In extreme cases, an organization's compensation practices may result in the revocation of its federal tax exemption. The vigilant organization should take note since many of these rules are not necessarily intuitive and present a trap for the unwary. This article seeks to summarize these rules in a concise and easy to understand fashion. Much detail has been omitted, thus, specific legal advice should be obtained prior to implementation.

Private Inurement

The place to begin is with what is often referred to as "private inurement." This phrase comes from the Internal Revenue Code which requires from all §501(c)(3) tax-exempt organizations that "no part of net earnings of which inures to the benefit of any private shareholder or individual." An organization violates the restriction on private inurement when it gives any benefit to an organization insider other than in the form of *reasonable compensation*. Let's explore what this means in more detail.

Who is an insider? The regulations state: "It is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests." This would include any individual who has a special relationship to the organization, people that have influence or control over the organization, and people with check-writing ability and financial control.

The organization has to be concerned with much more than simply providing cash or assets to these individuals. Other benefits are also included, such as extending to the insider a below market loan, purchasing an item from the insider for more than fair-market value or providing office or living space for below market rent. Each of these can constitute private inurement unless it is provided as part of the employee's compensation package, the package is documented as compensation for tax purposes and the package as a whole is reasonable.

That said, what is reasonable? With respect to the rules surrounding private inurement, there is little guidance regarding what constitutes reasonableness. It is generally a fact-specific analysis. This has contributed to the Internal Revenue Service ignoring smaller violations of this rule. Although the Code does not permit any private inurement and technically any amount of inurement can lead to sanctions, in practice, the IRS doesn't enforce violations of private inurement unless they are so egregious that the organization is no longer acting "charitable" in the interest of the public, but rather as a "piggy bank" for some private individuals. Only in those situations will the one and only sanction the IRS has available in inurement situations be enforced — the ultimate sanction — revocation of the organization's tax-exempt status.

The fact that in practice *de minimus* violations are generally ignored has led to the adoption of a set of detailed rules called "excess benefit transactions." These rules are also known as "intermediate sanctions" since they provide for penalties that are intermediate, i.e. short of revocation of exemption. It is important to note that these rules are an additional layer added on top of the original private inurement rules. Revocation is, thus, still a possibility and will be imposed in the more extreme cases.

In part two, next week, the details of excess benefit transactions, a third set of rules called private benefit and the possibility of state penalties will be explored.

Judah I. Kupfer, Esq. is a staff counsel at Agudath Israel of America. He received his B.A. from Touro College, J.D. from Brooklyn Law School and LL.M. in taxation from New York University School of Law. To contact the author, please email ykupfer@agudathisrael.org. Questions and comments are welcome. *With gratitude to Jacob I. Friedman, Esq. of Proskauer Rose LLP for his review and comments.*

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Legal Feature / By Judah I. Kupfer, Esq.

Is Your Organization Paying Reasonable Compensation? A Guide to Avoid IRS Penalties *(Part II)*

Last week we introduced restrictions imposed by the IRS on a tax-exempt organization's compensation practices. An organization violates the restriction on "private inurement" when it gives any benefit to an organization insider other than in the form of *reasonable compensation* (a loaded term discussed in detail in part one). The fact that in practice *de minimus* violations of private inurement are generally ignored has led to the adoption of a set of detailed rules called "excess benefit transactions." These rules are discussed below. As this article is a continuation from part one, the reader is strongly encouraged to read part one before proceeding further.

What is an excess benefit transaction (EBT)?

There is some overlap with the rules for private inurement but the rules differ in many respects and, in general, the rules of EBTs are much more detailed and deliberate (as you will soon come to realize). The tax Code provides in §4958 that an EBT is "any transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of any disqualified person if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit." The gist of this is that if certain benefits are provided to a "disqualified person," unless they are given as reasonable compensation and documented as such, sanctions will result to the disqualified person as well as to knowing and willful managers of the organization. There are many elements here, so let's take each one in turn.

Which organizations are included?

The first element in the rule is that the benefit must come from an "applicable tax-exempt organization." This includes §501(c)(3) or (c)(4) organizations but not private foundations. Shuls should note that although "churches" (the IRS-coined phrase for a shul) need not formally apply for §501(c)(3) status from the IRS, they are deemed to be §501(c)(3) organizations without the filing. Thus, they are too considered applicable tax-exempt organizations and included within these provisions. There is also no exemption for religious organizations.

Which persons are included?

The benefit has to be given to a "disqualified person" (DQP). This includes a broad range of organization heads including officers, directors, trustees, president of the organization, CEO, CFO, COO and their family members (spouse, ancestors, children, grandchildren, great-grandchildren, siblings, and any of these family members' spouses). But titles are not important — so long as the person is (or was within the prior five years) in a position to exercise substantial influence over the organization, the person is a DQP.

Even in situations where the person is not in charge of the entire organization, but merely manages a discrete segment or activity of the organization, he would be included. This would include a basketball coach of a university basketball team, a university dean and a department head at a nonprofit hospital. In the yeshivah context, this can include a *Menahel* and *Rosh Kollel,* and in the shul context, the Rabbi, president and board members would be DQPs. There may be some people who fall within a gray area and so advice should be sought to identify whether one is a DQP.

There are some important exceptions — the following will not be DQPs: Other §501(c)(3) or (c)(4) organizations, so transactions between organizations are not covered by these rules; an independent contractor who simply collects a fee but doesn't have decision-making authority over the organization — so transactions with a building contractor, attorney, accountant or investment advisor would generally not be covered; someone who is negotiating to join the organization for the first time and agrees to a binding contract with a fixed payment would fall within the "initial contract exception." Additionally, an employee who doesn't otherwise possess substantial control over the organization, is not a family member of one and earns overall compensation (including benefits) of $110,000 (which adjusts for inflation) or less per year, is deemed not to be a DQP.

Next, what may be given and not run afoul of these rules? The answer is *reasonable compensation*. This leaves us with two questions: what is *reasonable* and what is *compensation*? So let's first deal with what is included in compensation so that we can later determine whether the overall compensation package is reasonable.

What is included in the compensation package?

Payments (and most economic benefits) coming from the organization constitute compensation so long as they are classified as such on the books of the organization and for tax purposes to the employee. If taxable, this can be accomplished by including the payment on the employee's form W-2. It is important to note that if the required substantiation is lacking, even if the parties meant for it to be compensation and even if the overall compensation package including this unsubstantiated payment was in fact reasonable, it will automatically be deemed an EBT and the sanctions will kick in (we will soon describe what those sanctions are).

If payment comes from another entity that is controlled by the organization, that payment is included within the organization's compensation package. Payments coming from third parties, however, such as sponsorships, are not included in compensation from the organization for these purposes. (Please note that this discussion does not speak to whether these payments are subject to income tax, which in most circumstances, they are.)

Reasonable travel expenses paid by the organization for the DQP (which includes board members) need not be considered compensation; however, if the spouse's travel expenses are also covered, that would be compensation to the DQP. It too would need to be documented as such to avoid being classified as an EBT.

Certain benefits can be disregarded such as those fringe benefits excluded from income tax under §132, reimbursed expenses, benefits provided to a volunteer that are otherwise available to any member of the organization, and benefits provided solely as a member of a charitable class that the organization intends to benefit in furtherance of its exempt purposes.

Is the compensation package reasonable?

Once we have determined what is included in the DQP's compensation package, we can then seek to determine whether it is reasonable. Reasonableness is determined by comparing the compensation to what would ordinarily be paid for like services by a like enterprise under like circumstances. A comparison must be drawn between the DQP's entire compensation package with similarly situated people. This is a facts–and–circumstances analysis and must be determined on an individual basis.

One important note is that there is no requirement that nonprofit employees be paid less than their for-profit counterparts. It is understood and accepted that nonprofits require talented employees and such employees do not deserve less simply because they work for a nonprofit. Thus, in making this determination, comparisons can be made to similarly situated individuals in both the nonprofit as well as the for-profit sector.

Given that facts and circumstances are iffy and people appreciate reassurance and certainty (or as close to certainty as they can get), there is a "safe harbor" that is provided, wherein if the organization jumps through certain hoops, the compensation will be presumed to be reasonable (but the IRS would then have the burden to "rebut" the presumption in order to find it not reasonable). The safe harbor first requires the terms of the compensation package to be approved in advance by a disinterested board of trustees/directors (where no more than 20% of the board are comprised of organization employees). Second, the board must have relied on comparability data from other organizations, which may be nonprofit as well as for-profit organizations. Such data should look to their job responsibilities and level of supervision, prior experience and education, the location of the organization and the availability of specialty in the area. Consultants can be hired to provide this information easily. Even organizations with gross receipts of less than $1 million (these are considered "small" organizations) should obtain comparables from three other organizations to be within the safe harbor. Third, the board must document the basis for its determination. If the organization's board is not disinterested, should state law permit, a compensation committee may be appointed to review reasonableness to qualify for the presumption. (In New York, this is permitted only if the organization's by-laws permit it.)

What are the additional taxes due?

Assuming we have an applicable tax-exempt organization that gives an excess benefit to a DQP — what now? The DQP will have to pay a 25% tax on the excess benefit. That amount goes up to 200% unless the DQP returns the benefit to the organization and "undoes" the transaction within a specified time period. Organization managers who knew about the excess benefit and willfully permitted the organization to engage in it are also subject to a tax of 10% (capped at $20,000 for any single transaction) and if more than one manager is responsible, each may be jointly liable for the tax. Managers may escape liability if they had "reasonable cause," which usually means that they relied on a legal opinion; in these circumstances, the opinion would likely have to opine on the process the organization conducted in concluding that the compensation was reasonable or otherwise qualified for the safe harbor. The extra tax is to be paid to the IRS and the organization must file IRS Form 4720, Schedule I (see instructions to the form for details regarding how and when to file). Should the organization delay or fail to file and pay this tax, penalties and interest will be imposed.

Director and officer (D&O) insurance may cover the tax; however, whatever is paid out as the tax must be considered additional compensation to the DQP. In addition, the organization must disclose in its annual form 990 filing the names of each DQP who received an excess benefit during the year.

Private Benefit

Let's say the organization squanders money on paying an outside contractor an exorbitant fee. We have already seen that an outside contractor will generally not be a DQP (either because it does not have decision-making authority or because it qualifies for the "initial contract exception"), so this will not be an EBT. Nor will it constitute private

A Guide to Avoid IRS Penalties

inurement as the contractor is not an organization insider. So is there any possible sanction? The answer, unfortunately, is yes. There is yet a third layer of restrictions called "private benefit transaction." This includes everyone, insiders as well as outsiders. Like private inurement, the only sanction is the ultimate sanction, revocation of the organization's exempt status, but unlike private inurement, will only kick in if the violation was substantial (though, as mentioned, in practice, neither of them are generally enforced unless extreme).

State Penalties

In addition to the IRS acting as regulator of charities, each state's Attorney General also investigates violations committed by nonprofits (in New York, this is done by the Charities Bureau of the NYS Attorney General). It is therefore important to keep in mind that should an organization engage in the kinds of transactions described above, even should it escape the technical IRS rules and avoid IRS sanctions, the state AG may launch its own investigation for possible breaches of the organization's board/managers' duties of care and loyalty.

Conclusion

Although there is much talk about nonprofit salaries that seem excessive, the propriety of this practice rests on whether they are indeed reasonable under the circumstances. Reasonableness is a fact-specific determination based on all of the specific facts and circumstances. To aid the organization, should it follow certain procedures, it may qualify within a rebuttable presumption of reasonableness. In any case, nonprofits may only pay reasonable compensation that is documented as such with proper substantiation. Thus, even if clearly reasonable, the organization must be certain to properly document its compensation.

The rules surrounding benefits and compensation provided by exempt organizations are numerous and complicated and lend themselves to mistakes. This article merely seeks to alert the reader to the applicable issues. Specific legal advice should be obtained to help guide your organization.

Judah I. Kupfer, Esq. is a staff counsel at Agudath Israel of America. He received his B.A. from Touro College, J.D. from Brooklyn Law School and LL.M. in taxation from New York University School of Law. To contact the author, please email ykupfer@agudathisrael.org. Questions and comments are welcome. *With gratitude to Jacob I. Friedman, Esq. of Proskauer Rose LLP for his review and comments.*

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Not-For-Profit/Exempt Organizations Blog

Posted at 9:00 AM on April 7, 2011 by A. Nicole Spooner

Charity Loses Tax Exemption Because of Private Inurement - Is Your Charity Immune?

In PLR 20113041, the IRS **revoked** the tax exemption of a public charity based on excess benefit and **private inurement** issues. This ruling highlights practices that charities should *avoid* in order to maintain their **tax-exempt status.**

The charity's primary purpose was to pursue the study of how the interaction of land use, disturbance, and climate impact the structure and biodiversity of a particular region, and publish papers relating to such study. The charity had only **one staff member** who also functioned as the President. The charity's **governing board** consisted of **three immediate family members** - the President, his father (Vice President), and his wife (Secretary/Treasurer).

The IRS noted that the President had **no employment contract** with the charity and the charity itself had **no Conflict of Interest Policy** in place to determine how any conflicts, potential or actual, would be addressed.

The charity's records demonstrated that the President ***"consistently utilized"*** the charity's income for **private purposes**. Among the most **egregious examples**, the charity's records established that:

1. **The President routinely made "loans to officers,"** but **never fully substantiated** the *purpose* of these loans. Moreover, the charity's board *approved* these loans, which were withdrawals from the charity's checking account and payments for the President's personal expenses, ***"after the fact."*** **Note** that since the charity had no **Conflict of Interest Policy**, the President who made these loans in the first place, then approved these "loans" with his wife and father. All of these amounts went into a "Loans to Officers" account and **inadequate records** were kept on how this money was spent to further the charity's exempt purposes.

2. The President **sold luxury vehicles to the charity**, but **never transferred title**, and performed upgrades without being able to prove that the vehicle even existed or was owned by the charity. Similarly, the charity paid for the President's car expenses **without asking for business substantiation** for these expenses.

3. The charity **paid the President's personal legal expenses.**

Interestingly, the IRS **focused** on the President's withdrawals from the charity's accounts that could **not be substantiated** as being for the **furtherance of the charity's exempt purpose** and also touched on ways in which the **governing board** was not providing **proper oversight**. In fact, the IRS noted that the charity's **inurement issues** and **excess benefit transactions** *"resulted from the organization being*

under the control of one-person with a family-based governing board."

Moreover, the IRS noted that because of the charity's structure, "sufficient *safeguards ha[d] not been put in place to prevent future violations....*" Charities should be aware that **governing procedures and policies**, including a **Conflict of Interest Policy** and a **recordkeeping policy**, can provide these types of safeguards and help an organization function more efficiently and effectively. In fact, this ruling is a staunch *reminder* that these policies should be used where appropriate and *tailored* to the needs of each organization.

This ruling should force each charity to examine its organizational and governing structures to ensure that its **board** constitutes an **independent body** so that, unlike the charity here, its governing board has no "*inherent conflict of interest when placed in a position to approve financial transactions....*"

The amount of **compensation** paid was also at issue here because the President's salary was considered excessive based on the size of the organization's budget. Accordingly, charities, particularly *smaller* charities, should use **comparability data**, to the extent possible, in determining the salaries of its various officers and other staff. Also, having a well-written **employment contract** with senior employees or officers may help a charity better defend the terms and scope of an employee's or officer's employment and compensation.

This ruling confirms that **the IRS is paying close attention to what charities are doing in their "back" offices**. Consequently, charities that are **not** exercising good governance practices will certainly be **at risk** for revocation of their tax-exempt status.

For additional information on good governance practices for charities, please see our Good Governance, Getting Back to Basics, and Lessons Learned blog entries.

Comments (0) Read through and enter the discussion with the form at the end

Proskauer Rose LLP
Boca Raton 2255 Glades Road
Suite 421 Atrium
Boca Raton, FL 33431-7360
Phone: 561.241.7400
Boston One International Place
Boston, MA 02110-2600
Phone: 617.526.9600
Chicago Three First National Plaza
70 West Madison
Suite 3800
Chicago, IL 60602-4342
Hong Kong 36/F, Edinburgh Tower
The Landmark
Suites 3605-3607
15 Queen's Road Central
Hong Kong
Phone: 852.3410.8000
London Ninth Floor
Ten Bishops Square
London E1 6EG
United Kingdom
Phone: 44.20.7539.0600

Not-For-Profit/Exempt Organizations Blog

Posted at 4:46 PM on May 3, 2011 by Kathleen E. Gerber

IRS Warns that Fringe Benefits Trigger Intermediate Sanctions

At a recent conference on nonprofit governance sponsored by Georgetown Law Center, an IRS official stated that fringe benefits have become the most common trigger of intermediate sanctions under Section 4958 of the Code.

As most of you know, or should know, Section 4958 of the Code, enacted in 1996, imposes excise taxes on both "disqualified persons" who receive an "excess benefit" from an exempt organization and any organization manager who knowingly participates in an excess benefit transaction.

When an economic benefit is not treated as compensation by the organization, the benefit is presumed to constitute an excess benefit transaction in its entirety, unless the disqualified person can establish that it was properly excludable from income for income tax purposes, or involved a legitimate non-compensatory transaction with the organization.

In February of 2010, the IRS began its first Employment Tax National Research Project in 25 years. This three-year "study" focuses on uncollected taxes in the area of employment for both taxable and exempt entities. As part of this study, 2,000 taxpayers are being selected each year for a comprehensive audit. Fringe benefits are one of the main areas of focus in these audits, making this a priority issue for the IRS.

Exempt organizations should take note. While executives of charitable organizations often receive fringe benefits as part of their compensation package, organizations may fail to include the value of those benefits when calculating the total compensation paid to executives and may fail to report them on the executive's W-2. If taxable fringe benefits are not included on the executive's W-2, the omitted amount is an "automatic" excess benefit transaction.

Conference attendees report that Peter Lorenzetti, a manager in the Exempt Organizations division of the IRS, warned exempt organizations that for excludable working condition fringe benefits, organizations must put in place a comprehensive plan that provides guidance on reimbursements and requires employees to substantiate the expenses. A panelist at the conference noted that employees must present original receipts, rather than credit card statements, in order to meet these substantiation requirements. The panelist recommended that the board of an exempt organization should routinely review the CEO's expense reimbursements to insure that they are appropriate. The IRS manager also reminded exempt organizations that with respect to any taxable fringe benefits, an

organization must make its intent to treat such benefits as compensation clear in order to avoid the presumption that the provision of such benefits constitutes an excess benefit transaction.

Comments (0) Read through and enter the discussion with the form at the end

Proskauer Rose LLP
Boca Raton 2255 Glades Road
Suite 421 Atrium
Boca Raton, FL 33431-7360
Phone: 561.241.7400
Boston One International Place
Boston, MA 02110-2600
Phone: 617.526.9600
Chicago Three First National Plaza
70 West Madison
Suite 3800
Chicago, IL 60602-4342
Hong Kong 36/F, Edinburgh Tower
The Landmark
Suites 3605-3607
15 Queen's Road Central
Hong Kong
Phone: 852.3410.8000
London Ninth Floor
Ten Bishops Square
London E1 6EG
United Kingdom
Phone: 44.20.7539.0600
Los Angeles 2049 Century Park East
32nd Floor
Los Angeles, CA 90067-3206
Phone: 310.557.2900
Newark One Newark Center
Newark, NJ 07102-5211
Phone: 973.274.3200
New Orleans Poydras Center
650 Poydras Street
Suite 1800
New Orleans, LA 70130-6146
Phone: 504.310.4088
New York Eleven Times Square
New York, NY 10036-8299
Phone: 212.969.3000
Paris 374 rue Saint-Honoré
75001 Paris, France
Phone: 33.1.53.05.60.00
São Paulo Rua Funchal, 418
26° andar
04551-060 São Paulo, SP, Brasil
Phone: 55.11.3045.1250
Washington, D.C. 1001 Pennsylvania Avenue, NW

Business Feature / By Judah I. Kupfer, Esq.

Restrictions on Lobbying by Exempt Organizations: How Much Advocacy Is Too Much?

Introduction

As the leader of a nonprofit organization and a concerned member of society, Joseph takes it upon himself to stay in tune with the issues of the day and the latest legislation that may affect his organization as well as his broader community. When there is a bill introduced in the city council, state legislature or in Congress that may be of concern, he speaks to his elected officials, urging them not to pass the particular bill into law. Joseph also pushes his members to contact their legislators and convey to them their concerns. Whether or not he knows it, each of Joseph's actions constitutes lobbying activity on behalf of his organization.

Advocacy is an integral part of democracy and a hallmark of the American system. It is expected that people will and should stand up for what they believe in and advocate regarding issues of importance to them. However, when such advocacy is conducted by exempt organizations, federal law imposes certain restrictions to the amount of advocacy the organization may carry on. It is important for an organization to understand those limits so that it may confidently advocate without running afoul of these rules and risk loss of federal tax exemption.

Current law permits exempt organizations to engage in some lobbying activity but prohibits "substantial" lobbying. To determine what is substantial, organizations are subject to a "balancing test" that considers various factors and activities of the organization. Alternatively, most organizations have the option of electing out of the balancing test and instead choosing to be subject to a dollar limit to the amount the organization may spend on lobbying activities. Each of these sets of rules is summarized below. As this article is intended to merely alert the reader to the issues involved, it is important for organizations to seek legal advice for their particular circumstances and to learn the additional detail that was omitted from this article.

What is the restriction?

Under §501(c)(3), exempt organizations are restricted from engaging in substantial lobbying. In the words of the Tax Code: "no substantial part of [a §501(c)(3)'s] activities is carrying on propaganda, or otherwise attempting to influence legislation." It is important to note that the restriction permitting no engagement whatsoever in political campaign activity is completely distinct and separate and one should not confuse the two.

What kinds of contact constitute lobbying?

There are two types of lobbying: *direct lobbying* and *grassroots lobbying*. Direct lobbying is accomplished when an exempt organization directly contacts legislators or their staffs to propose, support or oppose legislation. This is the type that people would ordinarily assume to be lobbying. The second type of lobbying, grassroots lobbying, is accomplished when an organization urges the public to contact the legislators or their staffs. Thus, conversations with members or the general public may be lobbying as well. To violate the rule against substantial lobbying, an organization would need to conduct activities aimed towards influencing legislation and those activities must be substantial. Let's take a closer look at each of these elements.

What is "influencing legislation"?

We must first define what is included in "influencing legislation," so that we may later seek to determine whether it is substantial. Influencing legislation requires an understanding of the term "legislation." Legislation, for these purposes, is any action by Congress, a state legislature, local governing bodies (such as a city council or township) in an initiative, constitutional amendment or similar action. When the general public votes in a referendum, advocating to the public is also considered lobbying. However, actions by administrative agencies or the Executive Branch are not included. In a similar vein, an attempt to influence the confirmation of appointed judges is lobbying, but influencing the outcome of an election of judges would not be lobbying (but may be considered political campaign activity, a separate restriction on exempt organizations).

Organizations often speak to their members regarding issues of common interest. Such discussions would not constitute grassroots lobbying unless the organization in some form urged its members (and/or the general public) to contact their legislators to support, propose or oppose legislation. By the same token, organizations often conduct studies and research and share it with their legislators. Sharing such studies is not lobbying so long as the studies are conducted in a nonpartisan manner and the purpose was not to support or oppose a position. Organizations may also advocate social change or take a position on broad public issues without it being considered lobbying.

What is "substantial"?

The default rule for all §501(c)(3) organizations is a "balancing test" – to be safe, all lobbying conducted by an organization must be insubstantial relative to whatever else the organization does. Factors that are considered include: the percentage of the organization's budget or employee time spent on lobbying, the continuous or intermittent nature of the lobbying involvement, the nature of the organization and its aims, the controversial nature of the organization's position and its visibility. Essentially all of the organization's activities are considered and weighed against the lobbying activity in terms of time, cost, exposure and the nature of the activity. In any instance where various factors are balanced, the outcome would be less than clear; thus, an organization would be well advised to stay far enough away from the line so as not to risk crossing it. To add certainty and predictability, §501(h) is an option that allows organizations to elect an alternate test for "substantiality," which will be discussed below.

What if the organization fails the "balancing test"?

Should the organization fail the balancing test and be deemed to have engaged in substantial lobbying, the Internal Revenue Service will revoke the organization's federal tax exemption. In addition, most organizations (other than a private foundation, a shul that qualifies as a "church" for tax purposes, and those that make a §501(h) election) will also be subject to an excise tax in the amount of 5% of all lobbying expenditures (i.e., 5% of the amount it spent on lobbying activity) in the year in which the organization loses its exemption. An additional 5% is imposed on managers of the organization that knew of the conduct and willfully allowed it to go on, unless such managers had "reasonable cause," such as if they had relied on the well reasoned opinion of an attorney confirming that the conduct was permissible.

§501(h) Election

Whereas the balancing test looks to all facts and circumstances to determine whether the lobbying was substantial, the organization that makes the §501(h) election on form 5768 is given a ceiling dollar amount that it may spend on lobbying. It is available to all public charities except "churches." The election may be made midyear and such expenditures must be reported in the organization's annual form 990 on schedule C. Additionally, lobbying expenditures must be reported on form 4720 for the current year and the prior three years.

The organization would be required to separately keep track of its direct and grassroots lobbying, as different limits apply to each. Should the organization exceed either of the limits, a tax will be imposed and the organization risks loss of tax exemption if it exceeds its yearly ceiling by a specified percentage over a specified number of years.

Certain organizations should consider making an election: one that has a highly visible lobbying program, an organization that wants to do much lobbying for a short period of time, one that has a strong web presence (since this test looks to expense and the cost associated with posting information on a web page is likely minimal), one that has many volunteers, and an organization that has a smaller budget. There are many rules and restrictions associated with a §501(h) election; thus, an organization considering this option must seek specific legal guidance.

§501(c)(4) Organizations

Organizations that wish to lobby may form a separate sister organization organized as a §501(c)(4) "social welfare" organization. §501(c)(4) organizations may conduct unlimited lobbying. These organizations operate to promote the common good of the people in the community and their net earnings are devoted to charitable, educational or recreational purposes. They are entitled to most of the benefits of (c)(3) organizations with the notable exception that donations made to them are not deductible from income tax. The (c)(3) may control the (c)(4), they may share office space, and share a board of trustees, but they must be separate legal entities, expenses from each must be kept separate and monies of each may not be commingled. Most importantly, tax deductible contributions given to the (c)(3) may not be used by the (c)(4).

Conclusion

Lobbying activity includes more than one would expect. Urging constituents to contact their elected official may also constitute lobbying. Exempt organizations may conduct insubstantial lobbying. Determining what is substantial is not simple under the default balancing test and thus, many organizations may opt to make the §501(h) election, imposing a ceiling on the dollar amount to be spent on influencing legislation. It is important to reiterate that these rules are complicated and much detail has been omitted and so, it is important for the organization to seek legal guidance from its own professional.

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Judah I. Kupfer, Esq. is a staff counsel at Agudath Israel of America. He received his B.A. from Touro College, J.D. from Brooklyn Law School and LL.M. in taxation from New York University School of Law. To contact the author, please email ykupfer@agudathisrael.org. Questions and comments are welcome. *With gratitude to Jacob I. Friedman, Esq. of Proskauer Rose LLP for his review and comments.*

Legal Feature / By Judah I. Kupfer, Esq.

Nonprofit Intervention in Political Campaigns: How Involved May Your Organization Be? *(Part I)*

With the election season underway, many organization and shul leaders find themselves asking what their organizations may do on behalf of candidates for public office. Can my organization endorse a candidate? Can we host a fundraiser? Can we mail (or email) letters encouraging constituents or parents to vote for a particular candidate? Can we invite candidates to speak at our congregation or at our organization's dinner? What may I or my board do in our individual capacity?

Unlike lobbying (i.e. attempts to influence legislation) which §501(c)(3) tax-exempt organizations may conduct insubstantially, these organizations are absolutely prohibited from conducting any intervention in political campaigns. An organization that violates this prohibition may be subject to an excise tax and, in more extreme cases, may also lose its tax-exempt status. With the penalties great and a heightened environment of scrutiny that surrounds nonprofits, it is important to understand what involvement, if any, organizations may play in the campaign and electoral process.

The objective of this article is by no means meant to deter one from involving himself in the political process. To the contrary, one should get involved, learn about the issues and seek to elect the best possible candidate. The purpose of this article is to clarify what actions tax-exempt organizations and those involved with such organizations may take with respect to candidates for public office so not to run afoul of these important IRS rules. Indeed, many activities are thought to be prohibited simply due to ignorance of the applicable rules or lack of accurate information. This article seeks to educate nonprofit administration and their board members as to what is and is not permissible.

What's Included?

Section §501(c)(3) of the Internal Revenue Code prohibits tax-exempt organizations from participating in, or otherwise intervening in (including the publishing or distributing of statements), any political campaign on behalf of or in opposition to any candidate for public office. To run afoul of this rule, certain elements are needed: You need a *candidate* and you need *intervention*. So who is a *candidate for public office* and what activities constitute *intervention into a political campaign*?

A candidate for public office is any individual offering him or herself for national, state or local elective public office. This includes an individual who declares his intent to run, an incumbent who is likely to announce his candidacy to run, and elective judgeships. Elections need not be contested nor need they involve political parties. But mere speculation regarding whether a prominent public figure will run for office doesn't make one a candidate for these purposes. So, for example, speculation about whether Sarah Palin, Chris Christie, Donald Trump or Michael Bloomberg may jump into the 2012 presidential race doesn't necessarily make them candidates.

Now that we understand who a candidate is, we need to know what constitutes intervention in a political campaign on behalf of such a candidate. This is a complex question, and there are a number of possible activities to explore. We will divide these activities into categories, modeled after the situations listed in IRS Revenue Ruling 2007-41 with slight variation (and many sentences are copied verbatim without quotations). These categories and accompanying examples should provide a good basis for the governing law; but there are many gray areas in which organizations would be well advised to seek the advice of counsel prior to engaging in the activity.

Voter Education, Voter Registration and Get Out the Vote Drives

§501(c)(3) organizations are permitted to conduct certain voter education activities including the presentation of public forums and the publication of voter education guides if they are carried out in a *non-partisan* manner. They may also encourage people to participate in the electoral process through voter registration and get-out-the-vote drives, conducted in a *non-partisan* manner. If, however, such voter education or registration activities are conducted in a biased manner that favors (or opposes) one or more candidates, such activity is prohibited.

The definition for "nonpartisan" has never been clearly defined, but at the very least, an organization may not expressly advocate for or against particular candidates or parties. Let's see a couple of examples of what is considered to be partisan. (General note: The organizations referred to throughout this article are §501(c)(3) organizations. Also note that a shul is considered to be a §501(c)(3) organization regardless of whether it has ever formally applied to the IRS seeking tax-exempt status.)

An organization sets up a booth for citizens to register to vote. The signs and banners in and around the booth give only the name of the organization, the date of the next upcoming statewide election, and notice of the opportunity to register. No reference to any candidate or political party is made by the volunteers staffing the booth or in the materials available at the booth, other than the official voter registration forms which allow registrants to select a party affiliation. The organization is not engaged in political campaign intervention when it operates this voter registration booth since it was done in a non-partisan fashion.

In this next example, Organization C, a tax-exempt organization that educates the public on environmental issues, has intervened in a political campaign. Candidate G is running for the state legislature and an important element of his platform is challenging the environmental policies of the incumbent. Shortly before the election, C sets up a telephone bank to call registered voters in the district in which Candidate G is seeking election. In the phone conversations, C's representative tells the voter about the importance of environmental issues and asks questions about the voter's views on these issues. If the voter appears to agree with the incumbent's position, C's representative thanks the voter and ends the call. If the voter appears to agree with Candidate G's position, C's representative reminds the voter about the upcoming election, stresses the importance of voting in the election and offers to provide transportation to the polls. C is engaged in political campaign intervention when it conducts this get-out-the-vote drive.

In short, an organization may encourage people to vote and help them register to vote but may not tell the potential voter for whom to vote. Thus, a yeshivah or shul that encourages its parents or congregation to vote for a particular candidate would be in violation of this rule.

Individual Activity by Organization Leaders

We now know that the organization may not intervene into a political campaign. But one of the most frequently asked questions in this area involves what organization leaders may do in their individual capacity. The political campaign intervention prohibition is not intended to restrict free expression on political matters by leaders of organizations speaking for themselves as individuals. Nor are leaders prohibited from speaking about important issues of public policy. However, for their organizations to remain tax exempt under §501(c)(3), leaders cannot make partisan comments in official organization publications or at official functions of the organization. The organization may also not spend its funds in favor of or in opposition to a candidate, for instance through direct grants, employee time, or free use of office space. Let's see a few examples:

President A is the chief executive officer of Organization J and is well-known in the community. With the permission of five prominent community leaders, including President A, who have personally endorsed Candidate T, Candidate T publishes a full page ad in the local newspaper listing the names of the five leaders. President A is identified in the ad as the CEO of Organization J. The ad states, "Titles and affiliations of each individual are provided for identification purposes only." The ad is paid for by Candidate T's campaign committee. Because the ad was not paid for by Organization J, the ad is not otherwise in an official publication of Organization J, and the endorsement is made by President A in a personal capacity, the ad does not constitute campaign intervention by Organization J.

In another example, B is the executive director of Beis Medrash K. K publishes a monthly alumni newsletter that is distributed to all alumni of the *beis medrash*. In each issue, B has a column titled "My Views." The month before the election, B states in the "My Views" column, "It is my personal opinion that Candidate U should be re-elected." For that one issue, B even pays from his personal funds the portion of the cost of the newsletter attributable to the "My Views" column. Even though B paid part of the cost of the newsletter, the

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newsletter is an official publication of the Beis Medrash K — since the endorsement appeared in an official publication of the *beis medrash*, it constitutes campaign intervention by Beis Medrash K.

To take a further example, Rabbi C is the rabbi of a shul and is well-known in the community. Three weeks before the election, he attends a press conference at Candidate V's campaign headquarters and states that Candidate V should be re-elected. Rabbi C does not say he is speaking on behalf of his shul. His endorsement is reported on the front page of the local newspaper and he is identified in the article as the rabbi of his shul. Because Rabbi C did not make the endorsement at an official shul function, in an official shul publication or otherwise use the shul's assets, and he did not state that he was speaking as a representative of his shul, his actions do not constitute campaign intervention by his shul.

A final example: Chairman D is the chairman of the Board of Directors of M, a §501(c)(3) *tzedakah* organization. During a regular meeting of M shortly before the election, Chairman D spoke on a number of issues, including the importance of voting in the upcoming election, and concluded by stating, "It is important that you all do your duty in the election and vote for Candidate W." Because Chairman D's remarks indicating support for Candidate W were made during an official organization meeting, they constitute political campaign intervention by M.

Part Two Next Week

This article will continue next week (part two in a four part series) with further examples of campaign intervention including the issue of candidate appearances at nonprofit events.

Judah I. Kupfer, Esq. is a staff counsel at Agudath Israel of America. To contact the author, please email ykupfer@agudathisrael.org. Questions and comments are welcome.

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Legal Feature / By Judah I. Kupfer, Esq.

Nonprofit Intervention in Political Campaigns: How Involved May Your Organization Be? *(Part II)*

In part one, published last week, we introduced the rule that a nonprofit organization is absolutely prohibited from intervening into a political campaign on behalf of a candidate for public office. We explored who would be considered a candidate and some examples of activities that would (and wouldn't) constitute campaign intervention. Part one explored issues of voter registration, voter education, "get-out-the-vote" drives and that which one associated closely with a nonprofit may do in his or her individual capacity. Part two, below, continues with examples of what is permitted when seeking to have a candidate appear at a nonprofit organization's event. As this article is the second of a four-part series, the reader is strongly encouraged to first read part one before reading further.

Candidate Appearances

Depending on the facts and circumstances, an organization may invite political candidates to speak at its events. Political candidates may be invited in their capacity as candidates, or in their individual capacity, i.e. not as a candidate. Candidates may also appear without an invitation at organization events that are open to the public. When a candidate is invited to speak at an organization event in his or her capacity as a political candidate, the organization would not have participated or intervened in a political campaign so long as the organization provided to political candidates seeking the same office an equal opportunity to participate, the organization didn't indicate any support for or opposition to the candidate (including candidate introductions and communications concerning the candidate's attendance), and no political fundraising occurred.

In determining whether candidates are given an equal opportunity to participate, the nature of the event to which each candidate is invited will be considered, in addition to the manner of the presentation. For example, an organization that invites one candidate to speak at its well-attended annual dinner, but invites the opposing candidate to speak at a sparsely-attended general meeting, will likely have violated the political campaign prohibition, even if the manner of presentation for both speakers is otherwise neutral.

When an organization invites several candidates for the same office to speak at a public forum, the forum doesn't result in political campaign intervention if: the questions for the candidates are prepared and presented by an independent nonpartisan panel; 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; each candidate is given an equal opportunity to present his or her view on each of the issues discussed; the candidates are not asked to agree or disagree with positions, agendas, platforms or statements of the organization; and a moderator doesn't comment on the questions or otherwise imply approval or disapproval of the candidates. Let's see a few examples of how this comes up.

President E is the president of an organization. In the month prior to the election, President E invites the three local Congressional candidates to address the members of his organization, one each at a regular meeting held on three successive weeks. Each candidate is given an equal opportunity to address and field questions on a wide variety of topics from the members. The organization's publicity announcing the dates for each of the candidate's speeches and President E's introduction of each candidate include no comments on their qualifications or any indication of a preference for any candidate. The organization's actions do not constitute political campaign intervention.

> *An organization that invites one candidate to speak at its well-attended annual dinner, but invites the opposing candidate to speak at a sparsely attended general meeting, will likely have violated the political campaign prohibition.*

Let's say, however, there were four candidates in the race rather than three, and one of the candidates declines the invitations to speak. In the publicity announcing the dates for each of the candidate's speeches, the organization includes a statement that the order of the speakers was determined at random and the fourth candidate declined the organization's invitation to speak. President E makes the same statement in his opening remarks at each of the meetings where one of the candidates is speaking. In this case, the organization's actions do not constitute political campaign intervention.

In another example, Rabbi F is the Rabbi of Shul O. The Motzoei Shabbos before the November election, Rabbi F invites Senate Candidate X to speak to the congregation at their annual *Melaveh Malkah*. During his remarks, Candidate X states, "I am asking not only for your votes, but for your enthusiasm and dedication, for your willingness to go the extra mile to get a very large turnout on Tuesday." Rabbi F invites no other candidate to address the congregation during the Senatorial campaign. Because these activities take place during an official shul function, they are attributed to Shul O. By selectively providing shul facilities to allow Candidate X to speak in support of his campaign, Shul O's actions constitute political campaign intervention.

Candidate Appearances Where Speaking or Participating as a Non-Candidate

Candidates may also appear or speak at organization events in a non-candidate capacity. For instance, a political candidate may be a public figure who is invited to speak because he or she: currently holds, or formerly held, public office, is considered an expert in a nonpolitical field, or is a celebrity or has led a distinguished military, legal or public service career. A candidate may choose to attend an event that is open to the public, such as a lecture or dinner. The candidate's presence at an organization-sponsored event does not, by itself, cause the organization to be engaged in political campaign intervention.

However, if the candidate is publicly recognized by the organization, or if the candidate is invited to speak, the candidate's appearance doesn't result in political campaign intervention if: the individual is chosen to speak solely for reasons other than his candidacy for public office; the individual speaks only in a non-candidate capacity; neither the individual nor any representative of the organization makes any mention of his candidacy or the election; no campaign activity occurs in connection with the candidate's attendance; the organization maintains a nonpartisan atmosphere on the premises or at the event where the candidate is present; and the organization clearly indicates the capacity in which the candidate is appearing and does not mention the individual's political candidacy or the upcoming election in the communications announcing the candidate's attendance at the event. Let's see some examples.

Shul P is located in New York. President G is the president of P and customarily acknowledges the presence of any public officials present during *davening*. During a Congressional race, Senator Y who is Jewish as well as a candidate, attends the *davening* at Shul P. President G acknowledges Y's presence in his customary manner, saying, "We are happy to have joining us this Shabbos Senator Y." President G makes no reference in his welcome to the Senator's candidacy or the election. Shul P has not engaged in political campaign intervention as a result of President G's actions.

To take another example, Chairman H is the chairman of the Board of Hospital Q, a §501(c)(3) organization. Hospital Q is building a new wing. Chairman H invites Congressman Z, the representative for the district containing Hospital Q, to attend the groundbreaking ceremony for the new wing.

Congressman Z is running for reelection at the time. Chairman H makes no reference in her introduction to Congressman Z's candidacy or the election. Congressman Z also makes no reference to his candidacy or the election and does not do any political campaign fundraising while at Hospital Q. Hospital Q has not intervened in a political campaign.

Another example: Yeshivah X publishes an alumni newsletter on a regular basis. Individual alumni are invited to send in updates about themselves which are printed in each edition of the newsletter. After receiving an update letter from Alumnus Q, X prints the following: "Alumnus Q, class of 1989, is running for a congressional seat in New York." The newsletter does not contain any reference to this election or to Alumnus Q's candidacy other than this statement of fact. Yeshivah X has not intervened in a political campaign.

One last example: Mayor G attends a concert performed by Symphony S, a

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§501(c)(3) organization, in City Park. The concert is free and open to the public. Mayor G is a candidate for reelection, and the concert takes place after the primary and before the general election. During the concert, the chairman of S's board addresses the crowd and says, "I am pleased to see Mayor G here tonight. Without his support, these free concerts in City Park would not be possible. We will need his help if we want these concerts to continue next year so please support Mayor G in November as he has supported us." As a result of these remarks, Symphony S has engaged in political campaign intervention.

Part Three Next Week

This article will continue next week (part three in a four-part series) with further examples of campaign intervention dealing specifically with when a position taken by an organization is permitted issue advocacy or prohibited campaign intervention.

Judah I. Kupfer, Esq. is a staff counsel at Agudath Israel of America. To contact the author, please email ykupfer@agudathisrael.org. Questions and comments are welcome.

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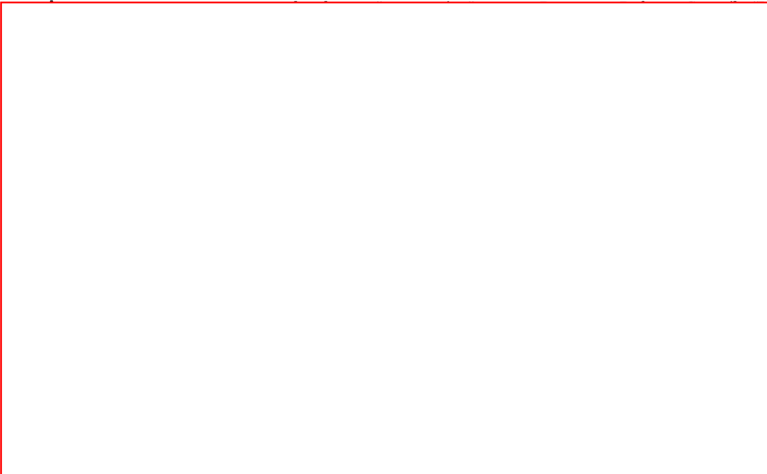

Legal Feature / By Judah I. Kupfer, Esq.

Nonprofit Intervention in Political Campaigns: How Involved May Your Organization Be? *(Part III)*

In part two, published last week, we described how a candidate for public office may appear at a nonprofit organization's event without the organization being seen as impermissibly intervening in a political campaign. Part three, below, continues with further examples of campaign intervention dealing specifically with when a position taken by an organization is permitted issue advocacy or prohibited campaign intervention. As this article is the third of a four-part series, the reader is strongly encouraged to read parts one and two before proceeding further.

Issue Advocacy vs. Political Campaign Intervention

§501(c)(3) organizations may take positions on public policy issues, including issues that divide candidates in an election for public office. However, organizations must avoid any issue advocacy that functions as political campaign intervention. Even if a statement does not expressly tell an audience to vote for or against a specific candidate, an organization delivering the statement is at risk of violating the political campaign intervention prohibition if there is any message favoring or opposing a candidate. A statement may be seen as indentifying a candidate not only by stating the candidate's name but also by other means such as showing a picture of the candidate, referring to political party affiliations or other distinctive features of a candidate's platform or biography. All the facts and circumstances need to be considered to determine if the advocacy is political campaign intervention.

Key factors in determining whether a communication results in political campaign intervention include the following: 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.

A communication is particularly at risk of political campaign intervention when it makes reference to candidates or voting in a specific upcoming election. Nevertheless, the communication must still be considered in context before arriving at any conclusions. Let's see some examples.

Yeshivah O prepares and finances a full page newspaper advertisement that is published in several large circulation newspapers in New Jersey shortly before an election in which Senator C is a candidate for nomination in a party primary. Senator C represents New Jersey in the United States Senate. The advertisement states that S. 24, a pending bill in the United States Senate, would provide additional opportunities for New Jersey residents to attend yeshivah, but Senator C has opposed similar measures in the past. The advertisement ends with the statement "Call or write Senator C to tell him to vote for S. 24." Educational issues have not been raised as an issue distinguishing Senator C from any opponent. S. 24 is scheduled for a vote in the United States Senate before the election, soon after the date that the advertisement is published in the newspapers.

Even though the advertisement appears shortly before the election and identifies Senator C's position on the issue as contrary to O's position, Yeshivah O has not violated the political campaign intervention prohibition because the advertisement does not mention the election or the candidacy of Senator C, education issues have not been raised as distinguishing Senator C from any opponent, and the timing of the advertisement and the identification of Senator C are directly related to the specifically identified legislation Yeshivah O is supporting and appears immediately before the United States Senate is scheduled to vote on that particular legislation. The candidate identified, Senator C, is an officeholder who is in a position to vote on the legislation. (Please note that this example raises lobbying issues, and the rules for nonprofit lobbying should be consulted. For more information, see "Restrictions on Lobbying by Exempt Organizations: How Much Advocacy Is Too Much?" *Hamodia*, June 7, 2011, at B34.)

Another example: Organization R, a §501(c)(3) organization that educates the public about the need for improved public education, prepares and finances a radio advertisement urging an increase in state funding for public education in California, which requires a legislative appropriation. Governor E is the governor of California. The radio advertisement is first broadcast on several radio stations in California beginning shortly before an election in which Governor E is a candidate for re-election. The advertisement is not part of an ongoing series of substantially similar advocacy communications by Organization R on the same issue. The advertisement cites numerous statistics indicating that public education in California is underfunded. While the advertisement does not say anything about Governor E's position on funding for public education, it ends with "Tell Governor E what you think about our under-funded schools." In public appearances and campaign literature, Governor E's opponent has made funding of public education an issue in the campaign by focusing on Governor E's veto of an income tax increase the previous year to increase funding of public education. At the time the advertisement is broadcast, no legislative vote or other major legislative activity is scheduled in the California legislature on state funding of public education.

Organization R has violated the political campaign prohibition because the advertisement identifies Governor E, appears shortly before an election in which Governor E is a candidate, is not part of an ongoing series of substantially similar advocacy communications by Organization R on the same issue, is not timed to coincide with a non election event such as a legislative vote or other major legislative action on that issue, and takes a position on an issue that the opponent has used to distinguish himself from Governor E.

One final example on this topic: Candidate A and Candidate B are candidates for the state senate in District W of Ohio. The issue of Ohio funding for a new mass transit project in District W is a prominent issue in the campaign. Both candidates have spoken out on the issue. Candidate A supports funding the new mass transit project. Candidate B opposes the project and supports Ohio funding for highway improvements instead. P is the executive director of C, a §501(c)(3) organization that promotes community development in District W. At C's annual fundraising dinner in District W, which takes place in the month before the election in Ohio, P gives a lengthy speech about community development issues including the transportation issues. P does not mention the name of any candidate or any political party. However, at the conclusion of the speech, P makes the following statement, "For those of you who care about quality of life in District W and the growing traffic congestion, there is a very important choice coming up next month. We need new mass transit. More highway funding will not make a difference. You have the power to relieve the congestion and improve your quality of life in District W. Use that power when you go to the polls and cast your vote in the election for your state senator." C has violated the political campaign intervention as a result of P's remarks at C's official function shortly before the election, in which P referred to the upcoming election after stating a position on an issue that is a prominent issue in a campaign that distinguishes the candidates.

Conclusion Next Week

This article will conclude next week with additional examples of campaign intervention in the context of standard business activity such as selling or renting of mailing lists, the leasing of office space and the maintenance of web sites. Part four will also provide for an option of a sister §501(c)(4) organization to campaign and will describe the potential penalties an organization that impermissibly campaigns may as a result incur.

Judah I. Kupfer, Esq. is a staff counsel at Agudath Israel of America. To contact the author, please email ykupfer@agudathisrael.org. Questions and comments are welcome.

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Legal Feature / By Judah I. Kupfer, Esq.

Nonprofit Intervention in Political Campaigns: How Involved May Your Organization Be? *(Part IV)*

In prior weeks, we described how a tax-exempt organization is absolutely prohibited from intervening into a political campaign on behalf of a candidate for public office. We described what kinds of actions may be considered campaign intervention, discussing such topics as voter education and registration, candidate appearances at nonprofit events and issue advocacy. This week, we conclude with some additional common practices such as selling or renting mailing lists, leasing office space, and maintaining web sites and discuss whether they may pose an issue for nonprofits. As this article is the final part in a four-part series, it is recommended that the reader see the prior parts before proceeding further.

Business Activity

Selling or renting mailing lists, the leasing of office space or the acceptance of paid political advertising by an organization may constitute invention in a political campaign. In this context, some of the factors to be considered include whether the good, service or facility is available to candidates in the same election on an equal basis; whether the good, service, or facility is available only to candidates and not to the general public; whether the fees charged to candidates are at the organization's customary and usual rates; and whether the activity is an ongoing activity of the organization or whether it is conducted only for a particular candidate. Let's see a couple of examples.

Yeshivah owns an historic building in Manhattan that has a large hall suitable for hosting dinners and receptions. For several years, Yeshivah has made the hall available for rent to members of the public. Standard fees are set for renting the hall based on the number of people in attendance, and a number of different organizations have rented the hall in the past. Yeshivah rents the hall on a first come, first served basis. Candidate P rents Yeshivah's social hall for a fundraising dinner. Candidate P's campaign pays the standard fee to Yeshivah for the hall rental. Yeshivah is not involved in political campaign intervention as a result of renting the hall to Candidate P for use as the site of a campaign fundraising dinner.

And now for an example that goes the other way: Yeshivah maintains a mailing list of all of its alumni and contributors. Yeshivah has never rented its mailing list to a third party. Yeshivah is approached by the campaign committee of Candidate Q, who supports increased funding for Yeshivos. Candidate Q's campaign committee offers to rent Yeshivah's mailing list for a fee that is comparable to fees charged by other similar organizations. Yeshivah rents its mailing list to Candidate Q's campaign committee. Yeshivah declines similar requests from campaign committees of other candidates. Yeshivah has intervened in a political campaign.

Web Sites

§501(c)(3) organizations use web sites to disseminate statements and information. They also routinely link their web sites to web sites maintained by other organizations as a way of providing additional information that the organizations believe is useful or relevant to the public. If an organization posts something on its web site that favors or opposes a candidate for public office, the organization will be treated the same as if it distributed printed material, oral statements or broadcasts that favored or opposed a candidate.

An organization has control over whether it establishes a link to another site. When an organization establishes a link to another web site, the organization is responsible for the consequences of establishing and maintaining that link, even if the organization does not have control over the content of the linked site. Because the linked content may change over time, an organization should monitor the linked content and adjust the links accordingly.

Links to candidate-related material, by themselves, do not necessarily constitute political campaign intervention. All the facts and circumstances must be taken into account when assessing whether a link produces that result. The facts and circumstances to be considered include: the context for the link on the organization's web site, whether all candidates are represented, any exempt purpose served by offering the link, and the directness of the links between the organization's web site and the web page that contains material favoring or opposing a candidate for public office. Let's see a few examples.

Tzedaka Organization M maintains a web site and posts an unbiased, nonpartisan voter guide. For each candidate covered in the voter guide, M includes a link to that candidate's official campaign web site. The links to the candidate web sites are presented on a consistent neutral basis for each candidate, with text saying "For more information on Candidate X, you may consult [URL]." M has not intervened in a political campaign because the links are provided for the exempt purpose of educating voters and are presented in a neutral, unbiased manner that includes all candidates for a particular office.

Another example: A shul maintains a web site that includes such information as times of *davening*, details of community outreach programs, *divrei Torah* and activities of members of its congregation. B, a member of the congregation, is running for a seat on the city council. Shortly before the election, the shul posts the following message on its web site, "Lend your support to B, your fellow congregant, in Tuesday's election for city council." The shul has intervened in a political campaign on behalf of B.

§501(c)(4) Organizations

Organizations that wish to intervene in political campaigns may form a separate sister organization organized as a §501(c)(4) "social welfare" organization. §501(c)(4) organizations may conduct political campaign activity so long as they are primarily engaged in activities that further social welfare. These organizations operate to promote the common good of the people in the community and their net earnings are devoted to charitable, educational or recreational purposes. They are entitled to most of the benefits of (c)(3) organizations with the notable exception that donations made to them are not deductible from income tax. The (c)(3) may control the (c)(4), they may share office space, share a board of trustees, but they must be separate legal entities, expenses from each must be kept separate and monies of each may not be commingled. Most importantly, tax deductible contributions given to the (c)(3) may not be used by the (c)(4).

What Are the Penalties?

Although tax-exempt organizations are prohibited from engaging in any amount of political campaign activity, and even a small amount can technically result in loss of federal tax exemption, historically, smaller violations have been ignored. This has led to the adoption and imposition of excise taxes which can be imposed in addition to, or in lieu of, revocation of tax exemption. The organization is subject to an excise tax equal to 10% of the amount it spent on the political campaign. Knowing and willful managers of the organization may also be subject to a tax of 2.5% of the expenditure, except if they had "reasonable cause," usually in the form of a well-reasoned legal opinion that such activity was permitted. If the expenditure is not corrected within a specified time period by having the candidate return the funds to the organization and establishing safeguards to prevent reoccurrence, the tax to the organization increases to 100% to the organization and 50% to the organization's managers. Loss of tax exemption is always available and is likely to be imposed in more egregious cases.

Conclusion

The Jewish community revolves around its shuls, yeshivos, *chessed* and *tzedakah* organizations. At the same time, it deeply cares about having the right elected officials in office — those who will be sympathetic to its specific needs and help the community continue to flourish. It is, thus, necessary to understand what involvement non-profit institutions may play in the political campaign process to ensure that they stay within the bounds set by Congress and enforced by the IRS. This article has detailed some of the most common issues and scenarios in this area but it is certainly no substitute for individualized legal advice for your specific situations.

Judah I. Kupfer, Esq. is a staff counsel at Agudath Israel of America. To contact the author, please email ykupfer@agudathisrael.org. Questions and comments are welcome.

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TABLE 12-1

POLITICAL CAMPAIGN ACTIVITIES BY CHURCHES

An Analysis of Selected Activities

CAMPAIGN ACTIVITY	IMPACT ON TAX-EXEMPT STATUS	BASIS
Contributions to political campaign funds.	Prohibited	IRS *Tax Guide for Churches and Religious Organizations*
Public statements of position (verbal and written) in favor of or in opposition to candidates for office—in official church publications and at official church functions.	Prohibited	IRS *Tax Guide for Churches and Religious Organizations*
Providing a forum for all candidates to address the church.	Permitted	IRS *Tax Guide for Churches and Religious Organizations*
Public comments made by ministers and other church employees in connection with political campaigns, not made at church facilities or in church publications and accompanied by statement that the comments are strictly personal and are not intended to represent the church.	Permitted	IRS *Tax Guide for Churches and Religious Organizations*; Jimmy Swaggart Ministries settlement with IRS; Revenue Ruling 2007-41
A church invites all candidates for a political office to address the congregation and informs the congregation before each candidate's speech that the views expressed are those of the candidate and not the church and that the church does not endorse any candidate.	Permitted	Revenue Ruling 74-574; IRS *Tax Guide for Churches and Religious Organizations*
A church invites only one candidate in a political campaign to address the congregation.	Prohibited	Revenue Ruling 2007-41
The church provides an opportunity for a candidate to speak in a noncandidate capacity (for example, as a member of the church, public figure, or expert in a non-political field) without providing equal access to all political candidates for the same office. The church ensures that the candidate speaks in a noncandidate capacity; no reference is made to the person's candidacy; the church mentions the capacity in which the candidate is appearing (without mentioning the person's political candidacy); and no campaign activity occurs.	Permitted	IRS *Tax Guide for Churches and Religious Organizations*
A church distributes a compilation of voting records of all members of Congress on major legislative issues involving a wide range of subjects; the publication contains no editorial opinion, and its contents and structure do not imply approval or disapproval of any members or their voting records.	Permitted	Revenue Ruling 78-248
A church distributes a voter guide containing questions demonstrating a bias on certain issues.	Prohibited	Revenue Ruling 78-248
The endorsement of candidates.	Prohibited	Int. Rev. News Release IR-96-23
Campaign activities by employees within the context of their employment.	Prohibited	FSA 1993-0921-1
A church fails to "disavow" the campaign activities of persons under "apparent authorization" from the church by repudiating those acts "in a timely manner equal to the original actions" and taking steps "to ensure that such unauthorized actions do not recur."	Prohibited	FSA 1993-0921-1
Engaging in fund-raising on behalf of a candidate.	Prohibited	Int. Rev. News Release IR-96-23
Neutral voter registration drives.	Permitted	11 C.F.R. § 111.4(c)(4)

(Continued on page 587)

TABLE 12-1

POLITICAL CAMPAIGN ACTIVITIES BY CHURCHES

An Analysis of Selected Activities (continued)

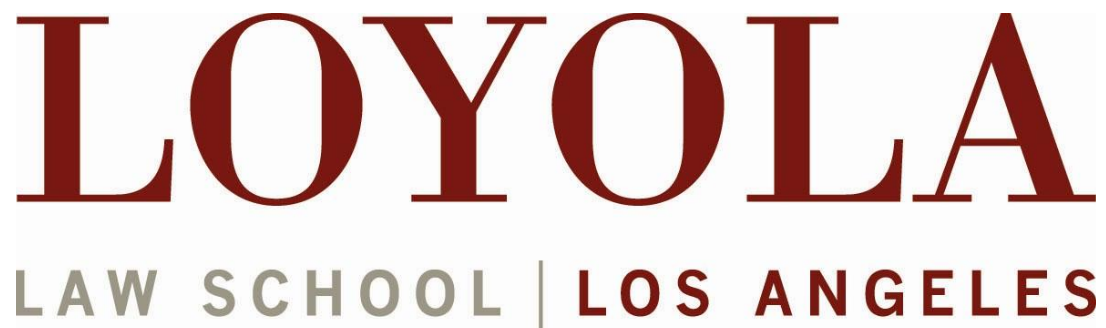
CAMPAIGN ACTIVITY	IMPACT ON TAX-EXEMPT STATUS	BASIS
Newspaper ads urging voters to vote for or against a candidate.	Prohibited	*Branch Ministries, Inc. v. Commissioner*, 99-1 USTC ¶50,410 (D.D.C. 1999), aff'd, *Branch Ministries v. Rossotti*, 2000 USTC ¶50,459 (D.C. Cir. 2000)
Church websites that contain information either supporting or opposing candidates for public office.	Prohibited	Revenue Ruling 2007-41
Church websites containing a link to candidate-related material, if the facts and circumstances indicate that one or more candidates are being supported or opposed.	Prohibited	Revenue Ruling 2007-41
A minister who is well-known in the community attends a press conference at a political candidate's campaign headquarters and states that the candidate should be reelected. The minister does not say he is speaking on behalf of his church. His endorsement is reported on the front page of the local newspaper, and he is identified in the article as the minister of his church.	Permitted	Revenue Ruling 2007-41
The Sunday before the November election, a minister invites a political candidate to preach to her congregation during worship services. During his remarks the candidate states, "I am asking not only for your votes, but for your enthusiasm and dedication, for your willingness to go the extra mile to get a very large turnout on election day." The minister invites no other candidate to address her congregation during the campaign.	Prohibited	Revenue Ruling 2007-41
A church maintains a website that includes biographies of its ministers, times of services, details of community outreach programs, and activities of members of its congregation. A member of the congregation is running for a seat on the town council. Shortly before the election, the church posts the following message on its website: "Lend your support to your fellow parishioner in Tuesday's election for town council."	Prohibited	Revenue Ruling 2007-41

the cost of the newsletter attributable to the "My Views" column. Even though he paid part of the cost of the newsletter, the newsletter is an official publication of the church. Because the endorsement appeared in an official publication of Church I, it constitutes campaign intervention attributed to Church I.

EXAMPLE. Minister D is the minister of Church M, a section 501(c)(3) organization. During regular services of Church M shortly before the election, Minister D preached on a number of issues, including the importance of voting in the upcoming election, and concluded by stating, "It is important that you all do your duty in the election and vote for Candidate W." Because Minister D's remarks indicating support for Candidate W were made during an official church service, they constitute political campaign intervention by Church M.

Political campaign activity—inviting a candidate to speak. Many churches have invited political candidates to address the congregation during a worship service. Sometimes the candidate is a member of the church. In other cases the candidate contacts the senior pastor and asks for permission to address the congregation. Do such activities jeopardize a church's tax-exempt status? The Guide addresses these questions directly in two separate contexts: (1) political candidates who address a church congregation as a candidate, and (2) political candidates who do not address a church congregation as a candidate.

Speaking as a candidate. The Guide notes that when a candidate is invited to speak at a church as a political candidate, the factors to consider in deciding whether the church participated or intervened in a political campaign include the following:



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AN OVERVIEW OF TAX ISSUES FOR RELIGIOUS CONGREGATIONS

Professor Ellen P. Aprill

Electronic copy available at: http://ssrn.com/abstract=1710186

An Overview Of Tax Issues For Religious Congregations

Ellen P. Aprill
is the John E. Anderson Professor of Tax Law, Loyola Law School, and Past President, Temple Israel of Hollywood.

Ellen P. Aprill

Religious freedom has its price.

MANY TAX LAWYERS ARE ASKED TO SERVE on the governing bodies of their religious congregations. Yet religious congregations are subject to some unique rules that tax lawyers are unlikely to have encountered. This article discusses the issues that I have most often been asked, or should have been asked, in the many years that I have been giving pro bono advice to religious congregations of my own religious tradition, locally, regionally, and nationally. The issues discussed are: a) requirements for setting compensation, b) lobbying and political activities, c) substantiation of charitable contributions, d) charitable fundraising, e) payroll taxes and withholding for clergy, f) parsonage and housing allowances, and g) discretionary funds. The discussion of applicable rules is designed to be accessible to lay leaders and congregational staff, whether volunteer or professional. Different groups of leaders and volunteers have interest in different topics; each topic is designed to stand alone, and thus there is some overlap in coverage. Moreover, to be as inclusive as possible of our country's many different religious traditions, I have used the terms "religious congregation" and "clergy," although the Internal Revenue Code uses the terms "church" and "minister" of the gospel, which it has interpreted broadly. *See, e.g.* IRC §§170(b)(1)(A)(i), 508(c)(1)(A), 7611, 107, 1402(c)(4),3121(b)(8(A). (All section references are to the Internal Revenue Code unless otherwise indicated.)

Electronic copy available at: http://ssrn.com/abstract=1710186

OVERVIEW • Religious congregations are exempt from income tax, but nonetheless must comply with many tax laws. They must also comply with other applicable federal and state laws, particularly state corporate laws applicable to nonprofit religious organizations and state property and sales tax laws.

Exempt Status

Exemption And Reporting

Religious congregations are not required to file an application with the IRS to be exempt under section 501(c)(3), but many do file Form 1023, application for exemption, to be on the published IRS list of section 501(c)(3) charities eligible to receive tax-deductible contributions. §508(c)(1)(A); Publication 78, *Cumulative List of Organizations Described in Section 170(c) of the Internal Revenue Code of 1986*, *available at* http://www.irs.gov/charities/article/0,,id=96136,00.html. Religious congregations do not need to file the annual federal information returns (Form 990) required of other kinds of charities. §6033(a)(3)(A)(i). State filing laws, however, may differ.

Intermediate Sanctions

The law designed to reduce the risk of revocation of exempt status does not exempt religious congregations and requires that, in setting compensation for clergy and others, particular care be taken in obtaining comparables and in recording the basis for the compensation package. §4958. *See below.*

Political Activities And Lobbying

Religious congregations cannot intervene in elections and are limited in the amount of lobbying they can do. §501(c)(3). *See below.*

Contributions, Fundraising

Dues And Fees

Religious congregations must acknowledge contributions of $250 or more (including dues); and they must inform members of the value of goods or services (other than intangible religious benefits) received in exchange for contributions. §170(f)(8). Difficult issues arise in connection with religious education and with donation of automobiles. *See below.*

Fundraising

Various fundraising activities, such as advertising in tribute books or newsletters and sale of scrip, must be done carefully so as not to subject religious congregations to the federal tax on unrelated business income. *See generally* §§511-514. That is, exempt organizations—including religious congregations—are not taxed on income related to their exempt purposes, but are subject to income tax on income from unrelated activities. Being subject to unrelated business tax will not jeopardize exempt status, unless such unrelated activities come to dominate the organization. Fundraising activities may also be subject to state and local regulation. *See below.*

Many congregations have begun to encourage their members to consider sophisticated estate planning techniques, such as charitable lead trusts or charitable remainder trusts, to benefit the congregation. Such plans must comply with all applicable tax rules, and members should consult their own tax advisors to understand the consequences.

Issues For Clergy And Other Staff

Income Tax Withholding, Social Security, Medicare

Clergy are subject to a unique set of tax rules regarding their compensation. Those regularly employed by a congregation are almost always consid-

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ered to be employees, but withholding of income tax is not required and they are subject to self-employment rather than employee payroll taxes. §§3401(a)(9),1402(a)(8),1402(c)(4),and 3121(b)(8(A). Their compensation should be reported on Form W-2, with no social security or Medicare tax withheld, not on Form 1099. *See below.*

Parsonage Or Housing Allowance

Clergy may exclude from income for purposes of the income tax the fair rental value of their housing, if certain requirements, including formal action by the religious congregation's board, are met. §107; Treas. Reg. §1.107-1. The amount of this housing allowance, along with clergy salary, is, however, subject to self-employment tax. §1402(a)(8). *See below.*

Discretionary Funds

An official statement of the religious congregation about the purpose and use of discretionary funds will help protect clergy from any assertion that these funds represent additional income to them. *See below.*

Other Employee Issues

For both clergy and non-clergy employees, some benefits are subject to income tax and payroll taxes and some are not. In many cases, the tax consequences of benefits, such as medical benefits and tuition discounts, will depend on how they are structured and to whom they are offered. For non-clergy employees, failure to comply with withholding and payroll tax laws risks the particularly stringent penalties on those who had the responsibility to deposit these funds. *See* §6672.

SUMMARY OF "INTERMEDIATE SANCTION" PROVISIONS APPLICABLE TO TAX-EXEMPT ORGANIZATIONS • The tax law makes it especially important to obtain comparable data in setting compensation. Some years ago Congress passed legislation, known as intermediate sanctions, requiring that nonprofit organizations pay reasonable compensation. §4958, Teas. Reg. §53.4958-4. Violation of these rules can lead to imposition of sizeable excise taxes on senior staff and organization managers (which include directors or trustees) of the organization. §§4958(a)-(b), (f)(2); Treas. Reg. §53.4958-1(d)(2).

The IRS has issued regulations regarding this legislation. Treas. Reg. §53.4958-1 through §53.4958-8. These regulations give a presumption of reasonableness for compensation (and other transactions, such as sales and contracts) if and only if the organization follows very specific procedures. Treas. Reg. §53.4958-6. The procedures include the organization obtaining and relying upon appropriate data as to comparability for compensation of those who have substantial influence over the organization and who receive total economic benefits above a specified amount ($110,000 for 2009 and 2010). IRS Notice 2009-94.

These procedures also require that the organization concurrently record the compensation package, the basis for the compensation package (including the comparables), and those who voted on the compensation package. Under the regulations, even small organizations (defined as those with gross receipts under $1 million) must obtain three comparables to have the benefit of the presumption or reasonable compensation.

This law does not exempt religious organizations, although the regulations state that the IRS will comply with the Church Audit Act. Treas. Reg. §53.4958-8(b). Under the Church Audit Act, the IRS could seek to impose these taxes only if it has a reasonable belief that such taxes are due and various notice requirements have been met. *See generally* §7611. The IRS has proposed but not finalized regulations under the Church Audit Act.

RULES REGARDING LOBBYING AND POLITICAL ACTIVITIES BY SECTION 501(C)(3) ORGANIZATIONS • The Internal Revenue Code distinguishes political campaigns from attempts to influence legislation. §501(c)(3).

All section 501(c)(3) organizations, including religious congregations, are prohibited, at risk of losing exemption, from participating in political campaigns. In general, political campaigns are defined for this purpose as campaigns by candidates for elective office. *Id.* (This prohibition was first introduced by Lyndon Johnson as an amendment in 1954. *See Charities, Churches, and Politics, available at* http://www.irs.gov/newsroom/article/0,,id=161131,00.html.) In *Branch Ministries v. Rossotti*, 211 F.3d 137 (D.C. Cir 2000), a federal appellate court upheld revocation of a church's exemption for running anti-Clinton newspaper ads. (The church had claimed, among other arguments, that the political campaign prohibition violates the First Amendment.)

Tax-exempt charities, including religious congregations, cannot endorse or oppose any candidate, directly or indirectly. They also cannot contribute any money or resources to any candidate's campaign or political party or rank candidates, even if the ranking is the result of neutral process. *See* Rev. Rul. 2007-41; *The Association of the Bar of the City of New York v. CIR*, 858 F.2d 876 (1988), *cert. denied*, 490 U.S. 1030 (1989); *IRS Tax Guide for Churches and Religious Organizations*, *available at* http://www.irs.gov/pub/irs-pdf/p1828.pdf. Avoid statements from the pulpit, at any official function, or in any official publication—including activities of any social action committee—that name candidates or that comment on their positions, because such statements are likely to be treated as being the position of the organization. *Id.*

Not all activities involving campaigns for elective office are considered prohibited political activity. Charities can register voters, conduct candidate debates, distribute general voter education information, or run get-out-the vote operation on election day—but only if these activities are conducted in a nonpartisan manner. *See* FS 2006-17, *available at* http://www.irs.gov/newsroom/article/0,,id=154712,00.html. A debate will not be considered nonpartisan unless all qualified candidates are invited to attend. *See* Rev. Rul. 86-95, 1986-2 C.B. 73.

In addition, clergy or other senior staff can on their own behalf and on their own time take a public position on a candidate or sign an endorsement letter published in a newspaper. *See* Rev. Rul. 2007-41, 2007-1 C.B. 1421; *IRS Tax Guide for Churches and Religious Organizations*. If the clergy's affiliation with the religious congregation is shown, however, accompanying language (such as "Affiliation for identification purposes only") should clearly disclaim the congregation's involvement. *Id.*

Although any involvement in a political campaign for elective office is prohibited, religious congregations, like other charities, can participate in lobbying to a limited degree. §501(c)(3). For tax purposes, lobbying is distinguished from intervening in electoral politics. *Id.* Lobbying is defined as an attempt to influence legislation, either directly through legislators or indirectly through grass roots campaigns which ask citizens to contact their legislators. *See* Treas. Reg. §1.501(c)(3)-1(c)(3). (Taking such positions on initiatives or propositions is considered lobbying, not political campaign activity. *See* Treas. Reg. §56.4911-2(b)(1)(iii).)

Under the Code, lobbying by charitable organizations is permitted to a limited extent; it cannot be a substantial part of the organization's activities. §501(c)(3); Treas. Reg. §1.501(c)(3)-1(c)(3). The meaning of substantial is not clear, but it is clear that it means more than dollars spent. *See Haswell v. U.S.*, 500 F.2d 1133 (Ct.Cl. 1974), *cert.denied,* 419 U.S. 1107 (1975). (Organizations other than churches can choose to have their lobbying activities subject to specified dollar limits, but this option is not available to churches. §501(h), (h)(5)(A).) The

Supreme Court has upheld the constitutionality of the lobbying limits, although the case did not involve a religious organization. *Regan v. Taxation with Representation*, 461 U.S. 540 (1983).

SUBSTANTIATION AND QUID PRO QUO REQUIREMENTS • To deduct contributions of cash or by check of less than $250, the donor must have a bank record or a written communication from the religious congregation (including electronic mail correspondence) showing the congregation's name, the date of the contribution, and the amount of the contribution. §170(f)(17). Offering envelopes are no longer sufficient to substantiate donations; religious congregations may wish to start providing periodic summaries of cash contributions to their members.

If charitable contributions total $250 or more, however, donors must substantiate the contribution with a contemporaneous acknowledgment. §170(f)(8). Substantiation requirements for deductible contributions of $250 or more may be satisfied for several such contributions with one or more contemporaneous acknowledgments. Treas. Reg. §1.170A-13(f)(1). Since each payment is considered separately, contributions of less than $250 are not subject to these heightened substantiation requirement, even if they exceed $250 in the aggregate. *Id.*

The acknowledgment must provide (1) the amount of cash paid and a description of any property transferred, (2) a statement of whether goods or services were provided for consideration, in whole or part, for such cash or property, (3) a description and good faith estimate of the value of any goods or services so provided, and (4) a statement by organizations providing intangible religious benefits that they do so. Treas. Reg. §1.170A-13(f)(2).

The written acknowledgment is contemporaneous if the taxpayer obtains it on or before the earlier of the taxpayer's filing date for the original return for the taxable year in which the contribution was made or the due date, including extensions, for such return. Treas. Reg. §1.170A-13(f)(3).

Goods or services are provided for consideration if the "the taxpayer receives or expects to receive goods or services in exchange for payment." Treas. Reg. §1.170A-13(f)(6).

Goods and services received in connection with fundraising may be disregarded and thus need not be acknowledged if either they have value of not more than two percent of the amount contributed, up to a maximum (for 2010) of $96, or if the goods received are only token items with the charity's name and logo or low-cost items worth no more than $9.60 when the taxpayer makes at least a minimum payment of $48. Treas. Reg. §1.170A-13(f)(8); Rev. Proc. 2009-50. (These numbers are adjusted for inflation annually.)

Newsletters of less than commercial quality and low-cost items provided for free without advance orders also are deemed to have insubstantial value. Rev. Proc. 90-12, 1990-1 C.B. 471.

The charitable contribution consequences of quid pro quo contributions—contributions that are partly a charitable contribution and partly consideration for return benefits in the form of services or goods—that exceed $75 must be disclosed; that is, the amount above the fair market of goods and services received that is deductible as a charitable contribution. §6115; Treas. Reg. §1.6115-1(a)(1). Failure to satisfy these rules subjects the charity to penalties of $10 per contribution, with a maximum of $5,000 per event or mailing. §6714.

The burden is on the taxpayer to show that all or part of a payment to a charitable organization is a contribution or gift. Treas. Reg. §1.170A-1(h)(1). A charitable deduction is not allowed for a payment to charity for goods or services (other than for intangible religious benefits) unless (a) the amount exceeds the fair market of the goods or services and (b) the taxpayer intends to make a payment in excess of such fair market value. Treas. Reg. §1.170A-1(h)(2). In determining this excess, if any,

the taxpayer may rely on the value of the goods and services as provided by the donee organization, unless the taxpayer knows the donee's stated value or good faith estimate of value is unreasonable. Treas. Reg.§1.170A-1(h)(4).

Dues paid to a religious congregation for membership are deductible; what is received in return for dues is deemed to be an entirely intangible religious benefit.

Recent decisions by the Ninth Circuit Court of Appeals, involving suits by a family named Sklar against the IRS Commissioner, concluded that the part of the payments by parents to a Jewish religious day school for religious education are NOT deductible as charitable contributions. *Sklar v. CIR*, 549 F.3d 1252 (9th Cir. 2008), *cert. denied,* 130 S.Ct. 53 (2009) *Sklar v. CIR*, 282 F.3d 610 (9th Cir. 2002). There is no IRS or judicial authority permitting deduction for costs of religious education; these costs are seen as payment for education, not a contribution that results in an intangible religious benefit.

In the case of donations of automobiles, new rules generally limit any deduction above $500 to the amount for which the charity sells the car. §170(f)(12).

An organization may use any reasonable methodology in making a good faith estimate of the value of goods and services it provides. Treas. Reg. §1.170A-13(f)(7). For goods or services that are not generally available in a commercial market, the good faith estimate may use goods or services that are similar or comparable even if they do not have the unique qualities of those offered by the organization. Treas. Reg. §1.6115-1(a)(2).

Acknowledgment for unreimbursed out-of-pocket expenses is satisfied if the taxpayer has records of the expenditures and obtains a timely statement from the organization describing the services provided by the taxpayer and whether the organization provided any goods or services in consideration for them. Treas. Reg. §1.170A-13(f)(10).

LAWS REGARDING CHARITABLE FUND-RAISING • Charitable fundraising, including that conducted by religious organizations, is subject to federal, state, and local laws.

Charitable contributions are deductible for income tax purposes only to the extent that they exceed the fair market value of what is received. Treas. Reg. §1.170A-1(h)(2). NOTE: The deductible contribution must be reduced by the fair market value of what is received, not the cost to the congregation. Thus, having the goods or services donated to a religious congregation does not prevent reduction of the deductible amount.

Additional federal disclosure laws apply to payments above $75 that involve both a charitable donation and a receipt of goods or services. §6115. Any fundraising event that costs more than $75 and involves the provision of a meal, such as a dinner dance or the typical "rubber chicken" dinner, will be subject to these rules. In such cases, the reduction in deductible contribution needs to be disclosed on the solicitation/invitation or receipt for the event. *Id.* A sample disclosure would look like this:

The estimated value of each ticket for the [name of event] [dinner/lunch/gala] is [$XX]. Only the amount of your contribution in excess of the value received in exchange for your contribution is tax deductible.

Auctions require particular care. *See* Treas. Reg.§1.170A-1(h)(5), Example 2. Fair market value of what is received needs to be established. In many cases, the amount paid is below fair market value and thus there is no charitable contribution deduction. In other cases, the amount bid will be the only indication of fair market value. Also, in a few states, such as California, the religious congregation must charge—and pay—sales tax on auction items.

Raffles and lotteries require particular care and state laws, including state gambling law, must be consulted. Under federal law, if someone wins $600 or more gambling (and gambling includes raffles), the religious congregation must issue a form W-2G,

the form for reporting gambling winnings, and if winnings amount to more than $5,000, the congregation must withhold. §3402(q).

Sales of advertising, scrip, magazines, candy, etc. will be exempt from tax on unrelated income if they meet some of the special exceptions to that tax. The most likely exceptions are (1) having substantially all the work conducted solely by volunteers or (2) having the sales activities not be regularly carried on—that is, sales activities conducted only a few weeks a year are not subject to tax. §§512, 513(a)(1).

Religious organizations need to determine whether they are subject to state and local solicitation or disclosure requirements.

Passive income received by religious congregations in the form of dividends, interest, rent for real property, and royalties is not subject to income tax. §512(b)(1), (2). It is important, however, that the rent be charged for space, not for services. Also, if anywhere between 10 and 50 percent of rent received is attributable to personal property, the amount attributable to rental of personal property is taxable. §512(b)(3). If more than 50 percent of the rent received is for personal property, all of the rental income received is taxable. *Id.* Thus, religious congregations that rent out not only social halls but also tables and chairs, etc. for non-religious purposes need to take great care. Also, debt-financed income, even if passive, will generally be subject to income tax. §514.

PAYROLL TAXES AND WITHHOLDING FOR CLERGY • Although clergy who work regularly part or full-time are, with only rare exceptions, employees of their religious congregations, they are subject to a special set of rules when it comes to income tax withholding and liability for social security and Medicare taxes. (Note that while there is a limit to the amount of wages to which social security taxes apply, there is no longer any limit on the taxes for Medicare.)

Income tax withholding is not required for clergy, although they may elect to have income tax withheld. §3401(a)(9).

There are special rules in the Code requiring that clergy be treated as self-employed for purpose of social security and Medicare taxes (but please note, only for this purpose). §§1402(a)(8),1402(c)(4), 3121(b)(8(A); *Social Security and Other Information for Members of the Clergy and Religious Workers*, IRS Publication 517, *available at* http://www.irs.gov/pub/irs-pdf/p517.pdf. That is, they are subject to self-employment tax, under SECA (the Self-Employment Contribution Act), rather than taxed as employees under FICA (Federal Insurance Contribution Act) on the amounts they are paid. In essence, this means that they are liable for both halves of this tax, where in the case of employees, the employee pays half and the employer pays half.

For clergy, because they are treated as self-employed, the social security tax is 12.4 percent of wages up to $106,800 in 2009 and 2010. Social Security Administration Notice 2009-80. Medicare tax is 2.9 percent of all wages. (For clergy, these taxes apply to net self-employment earnings; that is, based on an algebraic formula, one-half of the tax is deducted on their personal tax return in calculating the amount on which they pay self-employment tax.)

Although parsonage/housing allowances are excluded from income tax, they do constitute wages for purposes of social security and Medicare tax. §1402(a)(8). That is, clergy are subject to SECA (meaning they must pay both halves of the payroll tax) on all the wages they receive as clergy—both their salary and their parsonage/housing allowance.

In the vast, vast majority of situations, religious congregations should report the income of clergy who work regularly for the religious congregation on Form W-2, NOT Form 1099. That is, the law treating clergy as self-employed for purposes of

Medicare and Social Security does NOT make them independent contractors rather than employees for purposes of reporting income. The amount of income reported is reduced by the amount of parsonage/housing allowance properly claimed by the clergyperson, although it can be listed in the "other" box on the W-2. If the congregation has withheld amounts to help clergy satisfy payroll tax obligations, such amounts are reported as additional income tax withheld and not as social security or Medicare tax withheld.

If religious congregations reimburse their clergy for half of the payroll taxes, as some do, this reimbursement must be reported as additional income and is itself subject to payroll taxes (subject to the rules that permit certain income tax and payroll tax deductions for people subject to self-employment tax.)

Clergy employed by religious congregations remain employees for other purposes of the Code and for state law purposes. Thus, for example, they may deduct miscellaneous itemized deductions, including unreimbursed employee expense, only to the extent these exceed two percent of adjusted gross income. As employees, they are also eligible for employee fringe benefits, such as cafeteria plans, medical plans, etc. and for coverage as employees under the congregation's insurance plans.

Erroneously treating clergy as self-employed independent contractors poses several kinds of risks and disadvantages for the clergy. Many tax-free fringe benefits, such as cafeteria plans, are available only to employees. Audit risk is much lower for employees. If clergy are audited, the IRS in almost all cases will reclassify them as employees and the clergy/taxpayer is then likely to be liable for taxes, interest, and penalties for deductions improperly taken on Schedule C instead of as unreimbursed employee expenses. Generally, health plans and insurance contracts cover only employees.

OVERVIEW OF RULES REGARDING CLERGY'S PARSONAGE OR HOUSING ALLOWANCE • Clergy are defined by the tax law as those who are ordained, commissioned, or licensed. Treas. Reg. §1.1402(c)-5. Clergy who are hired to fill administrative or other positions and who do not function as clergy or teachers of theology are not entitled to parsonage/housing allowances. (A case challenging the constitutionality of the parsonage/housing allowance on First Amendment establishment clause grounds is currently being heard in California. *Freedom from Religion Foundation, Inc. v. Geithner*, No. 09-2894 (E.D. CA).) The IRS requires that clergy be hired to function as clergy on a substantial basis to be entitled to parsonage or housing allowances.

Clergy who function as such in the congregation are entitled to exclude from income the lowest of the following three numbers: (1) the portion of their income designated in advance by their employer as a housing/parsonage allowance; (2) the amount the clergy in fact used to pay for housing-related expenses; (3) the fair rental value of the home (furnished) plus utilities. §107; Treas. Reg. §1.107-1. Thus, particularly in the year a clergy person buys a house and pays a down payment, all actual housing expenses may not be excludible from income. Legislation passed in May 2002 and now codified in section 107 makes clear that housing allowances are limited to fair market rental value.

For any amounts to be excluded, there must be a housing/parsonage allowance adopted (1) by official action and (2) in advance of the time the amounts to be excluded are earned by services. Treas. Reg. §1.107-1(b). Applicable IRS regulations list the following as examples of official action: employment contract, board minutes, board resolution, and congregational budget. *Id.*

Some congregations follow the practice of having the clergyperson estimate, before the year begins, the housing expenses for the coming year and

use that estimate as the basis of a board resolution. Such practice is perfectly acceptable.

As noted, it is also permissible to set the allowance in the clergy's employment contract, since the contract is in writing, approved by the board and adopted before the amounts are earned.

Amounts that come within the parsonage allowance include: down payment, mortgage payments on loan to purchase or improve home (both principal and interest); real estate taxes, property insurance; utilities (electricity, gas, water, trash pickup, local telephone charges); furnishings and appliances (purchase and repair); structural repairs and remodeling; yard maintenance and improvements; maintenance items (household cleaners, light bulbs, pest control), *subject, however, to the limits described above.*

The amount of the parsonage allowance reduces the amount reported as compensation on the clergyperson's W-2 (or Form 1099, in those rare cases where the clergyperson is operating as an independent contractor), so it is important that the amounts be supplied by the clergy to the congregation in time to prepare the required form. It is recommended that the congregation have the clergyperson substantiate the amount claimed as a parsonage allowance.

In general, clergy do not need to work full-time to be eligible for the parsonage allowance. (Under the facts of the revenue ruling recognizing a Jewish cantor as a minister of the gospel for purposes of section 107, the cantor was employed full-time by the congregation. Rev. Rul. 78-301.)

Remember that anyone receiving the parsonage allowance must be treated as self-employed for purposes of social security and Medicare (payroll) taxes. They are subject to SECA, not FICA.

Clergy are permitted both to exclude housing from income and to deduct mortgage interest. §265(a)(6).

CLERGY DISCRETIONARY FUNDS • Religious congregations must exercise oversight of discretionary funds to protect both the clergy and the members who contribute. Clergy discretionary funds raise two different kinds of issues: income to clergy and deductibility for donors.

To avoid the former, the clergy cannot use the funds for personal purposes. (If they can, all monies in their discretionary fund could be deemed taxable income to them.) Examples of inappropriate personal purposes include such uses as professional dues, fees to attend conferences, tickets for the clergy or their family to attend events and dinners, gifts to others from the clergy, and satisfaction of personal pledges by the clergy.

To accomplish the latter, the clergy must be acting as an agent of the religious congregation. That is, the funds do no come from the clergy personally; they come from the congregation through the discretionary fund. Clergy act as agents of the congregation. The money is the property of the congregation, and the congregation's governing board must retain oversight over the funds to ensure that they are spent for religious, educational, and charitable (i.e. tax-deductible) purposes. Charitable for these purposes means relief of the poor, distressed, and needy. The IRS defines "needy" for these purposes to include not only financial impoverishment but also "a person who is temporarily not self-sufficient as a result of a sudden and severe personal or family crisis." Treas. Reg. §1.170A-4A(b)(2)(ii)(D). (Moreover, these funds cannot be used for political purposes, that is, they cannot be used for participating in an election campaign, at risk of losing the religious congregation's exemption.)

The bank account for the discretionary fund should be an account of the congregation, albeit one for which the clergy has signing authority. A sample resolution to accomplish these goals might look like this:

The clergy act as agents of this congregation in disbursing funds from their discretionary funds. These funds remain

the property of the congregation. The clergy of the congregation are authorized to use the monies contributed to their discretionary funds for needs and projects consistent with the religious, educational, and charitable purposes of the congregation. No monies from these discretionary funds shall be used or distributed for personal purposes of the clergy or their family. The purposes for which discretionary funds have been used shall be reviewed annually by the then-President and or any delegates appointed by the then-President, including, should the President so choose, outside auditors.

Oversight by the congregation should not violate the purpose of these funds—which is to allow the clergy to decide how to use these funds through exercise of their discretion within the broad permitted categories. Use of discretionary funds need not require prior approval, but all distributions must be reviewed for consistency with permitted uses. Thus, even use of discretionary funds for particular individuals must satisfy charitable purposes and be subject to review, but review should not violate confidentiality or expose any recipients of funds to embarrassment. The necessary oversight must be done with care and sensitivity. It can be accomplished by having the clergy report by category on the kind of uses to which they had put the funds and the amounts expended in each category, along with more detailed review annually of each distribution by one or two officers or outside auditors who are under an obligation to keep details about any individual recipient confidential. The purpose of such review is not to second guess or direct the clergy's use of the funds, but only to ensure that each use of the fund is within the permitted purposes.

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Special Feature / Judah I. Kupfer, Esq.

The Taxability of Kollel Pay:

Tax and Withholding Obligations of a Kollel and Its Members

Introduction

Moshe is a member of a new *Choshen Mishpat kollel*. As a member, he is required to attend at set times for learning with his *chavrusa* at a specific *beis medrash*, study a specific curriculum, be present at an in-depth lecture given by the *Rosh Kollel* twice a week, and score high on occasional written exams that test his knowledge of the intricate subject matter. At times, the *kollel* also requires Moshe to tutor young children with their *Chumash* studies, provide occasional *shiurim* to students of an outreach *kiruv* program that the *kollel* supports, and, twice a year, spend Shabbos in an out-of-town community to present a lecture on a topic of *halachah*. Moshe is provided with a monthly paycheck of $600. Moshe uses this money to pay for his family's personal living expenses. Also, prior to each Sukkos and Pesach, the *kollel* provides Moshe with an additional $400 to help defray the costs of his added holiday expenses. How does Moshe report his income? Is any or all of it taxable?

As our generation has seen a surge of Torah learning, many now find themselves in Moshe's situation and are unsure of the tax ramifications of their *kollel* pay. With the increase of government scrutiny and the penalties for infractions being so high, it is incumbent on each *kollel* and student alike to get it right.

The taxability of payments provided by a *kollel* to its members/students (which we will refer to simply as "Kollel Pay") has generated much confusion and varying views. The reason for the confusion is chiefly due to the mistaken assumption that all *kollelim* are the same. In reality, though, different *kollelim* operate in different manners and the taxability of Kollel Pay can thus vary broadly, depending on the particular circumstances of the *kollel*. In assessing the taxability of Kollel Pay, it is therefore necessary to analyze each *kollel* independently, in light of its customs, requirements, rules and regulations.

Outlined below are four broad classifications of how to categorize Kollel Pay. As each *kollel*'s obligations are diverse and fact-specific, the reader is cautioned to seek specific guidance from a tax professional in applying the principles articulated below. The rules outlined below only apply to *kollel* members who are U.S. citizens — different rules apply to international students.

It is also important to note at the outset that should Kollel Pay be provided for segregated tasks, assignments, projects or services, it is possible for different portions of Kollel Pay to fit within different categories, resulting in part taxable and part non-taxable even when being paid to the same student. Later, we'll revisit Moshe's situation and seek to apply these principles to his circumstances.

Non-Taxable Fellowship

The first category is a non-taxable fellowship. However, such a classification will likely not apply to most *kollelim*. This category would include payments to the student used only for tuition and required fees, books, supplies, or equipment. Non-taxable fellowships are not taxable income to the student, are not subject to FICA (also known as "payroll taxes," which are made up of taxes for Social Security and Medicare equal to 15.3% of the taxpayer's salary — generally, the employer is required to pay half, i.e. 7.65%, and the employee pays the other half), and there is no requirement for the *kollel* to withhold or report these payments to either the student or the Internal Revenue Service (IRS).

A fellowship is tax free only if the student is a "candidate for a degree" at an "eligible educational institution," (each defined below) and if the student uses the fellowship to pay "qualified education expenses" such as required fees, books, supplies or equipment. Payments used to cover room, board, travel or any other living expenses would not be included. To the extent that a fellowship does not fit within these rules, it is considered a taxable fellowship.

A student is a "candidate for a degree" if (a) he attends a primary or secondary school or is pursuing a degree at a college or university, or (b) he attends an accredited (by a national recognized accreditation agency) educational institution that is authorized to provide (i) a program that is acceptable for full credit toward a bachelor's or higher degree, or (ii) a program of training to prepare students for gainful employment in a recognized occupation.

An "eligible educational institution" is one that maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at the place where it carries on its educational activities.

Since Kollel Pay is most often used for personal living expenses, it will generally not fall within this category. Additionally, while some *kollelim* may qualify as "eligible educational institutions," most *kollel* students are not "candidates for a degree."

Taxable Fellowship

The next category is a taxable fellowship. This category, typically known as a stipend and used as a living allowance, includes payments to the student other than those defined as non-taxable fellowships. There is no requirement that the recipient perform any services for the benefit of the *kollel* as a condition of receiving the payment and these payments are often made as an incentive for students to attend the *kollel*. It is important to emphasize that if the student is being paid for services, such payment is not a fellowship at all but rather a taxable compensation for services, the third category below.

A fellowship recipient is an individual who receives a taxable and/or non-taxable fellowship, and whose activities may include: Engaging in research programs or participating in training to further his individual educational development; conducting independent research and determining what research activities he will be conducting; or providing help to a *Rosh Kollel,* provided that the activities are principally related to the recipient's progress rather than to the needs of the *kollel*.

> *It should be noted that it is possible for different portions of Kollel Pay to fit within different categories*

To the extent, however, that a program requires teaching or research activities to be performed by the recipient and these activities are performed for the benefit of the *kollel*, or if the recipient is performing other services for the *kollel* in exchange for a payment, the payment should be characterized as a payment involving services (the third category, below) and is not a fellowship.

Although taxable fellowships are taxable income to the student, the *kollel* is not required to report them to the student or the IRS, nor is the *kollel* required to withhold tax on them. These funds are also not subject to FICA. Students are responsible for reporting these payments and remitting any tax due, which can include estimated tax filings. It is important, however, to keep in mind that low income earners may not have an obligation to pay any federal income taxes. Given the total taxable amount earned by the student (and if married, the student's spouse as well), students must determine with their tax advisor whether they have a federal income tax obligation and, if so, whether it should be paid quarterly (as estimated taxes) to the IRS or with the filing of their personal income tax return.

Taxable Payments Involving Services

The third category involves taxable payments for services. This category is defined as payments made with respect to teaching, research and/or other activities performed for the benefit of the *kollel*, including activities for the *kollel* that may be associated with the student's course of study and educational experience. This would include a student's teaching responsibilities, tutoring and other activities where the primary purpose is to benefit the *kollel* or an objective of the *kollel*. If, however, as part of their program of training, all *kollel* students are required to perform part-time teaching with the primary purpose to benefit the student, such responsibilities should not be deemed part-time employment for which they are receiving taxable compensation.

Compensation is taxable to the recipients, and the *kollel* is required to withhold federal and state taxes and report such payments to the IRS (the *kollel* should issue a form W-2 to the student). The *kollel* is also required to contribute to half of the student's FICA obligation and withhold the other half from the student's pay.

Please note, the student may be able to qualify to have a portion (or all) of his taxable compensation (i.e. any Kollel Pay that is taxable compensation for services) pre-designated as a parsonage housing allowance that would be exempt from federal income tax (and, in most states, state and local income tax as well). The pre-designated amount would have to actually be used that year for the student's "housing expenses." The student would still be required to pay Social Security and Medicare taxes (both parts of his FICA obligation, see next paragraph) on the entire part of his Kollel Pay that fits within this category (both the parsonage and non-parsonage amounts). To qualify for parsonage, the student must be classified as a "minister" whose job it is to conduct "ministerial services."

By being classified as a minister, the student would also be subject to certain other rules applicable to ministers with respect to their ministerial services, including: (a) an exemption from FICA — thus, the *kollel* would not be required to withhold nor pay into FICA on behalf of the student; however, the student would be required to pay both parts of the FICA obligation on his own (also known as "SECA" or "self-employment taxes") in quarterly estimated payments; (b) the *kollel* would be exempt from federal income tax withholding on the non-parsonage amount, yet the student would be required to report and pay estimated federal income tax on his own on the non-parsonage amount.

As an aside, since parsonage is only available as payment for "ministerial services," Kollel Pay classified as a fellowship would likely not be eligible to be pre-designated as a parsonage housing allowance since a fellowship, by definition, does not constitute payment for services. If only part of a student's Kollel Pay is payment for ministerial services, while another part is provided as a fellowship, only the portion of pay categorized as payment for services may be eligible to be allocated as parsonage, assuming all the other requirements for receiving parsonage are met and that such service is ministerial in nature.

Those interested in designating part of their *kollel* pay as parsonage should seek specific guidance to ensure the proper application of the parsonage rules.

Charitable Grant to a "Needy" Individual

In very limited circumstances, Kollel Pay may be classified as charitable grants to needy individuals — essentially, a charitable tax-free gift. The IRS defines a needy person as someone who lacks the basic necessities of life — food, clothing, shelter, medical help or transportation —because of poverty or temporary distress. A person may have short-term needs in one or more of these areas even if he or she has resources (such as insurance or inheritances) that will be available in the long run.

If a *kollel* student fits within the definition of "needy," he may be eligible to receive a charitable gift. Such funds would be tax free to the recipient. The *kollel* would not be required to report such gifts to the student or issue forms 1099 or W-2, but would be required to maintain adequate records and case histories to show: (i) The name and address of each recipient of aid; (ii) The amount distributed to each; (iii) The purpose for which the aid was given; (iv) The manner in which the recipient was selected; and (v) The relationship, if any, between the recipient and (a) members, officers, or trustees of the *kollel*, or (b) a grantor or substantial contributor to the *kollel* or a member of the family of either. Before making such distributions, the *kollel* should also ensure that it is authorized to make such grants to needy individuals in its organizational documents. Should the *kollel* file a year-end form 990, such information must also be disclosed on it within Schedule I.

> *The IRS defines a needy person as one who lacks the basic necessities of life*

Some tax experts are doubtful about the availability of this category to *kollel* students if the *kollel* students are required to perform any kind of service in order to receive the funds. Even if a *kollel* simply requires its students to be in attendance, such a requirement may be problematic to this classification. Additionally, if the funds are provided on a regular basis (e.g. weekly, monthly), there is a concern that the distributions

look like compensation (which is taxable) as opposed to a scenario where funds are provided only at certain times of the year, e.g., before a Yom Tov, which would seem more akin to a non-taxable charitable gift. Furthermore, if any part of the Kollel Pay provided to a particular student is deemed compensation, an employer/employee relationship is thereby created between the *kollel* and the student. When that occurs, there is a presumption that any and all economic benefit provided by the employer to the employee is compensation and may not be considered a tax-free gift.

Tying It All Together

With a background of the law in hand, we can now return to Moshe's scenario. At the outset, we can probably rule out any part of Moshe's pay being classified as a non-taxable fellowship because the pay is being used for his personal living expenses — not for tuition or other required fees or equipment. Additionally, although the *kollel* may be considered an educational institution (we don't know enough about the *kollel* to say for certain), Moshe is likely not a candidate for a degree. So, we now need to take each of Moshe's responsibilities and examine them one by one.

First, Moshe is required to be in attendance at designated times, at a designated place, to study a set curriculum and attend bi-weekly *shiurim* given by the *Rosh Kollel*. These activities are consistent with taxable fellowship functions as Moshe is not acting to benefit the *kollel* in any way or performing any services. Thus, part of Moshe's Kollel Pay may be designated as a fellowship to assist him in his learning activities. For that portion of pay, the *kollel* would not be required to withhold federal income tax or FICA, but Moshe on his own would be required to pay federal, state and local income tax on this amount.

Second, the *kollel* requires Moshe to tutor children and lecture occasionally at the *kollel*-supported *kiruv* program. These activities represent services for which Moshe is being compensated. Thus, the part of his monthly pay representative of these services must be considered as taxable compensation. For this part of his income, the *kollel* is required to withhold federal income tax and FICA.

Should Moshe qualify as a "minister" (e.g. he has *semichah* or a certificate from his yeshivah detailing his qualifications to teach *limudei kodesh*), to the extent that his services qualify as "ministerial" in nature (e.g. learning *Chumash* with children and providing Torah lectures at a *kiruv* program), the *kollel* may pre-designate by "official action" as a housing allowance the part of Moshe's salary being paid to him in exchange for performing ministerial service. In such an instance, the *kollel* would not be required to withhold on this portion of Kollel Pay but Moshe would have to pay quarterly estimated SECA payments. To the extent that the pre-designated amount is actually used that year for housing expenses, it would not be subject to federal income tax and in most cases, state and local income tax as well.

Third, Moshe is required to spend Shabbos at an out-of-town community and present a *shiur* while there. As all members of Moshe's *kollel* possess this responsibility and it would appear that the objective is to provide the *kollel* students with practical hands-on training to teach and act in a rabbinic capacity, such teaching responsibility would likely fall within the taxable fellowship category. Readers should be cautioned that the distinction between whether part-time services should be considered taxable compensation or a fellowship is often nuanced and dependent on the specific circumstances; a tax professional should be consulted in making that decision.

Last, Moshe is paid a sum of $400 at certain times of the year to help defray holiday expenses. If Moshe were a "needy" individual (we don't know whether he has other sources of income, savings or investments to say whether he is indeed needy) who was not receiving any taxable compensation for services from the *kollel*, he may be able to classify these payments as a tax-free gift. However, since Moshe is receiving taxable compensation in exchange for services rendered (i.e. the part-time teaching), the IRS would consider any "gift" given from employer (the *kollel*) to employee (Moshe) as taxable.

This example should make clear that different kinds of activities will trigger different tax and withholding obligations — even when provided to the same *kollel* student.

When does Kollel Pay qualify as income for the Earned Income Credit and Child Tax Credit?

Should a student receive Kollel Pay as part of taxable payment involving services, such pay should be considered "earned income" for purposes of the earned income and child tax credits, so long as it is reported on a form W-2 and taxes are paid, as required. If a parsonage housing allowance is allocated, such amount would be considered "earned income" for purposes of the earned income credit, assuming self-employment tax is paid (as required), since earned income includes "the amount of the taxpayer's net earnings from self-employment." However, payments designated as parsonage would not be considered "taxable income" to qualify for the child tax credit.

Kollel Pay classified as a fellowship, whether taxable or non-taxable, is not considered earned income for purposes of the earned income and child tax credits and the receipt of a taxable fellowship may also negatively affect one's eligibility for these credits (consult your accountant for further details). Similarly, a tax-free gift is not considered earned income for purposes of these credits.

Kollel Pay classified as payment for services (even if parsonage is designated) or as a fellowship (taxable or non-taxable) should likely be declared as a source of income for purposes of other government programs/benefits, but the specific details of programs vary and must be considered individually in each state.

Reporting Fellowships

Whether you must report your fellowship depends on whether you must file a return and whether any part of your fellowship is taxable.

If your only income is a completely tax-free fellowship (and assuming you and your spouse don't have any other taxable sources of income), you do not have to file a tax return and no reporting is necessary. If all or part of your fellowship is taxable or if you or your spouse earns other taxable income, you are required to file a tax return and report the taxable amount, whether or not you received a form W-2.

For information on whether you must file a return, see IRS Publication 501, Exemptions, Standard Deduction, and Filing Information, or your income tax form instructions. For additional information regarding reporting, see IRS Publication 970.

Conclusion

The taxability of Kollel Pay is dependent on the specifics of each *kollel*'s customs and practices. It may fall within one of four broad categories outlined in this article. However, professional guidance should be sought to ensure the proper application of these principles to the specifics of your *kollel* and particular circumstances.

* * *

This note is provided for general information and educational purposes. Neither its distribution to any party nor any statement or information it contains is intended to or shall be construed as establishing an attorney-client relationship or to constitute legal advice. Readers also are cautioned that the information in this note may not apply to all situations. Consequently, readers must not rely upon this note or information it contains as a substitute for competent individualized legal advice about the specific circumstances of the readers. Attorney advertising, prior results do not guarantee a similar outcome.

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Judah I. Kupfer, Esq. is a staff counsel at Agudath Israel of America. He previously practiced as an associate at the law firm of Allen & Overy LLP in New York. Mr. Kupfer is a summa cum laude graduate of Touro College, a magna cum laude graduate of Brooklyn Law School and an LL.M. taxation candidate at New York University School of Law. To contact the author, please email ykupfer@agudathisrael.org. Questions and comments are welcome.

Operating Under the Church Umbrella

Introduction

Most of the schools in the American Association of Christian Schools ("AACS") operate under the umbrella of a local church ministry. Under current federal law, churches are considered to be tax-exempt organizations under Section 501(c)(3) of the Internal Revenue Code, without the necessity of applying to the Internal Revenue Service ("IRS") for tax-exempt status. Schools that operate under the umbrella of a church ministry enjoy the same tax-exempt status as their sponsoring churches.

Some AACS schools, however, do not have a local church sponsor. Those independent schools that do not operate under the umbrella of a local church ministry must file a formal application with the IRS seeking tax-exempt recognition. The IRS routinely grants these applications on the grounds that the independent school is a religious or educational organization that qualifies for tax-exempt recognition under Section 501(c)(3) of the tax code.

Because religious schools can obtain tax-exempt recognition, we are sometimes asked whether a school that operates under a larger church ministry should ever consider obtaining its own, separate tax-exempt status. In this Legal Report, we will discuss three different scenarios in which a school may want to consider the idea of obtaining tax-exempt recognition apart from its sponsoring church.

Discussion

A. What does it mean to be a "tax-exempt organization"?

Generally speaking, a tax-exempt organization is an entity that is not required to pay federal income taxes. The tax code includes many different categories of tax-exempt organizations, but churches and Christian schools fall under the group listed in Section 501(c)(3) of the code, i.e., charitable, educational or religious organizations. Churches enjoy automatic recognition as tax-exempt organizations under the tax code. For that reason, churches are not required to file a formal application with the IRS seeking tax-exempt recognition. While churches are automatically recognized as tax-exempt organizations under Section 501(c)(3) of the code, schools that desire their own tax-exempt recognition must go through a formal application process with the IRS.

Those entities that come within the definition of tax-exempt organizations listed in Section 501(c)(3) have another distinct advantage. That advantage is that most gifts or donations to 501(c)(3) organizations are tax-deductible for the donor. This advantage encourages individuals and corporate donors to make contributions to churches, religious schools, and other charitable organizations.

B. What situations might occur that would cause a Christian school to consider obtaining its own tax-exempt recognition from the IRS?

As noted above, a religious school that operates as a ministry of a local church enjoys the same tax-exempt status as the church. For that reason, a church school is not

required to seek separate tax-exempt recognition from the IRS. Nevertheless, situations may arise in which the church school either desires - or is asked - to seek its own, separate tax-exempt recognition. We will address three of those situations below. Please note, however, that this list is not exhaustive, and your ministry may encounter different scenarios in which the issue of separate tax-exempt recognition for the school should be considered.

1. A corporate donor wants to make a large contribution to the school, but does not want the gift to go to - or through - the church.

A church school could encounter a situation in which a corporation (or an individual) desires to make a donation to the school, but, for a variety of reasons, wants the donation to go directly to the school and not through the church. Two different problems can arise in this situation. First, the donor might refuse to make the donation to the church school because the school does not have its own "determination letter" from the IRS. And second, the donor might refuse to make the donation to the school because all gifts to the school must go through the church. As is discussed below, neither of these problems would arise if the school has obtained its own separate, tax-exempt recognition from the IRS.

Problem #1 - The school has no "determination letter."

When an organization files a formal application with the IRS seeking tax-exempt recognition, the IRS sends a letter to that organization in which the IRS makes a "determination" as to whether the organization has met the necessary requirements to become a tax-exempt organization. This letter is known as a "determination letter," and the information in this letter will tell a corporate donor whether the organization is entitled to receive tax-deductible donations. Many corporations, foundations, and wealthy individuals will not make a donation to an organization without first reviewing the organization's "determination letter."

As noted above, because churches are automatically recognized as tax-exempt entities under the tax code, they are not required to file an application with the IRS seeking tax-exempt recognition. This means that most churches - and most church schools - do not have a "determination letter." In fact, a church will never receive a "determination letter" unless it goes through the formal process of filing an application with the IRS, and receives written recognition as a tax-exempt entity.

For most corporate and other sophisticated donors, it is not enough to say, "but we are tax-exempt just like the church." To the contrary, most such donors - and their professional advisors - must see a "determination letter" prior to writing a check. In the vast majority of situations, when the school operates as a ministry of the local church, it will not have the "determination letter" that the corporation, foundation, or individual requires before making a donation to the school.

Problem #2 - All gifts to the school must go through the church.

In many church organizations, a gift to an individual ministry of the church must be "made out" to the church, and it must go through the church. One reason for this is that the only entity that is officially recognized by the IRS as a tax-exempt organization is the church. In other words, if the school operates as a ministry of the church, then it is not recognized as a separate tax-exempt entity, and the donor cannot send the gift directly to the school. Accordingly, the gift must go through the church.

This situation causes a problem for certain corporate donors. While corporate policy may allow donations to go to schools for educational purposes, that same policy may prohibit gifts to churches. Therefore, if the school says that the gift must go through the church, the corporate donor may find another place to make the donation. (Similarly, other donors may question whether the gift will be used strictly for the school ministry if it must go through the church account.)

As a result of the two problems discussed above, a school may be passed over for a large corporate donation unless it obtains its own, separate tax-exempt recognition. In particular, if a school is recognized as a tax-exempt organization, then it will have a "determination letter" that can be presented to the potential corporate donor. In addition, as a separate organization, the school can receive gifts without the necessity of those gifts passing through the church account.

2. Certain state tax benefits' may be available only to a school that has obtained an IRS "determination letter."

Some states, although not all, grant certain sales, property, or other tax exemptions only to organizations that have applied for and received an IRS "determination letter." For example, the state of Georgia exempts school purchases from sales tax only if the school is exempt from state and federal income tax under Section 501(c)(3). The current policy of the Georgia Department of Revenue is that a school is exempt under Section 501(c)(3) - and entitled to sales tax exemption - only if it produces an IRS "determination letter." (This is the current policy in Georgia even though in the past some church schools have been able to prove their tax-exempt status without the benefit of a "determination letter.")

As you can see from this example, obtaining separate tax-exempt recognition for the school may pay for itself many times over in sales or property tax exemptions. You may want to consult your own state law to determine whether your school could take advantage of certain tax exemptions if the school obtained its own, separate "determination letter."

3. A church wants to decrease its liability exposure -- and its insurance premiums.

Unless you are a trial lawyer, you probably do not enjoy thinking about lawsuits - especially those involving your ministry. Yet, as you know, churches and schools are sued on a regular basis, under a number of different legal theories. A second reason to consider separate incorporation for the school - which will require applying for tax-

exempt recognition - is to reduce the liability exposure and insurance premiums for the church.

In many ministries, the Christian school is covered under the same insurance policy as the church. If the amount of coverage under the church's insurance policy is insufficient to cover a particular judgment against the school, then the injured party may look to the church property to collect any amounts owed to him or her.

Having a school covered by the same policy as the church increases the potential exposure for the church. In particular, hundreds of individuals may be involved with the school for several hours a day, several days a week, while the same is not true for the church. Moreover, the school, in all likelihood, has many more activities going on each week involving school vans, athletic events, and other potential liability factors.

In sum, the school presents a higher liability risk than the church. Insurance companies take this into account and adjust premiums accordingly. One way to reduce both the liability risk to the church and the amount of insurance premiums paid by the church is to incorporate the school separately and let the school carry its own insurance policy. Under most situations, if the school is incorporated separately from the church, then the church property should not be at risk if the school incurs a judgment that is in excess of its own insurance coverage.

As stated above, since incorporation creates a new school entity that is not a church, the school must apply to the IRS for tax-exempt recognition. Please note, however, that with carefully-drafted language in the school's incorporation documents, the church can retain ultimate control over the separately-incorporated school ministry.

C. What should our ministry do if we have questions about these issues?

If you believe that your Christian school should consider separate, tax-exempt recognition, you may want to contact Tim Townsend of the law firm Townsend McKee in Alpharetta, Georgia. Mr. Townsend is a Christian lawyer who specializes in non-profit work, and he has assisted many other churches and Christian schools with this and a variety of other matters. Mr. Townsend's contact information is as follows: Timothy W. Townsend; Townsend McKee, P.C.; 1000 Mansell Exchange West, Suite 180; Alpharetta, Georgia 30022; (770) 640-1640.

Conclusion

Most AACS schools operate under the umbrella of a larger church ministry. This arrangement works well for a variety of reasons. Nevertheless, your ministry may encounter situations in which you want to explore the idea of allowing the school to seek its own separate, tax-exempt recognition. Of course, this will be a ministry-by-ministry decision, and your ministry may decide that the school should always remain under the church umbrella regardless of factors that support separate, tax-exempt recognition for the school.

Right From The Start: Responsibilities of Directors of Not-for-Profit Corporations

NEW YORK STATE OFFICE

of the

ATTORNEY GENERAL

Charities Bureau

120 Broadway
New York, NY 10271
(212) 416-8400

www.oag.state.ny.us

RIGHT FROM THE START

RESPONSIBILITIES OF DIRECTORS OF NOT-FOR-PROFIT CORPORATIONS

Attorney General
ANDREW M. CUOMO

Charities Bureau
120 Broadway
New York, NY 10271

(212) 416-8401
http://www.oag.state.ny.us

New York State Attorney General Andrew M. Cuomo is pleased to offer this booklet to assist current and future boards of directors of New York not-for-profit corporations to understand and carry out their fiduciary responsibilities to the organizations they serve.

This booklet contains general information concerning fiduciary oversight by boards of charitable assets. It is not a substitute for advice from a qualified lawyer, independent public accountant or other professional. The Attorney General publishes another booklet, *Internal Controls and Financial Accountability for Not-for-Profit Boards,* which describes policies and procedures for the protection and oversight of charitable assets. That booklet and other publications of interest to board members may be found at http://www.oag.state.ny.us.

* * * *

I. WHO MAY JOIN A BOARD?

Anyone over eighteen is legally qualified to serve on a board. Board members come from all backgrounds, bringing many different talents and professional and life experiences to the organizations they serve.

II. WHAT SHOULD A PROSPECTIVE BOARD MEMBER KNOW BEFORE JOINING A BOARD?

Anyone considering becoming a director of a not-for-profit corporation should do the following *before* joining:

⇨ Understand the commitment of time and effort that will be expected from you, including attendance at meetings and participation on committees. Understand any fundraising, personal giving or other commitments expected of board members.

⇨ Obtain a list of current board members and committee assignments. Talk to current and, if possible, recent former board members to learn about what the board does, how effectively the board is run, the relationship between board and staff, and why any former board members left the board. In addition, make sure that the board and committee meetings are well-attended.

⇨ Understand the organization's mission, learn about its programs, read its publications, visit its program sites, look at its website and talk to key staff and major donors. Find out about the organization's reputation in the community.

⇨ Read the organization's certificate of incorporation, application for federal income tax exemption, by-laws, and board and committee minutes for at least the prior year, to learn about the organization's stated purposes, activities and concerns.

⇨ Review the organization's Internal Revenue Service Form 990 or 990 PF and audited financial statements for at least the last two (2) years as well as its current internal financial reports to see how the organization uses its assets and to evaluate its financial health. Has the Internal Revenue Service recently audited the organization? What does its report say? Ask if the organization is in compliance with all conditions stated in the IRS federal income tax determination letter.

⇨ Obtain the current year's budget and cash flow projections. Find out how they compare to actual income and expenses and what processes are in place to monitor these comparisons.

⇨ Inquire about the organization's outside auditor and the auditor's reputation. Ask about the auditor's performance of the audit process for the organization. Is the auditor's report on the organization's financial statements unqualified? Review the past two (2) years' management letters received from the outside auditor and find out what has been done to remedy any problems identified.

⇨ Find out if the organization is required to register with the Attorney General's Charities Bureau and, if so, whether it has registered and filed all required reports. Find out whether there are any tax issues or concerns, or notices received from governmental authorities.

⇨ Obtain an understanding of the internal control structure of the organization and

the procedures in place to monitor it. Determine whether there is a current accounting policies and procedures manual that is followed. (For further information on internal controls and accountability, please see the Attorney General's booklet - *Internal Controls and Financial Accountability for Not-for-Profit Boards.* That booklet and other publications of interest to charitable fiduciaries are available at www.oag.state.ny.us.)

⇨ Make sure there is a conflicts of interest policy in place and review it before joining the board.

⇨ Review the organizational chart and understand the accountability structure of the organization. Find out the backgrounds of key management and understand employee evaluation and compensation processes. Ask about the due diligence procedures for transactions and contracts that require board approval.

⇨ Find out how information flows between management and the board. Is sufficient information provided to the board? Are materials provided to the board and its committees sufficiently in advance of meetings?

⇨ Find out whether the amount and scope of insurance coverage is appropriate, including Directors and Officers' liability and employee fidelity insurance.

⇨ Learn what training (if any) is provided to the board.

III. WHAT ARE THE DUTIES OF BOARDS OF DIRECTORS?

While the board is not usually involved in the day-to-day activities of the organization, it is responsible for overseeing the management of the organization and must make significant decisions, such as adding or removing board members, hiring and firing key officers and employees, engaging auditors and other professionals, and authorizing significant financial transactions and new program initiatives. In carrying out those responsibilities, members of a board of directors must fulfill fiduciary duties to the organization and the public it serves. Those primary legal duties include the duties of *care*, *loyalty* and *obedience*.

A. Duty of Care

The *duty of care* requires a director to be familiar with the organization's finances and activities and to participate regularly in its governance. In carrying out this duty, directors must act in "good faith" using the "degree of diligence, care and skill" which prudent people would use in similar positions and under similar circumstances. In exercising the duty of care, responsible board members should, among other things, do the following:

- ⇨ Attend all board and committee meetings and actively participate in discussions and decision-making. Carefully read the material prepared for board and committee meetings prior to the meetings and note any questions they raise. Allow time to meet without management present.

- ⇨ Read the minutes of prior meetings and all reports provided, including financial statements and reports by employees. Make sure that board minutes reflect any dissenting votes to actions taken by the board at meetings or that may be expressed in writing by letter to the board. Such records are necessary in order for a board member to disclaim responsibility for any particular decision. Absent board members must do this promptly in writing. Do not hesitate to suggest corrections, clarification and additions to the minutes or other formal documents.

- ⇨ Make sure to get copies of the minutes of any missed committee or board meeting and read them timely, suggesting any changes that may be appropriate.

- ⇨ Make sure there is a clear process for approval of major commitments of the organization, such as fundraising, professional fees (including auditors), compensation arrangements and construction contracts.

- ⇨ Read literature and reports produced as part of the organization's programs.

- ⇨ Make sure that monthly financial charts of accounts and financial reports prepared for management are available to the board or finance and audit committees, and that they are clear and communicate information necessary for stewardship. Make sure there is a regular comparison of actual to budget figures with discrepancies explained.

- ⇨ Participate in risk assessment and strategic planning discussions.

- ⇨ Ensure that the organization periodically addresses the sufficiency of its written internal financial controls and other policies that safeguard, promote and protect the organization's assets and that they are updated regularly. Have a policy regarding disclosure and identification of fraud (whether or not material). Make sure a policy for records retention and whistleblower protection is in place. Create a background check policy for prospective employees.

- ⇨ Encourage diversity among board members. Diversity will help ensure a

board committed to serve the organization's mission with a range of appropriate skills, experience and interests.

⇨ Be involved in the selection and periodic review of the performance of the organization's Chief Executive Officer, Chief Financial Officer and other key employees responsible for the day-to-day activities of the organization. The board is responsible for ascertaining whether these individuals have the appropriate education, skills and experience to assume a key position and then evaluating their performance.

B. Duty of Loyalty

Directors are charged with the duty to act in the best interests of the organization. The duty of loyalty requires that any conflict of interest, real or potential, always be disclosed in advance of joining a board and when they arise. Board members should avoid transactions in which they or their family members benefit personally. If, in extraordinary circumstances, such transactions are unavoidable, disclose them fully and completely to the board as soon as possible.

The board of directors must be careful to examine transactions that involve directors or officers, or individuals or entities with whom directors or officers are related or affiliated. The board must not approve any transaction that is not fair and reasonable, and a conflicted board member may not participate in the board vote.

There should be an established conflicts of interest policy in place so that directors are aware of the type of transactions that may prohibit them from joining or staying on the board. The policy should provide for written disclosure of anticipated or actual conflicts. All board members should read and sign the policy annually and advise the board whenever they become aware of an actual or potential conflict, and the policy should be enforced by the board.

Transactions involving conflicts should be fully documented in the board's minutes, and conflicts policies and disclosure statements should be discussed with the organization's auditors and attorneys.

C. Duty of Obedience

A board has a *duty of obedience* to ensure that the organization acts in furtherance of its mission, including:

⇨ Dedicating the organization's financial and operational resources to its mission.

⇨ Ensuring that the organization carries out its purposes and does not engage in unauthorized activities.

- ⇨ Complying with all applicable state and federal laws, including registering with and reporting to the Attorney General's Charities Bureau in New York State, complying with other applicable registration and reporting requirements and laws of all states in which it conducts activities and\or solicits contributions.

IV. IDENTIFY, UNDERSTAND AND UPDATE THE ORGANIZATION'S MISSION AND INTERNAL POLICIES

Nonprofit organizations are created to achieve a specific purposes, such as making grants to operating charities, setting up a soup kitchen, teaching children to read, providing health care, supporting cultural institutions, preserving the environment, assisting senior citizens or one of the many thousands of other charitable activities conducted in our state and our country. Those purposes, or the mission of the organization, are described in the organization's certificate of incorporation and/or by-laws or other organizational document.

If an organization's purposes are not already clearly stated in one of its organizational documents, one of the first activities of the board should be to draft a clear statement of the organization's mission (which should correspond to its stated purpose as described to the IRS) and to ensure that everyone involved with the organization - directors and officers, employees, volunteers, fundraising professionals, and other professionals - is fully familiar with and understands the mission. Those individuals plan the organization's future, conduct its programs, raise its funds, make it known to the public, and present its financial records to regulatory agencies and others. Unless they fully understand why the organization was formed and what it plans to accomplish, they will not be able to perform their respective tasks appropriately. The mission statement should be periodically re-assessed and evaluated and amended as needed.

Employees and volunteers should be aware of the organization's internal controls that affect their area of responsibility. At the time of adoption or revisions of internal controls, all directors, officers, employees and volunteers should be made aware of and given a copy of the policy and procedures. They should also be given training to understand what is expected of them in carrying out their duties and in advising the organization's management and/or the board of directors of violations of the policy. New employees and volunteers should be trained before they assume their responsibilities.

Periodic review of an organization's structure, procedures and programs will assist board members in determining what is working well and what practices the organization might want to change in order to be more efficient, effective or responsible.

V. MONITOR FUNDRAISING CONDUCTED ON BEHALF OF THE ORGANIZATION

Many organizations contract with fundraising professionals to raise funds on their behalf. Since the fundraiser represents the organization to the public, the selection of a fundraising professional is extremely important. Establishing and following procedures for selection and monitoring of a fund raising professional can avoid future problems.

Such procedures should include:

- ⇨ Obtaining bids from several fundraising professionals before entering into a contract. Services and fees differ, and comparing bids will aid in the selection of the best contractor for the organization.
- ⇨ Checking with the Attorney General's Charities Bureau to see if the fundraising professional under consideration is registered and has filed all required contracts and financial reports.
- ⇨ Asking the Charities Bureau for copies of the fundraising professional's contracts with other charities to determine the services performed for and the fees charged to those charities.
- ⇨ Contacting some of the clients of a prospective fundraiser to inquire the organizations were satisfied with the services received and the success of their fundraising campaigns.
- ⇨ Negotiating terms with the fundraiser that will result in the best financial return for the organization.
- ⇨ Reviewing all written solicitations and scripts used by the fund raising professional, making sure that solicitation material appropriately describes the organization and its activities, includes the name of the organization as registered with the Attorney General and advises potential contributors that they may obtain the organization's financial report from the organization itself or from the Attorney General.
- ⇨ Requiring, as mandated by New York State law, that the fundraising professional disclose its name and the name of any of its individual representatives during in all solicitations, and state that those soliciting are being paid to raise funds for the organization.

VI. MAKE USE OF AVAILABLE RESOURCES

In carrying out their responsibilities, board members should realize that there are many resources available to assist them. The Attorney General's Web site, http://www.oag.state.ny.us, has publications on a variety of subjects, as well as forms and instructions for registration and annual filing with the Charities Bureau. It also has links to other web sites that provide resources for not-for-profit boards.

Governance and Related Topics - 501(c)(3) Organizations

The Internal Revenue Service believes that a well-governed charity is more likely to obey the tax laws, safeguard charitable assets, and serve charitable interests than one with poor or lax governance. A charity that has clearly articulated purposes that describe its mission, a knowledgeable and committed governing body and management team, and sound management practices is more likely to operate effectively and consistent with tax law requirements. And while the tax law generally does not mandate particular management structures, operational policies, or administrative practices, it is important that each charity be thoughtful about the governance practices that are most appropriate for that charity in assuring sound operations and compliance with the tax law. As a measure of our interest in this area, we ask about an organization's governance, both when it applies for tax-exempt status and then annually as part of the information return that many charities are required to file with the Internal Revenue Service.

Some of the policies and practices we commend for your consideration are divided into the topics below. Although the discussion that follows is generally directed to public charities, private foundations and other exempt organizations should also consider these topics. Depending on an organization's specific situation, some of the recommended policies and practices will be more appropriate than others. References to Form 990, *Return of Organization Exempt From Income Tax*, are to the 2008 Form 990.

Mission

Organizational Documents

Governing Body

Governance and Management Policies

Financial Statements and Form 990 Reporting

Transparency and Accountability

1. Mission

The Internal Revenue Service encourages charities to establish and review regularly the organization's mission. A clearly articulated mission, adopted by the board of directors, serves to explain and popularize the charity's purpose and guide its work. It also addresses why the charity exists, what it hopes to accomplish, and what activities it will undertake, where, and for whom. Organizations required to file Form 990 may describe their mission in Part I, Line 1 and are required to describe their mission in Part III, Line 1.

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2. Organizational Documents

Regardless of whether a charity is a trust, corporation, unincorporated association, or other type of organization, it must have organizational documents that provide the framework for its governance and management. State law often prescribes the type of organizational document and its content. The organizational document of a trust is usually the trust agreement or declaration of trust, and of a corporation, its articles of incorporation. State law may also require corporations to adopt bylaws. The Internal Revenue Service requires the submission of organizational documents and bylaws, if adopted, with an application for exemption under section 501(c)(3), and will review these documents to ensure that the applicant is organized exclusively for exempt purposes and that the applicant's proposed or actual activities are consistent with those documents. Organizations required to file Form 990 will find that Part VI, Section A, Line 4 requires organizations to report significant changes to their organizational documents since the prior Form 990 was filed.

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3. Governing Body

The Internal Revenue Service encourages an active and engaged board believing that it is important to the success of a charity and to its compliance with applicable tax law requirements. Governing boards should be composed of persons who are informed and active in overseeing a charity's operations and finances. If a governing board tolerates a climate of secrecy or neglect, we are concerned that charitable assets are more likely to be diverted to benefit the private interests of insiders at the expense of public and charitable interests. Successful governing boards include individuals who not only are knowledgeable and engaged, but selected with the organization's needs in mind (e.g. accounting, finance, compensation, and ethics).

Attention should also be paid to the size of the board ensuring that it is the appropriate size to effectively make sure that the organization obeys tax laws, safeguards its charitable assets, and furthers its charitable purposes. Very small or very large governing boards may not adequately serve the needs of the organization. Small boards run the risk of not representing a sufficiently broad public interest and of lacking the required skills and other resources required to effectively govern the organization.

On the other hand, very large boards may have a more difficult time getting down to business and making decisions. If an organization's governing board is large, the organization may want to establish an executive committee with delegated responsibilities or advisory committees.

Irrespective of size, a governing board should include independent members and should not be dominated by employees or others who are not, by their very nature, independent individuals because of family or business relationships. The Internal Revenue Service reviews the board composition of charities to determine whether the board represents a broad public interest, and to identify the potential for insider transactions that could result in misuse of charitable assets. The Internal Revenue Service also reviews whether an organization has independent members, stockholders, or other persons with the authority to elect members of the board or approve or reject board decisions, and whether the organization has delegated control or key management authority to a management company or other persons. Organizations that file Form 990 will find that Part VI, Section A, Lines 1, 2 ,3, and 7 ask questions about the governing body.

If an organization has local chapters, branches, or affiliates, the Internal Revenue Service encourages it to have procedures and policies in place to ensure that the activities and operations of such subordinates are consistent with those of the parent organization. Organizations that file Form 990 will find that Part VI, Section A, Line 9 asks about such procedures and policies.

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4. Governance and Management Policies

Although the Internal Revenue Code does not require charities to have governance and management policies, the Internal Revenue Service will review an organization's application for exemption and annual information returns to determine whether the organization has implemented policies relating to executive compensation, conflicts of interest, investments, fundraising, documenting governance decisions, document retention and destruction, and whistleblower claims.

A. *Executive compensation*. A charity may not pay more than reasonable compensation for services rendered. Although the Internal Revenue Code does not require charities to follow a particular process in determining the amount of compensation to pay, the compensation of officers, directors, trustees, key employees, and others in a position to exercise substantial influence over the affairs of the charity should be determined by persons who are knowledgeable in compensation matters and who have no financial interest in the determination. Organizations that file Form 990 will find that Part VI, Section B, Line 15 asks whether the process used to determine the compensation of an organization's top management official and other officers and key employees included a review and approval by independent persons, comparability data, and contemporaneous substantiation of the deliberation and decision. In addition, Form

990, Part VII and Form 990, Schedule J, solicit compensation information for certain officers, directors, trustees, key employees and highest compensated employees.

The Internal Revenue Service encourages a charity to rely on the rebuttable presumption test of section 4958 of the Internal Revenue Code and Treasury Regulation section 53.4958-6 when determining compensation of its executives. Under this test, compensation payments are presumed to be reasonable if the compensation arrangement is approved in advance by an authorized body composed entirely of individuals who do not have a conflict of interest with respect to the arrangement, the authorized body obtained and relied upon appropriate data as to comparability prior to making its determination, and the authorized body adequately documented the basis for its determination concurrently with making the determination.

Comparability data generally involves looking to compensation levels paid by similarly situated organizations for functionally comparable positions. One method is to obtain compensation surveys or studies from outside compensation consultants for this purpose. The Internal Revenue Service will look to the independence of any compensation consultant used, and the quality of any study, survey, or other data, used to establish executive compensation. Once that test is met, the Internal Revenue Service may rebut the presumption that an amount of compensation is reasonable only if it develops sufficient contrary evidence to rebut the probative value of the comparability data relied upon by the authorized governing body.

The Internal Revenue Service has observed significant errors or omissions in the reporting of executive compensation on the IRS Form 990 and other information returns (e.g., Form W-2 and employment tax returns). Organizations should take steps to ensure accurate and complete compensation reporting on these forms, and to also ensure that appropriate income and employment taxes are withheld and deposited with the Internal Revenue Service. Executive compensation continues to be a focus point in our examination program.

B. *Conflicts of interest*. The directors of a charity owe it a duty of loyalty. The duty of loyalty requires a director to act in the interest of the charity rather than in the personal interest of the director or some other person or organization. In particular, the duty of loyalty requires a director to avoid conflicts of interest that are detrimental to the charity. Many charities have adopted a written conflict of interest policy to address potential conflicts of interest involving their directors, trustees, officers, and other employees.

The Internal Revenue Service encourages a charity's board of directors to adopt and regularly evaluate a written conflict of interest policy that requires directors and staff to act solely in the interests of the charity without regard for personal interests; includes written procedures for determining whether a relationship, financial interest, or business affiliation results in a conflict of interest; and prescribes a course of action in the event a conflict of interest is identified.

The Internal Revenue Service encourages organizations to require its directors, trustees, officers and others covered by the policy to disclose, in writing, on a periodic basis any known financial interest that the individual, or a member of the individual's family, has in any business entity that transacts business with the charity. The organization should regularly and consistently monitor and enforce compliance with the conflict of interest policy. Instructions to Form 1023 contain a sample conflict of interest policy. Organizations are urged to tailor the sample policy to their own particular situations and needs, with the help of competent counsel if necessary. Organizations that file Form 990 will find that Part VI, Section B, Line 12 asks whether an organization has a written conflict of interest policy, and whether it regularly and consistently monitors and enforces compliance with the policy.

C. *Investments*. The governing body or certain other persons may be required either by state law or by the organizational documents to oversee or approve major investments made by the organization. Increasingly, charities are investing in joint ventures, for-profit entities, and complicated and sophisticated financial products or investments that require financial and investment expertise and, in some cases, the advice of outside investment advisors.

The Internal Revenue Service encourages charities that make such investments to adopt written policies and procedures requiring the charity to evaluate its participation in these investments and to take steps to safeguard the organization's assets and exempt status if they could be affected by the investment arrangement. The Internal Revenue Service reviews compensation arrangements with investment advisors to see that they comply with federal tax law. Organizations that file Form 990 will find that Part VI, Section B, Line 16 asks whether an organization has adopted procedures and policies regarding participation in a joint venture or similar arrangement with a taxable entity. In addition, Form 990, Schedule D, asks detailed information about certain investments.

D. *Fundraising*. Charitable fundraising is an important source of financial support for many charities. The Internal Revenue Service encourages charities to adopt and monitor policies to ensure that fundraising solicitations meet federal and state law requirements and solicitation materials are accurate, truthful, and candid. Charities are encouraged to keep their fundraising costs reasonable and to provide information about fundraising costs and practices to donors and the public. Organizations that file Form 990 will find that Schedules G and M solicit information about fundraising activities, revenues and expenses.

E. *Governing body minutes and records*. The Internal Revenue Service encourages the governing bodies and authorized sub-committees to take steps to ensure that minutes of their meetings, and actions taken by written action or outside of meetings, are contemporaneously documented. Organizations that file Form 990 will find that Part VI, Line 8 asks whether an organization contemporaneously documents meetings or written actions undertaken during the year by its governing body and each committee with authority to act on behalf of the governing body.

F. *Document retention and destruction*. The Internal Revenue Service encourages charities to adopt a written policy establishing standards for document integrity, retention, and destruction. The document retention policy should include guidelines for handling electronic files. The policy should cover backup procedures, archiving of documents, and regular check-ups of the reliability of the system. For more information, see IRS Publication 4221, *Compliance Guide for 501(c)(3) Tax-Exempt Organizations*, available on the IRS website. Charities are required by the Internal Revenue Code to keep books and records that are relevant to its tax exemption and its filings with the Internal Revenue Service. Organizations that file Form 990 will find that Part VI, Section B, Line 14, asks about whether an organization has a written document retention and destruction policy.

G. *Ethics and whistleblower policy*. The public expects a charity to abide by ethical standards that promote the public good. The organization's governing body bears the ultimate responsibility for setting ethical standards and ensuring they permeate the organization and inform its practices. The Internal Revenue Service encourages a charity's board or trustees to consider adopting and regularly evaluating a code of ethics that describes behavior it wants to encourage and behavior it wants to discourage. A code of ethics will serve to communicate and further a strong culture of legal compliance and ethical integrity to all persons associated with the organization.

The Internal Revenue Service encourages the board of directors to adopt an effective policy for handling employee complaints and to establish procedures for employees to report in confidence any suspected financial impropriety or misuse of the charity's resources. Such policies are sometimes referred to as *whistleblower* policies. The Internal Revenue Service will review an organization to determine whether insiders or others associated with the organization have materially diverted organizational assets. Organizations that file Form 990 will find that Part VI, Section B, Lines 5 and 13 ask whether the organization became aware during the year of a material diversion of its assets, and whether an organization has a written whistleblower policy.

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5. Financial Statements and Form 990 Reporting

Directors are stewards of a charity's financial and other resources. The Internal Revenue Service encourages the board, either directly or through a board-authorized committee, to ensure that financial resources are used to further charitable purposes and that the organization's funds are appropriately accounted for by regularly receiving and reviewing up-to-date financial statements and any auditor's letters or finance and audit committee reports.

A. *Financial Statements.* Some organizations prepare financial statements without any involvement of outside accountants or auditors. Others use outside accountants to prepare compiled or reviewed financial statements, while others obtain audited financial statements. State law may impose audit requirements on certain

charities, and a charity must ensure that it abides by the requirements of state law. Many organizations that receive federal funds are required to undergo one or more audits as set forth in the Single Audit Act and OMB Circular A-133. However, even if an audit is not required, a charity with substantial assets or revenue should consider obtaining an audit of its financial statements by an independent auditor.

The board may establish an independent audit committee to select and oversee an independent auditor. An audit committee generally is responsible for selecting the independent auditor and reviewing its performance, with a focus on whether the auditor has the competence and independence necessary to conduct the audit engagement, the overall quality of the audit, and, in particular, the independence and competence of the key personnel on the audit engagement teams. The Internal Revenue Service encourages all charities to take steps to ensure the continuing independence of any auditor that conducts an audit of the organization. Organizations that file Form 990, will find that Part XI, Line 2, asks whether the organization's financial statements were complied or reviewed by an independent accountant, audited by an independent accountant, and subject to oversight by a committee within the organization. And, Part XI, Line 3 asks whether, as a result of a federal award, the organization was required to undergo an audit as set forth in the Single Audit Act and OMB Circular A-133.

B. *Form 990*. Although not required to do so by the Internal Revenue Code, some organizations provide copies of the IRS Form 990 to its governing body and other internal governance or management officials, either prior to or after it is filed with the Internal Revenue Service. Practices differ widely as to who sees the form, when they see it, and the extent of their input, review, or approval. Some, especially smaller organizations, may provide a copy of the Form 990 to the full board for review or approval before it is filed. Others provide a copy of the form to a portion of the governing body, or to a committee or top management officials, before it is filed. Still others provide a copy to the board, a committee or top management officials, but not until after it is filed. Organizations that file Form 990 will find that Part VI, Section A, Line 10 asks whether the organization provides a copy of Form 990 to its governing body, and requires the organization to explain any process of review by its directors or management.

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6. Transparency and Accountability

By making full and accurate information about its mission, activities, finance, and governance publicly available, a charity encourages transparency and accountability to its constituents. The Internal Revenue Code requires a charity to make its Form 1023 exemption application, Form 990, and Form 990-T, available for public inspection. The Internal Revenue Service encourages every charity to adopt and monitor procedures to ensure that its Form 1023, Form 990, Form 990-T, annual reports, and financial statements, are complete and accurate, are posted on its public website, and are made

available to the public upon request. Organizations that file Form 990 will find that Part VI, Section C, Lines 18 and 19, ask whether and how an organization makes its Form 1023, Form 990 and Form 990-T, governing documents, conflict of interest policy, and financial statements available to the public.

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Date posted: February 4, 2008

Nonprofit Governance: Compliance Issues for Trustees & Directors of Not-For-Profit Organizations

Tomer J. Inbar

Patterson Belknap Webb & Tyler LLP

The Corporate Form

- Most operating charities are formed as not-for-profit (nonprofit) corporations
  - Governed by state statute and typically overseen by the state Attorney General
- The corporate form provides the benefit of liability protection
- Options:
  - Religious Corporations
  - Membership Corporations
  - Non-Member Corporations

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Roles of Directors & Officers

- Directors (sometimes referred to as Trustees) are charged with overall management responsibility for the organization
- Day-to-day management duties are delegated to officers and employees charged with operating the organization under the board's supervision
- Although directors do not carry out day-to-day decision making, they are held to certain fiduciary standards in order to ensure that the organization is achieving its mission through its activities
- Many organizations have advisory boards (which generally do not have "fiduciary" obligations) and/or honorary directors (the fiduciary obligations of which will depend on whether they are considered "directors" for governance purposes)

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Sources of Director Duties and Responsibilities

- Governing Documents
- State law
- Internal Revenue Code and IRS administrative guidance
  - Form 990
  - Governance and Related Topics (www.irs.gov/pub/irs-tege/governance_practices.pdf)
- Best Practices

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Director Duties Under Governing Documents

- Compliance with Charter
- Compliance with Bylaws
- Faithfulness to mission
- Compliance with policies (e.g., conflict of interest policy)

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State Law Duties – Duty of Care

- Duty of Care
  - Handle duties with such care as an ordinarily prudent person would exercise in like position under similar circumstances
  - Be diligent and informed; exercise honest and unbiased business judgment
  - Business Judgment Rule: Generally requires that decisions be made:
    1) in good faith
    2) without a conflict of interest
    3) on a reasonably informed basis
    4) with a rational belief that the business judgment is in the best interests of the organization

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State Law Duties – Duty of Loyalty

- Duty of Loyalty
  - Act in good faith and in the best interests of the organization (do not allow individual interests to prevail over the those of the organization)
  - Focuses on
    1) conflicts of interest
    2) corporate opportunities
    3) confidentiality issues

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State Law Duties – Duty of Loyalty (cont.)

- Duty of Loyalty
  - An interested transaction will not breach this duty where:
    1) the interested director discloses interest and material facts;
    2) the transaction is approved by a disinterested majority of the Board (or a committee thereof); and
    3) the transaction was fair to the corporation at the time it was entered into

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State Law Duties – Duty of Obedience

- Duty of Obedience
  - A director should act with fidelity, within the bounds of the law, to the organization's mission and avoid committing acts beyond the scope of the powers of the corporation (ultra vires acts)
  - A director is generally held liable only if the act is in violation of public policy or specific statute
  - Courts often apply duty of care standards to this duty
  - Directors who deal with investment issues should be particularly aware of state laws affecting investments

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The Conflict of Interest Policy & Annual Disclosure

- Establish parameters:
  - Define scope (i.e., what transactions are covered)
  - Define reach (i.e., who is covered)
- Describe process for reviewing covered transactions:
  - Duty to disclose
  - Refrain from influence
  - Recusal from consideration and vote (though conflicted party may be present to answer questions)

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The Conflict of Interest Policy & Annual Disclosure (cont.)

  - Review and consideration by independent members of the Board or committee
  - Determination that the transaction is reasonable, fair and in the best interests of the organization (obtain comparability data as appropriate)
  - Document determination in minutes
- Annual disclosure and acknowledgement
  - Covered persons acknowledge that they have read and complied with the policy
  - Disclose affiliations, business dealings, compensation arrangements, other situations/relationships that may give rise to a conflict (or the appearance of conflict), etc.

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Basic Liability Protections for Directors

- Liability limitation in Articles of Incorporation
- Indemnification provision in Bylaws
- Directors and Officers liability insurance
- State volunteer immunity protection
- Federal Volunteer Protection Act

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Federal Tax Law Issues Impacting Corporate Governance

- Directors must oversee an organization in accordance with its exempt mission
- The IRS demonstrates interest in corporate governance:
  - Redesigned 990 focuses attention on governance practices and disclosure
    1) IRS recently published a schedule of significant changes to the Form 990 on its website (www.irs.gov)
  - IRS focus on reasonableness of executive compensation and other transactions with "insiders", including officers and directors

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Form 990 Part VI: Governance, Management and Disclosure

- Part VI of the Form 990 has three Sections
  - Section A: Governing Body and Management
  - Section B: Policies
  - Section C: Disclosure

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Form 990 Part VI: Governance, Management and Disclosure (cont.)

- Note parenthetical to heading to Section B
  - "(This Sections B requests information about policies not required by the Internal Revenue Code.)"
- Instructions note that all organizations must answer questions although not required by the Internal Revenue Code
  - "IRS considers such policies and procedures to generally improve tax compliance"
  - "the absence of appropriate policies and procedures can lead to opportunities for excess benefit transactions, inurement, operation for non-exempt purposes, or other activities inconsistent with exempt status"

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Form 990 Part VI, Section A: Governing Body and Management

- Requires disclosure of number of total and "independent" members of the governing body defined as
  - No compensation as officer or employee of organization (or a related organization)
    1) But OK to receive reasonable compensation for board service
  - No more than $10,000 for independent contractor services
  - No material financial benefits
  - No family member received compensation or material financial benefits

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Form 990 Part VI, Section A: Governing Body and Management (cont.)

- Requires disclosure of family or business relationships among directors, officers, key employees
  - Family relationship: spouse, ancestors, whole and half siblings, children, grandchildren and spouses
  - Business relationship:
    1) Employment with organization in which other party is more than 35% owner, trustee, director, officer or key employee
    2) Direct or indirect business transaction with value of more than $10,000
    3) Both parties are officers, directors, trustees or more than 10% owners of same business or investment entity

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Form 990 Part VI, Section A: Governing Body and Management (cont.)

- Must state whether board actions are "contemporaneously documented"
  - "Contemporaneously" means by the later of the date of next meeting or 60 days
- Must state whether copy of 990 was provided to governing body before it was filed
  - Must disclose 990 review process

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Form 990 Part VI, Part VI, Section B: Policies

- Must check yes/no as to whether organization has the following policies:
  - Conflict of interest policy/disclosure form
  - Whistleblower policy
  - Document retention and destruction policy
- Must state whether compensation process meets standards for rebuttable presumption of reasonableness for:
  - CEO
  - other officers
  - key employees

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Form 990 Part VI, Section C: Disclosure

- List states where 990 is required to be filed
- Check whether 990 is made public on the web or financial statements are made public upon request
- Describe whether and how governing documents, conflict policy and financial statements are made public

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Intermediate Sanctions

- Section 4958, enacted by Congress in 1996, was established as a way to sanction the misuse by certain insiders of a tax exempt organization's assets
- Applicable to public charities
- Private foundations have to comply with a different regime—self-dealing.

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Intermediate Sanctions (cont.)

- Section 4958 imposes "intermediate sanctions" in the form of excise taxes on "disqualified persons" (including founders, substantial contributors, officers, directors, and senior executives) who engage in "excess benefit transactions" with covered exempt organizations.
- Section 4958 also penalizes "organization managers" (officers and directors) who knowingly approve excess benefit transactions.

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Intermediate Sanctions (cont.)

- Public charities need to ensure that they are paying reasonable compensation that is determined according to a fair and disinterested process
- Directors should become familiar with the steps needed to establish the rebuttable presumption of reasonableness under the regulations

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Intermediate Sanctions: The Rebuttable Presumption of Reasonableness

- Transactions involving disqualified persons should be approved by a board or committee that
  - is composed of individuals unrelated to and not subject to the control of the disqualified persons;
  - obtains and relies upon appropriate data as to comparability or value; and
  - adequately and contemporaneously documents the basis for its determination

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Best Practices: Discharging the Duties of Care and Loyalty

- A board of directors should:
  - meet at regularly scheduled times throughout the year
  - receive information from management on a regular schedule established by the board
  - keep accurate and complete records of its meetings and actions
  - ensure that its documentation reflects the appropriate basis of board decisions
  - be careful about communications regarding board decisions, by e-mail or otherwise

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Best Practices: Discharging the Duties of Care and Loyalty (cont.)

- Directors have certain rights to ensure that they can adequately discharge their duties:
  - access to management and employees
  - access to books and records
  - adequate notice of meetings and actions
  - right to dissent and have such dissent recorded
  - access to regularly kept minutes

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Best Practices: Ensuring the Adequacy of Financial Controls/Oversight

- Financial expertise on the board
  - Consider establishing an audit committee comprised of outside directors, including at least one "financial expert."
- The auditor should report directly to the board or committee and should meet with the committee outside the presence of management
- The organization should also review procedures for:
  - Proper retention of records
  - Investigation of allegations by whistleblowers about financial (and other) improprieties

Patterson Belknap Webb & Tyler LLP

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Contact

Tomer J. Inbar 212.336.2310
tinbar@pbwt.com

Patterson Belknap Webb & Tyler LLP

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[NAME OF THE ORGANIZATION]

CHARITIES COMPLIANCE RESOLUTIONS

WHEREAS, [NAME OF THE ORGANIZATION] (the "Organization") has consistently adhered to the highest ethical standards of conduct in all of its activities, abiding by the letter and spirit of all applicable laws, and acting in a manner that enhances the Organization's standing in the broader community;

WHEREAS, the Organization recognizes that it is the responsibility of its trustees, officers and employees to act in a lawful and ethical manner and comply fully with appropriate standards of conduct and to avoid actions and relationships that might violate those standards; and

WHEREAS, the Organization desires to expand and strengthen its existing compliance system;

NOW, THEREFORE, IT IS HEREBY

RESOLVED, that the Organization hereby adopts the following policies and procedures as elements of its compliance program:

1. A Code of Ethics and Business Conduct in the form attached hereto as Exhibit A which sets forth the Organization's general standards of legal and ethical conduct and requires each trustee, officer and supervising employee to confirm that he or she will abide with such Code.

2. A Conflicts of Interest Policy in the form attached hereto as Exhibit B to confirm that all organizational decisions are made solely to promote the best interests of the Organization without favor or preference based on personal considerations, and to provide for the highest ethical conduct with respect to the actions and business relationships of all employees.

3. An Employee Protection Policy in the form attached hereto as Exhibit C to prohibit reprisals for good faith reporting by employees of actual or possible violations of the law or the Organization's policies.

4. A Document Retention Policy in the form attached hereto as Exhibit D.

and further

RESOLVED, that the Organization will adopt policies and procedures appropriate for its size and operations regarding receipts of

income and contributions, grants/scholarships, acting as an intermediary for fundraising purposes, as detailed in Exhibit E.

RESOLVED, that the Organization hereby establishes a new standing committee of its Board of Trustees known as the Audit Committee consisting of at least three (3) trustees (excluding the president and treasurer) to discuss with the organization's auditors any compliance and financial issues raised by the auditors and to ensure the organization's compliance with the Code of Conduct; and further

RESOLVED, that the Organization will maintain the services of a certified public accounting firm of appropriate size and sophistication to prepare annual audits of its financial records.

EXHIBIT A

[Name of Organization]

Code of Ethics and Business Conduct

Approved by the Board of Trustees
[Date]

[Name of Organization]'s (the "Organization") success and reputation depends on the integrity of its governing Board of Trustees, officers, employees, and agents. To maintain that success and reputation, it is the responsibility of each trustee, employee, and agent to act in a lawful and ethical manner and comply fully with appropriate standards of conduct in all of their duties and responsibilities for the Organization.

Accordingly, all of the Organization's trustees, officers, employees and agents must maintain appropriate standards of business and ethical conduct, including the following:

Rule 1: Compliance with Legal Requirements

We must act in accordance with all laws and regulations which apply to us.

Rule 2: Adherence to Ethical Standards

We must maintain the highest ethical standards of conduct in all the Organization's activities.

Rule 3: Respect for Beneficiaries

All beneficiaries of the Organization's mission are entitled to equal access to services and are to be treated with care and respect. In addition, we must respect their privacy.

Rule 4: Maintenance of Accurate Records and Documents

Organization records and reports must be accurately maintained. Under no circumstances may any records be falsified, wrongfully destroyed, or misused.

Rule 5: Avoidance of Conflict of Interest

Under no circumstances may any gift or other favor be given as an inducement or to be used for preferential treatment in organizational activities including, but not limited to, business and programmatic decisions.

Neither you or members of your family may make use of any proprietary or confidential information learned in the course of employment or board service for personal benefit.

Rule 6: Following Proper Business Practices

Dishonest, fraudulent or unethical activities are prohibited.

Rule 7: Community Benefit

The Organization must be operated for the benefit of the community and none of its assets or income may be used in a manner that would jeopardize the Organization's tax exempt status. This includes refraining from any political campaign activities.

Rule 8: Inspiration to the Community

We must conduct our affairs so that we inspire, and are looked upon favorably by, the broader community.

Reporting of Violations

All trustees, officers, employees and agents are required to come forward with any information regarding an actual or possible violation of this Code or the Organization's policies and to cooperate fully in the investigation of any alleged violation.

Reports should be made to the **[President]** or to the Board directly if with respect to the **[President]**.

No type of disciplinary action will be taken against a person who in good faith reports actual or possible violations of the Code.

Discipline for Violations

The Organization will take disciplinary action, including dismissal when appropriate, against any person who violates any legal requirements or the Organization's policies, including anyone who fails to report violations or retaliates against any individual for reporting in good faith a possible violation.

EXHIBIT B

[NAME OF ORGANIZATION]

POLICY ON CONFLICTS OF INTEREST

I. General Standards

All trustees and employees of [Name of Organization] (the "Organization") have a duty of loyalty to the Organization, which includes:

1. exercising utmost good faith in all matters relating to their duties and responsibilities to the Organization; and

2. acting in a manner reasonably believed to be in the best interest of the Organization when discharging their duties.

II. Confidential Information

Each trustee and employee must protect the confidential information of the Organization (including financial information, beneficiary information and donor lists) and may not use any confidential information of the Organization for personal gain.

III. Appropriation of Corporate Opportunity

A trustee or employee may not participate in a transaction the trustee or employee knows or has reason to believe would fall within the present plans of the Organization or any of its beneficiaries without making prior written disclosure to the president of the Organization.

IV. Disclosure of Potential Conflict of Interest

1. Definition of Potential Conflict of Interest

A trustee or employee has a potential conflict of interest if the trustee or employee or a Related Person (as defined below) is known to have a direct or indirect financial interest or other interest in or relationship (including board membership) with a beneficiary of the Organization (as defined below), or any business or entity which has a business, financial or competitive relationship with the Organization or a beneficiary of the Organization. Ownership of less than 5% of the outstanding shares of a publicly traded company will not be deemed a potential conflict of interest.

A "Related Person" is a person's spouse, parent, descendants, parents' descendants and spouse's parent's descendants.

A “beneficiary” is a person who directly benefits from the Organization’s activities.

2. Duty to Disclose

In connection with any actual or possible conflicts of interest, an interested trustee or employee must disclose the existence and nature of his or her financial interest and all material facts to the president of the Organization. The president must make disclosures regarding him or herself to the Board of Trustees. In addition, the hiring of any person as an employee or consultant who is a Related Person to board member, officer or manager of the Organization will be disclosed to the Board of Trustees.

3. Procedure

If the president of the Organization determines that there is a conflict of interest, the following shall apply:

(a) The individual in question may take no part in the Organization decisions to which the conflict relates.

(b) In addition, with reference to employees, the president may prohibit the activity giving rise to the conflict.

(c) In addition, with reference to trustees, if the conflict involves a matter under consideration by the Board of Trustees or a committee thereof, the trustee:

(i) shall disclose such interest to the other members of the Board or committee; and

(ii) shall not vote on such transaction or attempt to influence the decision directly or indirectly.

Such disclosure and the fact that the trustee did not vote or participate in the deliberations shall be recorded in the relevant minutes.

VII. Gifts

Trustees and employees of the Organization (and their Related Parties) may not solicit or accept gifts, gratuities, payments or other consideration of any kind, loans (other than from financial institutions) or other favors from, or on account of, any person or organization arising (i) because such person is or was a beneficiary of the Organization; or (ii) because such person or organization does, or is seeking to do, business or establish another relationship with the Organization.

VIII. Personal Use of Vendors or Beneficiaries

Trustees or employees in a position to influence purchasing decisions must promptly disclose to the president if within the last three years they (or their Related Parties) had, or are considering entering into, a personal transaction with a vendor or supplier known to be, or under consideration as, a vendor or supplier to the Organization. This requirement is in addition to the

disclosure of a potential conflict of interest requirement of section IV above and the prohibition of certain gifts pursuant to section VII above.

IX. Questionnaire and Statement

1. It is the responsibility of all trustees and employees of the Organization to familiarize themselves with this Policy and to comply and to ensure compliance of Related Parties with it.

2. In addition to the appropriate disclosures required by this Policy, the following persons must complete, sign and return to the president a questionnaire and statement concerning this Policy: (a) trustees of the Organization; (b) non-trustee officers of the Organization; (c) all supervisory employees of the Organization. All trustees are required to return the questionnaire and statement on an annual basis. Designated employees are required to return it on an annual basis.

3. The questionnaire and statement will require the recipient to disclose all financial interests relating to a potential conflict and to affirm that the recipient:

(a) has received a copy of the conflicts of interest policy,

(b) has read and understands the policy,

(c) has agreed to comply with the policy, and

(d) understands that the Organization is a charitable organization and that in order to maintain its federal tax exemption it must engage primarily in activities which accomplish one or more of its tax-exempt purposes.

X. Report to the Board of Trustees

The president shall report to the board of the Organization at least once annually concerning any disclosures of potential conflicts of interest made to them, and any other conflicts of interest which have occurred.

[NAME OF ORGANIZATION]

CONFLICTS OF INTEREST DISCLOSURE STATEMENT

The Conflicts of Interest Policy (the “Policy”) of [Name of Organization] (the “Organization”) requires that each trustee, officer and supervisory employee annually: (i) affirm to the Organization in writing certain specified matters as set forth below; and (ii) disclose to the Organization any financial interest (as defined in the Policy) that might directly or indirectly constitute a conflict of interest, as further described in the Policy.

____

Please initial each statement that applies to you:

____ I have received a copy of the Organization’s Conflicts of Interest Policy and have read and understand it.

____ I hereby agree to comply with the Conflicts of Interest Policy.

____ I understand that the Organization is a charitable, tax-exempt organization and that in order to maintain its tax-exempt organizational status, the Organization must engage primarily in activities that accomplish one or more of its charitable, tax-exempt purposes.

____ I have no actual knowledge and am not aware of financial Interest that I am required to disclose under the Conflicts of Interest Policy.

____ I have a financial interest that I am required to disclose under the Conflicts of Interest Policy. I hereby disclose all facts and circumstances concerning financial interest and conflict of interest that are known to me, as described in the attached letter. (***Please attach a letter providing complete details, facts and circumstances concerning such Financial or Other Material Interest***).

Signature: ____

Printed Name: ____

Position: ____

Date: ____

EXHIBIT C

[NAME OF ORGANIZATION]

Employee Protection Policy

The board of trustees of [Name of Organization] (the "Organization") has adopted the following Employee Protection Policy:

If any employee reasonably believes that some policy, practice, or activity of the Organization is in violation of law, a written complaint may be filed by that employee with the supervisor. However, if the employee is not comfortable reporting to the supervisor, or is not satisfied with the supervisor's response, the employee may speak with any other executive or board officer of the Organization.

It is the intent of the Organization to adhere to all laws and regulations that apply to the Organization, and the underlying purpose of this Policy is to support the Organization's goal of legal compliance. The support of all employees is necessary to achieving compliance with various laws and regulations. An employee is protected from retaliation only if the employee brings the alleged unlawful activity, policy, or practice to the attention of an appropriate person of the Organization and provides them with a reasonable opportunity to investigate and appropriately respond to and make appropriate corrections with respect to the alleged unlawful activity. The protection described below is only available to employees that comply with this requirement.

The Organization will not retaliate against an employee who, in good faith, has made a protest or raised a complaint against some practice of the Organization or of another individual or entity with whom the Organization had a business relationship, on the basis of a reasonable belief that the practice is in violation of law or a clear mandate of public policy.

Nothing in this Policy is intended to or shall alter the at work nature of any employee's employment status with the organization.

EXHIBIT D

[NAME OF ORGANIZATION]

RECORD RETENTION AND DESTRUCTION POLICY

1. Purpose

The purpose of this Policy is to ensure that necessary records and documents of are adequately protected and maintained and to ensure that records that are no longer needed by of [Name of Organization] (the "Corporation") or are of no value are discarded at the proper time. This Policy is also for the purpose of aiding employees of Corporation in understanding their obligations in retaining electronic documents - including e-mail, Web files, text files, sound and movie files, PDF documents, and all Microsoft Office or other formatted files.

2. Policy

This Policy represents the Corporation's policy regarding the retention and disposal of records and the retention and disposal of electronic documents.

3. Administration

Attached as Appendix A is a Record Retention Schedule that is approved as the initial maintenance, retention and disposal schedule for physical records of Corporation and the retention and disposal of electronic documents. The Executive Director (the "Administrator") is the officer in charge of the administration of this Policy and the implementation of processes and procedures to ensure that the Record Retention Schedule is followed. The Administrator is also authorized to: make modifications to the Record Retention Schedule from time to time to ensure that it is in compliance with local, state and federal laws and includes the appropriate document and record categories for Corporation; monitor local, state and federal laws affecting record retention; annually review the record retention and disposal program; and monitor compliance with this Policy.

4. Suspension of Record Disposal In Event of Litigation or Claims

In the event Corporation is served with any subpoena or request for documents or any employee becomes aware of a governmental investigation or audit concerning Corporation or the commencement of any litigation against or concerning Corporation, such employee shall inform the Administrator and any further disposal of documents shall be suspended until shall time as the Administrator, with the advice of counsel, determines otherwise. The Administrator shall take such steps as is necessary to promptly inform all staff of any suspension in the further disposal of documents.

5. Applicability

This Policy applies to all physical records generated in the course of Corporation s operation, including both original documents and reproductions. It also applies to the electronic documents described above.

APPENDIX A - RECORD RETENTION SCHEDULE

The Record Retention Schedule is as follows:

ACCOUNTING AND FINANCE

Record Type	Retention Period
Accounts Payable ledgers and schedules	7 years
Accounts Receivable ledgers and schedules	7 years
Annual Audit Reports and Financial Statements	Permanent
Annual Audit Records, including work papers and other documents that relate to the audit	7 years after completion of audit
Annual Plans and Budgets	2 years
Bank Statements and Canceled Checks	7 years
Employee Expense Reports	7 years
General Ledgers	Permanent
Interim Financial Statements	7 years
Notes Receivable ledgers and schedules	7 years
Investment Records	7 years after sale of investment
Credit card records (documents showing customer credit card number)	2 years

Credit card record retention and destruction

A credit card may be used to pay for donations to Corporation.

All records showing customer credit card number must be locked in a desk drawer or a file cabinet when not in immediate use by staff.

If it is determined that information on a document, which contains credit card information, is necessary for retention beyond 2 years, then the credit card number will be cut out of the document.

CONTRACTS

Record Type	Retention Period
Contracts and Related Correspondence (including any proposal that resulted in the contract and all other supportive documentation)	7 years after expiration or termination

CORPORATE RECORDS

Record Type	Retention Period
Corporate Records (minute books, signed minutes of the Board and all committees, corporate seals, articles of incorporation, bylaws, annual corporate reports)	Permanent
Licenses and Permits	Permanent

CORRESPONDENCE AND INTERNAL MEMORANDA

General Principle: Most correspondence and internal memoranda should be retained for the same period as the document they pertain to or support. For instance, a letter pertaining to a particular contract would be retained as long as the contract (7 years after expiration). It is recommended that records that support a particular project be kept with the project and take on the retention time of that particular project file.

Correspondence or memoranda that do not pertain to documents having a prescribed retention period should generally be discarded sooner. These may be divided into two general categories:

Those pertaining to routine matters and having no significant, lasting consequences should be discarded *within two years.* Some examples include:

- Routine letters and notes that require no acknowledgment or follow-up, such as notes of appreciation, congratulations, letters of transmittal, and plans for meetings.
- Form letters that require no follow-up.
- Letters of general inquiry and replies that complete a cycle of correspondence.
- Letters or complaints requesting specific action that have no further value after changes are made or action taken (such as name or address change).
- Other letters of inconsequential subject matter or that definitely close correspondence to which no further reference will be necessary.
- Chronological correspondence files.

Copies of interoffice correspondence and documents where a copy will be in the originating department file should be read and destroyed, unless that information provides reference to or direction to other documents and must be kept for project traceability.

Those pertaining to non-routine matters or having significant lasting consequences should generally be retained permanently.

ELECTRONIC DOCUMENTS

1. **Electronic Mail**: Not all email needs to be retained, depending on the subject matter.
   - All e-mail—from internal or external sources—is to be deleted after 12 months.
   - Staff will strive to keep all but an insignificant minority of their e-mail related to business issues.
   - Corporation will archive e-mail for six months after the staff has deleted it, after which time the e-mail will be permanently deleted.
   - All Corporation business-related email should be downloaded to a service center or user directory on the server.
   - Staff will not store or transfer Corporation -related e-mail on non-work-related computers except as necessary or appropriate for Corporation purposes.

2. Electronic Documents: including Microsoft Office Suite and PDF files. Retention also depends on the subject matter.
   - **PDF documents** – The length of time that a PDF file should be retained should be based upon the content of the file and the category under the various sections of this policy. The maximum period that a PDF file should be retained is 6 years. PDF files the employee deems vital to the performance of his or her job should be printed and stored in the employee's workspace.
   - **Text/formatted files -** Staff will conduct annual reviews of all text/formatted files (e.g., Microsoft Word documents) and will delete all those they consider unnecessary or outdated. After five years, all text files will be deleted from the network and the staff's desktop/laptop. Text/formatted files the staff deems vital to the performance of their job should be printed and stored in the staff's workspace.

3. **Web Page Files: Internet Cookies**
   - All workstations: Internet Explorer should be scheduled to delete Internet cookies once per month.

Corporation does not automatically delete electronic files beyond the dates specified in this Policy. It is the responsibility of all staff to adhere to the guidelines specified in this policy.

Each day the Corporation will run a tape backup copy of all electronic files (including email) on Corporation's servers, as specified in the Corporation Disaster Recovery Plan. This backup tape is a safeguard to retrieve lost information within a one-year retrieval period should documents on the network experience problems. The tape backup copy is considered a safeguard for the record retention system of Corporation, but is not considered an official repository of Corporation records. All monthly and yearly tapes are stored offsite according to Corporation's Disaster Recovery Policy.

In certain cases a document will be maintained in both paper and electronic form. In such cases the official document will be the electronic document.

GRANT RECORDS

Record Type	Retention Period
Original grant proposal	7 years after completion of grant period
Grant agreement and subsequent modifications, if applicable	7 years after completion of grant period
All requested IRS/grantee correspondence including determination letters and "no change" in exempt status letters	7 years after completion of grant period
Final grantee reports, both financial and narrative	7 years after completion of grant period
All evidence of returned grant funds	7 years after completion of grant period
All pertinent formal correspondence including opinion letters of counsel	7 years after completion of grant period
Report assessment forms	7 years after completion of grant period
Documentation relating to grantee evidence of invoices and matching or challenge grants that would support grantee compliance with the grant agreement	7 years after completion of grant period
Pre-grant inquiry forms and other documentation for expenditure responsibility grants	7 years after completion of grant period
Grantee work product produced with the grant funds	7 years after completion of grant period

INSURANCE RECORDS

Record Type	Retention Period
Annual Loss Summaries	10 years
Audits and Adjustments	3 years after final adjustment
Certificates Issued to Corporation	Permanent
Claims Files (including correspondence, medical records, injury documentation, etc.)	Permanent
Group Insurance Plans - Active Employees	Until Plan is amended or terminated
Group Insurance Plans – Retirees	Permanent or until 6 years after death of last eligible participant

Record Type	Retention Period
Inspections	3 years
Insurance Policies (including expired policies)	Permanent
Journal Entry Support Data	7 years
Loss Runs	10 years
Releases and Settlements	25 years

LEGAL FILES AND PAPERS

Record Type	Retention Period
Legal Memoranda and Opinions (including all subject matter files)	7 years after close of matter
Litigation Files	1 year after expiration of appeals or time for filing appeals
Court Orders	Permanent
Requests for Departure from Records Retention Plan	10 years

MISCELLANEOUS

Record Type	Retention Period
Consultant's Reports	2 years
Material of Historical Value (including pictures, publications)	Permanent
Policy and Procedures Manuals – Original	Current version with revision history
Policy and Procedures Manuals - Copies	Retain current version only
Annual Reports	Permanent

PAYROLL DOCUMENTS

Record Type	Retention Period
Employee Deduction Authorizations	4 years after termination
Payroll Deductions	Termination + 7 years
W-2 and W-4 Forms	Termination + 7 years
Garnishments, Assignments, Attachments	Termination + 7 years
Labor Distribution Cost Records	7 years
Payroll Registers (gross and net)	7 years
Time Cards/Sheets	2 years
Unclaimed Wage Records	6 years

PENSION DOCUMENTS AND SUPPORTING EMPLOYEE DATA

General Principle: Pension documents and supporting employee data shall be kept in such a manner that Donors Forum can establish at all times whether or not any pension is payable to any person and if so the amount of such pension.

Record Type	Retention Period
Retirement and Pension Records	Permanent

PERSONNEL RECORDS

Record Type	Retention Period
Commissions/Bonuses/Incentives/Awards	7 years
EEO- I /EEO-2 - Employer Information Reports	2 years after superseded or filing (whichever is longer)
Employee Earnings Records	Separation + 7 years
Employee Handbooks	1 copy kept permanently
Employee Medical Records	Separation + 6 years

Record Type	Retention Period
Employee Personnel Records (including individual attendance records, application forms, job or status change records, performance evaluations, termination papers, withholding information, garnishments, test results, training and qualification records)	6 years after separation
Employment Contracts – Individual	7 years after separation
Employment Records - Correspondence with Employment Agencies and Advertisements for Job Openings	3 years from date of hiring decision
Employment Records - All Non-Hired Applicants (including all applications and resumes - whether solicited or unsolicited, results of post-offer, pre-employment physicals, results of background investigations, if any, related correspondence)	2-4 years (4 years if file contains any correspondence which might be construed as an offer)
Job Descriptions	3 years after superseded
Personnel Count Records	3 years
Forms I-9	3 years after hiring, or 1 year after separation if later

PROPERTY RECORDS

Record Type	Retention Period
Correspondence, Property Deeds, Assessments, Licenses, Rights of Way	Permanent
Original Purchase/Sale/Lease Agreement	Permanent
Property Insurance Policies	Permanent

TAX RECORDS

General Principle: Donors Forum must keep books of account or records as are sufficient to establish amount of gross income, deductions, credits, or other matters required to be shown in any such return.

These documents and records shall be kept for as long as the contents thereof may become material in the administration of federal, state, and local income, franchise, and property tax laws.

Record Type	Retention Period
Tax-Exemption Documents and Related Correspondence	Permanent
IRS Rulings	Permanent
Excise Tax Records	7 years
Payroll Tax Records	7 years
Tax Bills, Receipts, Statements	7 years
Tax Returns - Income, Franchise, Property	Permanent
Tax Workpaper Packages - Originals	7 years
Sales/Use Tax Records	7 years
Annual Information Returns - Federal and State	Permanent
IRS or other Government Audit Records	Permanent

CONTRIBUTION RECORDS

Record Type	Retention Period
Records of Contributions	Permanent
Corporation's or other documents evidencing terms of gifts	Permanent

PROGRAM AND SERVICE RECORDS

Record Type	Retention Period
All services	7 years

EXHIBIT E

Additional Policies and Procedures

The organization will implement policies and procedures applicable to its size and operations in accordance with the following:

6. Receipts. The organization will consider adopting policies and procedures not accept cash for the payment of services, tuition or any fees for programs or services provided other than for nominal amounts (as determined by the Board of Trustees). If the organization does determine to accept cash for such items, the organization will comply with all applicable government reporting requirements with respect to the receipt of cash, including the IRS requirements to report cash transactions of over $10,000 for a single transaction or related transactions over a 12 month period. In addition, the organization will develop a system to log in all receipts and to account for them properly.

7. Grants/Scholarships. The organization will ensure that all grants and scholarships are awarded only after a formal approval process through a grant/scholarship approval committee. The process should include a formal written application that includes the reasons for the grant/scholarship, and documentation of the approval committee (including the details of who approved the grant). Once awarded, all grants are to be paid by check. The organization should designate an appropriate person or committee to monitor the grant (as applicable) and require documentation of how the funds were spent (as applicable).

8. Agency Transactions. A procedure will be established as to all transactions in which the organization acts as an intermediary for fundraising purposes to ensure its compliance with applicable law and as to the recording of the transactions.

Not-For-Profit/Exempt Organizations Blog

Posted at 6:36 PM on March 25, 2011 by Yafang Deng

Attorney General Issues Guide on the New York Prudent Management of Institutional Funds Act

On March 17, 2011, the New York State Attorney General's Charities Bureau published "A Practical Guide to the New York Prudent Management of Institutional Funds Act" (the "Guide"). The Guide provides a summary of the New York Prudent Management of Institutional Funds Act ("NYPMIFA") as well as practical guidance on its application. Although the Guide is not an official regulation, since the Charities Bureau is tasked with enforcement of NYPMIFA, not-for-profit institutions are well advised to take this guidance into serious consideration.

As we have previously reported, NYPMIFA was enacted into law on September 17, 2010. It updates the Uniform Management of Institutional Funds Act, which had governed charitable endowment funds since 1978, with New York's unique version of the Uniform Prudent Management of Institutional Funds Act ("UPMIFA"). By doing so, New York became the forty-seventh state to have enacted a version of UPMIFA.

NYPMIFA makes several important changes to prior law. Most importantly, NYPMIFA drops the requirement that institutions maintain the "historic dollar value" or original dollar amount of a gift. Instead, NYPMIFA sets forth certain investment and expenditure standards to ensure that endowment funds are used and maintained in a prudent manner. To balance this grant of broader discretion to charitable institutions, NYPMIFA also imposes new notice, decision-making, and corporate governance requirements on institutions and their boards.

Prior Donor Notice

In the Guide, the Charities Bureau highlights several key issues. First, the Guide addresses questions regarding the required notice to donors of gifts made prior to September 17, 2010. NYPMIFA provides that an institution must give 90-days prior written notice to "available" donors (those who are living and can be found with reasonable efforts) before exercising its new power to invade the historic dollar value of the gift. The notice grants each donor an opportunity to opt-out of appropriations below the historic dollar value of the gift. If a donor chooses to opt-out of appropriations below historic dollar value, the prudent investment and expenditure standards enacted by NYPMIFA still apply to the gift. During the 90-day notice period, an institution can continue to appropriate from these funds as long

as no expenditure below historic dollar value is made until the donor has granted his or her approval or the 90-day period expires.

The statute (N-PCL § 553(e)(1)) requires that the notice contains language substantially as follows:

> Attention, Donor:
> Please check Box #1 or #2 below and return to the address shown above.
> ( ) #1 The institution may spend as much of my gift as may be prudent.
> ( ) #2 The institution may not spend below the original dollar value of my gift.
> If you check Box #1 above, the institution may spend as much of your endowment gift (including all or part of the original value of your gift) as may be prudent under the criteria set forth in Article 5–A of the Not-for-Profit Corporation Law (The Prudent Management of Institutional Funds Act).
> If you check Box #2 above, the institution may not spend below the original dollar value of your endowment gift but may spend the income and the appreciation over the original dollar value if it is prudent to do so. The criteria for the expenditure of endowment funds set forth in Article 5–A of the Not-for-Profit Corporation Law (The Prudent Management of Institutional Funds Act) will not apply to your gift.

Institutions may wish to add an assurance to donors that their gift will still be subject to the prudent use standards enacted by NYPMIFA even if they opt out of below historical value appropriations by checking Box #2.

The statutory language describing the notice requirement raised the question of whether notice is required if the institution has no present plans to appropriate below historic dollar value. The Guide answers this question definitively, stating that notice is required to all prior donors, regardless of the institution's expenditure plans. There are only three exceptions to the notice requirement: (1) the gift instrument already permits spending below historic dollar value; (2) the gift instrument expressly prohibits spending below historic dollar value; (3) the donor made the gift in response to an institutional solicitation but did not include a separate statement restricting use of the funds.

Expenditure Decisions

NYPMIFA provides eight prudent use factors to be considered, if relevant, in all endowment fund appropriation decisions:

- The duration and preservation of the endowment,
- The purpose of the institution and the fund,
- General economic conditions,
- The possible effect of inflation or deflation,
- The expected total return from income and appreciation of investments,
- The institution's other resources,
- The alternatives, where appropriate, to spending and due consideration to the impact of those alternatives on the institution,
- The institution's investment policy.

The Guide clarifies that an institutional board must either consider each factor or make a specific determination that the factor is not relevant. The consideration of the factors and any determinations that a factor is irrelevant must be documented in a contemporaneous record. The record must describe the substance of the consideration rather than making a conclusory statement. The form of the record is not important; meeting minutes are sufficient, but a board can choose to develop a separate record. The record may, but need not, incorporate any written advice the board receives from professionals in making its decisions.

The seventh factor, the consideration of alternatives to spending, is unique among the states that have adopted UPMIFA. The Guide explains that the factor is intended to ensure that boards do not automatically turn to endowment expenditure when alternatives such as fund-raising, expense reductions, sale of assets, staff reductions, or deferred expenditures would better serve the institution and the fund. All considered alternatives should be documented in the record of the decision.

While these factors are meant to be applied on a fund-by-fund basis, the Guide indicates that a single decision can be made regarding multiple endowment funds provided the funds are "similarly situated." Written procedures for determining when a group of funds is similarly situated should be developed and may include factors such as the purposes, restrictions, financial condition, investment status, and duration of the funds. Even if a group appropriation decision is made, the decision should be justified if the prudent use factors were applied to each fund individually.

Investment Policy

NYPMIFA requires that charitable institutions have a written investment policy that applies to their endowment funds. While the statute provides a list of factors that should be considered in making investment decisions, NYPMIFA does not prescribe the contents of an institution's investment policy. The Guide indicates that there is no ideal investment policy; however, it gives examples of subjects a policy may wish to address, such as:

- General investment objectives,
- Permitted and prohibited investments,
- Acceptable levels of risk,
- Asset allocation and diversification,
- Procedures for monitoring investment performance,
- Scope and terms of delegation of investment management functions,
- The investment manager's accountability,
- Procedures for selecting and evaluating external agents,
- Processes for reviewing investment policies and strategies,
- Proxy voting.

Regular review and revision of the policy is recommended.

An institution's investment policy also must set forth guidelines for any delegation

of management and investment functions. The Guide advises institutional boards to be diligent in assessing the independence of outside investment agents both before and after retaining them. While NYPMIFA does not prohibit business or personal relationships between the board and its agents, the Guide cautions against the use of agents who may interfere with a board member's ability to make independent decisions and provide proper oversight. The best course of action may be to adopt a policy requiring all outside agents to be independent. The Guide advises boards ideally to adopt a policy of full disclosure of relationships with outside agents. At a minimum, boards should adopt and follow a conflict of interest policy in making decisions about outside agents.

Releasing Gift Restrictions

NYPMIFA expanded on existing options for an institution to seek the release of donor-imposed restrictions on an institutional fund. The preferred and easiest method is a release granted through the donor's written consent. If consent is not possible or not granted, an institution may seek judicial release of the restriction after notifying available donors and the Attorney General. The Guide advises institutions to submit a draft of any judicial petitions to the Charities Bureau prior to filing in order to resolve potential issues.

For "small, old" funds (funds that are less than $100,000 in value and have been in existence for more than 20 years) NYPMIFA also creates a non-judicial method for releasing fund restrictions. The institution must provide notice to the Attorney General and to available donors of the intent to modify or release the restriction. If the Attorney General does not respond within 90 days of the notice, the institution may proceed without further requirements.

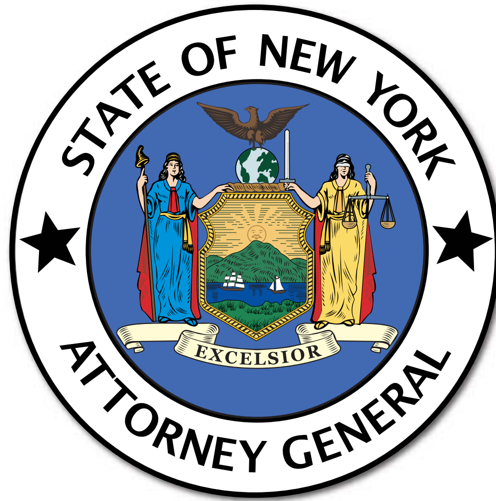
The statutory language provides a limited exception to the donor notice requirement for the release of a "small, old" fund. As drafted, NYPMIFA states that notice to the donor is not required when the gift instrument limits the institution's ability to appropriate below historic dollar value (as set forth in N-PCL § 553(e)(2)(B)). However, the Charities Bureau believes that the exception provision contains a drafting error and should in fact refer to funds received as a result of an institutional solicitation without a separate statement by the donor expressing a restriction on the use of the funds (N-PCL § 553(e)(2)(C)). Regardless, the Guide advises institutions to always provide notice to available donors.

For more information about investment management rules affecting not-for-profit organizations, please see our December 29, 2010 blog entry.

Comments (0) Read through and enter the discussion with the form at the end

Proskauer Rose LLP
Boca Raton 2255 Glades Road
Suite 421 Atrium
Boca Raton, FL 33431-7360
Phone: 561.241.7400
Boston One International Place
Boston, MA 02110-2600
Phone: 617.526.9600
Chicago Three First National Plaza

A PRACTICAL GUIDE TO THE NEW YORK PRUDENT MANAGEMENT OF INSTITUTIONAL FUNDS ACT



ATTORNEY GENERAL ERIC T. SCHNEIDERMAN
Charities Bureau
120 Broadway
New York, NY 10271

(212) 416-8400

www.charitiesnys.com

A PRACTICAL GUIDE TO THE NEW YORK PRUDENT MANAGEMENT OF INSTITUTIONAL FUNDS ACT

Office of the Attorney General
Charities Bureau

The Charities Bureau of the New York State Attorney General's Office offers this guide on the New York Prudent Management of Institutional Funds ("NYPMIFA" or "the Act"), which took effect on September 17, 2010. This guide provides an overview of the Act and includes practical guidance that is intended to assist charities and other institutions in complying with the Act's new requirements. This guide contains general information and is not a substitute for legal advice from an attorney.

BACKGROUND

NYPMIFA – New York's version of the Uniform Prudent Management of Institutional Funds Act ("UPMIFA") – governs the management and investment of funds held by not-for-profit corporations and other institutions. It replaces and updates key provisions of the Uniform Management of Institutional Funds Act ("UMIFA"), which was adopted in New York in 1978.

NYPMIFA makes important changes to the rules governing the spending of endowment funds – funds that are not wholly expendable on a current basis due to donor-imposed restrictions on spending. In particular, and unlike prior law, it allows institutions to spend endowment funds below their original dollar amount ("historic dollar value") without court approval or Attorney General review, if the institution's board of directors concludes that such spending is prudent. NYPMIFA also provides standards for the prudent management and investment of institutional funds, the delegation of management and investment functions to outside advisors, and procedures for lifting or modifying donor-imposed restrictions on the management, expenditure or use of institutional funds.

Recognizing that the proposed uniform legislation (UPMIFA) gives boards of directors broader authority to spend donor-restricted endowment funds than they had under prior law, New York's version of the legislation built in additional requirements for institutions and their boards and additional protections for donors – provisions unique among the 47 states that had thus far adopted UPMIFA. Among other things, NYPMIFA requires that boards determine whether it is appropriate to consider alternatives before deciding whether to authorize expenditure of an endowment fund. It also requires that a notice be given to available donors of endowment funds who executed the gift instrument before September 17, 2010, allowing these donors to opt out of the new rule permitting institutions to spend below the historic dollar value of endowment funds. In addition, the Act includes several provisions that strengthen corporate governance with respect to oversight of institutional funds and delegation of management and investment functions. These additional provisions are designed to encourage and assist boards to exercise their broader spending powers responsibly.

The text of the Act is on the Charities Bureau website at www.charitiesNYS.com.

OVERVIEW OF THE ACT

The Act adds a new Article, 5-A (§§ 550-558), to New York's Not-for-Profit Corporation Law (N-PCL),[1] which addresses four principal areas:

- Standards of conduct for prudently managing and investing institutional funds (new N-PCL § 552);
- Rules that boards must follow in deciding whether to appropriate from or accumulate endowment funds (new N-PCL § 553);
- Standards for delegating management and investment functions to outside agents (new N-PCL § 554); and
- Rules pertaining to the lifting or modification of donor restrictions on management and investment of institutional funds, and on donor restrictions on use of such funds (new N-PCL § 555).

The Act applies to all entities defined as "institutions" under the Act, including all New York not-for-profit corporations, corporations formed under the Religious Corporations Law and education corporations as defined in Education Law § 216-a.[2] Under the Act, whenever an action is required to be taken by an institution, such action must be authorized by the institution's governing board. N-PCL § 551(d).

Standard of Conduct in Managing and Investing Institutional Funds (N-PCL § 552)

The Act provides that each person responsible for managing and investing an institutional fund "shall manage and invest the fund in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances." N-PCL § 552(b). The Act sets forth basic requirements for satisfying the standard of prudence, including a requirement that an institution make a reasonable effort to verify facts relevant to the management and investment of the fund, and that an institution only incur costs that are reasonable and appropriate.

The Act also requires that the following factors, if relevant, be considered in managing and investing an institutional fund:

(1) general economic conditions;
(2) the possible effect of inflation or deflation;
(3) the expected tax consequences, if any, of investment decisions or strategies;
(4) the role that each investment or course of action plays within the overall investment portfolio of the fund;
(5) the expected total return from income and the appreciation of investments;

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[1] The Act also amends portions of N-PCL Article 5 and N-PCL § 717, as well as sections of the Religious Corporations Law, the Estates Powers and Trusts Law, the Surrogate's Court Procedure Act, and the Executive Law. L.2010 ch.490 §§ 2-14. The existing special rules for cemetery corporations continue to apply. *See* N-PCL § 1507.

[2] N-PCL § 551(d) defines "institution" as: "(1) a person, other than an individual, organized and operated exclusively for charitable purposes; (2) a trust that had both charitable and noncharitable interests, after all noncharitable interests have terminated; or (3) any corporation described in subparagraph five of paragraph (a) of section 102 (Definitions)."

(6) other resources of the institution;
(7) the needs of the institution and the fund to make distributions and to preserve capital; and
(8) an asset's special relationship or special value, if any, to the purposes of the institution.

N-PCL § 552(e)(1).

Additionally, the Act requires that investments of an institutional fund be diversified "unless the institution prudently determines that, because of special circumstances, the purposes of the fund are better served without diversification." N-PCL § 552(e)(4). A decision not to diversify must be reviewed as frequently as circumstances require, but at least annually.

The Act also requires every institution to adopt a written investment policy setting forth guidelines on investments and delegation of management and investment functions. N-PCL § 552(f).

Expenditure of Endowment Funds (N-PCL § 553)

Unless stated otherwise in the gift instrument, the assets in an endowment fund are donor-restricted assets (*i.e.*, may not be spent) until they are "appropriated for expenditure" by the institution. N-PCL § 553(a). Although this term is not defined in the Act, an appropriation is generally understood to mean a decision by the governing board to release a portion of an endowment fund from the donor-imposed restriction on spending, thus authorizing it to be spent in accordance with the terms of the gift instrument. Funds appropriated for expenditure need not be spent immediately; such funds may be appropriated on one date and spent at a later date or over a period of time. Effective September 17, 2010, decisions to appropriate from endowment funds are governed by N-PCL § 553.

Under prior law, an institution could appropriate for expenditure so much of the net appreciation as its governing board determined was prudent; however, the institution could not appropriate below the historic dollar value of an endowment fund without court approval unless the gift instrument permitted such appropriation. *See* former N-PCL § 513(c). The Act removes the prohibition on appropriations below the historic dollar value of endowment funds; however, the donor of an endowment fund established before September 17, 2010 who is "available" as defined in the Act may opt to retain the historic dollar value limit with respect to that fund by responding to a notice sent by the institution (see below). Furthermore, as under prior law, the donor of an endowment fund may include an explicit spending limitation in the gift instrument. The Act continues to require that decisions to appropriate for expenditure from endowment funds be made prudently, but adds specific criteria for determining when this standard is met.

In deciding whether to appropriate from an endowment fund, the institution must act "in good faith, with the care that an ordinarily prudent person in a like position would exercise under similar circumstances," and must consider, if relevant, the following factors:

(1) the duration and preservation of the endowment fund;
(2) the purposes of the institution and the endowment fund;
(3) general economic conditions;
(4) the possible effect of inflation or deflation;
(5) the expected total return from income and the appreciation of investments;
(6) other resources of the institution;

(7) where appropriate and circumstances would otherwise warrant, alternatives to expenditure of the endowment fund, giving due consideration to the effect that such alternatives may have on the institution; and
(8) the investment policy of the institution.

N-PCL § 553(a)(1)-(8).

The seventh factor, requiring an institution to consider alternatives to expenditure, is unique to New York and is discussed further in the Guidance below.

Contemporaneous Records

An institution must make a contemporaneous record of the consideration it gave to each of the factors in deciding to appropriate. If the institution decides to accumulate rather than appropriate from an endowment fund, it must also keep a record of such action. N-PCL § 553(a), (f).

Presumption of Imprudence

For endowment gifts made after September 17, 2010, the Act creates a rebuttable presumption of imprudence if an institution appropriates more than 7% of the fund's fair market value (averaged over a period of not less than the preceding five years) in any year. The presumption of imprudence does not apply to appropriations permitted by law or by the gift instrument. An appropriation of 7% or less of an endowment fund's value in any year is not presumptively prudent. N-PCL § 553(d)(1), (2).

Notice to Donors of Endowment Funds

The Act allows "available" donors of endowment gifts made pursuant to gift instruments executed before September 17, 2010 to opt out of the new rule permitting institutions to appropriate below the historic dollar value of endowment funds. A donor is considered available if the donor can be found with reasonable efforts and is living (if an individual) or conducting activities (if an entity). The institution must send each available donor a written notice describing the donor's two options, which contains language substantially as follows:

Attention, Donor:
Please check Box #1 or #2 below and return to the address shown above.

( ) #1 The institution may spend as much of my gift as may be prudent.
( ) #2 The institution may not spend below the original dollar value of my gift.

If you check Box #1 above, the institution may spend as much of your endowment gift (including all or part of the original value of your gift) as may be prudent under the criteria set forth in Article 5-A of the Not-for-Profit Corporation Law (The Prudent Management of Institutional Funds Act).

If you check Box #2 above, the institution may not spend below the original dollar value of your endowment gift but may spend the income and the appreciation over the original dollar value if it is prudent to do so. The criteria for the expenditure of endowment funds set forth in Article 5-A of the Not-for-Profit Corporation Law (The Prudent Management of Institutional Funds Act) will not apply to your gift.

N-PCL § 553(e)(1).

If the donor does not respond within 90 days from the date notice was given, or if the donor returns the notice within 90 days and checks Box #1, NYPMIFA's new spending rules will apply to the donor's endowment gift. If the donor checks Box #2, the institution may not appropriate for expenditure below the historic dollar value of the endowment gift but may spend the income and appropriate the appreciation over historic dollar value if it is prudent to do so, unless otherwise prohibited by the gift instrument. Institutions must keep a record of all notices sent to donors. *See* N-PCL § 553(f).

Donor notice is not required in three circumstances:

- The gift instrument already permits spending below historic dollar value;
- The gift instrument expressly limits spending in the manner set forth in § 553(b) of the Act; or
- The donor made the gift in response to an institutional solicitation but did not include a separate statement restricting use of the funds.

N-PCL § 553(e)(2).

Delegation of Management and Investment Functions to Outside Agents (N-PCL § 554)

NYPMIFA sets forth legal standards that govern the delegation of management and investment functions by boards of directors to agents outside of the institution (external agents). The Act requires that boards use prudence in selecting, continuing or terminating an agent, and that they consider, among other things, the agent's independence including any conflicts of interest that such agent has or may have.

<u>Standard of Care for Delegation</u>

The Act provides that, subject to any specific limitation set forth in a gift instrument or another law, an institution may delegate to an external agent the management and investment of an institutional fund to the extent that such a delegation is prudent under the circumstances. In order to delegate prudently, an institution must act in good faith, with the care that an ordinarily prudent person in a like position would exercise under similar circumstances in:

(1) selecting, continuing or terminating an agent, including assessing the agent's independence including any conflicts of interest such agent has or may have;

(2) establishing the scope and terms of the delegation, including the payment of compensation, consistent with the purposes of the institution and the institutional fund; and

(3) monitoring the agent's performance and compliance with the scope and terms of the delegation.

N-PCL § 554(a)(1)-(3).

<u>Standard of Care for External Agent Performing Delegated Duties</u>

In performing a delegated function, an external agent owes a duty to the institution to exercise reasonable care, skill and caution to comply with the scope and terms of the delegation. N-PCL § 554(b). The Act continues to require that any contract that delegates a management or investment function to an external agent must provide that the contract may be terminated at any time, without penalty, with up to 60 days prior notice. N-PCL § 554(e).

Release of Donor-Imposed Restrictions on Management, Investment, or Purpose of an Institutional Fund (N-PCL § 555)

The Act modifies the standards for releasing donor-imposed restrictions on institutional funds, including restrictions on the management and investment of funds, the expenditure of funds (endowment restrictions), and the purposes for which a fund may be used. It also sets forth procedures for seeking court release of restrictions, and a new procedure for releasing restrictions on funds valued at less than $100,000 that have been in existence for more than 20 years.

As under prior law, an institution may obtain the donor's written consent to release or modify a restriction on management or investment. If the donor is available and withholds such consent, or if the donor is not available, an institution may seek court approval to release or modify a restriction regarding the management or investment of an institutional fund if the restriction is impracticable or wasteful, impairs management or investment or if, because of circumstances not anticipated by the donor, a modification or release would further the purposes of the fund. To the extent practicable, any modification must be made in accordance with the donor's probable intention. N-PCL § 555(a), (b).

Similarly, an institution may obtain the donor's written consent to release or modify a use restriction. If the donor is available and withholds such consent, or if the donor is not available, an institution may also seek court approval to release a donor's restriction on the use of a fund if the restriction becomes impossible, impracticable, unlawful or wasteful. N-PCL § 555(c).

A key difference from prior law is that under NYPMIFA an institution may seek court release from a restriction if the donor does not consent to the release. Notice of the court proceeding must be provided to the donor and to the Attorney General, both of whom will have an opportunity to be heard. N-PCL § 555(b), (c). However, under the Act, the executors or heirs of a deceased donor are not included in the definition of "donor" and thus are not entitled to notice.

In addition, the Act provides a new procedure whereby an institution may lift or modify a donor-imposed restriction on the management, investment, or purpose of an institutional fund if the fund is less than $100,000 in value and has been in existence for more than 20 years. If an institution determines that such a restriction is unlawful, impracticable, impossible to achieve, or wasteful, the institution may release or modify the restriction, in whole or part, without court

approval, after giving written notice to the Attorney General, unless the Attorney General objects to the release or modification within 90 days. If the Attorney General does not notify the institution within 90 days, the institution may proceed with the release or modification. N-PCL § 555(d).

The institution's written notice to the Attorney General must contain the following:

- An explanation of (i) the institution's determination that the restriction is unlawful, impracticable, impossible to achieve, or wasteful, and (ii) the proposed release or modification;
- A copy of a record of the institution approving the release or modification; and
- A statement of the proposed use of the institutional fund after such release or modification.

N-PCL § 555(d)(2), (3).

The notice must also be given to the donor, if available.[3]

After releasing or modifying the restriction, the institution must use the property in a manner consistent with the purposes expressed in the gift instrument. N-PCL § 555(d)(1)(C).

Solicitations for Endowment Funds (Executive Law § 174-b[2])

The Act also amends Executive Law § 174-b[2] to require a disclosure when institutions solicit for endowment funds. Under the new provision, the solicitation must include a statement that, unless otherwise restricted by the gift instrument pursuant to N-PCL § 553(b), the institution may expend so much of the endowment fund as it deems prudent after considering the factors set forth N-PCL § 553(a).[4]

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[3] Although the Act provides that notice to the donor need not be given for funds described in N-PCL § 553(e)(2)(B), this appears to be a drafting error. The intended reference may have been to § 553(e)(2)(C), where the gift consists of funds received as a result of an institutional solicitation without a separate statement by the donor expressing a restriction on the use of funds. Absent clarification by the Legislature, it is the view of this Office that notice pursuant to N-PCL § 555(d) should be given to any donor that is available.

[4] L.2010 ch.490 §14 (amending Executive Law § 174-b[2]).

GUIDANCE

In the following sections, we provide practical guidance for institutions on key topics covered by the Act. This guidance is subject to change and may be supplemented from time to time. The views expressed here are those of the Attorney General's Charities Bureau; the meaning and effect of the provisions of the Act are ultimately matters for determination by the Courts of this State.

Notice to Donors of Endowment Funds

Is notice to donors required?

The Act states that unless an exception applies, an institution "must" provide 90 days notice to available endowment donors who executed gift instruments prior to September 17, 2010 before applying the new endowment spending rules in N-PCL § 553(a) for the first time. The notice requirement as written is not optional; the institution must send the notice before appropriating from the endowment fund. (The three exceptions to the notice requirement are described on page 5 above.)

It is possible that in the interim between September 17, 2010 and the issuance of this guidance some institutions, acting in good faith, may have appropriated from endowment funds before sending notice to the donors as required by N-PCL § 553(e)(1). In this case, the institution should promptly send the notice to donors if it has not already done so. If the donor responds by checking Box #2 on the notice, it is the view of this Office that the institution must restore the fund to its historic dollar value if any pre-notice appropriation reduced the fund below that level. (The rules that apply when the donor checks Box #2 are discussed below.)

Questions have been asked about whether notice is required if the endowment fund is above historic dollar value and the institution has no present intention to appropriate below historic dollar value. It is the view of this Office that notice is required. The Act makes no distinction between funds that are above historic dollar value or below; the notice is required in either case. If notice were not required while the fund is above historic dollar value, institutions could delay sending the notice, perhaps indefinitely, which is not, in our view, what the Legislature intended.

Read in the context of N-PCL § 553 as a whole, the notice serves two related but distinct policy objectives: (1) to provide the donor with *information* about the change in law with regard to an institution's authority to appropriate for expenditure below the historic dollar value of endowment funds, and (2) to give the donor an *opportunity to clarify or amend* the terms of the donor's gift with regard to such appropriations. The informational purpose of the notice is not served if the notice is not given. Furthermore, although a particular endowment fund may be "above water" now, the fund may drop below historic dollar value at some point in the future when the donor may no longer be available to clarify or amend the terms of the gift. Delaying the notice or withholding it altogether would deprive the donor of the statutorily-mandated opportunity to clarify or amend the terms of the gift with regard to appropriations below historic dollar value. For these reasons, it is this Office's view that institutions are required to send the

notice to all available donors of endowment gifts who executed the gift instrument before September 17, 2010, unless a statutory exception applies.

May an institution appropriate from an endowment fund during the 90-day period after notice is sent?

Although not expressly addressed in the Act, it is this Office's view that the Legislature did not intend the notice requirement to harm organizations by prohibiting any appropriation of endowment funds before the notice process is completed. A reasoned interpretation of the notice requirement is that, after notice is sent, an institution may appropriate the income and the net appreciation over historic dollar value of an endowment fund during the 90-day notice period, if it is prudent to do so in accordance with N-PCL § 553(a). Expenditures above historic dollar value after giving notice to the donor would not prejudice donors who may check Box #2 because principal would remain preserved during the 90-day notice period. An institution may not, however, appropriate for expenditure below the historic dollar value of an endowment fund until the 90-day notice period ends, unless the donor has returned the notice and checked Box #1.

What rules apply to the endowment fund if the donor checks Box #1 on the notice?

If the donor checks Box #1, all decisions to appropriate and spend endowment funds, as well as decisions to accumulate and not spend those funds, are governed by N-PCL § 553(a). The historic dollar value limitation on endowment appropriations that existed under prior law no longer applies.

What rules apply to the endowment fund if the donor checks Box #2 on the notice?

If the donor checks Box #2, the institution may not appropriate below the historic dollar value of the endowment fund without first obtaining court approval on notice to the Attorney General and the donor, if available. The institution may spend the income and appropriate the appreciation over the historic dollar value of the fund if it is prudent to do so. As under prior law, the historic dollar value of a "Box #2" endowment fund and the amount, if any, of appreciation of the fund that is available for appropriation is determined on a fund-by-fund basis, not by simply aggregating the asset values of multiple endowment funds. Also, as under prior law, if an institution appropriates below the historic dollar value of such an endowment fund (for example, as a result of applying a spending policy), it is the view of this Office that the institution has a duty under N-PCL §§ 553(e)(1) and 717 to restore the endowment fund to its historic dollar value.

Questions have been raised about the effect of language in the notice stating that if Box #2 is checked "the criteria for the expenditure of endowment funds set forth in Article 5–A of the Not-for-Profit Corporation Law (The Prudent Management of Institutional Funds Act) will not apply to your gift." When read in the context of the overall notice provision, it is apparent that this language was intended to clarify that the statutory criteria permitting expenditures below historic dollar value do not apply when Box #2 is checked. It is this Office's view that, other than the historic dollar value limitation, Article 5-A continues to apply to these endowment funds. Thus, for example, if the donor checks Box #2, the governing board must still determine that any appropriation from the endowment fund is prudent after considering the factors enumerated in § 553(a), and the board must make a contemporaneous record of each determination to

appropriate from the fund. To conclude otherwise would take "Box #2" endowment funds out of the Act entirely, with no statutory standard governing appropriation and accumulation of funds, which is a result the Legislature could not have intended.

While the Act requires that the notice to donors contain language substantially as set forth in N-PCL § 553(e)(1), institutions may wish to add an assurance to donors that if Box #2 is checked, all decisions to appropriate from the endowment fund must still be prudent under the Act and that the endowment fund will remain subject to other provisions of the Act.

Does the term "original dollar value" in the required notice have the same meaning as "historic dollar value"?

The Act does not define "original dollar value"; however, when read in the context of the statutory notice set forth in N-PCL § 553(e)(1), it is this Office's view that this term is intended to be a plain-English equivalent of "historic dollar value" as defined in N-PCL § 102(a)(16). That section defines "historic dollar value" as "the aggregate fair value in dollars of (i) an endowment fund at the time it became an endowment fund, (ii) each subsequent donation to the fund at the time it is made, and (iii) each accumulation made pursuant to a direction in the applicable gift instrument at the time the accumulation is added to the fund." That section goes on to state that "[t]he determination of historic dollar value made in good faith by the corporation is conclusive."

What steps should an institution take to determine whether a donor is "available" such that notice is required?

A donor who is an individual is "available" if the donor is living and can be identified and located with reasonable efforts. If the donor of a particular fund is not known, the institution should make reasonable efforts to identify the donor. For donors whose current address is unknown, the institution should make reasonable efforts to locate the donor, including Internet searches and contacting known associates of the donor, such as an attorney who represented the donor when the gift was made. The statute requires institutions that send the N-PCL § 553(e)(1) notice to keep a record. N-PCL § 553(f). The record should document the institution's efforts to locate donors even if those efforts ultimately did not succeed.

Expenditure of Endowment Funds

How does the Act modify previous concepts of endowment spending?

Traditional endowment concepts focused on preserving "principal" and spending "income." In the 1970s, UMIFA expanded permissible spending to include a prudent amount of the appreciation of the endowment fund; this remained the law until September 17, 2010. The Act takes a different approach, reflecting the view that a prudent investment strategy requires institutions to invest their endowments and other institutional funds for "total return," which may result in increases (or decreases) in principal, income or both. The Act thus requires institutions to determine spending based on the total assets of the endowment fund. As the drafters of UPMIFA have noted:

> Although the Act does not require that a specific amount be set aside as "principal," the Act assumes that the institution will act to preserve "principal" (i.e., to maintain the purchasing power of the amounts contributed to the fund) while spending "income" (i.e. making a distribution each year that represents a reasonable spending rate, given investment performance and general economic conditions). Thus, an institution should monitor principal in an accounting sense, identifying the original value of the fund (the historic dollar value) and the increases in value necessary to maintain the purchasing power of the fund.[5]

Must the board consider all eight factors for every endowment fund appropriation?

The Act states that the board must consider the eight factors "if relevant," so at a minimum the board must consider each factor to determine whether or not it is relevant. As discussed below under "Contemporaneous Records," if the board determines that any factor is not relevant, it should document how it reached that conclusion.

If a factor is relevant, the board should go on to consider to what extent the factor affects the decision whether or not to appropriate or how much to appropriate. Although the factors should be considered individually, the board should also look at the "big picture" and consider how the factors, considered together and weighted appropriately, affect the decision at hand. The nature and extent of the board's consideration of the factors may vary from institution to institution, depending on the institution's size, purposes, programs, financial condition and other circumstances.

May an institution make a single appropriation decision for multiple endowment funds?

In this Office's view, the Act contemplates that decisions to appropriate from endowment funds will ordinarily be made on a fund-by-fund basis and documented in a separate contemporaneous record for each endowment fund.[6] A question has arisen as to whether there are circumstances in which the Act would permit an institution to make a single decision to appropriate from multiple endowment funds and document that decision in a single contemporaneous record. The question is of particular interest to larger institutions holding numerous endowment funds, for example, a community fund with numerous endowment donors or an educational institution with hundreds or even thousands of endowment funds for scholarships, endowed chairs and other purposes.

In this Office's view, the governing board of an institution may make a single decision to appropriate from multiple endowment funds, and this decision may be documented in a single contemporaneous record, provided that the endowment funds are similarly situated. The

[5] National Conference of Commissioners on Uniform State Laws, Uniform Prudent Management of Institutional Funds Act (2006), available at http://www.law.upenn.edu/bll/archives/ulc/umoifa/2006final_act.pdf ("UPMIFA") § 4, Comment at p. 21.

[6] This is evidenced by N-PCL § 553's consistent use of the defined terms "donor," "endowment fund" and "gift instrument," each of which is phrased in the singular. See also the definitions of these terms in N-PCL § 551(a-1), (b) and (c).

governing board should develop written procedures for determining when a group of funds is similarly situated for this purpose. Such a determination may be based on factors including the purposes of the funds as stated in the gift instruments, the spending restrictions imposed in the gift instruments, the durations of the funds, the financial condition of the funds, whether the funds are invested similarly, and such other factors as may be relevant under the circumstances.

A decision to treat a group of endowment funds as similarly situated group should be made with care to ensure that any decision to appropriate from the funds collectively would be justified if the factors in N-PCL § 553(a) were applied to each fund individually.

What is meant by "alternatives to expenditure of the endowment fund," and how should institutions give consideration to that factor?

As noted above, N-PCL § 553(a) requires that, in making a determination to appropriate or accumulate from an endowment fund, the board must consider, if relevant, eight factors, including "(7) where appropriate and circumstances would otherwise warrant, alternatives to expenditure of the endowment fund, giving due consideration to the effect that such alternatives may have on the institution." In this Office's view, the inclusion of this factor, which is unique among all states that have adopted UPMIFA, was intended to ensure that boards do not automatically decide to appropriate from endowment funds when circumstances warrant considering whether reasonable alternatives are available. For example, if an endowment fund has diminished in value, the board may determine that it is appropriate to take steps to avoid or reduce further spending of the fund. Such steps might include, where appropriate, fund-raising efforts, expense reductions, sale of non-essential assets, or reductions in non-essential staff. The board might also consider whether certain expenditures can prudently be deferred. The board should identify the particular alternatives that might be appropriate in the circumstances and discuss to what extent these steps are feasible as an alternative to endowment spending, including what impact such alternatives would have on the institution's operations and programs. The consideration of alternatives should be appropriately documented (see "Contemporaneous Records," below).

Contemporaneous Records of the Determination to Appropriate

What should the contemporaneous record address?

The contemporaneous record of the determination to appropriate should address each of the eight factors included in N-PCL § 553(a) and discuss the consideration that the board gave to each factor. In this Office's view, it is not sufficient to state in a conclusory fashion that the board considered a particular factor; rather, the record should describe the substance of the consideration given to each factor. If any factor was deemed not relevant to the board's decision, the record should explain why.

As stated above, if the governing board of an institution makes a single decision to appropriate from multiple endowment funds that are similarly situated, it is this Office's view that the decision may be documented in one contemporaneous record.

How should the contemporaneous records be documented?

The form of the record is less important than the substance. The record may be made in the board's minutes; alternatively, boards may wish to develop a record especially for the purpose of documenting their decisions to appropriate endowment funds for expenditure. Contemporaneous records of decisions to appropriate from endowment funds should be maintained as part of the permanent records of the institution. The Charities Bureau may request production of these records in the exercise of the Attorney General's supervisory authority over institutions.

When should contemporaneous records be prepared?

To be contemporaneous, the record should be prepared at the time the board makes a decision to appropriate from an endowment or immediately thereafter. If the board relies on advice and information from professionals (such as lawyers, accountants or investment advisors) when it decides to appropriate endowment funds for expenditure, it may (but is not required to) incorporate all or part of such written advice in its contemporaneous record, to the extent such advice is not privileged, confidential or proprietary.

Presumption of Imprudence

Does the presumption of imprudence mean that an institution can safely appropriate up to 7% of the value of its endowment funds each year?

The Act makes it clear that an appropriation of 7% or less of the value of an endowment fund in any year does not create a presumption of prudence. The level of appropriation for each endowment fund held by an institution must be determined in accordance with the prudence standard in N-PCL § 553(a) of the Act, after consideration of the enumerated factors.

Does an endowment spending policy of 7% or less per year in itself ensure that the presumption of imprudence will not be triggered?

No. The Act's 7% standard is based on the endowment fund's fair market value averaged over at least *five years* immediately preceding the year in which the appropriation for expenditure is made (or over the life of the fund if the fund has been in existence less than five years). If, for example, an institution's spending policy is based on fair market value averaged over a shorter period, the spending policy may result in appropriations that are presumptively imprudent under the Act. All spending policies should be reviewed to determine how they interact with the presumption of imprudence. If necessary, institutions must perform a separate calculation, averaging the fund's fair market value over at least the preceding five years, in order to determine whether a proposed appropriation would be presumptively imprudent.

Managing and Investing Institutional Funds

What topics should the investment policy address?

There is no "one size fits all" investment policy that applies to all institutions. The contents of the investment policy will depend on factors including the extent of the financial resources of the institution, the types of investments it holds, the charitable purposes of the institution, and nature and scope of the institution's activities or programs. Examples of the subjects an investment policy may include:

(1) general investment objectives;
(2) permitted and prohibited investments;
(3) acceptable levels of risk;
(4) asset allocation and diversification;
(5) procedures for monitoring investment performance;
(6) scope and terms of delegation of investment management functions;
(7) the investment manager's accountability;
(8) procedures for selecting and evaluating external agents;
(9) processes for reviewing investment policies and strategies; and
(10) proxy voting.

The board should review the investment policy at regular intervals and whenever a change in the institution's financial condition or other circumstances so require.

Delegation of Management and Investment Functions to Outside Agents

What steps should a board take to assess an outside investment agent's independence?

Governing boards should be diligent in assessing the independence of outside investment agents – both before and after retaining them. Outside investment agents should be selected based on the agent's competence, experience, past performance, and proposed compensation, and not on any business or personal relationships between the agent and board members or other insiders. It is essential that board members are capable of objectively assessing and monitoring investment performance and risk without regard to those relationships.

Before retaining an agent, the governing board should consider whether any business or personal relationships would reasonably be expected to interfere with the ability of the board to provide proper oversight. For example, assume a chairman of the board asks the board to transfer management of institutional funds to his private investment firm. The board must decide whether it is prudent to do so under the circumstances, and whether it feels it can objectively oversee and monitor the agent's performance going forward. The governing board should also consider whether the retention of outside agents who have business or personal relationships with board members or other insiders might prevent the board from receiving independent advice on investment strategy and risk. For example, assume the board chair wishes to switch investments to his firm, in part to invest in derivative products developed by his firm. Can the board of directors, based on advice it receives from investment advisors employed by the board chair's firm,

objectively determine in good faith that such an investment strategy is in the best interests of the organization?

To avoid these situations and alleviate the pressure that board members may experience, some boards may determine that the best course of action is to adopt a policy requiring that all outside agents be independent. Although not required by the Act, it is this Office's view that institutions are well-advised to adopt policies that require full disclosure of relationships with outside agents and implement practices that ensure objective oversight by the board. At a minimum, an institution should have a conflict of interest policy and follow the policy in selecting, continuing or terminating the agent. Such a policy would generally include procedures for determining whether any of the institution's officers or directors have a financial interest in the agent or have any other material business or personal relationship with the agent. If so, the policy should provide for reporting such relationships or interests to the board and should address abstention or recusal of the director or officer in question.

Release of Donor-Imposed Restrictions on Management, Investment, or Purpose of an Institutional Fund

What should an institution do before seeking court release of a donor-imposed restriction on an institutional fund?

Because a court proceeding can be expensive and time-consuming, an institution may first wish to inquire whether the donor is available and willing to consent in writing to the proposed release or modification in accordance with N-PCL § 555(a). The donor's written consent would obviate the need for court approval.

If it is necessary to seek court release or modification of a donor-imposed restriction, when should the institution contact the Attorney General's Office?

Although not required by law, the Attorney General's Charities Bureau urges institutions and their counsel to submit a draft petition to the Charities Bureau for review and discussion before filing the petition with the court. A copy of the gift instrument and other relevant documentation should also be submitted in advance. Advance review by the Charities Bureau can help to identify and resolve potential issues, thus simplifying the proceeding and saving time. Petitions should be submitted to the Charities Bureau at the earliest possible time to allow sufficient time for review. Please confirm that the Charities Bureau's review has been completed before commencing a proceeding in court.

Release of Restrictions on "Small, Old" Funds

What procedures apply when submitting a notice to the Attorney General under N-PCL § 555(d) to release or modify a restriction on a "small, old" fund?

The institution should first determine whether the donor, if available, will consent to the release, thus avoiding the need to submit a notice to the Attorney General. If the donor is not

available or is unwilling to consent, then the institution must comply with § 555(d) in order to release the restriction. First, the institution must make a record (typically, a resolution of the board) approving the release or modification of the restriction. A copy of this record must be submitted to the Attorney General's Charities Bureau together with a written notice of the institution's intention to release the restriction and explaining why the restriction has become unlawful, impracticable, impossible to achieve, or wasteful. The notice must also describe the proposed use of the fund if the restriction is released.

In addition to meeting the above statutory requirements, the notice to the Attorney General's Charities Bureau should include a copy of the gift instrument and other documentary evidence sufficient to show that the fund's total value is less than $100,000 and that more than 20 years have elapsed since the fund was established. Additionally, if the donor is available, and particularly if the donor has withheld consent, the notice should include copies of any correspondence between the institution and the donor with regard to the proposed release or modification. If the donor has been notified pursuant to N-PCL § 555(d)(4), a copy of this notice should be included in the notice sent to the Attorney General.

Notices to the Attorney General pursuant to N-PCL § 555(d) should be sent as follows:

> *If sent by e-mail with PDF attachment (preferred method), to*:
> section555.notice@ag.ny.gov
>
> *If sent by regular mail, to*:
> Attorney General of the State of New York
> Attention: Chief, Charities Bureau
> 120 Broadway, 3rd Floor
> New York, NY 10271

What procedures apply after the § 555(d) notice is submitted to the Charities Bureau?

If the Charities Bureau has questions or requires further information, or if the Charities Bureau objects to the proposed release or modification, the Charities Bureau will notify the institution in writing within 90 days. If such notice is received, the institution should not release or modify the restriction unless and until it receives a further written notice from the Charities Bureau stating that any questions or objections have been resolved to the satisfaction of the Attorney General. We anticipate that many such issues will be resolved after discussions with the institution or its counsel.

CONCLUSION

For further information, please contact the Attorney General's Charities Bureau at the address shown above.

This and other Charities Bureau booklets, forms and instructions are available on the Attorney General's website at http://www.charitiesnys.com.

March 2011

Form 990, Part VI – Governance, Management, and Disclosure Frequently Asked Questions and Tips

Updated June 27, 2011

1. **Are all organizations required to complete Part VI and answer all of its questions regarding an organization's governance structure, policies, and practices?**

   Yes, all organizations that file Form 990 are required to answer all of the questions in Part VI. However, refer to Appendix E of the instructions to the Form 990 for instructions regarding how to complete Part VI in the case of a group return.

2. **Are all the policies and practices described in Part VI required by the Internal Revenue Code? If not, what happens if an organization reports that it does not have such policies in place?**

   In general, the policies and practices described in Part VI are not required by the Internal Revenue Code. However, organizations are required by the Code to make publicly available some of the items described in Question 18 of Part VI. This includes the Forms 990 of all organizations for their three most recent tax years; the Form 1023 or 1024 of all organizations that filed such forms on or after July 15, 1987, or had a copy on such date; and the Forms 990-T of a section 501(c)(3) organization for its three most recent tax years, if such forms were filed after August 17, 2006. The IRS will use the information reported in Part VI, along with other information reported on the form, to assess noncompliance and the risk of noncompliance with federal tax law for individual organizations and across the broader exempt sector.

3. **If an organization adopted a policy or practice after the close of its tax year but before it filed the Form 990 for such year, may it report that it had such policy or practice in place for purposes of answering Part VI?**

   In most instances, the instructions to the Part VI questions state the specific time or period to be used to answer a particular question. For example, Question 12a asks whether as of the end of the organization's tax year it had a written conflict of interest policy. An organization that did not have a written conflict of interest policy in place on such date must answer *no*. If that same organization adopted a written policy after the close of the tax year but before it filed its return, it may describe doing so in Schedule O. If the instructions to a particular question do not provide a specific time or period to be used to answer the question, the organization may take into account practices undertaken after the close of the tax year

in its response to that question (e.g., Question 12b regarding whether certain persons are required to disclose potential conflicts). Question 10 regarding whether the organization provided a copy of the Form 990 to its governing body before filing the form, and the process (if any) used by the organization to review the form, necessarily involves activity conducted after the close of the tax year.

4. Can our organization answer Yes to a question about having a policy if a committee of the board, rather than the board itself, adopted the policy, and was authorized to do so?

Yes. The organization may answer *Yes* to any question in Section B of Part VI, Form 990, that asks whether the organization has a particular policy if the organization's governing body (or a committee of the board, if the board delegated authority to that committee to adopt the policy) adopted the policy by the end of its tax year.

5. Part VI asks for information regarding an organization's members, if any, and any local chapters, branches or affiliates. Why is the IRS concerned about an organization's members and local units?

Much of Part VI focuses on who is responsible for governing the organization. In most organizations this includes a governing body, such as a board of directors, or trustees. Many organizations, however, also have members, who may be vested with certain governance or financial rights with regard to the organization. Part VI, Questions 6 and 7, ask whether an organization has members, and if so what their governance rights are, in order to provide a more complete and accurate picture about where governance authority is vested and about the organization's legal structure. Part VI, Question 9 asks about local chapters, branches and affiliates to obtain information about whether and how the organization exercises supervision and control over its chapters, branches, and affiliates to ensure that their activities are consistent with those of the organization. This question is designed to obtain information about the extent to which the filing organization's policies and practices extend to all of its parts or to affiliated entities.

6. **Is an organization required by federal tax law to provide a copy of Form 990 to its board or governing body, or have its board or governing body review the form, before it is filed with the IRS?**

No. Nonetheless, it is required to answer Question 10 regarding these matters.

7. **Question 1b asks for the number of independent voting members of the governing body. May an organization use its own definition of independence to answer this question?**

No, the organization must use the three-part definition contained in the instructions to this question to determine whether a particular voting member of its governing body is independent for purposes of Form 990 reporting. Note that this definition will vary from other meanings of the term *independent* that may apply to the organization, such as for state law or internal conflict of interest policy purposes.

8. **How hard do we have to look for the information requested in Questions 1 and 2 of Form 990, Part VI regarding independent directors and business and family relationships among Board members, officers, and key employees? What if we are unable to obtain and report all the reportable information?**

As described in the instructions, the organization need not engage in more than a reasonable effort to obtain the necessary information to answer these questions. An example of a reasonable effort would be for the Form 990 preparer or an officer eligible to sign the Form 990 to distribute a questionnaire annually to each of the organization's officers, directors, trustees, and key employees asking for the information that needs to be reported in response to Questions 1 and 2. The questionnaire could include the name, title, date, and signature of the person reporting information, and contain the Form 990 Glossary definitions of *independent voting member of governing body*, *family relationship*, *business relationship*, and *key employee*. The organization may rely on information it obtains in response to such a questionnaire in answering Questions 1 and 2.

9. **Does the IRS intend to provide model or sample policies (e.g., joint venture policy) that organizations could adopt in order to answer *yes* to the questions in Part VI regarding such policies or practices?**

The IRS does not plan to provide model or sample policies to be used for this purpose. Whether an organization adopts a policy of the type referred to in Part VI of Form 990 is a decision to be made by each individual organization. If an organization decides to adopt such a policy, it should consider its own particular facts and circumstances, including its size, culture, type and structure, in designing and implementing the policy.

10. Must the filing organization provide governance information regarding its related organizations?

In general, no. Part VI is to be completed with respect to the facts and circumstances of the filing organization. Thus, an organization is not required to provide information regarding the composition of the governing body or policies or practices of a related organization, such as a joint venture, for-profit subsidiary, parent, or brother-sister exempt organization. However, Appendix E provides information regarding how Part VI is to be completed in the case of a group return, Question 1b asks about compensation from transactions with related organizations for purposes of determining a governing board member's independence, and Question 9 asks whether the organization's policies and practices extend to local affiliates.

11. If the filing organization is controlled by an organization with a conflicts of interest policy, whistleblower policy, and document retention and destruction policy, should the filing organization answer *yes* or *no* to Part VI, Questions 12a, 13 and 14?

Because these questions ask whether the **filing organization** has these policies, answer *yes* only if the filing organization's governing body has adopted the policies of the controlling organization or other such policies. Otherwise, answer *no*. The filing organization can explain in Schedule O how it is governed or otherwise affected by the policies of its parent.

12. What are the governance reporting requirements for organizations that file Form 990-EZ?

Form 990-EZ was not revised to include a governance section. However, Question 34 (regarding changes to organizing documents), which was included in the 2007 Form 990-EZ, has been retained.

Not-For-Profit/Exempt Organizations Blog

Posted at 11:28 AM on June 20, 2011 by Christopher T. Bird

275,000 Nonprofits Lose Tax-Exempt Status

The IRS announced **June 8, 2011** that approximately **275,000** organizations lost their *tax-exempt status* because they did not file annual returns for **three** consecutive years. The IRS has published on its website separate lists of affected organizations for each state; OpenData also provides on its website a searchable combined list.

While Section 6033(a) of the Tax Code requires most tax-exempt organizations to file annual information returns, the Pension Protection Act of 2006 imposed a filing requirement on *small* organizations for the first time in 2007. Despite the IRS's information campaign over the last several years, it appears many organizations nevertheless remained unaware of their filing obligations and that, under Code Section 6033(j), organizations will lose their exempt status if they do not file for three consecutive years.

What does *automatic revocation* mean for *organizations* and their *donors*? An organization that loses it tax-exempt status must pay **corporate income tax** on its annual revenues and file the appropriate income tax return. The organization may also *lose* its **state tax exemption** if such exemption is dependent on federal tax-exempt status. In addition, the organization will no longer be eligible to receive **tax-deductible charitable contributions.**

Organizations subject to automatic revocation that wish to have their tax-exempt status reinstated must file an application for exemption and pay the appropriate user fee. In a show of heart, the IRS is allowing small organizations (i.e., those with annual gross receipts of $50,000 or less for 2010) applying for reinstatement to pay a lesser application fee of $100 instead of the usual fee of $400 or $850. And in an even grander gesture, the IRS will treat eligible small organizations applying for reinstatement before December 31, 2012 as having established "reasonable cause" for their filing failures, meaning their tax-exempt status will be reinstated retroactive to the date it was automatically revoked.

Eligible small organizations should consult IRS Notice 2011-43 to take advantage of retroactive reinstatement. Other organizations seeking retroactive reinstatement should review IRS Notice 2011-44. More information on automatic revocation, including a helpful FAQ, can be found on the IRS website and our previous posts on April 5, 2010 and July 27, 2010.

Comments (0) Read through and enter the discussion with the form at the end

Proskauer Rose LLP
Boca Raton 2255 Glades Road
Suite 421 Atrium
Boca Raton, FL 33431-7360
Phone: 561.241.7400

Elements of Relevant Criminal Statutes

By
Judah I. Kupfer, Esq.

I. Criminal Tax Fraud

A. **Tax Evasion (26 U.S.C. §7201)** (five year felony)

1. An affirmative act of evasion
   - Frequently this is the filing of a false tax return, but it can be many different things designed to hide or mislead
2. A substantial tax deficiency (i.e. successful at cheating on taxes)
3. Willfulness
   - I.e., a voluntary, intentional violation of a known legal duty (Cheek v. US, 498 US 192, 201 (1991))
   - This is usually the battleground in contested criminal tax cases – willfulness is the difference between civil tax liability vs. criminal tax liability
   - NOTE: Willful blindness may also constitute intent for criminal liability. Willful blindness is turning a blind eye to what otherwise should be obvious – deliberate ignorance and failure to follow up in the face of information that suggests probable illicit activity.

B. **"Tax Perjury" (26 U.S.C. §7206(1))** (three year felony)

1. The signing of a tax return under penalties of perjury
   - Extends to any document submitted to IRS that is signed under penalties of perjury
2. The return is false as to a material matter

   NB: it does not need to be a material amount
3. Willfulness

C. **Aiding and Assisting (26 U.S.C. §7206(2))**

1. Aid, assist or advise the preparation of a tax return
   - Extends to other documents submitted to the IRS
2. Which is false as to a material matter
3. Willfulness

Note: One can only be held liable for aiding and assisting if there was actual tax fraud. If there was no underlying fraud, there is no aiding and assisting liability.

D. **Conspiracy (18 U.S.C. §371)**

1. two or more persons
2. conspire
3. to defraud the United States or any agency thereof (e.g. IRS), or to evade and defeat a substantial part of the income taxes due.

Other criminal tax statutes include:

- 26 U.S.C. §7203 – misdemeanor for willful failure to file tax returns, but five year felony for willfully failing to file Report of Cash Transactions of more than $10,000 or to structure or counsel the structuring of such transactions (Form 8300)
- 26 U.S.C. §7207 – misdemeanor for submitting false documents to IRS
- 18 U.S.C. §287 – filing false claims i.e. seeking refunds by filing false returns
- 18 U.S.C. §7212 – obstructing the lawful function of the IRS (the "one man conspiracy statute")
- 31 U.S.C. §§ 5314-5322 – currency transaction reporting and structuring violations.

II. Money Laundering (18 U.S.C. §1956)

A. <u>"Transaction" Money Laundering</u>

1. Conducting a financial transaction with the intent to promote specified unlawful activity ("SUA")
2. Conducting a financial transaction with the intent to commit tax fraud
3. Conducting a financial transaction designed to conceal or disguise the proceeds of SUA
4. Conducting a financial transaction designed to avoid a state or federal reporting requirement

For any of the four "transaction" money laundering offenses, the government must prove:

1) The defendant knew that the property represents the proceeds of some form of unlawful activity
2) The property is in fact the proceeds of SUA
3) The defendant conducted a financial transaction or attempted to do so
4) The defendant intended to commit one of the four offenses listed in items 1-4, above.

B. <u>"Transportation" Money Laundering</u>

1. Transporting or transferring a monetary instrument into or out of the US with the intent to promote SUA

2. Transporting or transferring a monetary instrument into or out of the US with knowledge that it is the proceeds of unlawful activity and the transportation is designed to conceal or disguise the proceeds of SUA

3. Transporting or transferring a monetary instrument into or out of the US with knowledge that it is the proceeds of unlawful activity and the transportation is designed to avoid a reporting requirement

For any of the three "transportation" money laundering offenses, the government must prove:

1) Money or a monetary instrument
2) That is transported or transferred into or out of the US
3) With the intent to commit one of the three offenses listed in items 1-3, above

C. <u>"Sting Operations"</u>

A defendant can be found guilty of laundering "sting money" if he uses it to:

a) Conduct a financial transaction with the intent to promote the carrying on of SUA; or
b) Conduct a financial transaction with the intent to conceal or disguise the money believed to be the proceeds of SUA; or
c) Conduct a financial transaction with the intent to avoid a reporting requirement

D. <u>SUA Transactions</u>

It is a crime to engage in a monetary transaction where:

1. The defendant knows the transaction involves property constituting or derived from the proceeds of criminal activity

2. The proceeds are in fact derived from SUA

3. The property is worth more than $10,000

Operating as an Unlicensed Money Service Business

18 USCS §1960 provides:

"Whoever knowingly conducts, controls, manages, supervises, directs, or owns all or part of an unlicensed money transmitting business, shall be fined in accordance with this title or imprisoned not more than 5 years, or both."

"The term 'unlicensed money transmitting business' means a money transmitting business which affects interstate or foreign commerce in any manner or degree and—

(A) is operated without an appropriate money transmitting license in a State where such operation is punishable as a misdemeanor or a felony under State law, whether or not the defendant knew that the operation was required to be licensed or that the operation was so punishable;
(B) fails to comply with the money transmitting business registration requirements under *section 5330 of title 31, United States Code*, or regulations prescribed under such section; or
(C) otherwise involves the transportation or transmission of funds that are known to the defendant to have been derived from a criminal offense or are intended to be used to promote or support unlawful activity;"

"[T]he term "money transmitting" includes transferring funds on behalf of the public by any and all means including but not limited to transfers within this country or to locations abroad by wire, check, draft, facsimile, or courier;"

31 USCS § 5330 provides:

"Any person who owns or controls a money transmitting business shall register the business (whether or not the business is licensed as a money transmitting business in any State) with the Secretary of the Treasury…"

" The term "money transmitting business" means any business other than the United States Postal Service which … provides check cashing, currency exchange, or money transmitting or remittance services, or issues or redeems money orders, travelers' checks, and other similar instruments or any other person who engages as a business in the transmission of funds, including any person who engages as a business in an informal money transfer system or any network of people who engage as a business in facilitating the transfer of money domestically or internationally outside of the conventional financial institutions system;"

31 CFR §103.15 (also known as the "Bank Secrecy Act") provides:

A Money Service Business includes: "[A]ny person doing business, whether or not on a regular basis or as an organized business concern, in one or more of the capacities:

- **Check casher** A person engaged in the business of a check casher (other than a person who does not cash checks in an amount greater than $1,000 in currency or monetary or other instruments for any person on any day in one or more transactions)
- **Money transmitter**
  (A) Any person, whether or not licensed or required to be licensed, who engages as a business in accepting currency, or funds denominated in currency, and transmits the currency or funds, or the value of the currency or funds, by any means through a financial agency or institution, a Federal Reserve Bank or other facility of one or more Federal Reserve Banks, the Board of Governors of the Federal Reserve System, or both, or an electronic funds transfer network; or
  (B) Any other person engaged as a business in the transfer of funds."

31 CFR §103.41 provides:

"…each money services business (whether or not licensed as a money services business by any State) must register with the Department of the Treasury and, as part of that registration, maintain a list of its agents as required by 31 U.S.C. 5330 and this section."

"Any person who fails to comply with any requirement of 31 U.S.C. 5330 or this section shall be liable for a civil penalty of $5,000 for each violation. Each day a violation of 31 U.S.C. 5330 or this section continues constitutes a separate violation. In addition, under 31 U.S.C. 5320, the Secretary of the Treasury may bring a civil action to enjoin the violation. See 18 U.S.C. 1960 for a criminal penalty for failure to comply with the registration requirements of 31 U.S.C. 5330 or this section."

Reporting Requirement

IRS Form 8300

- This is a filing to be made with the IRS.
- Who needs to file?
  a) Each person engaged in a trade or business who, in the course of that trade or business, receives more than $10,000 in cash in one transaction or in two or more related transactions, must file Form 8300, OR
  b) If you receive more than one cash payment for a single transaction or for related transactions, you must report the multiple payments any time you receive a total amount that exceeds $10,000 within any 12-month period.
- What is a related transaction?
  a) Any transactions conducted between a payer (or its agent) and the recipient in a 24-hour period OR
  b) even if they occur over a period of more than 24 hours, if the recipient knows, or has reason to know, that each transaction is one of a series of connected transactions.
- What is included in "cash"?
  a) U.S. and foreign coin and currency received in any transaction.
  b) A cashier's check, money order, bank draft, or traveler's check having a face amount of $10,000 or less that is received in a designated reporting transaction, or that is received in any transaction in which the recipient knows that the instrument is being used in an attempt to avoid the reporting of the transaction.
- A yeshiva, shul or *gemach* are not exempt from this filing.
- There is a similar obligation to also file a "Currency Transaction Report" (CTR) with the Department of the Treasury, Financial Crimes Enforcement Network ("FinCEN")
- Need Not file: In a transaction that is not in the course of a person's trade or business. E.g. donation.
- Where to file? File the form with the Internal Revenue Service, Detroit Computing Center, P.O. Box 32621, Detroit, Ml 48232. Instructions are on the form.
- Penalties for not filing: A minimum penalty of $25,000 may be imposed if the failure is due to an intentional or willful disregard of the cash reporting requirements. Violations may also be subject to criminal prosecution which, upon conviction, may result in imprisonment of up to 5 years or fines of up to $250,000 for individuals and $500,000 for corporations or both.
- For more information about this form and filing requirement, instructions are located within the form.

FBAR Filing – Form TD F 90-22.1

- The FBAR is a Report of Foreign Bank and Financial Account.
- Who must file? Any U.S. person or corporation or other entities (this includes a U.S. citizen or a person in and doing business on a regular and consistent basis in the U.S.) who has a financial interest in or signature or other authority over any financial account in a foreign country, if the aggregate value of these accounts exceeds $10,000 at any time during the calendar year.
- What is signature or other authority? A person has such authority over an account if he can control the disposition of money or other property in it by delivery of a document

containing his signature to the bank or other person with whom the account is maintained. Other authority exists when a person can exercise power (orally or by some other means) that is comparable to signature authority by direct communication to the bank or other person with whom the account is maintained.

- Whether someone actually uses the authority is irrelevant.
- What is included in "financial account"? A bank, securities, securities derivatives or other financial instruments accounts. It includes: savings, demand, checking, deposits among others. An account with a financial institution that holds noncash assets such as gold is also included.
- The requirements to file would include a U.S. resident with elderly parents in Canada who has power of attorney on accounts in Canada even if he never exercises such power. If the person has power of disposition over the funds, it is included.
- If a U.S. company owns more than 50% of a foreign company that holds foreign accounts, the U.S. company must file.
- How do you report such accounts? On form 1040 Schedule B, by completing boxes 7a and 7b and completing form TD F 90-22.1.
- When is the FBAR due? June 30th of the year following the year that the account holder meets the $10,000 threshold. The granting by the IRS of an extension to file federal income tax return does not extend the due date for filing an FBAR. There is no extension available for filing the FBAR.
- The FBAR form is available on the IRS website or by calling 800-829-3676. The helpline for questions is 800-800-2877 or email FBARquestions@irs.gov.
- The FBAR is not to be filed together with the filer's federal tax return. Instead, it is to be sent to U.S. Department of the Treasury, P.O. Box 32621, Detroit, MI 48232-0621.
- What are the penalties for not filing an FBAR? Possible civil penalties (up to 6 years back) and criminal penalties.

Record Keeping

- The record keeping requirements do not vary greatly from that of a commercial corporation – generally, what is required is records sufficient to show receipt and disbursements including income and expenses. This should include:
    1. journals of cash receipts and cash disbursements (each in date order),
    2. loan ledger,
    3. general ledger
    4. and, if payroll is made, payroll records
    5. substantiation for any tax position
- The length of time the organization must hold these records depends on the kinds of records. It can vary between 3 years for some records, 7 years for others, and yet other records must be kept permanently. Your organization should consult an accountant for more detail and to institute a records retention policy, if you do not already have one in place.
- Records should be detailed enough so that the transaction is completely understood.

Other Corporate Formalities

- The first sign that any organization is not running properly is when corporate formalities are neglected, so it is important to ensure that these are taken seriously.

- Each corporation must have a **board of directors** that meets at occasional **board meetings** (even if those meetings are less formal).
- Both Religious Corporations and not-for-profits should have certain policies in place including:
    1. **by-laws** delineating oversight responsibility as well as its standards for financial transactions,
    2. a **file-retention/destruction policy**,
    3. **whistleblower protection policy**
    4. and a policy for **conflicts of interest**.

DO'S

Holding Scheduled Meetings

- The date for your **annual shareholders' meeting** should be in the bylaws.
- Bylaws typically call for an **annual board of directors meeting** to be held immediately after the annual shareholders' meeting.

Holding special meetings of the board when matters of importance come up such as:

- Entering into a new lease
- Entering into a substantial funding commitment
- Opening a new bank account
- Entering into any other significant contractual agreement
- Changing an officer's salary
- Filling a vacancy on the board or appointing a new officer
- Entering into a significant new venture;
- Considering the sale, in whole or in part, of the assets or the dissolution of the business

Keeping good records

- Take minutes of meetings and maintain a corporate record book.
- Keep good financial records.

Keeping things close to the vest

- Directors and officers owe a fiduciary duty to the corporation, meaning that they must at all times do what is in the best interest of the corporate entity and its shareholders.
- Keep corporate matters confidential to the extent possible.

Developing a Planning Routine:

- Review each year's activities during the final month of the fiscal year.
- Budget ahead for the longest period reasonably possible and review and analyze results at least semi-annually
- Review operations with your attorney and CPA to ensure tax planning is properly emphasized.
- Develop formal long-range planning capacities beyond the budgeting process.
- **Signing all contracts in the name of the corporation** with a signature block in substantially the following form:

--[Name of corporation]--

By:___________________________
--[Title of individual]—

And corporation representatives should also:

- Adopt a corporate resolution that **authorizes an officer to sign a contract**.
- Make all corporate purchases in the name of the corporation

- Maintain corporate funds in a **corporate account** or accounts separate and apart from any other account
- Carry reasonable **insurance** on the corporation, considering the risks inherent in the corporation's business
- Make sure you **fund the corporation at the time of incorporation with enough money** to keep it going during an initial phase of operations
- Set up a **review mechanism for decision-making**, so that all aspects of a proposed course of action will be considered
- **Comply with Articles of Incorporation, the Bylaws, and other organization documents** or contractual restrictions

DONT'S

- **Don't commingle corporate and personal funds**
- **Don't use corporate accounts for personal loans** or other personal purposes
- **Don't do insider deals** on loans, leases, etc., between the corporation and a principal other than on an "arm's length" basis (just as you would with someone not associated with the corporation)
- **Don't use corporate assets for personal use**

Parsonage Basics

1. What is parsonage?

    a) When reporting gross income,
    b) for federal (and most state and local) income tax purposes (but not social security tax)
    c) rabbonim, rabbeim and limudei kodesh teachers (male or female)
    d) may exclude a portion of his or her income
    e) previously designated (each year) by his employer (generally, a shul or yeshiva)
    f) as a "housing allowance."

2. Limitations on parsonage – The rabbi/rebbe, may exclude from federal income taxes the lesser of:

    a) The amount previously designated as the housing allowance
    b) The amount of actual housing expenses i.e. the amount actually spent that year on housing expenses
    c) If owns a home, the fair rental value of the property (furnishing plus utilities).

Qualified Tuition Reduction Basics

What is a QTR Program?

a) A program an educational organization may adopt
b) in which it may agree to pay
c) a specified sum (whatever the school designates to pay)

d) toward the tuition at the same or another educational organization (elementary, high school or college education – only undergraduate level classes)
e) incurred by certain relatives
f) of a designated class of employees (without discrimination to that class)
g) which will be tax-free to the employees (for all federal, state and local taxes – including FICA)
h) as a fringe benefit of employment (may not be salary reduction)

ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK
MARCH 11, 2010

OVERVIEW OF FEDERAL CRIMINAL TAX INVESTIGATIONS AND PROSECUTIONS

LAWRENCE S. HORN, ESQ.
SILLS CUMMIS & GROSS, P.C.
ONE RIVERFRONT PLAZA
NEWARK, NEW JESEY 07102

ONE ROCKEFELLER PLAZA
NEW YORK, NY 10022
973.643.5484
lhorn@sillscummis.com

INTRODUCTION

These materials are designed to provide a topical summary of timely criminal tax issues of interest to the non-criminal tax lawyer and an overview of how investigations are conducted, the critical element of willfulness in criminal tax cases and a brief discussion of how conspiracy has once again become "the darling of the modern [tax] prosecutor". Familiarity with these concepts is imperative in order for the lawyer to properly advise a client concerning what steps to take or not to take when becoming aware that his or her client is under investigation or about to be under investigation.

Discussion Points

Organization

- The Internal Revenue Service is divided into distinct divisions with distinct functions: Criminal Investigation and Operating Divisions, primarily Examination (Revenue Agents) who audit and Collection (Revenue Officers) who seek to collect delinquent taxes due and/or returns that have not been filed.

The Statutory and Regulatory Framework

- 26 U.S.C. § 7201 (five year felony for tax evasion), § 7203 (misdemeanor for willful failure to file tax returns, but five year felony for willfully failing to file Reports of Cash Transactions of more than $10,000 or to structure or counsel the structuring of such transactions (Form 8300)), § 7206 (three year felony for subscribing to materially false tax returns or aiding and assisting in

the preparation of false returns), § 7207 (misdemeanor for submitting false documents to IRS), 18 U.S.C. § 287 (filing false claims; i.e., seeking refunds by filing false returns), 18 U.S.C. § 371 (conspiracy to defraud an agency the United States (IRS) and/or to evade and defeat income taxes (five year felony)). Recently, 26 U.S.C. § 7212 (obstructing the lawful function of the IRS) has been used to bring "one man conspiracy" prosecutions against taxpayers for obstructive conduct dating back well beyond six years.

- 31 U.S.C. §§ 5314-5322 (currency transaction reporting and structuring violations), et seq. (currency transaction reporting violations).

- The impact of the United States Sentencing Guidelines (whether mandatory or advisory).

Principles and Common Misconceptions

- The IRS is just interested in tax collection.

FALSE - Every year, the IRS Criminal Investigation Division initiates several thousand investigations of suspected criminal non-compliance concerning violations of one or more federal statutes. The IRS will want its cake and eat it too! The IRS will prosecute criminally even if your client pays up after being contacted. In fact, the offer of payment and the filing of amended returns after IRS-CID contacts him/her is an admission which will often form part of the proof IRS uses to criminally prosecute and after the

criminal prosecution, IRS will still expect payment, plus substantial civil penalties (often 75% of the tax).

- Only the banks care about currency in amounts under $10,000.

FALSE - IRS also criminally prosecutes certain businesses (including attorneys) who receive large payments in currency ($10,000 or more) from customer/clients and fail to report such transactions on IRS Form 8300 and lawyers and accountants who counsel clients to structure their cash transactions in such a manner to evade their reporting responsibilities.

- IRS and State taxing authorities do not work together.

FALSE - There is no legal prohibition against the IRS and the State of New York prosecuting the same individual for the omission of the same income from his/her respective federal and state returns.

An increasing number of Circuits have held that the federal "tax loss" and state "tax loss" are combined for computing the U.S.S.G. guideline tax loss.

- Even if my client is prosecuted, he/she will only get probation because he/she is a "good citizen" and has never been in trouble before.

FALSE – Most people IRS prosecutes are ordinary "good citizens" with clean records and legal source income. Moreover, under current "advisory" United States Sentencing Guidelines some term

of incarceration is contemplated for criminal tax deficiencies of only $12,500.

- If my client is cooperative in the investigation, IRS will "go easy" and probably not prosecute criminally.

FALSE – As absurd as it seems, "cooperating" after an investigation has begun; i.e. freely speaking to the IRS, producing otherwise privileged documents, filing amended returns are all used as admissions in the ultimate prosecution of the client.

How Do I Know if an IRS Contact is Civil or Criminal?

- If two agents appear and want to speak to your client, it's a good bet they are Special Agents from the Criminal Investigation Division (IRS Special Agents, like FBI and other federal law enforcement personnel, always travel in pairs so that any "admissions" or, conversely, false statements made by the subject will have two witnesses).

- If an Operating Division Examination (Revenue Agent) or Collection (Revenue Officer) agent appears, he/she is civilly minded normally, but if there are known "landmines" in your client's tax situation (e.g. underreported income, unfiled returns, large tax balances due from previously filed returns, preparation of "less than accurate" IRS collection statements (Form 433), etc.) which, if discovered, appear to be fraudulent, these agents are required to refer their discovery to the Criminal Investigation Division for evaluations.

What makes a Tax Case Criminal? Answer: Willfulness

- Typically it is underreported income over a period of at least two years (i.e. a "pattern").

- How much income needs to be omitted for a case to be criminal?

  No hard and fast rule. IRS administratively considers unreported income giving rise to understatements of tax of $2,500/year and/or $10,000 in total to be potentially "criminal". In an egregious case, IRS may prosecute even if the dollars are less than those noted above.

- Wholly fictitious deductions of a significant amount (similar to "tax loss" as above) are also potentially criminal matters, although less commonly prosecuted.

- Deducting personal expenses on a corporate or partnership return for items like swimming pools, tennis courts, landscaping etc., if sizeable can turn a civil audit into a criminal investigation. Remember Leona Helmsley.

In criminal tax cases the Supreme Court has defined willfulness as a "'voluntary, intentional violation of a known legal duty.'" *Cheek v. United States*, 498 U.S. 192, 201 (1991) (quoting *United States v. Pomponio*, 429 U.S. 10, 12 (1976)).

In order to prove willfulness, the Government must prove "that the law imposed a duty on the defendant, that the defendant knew of his duty, and that he voluntarily and intentionally violated that

> duty." [Cheek, 498 U.S. at 201.] The showing of willfulness can be negated by "a defendant's claim of ignorance of the law or a claim that because of a misunderstanding of the law, he had *a good-faith belief* that he was not violating any of the provisions of the tax laws." *Id.* at 202 (emphasis added). The defendant's belief or misunderstanding need not be objectively reasonable, and whether it was held in good faith should be determined by the fact-finder. *Id.* at 202-203.

United States v. Aaron, No. 08-2185, 2009 U.S. App. LEXIS 28383, *6-7 (6th Cir. Dec. 28, 2009).

How are Criminal Tax Cases Investigated?

1. IRS Administrative Investigations

Special Agents of CI, working together with cooperating Revenue Agents (civil examiners from the Examination Division) investigate the case. A Special Agent can compel testimony and the production of documents by issuing IRS Administrative Summonses (26 U.S.C. §§ 7602-7609). After the Special Agent concludes the investigation with a recommendation of prosecution, the client's attorney has the opportunity to have a "Final District Conference" with the Special Agent in Charge (SAC) of the local CI office in an attempt to convince the SAC that prosecution is not warranted. The taxpayer's attorney must be extremely careful in making factual statements at that conference because the vicarious admissions rule applies because the attorney is the "representative" of the taxpayer by virtue of the

IRS Power of Attorney (Form 2848) that must be filed in order for IRS-CI to speak with the attorney.

If the Special Agent in Charge agrees with the prosecution recommendation of the Special Agent, the case is forwarded to the Tax Division of the Department of Justice where it will be assigned to an attorney in one of the regional Criminal Enforcement Sections. The taxpayer's attorney has the opportunity to have a conference with the Tax Division attorney and, at this conference, the vicarious admissions rule does not apply. The standard of review utilized by the Tax Division Attorney is (1) does the Government have a "prima facie" case, and (2) is there a reasonable likelihood of a conviction?

If the Tax Division of the Department of Justice agrees with the Special Agent's prosecution recommendation with or without modifications, the Assistant Attorney General for the Tax Division will authorize prosecution and send the case to the United States Attorney's Office in the District where venue lies with an instruction to initiate prosecution.

2. Title 26, Grand Jury Investigations

Special Agents of CI work directly with Assistant U.S. Attorneys in the investigation rather than use the administrative tools provided to them in the Internal Revenue Code to summon records and/or testimony. Initially (in the 1970s), this method was designed for the more complex case but in recent years is used in more than 50% of the tax investigations. A major benefit to the Government utilizing this method is that Grand Jury Subpoenae are used to compel testimony and the

production of documents and many of the legal roadblocks utilized by taxpayers' counsel in delaying production by virtue of the service of summonses, which are not self-executing, are eliminated by the service of a Grand Jury Subpoena.

If prosecution is recommended, there is no conference with the Special Agent in Charge in a Title 26 Grand Jury case. There is a conference with the attorney for the Tax Division of the Department of Justice but the Assistant U.S. Attorney handling the case is usually present at this conference. After the conference at the Tax Division, the Assistant Attorney General of the Tax Division will authorize prosecution and will send the case back to the investigating U.S. Attorney's Office with the necessary authorization to initiate prosecution. The taxpayer's attorney <u>must</u> request such a conference. It is not offered as a matter of right.

The New Favorite Tax Crime – Conspiracy, 18 U.S.C. § 371

In 1925 Second Circuit Judge Learned Hand described conspiracy as "that darling of the modern prosecutor's nursery." *Harrison v. United States*, 7 F.2d 259, 263 (2d Cir. 1925). If those words were aptly descriptive 85 years ago, they are even more so in the 21st Century. A review of the indictments and informations in major tax shelter prosecutions of certified public accountants from the most respected and prominent accounting firms, tax lawyers and bankers filed since 2000 shows a consistent charging of a multi-page conspiracy count running in one case in excess of fifty pages detailing with great specificity the alleged criminal acts of the conspirators. The conspiracy count is still very much a darling of the prosecutor because it can set forth highly detailed (and highly prejudiced) allegations in great detail in language understandable by a lay jury.

18 U.S.C. § 371 conspiracies may have one and/or two different objects; the first is to conspire to defraud the United States or an agency thereof (IRS), and the second is to conspire to evade and defeat a substantial part of the income taxes due. This broad language has been utilized by the United States Attorneys Offices in the New York metropolitan area.

In *United States v. Coplan* (S.D.N.Y. 09-Crim. 545, May 28, 2009), the "Klein" conspiracy, a term used to describe a conspiracy to defraud the United States or an agency thereof (named after *United States v. Klein*, 247 F.2d 908 (2d Cir. 1957)), the operative charging language for conspiring to defraud an agency of the United States (the IRS) reads as follows:

> It was a part and object of the conspiracy that *Coplan* and his co-conspirators unlawfully, willfully, and knowingly would and did defraud the United States and [an agency thereof, to wit,] the IRS, by impeding, impairing, defeating, and obstructing the lawful governmental functions of the IRS in the ascertainment, evaluation, assessment, and collection of income taxes.

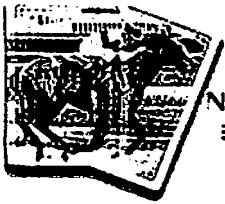
The operative charging language for conspiring to defeat and evade a substantial part of the income taxes due and owing in *Coplan* reads as follows:

> It was a part and object of the conspiracy that Coplan and his co-conspirators unlawfully, willfully, and knowingly would and did attempt to evade and defeat a substantial part of the income taxes

due and owing to the United States by the firm's clients, in violation of Title 26, United States Code, Section 7201.

Lastly, and quite importantly, in some cases there is a mail and/or wire fraud object of the conspiracy in order to provide the Government with a forfeiture predicate. In *United States v. Coplan* (*supra*), the wire fraud object of the conspiracy read:

> it was a part and object of the conspiracy that *Coplan* and his co-conspirators unlawfully, willfully, and knowingly having devised and intending to devise a scheme and artifice to defraud, and for obtaining money and property by means of false and fraudulent pretenses, representations, and promises, to wit, a scheme to defraud the IRS through the design, marketing, and implementation of the fraudulent tax shelter transactions, and for the purpose of executing such scheme and artifice and attempting so to do, would and did transmit and cause to be transmitted by means of wire and radio communications in interstate and foreign commerce, writings, signs, signals, pictures, and sounds, to wit, interstate telephone calls, faxes and e-mails, in violation of Title 18, United States Code, Section 1343.



New York State Racing And Wagering Board

Charitable Gaming

Raffles - Frequently Asked Questions:

1. What is considered a raffle?
A raffle shall mean and include those games of chance in which a participant pays money in return for a ticket or other receipt and in which a prize is awarded on the basis of a winning number or numbers, color or colors, or symbol or symbols designated on the ticket or receipt, determined by chance as a result of a drawing from among those tickets or receipts previously sold.

2. What about "50/50" and "split pot"? Are these considered raffles?
Yes. These activities are defined as raffles and are subject to the registration and licensing requirements listed below. Every "50/50" raffle (and all other raffles) must be properly listed on the organization's GCVS-1, GCVS-2 and if applicable, the GC-7R. All proceeds from all "50/50" raffles (and all proceeds from all other raffles) are required to be deposited into the organization's special raffle or games of chance checking account. All raffle proceeds are then to be disbursed according to NYS Games of Chance Rules and Regulations section 5624.21, "lawful expenditures".

3. Who is eligible to conduct a raffle?
Raffles may be conducted by "authorized organizations" who have applied for and received a games of chance identification number from the NYS Racing and Wagering Board.

"Authorized organizations" are defined in part to include bona fide religious or charitable organizations, bona fide educational, fraternal or service organizations or bona fide organizations of veterans or volunteer firefighters that operate without profit to their members.

In order for an organization to be eligible for a games of chance identification number, the organization must be domiciled in a municipality that has passed a local games of chance law. It is unlawful to conduct a raffle in a municipality that has not passed a local games of chance law. Furthermore, individuals and commercial businesses are not eligible for games of chance identification numbers and are restricted by law from conducting any type of raffle.

4. How does an organization apply for a games of chance identification number?
The organization must complete a 1A application and submit it to the NYS Racing and Wagering Board. The application includes providing a copy of the organizations Constitution and By-Laws and/or Incorporation papers. There is **no fee** to apply.

The 1A application can be printed from the website on the Charitable Gaming Forms and Applications page. Organizations may also call or write to the Board to obtain the application. The address and phone number are at the bottom of this page.

5. Are organizations required to obtain a raffle license from their city, town or village clerk?
Prior to the conduct of any raffle, an organization that has received a games of chance identification number must submit to the municipal clerk a completed "verified statement" (form GCVS-1) listing the dates of the organization's scheduled raffle drawings. A copy of the GCVS-1 shall also be submitted to the Racing and Wagering Board. If at the end of the calendar year the organization derived net profits of less than $30,000 from the conduct of raffles, a second completed "verified statement" (form GCVS-2) shall be submitted to the

municipal clerk listing the raffle activity of the organization. A copy of the GCVS-2 shall also be submitted to the Racing and Wagering Board.

6. What if the organization derives net profits of more than $30,000 from the conduct of raffles during the calendar year?
If during the calendar year the organization derives net profits of more than $30,000 from the conduct of raffles, the organization shall apply for a raffle license (on forms GC-2, 2A, 2B) from the municipal clerk at a cost of $25. A financial statement of raffle operations (form GC-7R) shall also be submitted to the municipal clerk at the end of the calendar year and an additional license fee of 2% of the net profits over $30,000 shall be paid either to the clerk (if the municipality has a bona-fide police department) or to the county fiscal officer (if the municipality does not have a bona-fide police department). A copy of the GC-7R shall also be submitted to the Racing and Wagering Board and if applicable, to the county fiscal officer.

7. What is an organization required to do with its raffle proceeds?
All raffle proceeds are to be disbursed according to Games of Chance Rules and Regulations Section 5624.21, "lawful expenditures". Fraternal and service organizations are required to donate 1/3 of their net raffle proceeds to a charity or charities on a calendar year basis.

If an organization derives more than $30,000 a calendar year from the conduct of raffles, that organization is required to deposit all raffle proceeds into a special raffle or games of chance checking account prior to disbursing any raffle proceeds. If an organization derives less than $30,000 a calendar year from the conduct of raffles, the organization is **not** required to have a separate account. However, the organization **is** required to submit a GCVS-2 to the municipal clerk to provide an accounting of raffle funds. A copy of the GCVS-2 shall also be submitted to the Racing & Wagering Board.

8. Who may sell raffle tickets on behalf of the organization?
NYS Racing and Wagering Board Games of Chance Rules and Regulations allow persons with a blood relationship or affiliate relationship to a member of the organization conducting the raffle to sell raffle tickets.

9. Can minors sell or purchase raffle tickets?
No. It is unlawful for persons under 18 years of age to sell or purchase raffle tickets.

10. Where can raffle tickets be sold?
Raffle tickets may be sold in the municipality where the organization is domiciled. Under certain circumstances raffle tickets may be sold in other municipalities. Raffle tickets may be sold in other municipalities in the organization's home county and in other municipalities in contiguous counties from the organization's home county only if a local games of chance law has been passed in each particular municipality where the organization intends to sell raffle tickets. The clerk in each particular municipality where the organization intends to sell raffle tickets must complete a Raffle Consent Form (form GC-RCF) allowing the organization to sell its raffle tickets in that particular municipality.

11. Is there a limit on the amount of prizes that an organization can award during the conduct of a raffle?
An organization may award raffle prizes in cash and/or merchandise not to exceed $100,000 in a calendar year. If during the conduct of one specific raffle an organization intends to award a single prize in excess of $50,000, a statement of such intent is required to be included in the organization's license application and/or verified statement (GCVS-1).

12. Is there a restriction regarding the types of prizes that may be awarded in a raffle?
Section 5622.13 of the Games of Chance Rules & Regulations states in part that, "No alcoholic beverages shall be offered as a prize in any game of chance." Section 5622.16 of the Games of Chance Rules & Regulations states that, "No licensee shall offer, distribute or give any prize consisting of real estate or an interest therein, bonds, shares of stock, securities or evidence of indebtedness, or any merchandise refundable in any of the foregoing."

13. Can raffle tickets be sold at bingo?
Yes. However, only the organization conducting bingo or the organization's affiliate(s) may conduct raffles during the bingo occasion. Organizations not affiliated with the organization conducting bingo are restricted from selling raffle tickets during the bingo occasion.

14. Is the cost of a raffle ticket limited in any way?
No. The cost of a raffle ticket is left to the discretion of the organization.

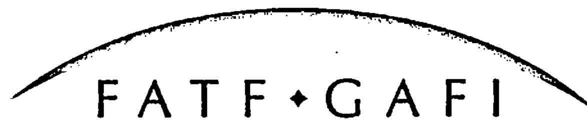
15. Where must the raffle drawing be held?
The organization is required to conduct the raffle drawing at its premise or where it is licensed to conduct games of chance and/or bingo.

16. How far in advance from the date of the raffle drawing may an organization sell raffle tickets?
An organization cannot begin selling tickets until 180 days prior to the raffle drawing. No tickets can be sold more than 180 days before the drawing.

17. Are organizations required to have certain information printed on raffle tickets?
Yes. Raffle tickets, with the exception of the two-part "admission-style" tickets utilized in the game commonly known as a "50/50 raffle" shall reflect the following:

- Name and identification number of the authorized organization;
- The location(s), date(s) and time(s) of the drawing(s);
- The consecutively printed serial number of the ticket;
- The price of the ticket;
- A list of the prizes offered;
- The statement: "Ticket holders need not be present to win."
- Each ticket stub or receipt shall reflect the name, address and telephone number of the ticket purchaser and the consecutively printed serial number of the ticket.

18. Are organizations required to purchase raffle tickets from designated suppliers or printers?
No. Organizations may purchase raffle tickets from vendors of their choice.



FATF Standards

FATF IX Special Recommendations

October 2001
(incorporating all subsequent amendments until February 2008)

Interpretative Note to

Special Recommendation VIII: Non-Profit Organisations

Introduction

1. Non-profit organisations (NPOs) play a vital role in the world economy and in many national economies and social systems. Their efforts complement the activity of the governmental and business sectors in providing essential services, comfort and hope to those in need around the world. The ongoing international campaign against terrorist financing has unfortunately demonstrated however that terrorists and terrorist organisations exploit the NPO sector to raise and move funds, provide logistical support, encourage terrorist recruitment or otherwise support terrorist organisations and operations. This misuse not only facilitates terrorist activity but also undermines donor confidence and jeopardises the very integrity of NPOs. Therefore, protecting the NPO sector from terrorist abuse is both a critical component of the global fight against terrorism and a necessary step to preserve the integrity of NPOs.

2. NPOs may be vulnerable to abuse by terrorists for a variety of reasons. NPOs enjoy the public trust, have access to considerable sources of funds, and are often cash-intensive. Furthermore, some NPOs have a global presence that provides a framework for national and international operations and financial transactions, often within or near those areas that are most exposed to terrorist activity. Depending on the legal form of the NPO and the country, NPOs may often be subject to little or no governmental oversight (for example, registration, record keeping, reporting and monitoring), or few formalities may be required for their creation (for example, there may be no skills or starting capital required, no background checks necessary for employees). Terrorist organisations have taken advantage of these characteristics of NPOs to infiltrate the sector and misuse NPO funds and operations to cover for or support terrorist activity.

Objectives and General Principles

3. The objective of Special Recommendation VIII (SR VIII) is to ensure that NPOs are not misused by terrorist organisations: (i) to pose as legitimate entities; (ii) to exploit legitimate entities as conduits for terrorist financing, including for the purpose of escaping asset freezing measures; or (iii) to conceal or obscure the clandestine diversion of funds intended for legitimate purposes but diverted for terrorist purposes. In this Interpretative Note, the approach taken to achieve this objective is based on the following general principles:

a) Past and ongoing abuse of the NPO sector by terrorists and terrorist organisations requires countries to adopt measures both: (i) to protect the sector against such abuse, and (ii) to identify and take effective action against those NPOs that either are exploited by or actively support terrorists or terrorist organizations.

b) Measures adopted by countries to protect the NPO sector from terrorist abuse should not disrupt or discourage legitimate charitable activities. Rather, such measures should promote transparency and engender greater confidence in the sector, across the donor community and

with the general public that charitable funds and services reach intended legitimate beneficiaries. Systems that promote achieving a high degree of transparency, integrity and public confidence in the management and functioning of all NPOs are integral to ensuring the sector cannot be misused for terrorist financing.

c) Measures adopted by countries to identify and take effective action against NPOs that either are exploited by or actively support terrorists or terrorist organisations should aim to prevent and prosecute as appropriate terrorist financing and other forms of terrorist support. Where NPOs suspected of or implicated in terrorist financing or other forms of terrorist support are identified, the first priority of countries must be to investigate and halt such terrorist financing or support. Actions taken for this purpose should to the extent reasonably possible avoid any negative impact on innocent and legitimate beneficiaries of charitable activity. However, this interest cannot excuse the need to undertake immediate and effective actions to advance the immediate interest of halting terrorist financing or other forms of terrorist support provided by NPOs.

d) Developing co-operative relationships among the public, private and NPO sector is critical to raising awareness and fostering capabilities to combat terrorist abuse within the sector. Countries should encourage the development of academic research on and information sharing in the NPO sector to address terrorist financing related issues.

e) A targeted approach in dealing with the terrorist threat to the NPO sector is essential given the diversity within individual national sectors, the differing degrees to which parts of each sector may be vulnerable to misuse by terrorists, the need to ensure that legitimate charitable activity continues to flourish and the limited resources and authorities available to combat terrorist financing in each jurisdiction.

f) Flexibility in developing a national response to terrorist financing in the NPO sector is also essential in order to allow it to evolve over time as it faces the changing nature of the terrorist financing threat.

Definitions

4. For the purposes of SR VIII and this interpretative note, the following definitions apply:

a) The term *non-profit organisation* or *NPO* refers to a legal entity or organisation that primarily engages in raising or disbursing funds for purposes such as charitable, religious, cultural, educational, social or fraternal purposes, or for the carrying out of other types of "good works".

b) The terms *FIU, legal arrangement and legal person* are as defined by the FATF Forty Recommendations (2003) (*the FATF Recommendations*).

c) The term *funds* is as defined by the Interpretative Note to FATF Special Recommendation II.

d) The terms *freezing, terrorist* and *terrorist organisation* are as defined by the Interpretative Note to FATF Special Recommendation III.

e) The term *appropriate authorities* refers to competent authorities, self-regulatory bodies, accrediting institutions and other administrative authorities.

f) The term *beneficiaries* refers to those natural persons, or groups of natural persons who receive charitable, humanitarian or other types of assistance through the services of the NPO.

Measures

5. Countries should undertake domestic reviews of their NPO sector or have the capacity to obtain timely information on its activities, size and other relevant features. In undertaking these assessments, countries should use all available sources of information in order to identify features and types of NPOs, which by virtue of their activities or characteristics, are at risk of being misused for terrorist financing.[1] Countries should also periodically reassess the sector by reviewing new information on the sector's potential vulnerabilities to terrorist activities.

6. There is a diverse range of approaches in identifying, preventing and combating terrorist misuse of NPOs. An effective approach, however, is one that involves all four of the following elements: (a) Outreach to the sector, (b) Supervision or monitoring, (c) Effective investigation and information gathering and (d) Effective mechanisms for international co-operation. The following measures represent specific actions that countries should take with respect to each of these elements in order to protect their NPO sector from terrorist financing abuse.

a. Outreach to the NPO sector concerning terrorist financing issues

(i) Countries should have clear policies to promote transparency, integrity and public confidence in the administration and management of all NPOs.

(ii) Countries should encourage or undertake outreach programmes to raise awareness in the NPO sector about the vulnerabilities of NPOs to terrorist abuse and terrorist financing risks, and the measures that NPOs can take to protect themselves against such abuse.

(iii) Countries should work with the NPO sector to develop and refine best practices to address terrorist financing risks and vulnerabilities and thus protect the sector from terrorist abuse.[2]

(iv) Countries should encourage NPOs to conduct transactions via regulated financial channels, wherever feasible, keeping in mind the varying capacities of financial sectors in different countries and in different areas of urgent charitable and humanitarian concerns.

b. Supervision or monitoring of the NPO sector

Countries should take steps to promote effective supervision or monitoring of their NPO sector. In practice, countries should be able to demonstrate that the following standards apply to NPOs which account for (1) a significant portion of the financial resources under control of the sector; and (2) a substantial share of the sector's international activities.

(i) NPOs should maintain information on: (1) the purpose and objectives of their stated activities; and (2) the identity of the person(s) who own, control or direct their activities, including senior officers, board members and trustees. This information should be publicly available either directly from the NPO or through appropriate authorities.

[1] For example, such information could be provided by regulators, tax authorities, FIUs, donor organisations or law enforcement and intelligence authorities.

[2] The FATF's *Combating the Abuse of Non-Profit Organisations: International Best Practices* provides a useful reference document for such exercises.

(ii) NPOs should issue annual financial statements that provide detailed breakdowns of incomes and expenditures.

(iii) NPOs should be licensed or registered. This information should be available to competent authorities.[3]

(iv) NPOs should have appropriate controls in place to ensure that all funds are fully accounted for and are spent in a manner that is consistent with the purpose and objectives of the NPO's stated activities.

(v) NPOs should follow a "know your beneficiaries and associate NPOs[4]" rule, which means that the NPO should make best efforts to confirm the identity, credentials and good standing of their beneficiaries and associate NPOs. NPOs should also undertake best efforts to document the identity of their significant donors and to respect donor confidentiality.

(vi) NPOs should maintain, for a period of at least five years, and make available to appropriate authorities, records of domestic and international transactions that are sufficiently detailed to verify that funds have been spent in a manner consistent with the purpose and objectives of the organisation. This also applies to information mentioned in paragraphs (i) and (ii) above.

(vii) Appropriate authorities should monitor the compliance of NPOs with applicable rules and regulations.[5] Appropriate authorities should be able to properly sanction relevant violations by NPOs or persons acting on behalf of these NPOs.[6]

c. *Effective information gathering and investigation*

(i) Countries should ensure effective co-operation, co-ordination and information sharing to the extent possible among all levels of appropriate authorities or organisations that hold relevant information on NPOs.

(ii) Countries should have investigative expertise and capability to examine those NPOs suspected of either being exploited by or actively supporting terrorist activity or terrorist organisations.

(iii) Countries should ensure that full access to information on the administration and management of a particular NPO (including financial and programmatic information) may be obtained during the course of an investigation.

[3] Specific licensing or registration requirements for counter terrorist financing purposes are not necessary. For example, in some countries, NPOs are already registered with tax authorities and monitored in the context of qualifying for favourable tax treatment (such as tax credits or tax exemptions).

[4] The term *associate NPOs* includes foreign branches of international NPOs.

[5] In this context, rules and regulations may include rules and standards applied by self regulatory bodies and accrediting institutions.

[6] The range of such sanctions might include freezing of accounts, removal of trustees, fines, de-certification, de-licensing and de-registration. This should not preclude parallel civil, administrative or criminal proceedings with respect to NPOs or persons acting on their behalf where appropriate.

(iv) Countries should establish appropriate mechanisms to ensure that when there is suspicion or reasonable grounds to suspect that a particular NPO: (1) is a front for fundraising by a terrorist organisation; (2) is being exploited as a conduit for terrorist financing, including for the purpose of escaping asset freezing measures; or (3) is concealing or obscuring the clandestine diversion of funds intended for legitimate purposes, but redirected for the benefit of terrorists or terrorist organisations, this information is promptly shared with all relevant competent authorities in order to take preventative or investigative action.

d. Effective capacity to respond to international requests for information about an NPO of concern

Consistent with Special Recommendation V, countries should identify appropriate points of contact and procedures to respond to international requests for information regarding particular NPOs suspected of terrorist financing or other forms of terrorist support.

Internal Revenue Service
Tax Exempt and Government Entities
Exempt Organizations

tax guide for Churches and Religious Organizations

benefits and responsibilities under the federal tax law

Congress has enacted special tax laws applicable to churches, religious organizations, and ministers in recognition of their unique status in American society and of their rights guaranteed by the First Amendment of the Constitution of the United States. Churches and religious organizations are generally exempt from income tax and receive other favorable treatment under the tax law; however, certain income of a church or religious organization may be subject to tax, such as income from an unrelated business. It is also important for a church or religious organization to understand the tax law to avoid losing its tax-exempt status by engaging in activity that violates the Internal Revenue Code.

Congress has enacted special tax laws applicable to churches, religious organizations, and ministers in recognition of their unique status in American society and of their rights guaranteed by the First Amendment of the Constitution of the United States. Churches and religious organizations are generally exempt from income tax and receive other favorable treatment under the tax law; however, certain income of a church or religious organization may be subject to tax, such as income from an unrelated business.

The Internal Revenue Service (IRS) offers this quick reference guide of federal tax law and procedures for churches and religious organizations to help them voluntarily comply with tax rules. The contents of this publication reflect the IRS interpretation of tax laws enacted by Congress, Treasury regulations, and court decisions. The information given is not comprehensive, however, and does not cover every situation. Thus, it is not intended to replace the law or be the sole source of information. The resolution of any particular issue may depend on the specific facts and circumstances of a given taxpayer. In addition, this publication covers subjects on which a court may have made a decision more favorable to taxpayers than the interpretation by the IRS. Until these differing interpretations are resolved by higher court decisions, or in some other way, this publication will present the interpretation of the IRS.

For more detailed tax information, the IRS has assistance programs and tax information products for churches and religious organizations, as noted in the back of this publication. Most IRS publications and forms can be downloaded from the IRS Web site at www.irs.gov, or ordered by calling toll-free (800) 829-3676. Specialized information can be accessed through the Exempt Organizations (EO) Web site under the IRS Tax Exempt and Government Entities division via www.irs.gov/eo or by calling EO Customer Account Services toll-free at (877) 829-5500.

The IRS considers this publication a living document, one that will be revised to take into account future developments and feedback. Comments on the publication may be submitted to the IRS at the following address:

Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224
Attn: T:EO:CE&O

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Introduction

This publication explains the benefits and the responsibilities under the federal tax system for churches and religious organizations. The term church *is found, but not specifically defined, in the Internal Revenue Code (IRC). The term is not used by all faiths; however, in an attempt to make this publication easy to read, we use it in its generic sense as a place of worship including, for example, mosques and synagogues. With the exception of the special rules for church audits, the use of the term church throughout this publication also includes conventions and associations of churches as well as* integrated auxiliaries of a church.

Because special tax rules apply to churches, it is important to distinguish churches from other religious organizations. Therefore, when this publication uses the term "religious organizations," it is not referring to churches or integrated auxiliaries. Religious organizations that are not churches typically include nondenominational ministries, interdenominational and ecumenical organizations, and other entities whose principal purpose is the study or advancement of religion.

Churches and religious organizations may be legally organized in a variety of ways under state law, such as unincorporated associations, nonprofit corporations, corporations sole, and charitable trusts.

Certain terms used throughout this publication—church, integrated auxiliary of a church, minister, and IRC section 501(c)(3)— are defined in the Glossary *on page 27.*

Tax-Exempt Status

Churches and religious organizations, like many other charitable organizations, qualify for exemption from federal income tax under IRC section 501(c)(3) and are generally eligible to receive tax-deductible contributions. To qualify for tax-exempt status, such an organization must meet the following requirements (covered in greater detail throughout this publication):

- the organization must be organized and operated exclusively for religious, educational, scientific, or other charitable purposes,
- net earnings may not inure to the benefit of any private individual or shareholder,
- no substantial part of its activity may be attempting to influence legislation,
- the organization may not intervene in political campaigns, and
- the organization's purposes and activities may not be illegal or violate fundamental public policy.

Recognition of Tax-Exempt Status

Automatic Exemption for Churches

Churches that meet the requirements of IRC section 501(c)(3) are automatically considered tax exempt and are not required to apply for and obtain recognition of tax-exempt status from the IRS.

Although there is no requirement to do so, many churches seek recognition of tax-exempt status from the IRS because such recognition assures church leaders, members, and contributors that the church is recognized as exempt and qualifies for related tax benefits. For example, contributors to a church that has been recognized as tax exempt would know that their contributions generally are tax-deductible.

Church Exemption Through a Central/Parent Organization

A church with a parent organization may wish to contact the parent to see if it has a *group ruling*. If the parent holds a group ruling, then the IRS may already recognize the church as tax exempt. Under the group exemption process, the parent organization becomes the holder of a group ruling that identifies other affiliated churches or other affiliated organizations. A church is recognized as tax exempt if it is included in a list provided by the parent organization. The parent is then required to submit an annual group exemption update to the IRS in which it provides additions, deletions, and changes within the group. If the church or other affiliated organization is included on such a list, it does not need to take further action to obtain recognition of tax-exempt status.

An organization that is not covered under a group ruling should contact its parent organization to see if it is eligible to be included in the parent's application for the group ruling. For general information on the group exemption process, see Revenue Procedure 80-27, 1980-1 C.B. 677.

Religious Organizations

Unlike churches, religious organizations that wish to be tax exempt generally must apply to the IRS for tax-exempt status unless their gross receipts do not normally exceed $5,000 annually.

Applying for Tax-Exempt Status

Employer Identification Number (EIN)

Every tax-exempt organization, including a church, should have an employer identification number (EIN), whether or not the organization has any employees. There are many instances in which an EIN is necessary. For example, a church needs an EIN when it opens a bank account, in order to be listed as a subordinate in a group ruling, or if it files returns with the IRS (e.g., Forms W-2, 1099, 990-T).

An organization may obtain an EIN by filing Form SS-4, *Application for Employer Identification Number*, in accordance with the instructions.

Application Form

Organizations, including churches and religious organizations, that wish to be recognized as tax exempt under IRC section 501(c)(3) must use Form 1023.

A religious organization must submit its application within 27 months from the end of the month in which the organization is formed in order to be considered tax exempt and qualified to receive deductible contributions as of the date the organization was formed. On the other hand, a church may obtain recognition of exemption for time periods prior to the date of its request for tax-exempt status, even if it does not submit its application within 27 months of formation.

Cost for applying for exemption. The IRS is required to collect a non-refundable fee from any organization seeking a determination of tax-exempt status under IRC section 501(c)(3). Although churches are not required by law to file an application for exemption, if they choose to do so voluntarily, they are required to pay the fee for determination.

The fee must be submitted with Form 1023; otherwise, the application will be returned to the submitter. Fees change periodically. The most recent user fee can be found at the Exempt Organizations (EO) Web site under the IRS Tax Exempt and Government Entities division via www.irs.gov/eo or by calling EO Customer Account Services toll-free at (877) 829-5500.

IRS Approval of Exemption Application

If the application for tax-exempt status is approved, the IRS will notify the organization of its status, any requirement to file an annual information return, and its eligibility to receive deductible contributions. The IRS does not assign a special number or other identification as evidence of an organization's tax-exempt status.

Public Listing of Tax-Exempt Organizations

The IRS lists organizations that are qualified to receive tax-deductible contributions in IRS Publication 78, *Cumulative List of Organizations Described in Section 170(c) of the Internal Revenue Code of 1986*. This publication is sold to the public through the Superintendent of Documents, U.S. Government Printing Office, Washington, DC. Publication 78 can also be downloaded from the IRS Web site at www.irs.gov. Note that not every organization that is eligible to receive tax-deductible contributions is listed in Publication 78. For example, churches that have not applied for recognition of tax-exempt status are not included in the publication. Only the parent organization in a group ruling is included by name in Publication 78.

If you have questions about listing an organization, correcting an erroneous entry, or deleting a listing in Publication 78, contact EO Customer Account Services toll-free at (877) 829-5500.

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Jeopardizing Tax-Exempt Status

All IRC section 501(c)(3) organizations, including churches and religious organizations, must abide by certain rules:

- their net earnings may not inure to any private shareholder or individual,
- they must not provide a substantial benefit to private interests,
- they must not devote a substantial part of their activities to attempting to influence legislation,
- they must not participate in, or intervene in, any political campaign on behalf of (or in opposition to) any candidate for public office, and
- the organization's purposes and activities may not be illegal or violate fundamental public policy.

Inurement and Private Benefit

Inurement to Insiders

Churches and religious organizations, like all exempt organizations under IRC section 501(c)(3), are prohibited from engaging in activities that result in inurement of the church's or organization's income or assets to insiders (i.e., persons having a personal and private interest in the activities of the organization). *Insiders* could include the minister, church board members, officers, and in certain circumstances, employees. Examples of prohibited inurement include the payment of dividends, the payment of unreasonable compensation to insiders, and transferring property to insiders for less than fair market value. The prohibition against inurement to insiders is absolute; therefore, any amount of inurement is, potentially, grounds for loss of tax-exempt status. In addition, the insider involved may be subject to excise tax. See the following section on *Excess benefit transactions*. Note that prohibited inurement does not include reasonable payments for services rendered, payments that further tax-exempt purposes, or payments made for the fair market value of real or personal property.

Excess benefit transactions. In cases where an IRC section 501(c)(3) organization provides an excess economic benefit to an insider, both the organization and the insider have engaged in an *excess benefit transaction*. The IRS may impose an excise tax on any insider who improperly benefits from an excess benefit transaction, as well as on organization managers who participate in such a transaction knowing that it is improper. An insider who benefits from an excess benefit transaction is also required to return the excess benefits to the organization. Detailed rules on excess benefit transactions are contained in the Code of Federal Regulations, Title 26, sections 53.4958-0 through 53.4958-8.

Private Benefit

An IRC section 501(c)(3) organization's activities must be directed exclusively toward charitable, educational, religious, or other exempt purposes. Such an organization's activities may not serve the private interests of any individual or organization. Rather, beneficiaries of an organization's activities must be recognized objects of charity (such as the poor or the distressed) or the community at large (for example, through the conduct of religious services or the promotion of religion). Private benefit is different from inurement to insiders. Private benefit may occur even if the persons benefited are not insiders. Also, private benefit must be substantial in order to jeopardize tax-exempt status.

Substantial Lobbying Activity

In general, no organization, including a church, may qualify for IRC section 501(c)(3) status if a substantial part of its activities is attempting to influence legislation (commonly known as lobbying). An IRC section 501(c)(3) organization may engage in some lobbying, but too much lobbying activity risks loss of tax-exempt status.

Legislation includes action by Congress, any state legislature, any local council, or similar governing body, with respect to acts, bills, resolutions, or similar items (such as legislative confirmation of appointive offices), or by the public in a referendum, ballot initiative, constitutional amendment, or similar procedure. It does not include actions by executive, judicial, or administrative bodies.

A church or religious organization will be regarded as *attempting to influence legislation* if it contacts, or urges the public to contact, members or employees of a legislative body for the purpose of proposing, supporting, or opposing legislation, or if the organization advocates the adoption or rejection of legislation.

Churches and religious organizations may, however, involve themselves in issues of public policy without the activity being considered as lobbying. For example, churches may conduct educational meetings, prepare and distribute educational materials, or otherwise consider public policy issues in an educational manner without jeopardizing their tax-exempt status.

Measuring Lobbying Activity

Substantial part test. Whether a church's or religious organization's attempts to influence legislation constitute a substantial part of its overall activities is determined on the basis of all the pertinent facts and circumstances in each case. The IRS considers a variety of factors, including the time devoted (by both compensated and volunteer workers) and the expenditures devoted by the organization to the activity, when determining whether the lobbying activity is substantial. Churches must use the substantial part test since they are not eligible to use the expenditure test described in the next section.

Consequences of excessive lobbying activity. Under the ***substantial part test***, a church or religious organization that conducts excessive lobbying activity in any taxable year may lose its tax-exempt status, resulting in all of its income being subject to tax. In addition, a religious organization is subject to an excise tax equal to five percent of its lobbying expenditures for the year in which it ceases to qualify for exemption. Further, a tax equal to five percent of the lobbying expenditures for the year may be imposed against organization managers, jointly and severally, who agree to the making of such expenditures knowing that the expenditures would likely result in loss of tax-exempt status.

Expenditure test. Although churches are not eligible, religious organizations may elect the expenditure test under IRC section 501(h) as an alternative method for measuring lobbying activity. Under the expenditure test, the extent of an organization's lobbying activity will not jeopardize its tax-exempt status, provided its expenditures, related to such activity, do not normally exceed an amount specified in IRC section 4911. This limit is generally based upon the size of the organization and may not exceed $1,000,000.

Religious organizations electing to use the expenditure test must file IRS Form 5768, *Election/Revocation of Election by an Eligible IRC Section 501(c)(3) Organization To Make Expenditures To Influence Legislation*, at any time during the tax year for which it is to be effective. The election remains in effect for succeeding years unless it is revoked by the organization. Revocation of the election is effective beginning with the year following the year in which the revocation is filed. Religious organizations may wish to consult their tax advisors to determine their eligibility for, and the advisability of, electing the expenditure test.

Consequences of excessive lobbying activity. Under the ***expenditure test***, a religious organization that engages in excessive lobbying activity over a four-year period may lose its tax-exempt status, making all of its income for that period subject to tax. Should the organization exceed its lobbying expenditure dollar limit in a particular year, it must pay an excise tax equal to 25 percent of the excess.

Political Campaign Activity

Under the Internal Revenue Code, all IRC section 501(c)(3) organizations, including churches and religious 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. Contributions to political campaign funds or public statements of position (verbal or written) made by or on behalf of the organization in favor of or in opposition to any candidate for public office clearly violate the prohibition against political campaign activity. Violation of this prohibition may result in denial or revocation of tax-exempt status and the imposition of certain excise tax.

Certain activities or expenditures may not be prohibited depending on the facts and circumstances. For example, certain voter education activities (including the presentation of public forums and the publication of voter education guides) conducted in a non-partisan manner do not constitute prohibited political campaign activity. In addition, other activities intended to encourage people to participate in the electoral process, such as voter registration and get-out-the-vote drives, would not constitute prohibited political campaign activity if conducted in a non-partisan manner. On the other hand, voter education or registration activities with evidence of bias that: (a) would favor one candidate over another; (b) oppose a candidate in some manner; or (c) have the effect of favoring a candidate or group of candidates, will constitute prohibited participation or intervention.

Individual Activity by Religious Leaders

The political campaign activity prohibition is not intended to restrict free expression on political matters by leaders of churches or religious organizations speaking for themselves, as *individuals.* Nor are leaders prohibited from speaking about important issues of public policy. However, for their organizations to remain tax exempt under IRC section 501(c)(3), religious leaders cannot make partisan comments in official organization publications or at official church functions. To avoid potential attribution of their comments outside of church functions and publications, religious leaders who speak or write in their individual capacity are encouraged to clearly indicate that their comments are personal and not intended to represent the views of the organization. The following are examples of situations involving endorsements by religious leaders.

Example 1: **Minister A is the minister of Church J, a section 501(c)(3) organization, and is well known in the community. With their permission, Candidate T publishes a full-page ad in the local newspaper listing five prominent ministers who have personally endorsed Candidate T, including Minister A. Minister A is identified in the ad as the minister of Church J. The ad states, "Titles and affiliations of each individual are provided for identification purposes only." The ad is paid for by Candidate T's campaign committee. Since the ad was not paid for by Church J, the ad is not otherwise in an official publication of Church J, and the endorsement is made by Minister A in a personal capacity, the ad does not constitute campaign intervention by Church J.**

Example 2: **Minister B is the minister of Church K, a section 501(c)(3) organization, and is well known in the community. Three weeks before the election, he attends a press conference at Candidate V's campaign headquarters and states that Candidate V should be reelected. Minister B does not say he is speaking on behalf of Church K. His endorsement is reported on the front page of the local newspaper and he is identified in the article as the minister of Church K. Because Minister B did not make the endorsement at an official church function, in an official church publication or otherwise use the church's assets, and did not state that he was speaking as a representative of Church K, his actions do not constitute campaign intervention by Church K.**

Example 3: Minister C is the minister of Church I, a section 501(c)(3) organization. Church I publishes a monthly church newsletter that is distributed to all church members. In each issue, Minister C has a column titled "My Views." The month before the election, Minister C states in the "My Views" column, "It is my personal opinion that Candidate U should be reelected." For that one issue, Minister C pays from his personal funds the portion of the cost of the newsletter attributable to the "My Views" column. Even though he paid part of the cost of the newsletter, the newsletter is an official publication of the church. Because the endorsement appeared in an official publication of Church I, it constitutes campaign intervention attributed to Church I.

Example 4: Minister D is the minister of Church M, a section 501(c)(3) organization. During regular services of Church M shortly before the election, Minister D preached on a number of issues, including the importance of voting in the upcoming election, and concluded by stating, "It is important that you all do your duty in the election and vote for Candidate W." Because Minister D's remarks indicating support for Candidate W were made during an official church service, they constitute political campaign intervention by to Church M.

Issue Advocacy vs. Political Campaign Intervention

Like other section 501(c)(3) organizations, some churches and religious organizations take positions on public policy issues, including issues that divide candidates in an election for public office. However, section 501(c)(3) organizations must avoid any issue advocacy that functions as political campaign intervention. Even if a statement does not expressly tell an audience to vote for or against a specific candidate, an organization delivering the statement is at risk of violating the political campaign intervention prohibition if there is any message favoring or opposing a candidate. A statement can identify a candidate not only by stating the candidate's name but also by other means such as showing a picture of the candidate, referring to political party affiliations, or other distinctive features of a candidate's platform or biography. All the facts and circumstances need to be considered to determine if the advocacy is political campaign intervention.

Key factors in determining whether a communication results in political campaign intervention include the following:

- 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.

A communication is particularly at risk of political campaign intervention when it makes reference to candidates or voting in a specific upcoming election. Nevertheless, the communication must still be considered in context before arriving at any conclusions.

Example 1: Church O, a section 501(c)(3) organization, prepares and finances a full page newspaper advertisement that is published in several large circulation newspapers in State V shortly before an election in which Senator C is a candidate for nomination in a party primary. Senator C is the incumbent candidate in a party primary. The advertisement states that a pending bill in the United States Senate would provide additional opportunities for State V residents to participate in faith-based programs by providing funding to such church-affiliated programs. The advertisement ends with the statement "Call or write Senator C to tell him to vote for this

bill, despite his opposition in the past." Funding for faith-based programs has not been raised as an issue distinguishing Senator C from any opponent. The bill is scheduled for a vote before the election. The advertisement identifies Senator C's position as contrary to O's position. Church O has not violated the political campaign intervention prohibition: The advertisement does not mention the election or the candidacy of Senator C or distinguish Senator C from any opponent. The timing of the advertising and the identification of Senator C are directly related to a vote on the identified legislation. The candidate identified, Senator C, is an officeholder who is in a position to vote on the legislation.

Example 2: Church R, a section 501(c)(3) organization, prepares and finances a radio advertisement urging an increase in state funding for faith-based education in State X, which requires a legislative appropriation. Governor E is the governor of State X. The radio advertisement is first broadcast on several radio stations in State X beginning shortly before an election in which Governor E is a candidate for re-election. The advertisement is not part of an ongoing series of substantially similar advocacy communications by Church R on the same issue. The advertisement cites numerous statistics indicating that faith-based education in State X is under funded. Although the advertisement does not say anything about Governor E's position on funding for faith-based education, it ends with "Tell Governor E what you think about our under-funded schools." In public appearances and campaign literature, Governor E's opponent has made funding of faith-based education an issue in the campaign by focusing on Governor E's veto of an income tax increase to increase funding for faith-based education. At the time the advertisement is broadcast, no legislative vote or other major legislative activity is scheduled in the State X legislature on state funding of faith-based education. Church R has violated the political campaign prohibition: The advertisement identifies Governor E, appears shortly before an election in which Governor E is a candidate, is not part of an ongoing series of substantially similar advocacy communications by Church R on the same issue, is not timed to coincide with a non-election event such as a legislative vote or other major legislative action on that issue, and takes a position on an issue that the opponent has used to distinguish himself from Governor E.

Example 3: Candidate A and Candidate B are candidates for the state senate in District W of State X. The issue of State X funding for a faith-based indigent hospital care in District W is a prominent issue in the campaign. Both candidates have spoken out on the issue. Candidate A supports funding such care; Candidate B opposes the project and supports increasing State X funding for public hospitals instead. P is the head of the board of elders at Church C, a section 501(c)(3) organization located in District W. At C's annual fundraising dinner in District W, which takes place in the month before the election, P gives a long speech about health care issues, including the issue of funding for faith-based programs. P does not mention the name of any candidate or any political party. However, at the end of the speech, P makes the following statement, "For those of you who care about quality of life in District W and the desire of our community for health care responsive to their faith, there is a very important choice coming up next month. We need more funding for health care. Increased public hospital funding will not make a difference. You have the power to respond to the needs of this community. Use that power when you go to the polls and cast your vote in the election for your state senator." C has violated the political campaign intervention prohibition as a result of P's remarks at C's official function shortly before the election, in which P referred to the upcoming election after stating a position on an issue that is a prominent issue in a campaign that distinguishes the candidates.

Inviting a Candidate to Speak

Depending on the facts and circumstances, a church or religious organization may invite political candidates to speak at its events without jeopardizing its tax-exempt status. Political candidates may be invited in their capacity as candidates, or individually (not as a candidate). Candidates may also appear without an invitation at organization events that are open to the public.

Speaking as a candidate. Like any other IRC section 501(c)(3) organization, when a candidate is invited to speak at a church or religious organization event as a political candidate, factors in determining whether the organization participated or intervened in a political campaign include the following:

- whether the church provides an equal opportunity to the political candidates seeking the same office,
- whether the church indicates any support of or opposition to the candidate. (This should be stated explicitly when the candidate is introduced and in communications concerning the candidate's appearance.)
- whether any political fundraising occurs,
- whether the individual is chosen to speak solely for reasons other than candidacy for public office,
- whether the organization maintains a nonpartisan atmosphere on the premises or at the event where the candidate is present, and
- whether the organization clearly indicates the capacity in which the candidate is appearing and does not mention the individual's political candidacy or the upcoming election in the communications announcing the candidate's attendance at the event.

Equal opportunity to participate. Like any other IRC section 501(c)(3) organization, in determining whether candidates are given an equal opportunity to participate, a church or religious organization should consider the nature of the event to which each candidate is invited, in addition to the manner of presentation. For example, a church or religious organization that invites one candidate to speak at its well attended annual banquet, but invites the opposing candidate to speak at a sparsely attended general meeting, will likely be found to have violated the political campaign prohibition, even if the manner of presentation for both speakers is otherwise neutral.

Public forum. Sometimes a church or religious organization invites several candidates to speak at a public forum. A public forum involving several candidates for public office may qualify as an exempt educational activity. However, if the forum is operated to show a bias for or against any candidate, then the forum would be prohibited campaign activity, as it would be considered intervention or participation in a political campaign. When an organization invites several candidates to speak at a forum, it should consider the following factors:

- whether questions for the candidate 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 views 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.

A candidate may seek to reassure the organization that it is permissible for the organization to do certain things in connection with the candidate's appearance. An organization in this position should keep in mind that the candidate may not be familiar with the organization's tax-exempt status and that the candidate may be focused on compliance with the election laws that apply to the candidate's campaign rather than the federal tax law that applies to the organization. The organization will be in the best position to ensure compliance with the prohibition on political campaign intervention if it makes its own independent conclusion about its compliance with federal tax law.

The following are examples of situations where a church or religious organization invites a candidate(s) to speak before the congregation.

Example 1: **Minister E is the minister of Church N, a section 501(c)(3) organization. In the month prior to the election, Minister E invited the three Congressional candidates for the district in which Church N is located to address the congregation, one each on three successive Sundays, as part of regular worship services. Each candidate was given an equal opportunity to address and field questions on a wide variety of topics from the congregation. Minister E's introduction of each candidate included no comments on their qualifications or any indication of a preference for any candidate. The actions do not constitute political campaign intervention by Church N.**

Example 2: **The facts are the same as in the preceding example except that there are four candidates in the race rather than three, and one of the candidates declines the invitation to speak. In the publicity announcing the dates for each of the candidate's speeches, Church N includes a statement that the order of the speakers was determined at random and the fourth candidate declined the church's invitation to speak. Minister E makes the same statement in his opening remarks at each of the meetings where one of the candidates is speaking. Church N's actions do not constitute political campaign intervention.**

Example 3: **Minister F is the minister of Church O, a section 501(c)(3) organization. The Sunday before the November election, Minister F invited Senate Candidate X to preach to her congregation during worship services. During his remarks, Candidate X stated, "I am asking not only for your votes, but for your enthusiasm and dedication, for your willingness to go the extra mile to get a very large turnout on Tuesday." Minister F invited no other candidate to address her congregation during the Senatorial campaign. Because these activities took place during official church services, they are attributed to Church O. By selectively providing church facilities to allow Candidate X to speak in support of his campaign, Church O's actions constitute political campaign intervention.**

Speaking as a non-candidate. Like any other IRC section 501(c)(3) organization, a church or religious organization may invite political candidates (including church members) to speak in a non-candidate capacity. For instance, a political candidate may be a public figure because he or she: (a) currently holds, or formerly held, public office; (b) is considered an expert in a non-political field; or (c) is a celebrity or has led a distinguished military, legal, or public service career. A candidate may choose to attend an event that is open to the public, such as a lecture, concert or worship service. The candidate's presence at a church-sponsored event does not, by itself, cause the organization to be involved in political campaign intervention. However, if the candidate is publicly recognized by the organization, or if the candidate is invited to speak, factors in determining whether the candidate's appearance results in political campaign intervention include the following:

- whether the individual speaks only in a non-candidate capacity,
- whether either the individual nor any representative of the church makes any mention of his or her candidacy or the election,
- whether any campaign activity occurs in connection with the candidate's attendance.
- whether the individual is chosen to speak solely for reasons other than candidacy for public office,
- whether the organization maintains a nonpartisan atmosphere on the premises or at the event where the candidate is present, and
- whether the organization clearly indicates the capacity in which the candidate is appearing and does not mention the individual's political candidacy or the upcoming election in the communications announcing the candidate's attendance at the event.

In addition, the church or religious organization should clearly indicate the capacity in which the candidate is appearing and should not mention the individual's political candidacy or the upcoming election in the communications announcing the candidate's attendance at the event.

Below are examples of situations where a public official appears at a church or religious organization in an official capacity, and not as a candidate.

Example 1: Church P, a section 501(c)(3) organization, is located in the state capital. Minister G customarily acknowledges the presence of any public officials present during services. During the state gubernatorial race, Lieutenant Governor Y, a candidate, attended a Wednesday evening prayer service in the church. Minister G acknowledged the Lieutenant Governor's presence in his customary manner, saying, "We are happy to have worshiping with us this evening Lieutenant Governor Y." Minister G made no reference in his welcome to the Lieutenant Governor's candidacy or the election. Minister G's actions do not constitute political campaign intervention by Church P.

Example 2: Minister H is the minister of Church Q, a section 501(c)(3) organization. Church Q is building a community center. Minister H invites Congressman Z, the representative for the district containing Church Q, to attend the groundbreaking ceremony for the community center. Congressman Z is running for reelection at the time. Minister H makes no reference in her introduction to Congressman Z's candidacy or the election. Congressman Z also makes no reference to his candidacy or the election and does not do any fundraising while at Church Q. Church Q has not intervened in a political campaign.

Example 3: Church X is a section 501(c)(3) organization. X publishes a member newsletter on a regular basis. Individual church members are invited to send in updates about their activities which are printed in each edition of the newsletter. After receiving an update letter from Member Q, X prints the following: "Member Q is running for city council in Metropolis." The newsletter does not contain any reference to this election or to Member Q's candidacy other than this statement of fact. Church X has not intervened in a political campaign.

Example 4: Mayor G attends a concert performed by a choir of Church S, a section 501(c)(3) organization, in City Park. The concert is free and open to the public. Mayor G is a candidate for reelection, and the concert takes place after the primary and before the general election. During the concert, S's minister addresses the crowd and says, "I am pleased to see Mayor G here tonight. Without his support, these free concerts in City Park would not be possible. We will need his help if we want these concerts to continue next year so please support Mayor G in November as he has supported us." As a result of these remarks, Church S has engaged in political campaign intervention.

Voter Education, Voter Registration and Get-Out-the-Vote Drives

Section 501(c)(3) organizations are permitted to conduct certain voter education activities (including the presentation of public forums and the publication of voter education guides) if they are carried out in a non-partisan manner. In addition, section 501(c)(3) organizations may encourage people to participate in the electoral process through voter registration and get-out-the-vote drives, conducted in a non-partisan manner. On the other hand, voter education or registration activities conducted in a biased manner that favors (or opposes) one or more candidates is prohibited.

Like other IRC section 501(c)(3) organizations, some churches and religious organizations undertake voter education activities by distributing *voter guides*. Voter guides, generally, are distributed during an election campaign and provide information on how all candidates stand on various issues. These guides may be distributed with the purpose of educating voters; however, they may not be used to attempt to favor or oppose candidates for public elected office.

A careful review of the following facts and circumstances may help determine whether or not a church or religious organization's publication or distribution of voter guides constitutes prohibited political campaign activity:

- whether the candidates' positions are compared to the organization's position,
- whether the guide includes a broad range of issues that the candidates would address if elected to the office sought,
- whether the description of issues is neutral,

- whether all candidates for an office are included, and
- whether the descriptions of candidates' positions are either:
  - the candidates' own words in response to questions, or
  - a neutral, unbiased and complete compilation of all candidates' positions.

The following are examples of church voter education and voter registration activities.

Example 1: Church R, a section 501(c)(3) organization, distributes a voter guide prior to elections. The voter guide consists of a brief statement from the candidates on each issue made in response to a questionnaire sent to all candidates for governor of State I. The issues on the questionnaire cover a wide variety of topics and were selected by Church R based solely on their importance and interest to the electorate as a whole. Neither the questionnaire nor the voter guide, through their content or structure, indicate a bias or preference for any candidate or group of candidates. Church R is not participating or intervening in a political campaign.

Example 2: Church S, a section 501(c)(3) organization, distributes a voter guide during an election campaign. The voter guide is prepared using the responses of candidates to a questionnaire sent to candidates for major public offices. Although the questionnaire covers a wide range of topics, the wording of the questions evidences a bias on certain issues. By using a questionnaire structured in this way, Church S is parti-cipating or intervening in a political campaign.

Example 3: Church T, a section 501(c)(3) organization, sets up a booth at the state fair where citizens can register to vote. The signs and banners in and around the booth give only the name of the church, the date of the next upcoming statewide election, and notice of the opportunity to register. No reference to any candidate or political party is made by volunteers staffing the booth or in the materials available in the booth, other than the official voter registration forms which allow registrants to select a party affiliation. Church T is not engaged in political campaign intervention when it operates this voter registration booth.

Example 4: Church C is a section 501(c)(3) organization. C's activities include educating its members on family issues involving moral values. Candidate G is running for state legislature and an important element of her platform is challenging the incumbent's position on family issues. Shortly before the election, C sets up a telephone bank to call registered voters in the district in which Candidate G is seeking election. In the phone conversations, C's representative tells the voter about the moral importance of family issues and asks questions about the voter's views on these issues. If the voter appears to agree with the incumbent's position, C's representative thanks the voter and ends the call. If the voter appears to agree with Candidate G's position, C's representative reminds the voter about the upcoming election, stresses the importance of voting in the election and offers to provide transportation to the polls. C is engaged in political campaign intervention when it conducts this get-out-the-vote drive.

Business Activity

The question of whether an activity constitutes participation or intervention in a political campaign may also arise in the context of a business activity of the church or religious organization, such as the selling or renting of mailing lists, the leasing of office space, or the acceptance of paid political advertising. (The tax treatment of income from such unrelated business activities follows.) In this context, some of the factors to be considered in determining whether the church or religious organization has engaged in prohibited political campaign activity include the following:

- whether the good, service, or facility is available to the candidates on an equal basis,
- whether the good, service, or facility is available only to candidates and not to the general public,
- whether the fees charged are at the organization's customary and usual rates, and
- whether the activity is an ongoing activity of the organization or whether it is conducted only for the candidate.

Example 1: Church K is a section 501(c)(3) organization. It owns a building that has a large basement hall suitable for hosting dinners and receptions. For several years, Church K has made the hall available for rent to members of the public. It has standard fees for renting the hall based on the number of people in attendance, and a number of different organizations have rented the hall. Church K rents the hall on a first come, first served basis. Candidate P's campaign pays the standard fee for the dinner. Church K is not involved in political campaign intervention as a result of renting the hall to Candidate P for use as the site of a campaign fundraising dinner.

Example 2: Church L is a section 501(c)(3) organization. It maintains a mailing list of all of its members. Church L has never rented the mailing list to a third party. The campaign committee of Candidate Q, who supports funding for faith-based programs, approaches Church L. Candidate A's campaign committee offers to rent Church L's mailing list for a fee that is comparable to fees charged by other similar organizations. Church L rents the list to Candidate A's campaign committee, but declines similar requests from campaign committees of other candidates. Church L has intervened in a political campaign.

Web Sites: The Internet has become a widely used communications tool. Section 501(c)(3) organizations use their own web sites to disseminate statements and information. They also routinely link their web sites to web sites maintained by other organizations as a way of providing additional information that the organizations believe is useful or relevant to the public.

A web site is a form of communication. If an organization posts something on its web site that favors or opposes a candidate for public office, the organization will be treated the same as if it distributed printed material, oral statements or broadcasts that favored or opposed a candidate.

An organization has control over whether it establishes a link to another site. When an organization establishes a link to another web site, the organization is responsible for the consequences of establishing and maintaining that link, even if the organization does not have control over the content of the linked site. Because the linked content may change over time, an organization may reduce the risk of political campaign intervention by monitoring the linked content and adjusting the links accordingly.

Links to candidate-related material, by themselves, do not necessarily constitute political campaign intervention. All the facts and circumstances must be taken into account when assessing whether a link produces that result. The facts and circumstances to be considered include, but are not limited to, the context for the link on the organization's web site, whether all candidates are represented, any exempt purpose served by offering the link, and the directness of the links between the organization's web site and the web page that contains material favoring or opposing a candidate for public office.

Example 1. Church P, a section 501(c)(3) organization, maintains a web site that includes such information as biographies of its ministers, times of services, details of community outreach programs, and activities of members of its congregation. B, a member of the congregation of Church P, is running for a seat on the town council. Shortly before the election, Church P posts the following message on its web site, "Lend your support to B, your fellow parishioner, in Tuesday's election for town council." Church P has intervened in a political campaign on behalf of B.

Example 2. Church N, a section 501(c)(3) organization, maintains a web site that includes such information as staff listings, directions to the church, and descriptions of its community outreach programs, schedules of services, and school activities. On one page of the web site, Church N describes a particular type of treatment program for homeless veterans. This section includes a link to an article on the web site of O, a major national newspaper, praising Church N's treatment program for homeless veterans. The page containing the article on O's web site does not refer to any candidate or election and has no direct links to candidate or election information. Elsewhere on O's web site, there is a page displaying editorials that O has published. Several of the editorials endorse candidates in an election that has not yet occurred. Church N has not intervened in a political campaign by maintaining a link on O's

web site because the link is provided for the exempt purpose of educating the public about its programs; the context for the link, the relationship between Church N and O, and the arrangement of the links going from Church N's web site to the endorsement on O's web site, do not indicate that Church N was favoring or opposing any candidate.

Example 3: Church M, a section 501(c)(3) organization, maintains a web site and posts an unbiased, nonpartisan voter guide that is prepared in accordance with the principles discussed on pages 12 and 13 of this publication. For each candidate covered in the voter guide, M includes a link to that candidate's official campaign web site. The links to the candidate web sites are presented on a consistent, neutral basis for each candidate, with text saying "For more information on Candidate X, you may consult [URL]." M has not intervened in a political campaign because the links are provided for the exempt purpose of educating voters and are presented in a neutral, unbiased manner that includes all candidates for a particular office.

Consequences of Political Campaign Activity

When it participates in political campaign activity, a church or religious organization jeopardizes both its tax-exempt status under IRC section 501(c)(3) and its eligibility to receive tax-deductible contributions. In addition, it may become subject to an excise tax on its political expenditures. This *excise tax* may be imposed in addition to revocation, or it may be imposed instead of revocation. Also, the church or religious organization should correct the violation.

Excise tax. An initial tax is imposed on an organization at the rate of 10 percent of the political expenditures. Also, a tax at the rate of 2.5 percent of the expenditures is imposed against the organization managers (jointly and severally) who, without reasonable cause, agreed to the expenditures knowing they were political expenditures. The tax on management may not exceed $5,000 with respect to any one expenditure.

In any case in which an initial tax is imposed against an organization, and the expenditures are not corrected within the period allowed by law, an additional tax equal to 100 percent of the expenditures is imposed against the organization. In that case, an additional tax is also imposed against the organization managers (jointly and severally) who refused to agree to make the correction. The additional tax on management is equal to 50 percent of the expenditures and may not exceed $10,000 with respect to any one expenditure.

Correction. Correction of a political expenditure requires the recovery of the expenditure, to the extent possible, and establishment of safeguards to prevent future political expenditures.

Please note that a church or religious organization that engages in any political campaign activity also needs to determine whether it is in compliance with the appropriate federal, state or local election laws, as these may differ from the requirements under IRC section 501(c)(3).

Unrelated Business Income Tax (UBIT)

Net Income Subject to the UBIT

Churches and religious organizations, like other tax-exempt organizations, may engage in income-producing activities unrelated to their tax-exempt purposes, as long as the unrelated activities are not a substantial part of the organization's activities. However, the net income from such activities will be subject to the UBIT if the following three conditions are met:

- the activity constitutes a trade or business,
- the trade or business is regularly carried on, and
- the trade or business is not substantially related to the organization's exempt purpose. (The fact that the organization uses the income to further its charitable or religious purposes does not make the activity substantially related to its exempt purposes.)

Exceptions to UBIT

Even if an activity meets the above three criteria, the income may not be subject to tax if it meets one of the following exceptions: (a) substantially all of the work in operating the trade or business is performed by volunteers; (b) the activity is conducted by the organization primarily for the convenience of its members; or (c) the trade or business involves the selling of merchandise substantially all of which was donated.

In general, rents from real property, royalties, capital gains, and interest and dividends are not subject to the unrelated business income tax unless financed with borrowed money.

Examples of Unrelated Trade or Business Activities

Unrelated trade or business activities vary depending on types of activities, as shown below.

Advertising

Many tax-exempt organizations sell advertising in their publications or other forms of public communication. Generally, income from the sale of advertising is unrelated trade or business income. This may include the sale of advertising space in weekly bulletins, magazines or journals, or on church or religious organization Web sites.

Gaming

Most forms of gaming, if regularly carried on, may be considered the conduct of an unrelated trade or business. This can include the sale of pull-tabs and raffles. Income derived from bingo games may be eligible for a special tax exception (in addition to the exception regarding uncompensated volunteer labor covered above), if the following conditions are met: (a) the bingo game is the traditional type of bingo (as opposed to instant bingo, a variation of pull-tabs); (b) the conduct of the bingo game is not an activity carried out by for-profit organizations in the local area; and (c) the operation of the bingo game does not violate any state or local law.

Sale of merchandise and publications

The sale of merchandise and publications (including the actual publication of materials) can be considered the conduct of an unrelated trade or business if the items involved do not have a substantial relationship to the exempt purposes of the organization.

Rental income

Generally, income derived from the rental of real property and incidental personal property is excluded from unrelated business income. However, there are certain situations in which rental income may be unrelated business taxable income:

- if a church rents out property on which there is debt outstanding (for example, a mortgage note), the rental income may constitute unrelated debt-financed income subject to UBIT. (However, if a church or convention or association of churches acquires debt-financed land for use in its exempt purposes within 15 years of the time of acquisition, then income from the rental of the land may not constitute unrelated business income.),
- if personal services are rendered in connection with the rental, then the income may be unrelated business taxable income, or
- if a church charges for the use of the parking lot, the income may be unrelated business taxable income.

Parking lots

If a church owns a parking lot that is used by church members and visitors while attending church services, any parking fee paid to the church would not be subject to UBIT. However, if a church operates a parking lot that is used by members of the general public, parking fees would be taxable, as this activity would not be substantially related to the church's exempt purpose, and parking fees are not treated as rent from real property. If the church enters into a lease with a third party who operates the church's parking lot and pays rent to the church, such payments would not be subject to tax, as they would constitute rent from real property.

Whether an income-producing activity is an unrelated trade or business activity depends on all the facts and circumstances. For more information, see IRS Publication 598, *Tax on Unrelated Business Income of Exempt Organizations*.

Tax on Income-Producing Activities

If a church, or other exempt organization, has gross income of $1,000 or more for any taxable year from the conduct of any unrelated trade or business, it is required to file IRS Form 990-T, *Exempt Organization Business Income Tax Return*, for that year. If the church is part of a larger entity (such as a diocese), it must file a separate Form 990-T if it has a separate EIN. Form 990-T is due the 15th day of the 5th month following the end of the church's tax year. (IRC section 512(b)(12) provides a special rule for parishes and similar local units of a church. A specific deduction is provided, which is equal to the lower of $1,000 or the gross income derived from any unrelated trade or business regularly carried on by such parish or local unit of a church.) See Filing Requirements on page 19.

Download IRS publications and forms at www.irs.gov or order free through the IRS at (800) 829-3676.

Employment Tax

Generally, churches and religious organizations are required to withhold, report, and pay income and Federal Insurance Contributions Act (FICA) taxes for their employees. Employment tax includes income tax withheld and paid for an employee and FICA taxes withheld and paid on behalf of an employee. Substantial penalties may be imposed against an organization that fails to withhold and pay the proper employment tax. Whether a church or religious organization must withhold and pay employment tax depends upon whether the church's workers are employees. *Determination of worker status* is important. Several facts determine whether a worker is an employee. For an in-depth explanation and examples of the common law employer-employee relationship, see IRS Publication 15-A, *Employer's Supplemental Tax Guide*. If a church or a worker wants the IRS to determine whether the worker is an employee, the church or worker should file IRS Form SS-8, *Determination of Employee Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding*, with the IRS.

Social Security and Medicare Taxes — Federal Insurance Contributions Act (FICA)

FICA taxes consist of Social Security and Medicare taxes. Wages paid to employees of churches or religious organizations are subject to FICA taxes unless *one* of the following exceptions applies:

- wages are paid for services performed by a duly ordained, commissioned, or licensed minister of a church in the exercise of his or her ministry, or by a member of a religious order in the exercise of duties required by such order,
- the church or religious organization pays the employee wages of less than $108.28 in a calendar year, or
- a church that is opposed to the payment of Social Security and Medicare taxes for religious reasons files IRS Form 8274, *Certification by Churches and Qualified Church Controlled Organizations Electing Exemption From Employer Social Security and Medicare Taxes*. Very specific timing rules apply to filing Form 8274. It must be filed before the *first* date on which the electing entity is required to file its first quarterly employment tax return. This election does not relieve the organization of its obligation to withhold income tax on wages paid to its employees. In addition, if such an election is made, affected employees must pay Self-Employment Contributions Act (SECA) tax. For further information, see Publication 517, *Social Security and Other Information for Members of the Clergy and Religious Workers*.

Withheld employee income tax and FICA taxes are reported on IRS Form 941, *Employer's Quarterly Federal Tax Return*. Some small employers are eligible to file an annual Form 944 instead of quarterly returns. See the instructions to Form 944 for more information. For more information about employment tax, see IRS Publication 15, *Circular E, Employer's Tax Guide*, and IRS Publication 15-A, *Employer's Supplemental Tax Guide*. *See also*, IRS Publication 517, *Social Security and Other Information for Members of the Clergy and Religious Workers*.

Federal Unemployment Tax Act (FUTA)

Churches and religious organizations are not liable for FUTA tax. For further information on FUTA, see IRS Publication 517, *Social Security and Other Information for Members of the Clergy and Religious Workers*.

Special Rules for Compensation of Ministers

Withholding Income Tax for Ministers

Unlike other exempt organizations or businesses, a church is not required to withhold income tax from the compensation that it pays to its duly ordained, commissioned, or licensed ministers for performing services in the exercise of their ministry. An employee minister may, however, enter into a voluntary withholding agreement with the church by completing IRS Form W-4, *Employee's Withholding Allowance Certificate*. A church should report compensation paid to a minister on Form W-2, *Wage and Tax Statement*, if the minister is an employee, or on IRS Form 1099-MISC, *Miscellaneous Income*, if the minister is an independent contractor.

Parsonage or Housing Allowances

Generally, a minister's gross income does not include the fair rental value of a home (parsonage) provided, or a housing allowance paid, as part of the minister's compensation for services performed that are ordinarily the duties of a minister.

A minister who is furnished a *parsonage* may exclude from income the fair rental value of the parsonage, including utilities. However, the amount excluded cannot be more than the reasonable pay for the minister's services.

A minister who receives a *housing allowance* may exclude the allowance from gross income to the extent it is used to pay expenses in providing a home. Generally, those expenses include rent, mortgage payments, utilities, repairs, and other expenses directly relating to providing a home. If a minister owns a home, the amount excluded from the minister's gross income as a housing allowance is limited to the least of the following: (a) the amount actually used to provide a home; (b) the amount officially designated as a housing allowance; or (c) the fair rental value of the home. The minister's church or other qualified organization must designate the housing allowance pursuant to official action taken *in advance* of the payment. If a minister is employed and paid by a local congregation, a designation by a national church agency will not be effective. The local congregation must make the designation. A national church agency may make an effective designation for ministers it directly employs. If none of the minister's salary has been officially designated as a housing allowance, the full salary must be included in gross income.

The fair rental value of a parsonage or housing allowance is excludable from income only for income tax purposes. These amounts are *not* excluded in determining the minister's net earnings from self-employment for Self-Employment Contributions Act (SECA) tax purposes. Retired ministers who receive either a parsonage or housing allowance are not required to include such amounts for SECA tax purposes.

As mentioned above, a minister who receives a parsonage or rental allowance excludes that amount from his income. The portion of expenses allocable to the excludable amount is not deductible. This limitation, however, does not apply to interest on a home mortgage or real estate taxes, nor to the calculation of net earnings from self-employment for SECA tax purposes.

IRS Publication 517, *Social Security and Other Information for Members of the Clergy and Religious Workers*, has a detailed example of the tax treatment for a housing allowance and the related limitations on deductions. IRS Publication 525, *Taxable and Nontaxable Income*, has information on particular types of income for ministers.

Social Security and Medicare Taxes — Federal Insurance Contributions Act (FICA) vs. Self-Employment Contributions Act (SECA)

The compensation that a church or religious organization pays to its ministers for performing services in the exercise of ministry is not subject to FICA taxes. However, income that a minister earns in performing services in the exercise of his ministry is subject to SECA tax, unless the minister has timely applied for and received an exemption from SECA tax.

Payment of Employee Business Expenses

A church or religious organization is treated like any other employer as far as the tax rules regarding employee business expenses. The rules differ depending upon whether the expenses are paid through an accountable or non-accountable plan, and these plans determine whether the payment for these expenses is included in the employee's income.

Accountable Reimbursement Plan

An arrangement that an employer establishes to reimburse or advance employee business expenses will be an accountable plan if it meets three requirements: (1) involves a business connection; (2) requires the employee to substantiate expenses incurred; and (3) requires the employee to return any excess amounts.

Employees must provide the organization with sufficient information to identify the specific business nature of each expense and to substantiate each element of an expenditure. It is not sufficient for an employee to aggregate expenses into broad categories such as travel or to report expenses through the use of non-descriptive terms such as *miscellaneous business expenses*. Both the substantiation and the return of excess amounts must occur within a reasonable period of time.

Employee business expenses reimbursed under an accountable plan are: (a) excluded from an employee's gross income; (b) not required to be reported on the employee's IRS Form W-2, *Wage and Tax Statement*; and (c) exempt from the withholding and payment of wages subject to FICA taxes and income tax withholdings.

Non-accountable Reimbursement Plan

If the church or religious organization reimburses or advances the employee for business expenses, but the arrangement does not satisfy the three requirements of an accountable plan, the amounts paid to the employees are considered wages subject to FICA taxes and income tax withholding, if applicable, and are reportable on Form W-2. (Amounts paid to employee ministers are treated as wages reportable on Form W-2, but are not subject to FICA taxes or income tax withholding.)

For example, if a church or religious organization pays its secretary a $200 per month allowance to reimburse monthly business expenses the secretary incurs while conducting church or religious organization business, and the secretary is not required to substantiate the expenses or return any excess, then the entire $200 must be reported on Form W-2 as wages subject to FICA taxes and income tax withholding. In the same situation involving an employee-minister, the allowance must be reported on the minister's Form W-2, but no FICA or income tax withholding is required. For further information see IRS Publication 463, *Travel, Entertainment, Gift and Car Expenses*.

One common business expense reimbursement is for *automobile mileage*. If a church or religious organization pays a mileage allowance at a rate that is less than or equal to the federal standard rate, the amount of the expense is deemed substantiated. (Each year, the federal government establishes a standard mileage reimbursement rate.) There are no income or employment tax consequences to the reimbursed individual provided that the employee substantiates the time, place, and business purposes of the automobile mileage for which reimbursement is sought. Of course, reimbursement for automobile mileage incurred for personal purposes is includible in the individual's income.

If a church or religious organization reimburses automobile mileage at a rate exceeding the standard mileage rate, the excess is treated as paid under a non-accountable plan. This means that the excess is includible in the individual's income and is subject to the withholding and payment of income and employment taxes, if applicable.

In addition, any mileage reimbursement that is paid without requiring the individual to substantiate the time, place, and business purposes of each trip is included in the individual's income, regardless of the rate of reimbursement.

No income is attributed to an employee or a volunteer who uses an automobile owned by the church or religious organization to perform church-related work.

Recordkeeping Requirements

Books of Accounting and Other Types of Records

All tax-exempt organizations, including churches and religious organizations (regardless of whether tax-exempt status has been officially recognized by the IRS), are required to maintain books of accounting and other records necessary to justify their claim for exemption in the event of an audit. See Special Rules Limiting IRS Authority to Audit a Church on page 22. Tax-exempt organizations are also required to maintain books and records that are necessary to accurately file any federal tax and information returns that may be required.

There is no specific format for keeping records. However, the types of required records frequently include organizing documents (charter, constitution, articles of incorporation) and bylaws, minute books, property records, general ledgers, receipts and disbursements journals, payroll records, banking records, and invoices. The extent of the records necessary generally varies according to the type, size, and complexity of the organization's activities.

Length of Time to Retain Records

The law does not specify a *length of time* that records must be retained; however, the following guidelines should be applied in the event that the records may be material to the administration of any federal tax law.

Type of Record	*Length of Time to Retain*
Records of revenue and expenses, including payroll records.	Retain for at least four years after filing the return(s) to which they relate.
Records relating to acquisition and disposition of property (real and personal, including investments).	Retain for at least four years after the filing of the return for the year in which disposition occurs.

Filing Requirements

Information and Tax Returns — Forms to File and Due Dates

Churches or religious organizations may be required to report certain payments to the IRS. The following is a list of the most frequently required returns, who should use them, how they are used, and when they should be filed.

Returns	*Who Should Use Them*	*How They are Used*	*When to File*
Form W-2 ***Wage and Tax Statement*** **Form W-3** ***Transmittal of Wage and Tax Statement***	Organizations with employees.		Furnish each employee with a completed Form W-2 by January 31; and file all Forms W-2 and Form W-3 with the Social Security Administration (SSA) by the last day of February.
Form W-2G ***Certain Gaming Winnings*** For more information on reporting requirements for gaming activities, see IRS Publication 3079, *Gaming Publication for Tax-Exempt Organizations.*	Any charitable or religious organization, including a church, that sponsors a gaming event (raffles, bingo) must file Form W-2G when a participant wins a prize over a specific value amount.	The requirements for reporting and withholding depend on the type of gaming, the amount of winnings, and the ratio of winnings to the wager.	For each winner meeting the filing requirement, the church or religious organization must furnish each winner Form W-2G by January 31; and file Copy A of Form W-2G with the IRS by February 28.
Form 941 ***Employer's Quarterly Federal Tax Return*** ***or*** ***Form 944, Employer's Annual Federal Tax Return***	Small employers that have been notified by the IRS to file Form 944 (see form instructions) may use that form; other employers required to file must use Form 941	Use Form 941 or 944 to report Social Security and Medicare taxes and income taxes withheld by the organization, and Social Security and Medicare taxes paid by the organization.	See form instructions for due dates.
Form 945 ***Annual Return of Withheld Federal Income Tax***		If a church or religious organization withholds income tax, including backup withholding, from non-payroll payments, it must file Form 945.	File Form 945 by January 31. This form is not required for those years in which there is no non-payroll tax liability.
Form 990 ***Return of Organization Exempt from Income Tax*** **Form 990-EZ** ***Short Form Return of Organization Exempt From Income Tax*** **Form 990-N (electronic postcard),** ***Electronic Notice for Tax Exempt Organizations Not Required to File Form 990 or 990-EZ.***	Generally, all religious organizations (See exception to file 990 below) must file Form 990, Form 990-EZ or Form 990-N. *Exceptions to file Form 990, 990-EZ and 990-N* The following is a list of some of the organizations that are not required to file Form 990, 990-EZ or 990-N. ■ Churches (as opposed to "religious organizations," defined earlier ■ Inter-church organization s of local units of a church ■ Mission societies sponsored by or affiliated with one or more churches or church denomination, if more than half of the activities are conducted in, or directed at, persons in foreign countries ■ An exclusively religious activity of any religious order See the form instructions for a list of other organizations that are not required to file.	For tax years 2008 through 2010, the thresholds for determining whether an organization should file Form 990, 990-EZ or 990-N will vary. See www.irs.gov/eo for the specific thresholds.	Form 990, 990-EZ or 990-N must be filed on or before the 15th day of the 5th month following the end of the organization's tax year. Form 990-N must be electronically filed.

Returns	*Who Should Use Them*	*How They are Used*	*When to File*
Form 990-T ***Exempt Organization Business Income Tax Return*** For more information on unrelated business income, see Unrelated Business Income Tax (UBIT) on page 12.	Churches and religious organizations.	Churches and religious organizations must file Form 990-T if they generate gross income from an unrelated business of $1,000 or more for a taxable year.	Form 990-T must be filed by the 15th day of the 5th month after the organization's accounting period ends (May 15 for a calendar year accounting period).
Form 990-W ***Estimated Tax on Unrelated Business Taxable Income for Tax-Exempt Organizations***	Churches and religious organizations.	If the tax on unrelated business income is expected to be $500 or more, the church or religious organization must make estimated tax payments. Use Form 990-W to compute the estimated tax liability.	
Form 1096 ***Annual Summary and Transmittal of U.S. Information Returns***	Churches and religious organizations.	Use Form 1096 to transmit Forms 1099-MISC, W-2G, and certain other forms to the IRS.	Form 1096 must be filed by February 28 in the year following the calendar year in which the payments were made.
Form 1099 ***Miscellaneous Income*** See the *Instructions for* Form 1099-MISC for details.	Churches and religious organizations.	A church or religious organization must use Form 1099-MISC if it pays an unincorporated individual or an entity $600 or more in any calendar year for one of the following payments: gross rents; commissions, fees, or other compensation paid to non-employees; prizes and awards; or other fixed and determinable income.	Churches or religious organizations must furnish each payee with a copy of Form 1099-MISC by January 31; and file Copy A of Form 1099-MISC with the IRS by February 28.
Form 5578 ***Annual Certification of Racial Nondiscrimination for a Private School Exempt from Federal Income Tax*** For information on racial and ethnic nondiscriminatory policies, see Revenue Procedure 75-50, 1975-2 C.B. 587 at www.irs.gov.	A church or religious organization that operates a private school, whether separately incorporated or operated as part of its overall operations, that teaches secular subjects and generally complies with state law requirements for public education. *Note:* It is not considered racially discriminatory for a parochial school to select students on the basis of membership in a religious denomination if membership in the denomination is open to all on a racially nondiscriminatory basis. Further, a seminary, or other purely religious school, that primarily teaches religious subjects usually with the purpose of training students for the ministry, is not subject to the racially nondiscriminatory requirements because it is considered to be a religious rather than an educational organization.	A church or religious organization must file Form 5578 to certify that it does not discriminate based on race or ethnic origin.	Form 5578 must be filed on or before the 15th day of the 5th month following the end of the organization's taxable year (May 15 for a calendar year). If an organization files Form 990 or Form 990-EZ, the certification must be made on Schedule A (Form 990 or Form 990-EZ).
Form 8282 ***Donee Information Return***	Churches and religious organizations.	A church or religious organization must file Form 8282 if it sells, exchanges, transfers, or otherwise disposes of certain non-cash donated property within three years of the date it originally received the donation. This applies to non-cash property that had an appraised value of more than $5,000 at time of donation.	The church or religious organization must file Form 8282 with the IRS within 125 days of date of disposition of the property; and furnish the original donor with a copy of the form.

Charitable Contributions— Substantiation and Disclosure Rules

Recordkeeping

A church or religious organization should be aware of the recordkeeping and substantiation rules imposed on donors of charities that receive certain quid pro quo contributions.

Recordkeeping Rules

A donor cannot claim a tax deduction for any contribution of cash, a check or other monetary gift made on or after January 1, 2007 unless the donor maintains a record of the contribution in the form of either a bank record (such as a cancelled check) or a written communication from the charity (such as a receipt or a letter) showing the name of the charity, the date of the contribution, and the amount of the contribution.

Substantiation Rules

A donor cannot claim a tax deduction for any single contribution of $250 or more unless the donor obtains a contemporaneous, written acknowledgment of the contribution from the recipient church or religious organization. A church or religious organization that does not acknowledge a contribution incurs no penalty; but without a written acknowledgment, the donor cannot claim a tax deduction. Although it is a donor's responsibility to obtain a written acknowledgment, a church or religious organization can assist the donor by providing a timely, written statement containing the following information:

- name of the church or religious organization,
- date of the contribution,
- amount of any cash contribution, and
- description (but not the value) of non-cash contributions.

In addition, the timely, written statement must contain one of the following:

- statement that no goods or services were provided by the church or religious organization in return for the contribution,
- statement that goods or services that a church or religious organization provided in return for the contribution consisted entirely of intangible religious benefits, or
- description and good faith estimate of the value of goods or services other than intangible religious benefits that the church or religious organization provided in return for the contribution.

The church or religious organization may either provide separate acknowledgments for each single contribution of $250 or more or one acknowledgment to substantiate several single contributions of $250 or more. Separate contributions are not aggregated for purposes of measuring the $250 threshold.

Disclosure Rules that Apply to *Quid Pro Quo* Contributions

A contribution made by a donor in exchange for goods or services is known as a *quid pro quo* contribution. A donor may only take a contribution deduction to the extent that his or her contribution exceeds the fair market value of the goods and services the donor receives in return for the contribution. Therefore, donors need to know the value of the goods or services. A church or religious organization must provide a written statement to a donor who makes a payment exceeding $75 partly as a contribution and partly for goods and services provided by the organization.

Example 1: If a donor gives a church a payment of $100 and, in return, receives a ticket to an event valued at $40, this is a *quid pro quo* contribution, and only $60 is deductible by the donor ($100 - $40 = $60). Even though the deductible amount does not exceed $75, since the *quid pro quo* contribution the church received is in excess of $75, the church must provide the donor with a written disclosure statement. The statement must: (1) inform the donor that the amount of the contribution that is deductible for federal income tax purposes is limited to the excess of money (and the fair market value of any property other than money) contributed by the donor over the value of goods or services provided by the church or religious organization; and (2) provide the donor with a good-faith estimate of the value of the goods or services.

The church or religious organization must provide the written disclosure statement with either the solicitation or the receipt of the contribution and in a manner that is likely to come to the attention of the donor. For example, a disclosure in small print within a larger document may not meet this requirement.

Exceptions to Disclosure Statement

A church or religious organization is not required to provide a disclosure statement for *quid pro quo* contributions when: (a) the goods or services meet the standards for *insubstantial value*; or (b) the only benefit received by the donor is an *intangible religious benefit*. Additionally, if the goods or services the church or religious organization provides are *intangible religious benefits* (examples follow), the acknowledgement for contributions of $250 or more does not need to describe those benefits.

Generally, intangible religious benefits are benefits provided by a church or religious organization that are not usually sold in commercial transactions outside a donative (gift) context.

Intangible religious benefits include:

- admission to a religious ceremony
- de minimus tangible benefits, such as wine used in religious ceremony

Benefits that are not intangible religious benefits include:

- tuition for education leading to a recognized degree
- travel services
- consumer goods

IRS Publication 1771, Charitable Contributions: Substantiation and Disclosure Requirements, provides more information on substantiation and disclosure rules.

Order Publication 1771 free through the IRS at (800) 829-3676.

Special Rules Limiting IRS Authority to Audit a Church

Tax Inquiries and Examinations of Churches

Congress has imposed special limitations, found in IRC section 7611, on how and when the IRS may conduct civil tax inquiries and examinations of churches. The IRS may only initiate a *church tax inquiry* if the Director, Exempt Organizations, Examinations reasonably believes, based on a written statement of the facts and circumstances, that the organization: (a) may not qualify for the exemption; or (b) may not be paying tax on an unrelated business or other taxable activity.

Restrictions on Church Inquiries and Examinations

Restrictions on church inquiries and examinations apply only to churches (including organizations claiming to be churches if such status has not been recognized by IRS) and conventions or associations of churches. They do not apply to related persons or organizations. Thus, for example, the rules do not apply to schools that, although operated by a church, are organized as separate legal entities. Similarly, the rules do not apply to integrated auxiliaries of a church.

Restrictions on church inquiries and examinations do not apply to all church inquiries by the IRS. The most common exception relates to routine requests for information. For example, IRS requests for information from churches about filing of returns, compliance with income or Social Security and Medicare tax withholding requirements, supplemental information needed to process returns or applications, and other similar inquiries are not covered by the special church audit rules.

Restrictions on church inquiries and examinations do not apply to criminal investigations or to investigations of the tax liability of any person connected with the church, e.g., a contributor or minister.

The procedures of IRC section 7611 will be used in initiating and conducting any inquiry or examination into whether an excess benefit transaction (as that term is used in IRC section 4958) has occurred between a church and an insider.

Audit Process

The following is the sequence of the audit process.

1. If the *reasonable belief* requirement is met, the IRS must begin an inquiry by providing a church with written notice containing an explanation of its concerns.

2. The church is allowed a reasonable period in which to respond by furnishing a written explanation to alleviate IRS concerns.

3. If the church fails to respond within the required time, or if its response is not sufficient to alleviate IRS concerns, the IRS may, generally within 90 days, issue a second notice, informing the church of the need to examine its books and records.

4. After issuance of a second notice, but before commencement of an examination of its books and records, the church may request a conference with an IRS official to discuss IRS concerns. The second notice will contain a copy of all documents collected or prepared by the IRS for use in the examination and subject to disclosure under the Freedom of Information Act, as supplemented by IRC section 6103 relating to disclosure and confidentiality of tax return information.

5. Generally, examination of a church's books and records must be completed within two years from the date of the second notice from the IRS.

If at any time during the inquiry process the church supplies information sufficient to alleviate the concerns of the IRS, the matter will be closed without examination of the church's books and records. There are additional safeguards for the protection of churches under IRC section 7611. For example, the IRS cannot begin a subsequent examination of a church for a five-year period unless the previous examination resulted in a revocation, notice of deficiency of assessment, or a request for a significant change in church operations, including a significant change in accounting practices.

Glossary

Church. Certain characteristics are generally attributed to churches. These attributes of a church have been developed by the IRS and by court decisions. They include: distinct legal existence; recognized creed and form of worship; definite and distinct ecclesiastical government; formal code of doctrine and discipline; distinct religious history; membership not associated with any other church or denomination; organization of ordained ministers; ordained ministers selected after completing prescribed courses of study; literature of its own; established places of worship; regular congregations; regular religious services; Sunday schools for the religious instruction of the young; schools for the preparation of its ministers. The IRS generally uses a combination of these characteristics, together with other facts and circumstances, to determine whether an organization is considered a church for federal tax purposes.

The IRS makes no attempt to evaluate the content of whatever doctrine a particular organization claims is religious, provided the particular beliefs of the organization are truly and sincerely held by those professing them and the practices and rites associated with the organization's belief or creed are not illegal or contrary to clearly defined public policy.

Integrated Auxiliary Of A Church. The term integrated auxiliary of a church refers to a class of organizations that are related to a church or convention or association of churches, but are not such organizations themselves. In general, the IRS will treat an organization that meets the following three requirements as an integrated auxiliary of a church. The organization must:

- be described both as an IRC section 501(c)(3) charitable organization and as a public charity under IRC sections 509(a)(1), (2), or (3),
- be affiliated with a church or convention or association of churches, and
- receive financial support primarily from internal church sources as opposed to public or governmental sources.

Men's and women's organizations, seminaries, mission societies, and youth groups that satisfy the first two requirements above are considered integrated auxiliaries whether or not they meet the internal support requirements. More guidance as to the types of organizations the IRS will treat as integrated auxiliaries can be found in the Code of Regulations, 26 CFR section 1.6033-2(h).

The same rules that apply to a church apply to the integrated auxiliary of a church, with the exception of those rules that apply to the audit of a church. See section Special Rules Limiting IRS Authority To Audit A Church on page 22.

Minister. The term minister is not used by all faiths; however, in an attempt to make this publication easy to read, we use it because it is generally understood. As used in this booklet, the term minister denotes members of clergy of all religions and denominations and includes priests, rabbis, imams, and similar members of the clergy.

IRC Section 501(C)(3). IRC section 501(c)(3) describes charitable organizations, including churches and religious organizations, which qualify for exemption from federal income tax and generally are eligible to receive tax-deductible contributions. This section provides that:

- an organization must be organized and operated exclusively for religious or other charitable purposes,
- net earnings may not inure to the benefit of any private individual or shareholder,
- no substantial part of its activity may be attempting to influence legislation,
- the organization may not intervene in political campaigns, and
- the organization's purposes and activities may not be illegal or violate fundamental public policy.

These requirements are set forth in greater detail throughout this publication.

Help From The IRS

IRS Tax Publications to Order

The IRS provides free tax publications and forms. Order publications and forms by calling toll-free (800) 829-3676, or download publications and forms from the IRS Web site at www.irs.gov. The following list of publications may provide further information for churches and other religious organizations:

Publication	Title
Publication 1	*Your Rights as a Taxpayer*
Publication 15	*Circular E, Employer's Tax Guide*
Publication 15-A	*Employer's Supplemental Tax Guide*
Publication 334	*Tax Guide for Small Business (For Individuals Who Use Schedule C or C-EZ)*
Publication 463	*Travel, Entertainment, Gift, and Car Expenses*
Publication 517	*Social Security and Other Information for Members of the Clergy and Religious Workers*
Publication 525	*Taxable and Nontaxable Income*
Publication 526	*Charitable Contributions*
Publication 557	*Tax-Exempt Status for Your Organization*
Publication 561	*Determining the Value of Donated Property*
Publication 571	*Tax-Sheltered Annuity Programs for Employees of Public Schools and Certain Tax-Exempt Organizations*
Publication 598	*Tax on Unrelated Business Income of Exempt Organizations*
Publication 910	*Guide to Free Tax Services*
Publication 1771	*Charitable Contributions: Substantiation and Disclosure*
Publication 3079	*Gaming Publication for Tax-Exempt Organizations*
Publication 4221-PC	*Compliance Guide for 501(c)(3) Public Charities*
Publication 4630	*Exempt Organizations Products and Services Navigator*

IRS Customer Service

Telephone assistance for general tax information is available by calling: IRS Customer Service toll-free at (800) 829-1040.

EO Customer Service

Telephone assistance specific to exempt organizations is available by calling: IRS Exempt Organizations Customer Account Services toll-free at (877) 829-5500.

EO Web Site

Visit the IRS Exempt Organizations Web site at www.irs.gov/eo.

Stay Exempt - Tax Basics for 501(c)(3)s - a free on-line IRS workshop covering tax compliance issues confronted by small and mid-sized tax-exempt organizations, available at www.stayexempt.org.

EO Update

To receive IRS Exempt Organization's Update, a periodic newsletter with information for tax-exempt organizations and tax practitioners who represent them, visit www.irs.gov/eo and click on "EO Newsletter."

Internal Revenue Service

Tax Exempt and
Government Entities

Exempt Organizations

Compliance Guide for 501(c)(3) Public Charities

Covers:

Activities that may jeopardize a charity's exempt status

Federal information returns, tax returns or notices that must be filed

Recordkeeping—why, what, when

Changes to be reported to the IRS

Required public disclosures

Resources for public charities

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1(c)(3)

Federal tax law provides tax benefits to nonprofit organizations recognized as exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code (Code). The Code requires that tax-exempt organizations must comply with federal tax law to maintain tax-exempt status and avoid penalties.

In Publication 4221-PC, the IRS addresses activities that could jeopardize a public charity's tax-exempt status. It identifies general compliance requirements on recordkeeping, reporting, and disclosure for exempt organizations (EO's) described in section 501(c)(3) of the Code that are classified as public charities. Content includes references to the statute, Treasury regulations, IRS publications and IRS forms with instructions. Publication 4221-PC is neither comprehensive nor intended to address every situation.

To learn more about compliance rules and procedures that apply to public charities exempt from federal income tax under section 501(c)(3), see IRS Publication 557, Tax-Exempt Status for Your Organization, and the Life Cycle of a Public Charity on www.irs.gov/eo. Stay abreast of new EO information, also on this Web site, by signing up for the EO Update, a free newsletter for tax-exempt organizations and practitioners who represent them. For further assistance, consult a tax adviser.

What activities may jeopardize a public charity's tax-exempt status?

Once a public charity has completed the application process and has established that it is exempt under section 501(c)(3), the charity's officers, directors, trustees and employees still have ongoing responsibilities. They must ensure that the organization maintains its tax-exempt status and meets its ongoing compliance responsibilities.

A 501(c)(3) public charity that does not restrict its participation in certain activities and does not absolutely refrain from others, risks failing the operational test and jeopardizing its tax-exempt status. The following summarizes the limitations on the activities of public charities.

Private Benefit and Inurement

A public charity is prohibited from allowing more than an insubstantial accrual of private benefit to individuals or organizations. This restriction is to ensure that a tax-exempt organization serves a public interest, not a private one. If a private benefit is more than incidental, it could jeopardize the organization's tax-exempt status.

No part of an organization's net earnings may inure to the benefit of a private shareholder or individual. This means that an organization is prohibited from allowing its income or assets to accrue to insiders. An example of prohibited inurement would include payment of unreasonable compensation to an insider. An insider is a person who has a personal or private interest in the activities of the organization such as an officer, director, or a key employee. Any

amount of inurement may be grounds for loss of tax-exempt status.

In cases where a public charity provides an excess economic benefit to a person who is in a position to exercise substantial influence over its affairs, the organization has engaged in an excess benefit transaction (see **Reporting Excess Benefit Transactions** on page 8) that subjects the person to possible excise taxes. Go to *www.irs.gov/eo* for details about inurement, private benefit, and excess benefit transactions.

Political Campaign Intervention

Public charities are absolutely prohibited from directly or indirectly participating in, or intervening in, any political campaign on behalf of (or in opposition to) a candidate for public office. Contributions to political campaign funds or public statements of position made on behalf of the organization in favor of or in opposition to any candidate for public office clearly violate the prohibition against political campaign activity. Violation of this prohibition may result in revocation of tax-exempt status and/or imposition of certain excise taxes.

Certain activities or expenditures may not be prohibited depending on the facts and circumstances. For example, the conduct of certain voter education activities (including the presentation of public forums and the publication of voter education guides) in a non-partisan manner do not constitute prohibited political campaign activity. Other activities intended to encourage people to participate in the electoral process, such as voter registration and get-out-the-vote drives, would not constitute prohibited political campaign activity if conducted

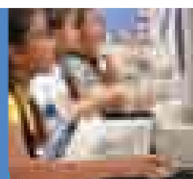
in a non-partisan manner. On the other hand, voter education or registration activities with evidence of bias that would favor one candidate over another, oppose a candidate in some manner, or have the effect of favoring a candidate or group of candidates, will constitute campaign intervention.

The political campaign activity prohibition is not intended to restrict free expression on political matters by leaders of public charities speaking for themselves as individuals. However, for their organizations to remain tax exempt under section 501(c)(3), organization leaders cannot make partisan comments in official organization publications or at official functions and should clearly indicate that their comments are personal and not intended to represent the views of the organization. Read Revenue Ruling 2007-41 at *www.irs.gov/eo* for additional information on the prohibition against political campaign intervention.

Legislative Activities

A public charity is not permitted to engage in substantial legislative activity (commonly referred to as lobbying). An organization will be regarded as attempting to influence legislation: if it contacts, or urges the public to contact, members or employees of a legislative body for purposes of proposing, supporting or opposing legislation; or if the organization advocates the adoption or rejection of legislation.

If lobbying activities are substantial, a 501(c)(3) organization may fail the operational test and risk losing its tax-exempt status and/or be liable for excise taxes. Substantiality is measured by either the *substantial part test* or the *expenditure test*.



The *substantial part test* determines substantiality on the basis of all the pertinent facts and circumstances in each case. The IRS considers a variety of factors, including the time devoted and expenditures devoted by the organization to the activity, when determining whether the lobbying activity is substantial.

As an alternative, a public charity (other than a church) may elect to use the *expenditure test* by filing Form 5768, *Election/Revocation of Election by an Eligible Section 501(c)(3) Organizations To Make Expenditures To Influence Legislation*. Under the expenditure test, a public charity's lobbying activity will not jeopardize its tax-exempt status provided its expenditures related to lobbying do not normally exceed a set amount specified in section 4911 of the Code. This limit is generally based on the size of the organization and may not exceed $1 million. Read the *Life Cycle of a Public Charity* at *www.irs.gov/eo* for additional information about the rules against substantial legislative activities.

What federal information returns, tax returns and notices must be filed?

While 501(c)(3) public charities are exempt from federal income tax, most of these organizations have information reporting obligations under the Code to ensure that they continue to be recognized as tax-exempt. In addition, they may also be liable for employment taxes, unrelated business income tax, excise taxes, and certain state and local taxes.

Form 990, *Return of Organization Exempt from Income Tax and Form 990-EZ*

Public charities generally file Form 990, *Return of Organization Exempt from Income Tax*, Form 990-EZ, *Short Form Return of Organization Exempt from Income Tax*, or Form 990-N, *Electronic Notice (e-Postcard) for Tax-Exempt Organizations not Required To File Form 990 or 990-EZ*.

The type of Form or Notice required is generally determined by the public charity's financial activity. An organization may file Form 990-EZ if its gross receipts are normally more than $25,000 but less than $100,000, and its total assets are less than $250,000 at the end of the year. (The Form 990 Instructions show how to compute an organization's "normal" receipts.) If the organization's gross receipts are $100,000 or greater, the organization generally must file Form 990. If the organization's gross receipts are generally less than $25,000, the organization must file the Form 990-N, but may elect to file a complete Form 990 or Form 990-EZ. (See Form 990-N, *Electronic Notice (e-Postcard) for Tax-Exempt Organizations not Required To File Form 990 or 990-EZ* on page 9.)

Forms 990 and 990-EZ must be filed by the 15th day of the fifth month after the end of the organization's annual accounting period. The due date may be extended for three months, without showing cause, by filing Form 8868, *Application for Extension of Time To File an Exempt Organization Form*, before the due date. An additional three-month extension may be requested on Form 8868 if the organization shows reasonable cause why the return cannot be filed by the extended due date.

Forms 990 and 990-EZ Filing Exceptions

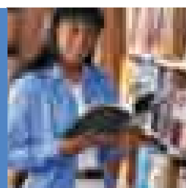
Public charities that are not required to file Forms 990 or 990-EZ include:

- churches and certain church-affiliated organizations,
- certain organizations affiliated with governmental units,
- organizations that file as part of a group ruling, and
- organizations whose annual gross receipts are normally less than $25,000 (see Form 990-N, *Electronic Notice (e-Postcard) for Tax-Exempt Organizations not Required To File Form 990 or 990-EZ* on page 9).

If a public charity is excepted from filing a Form 990 or Form 990-EZ because gross receipts are below the $25,000 threshold, it is not required to file a return even if the IRS sends it a Form 990 package. Should the public charity elect to file the Form 990 or Form 990-EZ, it must complete the entire return; otherwise, it must file the Form 990-N.

Special Requirements for Supporting Organizations

Public charities that are supporting organizations described in section 509(a)(3) are generally required to file Form 990 or Form 990-EZ even if their gross receipts are less than $25,000, effective for returns filed after August 17, 2006. Supporting organizations of religious organizations need not file Form 990 or Form 990-EZ if their gross receipts are normally $5,000 or less. Such organizations will, however, be required to file the Form 990-N. Supporting organizations will be required to indicate whether they are a Type 1, Type 2, or Type 3 supporting organization,



identify their supported organizations, and annually certify that they are not controlled by a disqualified person. See the instructions for Schedule A (Form 990 or Form 990-EZ) and Notice 2006-109 to determine an organization's appropriate supporting organization type for information return purposes. Learn about filing and new requirements applicable to supporting organizations on the IRS Nonprofits and Charities Web site at *www.irs.gov/eo*.

Form 990 Schedules A and B

Public charities that file Form 990 or Form 990-EZ must file Schedule A of that return. Schedule A reports information about compensation of officers, directors, key employees, and independent contractors; the basis for the organization's public charity classification; lobbying expenditures; and certain other activities, as noted on Schedule A instructions. Private schools must fill out a special questionnaire on Schedule A. Organizations that file Form 990 or Form 990-EZ also must file Schedule B if they report contributions over a specified amount on these annual returns. See the *Guidelines for Meeting the Requirements for Schedule B* in the instructions for Form 990 and Form 990-EZ and the instructions to Schedule B (Form 990, 990-EZ) for complete information.

Reporting Excess Benefit Transactions

If a public charity believes it provided an unreasonable benefit to a person who is in a position to exercise substantial influence over the organization's affairs, it must report the transaction on Form 990 or Form 990-EZ. Excess benefit transactions are governed by section 4958 of the Code. Additional information can be found in the Form 990 and Form 990-EZ instructions.

Form 990-N, *Electronic Notice (e-Postcard) for Tax-Exempt Organizations not Required To File Form 990 or 990-EZ*

Section 6033(i) requires a public charity to file Form 990-N, *Electronic Notice (e-Postcard) for Tax-Exempt Organizations not Required To File Form 990 or 990-EZ*, for tax periods beginning after December 31, 2006, if that organization is not required to file Form 990 (or Form 990-EZ), because the organization's gross receipts are normally $25,000 or less.

The Form 990-N is due by the 15th day of the fifth month after the close of your tax period. For example, if your organization's tax period ends on December 31, 2007, the Form 990-N is due May 15, 2008.

An organization is required to provide the following information on Form 990-N.

- the organization's name,
- any other names the organization uses,
- the organization's address,
- the organization's website address (if applicable),
- the organization's taxpayer identification number (TIN),
- name and address of a principal officer of the organization,
- the organization's annual tax period, and
- a statement that the organization's annual gross receipts are still normally $25,000 or less.

Form 990-N also includes a check-box for the organization to notify the IRS that it is terminating.

Read **Filing Penalties and Revocation of Tax-exempt Status** on page 10, for consequences for failure to file this annual electronic notice and *www.irs.gov/eo* for information about the Form 990-N.

e-filing Requirements

Public charities with $10 million or more in total assets and that also file at least 250 returns in a calendar year, (including income, excise, employment tax, and information returns such as Forms W-2's and 1099's), are required to electronically file Form 990. Other public charities are given a choice to file Form 990 electronically. Click on the "IRS *e-file*" logo on the IRS Web site to get the facts on e-filing.

FILING PENALTIES AND REVOCATION OF TAX-EXEMPT STATUS

If a Form 990 or Form 990-EZ is not filed, the IRS may assess penalties on the organization of $20 per day until it is filed. This penalty also applies when the filer fails to include required information or to show correct information. The penalty for failure to file a return or a complete return may not exceed the lesser of $10,000 or 5 percent of the organization's gross receipts. For an organization that has gross receipts of over $1 million for the year, the penalty is $100 a day up to a maximum of $50,000. The IRS may impose penalties on organization managers who do not comply with a written demand that the information be filed.

Section 6033(j) of the Code provides that failure to file Form 990, Form 990-EZ, or Form 990-N for 3 consecutive years results in revocation of tax-exempt status as of the filing due date for the third return. An organization whose exemption is revoked under this section must apply for reinstatement by filing a Form 1023 and paying a user fee, whether or not the organization was originally required to file for exemption. Reinstatement of exemption may be retroactive if the organization shows that the failure to file was for reasonable cause. Information with respect to the implementation of Section 6033(i) is available at *www.irs.gov/eo*.

Form 8734, *Support Schedule for Advance Ruling Period*

A newly formed exempt organization that cannot show enough public support to qualify as a public charity, rather than a private foundation, when it

files its application for exemption, may request an advance ruling of public charity status. Within 90 days after the end of the advance ruling period, which usually lasts five tax years, the charity must file a Form 8734, *Support Schedule for Advanced Ruling Period*, showing its significant and diversified sources of public support. If the organization does not provide the information or the information is not sufficient to demonstrate that the organization is a public charity, the IRS will reclassify the organization as a private foundation.

Publication 4220, *Applying for 501(c)(3) Tax-Exempt Status*, details the distinctions between private foundations and public charities.

Form 990-T, *Exempt Organization Business Income Tax Return*

Even if a public charity is not required to file a Form 990 or Form 990-EZ, it must file a Form 990-T, *Exempt Organization Business Income Tax Return*, if it has $1,000 or more of gross receipts from an unrelated trade or business during the year. Net income from income-producing activities is taxable if the activities:

- constitute a trade or business,
- are regularly carried on, and
- are not substantially related to the organization's exempt purpose.

The public charity must pay quarterly estimated tax on unrelated business income if it expects its tax for the year to be $500 or more. Form 990-W, *Estimated Tax on Unrelated Business Taxable Income for Tax-Exempt Organizations*, is a worksheet to determine the amount of estimated tax payments required.

FORM 990-T FILING PENALTIES

An organization may be subject to interest and penalty charges if it files a late return, fails to pay tax when due, or fails to pay estimated tax, if required, even if it did not expect its tax for the year to be $500 or more.

Exceptions and Special Rules

Income from certain business activities, is excepted from the definition of unrelated business income. Earnings from these sources are not subject to the unrelated business income tax. Exceptions generally include business income from:

- activities, including fundraisers, that are conducted by volunteer workers, or where donated merchandise is sold;
- activities conducted for the convenience of members, students, patients or employees;
- qualified conventions and trade shows;
- qualified sponsorship activities; and
- qualified bingo activities.

Income from certain "passive" business activities are usually excluded from the calculation of unrelated business activity. Examples of this type of income include earnings from routine investments such as certificates of deposit, savings accounts, or stock dividends, royalties, certain rents from real property, and certain gains or losses from the sale of property.

Special rules apply to income derived from real estate or other investments purchased with borrowed funds. Such income is called "debt-financed" income. Debt-financed income generally is subject to the unrelated business income tax.

To learn about unrelated business income, get Publication 598, *Tax on Unrelated Business Income of Exempt Organizations*, Form 990-T instructions, and Form 990-W instructions at *www.irs.gov*.

Employment Tax Returns

Like other employers, all public charities that pay wages to employees must withhold, deposit, and pay employment tax, including federal income tax withholding and Social Security and Medicare (FICA) taxes. A public charity must withhold federal income tax from employee wages and pay FICA on each employee paid more than $100 in wages during a calendar year. To know how much income tax to withhold, a public charity should have a Form W-4, *Employee's Withholding Allowance Certificate*, on file for each employee. Employment taxes are reported on Form 941, *Employer's Quarterly Federal Tax Return*. Any person that fails to withhold and pay employment tax may be subject to penalties. Public charities do not pay federal unemployment (FUTA) tax.

Public charities do not generally have to withhold or pay employment tax on payments to independent contractors, but they may have information reporting requirements. If a charity incorrectly classifies an employee as an independent contractor, it may be held liable for employment taxes for that worker.

The requirements for withholding, depositing, reporting and paying employment taxes are explained in Publication 15, *Circular E, Employer's Tax Guide*. For help in determining if workers are employees or independent contractors, see Publication 15-A, *Employer's Supplemental Tax*

Guide. Publication 557, *Tax Exempt Status for Your Organization*, covers the employment tax responsibilities of public charities. These IRS publications can be downloaded at *www.irs.gov*.

Employment Taxes and Churches

Although churches are excepted from filing Form 990, they do have employment tax responsibilities. Employees of churches or church-controlled organizations are subject to income tax withholding, but may be exempt from FICA taxes. Like other 501(c)(3) organizations, churches are not required to pay federal unemployment tax (FUTA). In addition, although ministers generally are common law employees, they are not treated as employees for employment tax purposes. These special employment tax rules for members of the clergy and religious workers are explained in Publication 517, *Social Security and Other Information for Members of the Clergy and Religious Workers*. Churches also should consult Publications 15 and 15-A and Publication 1828, *Tax Guide for Churches and Religious Organizations*.

Why keep records?

In general, a public charity must maintain books and records to show that it complies with tax rules. The charity must be able to document the sources of receipts and expenditures reported on Form 990, *Return of Organization Exempt From Income Tax or*

Form 990-EZ, Short Form Return of Organization Exempt From Income Tax, and Form 990-T, *Exempt Organization Business Income Tax Return*. (See **Prepare Annual Information And Tax Returns** on page 16.)

If an organization does not keep required records, it may not be able to show that it qualifies for tax-exempt status or is a public charity. Thus, the organization may lose its tax-exempt status or be classified as a private foundation rather than a public charity. In addition, a public charity may not be able to complete its returns accurately and may be subject to penalties described under **Filing Penalties and Revocation of Tax-exempt Status** on page 10. When good recordkeeping systems are in place, a public charity can evaluate the success of its programs, monitor its budget, and prepare its financial statements and returns.

Evaluate Charitable Programs

A charity can use records to evaluate the success of its charitable program and determine whether the organization is achieving desired results. Good records can also help a charity identify problem areas and determine what changes it may need to make to improve performance.

Monitor Budgetary Results

Without proper financial records, it is difficult for a charity to assess whether the charity has been successful in adhering to budgetary guidelines. The ability to monitor income and expenses and ensure that the organization is operating within its budget is crucial to successful stewardship of a public charity.

Prepare Financial Statements

It is important to maintain sufficient financial information in order to prepare accurate and timely annual financial statements. A charity may need these statements when it is working with banks, creditors, contributors, and funding organizations. Some states require charities to make audited financial statements publicly available.

Prepare Annual Information and Tax Returns

Records must support income, expenses, and credits reported on Form 990 series and other tax returns. Generally, these are the same records used to monitor programs and prepare financial statements. Books and records of public charities must be available for inspection by the IRS. If the IRS examines a public charity's returns, the organization must have records to explain items reported. Having a complete set of records will speed up the examination.

Identify Sources of Receipts

Public charities may receive money or property from many sources. With thorough recordkeeping, a charity can identify the sources of receipts. Organizations need this information to separate program from non-program receipts, taxable from non-taxable income, and to complete Schedule A or B of Form 990 or Form 8734, *Support Schedule for Advance Ruling Period*, noted in **What federal information returns, tax returns, and notices must be filed?** on page 5. An organization that checks box 10, 11, or 12, Part IV, of Schedule A, must keep records showing how much support it receives from specific contributors.

Substantiate Revenues, Expenses and Deductions for Unrelated Business Income Tax (UBIT) Purposes

A public charity may need records to substantiate the amount, if any, of unrelated business taxable income. An organization must appropriately track the financial revenues and expenses subject to UBIT reporting in order to prepare its unrelated business income tax return, Form 990-T, *Exempt Organization Income Tax Return*.

Comply with Grant-Making Procedures (Grants to Individuals)

A public charity that makes grants to individuals must keep adequate records and case histories to demonstrate that grants to individuals serve its charitable purposes. Case histories on grants to individuals should show names, addresses, purposes of grants, manner of selection, and relationship (if any) that the recipient has with any members, officers, trustees, or donors of the organization.

Comply with Racial Nondiscrimination Requirements (Private Schools)

Private schools must keep records that show that they have complied with requirements relating to racial nondiscrimination, including annual publication of a racially nondiscriminatory policy through newspaper or broadcast media to the general community served. For more information, see Part V of Schedule A (Form 990 or 990-EZ), *Supplementary Information – Organizations Exempt Under Section 501(c)(3).*

What records should be kept?

Except in a few cases, the law does not require a special kind of record. A public charity can choose any recordkeeping system, suited to its activities, that clearly shows the organization's income and expenses. The types of activities a public charity conducts determines the type of records that should be kept for federal tax purposes. A public charity should set up a recordkeeping system using an accounting method that is appropriate for proper monitoring and reporting of its financial activities for the tax year. If a public charity has more than one program, it should ensure that the records appropriately identify the income and expense items that are attributable to each program.

A recordkeeping system should generally include a summary of transactions. This summary is ordinarily written in the public charity's books (for example, accounting journals and ledgers). The books must show gross receipts, purchases, expenses (other than purchases), employment taxes, and assets. For most small organizations, the checkbook might be the main source for entries in the books while larger organizations would need more sophisticated ledgers and records. A public charity must keep documentation that supports entries in the books.

Accounting Periods and Methods

Public charities must keep their financial records based on an annual accounting period called a tax year in order to comply with annual reporting requirements.

Accounting Periods - A tax year is usually 12 consecutive months. There are two kinds of tax years.

calendar tax year	**This is a period of 12 consecutive months beginning January 1 and ending December 31.**
fiscal tax year	**This is a period of 12 consecutive months ending on the last day of any month except December.**

Accounting Method - An accounting method is a set of rules used to determine when and how income and expenses are reported. A public charity chooses an accounting method when it files its first annual return. There are two basic accounting methods:

cash method	**Under the cash method, a public charity reports income in the tax year received. It usually deducts expenses in the year paid.**
accrual method	**Under an accrual method, a public charity generally records income in the tax year earned, (i.e., in the tax year in which a pledge is received, even though it may receive payment in a later year.) It records expenses in the tax year incurred, whether or not it pays the expenses that year.**

For more information about accounting periods and methods, see Publication 538, *Accounting Periods and Methods*, and the instructions to Form 990 and Form 990-EZ.

Supporting Documents

Organization transactions such as contributions, purchases, sales, and payroll will generate supporting documents. These documents — grant applications and awards, sales slips, paid bills, invoices, receipts, deposit slips, and canceled checks — contain information to be recorded in accounting records. It is important to keep these documents

because they support the entries in books and the entries on tax and information returns. Public charities should keep supporting documents organized by year and type of receipt or expense. Also, keep records in a safe place.

Records Management

GROSS RECEIPTS

Gross receipts are the amounts received from all sources, including contributions. A public charity should keep supporting documents that show the amounts and sources of its gross receipts. Documents that show gross receipts include: donor correspondence, pledge documents, cash register tapes, bank deposit slips, receipt books, invoices, credit card charge slips, and Forms 1099-MISC, *Miscellaneous Income*.

PURCHASES, INCLUDING ACCOUNTING FOR INVENTORY

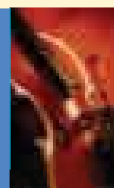
Purchases are items bought, including any items resold to customers. If an organization produces items, it must account for any items resold to customers. Thus, for example, the organization must account for the cost of all raw materials or parts purchased for manufacture into finished products. Supporting documents should show the amount paid, and that the amount was for purchases. Documents for purchases include: canceled checks, cash register tape receipts, credit card sales slips, and invoices. These records will help a public charity determine the value of its inventory at the end of the year. See Publication 538, *Accounting Periods and Methods*, for general information on methods for valuing inventory.

EXPENSES

Expenses are the costs a public charity incurs (other than purchases) to carry on its program. Supporting documents should show the amount paid and the purpose of the expense. Documents for expenses include: canceled checks, cash register tapes, contracts, account statements, credit card sales slips, invoices, and petty-cash slips for small cash payments.

EMPLOYMENT TAXES

Organizations that have employees must keep records of compensation and specific employment tax records. See Publication 15, *Circular E, Employer's Tax Guide*, for details.



ASSETS & LIABILITIES

Assets are the property, such as investments, buildings and furniture, an organization owns and uses in its activities. Liabilities reflect the pecuniary obligations of the organization. A public charity must keep records to verify certain information about its assets and liabilities. Records should show:

- when and how the asset was acquired
- whether any debt was used to acquire the asset
- documents that support mortgages, notes, loans, or other forms of debt
- purchase price
- cost of any improvements
- deductions taken for depreciation, if any
- deductions taken for casualty losses, if any, such as losses resulting from fires or storms
- how the asset was used
- when and how the asset was disposed of
- selling price
- expenses of sale

Documents that may show the above information include: purchase and sales invoices, real estate closing statements, canceled checks, and financing documents. If a public charity does not have canceled checks, it may be able to show payment with certain financial account statements prepared by financial institutions. These include account statements prepared for the financial institution by a third party. All information, including account statements must be highly legible. The following defines acceptable account statements.

IF payment is by:	**THEN** statement must show:
check	check number, amount, payee's name, and date the check amount was posted to the account by the financial institution
electronic funds transfer	amount transferred, payee's name, and date the transfer was posted to the account by the financial institution
credit card	amount charged, payee's name, and transaction date

How long should records be kept?

Public charities must keep records for federal tax purposes for as long as they may be needed to document evidence of compliance with provisions of the Code. Generally, this means the organization must keep records that support an item of income or deduction on a return until the statute of limitations for that return runs. The statute of limitations has run when the organization can no longer amend its return and the IRS can no longer assess additional tax. Generally, the statute of limitations runs three years after the date the return is due or filed, whichever is later. An organization may be required to retain records longer for other legal purposes, including state or local tax purposes.

Record Retention Periods

Record retention periods vary depending on the types of records and returns.

Permanent Records – Some records should be kept permanently. These include the application for recognition of tax-exempt status, the determination letter recognizing tax-exempt status, and organizing documents, such as articles of incorporation and by-laws, with amendments, as well as board minutes.

Employment Tax Records – If an organization has employees, it must keep employment tax records for at least four years after the date the tax becomes due or is paid, whichever is later.

Records for Non-Tax Purposes – When records are no longer needed for tax purposes, an organization should keep them until they are no longer needed for non-tax purposes. For example, a grantor, insurance company, creditor, or state agency may require that records be kept longer than the IRS requires.

How should changes be reported to the IRS?

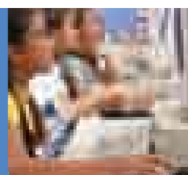
Reporting Changes on the Annual Information Return

A public charity that is required to file Form 990 or Form 990-EZ must report name, address, structural and operational changes on its annual information return. Regardless of whether a public charity files an annual information return, it may also report these changes to the EO Determinations Office at the mailing address set out in **How to get IRS assistance and information** at the end of this publication; however, such reporting does not relieve the organization from reporting the changes on its annual information return.

TIP: Attach copies of any signed or state certified articles of incorporation, or association, constitution or trust instrument or other organization document, or the bylaws or other governing document showing changes. If signed or state certified copies of a governing document are not available, an authorized officer may certify that the governing document provided is a complete and accurate copy of the original document.

Determination Letters and Private Letter Ruling Requests

A public charity may request a copy of a lost exemption letter or an updated exemption letter that reflects a name or address change from the EO Determinations office. A public charity that has had a change in its public charity or private foundation status should request a new determination letter from the EO Determinations office as well. See **How to get IRS assistance and information** for the appropriate address for the EO Determinations office.



An organization may request a ***determination letter*** regarding the effect of certain changes on its tax exempt status or public charity status. For example, as noted above, a determination letter will be issued to classify or reclassify an organization as a public charity or a private foundation. A public charity may also request a determination letter to approve the treatment of a contribution as an unusual grant, or to determine whether an organization is exempt from filing annual information returns in certain situations. However, the IRS will not make any determination regarding any completed transaction.

If a public charity is unsure about whether a proposed change in its purposes or activities is consistent with its status as an exempt organization or as a public charity, it may want to request a ***private letter ruling.***

The IRS issues ***private letter rulings*** on *proposed* transactions and on completed transactions—if the request is submitted before the return is filed for the year in which the transaction was completed. The IRS generally does not issue rulings to public charities on any other completed transactions. The IRS will issue letter rulings to public charities on matters involving a public charity's exempt status, its public charity status, as well as other matters including issues under sections 501 through 514, 4911, 4912, 4955, 4958, 6033, 6104, and 6115.

Consult *www.irs.gov/eo* for the appropriate procedures for preparing and submitting a request for a determination letter, private letter ruling, replacement exemption letter or a letter reflecting a new name and address. For general information about reporting changes, you may contact EO customer service at (877)829-5500.

What disclosures are required?

There are a number of disclosure requirements for public charities. Detailed information on federal tax law disclosure requirements for 501(c)(3) tax-exempt organizations can be found in Publication 557, *Tax Exempt Status for Your Organization*, on the IRS Charities and Nonprofits Web site at *www.irs.gov/eo*, and in the final regulations.

Public Inspection of Annual Returns and Exemption Applications

A public charity must make the following documents available for public inspection and copying upon request and without charge (except for a reasonable charge for copying). The IRS makes these documents available for public inspection and copying.

Exemption Application – A public charity must disclose its exemption application, Form 1023, *Application for Recognition of Exemption Under Section 501(c)(3)* of the Internal Revenue Code, along with each of the following documents:

- all documents submitted with Form 1023;
- all documents the IRS requires the organization to submit in support of its application; and
- the exemption ruling letter issued by the IRS

Annual Information Return – A public charity must disclose its annual information return (Form 990 series) with schedules, attachments, and supporting documents filed with the IRS. However, the organization does not have to disclose Schedule B of Form 990 and does not need to identify its contributors. Certain information may be withheld from public inspection. Returns need to be available for disclosure for only three years after the due date or filing date of the return.

Form 990-T – For returns filed after August 17, 2006, a public charity must make its Form 990-T available for public inspection. Go to *www.irs.gov/eo* for information regarding how the returns are to be made public. NOTE: Form 990-T must be made available by the organization but not by the IRS.

A public charity may place reasonable restrictions on the time, place, and manner of in-person inspection and copying, and may charge a reasonable fee for providing copies. A tax-exempt organization does not have to comply with individual requests for copies if it makes the documents widely available. This can be done by posting the documents on a readily accessible Web site. For details on disclosure rules and procedures for 501(c)(3) organizations, see the *Life Cycle of a Public Charity* and the instructions to Forms 990 and 1023 at *www.irs.gov/eo*.

Sale of Free Government Information

If a public charity offers to sell goods or services that are available free from the federal government, the organization must disclose that fact in a conspicuous and easily recognized format. An organization that intentionally disregards this requirement is subject to a penalty.

Charitable Contributions – Substantiation And Disclosure

A public charity should be aware of the substantiation and disclosure rules imposed on donors of charitable contributions and the disclosure rules imposed on charities that receive certain quid pro quo contributions.

Recordkeeping Rules

A donor cannot claim a tax deduction for any cash, check, or other monetary contribution made on or after

January 1, 2007, unless the donor maintains a record of the contribution in the form of either a bank record (such as a cancelled check) or a written communication from the charity (such as a receipt or a letter) showing the name of the charity, the date of the contribution, and the amount of the contribution.

Substantiation Rules

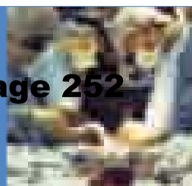
A donor cannot claim a tax deduction for any single contribution of $250 or more unless the donor obtains a contemporaneous acknowledgment of the contribution from the recipient public charity. A public charity may assist the donor by providing a timely written statement including the name of the public charity, date and amount of the contribution and description of any non-cash contributions.

In addition, the acknowledgment should indicate whether any goods or services were provided in return for the contribution. If any goods or services were provided in return for a contribution, the organization should provide a good faith estimate of the value of goods or services provided in return for the contribution.

The public charity may either provide separate acknowledgments for each single contribution of $250 or more or one acknowledgment to substantiate several single contributions of $250 or more. Separate contributions are not aggregated for purposes of measuring the $250 threshold.

Disclosure Rules That Apply to *Quid Pro Quo* Contributions

Contributions are deductible only to the extent that they are gifts and no consideration is received in return. Depending on the circumstances, ticket purchases and similar payments made in conjunction with fundraising events may not qualify as charitable



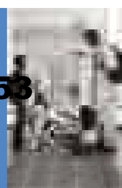
contributions in full. A contribution made by a donor in exchange for goods or services is known as a *quid pro quo* contribution. A donor may only take a charitable contribution deduction to the extent that the contribution exceeds the fair market value of the goods and services the donor receives in return for the contribution.

If a public charity conducts fundraising events such as benefit dinners, shows, and membership drives, where something of value is given to those in attendance, it must provide a written statement informing donors of the fair market value of the specific items or services it provided in exchange for contributions. Token items and services of intangible religious value need not be taken into account. A public charity should provide the written disclosure statement in advance of any event, determine the fair market value of any benefit received, and state this information in fundraising materials such as solicitations, tickets, and receipts. The disclosure statement should be made, at the latest, at the time payment is received. Subject to certain exceptions, the disclosure responsibility applies to any fundraising circumstance where each complete payment, including the contribution portion, exceeds $75.

Read Publication 1771, *Charitable Contributions—Substantiation and Disclosure Requirements*, and Publication 526, *Charitable Contributions*, for details on the federal tax law for organizations such as public charities, including churches, that receive tax-deductible charitable contributions and for taxpayers who make contributions.

PENALTIES

Penalties apply to organizations that do not comply with disclosure requirements and to persons responsible for the failure to comply.



How to get IRS assistance and information

The IRS offers help, through assistors and with reading material that is accessible either online, via mail by telephone, and at IRS walk-in offices in many areas across the country. IRS forms and publications can be downloaded from the Internet and ordered by telephone.

Specialized Assistance for Tax-exempt Organizations

Get help with questions about applying for tax-exempt status, annual filing requirements, and information about exempt organizations through the IRS Exempt Organizations (EO).

EO Web site ***www.irs.gov/eo***

Highlights:

- *The Life Cycle of a Public Charity* – describes the compliance obligations of charities.
- Subscribe to the *EO Update*, an electronic newsletter with information for tax-exempt organizations and tax practitioners who represent them.

EO Web based training ***www.stayexempt.org***

Web based training modules:

- Tax Exempt Status
- Unrelated Business income
- Employment Issues
- Form 990
- Required Disclosures

EO Customer Service (877) 829-5500

EO Determinations Office mailing address

Internal Revenue Service
TE/GE, EO Determinations Office
P.O. Box 2508
Cincinnati, OH 45201

Tax Publications for Exempt Organizations

Get publications via the Internet or by calling the IRS at (800) 829-3676.

Pub 15, ***Circular E, Employer's Tax Guide***

Pub 15-A, ***Employer's Supplemental Tax Guide***

Pub 463, ***Travel, Entertainment, Gift, and Car Expenses***

Pub 517, ***Social Security and Other Information for Members of the Clergy and Religious Workers***

Pub 538, ***Accounting Periods and Methods***

Pub 557, ***Tax-Exempt Status for Your Organization***

Pub 583, ***Starting a Business and Keeping Records***

Pub 598, ***Tax on Unrelated Business Income of Exempt Organizations***

Pub 1771, ***Charitable Contributions – Substantiation and Disclosure Requirements***

Pub 1828, ***Tax Guide for Churches and Religious Organizations***

Pub 3833, ***Disaster Relief, Providing Assistance Through Charitable Organizations***

Pub 4220, ***Applying for 501(c)(3) Tax-Exempt Status***

Pub 4221-PF, ***Compliance Guide for 501(c)(3) Private Foundations***

Pub.4202, ***A Charity's Guide to Vehicle Donations***

Pub.4203, ***A Donor's Guide to Vehicle Donations***

Forms for Exempt Organizations

Get forms via the Internet or by calling the IRS at (800) 829-3676.

Form 941, ***Employer's Quarterly Federal Tax Return***

Form 990-EZ, ***Short Form Return of Organization Exempt From Income Tax***

Form 990-PF, ***Return of Private Foundation or Section 4947(a)(1) Nonexempt Charitable Trust Treated as a Private Foundation***

Schedule A, of Form 990 or 990-EZ, ***Supplementary Information – Organization Exempt Under Section 501(c)(3)***

Schedule B, of Form 990, 990-EZ, or 990-PF, ***Schedule of Contributors***

Form 990-N, ***Electronic Notice (e-Postcard) For Tax-Exempt Organizations not Required To File Form 990 or 990-EZ***

Form 990-T, ***Exempt Organization Business Income Tax Return***

Form 990-W, ***Estimated Tax on Unrelated Business Taxable Income for Exempt Organizations***

Form 1023, ***Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code***

Form 1041, *U.S. Income Tax Return for Estates and Trusts*

Form 4720, *Return of Certain Excise Taxes Under Chapters 41 and 42 of the Internal Revenue Code*

Form 5578, *Annual Certification of Racial Non-Discrimination for a Private School Exempt from Federal Income Tax*

Form 5768, *Election/Revocation of Election by an Eligible Section 501(c)(3) Organization To Make Expenditures to Influence Legislation*

Form 8282, *Donee Information Return*

Form 8283, *Noncash Charitable Contributions*

Form 8734, *Support Schedule for Advance Ruling Period*

Form 8868, *Extension of Time To File an Exempt Organization Return*

General IRS Assistance

Get materials on the latest tax laws, assistance with forms and publications, and filing information.

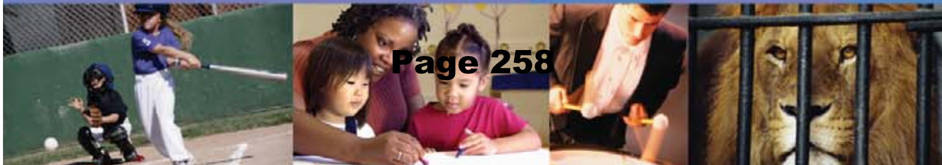
IRS Web site	www.irs.gov
federal tax questions	(800) 829-1040
employment tax questions	(800) 829-4933
order IRS forms and publications	(800) 829-3676

Internal Revenue Service

Tax Exempt and Government Entities

Exempt Organizations

Applying for 501(c)(3) Tax-Exempt Status



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(c)(3)

Federal tax law provides tax benefits to nonprofit organizations recognized as exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code (IRC). It requires that most organizations apply to the Internal Revenue Service (IRS) for that status.

This IRS Publication 4220 presents general guidelines for organizations that seek tax-exempt status under section 501(c)(3) of the IRC. Content includes references to the statute, Treasury regulations, other IRS publications that explain the requirements for tax-exempt status, and IRS forms with instructions. Publication 4220 is neither comprehensive nor intended to address every situation. As an alternative to applying for exemption, an organization may obtain many of the benefits of 501(c)(3) status by affiliating with an existing charity that acts as its agent. It is important to note that the existing charity must be given full control and authority over the program.

To learn more about the rules and procedures that pertain to organizations applying for exemption from federal income tax under section 501(c)(3) of the IRC, see Publication 557, Tax-Exempt Status for Your Organization. *For assistance on 501(c)(3) status, you may also want to consult a tax adviser.*

Why apply for 501(c)(3) status?

The benefits of having 501(c)(3) status include exemption from federal income tax and eligibility to receive tax-deductible charitable contributions. To qualify for these benefits, most organizations must file an application with, and be recognized by, the IRS as described in this publication. Another benefit is that some organizations may be exempt from certain employment taxes.

Individual and corporate donors are more likely to support organizations with 501(c)(3) status because their donations can be tax deductible. Recognition of exemption under section 501(c)(3) of the IRC assures foundations and other grant-making institutions that they are issuing grants or sponsorships to permitted beneficiaries.

An IRS determination of 501(c)(3) status is recognized and accepted for other purposes. For example: state officials may grant exemption from state income, sales, and property taxes; and the U.S. Postal Service offers reduced postal rates to certain organizations.

Who is eligible for 501(c)(3) status?

There are three key components for an organization to be exempt from federal income tax under section 501(c)(3) of the IRC. A not-for-profit (i.e., nonprofit) organization must be *organized* and *operated* exclusively for one or more *exempt purposes*.

organized—A 501(c)(3) organization must be *organized* as a corporation, trust, or unincorporated association. An organization's organizing documents

(articles of incorporation, trust documents, articles of association) must: limit its purposes to those described in section 501(c)(3) of the IRC; not expressly permit activities that do not further its exempt purpose(s), i.e., unrelated activities; and permanently dedicate its assets to exempt purposes.

operated—Because a substantial portion of an organization's activities must further its exempt purpose(s), certain other activities are prohibited or restricted including, but not limited to, the following activities. A 501(c)(3) organization:

- must absolutely refrain from participating in the political campaigns of candidates for local, state, or federal office;
- must restrict its lobbying activities to an insubstantial part of its total activities;
- must ensure that its earnings do not inure to the benefit of any private shareholder or individual;
- must not operate for the benefit of private interests such as those of its founder, the founder's family, its shareholders or persons controlled by such interests;
- must not operate for the primary purpose of conducting a trade or business that is not related to its exempt purpose, such as a school's operation of a factory; and
- may not have purposes or activities that are illegal or violate fundamental public policy.

exempt purpose—To be tax exempt, an organization must have one or more *exempt purposes*, stated in its organizing document. Section 501(c)(3) of the IRC lists the following exempt purposes: charitable, educational, religious, scientific, literary, fostering national or international sports competition, preventing cruelty to children or animals, and testing for public safety.

501(c)(3) Organizations

The most common types of 501(c)(3) organizations are charitable, educational, and religious.

CHARITABLE

Charitable organizations conduct activities that promote:

- relief of the poor, the distressed, or the underprivileged
- advancement of religion
- advancement of education or science
- erection or maintenance of public buildings, monuments, or works
- lessening the burdens of government
- lessening neighborhood tensions
- eliminating prejudice and discrimination
- defending human and civil rights secured by law
- combating community deterioration and juvenile delinquency

EDUCATIONAL

Educational organizations include:

- schools such as a primary or secondary school, a college, or a professional or trade school
- organizations that conduct public discussion groups, forums, panels, lectures, or similar programs
- organizations that present a course of instruction by means of correspondence or through the use of television or radio
- museums, zoos, planetariums, symphony orchestras, or similar organizations
- nonprofit day-care centers
- youth sports organizations

RELIGIOUS

The term *church* includes synagogues, temples, mosques, and similar types of organizations. Although the IRC excludes these organizations from the requirement to file an application for exemption, many churches voluntarily file applications for exemption. Such recognition by the IRS assures church leaders, members, and contributors that the church is tax exempt under section 501(c)(3) of the IRC and qualifies for related tax benefits. Other religious organizations that do not carry out the functions of a church, such as mission organizations, speakers' organizations, nondenominational ministries, ecumenical organizations, or faith-based social agencies, may qualify for exemption. These organizations must apply for exemption from the IRS. See Publication 1828, *Tax Guide for Churches and Religious Organizations*, for more details.

Public Charities and Private Foundations

Every organization that qualifies for tax-exempt status under section 501(c)(3) of the IRC is further classified as either a *public charity* or a *private foundation*. Under section 508(b) of the IRC, every organization is automatically classified as a private foundation unless it meets one of the exceptions listed in sections 508(c) or 509(a).

For some organizations, the primary distinction between a classification as a public charity or a private foundation is the organization's source of financial support. Generally, a public charity has a broad base of support while a private foundation has very limited sources of support. This classification is important because different tax rules apply to the operations of each. Deductibility of contributions to a private foundation is more limited than deductibility of contributions to a public charity. See Publication 526, *Charitable Contributions*, for more information on deductibility of contributions. In addition, private foundations are subject to excise taxes that are not imposed on public charities. For more information about the special tax rules that apply to private foundations, see Publication 4221-PF, *Compliance Guide for 501(c)(3) Private Foundations*; and the Life Cycle of a Private Foundation website on www.irs.gov/eo.

Organizations statutorily classified as public charities under section 509(a) of the IRC are:

- churches;
- schools;
- organizations that provide medical or hospital care (including the provision of medical education and in certain cases, medical research);

- organizations that receive a *substantial* part of their support in the form of contributions from publicly supported organizations, governmental units, and/or from the general public;
- organizations that normally receive not more than one-third of their support from gross investment income and more than one-third of their support from contributions, membership fees, and gross receipts from activities related to their exempt functions; and
- organizations that support other public charities.

If the organization requests public charity classification based on receiving support from the public, it must continue to seek significant and diversified public support in later years. Beginning with the organization's sixth year of existence and for all succeeding years, the organization must demonstrate in its annual return that it receives the required amount of public support. If the organization does not meet the public support requirement, it could be reclassified as a private foundation.

In addition, to avoid unexpectedly losing its public charity classification, the organization should keep careful track of its public support information throughout the year, so that it will have the information it needs to complete Schedule A, Form 990 or 990-EZ. Unless the organization is committed to raising funds from the public, it may be more appropriate to consider an alternate statutorily based public charity classification. See Publication 557, *Tax-Exempt Status for Your Organization,* for assistance with determining how your organization would be classified.

What responsibilities accompany 501(c)(3) status?

While conferring benefits on 501(c)(3) organizations, federal tax law also imposes responsibilities on organizations receiving that status.

Recordkeeping

Section 501(c)(3) organizations are required to keep books and records detailing all activities, both financial and nonfinancial. Financial information, particularly information on its sources of support (contributions, grants, sponsorships, and other sources of revenue) is crucial to determining an organization's private foundation status. See Publications 4221-PC and 4221-PF, Publication 557, and the instructions to Forms 990, 990-EZ, and 990-PF for more information.

Filing Requirements

Annual Information Returns – Organizations recognized as tax exempt under section 501(c)(3) of the IRC may be required to file an annual information return: Form 990, Form 990-EZ, or Form 990-PF along with certain schedules that may be required for your organization. Certain categories of organizations are excepted from filing Form 990 or Form 990-EZ including churches and very small organizations. See the instructions with each of these forms for more information. See Publication 4221 for more information about annual information return requirements.

Annual Electronic Notice – Small organizations are not required to file Form 990 if their gross receipts are normally $25,000 or less. Beginning in 2008, however, these organizations must submit an

annual electronic notice using Form 990-N, *Electronic Notice (e-Postcard) for Tax-Exempt Organizations not Required To File Form 990 or 990-EZ*. The e-Postcard can only be filed electronically; there is no paper version. For more information about the e-Postcard, go to www.irs.gov.

Unrelated Business Income Tax – In addition to filing Form 990, 990-EZ, or 990-PF, an exempt organization must file Form 990-T if it has $1,000 or more of gross income from an unrelated trade or business during the year. The organization must make quarterly payments of estimated tax on unrelated business income if it expects its tax liability for the year to be $500 or more. The organization may use Form 990-W to help calculate the amount of estimated payments required. In general, the tax is imposed on income from a regularly carried-on trade or business that does not further the organization's exempt purposes (other than by providing funds). See Publication 598, *Tax on Unrelated Business Income of Exempt Organizations*, and the Form 990-T instructions for more information.

Disclosure Requirements

Public Inspection of Exemption Applications and Returns – Section 501(c)(3) organizations must make their application (Form 1023) and the annual returns (Form 990 or Form 990-EZ) available to the public for inspection, upon request and without charge (except for a reasonable charge for copying). Each annual return must be made available for a three-year period starting with the filing date of the return. The IRS also makes these documents available for public inspection and copying. Private foundation returns (Form 990-PF) filed on or after March 13, 2000, are subject to the same disclosure rules. These documents must be made available at the organization's principal office during regular business hours.

Upon request, an organization must furnish copies of the application and the three most recent annual returns. The requests may be made in person or in writing. See Publication 557 for more information.

For tax years beginning after August 17, 2006, section 501(c)(3) organizations that file unrelated business income tax returns (Forms 990-T) must make them available for public inspection, and the IRS must make those returns publicly available.

Charitable Contributions— Substantiation and Disclosure – Organizations that are tax exempt under section 501(c)(3) of the IRC must meet certain requirements for documenting charitable contributions. The federal tax law imposes two general disclosure rules: 1) a donor must obtain a *written acknowledgment* from a charity for any single contribution of $250 or more before the donor can claim a charitable contribution on his/her federal income tax return; 2) a charitable organization must provide a *written disclosure* to a donor who makes a payment in excess of $75 partly as a contribution and partly for goods and services provided by the organization. See Publication 1771, *Charitable Contributions – Substantiation and Disclosure Requirements,* for more information.

Recordkeeping Requirements

A donor cannot claim a tax deduction for any contribution of cash, a check or other monetary gift made on or after January 1, 2007, unless the donor maintains a record of the contribution in the form of either a bank record (such as a cancelled check) or a written communication from the charity (such as a receipt or a letter) showing the name of the charity, the date of the contribution, and the amount of the contribution.

How do you apply for 501(c)(3) status?

Organizations that want to apply for 501(c)(3) status should be aware of the forms required, the user fee, the filing deadline, and the processing procedures.

Forms to File

FORM SS-4

An employer identification number (EIN) is your account number with the IRS and is required regardless of whether the organization has employees. Include the organization's EIN on all correspondence to the IRS. Apply for an EIN by completing Form SS-4, *Application for Employer Identification Number*, by calling toll-free (866) 816-2065, or by submitting an online version of the form via *www.irs.gov.* Form SS-4 is available at Social Security Administration offices, by request through the IRS at (800) 829-3676, and by downloading the form from the IRS Web site at *www.irs.gov.* For more information about EINs, see Publication 1635, *Understanding Your EIN.*

FORM 1023

Complete Form 1023, *Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*, and mail to the address indicated in the instructions. The required user fee must accompany Form 1023. The IRS will not process an application until the user fee is paid.

FORMS 2848 and 8821

Attach Form 2848, *Power of Attorney and Declaration of Representative*, if someone other than your principal officer or director will represent you on matters about the application. Attach Form 8821, *Tax Information Authorization*, if you want the IRS to be able to provide information about your application to someone other than a principal officer or director.

When to File

Most organizations must file Form 1023 by the end of the 15th month after they were created, with a 12-month extension available. An organization that is not a private foundation is not required to file Form 1023 unless its annual gross receipts are normally more than $5,000. An organization must file Form 1023 within 90 days of the end of the year in which it exceeds this threshold.

> ***Example 1: An organization that was created on January 1, 2007, and exceeds the gross receipts threshold, must file Form 1023 by April 30, 2010.***
>
> ***Example 2: An organization that was created on January 1, 2004, but did not exceed the gross receipts threshold until September 30, 2008, must file Form 1023 by March 31, 2009.***

An organization that files its application before the deadline will be recognized as tax exempt under section 501(c)(3) of the IRC from the date of its creation. An organization that files an application after the deadline may be recognized as tax exempt from the date of the application; it may also request exemption retroactive as of the date of creation. See the instructions to Form 1023 for more information.

Determination Letter

The IRS tax specialist reviewing an application may request additional information in writing. If all information received establishes that an organization meets the requirements for exemption, the IRS will issue a determination letter recognizing the organization's exempt status and providing its public charity classification. This is an important document that should be kept in the organization's permanent records.

While Your Application is Pending

While an organization's Form 1023 is waiting for approval from the IRS, the organization may operate as a tax-exempt organization.

If an annual exempt organization return is due, the organization must file it, indicating that its application is pending. These returns are subject to public disclosure. If the organization has unrelated business income of more than $1,000, it must also file a Form 990-T. See Publication 4221-PC or 4221-PF for more information.

Although donors have no assurance that contributions are tax-deductible for federal income tax purposes until the application is approved, contributions made while an application is pending would qualify if the application is approved. However, if the application is disallowed, contributions would not qualify. Moreover, the organization would be liable for filing federal income tax returns unless its income is otherwise excluded from federal taxation.

The EO website (www.irs.gov/eo) provides information about how to find out about the status of an application for tax-exempt status.

How to get IRS assistance and information

The IRS offers help through assistors and with reading material that is accessible either online, via mail, by telephone, and at IRS walk-in offices in many areas across the country. IRS forms and publications can be downloaded from the Internet and ordered by telephone.

Specialized Assistance for Tax Exempt Organizations

Get help with questions about applying for tax-exempt status, annual filing requirements, and information about exempt organizations through the IRS Exempt Organizations (EO).

EO Web site ***www.irs.gov/eo***

Highlights:

- The *Life Cycle of a Public Charity* and *Life Cycle of a Private Foundation* – describe the compliance obligations of charities.
- Subscribe to the *EO Update*, an electronic newsletter with information for tax-exempt organizations and tax practitioners who represent them.

Web based training module & mini-courses ***www.stayexempt.org***

- Tax-Exempt Status
- Unrelated Business Income
- Employment Issues
- Form 990
- Required Disclosures

The IRS also provides mini-courses on specific topics of interest to tax-exempt organizations

EO customer service (877) 829-5500

EO Determinations Office mailing address

Internal Revenue Service
TE/GE, EO Determinations Office
P.O. Box 2508
Cincinnati, OH 45201

Tax Publications for Exempt Organizations

GET PUBLICATIONS VIA THE INTERNET OR BY CALLING THE IRS AT (800) 829-3676:

Pub 15, ***Circular E, Employer's Tax Guide***

Pub 15-A, ***Employer's Supplemental Tax Guide***

Pub 463, ***Travel, Entertainment, Gift, and Car Expenses***

Pub 517, ***Social Security and Other Information for Members of the Clergy and Religious Workers***

Pub 526, ***Charitable Contributions***

Pub 538, ***Accounting Periods and Methods***

Pub 557, ***Tax-Exempt Status for Your Organization***

Pub 583, ***Starting a Business and Keeping Records***

Pub 598, ***Tax on Unrelated Business Income of Exempt Organizations***

Pub 1771, ***Charitable Contributions – Substantiation and Disclosure Requirements***

Pub 1828, ***Tax Guide for Churches and Religious Organizations***

Pub 3079, ***Gaming Publication for Tax-Exempt Organizations***

Pub 3833, ***Disaster Relief, Providing Assistance Through Charitable Organizations***

Pub 4202, ***A Charity's Guide to Vehicle Donations***

Pub 4203, ***A Donor's Guide to Vehicle Donations***

Pub 4220, ***Applying for 501(c)(3) Tax-Exempt Status***

Pub 4221-NC, ***Compliance Guide Tax-Exempt Organizations (other than 501(c)(3) Public Charities and Private Foundations).***

Pub 4221-PC, ***Compliance Guide for 501(c)(3) Public Charities***

Pub 4221-PF, ***Compliance Guide for 501(c)(3) Private Foundations***

Forms for Exempt Organizations

GET FORMS VIA THE INTERNET OR BY CALLING THE IRS AT (800) 829-3676:

Form SS-4, ***Application for Employer Identification Number***

Form 941, ***Employer's Quarterly Federal Tax Return***

Form 990, ***Return of Organization Exempt From Income Tax***

Form 990-EZ, ***Short Form Return of Organization Exempt From Income Tax***

Form 990-PF, ***Return of Private Foundation or Section 4947(a)(1) Nonexempt Charitable Trust Treated as a Private Foundation***

Form 990-N, ***Electronic Notice (e-Postcard) For Tax-Exempt Organizations Not Required to File Form 990 or 990-EZ*** **(available electronically only)**

Form 990-T, ***Exempt Organization Business Income Tax Return***

Form 990-W, ***Estimated Tax on Unrelated Business Taxable Income for Exempt Organizations***

Form 1023, ***Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code***

Form 1041, ***U.S. Income Tax Return for Estates and Trusts***

Form 4720, ***Return of Certain Excise Taxes Under Chapters 41 and 42 of the Internal Revenue Code***

Form 5578, ***Annual Certification of Racial Non-Discrimination for a Private School Exempt from Federal Income Tax***

Form 5768, ***Election/Revocation of Election by an Eligible Section 501(c)(3) Organization To Make Expenditures to Influence Legislation***

Form 8282, ***Donee Information Return***

Form 8283, ***Noncash Charitable Contributions***

Form 8868, ***Extension of Time To File an Exempt Organization Return***

Form TD F 90-22, ***Report of Foreign Bank and Financial Accounts*** **(filed with Treasury Department)**