Selected Pitfalls in the Life Cycle of a Charity

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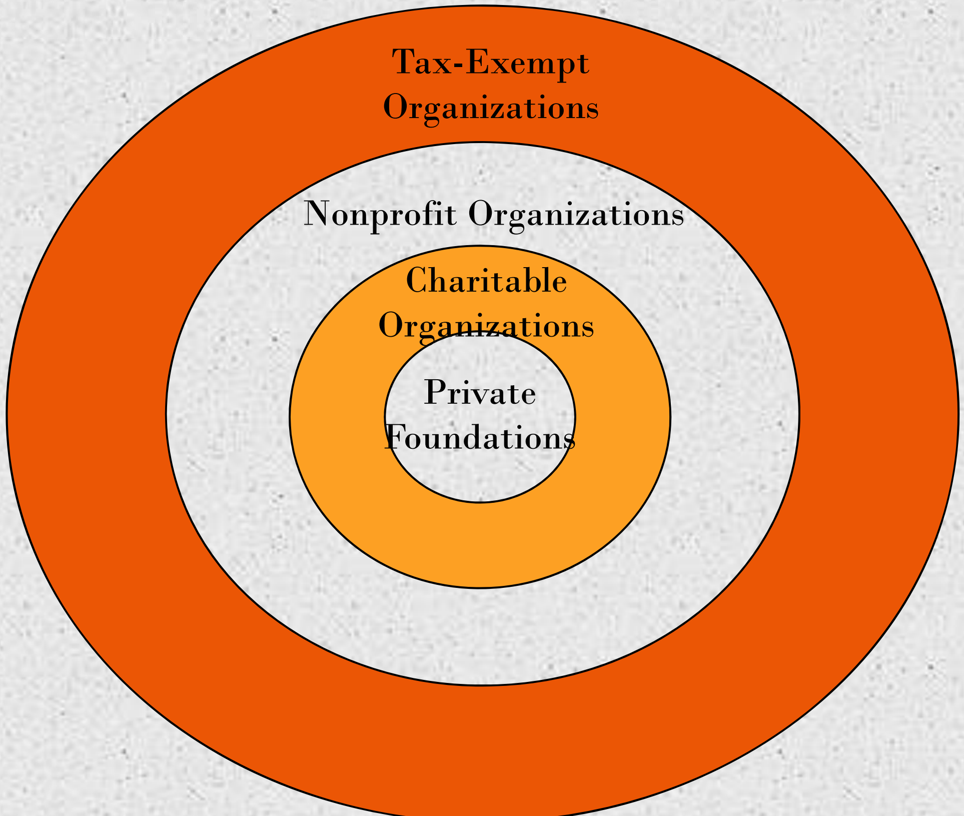
Facts and Figures about Charitable Organizations

- In 2011, over 1.6 million tax-exempt nonprofit organizations were registered with the IRS
- About 75% of these make up the "independent sector" – including 501(c)(3)s and (c)(4)s.
  - About 10% are (c)(4)s [examples include the NAACP, the NRA, and the Sierra Club]

Nonprofit vs Charitable Organization



§ 501(c)(3) Elements

- Organized exclusively for charitable purposes
- Operated exclusively for charitable purposes
- No part of net earnings inures to benefit of private individual
- Not an action organization
- <<case law>> - not violative of public policy

Pitfall #1: The Organizational Test

- Look to enabling documents
- Must be organized "exclusively" for "charitable" purposes
- May be general or specific
- Must dedicate assets with proper dissolution clause

Pitfall #2: The Exemption Application Process

- Obtaining Tax-Exempt Status
  - Recognition of tax-exempt status occurs when IRS agrees with the organization that it is eligible for tax-exempt status
  - For charitable organizations, absent an exception, must file Form 1023 to achieve tax-exempt status
  - Form 1023 also notifies the IRS if the organization is to be classified as a public charity or private foundation
  - Exceptions to filing Form 1023: churches, associations of churches, integrated auxiliaries of churches, organizations (other than PFs) normally having annual gross receipts of not more than $5000
  - Non-501(c)(3)'s apply with a different form and recognition of exempt status is not mandatory
- Form 1023 Timing
  - Must be filed within 27 months of last day of month in which organization established to be retroactive to organization's initiation
  - Generally takes up to 120 days to process
  - When substantially complete and all follow up requests for information answered, organization may seek a declaratory judgment as to exempt status following expiration of 270 days from date of submission
  - IRS response is a "Determination Letter"
- Form 1023-EZ?

Pitfall #3: The Operational Test

- Look at actual activities of organization
- Must be operated “exclusively” for “charitable” purpose(s)
- May not engage in substantial activities that fail to further charitable purposes
  - Private Benefit/Private Inurement
  - Substantial Lobbying/Political Intervention
  - Violating Public Policy

Private Benefit

- Implicit in requirement that the organization must be operated for charitable (public) purposes
- Benefits cannot be limited to a group of persons (results in private rather than public benefit)
- Insubstantial (incidental) private benefits
  - **Qualitative and quantitative analysis:** To be incidental qualitatively, the private benefit must be necessary to the exempt activity; to be incidental quantitatively, the private benefit must be insubstantial, measured in the context of overall tax-exempt benefit conferred by the activity

Private Inurement

- Subset of private benefit
  - If an organization allows its assets to inure to an insider, it violates not only the private inurement prohibition but also operates to benefit a private interest
- Private inurement can result in revocation of tax-exempt status
  - Can also result in intermediate sanctions as excess benefit transactions

Excess Benefit Transactions

- § 4958(c)(1): 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 **DP** if the **value of the economic benefit provided exceeds the value of the consideration** (including the performance of services) received for providing such benefit
- Disqualified Persons = Substantial Influence (5 year lookback) (+) family and entities they control (35%+)
- Consequences
  - Two tier excise tax on DP (25%; 200%)
  - Tax on organization manager (10% not to exceed $10,000)
  - Revocation still possible
- Must correct

Excess Benefit Transactions: Compensation

- Organization must clearly indicate intent to treat the economic benefit as compensation when the benefit is paid
  - Written contemporaneous substantiation
    - Employment contract
    - W-2, 1099, 990
    - DP reports on 1040
    - Exception: amounts excluded from gross income (e.g. employer-provided health benefits)
- Rebuttable Presumption of Reasonableness
  - Transaction approved by an authorized body of the organization composed of non-conflicted individuals
  - Prior to making determination, authorized body obtained and relied upon appropriate comparability data
  - Authorized body adequately documents basis for determination concurrently with making decision

Pitfall #4: Annual Filing Requirements

- Must file applicable 990 annually unless exempt
- Must file 990-T for UBTI in excess of $1000
- Must file franchise tax return unless exempt
- Must file Form 802, Periodic Report with Secretary of State as requested

Pitfall #5: Governance and the Attorney General

- Directors and Officers are Fiduciaries
  - Duty of Care
  - Duty of Loyalty
  - Duty of Obedience
- Governance and following good governance policy matters
  - To the OAG
  - To the IRS
  - To the public
- OAG has broad powers
  - Common law
  - Constitutional
  - Statutory (Property Code/DTPA)

Pitfall #6: Handling Restricted Gifts

- Effect of restriction
  - Binding
  - Creates fiduciary obligation
- Clarifying restrictions
  - Declaratory Judgment
- Modifying restrictions
  - Cy pres/equitable deviation
  - UPMIFA
- Violating restrictions (Pro Tip: Don't.)
- Returning a restricted gift—be careful!

Pitfall #7: Unrelated Business Income

- Trade or business
  - Activity carried on for production of income from sale of goods/services
- Regularly carried on
  - Look to frequency and continuity of activity as compared with non-exempts
- Not substantially related to exempt purpose
  - Must contribute importantly to accomplishment of exempt purpose(s)
- Exceptions
  - Volunteer Exception
  - Convenience Exception
  - Thrift Store/Donated Merchandise Exception
- Exclusions: Passive income (with some exceptions)

Pitfall #8: Public Disclosure

- Federal
  - Form 1023
  - Form 990 and attachments (not Sch. B)
  - Form 990-T
- State
  - Certificate of Formation and amendments
  - Franchise Tax Report (if not exempt)
  - Public Information Report (Form 802)
  - “Books and Records”

Pitfall #9: Substantiating Gifts

- Gift receipt from donee organization (not enough to have records prepared by donor)
- If claiming contribution of $250 or more, also need to have contemporaneous written gift acknowledgment
  - Name, amount of $ or property description, & statement of whether any goods/services provided in return
    - IRC § 170(f)(8); Treas. Reg. § 1.170A-13(f)
  - Donor must request & obtain the acknowledgement from donee
  - “Thank you for your cash contribution of $350 that [charity] received on [date]. In exchange for your contribution, we gave you a cookbook with an estimated fair market value of $60.”
  - “Thank you for your contribution of a used oak baby crib and matching dresser that [charity] received on [date]. No goods or services were provided in exchange for your contribution.”

Pitfall #9: Substantiating Gifts

- Non-cash gift over $500
  - Donor must include additional information in records
  - Donor must describe contribution on tax return and complete Form 8283
  - If over $5,000, donor must get qualified appraisal
- Gift of vehicle valued over $500
  - Organization must file Form 1098-C and send copy to donor
  - IRC 170(f)(12) – more significant gift acknowledgment required
- Quid Pro Quo gift over $75
  - Written disclosure statement required
- If org. sells the contributed property, for which Form 8283 was required (i.e. $500 or more), within 3 years after receipt, it must file Form 8282 with IRS
  - If amount claimed by donor significantly exceeds the amount received by the charity, IRS may question the donor’s deduction

Pitfall #10: Ending the Organization

- Compliance with state law requirements
  - Nonprofit corporation
    - Resolution approving plan of dissolution adopted by board of directors and members, if any
    - Conveyance of assets pursuant to plan of dissolution
    - Filing of Certificate of Termination
- Compliance with federal tax requirements
  - File final Form 990 and provide a certified copy of the Certificate of Termination
- Assets are required to be distributed for charitable purposes

The information set forth in this outline should not be considered legal advice, because every fact pattern is unique. The information set forth herein is solely for purposes of discussion and to guide practitioners in their thinking regarding the issues addressed herein.

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