

**2002 MAY MEETING**  
**SECTION PROGRAM**

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**THE TAX EXEMPT TOOL KIT**

Thursday, May 9, 2002  
5:00PM - 7:30PM  
The Grand Hyatt Hotel, Washington, DC

**Program Chair**

SHANNON KING NASH, Amgen Inc., Thousand Oaks, CA

**Panelists**

SUSAN DORN, Dorn & Klamp P.C., Washington D.C.  
DON MORGANE, The Success Zone, Silver Springs, MD  
JOHN POMERANZ, Alliance For Justice, Washington D.C.  
ANDREW SCHULZ, Council of Foundation, Washington D.C.  
ALEXIS M. NEELY, Munger, Tolles & Olson, Los Angeles, CA  
JENNIFER FRANKLIN, Simpson, Thacher & Bartlett, New York, NY  
JEANNIE CARMEDELLE FREY, McDermott, Will & Emery, Chicago, IL  
M. MICHELE HOGAN, American Association of Immunologists, Bethesda, MD

***Sponsored by the American Bar Association Tax Section Diversity Committee***

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This Tax Exempt Tool Kit began as a joint project of the American Bar Association Tax Section Diversity Committee, the American Bar Association Commission on Racial and Ethnic Diversity in the Profession, the American Bar Association Business Law Section Nonprofit Committee and the Asian and Asian American Studies Department of Loyola University, Chicago, IL. The first seminar was held at the American Bar Association annual meeting in August 2001. The materials were also placed on the American Bar Association Tax Section's web site at <http://www.abanet.org/tax/>. This second seminar is being held in conjunction with the American Bar Association Tax Section's May meeting. There are plans to continue the program at future American Bar Association Tax Section meetings. The Commission on Racial and Ethnic Diversity in the Profession plans to have the materials translated into several languages.

The Tax Exempt Tool Kit is designed to give directors, executives, volunteers and others associated with small exempt organizations, a basic overview of the various laws and financial responsibilities that the average small exempt organization is faced with. The Tax Exempt Tool Kit will provide basic introductory information for smaller tax exempt organizations on a myriad of issues such as:

- How to start a tax exempt organization.
- Lobbying and political activities.
- Federal and state filing requirements.
- Fiduciary responsibilities for the board of directors.
- Unrelated business activities.
- Intermediate sanctions.
- Employment issues.
- Accounting issues.
- Public disclosure requirements.
- Internet activities.
- Charitable contribution vs. business expenses.
- Basic contract law.
- Copyright and trademark issues.
- Bibliography of helpful websites and much more.

The toolkit is not a treatise or a comprehensive explanation on any one issue. Thus, for specific questions, readers should consult with competent legal counsel and/or an accountant. The primary focus will be on public charities exempt under Section 501(c)(3) but there will be some information geared towards Section 501(c)(4) organizations and trade association or business leagues exempt under Section 501(c)(6).

All references in this outline to a Code are to the Internal Revenue Code of 1986, as amended and the Treasury Regulations promulgated thereunder (hereinafter referred to as the "Code"). Unless otherwise noted, "Section" shall refer to sections of the Code. References to the IRS mean the Internal Revenue Service. Many references to Exempt Organizations are made using the abbreviated term "EO". Similarly, references to unrelated business taxable income are sometimes made using the abbreviated term "UBTI".

## **TAX EXEMPT TOOL KIT SPEAKER BIOGRAPHIES**

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### **Shannon King Nash, Senior Tax Attorney Amgen, Thousand Oaks, California**

Shannon King Nash is Senior Tax Counsel for Amgen Inc., a large biotechnology corporation, where she is responsible for handling federal and state income tax appeals, providing legal support to the Amgen's tax services group which handles federal and state tax audits, providing counsel to Amgen's international tax group on various issues including transfer pricing and assisting in tax planning initiatives. She also serves as special counsel to the Amgen Foundation and is on the Foundation's Health and Medicine Committee.

Most recently, Ms. Nash was a tax associate with the law firm of Cooley Godward LLP in Reston, Virginia where she concentrated on corporate and partnership taxation for venture capital fund formations, mergers and acquisitions for high tech companies, and providing counsel to nonprofit organizations. Prior to Cooley Godward LLP, Ms. Nash was a tax associate at Kirkpatrick & Lockhart in Washington, D.C., and at Goulston & Storrs in Boston, Massachusetts, where she had a general federal tax and corporate practice. Ms. Nash began her practice with the law firm of Ginsburg, Feldman & Bress in Washington, D.C., where she concentrated on low-income housing tax credit syndication transactions with nonprofit organizations.

Ms. Nash has participated on many panels and written several tax related articles. She currently chairs a tax-exempt tool-kit program for the American Bar Association ("ABA") Tax Section. This program is designed to help small nonprofit organizations work through the maze of laws (primarily tax) and operational issues that face them. The first program was held in August 2001 in Chicago. Similar programs are planned for May 2002 in Washington, D.C. and October 2002 in Los Angeles. The materials are available free of charge on the American Bar Association Tax Section's website and will be translated and available in several languages in late 2002. She also recently spoke on a panel sponsored by the ABA Tax Section's Foreign Activities of US Taxpayers committee dealing with Section 904 foreign tax credit limitations.

She is also very active in nonprofit organizations. She is the ABA Tax Section's liaison to the ABA Commission on Racial and Ethnic Diversity in the Profession and she co-chairs the National Bar Association's Tax Committee. She also served as a co-chair to the ABA Tax Section's Diversity Committee and received one of the ABA Tax Section's 2000 Nolan Fellow Awards, bestowed upon tax lawyers of achievement and promise. She has been a director on the boards of various nonprofit organizations ranging from small cultural organizations to affiliates/local chapters of large national nonprofit organizations, including: the American Red Cross, Planned Parenthood, Children and Family Services (RI) and the Providence Black Repertory Company. She was also appointed by the Governor of Rhode Island to serve as a Commissioner on the Rhode Island Human Rights Commission. Most recently she was appointed by the Thousand Oaks California City Council to serve on the Community Events Funding Committee, a committee responsible for awarding grants to various 501(c)(3) organizations for community events and sports facilities.

Ms. Nash received her Bachelor's degree in accounting and her law degree from the University of Virginia. Ms. Nash is a member of the state bars of Virginia and Washington, D.C. and holds a C.P.A. license from the State of Virginia.

### **Alexis Martin Neely, Attorney Munger, Tolles & Olson, LLP**

Alexis Martin Neely is a tax associate with the law firm of Munger, Tolles & Olson LLP, where she practices Trusts and Estates and counsels nonprofit organizations on both tax and corporate matters. Ms. Neely is a member of the American Bar Association, both in the Taxation Section and the Young Lawyer's Division, Women in the Profession Committee. Additionally, Ms. Neely is a member of the Los Angeles County Bar Association, Exempt Organizations Committee, where she will serve as Secretary. Ms. Neely has spoken at the State Bar of California Tax Section on Life and Death Planning for Unmarried Couples and at the University of West Los Angeles mini-law program on Estate

Planning Fundamentals. Ms. Neely serves on the board of directors of the Breastfeeding Task Force of Greater Los Angeles.

Ms. Neely received her J.D. degree summa cum laude from Georgetown University Law Center in 1999, and served as a law clerk to the Honorable Peter T. Fay on the 11th Circuit U.S. Court of Appeals from 1999 to 2000. While at Georgetown University Law Center, Ms. Neely received a John M. Olin Student Fellowship in Law & Economics, the Francis E. Lucey, S.J. Award, the Sewall Key Prize for best combined scholastic record in the field of taxation, and was elected for enrollment into the Order of the Coif. Additionally, Ms. Neely was a member of the Georgetown Law Journal, and the editor-in-chief of the Law Journal's Criminal Procedure Project. Ms. Neely is a member of the state bar of California.

## **Jennifer L. Franklin, Attorney Simpson Thacher & Bartlett, New York New York**

Jennifer Franklin is an attorney at Simpson Thacher & Bartlett where she works in the Exempt Organizations and Tax Groups. She advises a variety of international and domestic exempt organizations, including both private foundations and public charities, and has worked on several transactions involving hospitals and other health-care organizations. Jennifer also has experience in the area of donor-advised funds, charitable gift-planning and charitable economic development activities. In addition, Jennifer has significant expertise in corporate tax law, particularly in the area of federal income taxation of mergers and acquisitions.

Jennifer's professional associations include membership with the Exempt Organizations Committee of the American Bar Association Section of Taxation, where she currently serves as the Secretary of that Committee. Jennifer is also a member of the New York State Bar Association's Section of Taxation.

Jennifer recently co-authored an article with David A. Shevlin entitled "Planning Considerations for Donors and Charities When Making and Accepting Gifts of Restricted Stock," which was published in the February 2002 edition of *The Exempt Organization Tax Review*. Jennifer has also been named as a 2002 John S. Nolan Fellow of the American Bar Association Section of Taxation.

Jennifer earned her J.D. degree at Duke University where she graduated Magna Cum Laude, and earned her B.S. degree from Georgetown University where she also graduated Magna Cum Laude.

## **Jeannie Carmedelle Frey, Partner McDermott, Will & Emery, Chicago, Illinois**

Jeannie Carmedelle Frey is a partner in the Health Law Department in McDermott, Will & Emery's Chicago office. Her practice focuses primarily on mergers, acquisitions, joint ventures and other transactions involving tax-exempt and for-profit healthcare institutions and businesses, and on corporate governance matters affecting nonprofit organizations generally.

Ms. Frey previously worked in Denver, Colorado, where she concentrated her practice in corporate and securities transaction matters. She also worked as a staff attorney for the Securities and Exchange Commission, Branch of Regional Office Assistance, Enforcement Division, Washington, D.C., during 1987 and 1988.

Ms. Frey is a member of the Health Law Section and the Business Law Section of the American Bar Association, the American Health Lawyers Association and the Illinois Association of Healthcare Attorneys. She is the co-editor of the Guidebook for Directors of Nonprofit Corporations (2<sup>nd</sup> ed.) recently published by the American Bar Association Section of Business Law). Ms. Frey is a past winner of the Outstanding Nonprofit Lawyer Award presented through the American Bar Association's Business Law Section. She is a frequent speaker on non-profit governance issues, as well as business and regulatory issues relevant to health care providers and businesses.

Ms. Frey received her bachelor's degree with distinction (highest honors) from the University of Colorado in 1980. She received her law degree in 1985 from Yale Law School.

### **Susan Dorn, Managing Partner Dorn & Klamp, Washington, DC**

Susan Dorn is managing partner of Dorn & Klamp, PC, a Washington, D.C.-based law firm which exclusively serves as counsel to nonprofit organizations. Ms. Dorn has written and lectured extensively on subjects as varied as intermediate sanctions, hotel contract negotiations, and antitrust risks in standard setting to such organizations as the American Society of Association Executive, the National Organization for Competency Assurance and the Council of State Governments. She is a co-author of the National Center for Nonprofit Boards publication *The Nonprofit Board's Guide to Bylaws*. Most recently, she prepared a chapter about the governance structures of certification organizations within *The Licensure and Certification Mission* published by the Professional Examination Service. Ms. Dorn has served as general counsel to professional societies, certification agencies and philanthropic organizations since she graduated in 1985 from the public interest law school, Antioch School of Law. Ms. Dorn's practice emphasizes tax, contracts, and corporate governance counseling. The variety of issues posed by her clients continues to stimulate and challenge her.

### **Donald Carroll Moragne, Managing Principal The Success Zone, Washington, DC**

Donald Carroll Moragne, is the Managing Principal of The Success Zone, a respected business development and financial management firm, with a client base that is Nationwide and includes the Caribbean. The Success Zone is adept in enhancing the profitability of business entities by assisting in diversifying revenue sources, controlling the gross profit margin and monitoring operations and operational costs. The firm's strength is in addressing the tax and financial management requirements of businesses, business professionals and individuals. The firm has as its credo, "... Your Company's Outside CFO". Don acquired his in-depth experience in corporate auditing, accounting, and management as a former Agent, Examination Manager and Staff Chief with the Internal Revenue Service, and as a corporate accountant and management consultant in private industry. He is amongst the few IRS Managers inducted into the Internal Revenue Service's EEO Hall of Fame for managerial excellence. Don has been an entrepreneur since 1987 and is a principal in four other financial services firms and a training development and production firm.

Don is a tax representation specialist, certified by the Department of the Treasury as an Enrolled Agent (EA), authorized to practice before the Internal Revenue Service. Adept in taxation, management and business development, he is a skilled Management Consultant and Financial Consultant with an aggregate of more than 25 years of business management experience. Don holds a Bachelors of Science in Accounting from New York's City College and received advanced auditing and managerial training while in government.

Don has lectured at George Washington University and Howard University on tax and financial management topics. He has presented seminars on taxes and management for SBA Small Business Development Centers, The Metropolitan Washington Council of Governments, and various municipalities and professional organizations.

Don's business and management skills have been recognized at many levels, but he is very proud that he was selected by the U.S. Small Business Administration as their 1996 Minority Small Business Advocate of the Year for the Metropolitan Washington area.

An energetic speaker with a writing and public speaking portfolio that includes articles and electronic appearances on taxation, financial matters, and self-motivation, Don is a personable, experienced, and highly effective presenter of speeches, training courses and seminars. His audiences have included government employees, university students, business owners, professional and civic organizations, and foreign government and business officials.

Don is member of the Maryland Society of Accountants and is on the board of several nonprofit organizations. He contributes his talents and time to several civic and professional organizations. His expertise and business wisdom are sought by many businesses, professional practices, and business principals.

### **John Pomeranz, Nonprofit Advocacy Counsel Alliance For Justice, Washington, DC**

John Pomeranz is Nonprofit Advocacy Counsel at the Alliance for Justice, a national association of public interest advocacy organizations in Washington, D.C. John works with nonprofits around the country to enhance their capacity to participate in the policy process. The assistance he provides includes: workshops on the rules governing nonprofit lobbying and political activity; plain-language legal guides for nonprofit organizations; and, information on federal legislative developments that impact 501(c)(3)s. Before joining the Alliance, John taught at the Harrison Institute for Public Law at the Georgetown University Law Center. He has also worked as a lobbyist for a group representing the interests of consumers of legal services .

John received his law degree from the University of Southern California and has an LL.M. from Georgetown.

### **Andrew C. Schulz, Staff Attorney Council on Foundation, Washington, DC**

Andrew Schulz is an attorney for the Council on Foundations, a national membership organization for grantmakers that serves the public good by promoting and enhancing responsible and effective philanthropy. Mr. Schulz's responsibilities include maintaining ongoing expertise in a broad cross-section of tax, legislative and regulatory issues in order to provide assistance and consultation to Council members and the general public. Prior to joining the Council, Mr. Schulz was an associate at the law firm of Dorn & Klamp in Washington, DC, where he worked exclusively for non-profit organizations. Mr. Schulz has written a number of articles on legal issues affecting non-profits, including several contributions to [The Exempt Organization Tax Review](#).

Mr. Schulz is a graduate of the College of Wooster (Wooster, OH) and the George Washington University Law School. He is a member of the Maryland Bar and the District of Columbia Bar.

### **M. Michele Hogan, Executive Director American Association of Immunologists, Washington, DC**

M. Michele Hogan is the Executive Director for the American Association of Immunologists. She is also the Managing Editor of *The Journal of Immunology*, and the Editor of the *AAI Newsletter*. Prior to AAI she held several positions with the Division of Allergy, Immunology and Transplantation, National Institute of Allergy and Infectious Diseases, National Institutes of Health, including Chief, Basic Immunology Branch. Ms. Hogan is a member of the American Association for the Advancement of Science , the American Association of Immunologists and the American Society of Association Executives. She also serves on numerous committees and have received numerous honors and awards. Ms. Hogan received her Ph.D. from the University of Minnesota, Dept of Laboratory Medicine and Pathology.

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## Section I. Tax Exempt Organizations<sup>1</sup>

This section will provide a general overview of the rules and restrictions governing the following tax exempt organizations:

501(c)(3) organizations – charities and private foundations

501(c)(4) organizations – social welfare organizations

501(c)(6) organizations – trade associations and business leagues

### A. Section 501(c)(3) Charitable Organizations

Many nonprofit organizations qualify for exemption from federal income tax under section 501(c)(3) of the Code. To be exempt as a charitable entity, the organization must be both organized and operated for one of the below permissible purposes. The organization's articles of incorporation and bylaws must limit the purposes of the organization to one or more of the exempt purposes. Additionally, the organization's may not engage in substantial lobbying, political activities or allow its assets to inure to the private benefit of any individual.

#### 1. Organized and Operated for Exempt Purposes

An organization applying for recognition as a charitable organization under Section 501(c)(3) of the Code must be organized and operated for exempt purposes. These exempt purposes include: religious, charitable, scientific, literary, or educational purposes, testing for public safety, the prevention of cruelty to children or animals, or the promotion of national or international amateur sports competition. Most smaller charitable organizations are organized and operated for charitable, educational, scientific or religious purposes.

##### Charitable

“Charitable” organizations are those whose purposes include one or more of the following: relief of the poor or underprivileged; advancement of religion; advancement of education or science; erection or maintenance of public building, monuments or works; lessening the burdens of government; and the promotion of social welfare by an organization designed to reduce neighborhood tensions, eliminate prejudice or discrimination, defend human or civil rights secured by law, or deter juvenile delinquency or community deterioration. Additionally, although Treasury Regulations do not contain any specific reference to it, the IRS and the Courts consider the promotion of health to be a charitable purpose.

##### Educational

“Educational,” for purposes of Section 501(c)(3) of the Code, includes both the instruction of individuals in order to improve their abilities and “the instruction of the public on subjects useful to the individual and beneficial to the community.” The broad scope of this definition embraces conventional classroom instruction, the publication and distribution of written or recorded materials, public television and more. The IRS has issued guidance in Revenue Procedure 86-43, which focuses not on content but on the methods used by the organization to educate the public. To qualify as educational, an organization must “provide a factual foundation for the viewpoint or position being advocated” or “provide a development from the relevant facts that would materially aid a listener or reader in a learning process.”

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<sup>1</sup> Portions of the materials in this section are being reproduced from *the Guidebook for Directors of Nonprofit Corporations* written by the Nonprofit Corporations Committee of the Business Law Section of the American Bar Association. Remaining portions were written by Alexis Neely and Shannon Nash

## **Scientific**

An organization has a scientific purpose if its research efforts are in the public interest. The IRS treats scientific research as being in the public interest if any one of the following conditions is satisfied:

1. The results of the research (including any intellectual property resulting from it) are made available to the public on a nondiscriminatory basis, or
2. The research is performed for a federal government agency, a state or a political subdivision of a state, or
3. The research is directed toward benefiting the public.

## **Religious**

An organization operating exclusively for religious purposes qualifies for exemption under Section 501(c)(3) of the Code. The IRS and the courts are reluctant to precisely define what is or is not a religious activity or organization due to the proscription against establishment of religion in the First Amendment of the United States Constitution. Consequently, federal tax law lacks a workable definition of the term. There are several categories of institutions that may be regarded as religious organizations, including churches, conventions and associations of churches, religious orders, schools, corporations, community chests, funds, or foundations.

The concept of a church is narrower than that of a religious organization. The IRS's position is that to be a church for tax purposes an organization must satisfy at least some of the following criteria: a distinct legal existence, a recognized creed and form of worship, a definite and distinct ecclesiastical government, a formal code of doctrine and discipline, a distinct religious history, a membership not associated with any other church or denomination, an organization of ordained ministers, ordained ministers selected after completing prescribed studies, a literature of its own, established places of worship, regular congregations, regular religious services, Sunday schools for the religious instruction of the young, and schools for the preparation of ministers. The IRS makes it clear that these criteria are not exclusive and are not mechanically applied; the analysis considers the totality of the facts and circumstances.

## **2. Prohibitions**

Organizations recognized as tax-exempt under Section 501(c)(3) are subject to three basic prohibitions.

### **Private Benefit and Private Inurement**

The first prohibition protects the public nature and purpose of 501(c)(3) organizations by prohibiting private inurement and private benefit. The private inurement prohibition provides that no part of the organization's net earnings may inure to the benefit of any private individual. This is an absolute bar and a violation of the private inurement prohibition can result in the loss of tax-exemption. However, in 1996 Congress enacted Section 4958 of the Code, which imposes penalties on the insiders who receive excess benefits from their direct or indirect transactions with the organization. Although these intermediate sanctions are not in lieu of loss of exemption, the IRS will in many situation assert these sanctions first and give the organization a chance to remedy the problem.

The prohibition on private benefit provides that a 501(c)(3) organization may not be operated for the benefit of private interests. In contrast to the strict prohibition on private inurement, an incidental amount of private benefit is permitted. The incidental nature of a private benefit is examined both qualitatively and quantitatively. The qualitative element considers whether the private benefit to insiders is a necessary concomitant of the activity which benefits the public at large, meaning that the activity can be accomplished only by benefiting private individuals. The quantitative element considers whether the private benefit is substantial after considering the overall public benefit conferred by the activity.

### **Lobbying**

The second prohibition requires that no substantial part of an organization's activities attempt to influence legislation. An attempt to influence legislation can occur in two ways; 1) the organization contacts, or urges the public to contact, members of a legislative body for the purpose of proposing, supporting, or opposing legislation; or 2) advocates the adoption or rejection of legislation. A permissible amount of lobbying is allowed before an organization jeopardizes its tax-exempt status. Lobbying is discussed in Section IV of the outline.

### **Political Campaigns**

The third prohibition, prohibits organizations from participating in any political campaign. This, unlike the lobbying prohibition, is an absolute bar. The political campaign prohibition is triggered if there is participation or intervention by the organization in a political campaign with respect to an individual who is a candidate for a public office. All four elements must be met before the prohibition becomes effective. The political campaign prohibition is discussed in Section IV of the outline.

## **3. Private Foundations<sup>2</sup>**

All organizations applying for recognition as tax-exempt under Section 501(c)(3) of the Code are presumed to be private foundations. This presumption is rebutted by establishing that the organization is a public charity, meaning that it is either a publicly supported organization or that it supports a publicly supported organization (a "public charity"). The public support test is discussed in Section III of the outline under the Form 1023 discussion. Smaller charitable organizations generally do not want to be treated as private foundations because such organizations are subject to the following stricter restrictions on their activities.

### **Charitable Contributions**

Deductions for contributions of appreciated assets to a private foundation are limited to the cost basis of the assets unless the contribution is of stock for which market quotations are readily available. This is a significant limitation as many donors are interested in donating appreciated assets to avoid incurring capital gains tax on a sale of such property. Also, contributions of cash are deductible only up to 30% of the donor's adjusted gross income; contributions of other assets are deductible only up to 20% of the donor's adjusted gross income.

### **Net Investment Income**

A private foundation must pay a tax of 2% of its net investment income. This 2% tax can be reduced to 1% if the organization makes additional qualifying distributions under section 4942 (see discussion below annual distribution of income).

### **Self Dealing**

A tax is imposed on acts of self-dealing, which include a direct or indirect sale or exchange between the private foundation and a disqualified person.

### **Annual Distribution of Income**

The failure to annually distribute an amount equal to 5% of the fair market value of the investment assets of a private foundation is subject to an excise tax.

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<sup>2</sup> The law relating to private foundations is beyond the scope of this article and, therefore, will not be discussed outside of this section.

· **Excess Business Holdings**

A private foundation is taxed on any business holdings in excess of 20% (or in some cases 35%) of a corporation's voting stock other equivalent interest in a business enterprise.

· **Jeopardizing Investments**

An excise tax is imposed on jeopardy investments, such as puts, calls, and straddles.

· **Taxable Expenditures**

Payments to persons or entities other than qualified public charities are taxed unless the foundation exercises expenditure authority over the payments.

· **Grant Restrictions**

Finally, the most important disadvantage of qualifying as a private foundation, rather than as a public charity, is that many grantmakers (themselves typically private foundations) are probably only willing to make grants to an organization that qualifies as a public charity. Therefore, it is very important that your organization comply with all the requirements necessary to maintain public charity status.

**B. Section 501(c)(4) Organizations**

**1. Purposes**

An organization applying for exemption under 501(c)(4) must be operated exclusively for the promotion of social welfare.

**2. Prohibitions**

A 501(c)(4) organization may not, as its primary activity, conduct a business with the general public in a commercial manner. Any earnings of such an organization must be devoted exclusively to charitable, educational, or recreational purposes.

**3. Comparison to 501(c)(3)**

Although the requirements of 501(c)(3) and 501(c)(4) appear to be similar, a corporation may more easily satisfy the requirements of 501(c)(4). First, it may benefit a smaller or more specific group or community than would qualify a corporation for charitable status under 501(c)(3). Second, a 501(c)(4) organization may engage in some social activities, some lobbying and some political activity.

Section 501(c)(3) status is preferable to 501(c)(4) status if tax-deductible contributions or tax-exempt financing is important to the organization. However, 501(c)(4) status may be advantageous if:

1. lobbying will be a substantial part of the corporation's activities,
2. freedom to support or oppose candidates for office is sought, or
3. the organization would be subject to the restrictions imposed on a private foundation if the organization were exempt under 501(c)(3)

However, if an organization was once exempt as a 501(c)(3) organization, but has lost its exemption because of lobbying or political campaign activities, it cannot then convert into a 501(c)(4) organization.

## **C. Section 501(c)(6) Organizations**

### **1. Purposes**

An organization applying for exemption under 501(c)(6) must be composed of persons having a common business interest and the organization must promote such interest. These organizations must improve the business condition of the industry in general rather than benefiting individual members by supplying such members with such things as management services or improving the economy and convenience of conducting individual businesses. The corporation may satisfy the requirement, if as a whole, it represents all components of an industry or line of business within a particular geographic area. The corporation generally may not, however, be in competition with another group within the same industry or line of business, although members within the corporation may compete with each other. Generally trade associations, professional associations and business leagues will qualify as section 501(c)(6) organizations.

### **2. Prohibitions**

Section 501(c)(6) organizations are subject to a similar private benefit and private inurement prohibition. Although there is not an absolute prohibition against political activities, a section 501(c)(6) organization may not engage in political activities as its primary activity. However, these organizations may engage in lobbying as its primary activity without jeopardizing its tax exempt status.

## **D. Bibliography**

[www.irs.ustreas.gov/prod/bus\\_info/eo](http://www.irs.ustreas.gov/prod/bus_info/eo) - IRS website providing general information for tax exempt organizations.

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<http://www.deathandtaxes.com/pub1828.htm> – Publication 1828 *Tax Guide for Churches and Other Religious Organizations*.

Guidebook for Directors of Nonprofit Corporations, Chapter 4, “Taxation” (2<sup>nd</sup> ed., G. Overton and J. Frey, eds.; American Bar Association, 2002).

## Section II. State Formation and State Tax Exemption Issues

This Section will briefly describe the primary legal issues and requirements relating to formation of a nonprofit corporation under state law and establishment and maintenance of tax-exempt status.

### A. State Formation Issues<sup>3</sup>

Although some non-incorporated associations may qualify for tax-exempt status, the most well-known kinds of tax-exempt organizations, including 501(3) community and public benefit organizations, are commonly organized as nonprofit corporations under state law. Many states have separate nonprofit corporation statutes. However in some states nonprofits (sometimes referred to as “non-stock” corporations) are formed under the state’s general corporations law.

#### 1. Articles of Incorporation

To incorporate, an organization must file articles of incorporation (or other charter document depending on the state) that set forth the organization’s purposes. Articles of EOs should contain language that affirmatively tracks the exempt purposes language contained in the Code and disavows use of the corporation’s assets for private inurement and private benefit.

For 501(c)(3)s, the purposes language in the organization’s articles should at a minimum state that:

- the organization is organized and operated exclusively for charitable purposes;
- none of its earning shall inure to the benefit of private individuals;
- no substantial part of the activities of the EO shall constitute the carrying on of propaganda or otherwise attempting to influence legislation;
- the EO shall not intervene in political campaigns;
- it is not a private foundation;
- (catch all phrase - ) the EO shall not carry on any other activities not permitted to be carried on by an organization exempt from federal income tax under section 501(c)(3); and
- upon the dissolution of the EO, its assets shall be distributed for one or more exempt purposes within the meaning of section 501(c)(3) of the Internal Revenue Code or corresponding section of any future federal tax code, or shall be distributed to other 501(c)(3) organizations as are designated in the corporation’s organizational documents, by the organization’s board or member(s), or a local court, at the time of dissolution, or otherwise for a charitable or public purposes.

The articles of incorporation must be executed by an incorporator. In most states, the incorporator need only be an individual, at least 18 years of age. The incorporator(s) generally need not be an “organizer” or be a future director or officer of the new corporation. An attorney can and often does act as the incorporator by signing the initial articles of incorporation. Initial articles often include the names of the members of the initial board of directors. The articles of incorporation are then filed with the appropriate state agency (generally the Secretary of State’s office) along with a filing fee. The EOs legal existence begins when the Secretary of State accepts the articles of incorporation for filing.

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<sup>3</sup> The Section was prepared by Jeannie Carmedelle Frey of the ABA Business Law Section’s Nonprofit Corporation’s Committee and Shannon Nash.

Although most nonprofit corporations incorporate in the State where their principal activity is located, nonprofit corporations may incorporate in any state, and then register as a “foreign” corporation doing business in the state(s) of their physical operation. This principle also applies to nonprofit corporations that operate primarily over the Internet. Although such Internet-based organizations may be deemed to be doing business in the state in which their server or any employees/volunteers are located, they can choose another state as their state of incorporation. Nonprofit organizers should be aware of a state’s general regulatory regime as it applies to nonprofits before incorporation. If a nonprofit chooses to incorporate in a state in which it has no physical presence, it will need to pay someone -- such as a corporation service company – to serve as the corporation’s registered agent in the state.

For “national” nonprofits (such as the United Way) with many local chapters, the organization may either incorporate in a single state and register as a foreign corporation doing business in each state in which a chapter is located, or may have each chapter separately incorporate. For liability purposes, many such national organizations choose the latter approach.

## **2. Bylaws**

The EO’s board must adopt Bylaws, which generally provide the internal governing procedures for the organization. The Bylaws typical include details on the following sections:

- Name of the EO;
- If a membership organization, details on the members, annual meetings, and member voting rights;
- Board of Directors - number, how chosen , duties, meetings and voting requirements;
- Officers – how appointed, duties;
- Committees of the Board of Directors – general or specific provisions for standing committees and ad hoc committees;
- Financial Management issues – such as fiscal year;
- Indemnification of officers and directors; and
- Miscellaneous other provisions, including amendment provisions.

## **3. Maintenance of Corporate Organization and Meeting Documents**

The EO should maintain a corporate minute book containing all of its organization documents (Articles/Charter and Bylaws) and the corporate minutes taken at each meeting of the members and directors. The minute book serves as a record of actions taken by the corporation (through its Board and members). It thus serves as legal evidence of such actions and their due authorization. The minute book is also a good place to keep the EO’s federal tax-exemption determination letter.

### **B. Board of Directors**

#### **1. Duties of Care and Loyalty**

In carrying out their governance function as a board member, the board or directors act as fiduciaries in the corporation’s behalf. As such, directors are subject to two primary obligations: a duty of care and a duty of loyalty. A third duty, the duty of obedience to a nonprofit corporation’s purposes, is sometimes also said to apply to nonprofit directors. However, such duty may also be deemed to be included within the director’s duty of care and the duty of loyalty.

## 2. Duty of Care

The Duty of Care requires a director to act in a reasonable and informed manner when taking part in board deliberations and activities. The director is generally expected to use the same degree of care as an ordinarily prudent person in a like position would believe appropriate under similar circumstances. At minimum, the director can fulfill this duty of care by reading board packet materials in advance; regularly attending board and committee meetings; and actively participating in board discussions. The director should also determine whether proper procedures are in place to assure that the corporation complies with applicable law.

The Duty of Care requires use of informed, independent judgment when participating as a member of the board. Thus directors should:

- a. Understand and act in a manner that supports the corporation's mission and purposes.
- b. Make sure the Board is receiving the level of information necessary to make informed decisions.
- c. Reasonably rely on staff, Board committees, and outside experts, but avoid undue reliance on opinions of board members and executive management.
- d. Ask questions; be persistent.
- e. Understand the higher level of care that may apply to you if you have special training (lawyer, accountant, banker, insurance agent, etc.) or if you also serve as an executive of the organization

## 3. Duty of Loyalty

The Duty of Loyalty requires a director to place the corporation's interests above the director's personal interests. Duty of Loyalty issues may arise in the following situations:

### Conflicts of Interest

Directors may have interests in conflict with the EO. The "classic" conflict of interest situation occurs when a director or other insider has a material personal interest in a proposed transaction to which the EO may be a party. For example, the director may personally involved with a transaction, or may have an employment or investment relationship with an entity that the EO is dealing with (such as a bank or other vendor, or a prospective buyer or seller of property), or a family member may be involved in a proposed transaction. Conflicts of interest involving a director are not inherently illegal, nor are they to be regarded as a reflection on the integrity of the board or of the director. It is the manner in which the director and the board deals with a disclosed conflict which determines the propriety of the transaction. It is highly recommended that EOs have a written conflict of interest policy which sets forth requirements for annual and periodic disclosures of actual and potential conflicts of interests, and procedures for addressing conflicts that arise. A director's conflicts should be addressed by the following:

- a. Disclosure – the conflict must be disclosed to the other members of the board, and
- b. Informed Consideration – any transaction relating to the conflict generally may be approved by a majority of disinterested board members (or a committee thereof). Ideally (and as may be required by the organization's conflict of interest policy) the interested director should not be present during the discussion and vote on such transaction. The disinterested persons should determine if the transaction is in the best interests of the EO,

even if the interested director (or family member) receives benefits (but no more than fair market value). Some states, such as California, have stricter provisions than others relating to what factors must be present for a transaction involving an interested director to be valid, such as a board determination that the corporation could not have obtained a more advantageous arrangement with reasonable effort.

Also, a transaction between an insider (or family member) and the corporation may be subject to challenge by the IRS as an “excess benefit” transaction, under which both the insider and the organization directors or managers who approved the transaction could be required to pay certain penalties, as discussed in Section V of this Outline. In such cases the conflict should be dealt with by following the procedures for establishing a “rebuttable presumption of reasonableness,” as referenced in Section V.

### **Competition; Usurpation of Corporate Opportunities**

Generally, a director or other EO insider may not compete with the organization without resigning his or her position. Similarly, an EO insider is prohibited under the duty of loyalty principles from taking advantage of a transaction that the insider should know would be of interest to the EO, without prior disclosure and giving the EO first opportunity to take advantage of the opportunity. Whether or not a transaction is regarded as a “corporate opportunity” depends on a number of factors, including how the insider found out about the opportunity

### **Confidentiality; Use of Corporate Assets**

A director should not disclose information about the EO’s activities unless they are already known by the public or are of public record. Moreover, the director should not use the EO’s proprietary information, or any other corporate asset, for personal purposes or benefit.

## **4. General Responsibilities of Directors**

- a. Varies with size of board, size of organization, and type of organization
- b. In general, directors are expected to oversee ongoing operations and help define long-term direction and policies.
- c. Fundraising
- d. Representing corporation in community
- e. Roles of “special purpose” director – identify expectations and hazards for: new board members; directors appointed by or as a “representative” of the organization’s members or its beneficiaries; directors with special expertise (such as attorneys, financial managers, accountants, etc.)

## **5. Indemnification**

Generally, a director’s possible liability in litigation does not arise simply because the EO may be liable; it arises because the director is charged with some breach of duty owed either to the EO or to a specific party. In some cases the EO itself may be the party asserting the claim – generally, that the director has breached the duty of care or the duty of loyalty. The director should be informed regarding what indemnification and insurance is provided for directors, in the corporation’s Bylaws and other documents. The director should also inquire about any statutory exoneration or other legal provisions that may limit the director’s liability.

Further, the director (or prospective director) should review the level of indemnification available under the corporation's Articles, Bylaws and under State law. Is indemnification "to the maximum extent permitted by law" mandatory, or at the discretion of the board? Are indemnifiable expenses incurred payable in advance?

#### **Director's and Officer's Insurance**

Even if the EO has expansive indemnification provisions in its articles of incorporation or bylaws, these assurances must be considered in light of the financial strength of the EO. Director's and officer's insurance may provide the extra protection that directors require to serve on the EO's board. The director should know if there is a D & O insurance in place, and if so, should understand what the policy does and does not cover.

#### **Contractual Rights**

Consider contractual rights to indemnification – contracts with the corporation itself; and contracts with third parties that may provide indemnification of directors.

#### **State and Federal Protection Statutes**

State and federal volunteer protection statutes may provide some protection from liability for non-management directors.

### **C. State Tax Exemptions and Filings**

Once the EO receives federal exemption, it may apply for exemption from various state taxes.

#### **1. State Income Tax**

EOs must file a form with the appropriate state taxing to be exempt from income taxes. In some states this involves filing out a short form and attaching a copy of the IRS determination letter stating that the organization is exempt. Once granted, no income tax returns need to be filed unless the organization has UBIT. There is typically a small filing fee associated with this application.

#### **2. Property Tax**

In general, property owned by a charitable organization that is used in furthering its exempt purpose will qualify for exemption from state property taxes. In most states, this exemption is not automatic and the EO must file for exemption with the proper state entity. These applications may be time-consuming to prepare, depending on the size and nature of the property at issue. Generally the property tax affects real property owned – but in some states or localities there are also property taxes on tangible personal property (i.e., office furniture, computers, etc.). There is typically a filing fee associated with such applications. Some communities may be more stringent than others in granting property tax exemptions, due to budgetary concerns and taxpayer pressures.

#### **3. Sales and Use Tax**

The EO may also qualify for exemption from sales and use taxes on tangible personal property that it purchases. Again, in many states an application must be filed to receive this exemption. There is typically a small filing fee associated with this application. This exemption does not apply to sales taxes that may be levied on the tangible personal property that the EO sells to a third party. Thus, the EO may have the duty to collect a sales tax from a third party and remit such amounts to the appropriate state taxing authorities.

#### **4. Federal Postage Reduction**

EOs may apply for a reduced postal rate for their mailings through the US Postal Service. PS Form 3624, *Application to Mail at Nonprofit Standard Mail Rates*, must be completed and filed with the EOs local post office.

#### **5. Charitable Solicitation License**

Prior to soliciting any contributions in most states, charities exempt under section 501(c)(3) intending to solicit contributions must register with an appropriate state(s) agency (typically the state's Attorney General's office) to obtain a charitable solicitation license. There is typically a small filing fee associated with this license and then an annual fee generally based on the amount of solicitations. In some states certain organizations, such as churches, are exempt from this registration. Also, some states regulate solicitation made by professional fundraisers. In these states the professional fundraiser must register with the appropriate state agency and in often the actual contracts between the fundraisers and the charity must be filed with the state. If a charitable organization raises funds over the Internet, it may need to register under the charitable solicitation laws of other states and localities.

#### **D. Bibliography**

[www.irs.ustreas.gov/prod/bus\\_info/eo](http://www.irs.ustreas.gov/prod/bus_info/eo) – IRS website that provides information for tax exempt organizations and help in completing Form 1023.

[http://www.irs.ustreas.gov/prod/forms\\_pubs/index.html](http://www.irs.ustreas.gov/prod/forms_pubs/index.html) – IS website with link to Publication 557 *Tax Exempt Status for Your Organization*.

[www.nonprofit-info.org](http://www.nonprofit-info.org). – sample bylaws and articles.

<http://www.mapnp.org/library/boards/boards> – Sample articles of incorporation and bylaws for nonprofit corporations, and other information and samples useful to nonprofit boards and executives.

<http://www.usps.gov> – for a copy of PS Form 3624, *Application to Mail at Nonprofit Standard Mail Rates*.

Guidebook for Directors of Nonprofit Corporations (2<sup>nd</sup> ed., G. Overton and J. Frey, eds.; American Bar Association, 2002).

Nonprofit Governance and Management (V. Futter, et. al., eds., American Bar Association and American Society of Corporate Secretaries, 2002).

### Section III. Federal Exemption

Section III will explore the process involved with seeking exemption from federal income taxes and provide a detailed analysis of IRS Form 1023 and Form 1024.

#### A. Internal Revenue Service Form 1023<sup>4</sup>

An organization that is applying for exemption under section 501(c)(3) must file IRS Form 1023, Application for Recognition of Exemption Under Section 501(c)(3).<sup>5</sup> This following is a part by part analysis of the Form 1023. It is recommended that before filling out a Form 1023, a copy of the instructions for this form be obtained and a tax advisor by consulted.

#### Part I - Identification of Applicant

In this section the organization must provide general background information such as its name, address, phone number and a contact person. Other notable information that must be provided in this part includes:

**Line 2 - Employer identification number (EIN)** - The organization must apply for an employer identification number ("EIN"). The EIN is a nine-digit number that can be obtained by filing IRS Form SS-4, Application for Employer Identification Number. In most districts, a director or officer of the organization can obtain this identification number immediately over the phone by calling the appropriate IRS office or by faxing the SS-4 directly to the IRS. Each IRS district has its own rules, thus individual districts should be consulted for their procedures. Contact numbers are available on the SS-4 instructions.

**Line 4 - Month the annual accounting period ends** - The organization must chose a month for its annual accounting period to end. Many charities chose a fiscal year that mirrors the calendar year. However an organization may consider choosing a month other than December where it operations dictate. For example, a charity may receive the majority of its funding from an annual event that takes place in June. Ending its fiscal year in August when most receipts are in from the event may be more fiscally sound.

**Line 8 - Is this Organization required to file Form 990 (or Form 990 - EZ)?** Nonprofit organizations are required to report their operations annually on a Form 990 or Form 990-EZ Return of Organization Exempt from Income Tax. If the organization's gross receipts are not normally more than \$25,000 it will not be required to file a Form 990. Form 990-EZ is for use by organizations with gross receipts of less than \$100,000 and total assets of less than \$250,000 at the end of the year. See Section VIII of this outline for more information on Form 990 and Form 990EZ.

**Line 10 – Checks the Box for the type of corporation and attach conformed copies of organizing documents** - Most organizations will check the box as a corporation. Organizing documents for corporations will generally include articles of incorporation and by-laws. A conformed copy is one that is typically a photocopy of the original documents with a certification attached from a director or officer of the organization that the attached copy is a complete and accurate copy of the original document.

#### Part II - Activities and Operational Information

In this section, the charity provides the IRS with the information necessary to conclude that the organization meets the requirements of section 501(c)(3).

**Line 1 - Provide a detailed description of all the activities of the organization** - In this section it is important that the organization not just reiterate its purposes listed in the articles of incorporation. Details and descriptions of the organization's activities should be provided. For example, a theatrical group whose

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<sup>4</sup> The following discussion on was prepared by Shannon Nash and Alexis Neely

<sup>5</sup> Churches are not required to file form 1023.

purposes as provided in its articles include cultural and educational activities may discuss its schedule of performances in this section.

**Line 2 – What are or will be the organization’s sources of financial support? List in order of size.**

The organization should detail its primary sources of revenue, keeping in mind that as a public charity it should generate at least one-third of its support from the public, government funding and/or revenue generated from activities related to its exempt status. For example, A public charity formed to hold theatrical and cultural performances would list ticket sales as a source of funding.

**Line 3 - Describe the organization’s fundraising program.** In this section the organization should detail how it plans to raise funds to support its’ exempt activities. Many organizations will solicit funds through direct mailings. Copies of such mailings should be attached as an example to the Form 1023. Other organizations solicit funds through grant applications to the government and foundations. Copies of the grant applications should be attached. For organizations that solicit donations via their website, copies of these web pages should be provided. If the charity uses third party donation websites such as charity malls or internet retailers, details of the arrangements with the third party websites should be provided. See Section XIII of this outline for more information on internet fundraising.

**Line 4b – Names, addresses, and titles of officers, directors, trustees, etc; annual compensation.** The public charity should be careful when it provides compensation to its directors and officers in return for their governance services. To the extent that compensation arrangements are contemplated, the services should be valued at fair market value and not above. See Section V of this outline for a discussion of reasonable compensation and intermediate sanctions.

**Line 4d - Are any members of the organization’s governing body “disqualified persons”?** In general, a disqualified person will be one who contributes more than \$5000 to the public charity when such amount is more than 2% of the total contributions made to the public charity in that fiscal year. All family members of the substantial contributor are also themselves disqualified persons.<sup>6</sup> To the extent a public charity does have disqualified persons, such individuals should be listed and the public charity should explain.

**Line 5 - Does the organization control or is it controlled by any other organization?** Some public charities are outgrowths or offspring of other organizations. To the extent that the other organization continues to control the public charity, such relationship must be disclosed. In this section, the IRS is specifically looking for any special relationships that the public charity shares with another organization such as interlocking boards of directors or shared membership rolls, officers, or office space.

**Line 6 – Does or will the organization directly or indirectly engage in certain transactions with any political organization or other exempt organization (non 501(c)(3) organization)?** Similar to the information requested in Line 5, the IRS is looking for special relationships that the public charity may share with other non-charitable exempt organizations (i.e., a trade association) or a political organization.<sup>7</sup> In addition to probably listing the relationship under line 5, all financial transactions between the two organizations must also be detailed in this section.

**Line 7 – Is the organization financially accountable to any other organization?** Even if another organization does not “control” the public charity or the public charity does not engage in any financial transactions with non-charitable exempt organizations or political organizations, to the extent the public charity is financially accountable to another organization (i.e., it must report its income and expenses to another organization), such relationship must be disclosed.

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<sup>6</sup>Moreover, anyone who owns 20% or more of the total combined voting power of a corporation that donated more than \$5000 to the public charity which again is more than 2% of the total contributions made to the public charity in a fiscal year, is also a disqualified person.

<sup>7</sup> For example, a public charity may be set up to be the philanthropic arm of a trade association.

**Line 8 – What assets does the organization have that are used in the performance of its exempt function?** All assets that the public charity owns, with the exception of cash, stocks, and other short-term marketable securities, must be disclosed. For many small public charities this will include listing the public charity's office equipment and furniture.

**Line 10 – Will the organization's facilities or operations be managed by another organization under a contractual agreement?** Is the organization a party to any leases? To the extent the public charity outsources a portion of its activities to another organization or individual, such relationship must be disclosed. For example, a public charity that hires a property manager to manage its properties must attach a copy of the contract and explain the relationship. Also, all lease arrangements that the public charity is a party to must be disclosed. Typically, the public charity will include information regarding its rental of office space or equipment under this section.

**Line 11 – Is the organization a membership organization?** For a membership organization, this section requires details about the members including (1) the membership requirements and membership fees, (2) a description of the methods used to attract new members including all promotional material and (3) the benefits that the members receive in exchange for their membership dues.<sup>8</sup>

**Line 12 - Does the organization provide benefits, services or products? Are the recipients required to pay for them?** Does the organization limit these benefits to specific individuals? For a public charity that derives all or a portion of its revenue from providing services (i.e., a theatrical group that generates revenues from ticket sales to its performances) a description of the services along with a fee schedule, must be provided. To the extent that the public charity subsidizes the services for certain individuals (i.e., the elderly pay a reduced fee) such limitations must also be disclosed.

**Line 13 and 14 – Does or will the organization attempt to influence legislations or intervene in political campaigns?** As provided in section 501(c)(3), a public charity cannot engage substantially in political and lobbying activities. To the extent lobbying activities are contemplated, they should be disclosed in this section. See Section IV of this outline for more information on lobbying and political campaign activities.

### **Part III - Technical Requirements**

A newly formed organization must file its Form 1023 within 15 months from the end of the month in which it was formed (i.e., incorporated). Lines 1 through 6 deal with the technical requirements of filing within the required time frame and provide exceptions. If the organization is filing within the 15-month period, it may skip lines 2 through 6 and proceed directly to line 7. Lines 7 through 14 address a very important issue for donors to charitable organizations - Is the organization a public charity or a private foundation?

**Line 7– Is the organization a private foundation?** In general, organizations that are exempt under section 501(c)(3), are presumed to be private foundations unless they qualify as a public charity under the provisions of Sections 509(a)(1) through 509(a)(4) of the Code (see line 9 below for these exceptions). In general, it is more advantageous for an organization to be treated as a public charity and not as a private foundation. As a private foundation, the organization is subject to detailed operating restrictions and potential excise taxes on the failure to comply with such restrictions. In addition, private foundations are subject to a 2% excise tax on investment income.

Moreover, from the donor's perspective, there are stricter limitations on the amount that can be deducted as a charitable contribution to a private foundation. Charitable contributions made to a public charity are deductible up to 50% of the donor's adjusted gross income. However, charitable contributions made to a private foundation are limited to 30% of the donor's adjusted gross income. In light of all these limitations, being treated as a public charity is desirable for a charitable organization. To answer line 7 the

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<sup>8</sup> In recent years it is the third prong, the benefits description, that the IRS has focused on in determining whether benefits received by members who are not deemed full or regular members (i.e., associate members) of the public charity will be subject to taxation.

organization should refer to line 9 and ensure that it can meet one of the exceptions to private foundations status.

**Line 9 - The organization is not a private foundation because it qualifies:** Line 9 provides the exceptions to private foundation status as enumerated in Sections 509(a)(1) through 509(a)(4) of the Code. The majority of charitable organizations are excluded from private foundation status under section 509(a)(1) and section 509(a)(2) as a publicly supported organization. Box h and i provide the exceptions under sections 509(a)(1) and 509(a)(2) respectively.<sup>9</sup>

Under 509(a)(1), (box h), the public charity must either meet a strict one-third public support test or a looser facts and circumstances test. Under the one-third support test the public charity must receive at least one-third of its total support from the public including governmental units and/or the general public. Please note, that generally contributions from an individual (or entity) are treated as public support, provided that any amount contributed in excess of 2% of the public charity's total support is not treated as public support. Thus if most donations are relatively small (less than 2% of the total support), the public charity should have little trouble with the public support test.

If the public charity fails the public support test, it may still qualify under 509(a)(1) under a two prong facts and circumstances test. First, the public charity must receive at least 10% of its total support from the public including governmental units and/or the general public. Second, the organization must meet an attraction of the public support requirement. Under this test, the public charity must provide that it maintains a continuous and bona fide program for the solicitation of funds from the general public, community, or membership group involved, or it carries on activities designed to attract support from governmental units or other charitable organizations.

Under 509(a)(2), (box i), the public charity can also qualify as publicly supported if it satisfies a two prong test: (1) a one-third support test and (2) a not-more-than-one-third support test. The one-third support will be met if the organization receives at least one-third of its total support from any combination of: (1) gifts, grants, contributions or membership fees, and (2) gross receipts from admissions, sales of merchandise, performance of services, or furnishing facilities in any activity that furthers the charitable purposes of the organization. Under the not-more-than-one-third support test, the public charity cannot receive more than one-third of its support from gross investment income and the excess of any unrelated trade or business income over the tax imposed on such income. See Section VII of this outline for more information on unrelated business taxable income.

Generally, an organization that generates a majority of its revenue from services related to its exempt purposes instead of from contributions, will file for public charity status under section 509(a)(2). However, many organizations can meet the support requirements under both section 509(a)(1) and section 509(a)(2). In such a case, the organization is treated as qualifying under section 509(a)(1). If the organization cannot decide, it should check box j for 509(a)(1) and the IRS will determine the proper classification.

It is important to keep in mind that this entire section deals with whether or not the public charity will be treated as a public charity or a private foundation. To the extent the public charity cannot meet one of the aforementioned exceptions, it will be treated as a private foundation and thus subject to the stricter requirements mentioned in line 7 above.

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<sup>9</sup>Other organizations that are exempt from private foundation status under 509(a)(1) include: (1) churches or a convention or association of churches, (2) educational organizations such as schools or colleges, (3) hospitals or medical research organizations operated in conjunction with a hospital, (4) organizations operated for the benefit of certain state and municipal colleges and universities, and (5) governmental units. Under 509(a)(3), an organization that is operated solely for the benefit of another charitable organization that is itself exempt from private foundation status may in essence borrow that organization's public charity status. Also section 509(a)(4) exempts all public charities that are organized and operated exclusively for the testing of public safety. All of the aforementioned organizations are provided in boxes a through g of line 9 and all have corresponding schedules that must be completed. Such organizations are beyond the scope of this outline and a tax practitioner should be consulted for more information.

**Line 10 - Has the organization completed by tax year of at least 8 months.** Once the public charity decides that it is not a private foundation by virtue of 501(a)(1) or 509(a)(2), it must next determine whether it wants a definitive ruling or an advance ruling from the IRS. With a definitive ruling, the IRS is concluding that based on the information provided in the organization's Form 1023, the organization has definitively satisfied the requirements of section 501(c)(3) and is not a private foundation under 509(a)(1) or 509(a)(2).<sup>10</sup> To receive a definitive ruling the organization must have completed a tax year of at least 8 months. Organizations that are extremely confident that their operations to date can meet the public support tests will file for a definitive ruling.

Many newly formed organizations opt for an advance ruling because the organization has not received significant public support during its first or second year of operation. With an advance ruling the IRS gives the organization five years ("the advance ruling period") to prove that its operations meet the requirements of sections 509(a)(1) or 509(a)(2). During the advance ruling period, the organization is treated as a public charity. Thus, contributions to the organizations will be treated as charitable contributions, deductible under section 170 of the Code. At the end of the advance ruling period, the public charity will be required to prove that it was actually publicly supported based on its average public support ratio during the advance ruling period. If the organization is requesting an advance ruling, it need not answer lines 12 and 13.

**Line 11 - Unusual grants.** Unusual grants are substantial contributions and bequests from disinterested persons that are unexpected in amount and would, by reason of their size, adversely affect the organization's public charity status (i.e., the contribution is more than 2% of the organization's total support). A description of the unusual contribution including the name of the donor, the date and the amount, and the nature of the grant (i.e., one time donation vs. annual donation) is required. Also, the amount of the grant must be included on the Statement of Revenue and Expenses in Part IV, line 14.

**Line 14 - Schedules.** Schedules A - I are provided for certain types of section 501(c)(3) organizations. For example, Schedule A applies to a church organization.<sup>11</sup> It is important that the charity not forget to check "no" for each box listed in line 14. Neglecting to complete this line may delay the IRS's review of the entire 1023 application. Such mistakes or omissions can greatly prolong the organization's waiting period for a ruling on its exempt status.

## **Part IV - Financial Data**

### **A. Statement of Revenue and Expenses -**

Generally, a public charity must provide 3 to 4 years of financial information. For organizations already in existence this includes the current year and three years immediately before it. For organizations in existence less than 1 year, financial data for the current year and proposed budgeted information for the following 2 years must be provided.

**Line 1 - Gifts, grants and contributions.** - This amount should be the largest revenue source for charities that meet the public support test under section 509(a)(1). This line should not include amounts received by the charity in the performance of its exempt functions, such as ticket sales for an event. Such revenue should be included on line 9.

**Line 2 - Membership fees received.** For charities that are membership organizations, membership dues should be included on this line.

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<sup>10</sup>Note that a definitive ruling may only be given to a public charity that meets the requirements of section 509(a)(1) and (a)(2). Organizations that are exempt from private foundation status under 509(a)(3) or 509(a)(4) may skip this line.

<sup>11</sup> These special situations are beyond the scope of this outline and a tax advisor should be consulted for further information

**Line 3 - Gross investment income.** Charities that contemplate having net income at the end of a year on line 24 should include some amount on this line in the next year attributable to interest earned on the net income.

**Line 4 – UBTI income.** All income derived from unrelated business activities (i.e., after deducting all associated expenses) should be included on this line. Although listing an amount on this line is not per se detrimental to obtaining charitable status under section 501(c)(3), the IRS will be looking at the amount of unrelated business taxable income in relation to organization’s other revenue. Too much unrelated business taxable income may cause the IRS to deny the organization charitable status. See Section VII of this outline for more information on UBTI.

**Line 7 - Other Income.** Included on this line are all other revenue sources not included on any other line.

**Line 9 - Gross Receipts from admissions, sales of merchandise or services, furnishing of facilities in any activities that is not unrelated.** This amount should be the largest revenue source for charities that meet the public support test under section 509(a)(2).

**Line 11- Capital Gains.** If the organization plans to sell a capital asset, such as publicly traded stock, any capital gain should be reported on this line.

**Line 14 - Fundraising Expenses -** The amount of fundraising expenses should be included on this line and should be consistent with scope of the charity’s fundraising activities as they were described in Part I, line 3 of Form 1023.

**Line 15 - Contributions/Gifts -** As part of their charitable purpose, many charities make grants and contributions to individuals and other organizations. A schedule must be attached describing the purposes and the amount of the contribution.

**Line 16 - Disbursements to or for the benefit of members.** For membership organizations, amounts or benefits paid to members should be included on this line and detailed on an attached schedule.

**Line 17 - Compensation of officers, directors and trustee -** Amounts paid to officers and directors for compensation should be included on this line. This line does not include amounts paid to directors or officers that are non-compensation payments such as reimbursements for the charity’s expenses (telephone, photocopying expenses, etc). Also a schedule detailing the name of the officer or director, the average amount of time devoted to the organization’s affairs, and the amount of compensation paid must be attached.

The amount included on this line should be consistent with amounts that were disclosed in Part II line 4b of Form 1023. Typically, the amount paid to the charity’s chief officer, often called the president or executive director, must be disclosed here. Board members of charitable organizations don’t typically receive compensation for their services. The charity should be cautious in all compensation arrangements with its officers and directors and ensure that they are based on arms length negotiations and at fair market value. See Section V of this outline for a discussion of reasonable compensation and intermediate sanctions.

**Line 18 - Other salaries and wages.** Compensation paid to non-officers and board members, such as employees should be included on this line.

**Line 20 - Occupancy -** All amounts paid for renting or leasing the charity’s office space should be included on this line. A copy of the actual rental or leasing contract should be attached to the Form 1023 as provided in Part II, 10b. Also other utility expenses, such as gas, electricity, water, etc. should be included on this line. If the organization owns its office space, mortgage interest and real estate taxes may be deducted on this line.

**Line 22- Other expenses.** All other expenses not included on any other line should be listed on an attached schedule with the total provided on this line.

## **B. Balance Sheet**

As part of the required financial statements, the organization must also complete a balance sheet. The balance sheet information is a standard listing of cash, assets, and liabilities of the organization. Generally, the organization will complete a balance sheet on a date ending close to the filing of the Form 1023. However, this date may not be greater than 60 days from the filing of the form. Thus, the balance sheet is typically one of the last sections completed in finalizing the Form 1023. Failure to meet the 60 days requirement may delay the processing of the organization's Form 1023. .

### **The Form 1023 Submission Package**

After the Form 1023 is completed, it must be mailed to the appropriate IRS key district office. This office is determined by the location of the organization's principal place of business or office. Form 8718, User Fee for Exempt Organization Determination Letter Request lists IRS key district offices. It is also the form that the organization uses to select the user fee that must be paid to the IRS in connection with filing the Form 1023. For many organizations requesting an advance ruling on Form 1023, the cost will be \$500.

In addition to including a Form 8718 in the Form 1023 submission package, the organization must also submit two copies of Form 872-C, Consent Fixing Period of Limitation upon Assessment of Tax Under Section 4940 of the Internal Revenue Code. Also, if the organization is working with an accountant, attorney, or other tax preparer, a Form 2848, Power of Attorney, must be completed and submitted. The organization should remember to attach a conformed copy of its articles of incorporation and bylaws to the Form 1023 application. Finally, any other attachments (i.e., additional information, copies of documents, etc) must contain the organization's name, address and employer identification number, as well as the part and line item number to which the attachment relates.

In the Form 1023 application package, the IRS includes a procedural checklist to make sure that the Form 1023 application is complete. The IRS also provides a list of the top ten reasons for delays in obtaining tax exempt status on their website (provided below in the bibliography section). Organizations should review both of these before sending in the Form 1023 submission package. Simple mistakes or omissions, such as forgetting to sign the first page of the Form 1023 application can delay review of the application and in severe cases cause the entire application to be mailed back to the organization; thereby causing the organization to incur an additional user fees when the Form 1023 Application is resubmitted.

### **The Waiting Game**

For Form 1023 applications that are complete and do not require additional information from the organization, it will generally take up to 180 days for the IRS to rule on the organization's exempt status. However, in many cases response times have been less than 3 months. Delays, of course, can affect this timing and often are due to careless mistakes or omissions in the Form 1023 package or requests for more information from the IRS technical reviewer. In the mean time, the organization is in a limbo status. It cannot claim to be an exempt organization. Thus donors who contribute during the waiting period time should be told that their donations may not be deductible. Of course, once the organization receives a determination letter that it is exempt under section 501(c)(3), its exemption is retroactive to the date of its incorporation.

## **B. Internal Revenue Service Form 1024<sup>12</sup>**

Internal Revenue Service Form 1024, Application for Recognition of Exemption Under Section 501(a), is used by organizations to apply for recognition of exemption from federal income taxation under Code section 501(a) as organizations described in several subsections of Code section 501(c), including:

- **Code section 501(c)(4):** civic leagues, social welfare organizations and local associations of employees.
- **Code section 501(c)(6):** business leagues and chambers of commerce.

### **When to File**

An organization seeking exemption under any subsection of Code section 501(c) other than subsection (c)(3), (c)(9) or (c)(17) is not required to file an application with the IRS in order to be exempt from federal income taxation. If an organization meets the requirements for the specific subsection, it is automatically granted tax-exempt status without taking any affirmative action. Therefore, there is no deadline as to when an organization may file Form 1024. However, it is recommended that an organization confirm its exemption under Code section 501(c) by filing Form 1024.

### **Required User Fee**

An organization must complete IRS Form 8718, User Fee for Exempt Organization Determination Letter Request, and enclose a required user fee, as follows:

1. **Gross Receipts Less Than \$10,000:** An organization that has had during the previous four years or expects to have during the coming four years annual gross receipts averaging less than \$10,000 must pay a user fee of \$150.
2. **Gross Receipts of \$10,000 or More:** An organization that has had during the previous four years or expects to have during the coming four years annual gross receipts averaging \$10,000 or more must pay a user fee of \$500.

**Required Information:** The applicant organization must complete Parts I through III of Form 1024. The questions in many of the Parts of Form 1024 are the same as or often very similar to the questions in IRS Form 1023, with the exception of certain questions posed in Part III that are directed toward member benefits. Thus the following analysis focuses on Part III.

### **Part III – Financial Data:**

#### **Statement of Revenue and Expenses:**

- In general, the statement must be completed for the current year and each of the three immediately-preceding years (or the years the organization has existed, if less than four).
- For the current year, information must be provided for the period beginning on the first day of the organization's current fiscal year and ending on any day that is within sixty days of the date of Form 1024. If the date of Form 1024 is within 60 days of the organization's current fiscal year, no financial information is required for the current fiscal year.
- For organizations that have existed for less than one year, financial data must be provided for the current year and proposed budgets must be provided for the following two years.

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<sup>12</sup> The following discussion on Form 1024 was prepared by Jennifer L. Franklin.

**Balance Sheet:**

- If the organization has no assets at the time of filing Form 1024, the Balance Sheet must be completed with “zero” entered on each line.

**Schedules**

Organizations seeking exemption under specific subsections of Code section 501(c) must file certain schedules, as follows:

**Schedule B – Code section 501(c)(4)** – To qualify under section 501(c)(4) as a civic league or social welfare organization, the applicant must show that is operated primarily to further the common good and general welfare of the people of the community. Therefore, if the primary purpose of an applicant will be to conduct social activities, the applicant should attempt to obtain exemption under section 501(c)(7) as a social or recreational club instead. To qualify under section 501(c)(4) as a local association of employees, the applicant must show that its membership is limited to employees of a designated person or persons in a particular municipality and that the net earnings of the association will be devoted exclusively to charitable, educational or recreational purposes

**Schedule D – Code section 501(c)(6)** – An applicant seeking exemption under section 501(c)(6) as a business league, chamber of commerce, real-estate board, board of trade or professional football league must show that it is devoted to the improvement of business conditions of one or more lines of business as distinguished from the performance of particular services for individuals.

**Attachments:**

As with the discussion under the Form 1023 any attachments to the Form 1024 must contain the organization’s name, address and employer identification number, as well as the part and line item number to which the attachment relates.

**Where To File:**

**Regular Mail:** If using regular mail, the application should be sent to the Internal Revenue Service at P.O. Box 192, Covington, Kentucky, 41012-0192. It is recommended to send the application by certified mail, return receipt requested.

**Express Mail Services:** If using an express mail service, the application should be sent to the Internal Revenue Service at 201 West Rivercenter Boulevard, Attention: Extracting Stop 312, Covington, Kentucky 41011.

**C. Bibliography**

[www.irs.ustreas.gov/prod/bus\\_info/eo](http://www.irs.ustreas.gov/prod/bus_info/eo) - This is the IRS website that provides information for tax exempt organizations and help in completing Form 1023.

[http://www.irs.ustreas.gov/prod/forms\\_pubs/index.html](http://www.irs.ustreas.gov/prod/forms_pubs/index.html) - IRS Publication 557 *Tax Exempt Status for Your Organization*, Form 1023 *Application for Recognition of Exemption Under Section 501(c)(3)*, Form 1024, *Application for Recognition of Exemption Under Section 501(a)*.

[http://www.irs.gov/bus\\_info/eo/tax-tips.html](http://www.irs.gov/bus_info/eo/tax-tips.html) – IRS provides top 10 reasons for delays in processing form 1023 applications.

## **Section IV. Lobbying and Political Activities<sup>13</sup>**

This section will provide a general overview of the prohibition against political campaign activities and the limits on lobbying activities. This section will generally apply to the activities of a Section 501(c)(3) organization.

### **A. Political Campaign Activity Prohibition**

A Section 501(c)(3) organization must “not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.” A violation of this prohibition may disqualify the organization from tax-exempt status. A violation occurs if there is participation or intervention by the organization in a political campaign with respect to an individual who is a candidate for a public office. A candidate for public office is defined as an individual who offers himself or is proposed by others as a contestant for elective public office. An organization that contributes to the political campaign of a candidate or evaluates the qualifications of potential candidates and supports particular slates of candidates will be deemed to participate or intervene in a political campaign.<sup>14</sup> However, the following activities are generally excluded from political campaign activities.

#### **1. Voter Education**

Educational activities are distinguished from political campaign activities. Encouraging greater participation in government and political affairs or conducting forums at which a broad spectrum of political issues are debated, but not for the purpose of participating in political campaigns, are permissible activities by a Section 501(c)(3) organization. The organization must equitably distribute information regarding the issues and candidates without evidence of bias towards any particular issue or candidate. For example, an organization cannot distribute a voter guide that contains the voting records of candidates on selected issues that are important to the organization or send a questionnaire to candidates if the questions evidence bias on the issues. However, the organization can send an unbiased questionnaire to candidates and publish the answers or publish a voter guide with the voting records of all the Members of Congress on a wide range of legislative issues. The key to any voter education activity is to ensure that it is performed in a neutral and educational manner.

#### **2. Judicial Appointments**

A 501(c)(3) organization may attempt to influence the Senate’s confirmation of a federal judicial nominee without jeopardizing its exempt status because federal judges aren’t elected, but are instead appointed by the President. However, though the attempt to influence the Senate’s confirmation is not prohibited campaigning, it is treated as legislative lobbying and as such must be within the permissible lobbying limitations, discussed below.

### **B. Lobbying**

Section 501(c)(3) requires that “no substantial part” of an organization’s activities involve carrying on propaganda, or otherwise attempting, to influence legislation. This does not mean that an organization should not engage in lobbying activities, but instead that an organization that is influencing legislation does so with the awareness of legal limitations. In determining what amounts to a substantial level of lobbying activities, the organization has two options. The organization may make an election pursuant to Section 501(h), which provides an objective method for measuring permissible lobbying expenditures. Alternatively, the organization may use a facts and circumstances test to determine whether more than a substantial part of its activities involve lobbying. Both methods are described below.

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<sup>13</sup> This Section was prepared by Alexis Neely and Shannon Nash

<sup>14</sup> Rev. Rul. 67-71, 1967-1 C.B. 125.

**“Substantial Part” Test – Facts and Circumstances**

The facts and circumstances test is an imprecise measure of an organization’s lobbying activities considering all the facts and circumstances of the organization’s lobbying activities, including those that cost the organization nothing, such as lobbying by volunteers. Case law on this issue has suggested that an organization spending five percent of its time and effort on legislative activities does not exceed the lobbying limitation.<sup>15</sup> Other authorities suggest that spending 16 to 20 percent of an organization’s time on legislative activities would be a substantial part; thereby exceeding the lobbying limitation.<sup>16</sup> An organization that spends less than five percent of its time on influencing legislation should not be concerned that its 501(c)(3) status will be jeopardized because a substantial part of its activities are spent on lobbying. As an organization gets closer to the line of using 16 percent of its resources to influence legislation, the organization should be aware of the danger of exceeding the lobbying limitation. Pursuant to the facts and circumstances test, organizations do not have certainty about which of their activities count towards the analysis; the organization should consider their lobbying activities as a whole, including volunteer activity, in the context of all of their organizational activities. The sanction for violating the lobbying limitation in the absence of a 501(h) election is revocation of the organization’s exempt status. For organizations that are unwilling to rely on such an amorphous standard, charitable organizations, other than governmental units, churches, their integrated auxiliaries, and conventions or associations of churches, can obtain clarity by making an election pursuant to Section 501(h).

**“Section 501(h) Expenditure” Test**

The Section 501(h) Expenditure test utilizes a mechanical test and sliding scale to measure the total amount of permissible direct and grassroots lobbying expenditures by an organization. See the discussion below for more information on direct lobbying and grassroots lobbying. The scale is determined by reference to declining percentages of the organization’s total exempt purpose expenditures. The annual level of expenditures for direct legislative efforts is determined as follows: 20 percent of the first \$500,000 of an organization’s expenditures for an exempt purpose, plus 15 percent of the next \$500,000, 10 percent of the next \$500,000, and 5 percent of any remaining expenditures, with a total limitation on lobbying expenditures in any one year of \$1,000,000. A separate limitation – amounting to 25 percent of the total lobbying expenditure limitation - is imposed upon grassroots lobbying. See the chart below.

Exempt-Purpose Expenditures	Total Lobbying Expenditures	Amount of Total Allowable for Grassroots Lobbying
Up to \$500,000	20% of exempt-purpose expenditures	One-quarter
\$500,000 - \$1,000,000	\$100,000 + 15% of excess over \$500,000	\$25,000 + 3.75% of excess over \$500,000
\$1,000,001 - \$1,500,000	\$175,000 + 10% of excess over \$1,000,000	\$43,750 + 2.5% of excess over \$1,000,000
\$1,500,001 - \$17,000,000	\$225,000 + 5% of excess over \$1,500,000	\$56,250 + 1.25% of excess over \$1,500,000
Over \$17,000,000	\$1,000,000	\$250,000

An organization seeking to make an election pursuant to Section 501(h) should file Form 5768 with the IRS. Although making the 501(h) election gives the organization more certainty as to the allowable amount of lobbying expenditures that it may incur, the electing organization will incur sanctions if it

<sup>15</sup> *Seasongood v. Comm’r*, 332 F.2d 907, 912 (6th Cir. 1995).

<sup>16</sup> *Haswell v. United States*, 500 F.2d 1133 (Ct.Cl. 1974).

exceeds the lobbying expenditure limitations. If the organization spends more on lobbying expenditures than is permissible under 501(h), a tax of 25% is imposed on the excess lobbying expenditures. Moreover, in extreme cases, an organization may lose its exempt status if its lobbying expenditures exceed the permitted amount by more than 50% over a four year period.

## 2. Direct Lobbying

As depicted in the chart above, organizations are permitted to spend more money on direct lobbying expenditures than on grassroots lobbying expenditures; thus, it is important that the organization be able to identify the characteristics of each. Direct lobbying communications generally include any attempt to influence legislation through communication with any member or employee of a legislative body or any other governmental official who participates in the formulation of legislation. All preparatory activities, such as research, planning, coordination, and decision to make a lobbying communication are direct lobbying communications if engaged in for the purpose of making a lobbying communication. If all the elements are there it's lobbying even if you are also educating legislators, providing technical advice or assistance to an individual legislator.

Urging the public to vote for or against a ballot initiative or referendum is direct lobbying because the public becomes the legislature. Urging the organization's members to contact public officials about legislation is also *direct* lobbying and, thus, subject to the higher lobbying expenditures limit. In contrast, if the organization encourages its members to urge the general public to contact legislators, that is grassroots lobbying and subject to the lower lobbying expenditure limitation. Members of an organization are defined as those who contribute more than a "nominal" amount of money or time to an organization, such as paying dues, making other contributions, or volunteering to work for the organization.

## 3. Grassroots Lobbying

Grassroots lobbying occurs when an organization attempts to affect the opinion of the general public, unless the general public is in the position of the legislature as in a ballot measure or referendum. A grassroots lobbying communication must refer to specific legislation, reflect a view on that legislation, *and* encourage the message recipient, other than a member of the organization,<sup>17</sup> to take action with respect to the legislation, called issuing a "call to action."

A communication encourages the message recipient to take action (issues a "call to action") if it communicates any of the following:

1. states the recipient should contact legislators,
2. states the address or phone number of a legislator or legislator's employee,
3. provides a convenient means of contacting a legislator, *or*
4. specifically identifies one or more legislators who will vote on the legislation as opposing the communication's view with respect to the legislation; being undecided with respect to the legislation; being the recipient's representative in the legislature; or being a member of the legislative committee or subcommittee that will consider the legislation. Naming the main sponsors of the bill for the purposes of its identification is not considered encouraging action.

This "call to action" requirement permits an organization to communicate its position on specific legislation without making a lobbying expenditure. Thus, so long as the communication is not a paid advertisement in the mass media as discussed below, an organization could send a message referring to

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<sup>17</sup> Encouraging a member of the organization to contact their legislator is direct lobbying, not grassroots lobbying.

specific legislation and reflecting a view on that legislation without counting the expense of the message against its grassroots lobbying expenditure limitation because there is no call to action.

#### **4. Paid Mass Media Advertisement**

Even without a “call to action,” an organization is subject to a rebuttable presumption that its communication is grassroots lobbying if the organization communicates its position regarding specific legislation in the mass media (television, radio, and general circulation newspapers and magazines)<sup>18</sup> within two weeks before a legislative vote on “highly publicized” legislation and either refers directly to the legislation or states a view on the legislation and urges the public to communicate with legislators about the subject. The advertisement can merely refer to the legislation and if the other publication requirements are met, the organization can be forced to allocate its expenses for the communication to grassroots lobbying.

Highly publicized legislation is legislation that has received so much publicity that its general terms, purpose, or effect are known to a significant element of the general public, not just to the particular interest groups directly affected. The lobbying presumption is rebutted if the organization can show that the advertisement is regularly made by the organization in the mass media in the customary course of its business or that the timing of the advertisement was unrelated to the upcoming legislative action.

For example, the National Organization for Motherhood places a television advertisement advocating support for the President’s plan to provide six months of paid maternity leave, popularly known as “the President’s Healthy Children Plan.” The advertisement concludes: “SUPPORT THE PRESIDENT’S HEALTHY CHILDREN PLAN!” The plan is outlined by the President in a series of speeches and is drafted into proposed legislation. The President’s plan and position are highly publicized during the two weeks before the Senate vote. The initiative is voted on by the Senate four days after the National Organization for Motherhood’s advertisement. Although the advertisement doesn’t encourage recipients to contact legislators or other government officials, it does refer to the legislation and reflect a view on the general subject of the legislation. The communication is presumed to be a grass roots lobbying communication. The presumption can be rebutted if the National Organization for Motherhood could show that it had placed this same ad weekly regardless of the pending vote and the placement of the advertisement was unrelated to the pending vote.

#### **C. Activities Excluded from Lobbying**

The following activities are excluded from lobbying expenditure limitations for the organization that makes a Section 501(h) election:

- Contacts with government officials in support of or opposition to proposed *regulations*.
- Lobbying by organization volunteers is only counted against the lobbying expenditure limitations to the extent that the organization incurs expenses.
- An organization’s communication to its members is not lobbying as long as the organization does not encourage its members or others to lobby.
- A nonprofit’s response to written requests from a *legislative body* for technical advice on pending legislation is not lobbying.
- Expenditures on lobbying legislators regarding matters that affect the organization’s existence, powers, or tax-exempt status are not counted for the purpose of lobbying expenditure limitations.

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<sup>18</sup> See Section XIII of this outline covering the internet for a discussion of whether publication on the internet is mass media publication.

- Making available the results of nonpartisan analysis, study, or research on a legislative issue that presents a sufficiently full and fair exposition of the pertinent facts to enable the audience to form an independent opinion does not fall within the ambit of lobbying.
- An organization's discussion of broad social, economic, and similar policy issues for which resolution would require legislation is not considered lobbying so long as the discussion does not address the merits of specific legislation.<sup>19</sup>

#### **D. Recordkeeping Requirements<sup>20</sup>**

An organization that makes a 501(h) election must keep a record of its direct and grass roots lobbying expenditures for the tax year. The required records include the following:

1. amounts directly paid or incurred for direct and for grassroots lobbying;
2. the portion of amounts paid or incurred as current or deferred compensation for an employee's services for direct and for grassroots lobbying;
3. amounts paid for out-of-pocket expenditures incurred on behalf of the organization and for direct and for grassroots lobbying, whether or not incurred by an employee;
4. the allocable portion of administrative, overhead and other general expenditures attributable to direct and to grass roots lobbying; and
5. expenditures for publications, or for communications with members, to the extent the expenditures are treated as direct or as grass roots lobbying under the rules regarding membership communications.

#### **E. Allocation of Expenses**

There are fairly complex rules for allocating expenses among *mixed purpose* expenditures, which are expenditures on a single communication with both lobbying and nonlobbying purposes and *mixed lobbying* expenditures, which are those expenditures on both direct and grassroots lobbying communications. If the organization is making communications that include both direct and grassroots lobbying and making communications that include both lobbying and nonlobbying, it must devise a reasonable method of allocating the expenses to each category. For example, if the organization's administrative staff person works on a single communication that has both nonlobbying, direct lobbying, and grassroots lobbying elements, that staff person should allocate some of his/her time to all three categories.<sup>21</sup>

#### **F. Practical Suggestions**

1. Do not engage in any political campaigning.
  - If your organization plans on conducting any lobbying, make a section 501(h) election and keep clear records of your lobbying expenditures. By making a 501(h) election your organization will have certainty about how much lobbying it can engage in and any activities that do not cost the organization money, such as lobbying by volunteers, will not count against the lobbying limitation. Finally, if the

<sup>19</sup> Most of these exceptions were taken from "The Nonprofit Lobbying Guide," 2nd. Ed., Bob Smucker. This book and more detailed information about lobbying by nonprofits is available at <http://www.independentsector.org/clpi/index.html>.

<sup>20</sup> Treas. Reg. § 56.4911-6.

<sup>21</sup> A complete explanation of the allocation regulations is beyond the scope of this article and a tax advisor should be consulted for more information.

organization does exceed the lobbying limitations, sanctions are imposed first rather than revocation of exempt status.

- Allocate your expenses among direct lobbying, grassroots lobbying, and nonlobbying communications in a reasonable manner.
- Urge your members to contact their legislators, which will be considered direct lobbying, rather than grassroots lobbying, and subject to the higher lobbying expenditure limitations.

#### **G. Lobbying and Political Campaign Activities of Section 501(c)(4) and 501(c)(6) Organizations**

A Section 501(c)(6) organization may engage in lobbying as its primary activity without jeopardizing its tax exempt status. However, if the organization engages in lobbying it may be required to provide notice to its members regarding the percentage of their dues paid that are applicable to lobbying activities and hence not deductible as a business expense or the organization will be required to pay a proxy tax. Section 501(c)(6) organizations may also engage in some political activities. However, they will be subject to federal taxation on such activities under section 527(f) of the Code.

A Section 501(c)(4) organization may engage in lobbying activities and often such organizations are formed to do just that. Often a 501(c)(3) organization will form an affiliate 501(c)(4) organization to conduct the lobbying activities that are important to the 501(c)(3) and thereby avoid having to deal with the lobbying restrictions placed upon Section 501(c)(3) organizations. However, a 501(c)(3) organization that has lost its exempt status due to substantial lobbying activities may not then re-file for exemption under Section 501(c)(4). Again, as with 501(c)(6) organizations, the 501(c)(4) organization may have to notify its members regarding the percentage of their dues paid that are applicable to lobbying activities and hence not deductible as a business expense or the organization will be required to pay a proxy tax. Similarly, Section 501(c)(4) organizations may also engage in some political activities. However, they will be subject to federal taxation on such activities under Section 527(f) of the Code.

#### **H. Bibliography**

<http://www.independentsector.org/clpi/index.html> – This website provides a wealth of information on lobbying and political activities including: Bob Smucker, “The Nonprofit Lobbying Guide,” 2nd Ed and a copy of the IRS lobbying letter mailed to nonprofits answering nine common question regarding lobbying activities.

<http://www.afj.org/eadvocacy/index.htm> - Elizabeth Kingsley, Gail Harmon, John Pomeranz, & Kay Guinane, “E-Advocacy for Nonprofits: The Law of Lobbying and Election Related Activity on the Net.” Also see [www.afj.org](http://www.afj.org) for the nonprofit advocacy project and other publications and information.

<http://www.ombwatch.org/las/> - Let America Speak!

## Section V. Intermediate Sanctions<sup>22</sup>

Section 501(c)(3) prohibits insiders from benefiting improperly from transactions involving charities. Until 1996, however, the IRS had only one remedy for public charity insider transactions: revoking the tax-exempt charitable status of the EO involved. Unfortunately, this remedy deprived the community of any benefit it may have received from the EO's activities, without reaching those who took advantage of their insider status to benefit improperly. Section 4958 of the Code (so called intermediate sanctions), adopted in 1996, allows the IRS to penalize those improperly benefiting from a public charity, without penalizing the public as well.

### A. General<sup>23</sup>

Section 4958 imposes penalty taxes any time an "applicable tax-exempt organization" – that is, a Section 501(c)(3) charity that is not a private foundation, a Section 501(c)(4) social welfare organization, or an organization that would be described in either of those categories – pays an excess benefit to any person or organization that fits the definition of a disqualified person (defined below). These taxes do not apply to Section 501(c)(6) organizations. The taxes involved are paid by the disqualified person and by "organization managers" (officers, directors, trustees and other persons in the organization with similar powers or responsibilities) who knowingly approve or otherwise participate in the excess benefit transaction.

### B. Excess Benefit Transactions

If an EO has directly or indirectly conferred an economic benefit on a disqualified person (as defined below) that exceeds the value of what the EO received in return, an excess benefit transaction has occurred. Compensation must be reasonable under all circumstances, i.e., only what would ordinarily be paid for like services by like enterprises under like circumstances. Compensation, employee benefits, and property transfers are likely to be the most common excess benefit transactions.

Excess benefits may also arise from revenue-sharing transactions, in which an economic benefit to a disqualified person is linked to the EO's revenues from a particular activity, if the disqualified person may receive additional compensation without proportional benefit to the EO. A revenue-sharing transaction will be an excess benefit transaction if it is structured so that the disqualified person benefits whether or not the arrangement is productive for the EO.

### C. Disqualified Persons

A disqualified person is any person or organization that was in a position to exercise substantial influence over the affairs of the organization at any time during the five years ending on the date of the transaction in question. (There is no "qualified person" category). People and organizations that are deemed to have substantial influence include voting members of the EO's governing body; the president, chief executive officer, chief operating officer, treasurer and chief financial officer or anyone holding those powers or responsibilities, regardless of title; family members of a disqualified person; and an entity in which disqualified persons hold more than 35 percent of the control (i.e., voting power in the case of a corporation, profits interest in the case of a partnership, or beneficial interest in the case of a trust). Individuals and entities that do not fall into any of these categories may nevertheless be disqualified persons if the fact and circumstances show that they are in a position to exercise substantial influence. A person may be in such an influential position if the person:

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<sup>22</sup> Portions of this outline are being reproduced from *The Rules of The Road, A Guide to the Law of Charities in the United States* by Betsy Buchalter Adler and produced by the Council of Foundations. The remaining portions were written by Shannon Nash.

<sup>23</sup> See Treas. Reg. Sections 53.4958-1 through 53.4958-8 for the various rules discussed herein regarding intermediate sanctions.

- founded the EO,
- is a substantial contributor,
- is compensated on the basis of revenues derived from activities of the EO that the person controls,
- has authority to control or determine a significant portion of the EO's capital expenditures, operating budget or employee compensation,
- has managerial authority or is a key advisor to someone who does, or
- owns a controlling interest in a corporation, partnership or trust that is a disqualified person.

#### **D. Presumption of Reasonableness**

Ordinarily, the burden of proof in a tax dispute is on the taxpayer, because the taxpayer has unlimited access to its own records. This means that the EO and the disqualified person would have to prove that the transaction is reasonable. An EO may shift the burden of proof to the IRS—that is, it may force the IRS to demonstrate that a transaction is not reasonable—if the following three requirements are satisfied:

- the transaction is approved by the EO's governing body, or a committee of the governing body, and no member of the board or committee has a conflict of interest with respect to the transaction,
- the governing body or committee obtains and relies on appropriate data on comparability before approving the transaction, and
- the governing body or committee adequately documents the basis for its determination, concurrently with making the determination.

#### **E. Decisionmaking Body**

The IRS recognizes that a board is likely to include persons with a potential conflict of interest and that state corporate law may require board approval of particular transactions. If a director with a conflict of interest regarding a particular transaction meets with the other directors only to answer questions and otherwise leaves the room and does not participate in the debate or vote on the transaction, that director is not considered a member of the governing body for purposes of Section 4958. Thus, a board with one or more interested directors may invoke the presumption of reasonableness by following this procedure. This provision is stricter than the laws of most states dealing with conflicts of interests, which generally require an interested director to abstain from voting but do not expressly require the director to leave the room during the debate and the vote.

#### **F. Appropriate Data**

A board or committee has appropriate data on comparability “if, given the knowledge and expertise of its members, it has information sufficient to determine” whether the transaction is reasonable. Examples of appropriate data include:

- compensation paid by similar organizations, both taxable and tax-exempt, for “functionally comparable positions,”
- information on whether similar services are available in the EO's geographic area,

- “independent compensation surveys compiled by independent firms,”
- actual written jobs offers from similar institutions competing for the person in question, and
- independent appraisals of the value of property involved in the transaction.

EOs with annual gross receipts of less than \$1 million may avail themselves of a safe harbor designed to enable them to avoid the significant expense of commissioning an independent salary survey. The board or committee is considered to have obtained appropriate data if it gathers compensation data from three comparable organizations in similar communities for similar services.

#### **G. Adequate Documentation**

To benefit from the presumption of reasonableness, the EO must document its decision concurrently; it is not possible to gain the presumption of reasonableness retroactively. At a minimum the documentation should include:

- records of the decision and the date approved,
- who participated in the debate and voted in the decision,
- what information the directors relied on and how it was obtained, and
- records of the actions of interested directors or others having a conflict of interest.

The documentation must be prepared by the next meeting of the approving body after the meeting where final action is taken (or 60 days after the final actions of the approving body). Moreover, the body must approve them as “reasonable, accurate and complete within a reasonable time period thereafter.”

#### **H. Failing the Rebuttable Presumption**

Some EOs will not be able to qualify for the rebuttal presumption of reasonableness. Fortunately, the IRS has made it clear that this is not fatal. Failing to qualify for the presumption does not create an inference that the transaction is an excess benefit transaction. It simply means that the EO must prove to the IRS, if questioned, that the transaction was reasonable.

#### **I. Penalties for Violation**

Section 4958 penalizes the wrongdoers, not the organization. A disqualified person who receives an excess benefit is subject to a tax equal to 25 percent of the excess benefit amount. If the disqualified person does not correct the excess benefit transaction promptly, there is an additional tax of 200 percent of the excess benefit amount. In addition, any “organization manager” (a director, officer, trustee or other person with similar responsibilities or powers) who knowingly approves or otherwise participates in an excess benefit transaction is subject to a tax of 10 percent of the excess benefit amount, up to a total tax of \$10,000 per transaction. However, organization managers who relied on a reasoned written opinion of legal counsel, an opinion of an accountant, or the opinion of certain valuation experts, in approving a transaction are not subject to this tax, even if the transaction later proves to have been excessive.

#### **J. Practical Guidance**

Steve Miller, the Director of the IRS Exempt Organization’s Division, has written a helpful explanation of the intermediate sanction rules as they apply to using the rebuttable presumption to determine reasonable compensation. A copy of Mr. Miller’s suggestions may be obtained in their entirety on line (see the website link below under the bibliography section). Mr. Miller provides a rebuttable presumption checklist

that can be used by directors when they are attempting to satisfy the rebuttable presumption. Although Mr. Miller's checklist only applies to compensation arrangements that may be deemed excess benefit transactions, a similar checklist can be used for other types of transactions (i.e., property transaction between the EO and a disqualified person).

**K. Bibliography**

<http://www.nptimes.com/sanctions.pdf> – A copy of the final intermediate sanction regulations, as published in the Federal Register, can be found on this website. The regulations became effective January 23, 2002.

<http://www.irs.ustreas.gov/pub/irs-utl/m4958a2.pdf> – A free copy of Steve Miller's practical suggestions for intermediate sanction rules may be obtained from this website.

<http://cof.org> – Council on Foundations website for information on obtaining The Rules of The Road, A Guide to the Law of Charities in the United States by Betsy Buchalter Adler

## Section VI. Employment Issues<sup>24</sup>

This Section will provide an overview of the various employment concerns that face a small exempt organization. It is not meant to be in depth description of the various employment and benefits issues that may arise. When faced with complex issues competent advisors should be obtained. The section will cover:

- the differences between employees and independent contractors,
- employee and volunteer liability issues,
- payroll and withholding taxes,
- a brief overview of employee benefits
- and an example of standard employment policies found in human resource manuals.

Determining reasonable compensation for employees will be covered in Section V of the outline.

### A. Employee v. Independent Contractor

Every organization must make the basic decision – will its operations be run by employees, independent contractors or a combination of both. The answer may make a big difference on the type of taxes that the organization pays and the type of benefits that it will offer. Many small EOs will have a few employees. Others may only be able to hire independent contractors.

People such as lawyers, contractors, subcontractors, public stenographers, and auctioneers who follow an independent trade, business, or profession in which they offer their services to the public, are generally not employees. However, whether such people are employees or independent contractors depends on the facts in each case. The general rule is that an individual is an independent contractor if the payer has the right to control or direct only the result of the work and not the means and methods of accomplishing the result.

The following is a list of factors used by the IRS in determining whether a given worker is an “employee” or an “independent contractor.” However, the final determination is made on a case-by-case basis.

#### 1. 20 Factor Test:

1. Instructions: An employee must comply with instructions about when, where and how to work. Even if no instructions are given, the control factor is present if the employer has the right to control how the work results are achieved.
2. Training: An employee may be trained to perform services in a particular manner. Independent contractors ordinarily use their own methods and receive no training from the EO.
3. Integration: An employee’s services are usually integrated into the business operations because the services are important to the success or continuation of the business. This shows that the employee is subject to direction and control.

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<sup>24</sup> This section was prepared by Diana Salmann, Shannon Nash, Darius Bolling and Jeannie Carmedelle Frey.

4. Services rendered personally: An employee renders services personally. This shows that the employer is interested in the methods as well as the results.
5. Hiring assistants: An employee works for an employer who hires, supervises and pays workers. An independent contractor can hire, supervise and pay assistants under a contract that requires him or her to provide materials and labor and to be responsible only for the result.
6. Continuing relationship: An employee has a continuing relationship with an employer. A continuing relationship may exist even if work is performed at recurring although irregular intervals. The independent contractors relationship is determined under the terms of the contract. It usually ends when the services covered under the contract are deemed completed.
7. Set hours of work: An employee usually has set hours of work established by an employer. An independent contractor generally can set his or her own work hours.
8. Full-time required: An employee may be required to work or be available full-time. This indicates control by the employer. An independent contractor can work when and for whom he chooses.
9. Work done on premises: An employee usually works on the premises of an employer, or works on a route or at a location designated by an employer.
10. Order or sequence set: An employee may be required to perform services in the order or sequence set by an employer. This shows that the employee is subject to direction and control.
11. Reports: An employee may be required to submit reports to an employer. This shows that the employer maintains a degree of control.
12. Payments: An employee is paid by the hour, week or month. An independent contractor is usually paid by the job or on a straight commission.
13. Expenses: An employee's business and travel expenses are generally paid by an employer. This shows that the employee is subject to regulation and control.
14. Tools and materials: An employee is normally furnished significant tools, materials and other equipment by an employer.
15. Investment: An independent contractor has a significant investment in the facilities he or she uses in performing services for someone else.
16. Profit or loss: An independent contractor can make a profit or suffer a loss.
17. Works for more than one person or firm: An independent contractor is generally free to provide his or her services to two or more unrelated persons or firms at the same time.
18. Offers services to the general public: An independent contractor makes his or her services available to the general public.
19. Right to fire: An employee can be fired by an employer. An independent contractor cannot be fired so long as he or she produces a result that meets the specifications of the contract.

20. Right to quit: An employee can quit his or her job without at any time incurring liability. An independent contractor usually agrees to complete a specific job and is responsible for its satisfactory completion, or is legally obligated to make good for failure to complete it.

## **2. Form SS-8**

Determination of employment status may be made by the IRS on Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding, with the IRS. Note that it not an anonymous form and once filed it becomes a part of IRS records.

## **3. Practical Suggestions**

Small Eos generally require a lot of administrative support (i.e., secretaries or assistants) for day to day activities. They also often require professional help such as lawyers and accountants or fundraisers. The individuals running the day to day activities are generally employees (regardless of whether or not they are full-time or part-time). The other individuals that provide a professional service are typically independent contractors. The board of directors are typically unpaid volunteers and thus are neither employees or independent contractors. Officers may or may not be compensated. If they are compensated they will generally be deemed employees. In most instances the executive director will also be an employee.

### **B. Employee and Volunteer Liability**

A significant percentage of lawsuits against nonprofit organizations relate to the activities of employees or volunteers. Directors of nonprofits may also be named as defendants in such suits.

A nonprofit corporation may be liable for employee or volunteer activities in two ways: (1) claims by third parties relating to acts or omissions of an employee or volunteers; and (2) claims by an employee or volunteer against the nonprofit organization.

#### **1. Claims of Harm to Third Parties**

An EO may be sued – or complained to – about the actions of employees or volunteers who have allegedly caused harm to third persons. For example, employees or volunteers operating motor vehicles (whether their own or the corporation's) for corporation purposes, or dealing with children, the elderly or other members of the public, may be charged with wrongdoing that is attributed to the corporation. In such circumstances, the employee or volunteer is viewed as the corporation's agent, and the corporation may be held liable for the agent's action. The corporation may be charged with direct liability for negligence in hiring or supervising an employee or volunteer.

#### **2. Claims by Employees or Volunteers Against the Corporation**

An EO also be sued by its own employees or volunteers, based on alleged wrongdoing of the EO itself or of other employee/volunteer agents of the corporation.

All corporations, whether for-profit or nonprofit, are subject to a host of laws related to employees. Some such laws also apply to volunteers. Many employment-related laws only apply if the corporation employs a certain minimum number of employees (often, 15 is the "magic number"). Such laws include the following:

1. Pregnancy Discrimination Act (covers discrimination based on pregnancy or childbirth);
2. Americans with Disabilities Act (covers discrimination based on disability);
3. Age Discrimination in Employment Act (covers discrimination against employees over 40 years old);

4. Equal Pay Act (covers discrimination in compensation based on gender);
5. Title VII, Civil Rights Act of 1963 (covers discrimination based on race, gender, national origin and religion; includes prohibition on sexual harassment as part of prohibition on gender discrimination; religious-based corporations are exempt from certain religious-based discrimination rules);
6. Family and Medical Leave Act (requires employers to provide eligible employees up to 12 weeks of unpaid leave for childbirth, adoption, care of an immediate family member or an employee's own serious health condition);
7. Occupational Health and Safety Act (requires compliance with mandatory safety and health standards);
8. Fair Labor Standards Act (requires payment of federal minimum wage and overtime pay for non-exempt employees working over 40 hours in one week);
9. Tax Withholding and Payroll Tax Laws (federal, state and local); and
10. Immigration Reform and Control Act of 1986 (prohibits employment of unauthorized aliens).

**C. Payroll/ Withholding Tax Issues<sup>25</sup>**

**1. Employees**

Although EOs are themselves exempt from income tax on their operations, they do have to withhold income tax (federal and state) from the pay of their employees. They also generally (with a few exceptions) have to withhold other payroll taxes such as social security, Medicare (Medicare and social security together are called FICA taxes). Federal unemployment (FUTA) and State unemployment (SUTA), though not withheld, must be by the employer and is typically paid on the first \$9,000 of wages. Thus, FUTA and SUTA are expenses borne completely by the employer. Also, employer's are subject to a FICA tax match, which is due for all FICA tax withheld from employees to cover Medicare and social security taxes.

**Income tax**

The income tax is withheld from the wages of employees by the employer. The amount withheld is based on the number of exemptions claimed on the employee's Form W-4. This employment tax is withheld on many benefits in addition to wages paid.

**FICA — Federal Insurance Contributions Act — Social Security tax and Medicare tax.**

FICA is a federal system of old age, survivors, disability and hospital insurance. The employer collects and pays the employee's part of these taxes. The employer must also pay a matching amount from its own funds. As of 1992-93 the rate for social security is 6.2 percent each for the employee and the employer (12.4 percent total). The tax rate for Medicare is 1.45 percent each for employers and employees (2.9 percent total).

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<sup>25</sup> This Section does not cover the various rules and exemptions from withholding requirements for certain churches and religious organizations. Please consult IRS Publication 1828 for more information.

## **FUTA — Federal Unemployment Tax.**

Federal unemployment tax applies to all employees and is paid by the employer on Form 940.

## **SUTA – State Unemployment Tax**

State unemployment tax varies from state to state but generally provides for a credit when federal unemployment tax is paid. Thus, if the employer does not pay FUTA, the amount of SUTA paid will be higher.

## **2. Independent Contractors**

Employers do not generally have to withhold or pay any taxes on payments to independent contractors. Independent contractors must pay their own ordinary federal and state income taxes, FUTA taxes, SUTA taxes and FICA taxes. Self-employed independent contractors also must estimate their individual income taxes for each year, then pay a quarter of the estimated amount owed to the federal and state government.

Independent contractors are required to fill out Form W-9, noting their name and address, social security or federal identification number (FEIN number). This form must be kept in the employer's files throughout the duration of the independent contractor's service. Independent contractors receive a Form 1099MISC at the end of the year. Like the Form W-2, this form reports to the IRS the amounts paid, but in the case of the report on Form 1099MISC there is no tax withheld. Form 1099MISC is required for payments over \$600 per year, to individuals, partnerships, and other unincorporated entities. However, independent contractor, unlike employees, have the ability to deduct from gross income all legitimate business expenses including personal and fringe benefits. Form 1099MISC must be sent to the independent contractors by January 31<sup>st</sup> of the year after the tax year in questions. Failure to do this may result in penalties to the employer.

## **D. Employee Benefits**

In additions to the salary paid to employees, the small EO must be concerned about what benefits it will provide to its employees (independent contractors do not get these benefits). Some possible benefits may include:

- Health Care
- Retirement/Pension Plans
- Insurance (Life, Accidental, Supplemental)
- Short and Long Term Disability

## **E. Human Resource Policies**

EOs should also adopt get human resource manual covering various policies and procedures that apply to employees. The following is an example of various policies described in one EO's human resource manual.

### **Vacation Time**

- a. All full-time employees shall accrue vacation at the rate of 1 day per month, 12 days per year total. All part-time employees shall accrue vacation at the rate equal to the percentage of full-time that each employee works. This time may be taken at the employees' discretion with the approval of the immediate supervisor. Employees are expected to take time off for vacation rather than receive payment instead of time off. If an observed holiday occurs during the vacation leave, an additional day of vacation shall

be granted. Part-time employees who work less than 20 hours per week are not entitled to paid vacation time.

- b. After three years of service at the EO, all full-time employees accrue vacation at the rate of 1.25 days per full month worked, for a total of 15 days per year. After three years of service at the EO, all part-time employees accrue vacation at the rate equal to the percentage of full-time that each employee works.
- c. All employees shall be entitled to vacation only after completion of their probationary period. Vacation time must be taken in the year in which it is earned or can be accrued up to two year's credit. Employees may elect to receive vacation pay for up to five days of unused vacation per year.
- d. Prior to beginning any vacation leave, the employee shall determine the tasks to be completed, complete them and participate in arrangements for coverage of ongoing work during vacation leave.

**Holidays**

The EO shall observe the following holidays:

- 1. New Year's Day
- 2. Martin Luther King Jr's Birthday
- 3. President's Day
- 4. Memorial Day
- 5. Independence Day
- 6. Labor Day
- 7. Thanksgiving Day
- 8. Thanksgiving Friday
- 9. Christmas Day

If the holiday falls on Saturday it will be observed on Friday. If the holiday falls on Sunday it will be observed on Monday.

**Sick Leave**

All full-time employees shall be entitled to earn sick leave at a rate of one day per month, (twelve days per year). Employees are able to accrue any unused sick days beyond each anniversary year up to a maximum of 50 days. Accumulated sick leave shall not be used as additional vacation time. Part-time employees who work at least 20 hours per week will be entitled to earn sick leave at a rate of 1/2 day per month (six days per year). Upon employment, employees are entitled to use sick leave as it accrues. For absences of more than three days or recurrent absences, a physician's statement is required. Unused sick leave is forfeited at the time of termination, however, two bonus days will be granted if no sick leave was requested or taken during the previous twelve month period. Any employee taking a sick day must notify the office at the beginning of the work day. If an employee is absent from work due to personal illness and there is insufficient sick leave accumulated to enable regular payment of salary, the time may be charged to other leave categories such as vacation, compensatory time, personal business day, etc., provided the employee is eligible for such leave.

**Personal Leave**

All full-time employees shall be granted two personal leave days per contract year. Personal leave days shall not be accumulated and must be taken in the year earned.

### **Family Death Leave**

In case of serious illness or death in the immediate family of the employee, spouse, parents, parents-in-law, brother, sister, child, grandparents, the supervisor can authorize a maximum of three days leave with pay.

### **Jury Duty**

In the event that an employee is called for jury duty or for service as a witness in a court of law, EO shall pay the regular salary of the employee. The employee is required to turn into the EO the pay received for jury duty or services as a witness. An employee is expected to report to work if jury duty or services as a witness does not require full-time service. Sick time and vacation days continue to accrue during jury duty leave.

### **Medical Leave**

Full-time employees shall be granted medical leave, with a letter from the employee's physician, provided that such leave does not exceed one month in length. The employee may elect to use all accrued sick, vacation and compensatory time at the commencement of this leave. Vacation and sick leave shall accrue during such leaves. The employee may return to the previously held position or a comparable position at the end of this leave.

### **Family Leave**

Employees eligible under the Family and Medical Leave Act (effective August 5, 1993) are entitled to up to 12 workweeks of unpaid leave, under the terms of the Family and Medical Leave Act.

### **Other Leaves of Absence**

The employee may take other leaves up to six months maximum (i.e., education, etc.) upon permission from the Executive Director or in the case of the Executive Director, the Board of Directors. Vacation and sick leave will not be accrued at this time. The staff member's position will not be filled during his/her leave of absence, although temporary arrangements may be made to cover the workload. The employee may return to the previously held position or a comparable position at the end of this leave. To be eligible for a leave of absence, the employee must have completed a minimum of two year's service with the EO. The staff may continue membership with the EO's group plan for medical care and life insurance, but at his/her own expense. Payments to Social Security, Worker's Compensation and Unemployment Compensation will be suspended because taxable wages are not being paid during the leave of absence.

Paternity leave may be given to an employee after the birth of their child or after adopting a child. Education leave may be given to an employee to attend classes to further their education.

## **F. Bibliography**

[http://www.irs.ustreas.gov/prod/forms\\_pubs/index.html](http://www.irs.ustreas.gov/prod/forms_pubs/index.html) - IRS publications and forms, including Publication 505, *Tax Withholding and Estimated Tax*; Form SS-8, *Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding*; Publication 15, *Employer's Tax Guide*, Publication 1976, *Employee or Independent Contractor*; Form W-2, *Wage and Tax statement*; Form W-9, *Request for Taxpayer Identification Number*; and Form 1099MISC, *Miscellaneous Income*.

<http://charitychannel.com/> - charityChannel provides an on-line professional community that exceeds 45,000 nonprofit-sector professionals. The site has many discussion forums on various topics of interests to EOs, including a human resources discussion forum called CharityHR.

<http://www.employers.gov> - This website is called Firstgov for Employers and is a joint effort among the Department of Labor, Internal Revenue Service, Small Business Administration, Social Security

Administration, Treasury, States, and Simplified Tax and Wage Reporting System. The site provides resources and cross-agency information for employers, as well as new and established businesses. It provides helpful information on hiring employees, including links to forms and explanations of payroll taxes.

[www.noacentral.org](http://www.noacentral.org). National Organizers Alliance, a non-profit group with 1,000 members that represents the interests of people who work in “social justice “ fields as disparate as homelessness, race relations, the environment, and labor activism. NAO formed a coalition in 1992 to form a joint pension plan for many small nonprofit organizations that could not afford to do so on their own. Non-profit organizations that join must contribute at least 5 per cent of employees’ total annual salary to the retirement plan, and workers must have at least one year’s employment at a social-justice organization to be eligible.

<http://www.deathandtaxes.com/pub1828.htm> - Tax Guide for Churches and Other Religious Organizations (not yet issued by the IRS)

Guidebook for Directors of Nonprofit Corporations, Chapter 7, “Volunteers” and Chapter 8, “Employees” (2<sup>nd</sup> ed., G. Overton and J. Frey, eds., American Bar Association 2002).

## Section VII. UBTI<sup>26</sup>

EOs are, by definition, exempt from income tax. This is true for donations and revenues from the performance of exempt functions—that is, from conducting the activities for which the entity was organized. Revenues from other sources, however, are income from the conduct of an unrelated trade or business, and they are subject to tax under Sections 511 through 514 of the Code unless they are specifically excluded from taxation by law. This tax is known as the unrelated business income tax.

The unrelated business income tax rules focus on the activity that generates the income, not on how the EO uses the income. A section 501(c)(3) charity that operates a restaurant in order to teach job skills to homeless and unemployed people, for example, is not taxed on any income generated by the restaurant, because the activity itself serves a charitable purpose entirely apart from how the income is used. However, a section 501(c)(3) charity that operates a restaurant only to generate income for its other charitable activities is taxed on that income. This is true even though the income in the second example was applied exclusively to charitable purposes.

The unrelated business income tax rules contain numerous exceptions and exclusions. This chapter focuses first on the general rules and then on the exceptions.

### A. General Rules And Definitions

Section 512 of the Code defines unrelated business taxable income in language that is almost as convoluted as the definition of a charitable organization under Section 501(c)(3). Put more simply, unrelated business taxable income is the gross income (less allowable deductions) that an EO derives from any activity that is (1) a trade or business, (2) regularly carried on by the EO, and (3) not directly causally related to achieving the EO's exempt purposes. For the income to be taxed, all three elements must be present. Thus, if the trade or business is regularly carried on but its conduct is related to the organization's exempt purposes, as with the restaurant example, the income from that activity is not taxed. Similarly, an unrelated trade or business that is not regularly carried on (such as a food booth at a county fair, operated one week per year) will not generate taxable income. It is, therefore, important to understand the elements of the definition.

#### 1. Trade or Business

For this discussion, a trade or business is an activity that involves the sale of goods or services to produce income. It is not necessary to compete with for-profit enterprises, although the existence of competition is likely to influence the IRS or a reviewing court; the key is whether the EO conducted the activity with the intent to make a profit.

#### 2. Regularly Carried On

An activity is “regularly carried on” by an EO if it is conducted with the same frequency and continuity as if it were operated by a nonexempt organization. An EO that presents a concert by a popular performer once a year to raise money, for example, cannot be equated with an impresario who presents concerts year-round. Thus, the facts and circumstances are likely to be decisive in determining whether an activity is regularly carried on.

#### 3. Relationship to Exempt Purposes

If the conduct of a trade or business is substantially causally related to the achievement of the EO's exempt purposes, the income generated by that activity is not subject to taxation. The test focuses on the activity

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<sup>26</sup> Portions of this outline are being reproduced from “The Rules of The Road, A Guide to the Law of Charities in the United States” by Betsy Buchalter Adler and produced by the Council of Foundations. The remaining portions were written by Shannon Nash.

itself, not on how the EO uses the income. The fact that all proceeds are used to support exempt-purpose activities does not make an unrelated activity into a related activity.

What, then, qualifies as related? In practice, if the actual conduct of the activity makes an important nonfinancial contribution to the nonprofit's exempt-purpose program, the IRS will consider the activity related, and the income that it generates is tax-free. This means that the facts and circumstances determine the result. Consider these examples:

- An art museum uses its auditorium during regular hours for lectures on art history. In the evening its shows films of general interest. Admission fees for the film series are income from an unrelated business.
- The museum store sells reproductions of works of art, some from its own collection and some from other similar collections. The museum store also sells jewelry and recorded music. Income from the sale of reproductions and similar items is considered related because it educates the public about art of the type presented at the museum, but the jewelry and music do not accomplish the goal. Therefore, income from the sale of those items is taxable.

## **B. Debt-Financed Income**

EOs, like other entities, sometimes borrow money to acquire income-producing property. They may also receive encumbered property through a gift or bequest. Section 514 of the Code provides that income from debt-financed property is taxable in the proportion that the EO's acquisition indebtedness bears to its equity in the property. The taxable proportion of the income diminishes as the debt is paid off. If the property is sold while indebtedness remains, however, the capital gains on the property are taxed proportionately.<sup>27</sup> Please note that these rules override the exceptions, modifications and exclusions discussed below. Thus, rental income that would otherwise be excluded from tax is taxable in part if the rental property is debt-financed.

### **1. Sales of Merchandise or Goods**

EOs that sell goods or merchandise may be subject to UBTI on the income derived from such activity. The IRS uses an item by item analysis. Items that are related to the EO's exempt purposes will not be subject to UBTI (i.e., an arts organization that sells reproductions of artistic works). However, certain convenience items such as (souvenirs, food, etc) may be subject to UBTI. Please note the sale of donated goods by the EO will not be subject to UBTI.

### **2. Advertising**

Advertising payments will generally be subject to UBTI. Advertising includes:

- Messages containing qualitative or comparative language, price information or other indications of savings or value,
- endorsements, or
- inducements to purchase, sell or use the sponsor's products or services.

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<sup>27</sup> The intricacies of the debt-financed income rules are beyond the scope of this outline and thus a competent tax adviser should be consulted for further questions.

Advertising does not include the use or the mere acknowledgment of a sponsor. Those payments are treated as corporate sponsorship and are discussed in more detail below. The use of promotional logos and slogans or the distribution or display of the sponsor's products (whether free or for remuneration) is also not considered advertising.

### **3. Associate Member Dues**

There is another category of income that may be subject to UBTI and is of particular concern for Section 501(c)(6) organizations. Associate member dues will be subject to UBTI where the principal purpose of such dues is to raise income for the EO. These associate members typically have very little in common with the regular members of the EO. Moreover, the benefits received by these associate members are typically very general in nature and have very little relationship to the purposes of the EO. For example, an EO that creates an associate membership category solely to allow these members to purchase insurance through the EO, will generally be subject to UBTI on these dues. Associate members dues will not be treated as UBTI if they are less than the annual limit, which is determined yearly. For 2000 the annual limit was \$112.

### **C. Exceptions and Exclusions**

Although some income-generating activities are clearly not related to accomplishing an EO's exempt purposes, they are nonetheless excluded from the definition of an unrelated trade or business. Income from these excluded activities is not subject to UBTI. The most frequently encountered exclusions apply to:

- any activity in which volunteers perform substantially all of the work;
- activities that are conducted primarily for the convenience of the organization's members; and
- the sale of donated merchandise.

Section 513 of the Code also contains special rules for the treatment of income from certain categories of the activities. Among these are the operation of trade shows, state fairs and conventions, the sale or exchange of mailing lists and the provision of "commercial-type" insurance.

Section 512(b) of the Code contains numerous modifications to the definition of unrelated business income. The modifications that EOs are most likely to encounter include investment income, royalties, and rent.

#### **1. Investment Income**

Dividends, interest, rents, royalties, capital gains and similar passive investment income are generally excluded from the reach of the unrelated business income tax except in two circumstances; if they are derived from debt-financed property, in which case the funds are partially taxable, or if they are paid by an organization controlled by the EO. Control, for this purpose, means a 50 percent interest.

#### **2. Royalties**

Section 512(b)(2) of the Code excludes "all royalties (including overriding royalties) whether measured by production or by gross or taxable income from the property and all deductions directly connected with such income." As with interest and annuities, royalties from debt-financed property or from controlled organizations are treated as unrelated business income.

In recent years, the IRS has begun to look closely at whether an exempt organization is being paid for the use of intellectual property (a tax-free royalty) or for services provided to another entity (a taxable fee for services). Payments for the use of an EO's mailing list have been the subject of much litigation, most recently in the context of affinity credit cards—that is, credit cards bearing the EO's logo and marketed by

the issuing bank to the EO's supporters through the EO's mailing list. The IRS continues to argue that unless the parties on both sides of the transaction are EOs, the transaction is not a tax-free royalty but a taxable payment for services. This is because, as the IRS sees it, the owner of the mailing list is actively involved in maintaining the list and, thus, providing services for which it is being paid.

This argument has not fared as well in court as the IRS would have liked. In several recent decisions, courts have ruled that bank payments to the Sierra Club (a Section 501(c)(4) organization) in connection with its participation in an affinity credit card program were payments for intangible intellectual property—that is, the Sierra Club's name, logo and mailing list—and, thus, tax-exempt royalties.<sup>28</sup> The IRS continues to argue that an EO's provision of any service in connection with a mailing list (such as sorting members' names by donation size or preparing mailing labels) converts the transaction from a tax-free royalty arrangement to a joint venture with a for-profit enterprise.

### **3. Rent**

Section 512(b)(3) of the Code excludes income received from the rental of real property (land and buildings). However, there are numerous exceptions to this general rule. If the rent is from a controlled organization, as discussed above, it is considered unrelated business income. If the rent is derived from debt-financed property, part of the rent is taxable. Income from the rent of personal property (such as office equipment or furniture) is taxable unless the personal property is leased with real property and the rent attributable to the personal property is no more than 10 percent of the total rent from all the property leased.

Rent may be based on a fixed percentage of sales or receipts. But if the rent amount depends wholly or partly on the income or profits derived by any person from the leased property, the rental income is taxable.

An EO's landlord may provide normal maintenance services. However, if the EO provides services beyond what landlord usually provide in the circumstances, the rent exception does not apply and the income is taxable. An EO's landlord may provide utilities, collect trash and clean public areas without rendering its rental income taxable, but provision of maid service with the rental of living quarters is beyond normal maintenance services and would subject the rents to the unrelated business income tax.

An EO's income-generating transactions can often be structured to avoid the unrelated business income tax. If no exception or modification applies, however, that does not necessarily mean that an EO should avoid the transaction. As long as the EO's exempt-purpose activities are commensurate with its income and its primary purpose remains the conduct of those activities, the receipt of taxable income from unrelated business activities will not imperil the EO's tax-exempt status.

### **4. Corporate Sponsorship**

Unlike advertising payments, qualified corporate sponsorship payments are not subject to UBTI. With these payments the sponsor does not receive a substantial benefit from the EO other than the use or acknowledgement of the sponsor's name, logo or product line.

#### **D. Calculating the Tax**

UBTI is taxable at regular corporate income tax rates. In calculating the amount of UBTI that an EO is taxable on, deductions directly connected with carrying on the unrelated trade or business may be taken. Thus, on its unrelated business taxable income, the EO is treated just like a regular corporate tax paying

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<sup>28</sup> *Sierra Club, Inc.*, 103 TC 307 (1994): affirmed in part, *Sierra Club, Inc. v. Commissioner*, 86 F.3d 1526 (9<sup>th</sup> Cir. 1996).

entity.<sup>29</sup> The UBTI tax is reported and paid on Form 990-T. See Section VIII of the outline for more information on Form. 990-T.

**E. Bibliography**

[http://www.irs.ustreas.gov/prod/forms\\_pubs/index.html](http://www.irs.ustreas.gov/prod/forms_pubs/index.html) - IRS Publication 598, *Tax on Unrelated Business Income of Exempt Organizations*.

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<sup>29</sup> The intricacies of corporate taxation are beyond the scope of this outline and thus a competent tax advisor should be consulted for further questions.

## Section VIII. Internal Revenue Service Form 990s<sup>30</sup>

This Section will provide an overview of the federal tax forms that EO's may be required to file.

### A. Form 990, Form 990-EZ and Form 990-PF

#### 1. General Filing Requirements

Every EO must file an annual information return on either:

- IRS Form 990, Return of Organization Exempt From Income Tax;
- IRS Form 990-EZ, Short Form Return of Organization Exempt From Income Tax; or
- IRS Form 990-PF, Return of Private Foundation or Section 4947(a)(1) Nonexempt Charitable Trust Treated as a Private Foundation.

#### 2. Organizations with Exemption Pending

An EO that claims to be exempt under Section 501(c)(3) but whose application on IRS Form 1023 has not yet been filed or is still pending must still file Form 990, Form 990-EZ or Form 990-PF, as the case may be, and may be subject to penalties for not doing so. If the EO's application is pending with the IRS, the EO should indicate this by checking the "application pending" box on page 1 of the applicable form.

#### 3. Exceptions for Small Exempt Organizations

A small EO (other than a private foundation) having annual gross receipts that normally are not more than \$25,000 will generally be exempt from filing a Form 990. An EO's annual gross receipts are considered to normally not be more than \$25,000 if:

- The EO is up to one-year old and has received, or donors have pledged to give, \$37,500 or less during its first taxable year;
- The EO is between 1 and 3 years-old and averaged \$30,000 or less in gross receipts during each of its first 2 taxable years; or
- The EO is 3 years-old or more and averaged \$25,000 or less in gross receipts for the immediately preceding 3 taxable years, including the year for which the return would be filed.

Gross receipts are equal to the total amount the EO received from all sources during its annual accounting period, without subtracting any costs or expenses.

An EO that normally receives annual gross receipts of \$25,000 or less should probably still file Form 990 or 990-EZ for the following reasons:

- The EO will most likely need to furnish copy of Form 990 or 990-EZ if it is applying for grants from other EOs, particularly private foundations.
- The EO may be required to or may be able to (depending on the particular state statute) use Form 990 or Form 990-EZ to satisfy certain annual state reporting requirements. See Section IX of this outline for the various annual state filing requirements.

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<sup>30</sup> This Section was prepared by Victoria Bjorklund and Jennifer Franklin

- The EO may need to file Form 990 or Form 990-EZ to be included in IRS Publication 78 and Guidestar's on-line database of EOs. (See bibliography below for a link to Guidestar's website which contains a database of all Section 501(c)(3) charities that submit Form 990 to the IRS and is often the starting point for a donor who is considering making contributions to an EO).

#### **4. Other Exceptions from Filing a Form 990**

The following EOs are also exempt from filing Form 990:

- Churches and church-affiliated organizations, including schools below college level and mission societies,
- State institutions whose income is excluded from gross income under Section 115,
- Corporations exempt under Section 501(c)(1) as corporations organized under an Act of Congress and instrumentalities of the United States,
- Foreign organizations described in Section 501(a) (other than private foundations) that normally do not receive more than \$25,000 in annual gross receipts from sources within the United States and have no significant activities in the United States.

#### **5. Which Form Must Be Filed?**

- Form 990: Used by EOs exempt from federal income taxation under Section 501(a), which have annual gross receipts that are normally more than \$25,000. EOs exempt under Section 501(c)(3) must also file Schedule A to Form 990. All EOs must file Schedule B to Form 990 to disclose the information regarding contributors that is required on Line 1(d) of Form 990, unless they certify that they do not meet the filing requirements of Schedule B by checking the box in Item L of the heading of the form.
- Form 990-EZ: Filed in lieu of Form 990 by EOs exempt from federal income taxation under Section 501(a) which have annual gross receipts of less than \$100,000 and total assets at the end of the taxable year of less than \$250,000. Again, EOs exempt under Section 501(c)(3) must also file Schedule A to Form 990-EZ. All EOs must file Schedule B to Form 990-EZ to disclose the information regarding contributors that is required on Line 1 of Form 990-EZ, unless they certify that they do not meet the filing requirements of Schedule B by checking the box in Item L of the heading of the form.
- Form 990-PF: Must be filed by all private foundations exempt from federal income taxation under Section 501(a), regardless of the amount of their annual gross receipts. How are gross receipts calculated for these purposes? An EO's gross receipts are equal to the total amount the EO received from all sources during its annual accounting period, without subtracting any costs or expenses.

#### **6. When and Where Should Form 990, Form 990-EZ or Form 990-PF Be Filed?**

**Time of Filing:** Form 990, Form 990-EZ or Form 990-PF must be filed by the 15<sup>th</sup> day of the fifth month after the EO's taxable year ends. If the regular due date falls on a Saturday, Sunday or legal holiday, the applicable form can be filed on the next business day.

**Extension of Time to File:** An EO can file IRS Form 8868, Application for Extension of Time to File Exempt Organization Return, to request an automatic 3-month extension of time to file Form 990, Form 990-EZ or Form 990-PF. An EO can use the same form (Form 8868) to request an additional (not automatic) extension of time to file by showing reasonable cause for the need for additional time.

Where to File: The applicable form should be mailed via either certified mail, return receipt requested or a private delivery service approved by the IRS to the Internal Revenue Service Center, Ogden, UT 84201-0027.

#### **7. What are the Penalties for Not Filing?**

An EO that is required to file Form 990, Form 990-EZ or Form 990-PF but fails to do so will be subject to a penalty of \$20/day for each day the failure continues, up to a maximum penalty (for any one annual information return) equal to the lesser of \$10,000 or 5% of the EO's gross receipts for the taxable year (plus interest). An EO that has gross receipts of over \$1 million for the taxable year but fails to file Form 990 or Form 990-PF will be subject to a penalty of \$100/day, up to a maximum of \$50,000 (plus interest).

#### **8. Reporting Excess Benefit Transactions**

Under the IRS's intermediate sanctions rules, organizations that are exempt under Code sections 501(c)(3) and 501(c)(4) must report on their Form 990s whether any excess benefit transaction involving a director, executive officer or other insider (a "disqualified person") occurred during the fiscal year covered by the Form 990.

### **B. Form 990-T, Exempt Organization Business Income Tax Return:**

#### **1. Who Must File IRS Form 990-T?**

Section 501(c)(3), 501(c)(4) and 501(c)(6) organizations that generate more than \$1000 in gross income from unrelated businesses (or UBTI) must file Form 990-T. See Section VII of this outline for more information on UBTI.

#### **2. When and Where is Form 990-T Filed?**

- **When To File:** Form 990-T must be filed by the 15<sup>th</sup> day of the fifth month after the EO's taxable year ends. If the regular due date falls on a Saturday, Sunday or legal holiday, Form 990-T can be filed on the next business day.
- **Extension of Time to File:** A corporation can file IRS Form 7004, Application for Automatic Extension of Time to File Corporation Income Tax Return, to request an automatic 6-month extension of time to file Form 990-T. A trust, on the other hand, may request an extension of time to file Form 990-T by filing IRS Form 2758, Application for Extension of Time to File Certain Excise, Income, Information and Other Returns, but such a request will not be automatically granted.
- **Where to File:** Form 990-T should be mailed via either certified mail, return receipt requested or a private delivery service approved by the IRS to the Internal Revenue Service Center, Ogden, UT 84201-0027.

#### **3. How is the Tax Calculated and How is it Paid?**

**Calculation of Tax:** An EO will be subject to federal income tax at regular graduated rates applicable to for-profit corporations on its "unrelated business income." See Section VII of this outline for a discussion of the unrelated business income tax.

#### **4. Estimated Tax Payments:**

An EO must make estimated tax payments if it expects its unrelated business income tax to be \$500 or more.

## 5. When Due:

Estimated tax payments are generally due by the 15<sup>th</sup> day of the fourth, sixth, ninth and twelfth month of the EO's taxable year. If the regular due date falls on a Saturday, Sunday or legal holiday, the payment will be due on the next business day.

## 6. How Calculated:

An EO can base its required estimated tax payments on 100% of the tax shown on its return for the preceding year (unless no tax was shown) but only if its taxable income for each of the three preceding taxable years was less than \$1 million. If an EO's taxable income for any of the preceding three years was \$1 million or more, the EO can base only its first required estimated tax payment on its tax for the prior year. An EO should use Form 990-W, Estimated Tax on Unrelated Business Taxable Income for Tax-Exempt Organizations, to calculate its estimated tax payments.

## 7. What are the Penalties for Not Filing?

**Penalty for Late Filing of Form 990-T:** An EO that fails to file its return when due is subject to a penalty of 5% of the unpaid tax for each month or part of a month the return is late, up to a maximum of 25% of the unpaid tax (plus interest). The penalty may be abated upon a showing of reasonable cause for the delay. The minimum penalty for a return that is more than 60 days late is the smaller of the tax due or \$100 (plus interest).

**Penalty for Late Payment of Tax:** Any tax due with Form 990-T must be paid in full when the form is filed, but no later than the date the return is due (determined without taking into account any extensions). An EO who does not pay its tax when due will be subject to a penalty of ½ of 1% of the unpaid tax for each month or part of a month the tax is unpaid, up to a maximum of 25% of the amount due (plus interest).

**Estimated Tax Penalty:** An EO that fails to make estimated tax payments when due may be subject to an underpayment penalty (plus interest). Generally, an EO will be subject to this penalty if its tax liability is \$500 or more and the EO did not make estimated tax payments of at least the smaller of the tax shown due on the return or 100% of the prior year's tax.

## C. Bibliography

<http://www.irs.gov/pub/irs-pdf/p557.pdf> - IRS Publication 557 *Tax Exempt Status for Your Organization*. IRS Publication 598, *Tax on Unrelated Business Income of Exempt Organizations*, Form 990, Form 990-EZ, Form 990-PF, Form 990T may all be found on this website.

<http://www.irs.gov/exempt/display/0,,i1%3D3%26genericId%3D6903,00.html> – IRS provides filing tips for Form 990.

<http://www.guidestar.org> -- Guide star has compiled a database of all 501(c)(3) charities that submit 990 forms to the IRS.

<http://www.wiley.com> - This website provides information on the following publications which are for sale: Jody Blazek, *Tax Planning and Compliance for Tax-Exempt Organizations: Forms, Checklists and Procedures*, John Wiley & Sons, Third Edition, 1999, Jody Blazek *990 Handbook: A Line-by-Line Approach*, John Wiley & Sons, 2000, Jody Blazek, *Tax Planning and Compliance for Tax-Exempt Organizations: Forms, Checklists and Procedures*, John Wiley & Sons, Third Edition, 1999.

<http://www.nonprofitfinancial.org> - Nonprofit Financial Center is a nonprofit financial resource organization formed to help nonprofit organizations develop sound financial management. NFC also gives loans to Illinois nonprofits and provides valuable links for Illinois nonprofits.

<http://www.990accountant.com> - A guide to form 990s and other IRS nonprofit related forms.

<http://www.qual990.org/links.htm> – This site provides information about the Form 990, nonprofit accountability, and other accounting/tax issues.

<http://www.form990.org> - This site is a prototype of an electronic or magnetic filing system that when enabled will allow the user to complete a Form 990 and submit it to the appropriate agencies. Additionally the site will enable the public to view any Form 990 on record. The form 990 will be a smart form and will signal the user when calculation, ratio, and omission errors are made.

## **Section IX. State Tax and Other Yearly Filings<sup>31</sup>**

### **A. State Taxes**

A nonprofit corporation may have to pay state income or other taxes if exemptions for such taxes are not obtained. An EO may be subject to taxes in more than one state depending on the nature of its activities and its location. For example, an EO located close to the border of another state may have this issue. This section gives a general overview of the state taxes that may apply to an EO.

#### **1. Income Tax**

Although the EO may be generally exempt from state income taxes, just as with its federal exemption, the EO will continue to be subject to taxation on any unrelated business income or UBTI. For more on UBTI please refer to section VII of this outline.

Whether income is unrelated business income for federal income tax purposes depends on whether the activity is “substantially related” to the organization’s exempt purposes and “contributes importantly” to the accomplishment of such purposes. In determining whether income should be treated as UBTI, all of the rules and exclusions discussion in Section VII of the outline continue to apply.

#### **2. Sales Tax**

The EO will be required to pay state sales taxes on its purchases if it did not file for exemption from state sales tax or if the exemption was denied. As with income tax, the state sales tax exemption may not apply to all of the EO’s activities, so even with an exemption, state sales tax may still apply on certain purchases.

#### **3. Property Tax**

An EO’s properties may or may not qualify for exemption from property tax (see the discussion in Section II of this outline), depending on the kind of activities engaged in, the kind of 501(c) organization, and the extent to which the property is used to further the organization’s exempt purposes). In some locations, continued property tax exemption may not be assured after a planned transfer to another EO, such as in a reorganization.

#### **4. Other Local Taxes and Assessments**

Some states and localities have local assessments and business licenses that apply to EOs. Also, as states’ tax bases erode, some states have begun to look for other ways to raise funds from EOs. For example in some areas, EOs are subject to special energy taxes (assessed on utility bills) or “head taxes” (based on number of employees).

### **B. Corporate Filings**

Annual/bi-annual corporate reports are usually filed with the Secretary of State, in a form prepared by the State. Such forms typically require identification of the current officers and directors, the organization’s principal location, and other general information. In some states, filing a copy of the organization’s Federal Form 990 may be required. There is generally a fee associated with this filing. Such annual or bi-annual corporate report forms are mailed to whomever is listed as the organization’s registered agent. The corporation should make sure that the person currently serving as its registered agent will complete such forms on a timely basis.

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<sup>31</sup> This section was prepared by Jeannie Carmedelle Frey and Shannon Nash

### **C. Charitable Solicitation Requirements**

As mentioned in Section II of the outline, the EO will also have a yearly filing responsibility to keep it's charitable solicitation license current.

### **D. Bibliography**

The following is a list of state agency (typically the Secretary of State or Attorney General's office) where EOs may find helpful information and links on these filing requirements.

<http://www.law.state.ak.us/consumer/charities.html> – Alaska Attorney's General Charity website

[http://www.sosaz.com/Business\\_Services/Charities.htm](http://www.sosaz.com/Business_Services/Charities.htm) – Arizona Secretary of State Charity website

<http://www.ago.state.al.us> -Alabama Attorney General website

<http://www.ag.state.ar.us> - Arkansas Attorney General website

<http://caag.state.ca.us/charities> - California Attorney General Charity website

<http://www.sos.state.co.us> – Colorado Secretary of State website

<http://www.cslib.org/attygen/mainlinks/tabindex8.htm> – Connecticut Attorney General website

<http://www.state.de.us/attgen> – Delaware Attorney General website

<http://www.dcpsc.org/index.html> – District of Columbia Public Service Commission

<http://legal.firn.edu> - Florida Attorney General website

<http://www.sos.state.ga.us> – Georgia Secretary of State website

<http://www.cpja.ag.state.hi.us> - Hawaii Attorney General website

<http://www2.state.id.us/ag> - Idaho Attorney General website

<http://www.ag.state.il.us/charitable/charity.html> – Illinois Attorney General charity website

<http://www.state.in.us/attorneygeneral> – Indiana Attorney General website

<http://www.state.ia.us/government/ag/index.html> - Iowa Attorney General website

<http://www.kssos.org/main.html> – Kansas Secretary of State website

<http://www.law.state.ky.us/cp/charity.htm> - Kentucky Attorney General website

<http://www.ag.state.la.us> - Louisiana Attorney General website

<http://www.state.me.us/ag> – Maine Attorney General website

<http://www.sos.state.md.us/sos/charity/html/cod.html#other> – Maryland Secretary of State Charity website

<http://www.ago.state.ma.us/charity.asp> – Massachusetts Attorney General website

<http://www.ag.state.mi.us> – Michigan Attorney General website

<http://www.ag.state.mn.us/charities/Default.htm> – Minnesota Attorney General Charity website

<http://www.sos.state.ms.us> – Mississippi Secretary of State

<http://www.ago.state.mo.us/index.htm> – Missouri Attorney General website

<http://sos.state.mt.us/css/index.asp> – Montana Secretary of State website

<http://www.nol.org/home/SOS> – Nebraska Secretary of State website

<http://ag.state.nv.us> – Nevada Attorney General website

<http://www.state.nh.us/nhdoj/CHARITABLE/char.html> – New Hampshire Attorney General Charity website

<http://www.state.nj.us/lps/ca/ocp.htm> – New Jersey Consumer protection website

<http://www.sos.state.nm.us> – New Mexico Secretary of State website

<http://www.oag.state.ny.us/charities/charities.html> – New York Attorney General Charity website

<http://www.secretary.state.nc.us/sls/default.asp> – North Carolina Secretary of State Charity website

<http://www.state.nd.us/sec> – North Dakota Secretary of State website

<http://www.ag.state.oh.us> – Ohio Attorney General website

<http://www.sos.state.ok.us> – Oklahoma Secretary of State website

<http://www.doj.state.or.us/ChariGroup/welcome2.htm> – Oregon Attorney General Charity website

<http://www.dos.state.pa.us/charities/charities.html> – Pennsylvania Department of State Charities website

<http://www.dbr.state.ri.us> – Rhode Island Department of Business Regulation

<http://www.scsos.com> – South Carolina Secretary of State website

<http://www.state.sd.us/attorney/index.html> – South Dakota Attorney General website

<http://www.state.tn.us/sos/charity.htm> – Tennessee Secretary of State Charity website

<http://www.oag.state.tx.us> – Texas Attorney General website

<http://attygen.state.ut.us> – Utah Attorney General website

<http://www.state.vt.us/atg> – Vermont Attorney General website

<http://www.vdacs.state.va.us/consumers/oca-regulatory.html> – Virginia Office of Consumer Affairs Charity website

<http://www.secstate.wa.gov> – Washington Secretary of State website

<http://www.state.wv.us/sos/charity/default.htm> – West Virginia Secretary of State Charity website

<http://www.doj.state.wi.us> – Wisconsin Attorney General website

[http://soswy.state.wy.us/index\\_1.htm](http://soswy.state.wy.us/index_1.htm) – Wyoming Secretary of state website

## **Section X. Accounting Issues<sup>32</sup>**

Accounting standards and rules govern how the EO keeps its internal financial books. They are often used by the board of directors and required by outside donors (i.e., big foundations). Thus, it is prudent for even a small EO to get in the practice of keeping sound internal accounting records. Moreover, the information in the financial records is often helpful in preparing the annual federal and state tax returns.

### **A. Financial Statements**

The EO must have a set of financial documents that its board of directors can use to govern its affairs and plan for its future. They should be provided at each meeting of the board of directors and should be adopted by the board. Also, it may be prudent to have financial documents prepared on a yearly basis by an independent accountant. Sometimes these financial statements may actually need to be reviewed or audited and will often depend on the parameters imposed donors. The following is a list of typical financial statements.

### **B. Statement of Revenue and Expenditures**

The statement of revenue and expenditures shows the financial performance of the EO over a period of time.

### **C. Balance Sheet**

The balance sheet reflects the assets and liabilities of the EO on a particular date.

### **D. Cash Flow Statement**

The cash flow statement shows the cash inflows and outflows of the EO over a period of time. This is especially helpful in developing budgets for the EO as it gives an indication of all the cash issues that the EO is having.

### **E. FAS 116 and 117**

Financial Accounting Standards are promulgations adopted by the Financial Accounting Standards Board. FAS 116 governs the recognition and valuation of contributions to the EO. FAS 117 governs the statement of cash flows and requires the EO to identify net assets as unrestricted, temporarily restricted or permanently restricted.

### **F. Fund Accounting**

#### **1. General**

Many EO use a system of accounting commonly referred to as fund accounting. Fund accounting requires separate funds to be kept for assets donated to the EO which are subject to restrictions imposed by the donor. Thus, assets are grouped into funds – in their presentation on the balance sheet. The typical funds include:

#### **2. General Fund**

This category is for assets with no restrictions such as cash. The assets in this fund are generally used by the EO in carrying out its activities.

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<sup>32</sup> This section was prepared by Darius Bolling and edited by Shannon Nash.

### **3. Restricted Fund**

The restricted fund contains assets that the EO may only use for a restricted purpose(s).

### **4. Endowment Fund**

The endowment fund covers assets that are restricted in that only the income earned from such assets can be used by the EO.

### **5. Fixed Asset Fund**

The fixed asset fund is a special fund designed to track an account for capitalized assets that usually cost over \$500. Fixed assets can include significant repair costs, therefore an EO should establish a company policy covering the threshold of both asset cost and capitalized repairs.

## **G. Bibliography**

<http://www.990accountant.com> - A guide to Form 990s and other IRS nonprofit related forms

<http://www.nonprofitfinancial.org> - Nonprofit Financial Center is a nonprofit financial resource organization formed to help nonprofit organizations develop sound financial management. NFC also gives loans to Illinois nonprofits and provides valuable links for Illinois nonprofits.

<http://www.qual990.org/links.htm> - provides information about the Form 990, nonprofit accountability, and other issues that NACs may tackle.

## Section XI. Public Disclosure Rules<sup>33</sup>

Section 501(c)(3), 501(c)(4) and 501(c)(6) organizations must make copies of their informational tax returns and exemption applications readily available to the public.<sup>34</sup> This section will provide an overview of the information required to be disclosed and the manner in which they should be made available.

### A. Information Required to be Disclosed

#### 1. Annual Tax Returns

Upon request, EOs must provide copies of their three most recent annual informational tax returns (i.e., Forms 990, 990-EZ, 990-BL and Form 1065), including all attachments and schedules. This will result in the disclosure of the names and addresses of all individuals on the EO's board of directors and compensation information for officers, directors and key employees. EOs need not make available for public inspection nor for photocopying Form 990-T (dealing with unrelated business income). In addition, EOs that are public charities need not make available the portion of an informational return that identifies names and addresses of contributors.

#### 2. Application for Exemption

Upon request, EOs must provide copies of their tax-exempt applications (i.e., Form 1023 or Form 1024) along with all schedules, attachments and documents, including the EO's organizational documents such as articles and bylaws. This disclosure only applies to applications that have been approved by the IRS. EOs waiting for their exempt status to be approved by the IRS need not comply. The disclosure rules also do not apply to exemption applications that were filed before July 15, 1987, unless the EO actually possessed a copy of the application on that date.

### B. Public Inspection

EOs must show copies of their annual informational returns and exemption application to anyone who requests them during regular business hours at the EO's principal office, or in some cases its regional or district offices. However, where an EO does not have a principal office (as is the case with many start-up EOs), the EO may either choose a reasonable location or mail the requester a copy of the documents, all within two weeks of the request. During a public inspection, the EO may have an employee present in the room.

### C. Requests for Copies

The EO has 30 days to fulfill requests for copies made in writing. A request for copies of documents made in person must be honored on the same day that the request is made. However, where unusual circumstances exist that prevent the EO from fulfilling the request on the same day, the EO will have up to five business days to respond to the request. Examples of unusual circumstances include the following: requests received shortly before the end of regular business hours, a significant volume of requests received on the same day, or requests received when the EO's administrative staff is busy conducting special duties (e.g., all-day office training, off-site meeting, etc.). The EO may not charge a fee for providing these documents, except for reasonable reimbursements for copying and/or actual postage costs incurred. A reasonable fee for copying cannot exceed the fee that the IRS charges the public for copies of tax-exempt organization tax returns and related documents. That fee is currently \$1 for the first page and 15¢ for each additional page.

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<sup>33</sup> This Section was prepared by Shannon Nash.

<sup>34</sup> Treas. Reg. §§ 301.6104(d)-3 through 301.6104(d)-5; T.D. 8818 (April 18, 1999).

#### **D. Internet Exception**

An EO need not furnish a copy of its documents if they are widely available to the public such as by posting them on the internet. This posting can be done on the EO's web site or as part of a database of similar documents of other tax-exempt EOs maintained by another entity. The web site must inform users of the documents' availability and provide instructions for downloading the documents. A document must be posted in a format that, when downloaded, exactly reproduces the document as originally filed with the IRS. Anyone with Internet access must be able to download the documents without special computer hardware or software (other than software that is readily available to members of the public without payment of any fee). Portable Document Format (PDF) or Adobe Acrobat files will fulfill these formatting requirements.

Neither the EO nor any entity maintaining the web page may charge a fee for downloading and viewing the documents. The EO must provide the web site address immediately to a person requesting documents in person and within seven days of receiving a request in writing. Keep in mind that this internet exception only absolves the EO from furnishing copies of its documents. The EO must still make its returns and exemption applications available for public inspection at its offices.

#### **E. Penalties**

An EO that fails to comply with these public inspections and requests for information returns may be subject to a \$20 per-day penalty for every day that it is in violation, subject to a maximum penalty of \$10,000 per return. Failure to comply with the disclosure rules with respect to exemption applications subjects the EO to a \$20 per-day penalty, with no maximum. There is an additional penalty of \$5,000 for the "willful" failure to adhere to any of these disclosure rules.

#### **F. Harassment Campaigns**

EOs need not fulfill requests for copies of documents when the purpose is meant to disrupt the operations of the EO. EOs may disregard a request as being harassment motivated, when more than two requests per month or four requests per year are made by a single individual or from a single address. Otherwise, the EO must file an application for harassment campaign determination within 10 days of the purported harassment. Harassment campaigns may exist where the EO notices a sudden increase in the number of requests, an extraordinary number of requests made through form letters, or requests that contain language hostile to the EO. If the IRS denies the harassment campaign application, the EO may still be subject to the penalties for failure to comply with the disclosure rules. Realizing that in certain situations it may be appropriate to mitigate the EO's exposure to these penalties, the IRS is drafting a revenue procedure that will provide additional details on harassment campaign determination procedures and the imposition and mitigation of penalties.

#### **G. Outsourcing the Burden**

EOs may outsource the responsibility of fulfilling requests for copies of documents. However, the duty to comply with the law is still borne by the EO. Thus, if the EO's agent fails to process a request made in writing within the required 30 day time limit, the EO will remain subject to the penalty provisions. Moreover, the 30 day response period commences when the EO receives the request, and not when its agent is notified.

An agent may also be used to process requests for documents made in person.. The agent must be located within reasonable proximity of the EO's office. Again, the duty to comply with the law is still borne by the EO. If the agent fails to process the request in the same business day, unless there are unforeseen circumstances, the EO may be subject to penalties.

## **H. In Practice**

Posting the information returns and exemption applications on the Internet is a viable option for complying with the regulations, especially if the EO already maintains a website. However, for smaller EOs, the time and expense involved in creating a website may be too burdensome. These EOs may want to consider outsourcing the burden to another entity.

## **I. Bibliography**

<http://www.irs.gov/pub/irs-utl/topic00.pdf> – For IRS Continuing Professional Education article on disclosure of information returns and exemption applications.

<http://www.guidestar.org> -- Guide star has compiled a database of all 501(c)(3) charities that submit Form 990s to the IRS.

## **Section XII. Deductions<sup>35</sup>**

This section will provide an overview of the two type of deductions available for contributions made to section 501(c)(3) organizations – the charitable contribution deduction and the business expense deduction. There will also be a discussion of the type of records that taxpayers must keep in order to substantiate these deductions on their personal federal income tax returns. The section will provide a comparison of the two deductions and conclude with a bibliography listing other helpful sources on this topic.

### **A. Charitable Contribution Deduction**

#### **1. General Rules**

Contributions to section 501(c)(3) organizations will often qualify for the charitable contribution deduction. Section 170 of the Code allows a deduction for charitable contributions. For individuals this deduction is taken on Schedule A of the Form 1040. However, the amount of the actual charitable contribution deduction is subject to certain limitations. The deduction is limited to 50 percent of an individual's adjusted gross income. Also as an itemized deduction, charitable contributions are further limited in that they can only be taken if the individual itemizes. Generally, an individual will itemize only if the total amount of the itemized deductions exceeds the standard deduction, which for 2001 was \$4,550 for single taxpayers and \$7,600 for married taxpayers filing jointly.

#### **2. Substantiation Rules**

Even if a contribution is made to a charity, failure to obtain the required substantiation of such deduction may result in denial of the contribution deduction<sup>36</sup>.

#### **Contributions in General**

The general substantiation requirements provide that the donor keep proof of the donation by way of a cancelled check, receipt or some other form that shows:

- the donee's name,
- the date of the contribution, and
- the amount of the contribution.

#### **Gifts of \$250 or More**

A donor who contributes money or property valued at \$250 or more must substantiate the contribution by a contemporaneous written acknowledgment that includes the following information:

- the amount of the contribution and a description of any property,
- a statement of whether or not the charity provided any goods or services in consideration, in whole or in part in exchange for the contribution ("quid pro quo benefits"), and
- a description and good-faith estimate of the value of any quid pro quo benefits.

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<sup>35</sup> This section was prepared by Shannon Nash.

<sup>36</sup> Please note the substantiation rules being discussed generally apply to contribution made in cash. The substantiation rules for contributions of other types of property see IRS Publications 526 and 1771.

### **Quid Pro Quo Rule - Gifts of \$75 or More**

If the donor receives a benefit in return for making a contribution to the charity in excess of \$75, the charity must provide the donor with a written statement that includes the following information:

- the donor may only treat as a tax deductible charitable contribution, the amount by which the total contribution exceeds the fair-market value of the benefits provided by the charity, and
- a good faith estimate of the fair-market value of the quid pro quo benefits.

Insubstantial quid pro quo benefits may be ignored and any written acknowledgement may state that no goods or services were provided. Examples of benefits that may be disregarded include:

- benefits bearing the charity's name or logo, worth less than \$7.60 (for 2001) received in connection with a contribution worth at least \$38 (for 2001),
- benefits worth the lesser of two (2) percent of the value of the contribution or \$76 (for 2001),
- noncommercial quality newsletters, and
- certain annual membership benefits

### **3. Forms of Charitable Contributions**

The most common method of making a charitable contribution to a Section 501(c)(3) organization is by a cash payment. However, other forms may be used as discussed below.

#### **Property (other than stock)**

This category includes tangible personal property such as computers and office furniture. Also included in this category is real estate. The amount of the charitable contribution deduction is generally the fair market value of the property.<sup>37</sup> The donor must keep reliable written records to substantiate this deduction. (See IRS Publication 526 Charitable Contributions for more information on the substantiation requirements).

#### **Stock**

With the dot.com craze, in recent years organizations have seen an increase in donation of stock. Contributions of stock enjoy favored treatment in that the deduction is based on the fair market value of the stock and not the donee's basis. Thus if the stock has appreciated, the donee may be able to deduct the fair market value of the stock without recognizing any gain over his/her basis in that stock.

#### **Out-of-pocket expenses for volunteers**

Volunteers of the Section 501(c)(3) organizations (i.e., officers and directors) may be able to deduct as charitable contributions, their unreimbursed expenses incurred while performing services for the organizations. Common expenses will include travel, transportation, meals and lodging. Costs related to the use of the volunteer's personal car may also be deducted either by taking the actual out-of-pocket expenses, such as gas and oil or the standard mileage deduction which was 36.5 cents per mile for 2002. Costs for parking fees and tools may be deducted under either method. The costs for general repair and maintenance, depreciation, registration fees or insurance are not deductible. Volunteers must keep reliable

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<sup>37</sup> Determining the value of contributed property is beyond the scope of this section and IRS Publication 561 Determining the Value of Donated Property should be reviewed.

written records to substantiate this deduction. (See IRS Publication 526 Charitable Contributions for more information on the substantiation requirements).

#### **4. Practical Tips**

##### **· Quid Pro Quo Benefits less than \$75**

Even if the quid pro quo benefit is given in connection with a donation of less than \$75, the actual donation is still limited to the amount the donor gave less the benefit received in return. Thus the charity should be in the practice in its form thank you letter of describing the net gift.

##### **· Mailing of written acknowledgments**

A written acknowledgment is contemporaneous if it is obtained prior to the earlier of: (1) the date the donor files his or her original tax return in the year in which the contribution was made, or (2) the due date, including extensions for filing the donor's original tax return. Thus, for each tax year written acknowledgements should be sent to donors by January or the next tax year but at least before April 15<sup>th</sup> of the next tax year.

##### **· Aggregation**

There is no aggregation requirement. Also, there is no requirement that contributions by a particular donor to a single charity be aggregated in determining if the \$250 threshold is met. Thus, a donor can contribute \$249 daily to a single charity and never be required to obtain this written acknowledgment (assuming quid pro quo benefits are not received that would trigger the quid pro quo rule).

##### **· Penalties for failing to Provide Substantiation**

The Section 501(c)(3) organization faces a \$10 penalty per contribution for each failure to provide the required written statement to a donor who receives quid pro quo benefits. There is a maximum penalty of \$5000 per contribution. This penalty may be avoided if the organization can show that the failure was due to reasonable cause. Also the organization may be subject to penalties if it knows or has reason to know of a falsity in its written substantiation to donors.

##### **· EOs record retention**

How long should charity keep copies of the substantiation records? As a general rule donors need only keep their copies of acknowledgments for 3 years. Depending on the resources of the EO, it may be prudent (and certainly helpful for the donors) to keep copies of acknowledgements for a longer period (i.e., 6 years).

##### **· Be wary of stock contributions**

As previously mentioned, contributions of stock have become increasing popular because the donee gets a fair market value deduction without recognizing any gain on the stock. But accepting this stock can be fraught with issues. Small charities with few resources to help them deal responsibly with illiquid or restricted stock may be better off turning down gifts like shares in family-owned businesses and other unmarketable securities.

##### **· IRS Form 8283 Noncash Charitable Contributions**

Form 8283 must be completed by donors who make noncash contribution over \$500 and the form must be attached to their Form 1040. The taxpayer must fill out section A of Form 8283 for noncash contributions less than \$5000.

For contributions over \$5000, section B of the form must also be completed and the organization must sign the form. If the organization disposes of the property within 2 years after the date of receipt of the contribution, the organization must file form 8282 Donee Information Return and send a copy of this form to the donor. This form must be filed within 125 days of the disposition of the property. Thus, although noncash contributions of \$5,000 or more are often welcomed by small EOs, the organization's administrative system for tracking donations should also incorporate a mechanism for tracking when noncash contributions over \$5000 are sold. Please note that property for these purposes does not include cash or publicly traded securities.

## **B. Business Expense Deduction**

### **1. General Rules**

Amounts contributed to 501(c)(4) and 501(c)(6) organizations cannot qualify as charitable deductions and can only be deducted as business expenses. In some situations, amount contributed to 501(c)(3) organizations will also qualify as business expenses.

Section 162 provides for a deduction of all ordinary and necessary expenses incurred in a trade or business. For individuals this deduction is taken on Schedule C of the Form 1040. Although generally there are no percentage limitations on the actual amount of the business expense deduction, there is a special rule for deductions that could have qualified as charitable contributions. Specifically, Section 162(b) provides that the business expense deduction cannot be used to deduct amounts that would have been deductible as charitable contributions but for the percentage limitations under Section 170. Thus, a taxpayer cannot take a charitable contribution deduction for most of his or her gift and then take a business deduction for the remaining amount of the gift that was disallowed under the percentage limitation rules of section 170.

However, remember that to claim business expense deductions, the individual must be engaged in a trade or business. It is not crucial whether the individual engages in this business on a full-time basis or as a part time business. Moreover, it does not matter whether the individual conducts this activity as a sole proprietor or through some type of entity (i.e., limited liability company, S corporation or partnership). All that is required is that the taxpayer incur the expense while being engaged in a trade or business.

### **2. Substantiation Rules**

Unlike with the charitable contribution deduction there are no specific requirements for substantiating business expenses. The taxpayer should keep a record that contains reasonable information to prove that the expense was incurred. Also the taxpayers should keep all pertinent tax records for until the statute of limitation for the tax return in which the deduction was taken expires. In many cases this will be three years (although the period should be longer such as 6 years where the tax return contains substantial omissions of income).

However, a Section 501(c)(4) or 501(c)(6) organization must include an express statement, in a conspicuous and easily recognizable format, that contributions to the organization are not deductible for Federal income tax purposes as charitable contributions. Failure to include this statement will subject the organization to penalties. This penalty does not apply to organizations with annual gross receipts that do not normally exceed \$100,000. Also, if these organizations engage in lobbying activities, they may also be required to notify their members that a portion of their dues paid that are applicable to such activities may be nondeductible (or the organization may pay a proxy tax). See Section IV of the outline for more information regarding the lobbying activities of section 501(c)(4) or 501(c)(6) organizations.

## **C. What distinguishes the two type of deductions?**

In the case of a donation given to a public charity exempt under section 501(c)(3), it is the taxpayer's expectation of a financial return in connection with the donation that is crucial in deciding which deduction to take. A payment made without the expectation of a commensurate financial return is generally a

charitable contribution. Conversely, with a business expense the taxpayer is typically expecting a return that bears some relationship to his or her trade or business. In practice it is often hard to distinguish between the two motives. For example, take the case of an artist who is in the business of selling his or her art work. This artist makes a donation to become a member of a public charity whose purpose is to further artistic and cultural endeavors. Did the artist make this donation with or without the expectation of commensurate financial return? This is a factual decision and will depend on the circumstances of the particular individual and the charity.

#### **D. What's the Big Deal?**

The business expense deduction has several advantages over the charitable contribution deduction. To qualify for deduction, charitable contributions have to be substantiated by written receipts requiring certain information. Although taxpayers generally must be able to substantiate business expenses, there is no specific form language that must be obtained from a charity (but note Section 501(c)(6) and 501(c)(4) organizations must provide some cautionary language). Moreover, business expense deductions by themselves are not subject to the charitable contribution percentage limitations or the overall itemized deduction limitations.

However, from a practical standpoint, for most individuals the actual amount of the deduction is the same. Keep in mind, charitable contributions are limited to 50% of the taxpayer's adjusted gross income. Thus, individuals may deduct contributions up to half of their salary, wages and other earned income. Most individuals do not make contributions quite that large and, in practice, deduct the full amount of their charitable contributions. Moreover, many individuals are not engaged in a trade or business and, thus, cannot take a business expense deduction.

#### **E. Bibliography**

[http://www.irs.ustreas.gov/prod/forms\\_pubs/index.html](http://www.irs.ustreas.gov/prod/forms_pubs/index.html) - for IRS Publications and Forms.

[http://www.irs.ustreas.gov/prod/bus\\_info/eo/index.html](http://www.irs.ustreas.gov/prod/bus_info/eo/index.html) – for IRS Exempt Organization general information.

[http://www.irs.ustreas.gov/prod/bus\\_info/eo/contrib.html](http://www.irs.ustreas.gov/prod/bus_info/eo/contrib.html) - for links to information regarding penalties to 501(c)(3) organizations for not providing written acknowledgments for quid pro quo contribution or for knowingly providing false substantiation to donors.

### **Section XIII. Internet Issues<sup>38</sup>**

Today, maintaining a presence of the internet is almost mandatory for any business wishing to make an impact. For the exempt organization that is equally true. However, there are a number of issues that the exempt organization must be aware of or it can unwittingly risk its tax exempt status. The following discussion will highlight some of these issues.

The Internal Revenue Service (IRS) recently solicited public comment regarding the activities of exempt organizations on the internet. Some of the issues that the comment request focused on were substantiation and disclosure over the internet, third-party donations and sponsorship, attribution between organizations, and political campaigning and lobbying on the internet. See IRS Announcement 2000-84. The IRS has not yet issued guidance in any of these areas.

#### **A. Attribution in General: Implications for UTBI, Lobbying, and Political Campaign Restrictions**

An overarching concern for exempt organizations maintaining a presence on the internet is attribution of the non-exempt activities of an organization to an exempt organization as if the activities were being conducted directly by the exempt organization. Such attribution, which can occur without the intent or knowledge of the exempt organization, could cause the exempt organization to have UBTI, be engaged in lobbying activities or, most dangerously, be engaged in prohibited political campaign activities.

##### **1. Link to Sites of Outside Organization**

There is currently no IRS policy regarding attribution when one organization links to another on the internet. The overwhelming belief by commenting organizations, including the Members of the Committee on Exempt Organizations of the American Bar Association Section of Taxation (“the Committee Members”), seems to be that no automatic attribution should be imposed on exempt organizations. The Committee Members’ comments suggested that the IRS adopt a “one link” safe harbor or a “two-click” rule. This would mean that if a visitor to the exempt organization’s website needed to click on more than one link to reach a particular webpage there would be no attribution with respect to the content on the linked to page. Thus, an organization that had a splash page, which alerted a viewer that the viewer is about to leave the organization’s website would not be subject to attribution from sites the viewer visited after leaving the site. Failure of the safe harbor would not result in automatic attribution, but merely an inquiry into the facts and circumstances to determine whether attribution should result. The American Institute of Certified Public Accountants (AICPA) also commented on issue of links and indicated that a facts and circumstances test should apply for attribution purposes and most likely should apply only to sites directly linked from an exempt organization website.

##### **2. Listserves**

Many EOs like to have discussion groups/message boards or e-mail subscription lists so that their members can communicate with each other easily. There is some concern that any communications on a list open to the general public will likely be treated as communications to the general public. If the organization can limit subscribers to the list or can identify the subscribers as members, the organization may be able to allocate costs of advocacy as member communications, which are given more leniency. See the section on lobbying more information.

It is not clear how the IRS will treat communications on listserves from listserve subscribers, but not on behalf of the organization. For example, a subscriber could post a lobbying message or endorse a candidate. If the IRS attributes such an endorsement to the organization supporting the listserve, the organization could lose its tax-exempt status. According to the Alliance for Justice, an organization may be able to

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<sup>38</sup> The Political Campaigning and Lobbying Issues Section was written by Alexis Neely and the Fundraising Section was written by Alexis Neely and Shannon Nash.

protect itself by opening the listserv to opposing views, distributing frequent disclaimers or appending a message to each listserv message indicating that the posts reflect the views of the individual subscribers and not the organization. Finally, the organization can moderate the list and only distribute those posts that comply with strict guidelines, but in that case the content of the message is more likely to be attributed to the organization and the time commitment from the organization is much greater.

### **3. Practical Suggestions**

1. Maintain a stated policy with respect to including links to outside sites on your website.
2. Check links monthly or quarterly to ensure your site does not inadvertently link to content your organization does not approve of or that will jeopardize your exempt status. Keep a record of your review.
3. Archive your sites pages on a regular basis.
4. If your organization can afford to create a splash page informing users that they will be leave your site when they click on an outside link, you could protect your organization from unwanted attribution.
5. Take steps to ensure that the content of listserv messages will not be attributed to your organization.

## **B. Political Campaigning and Lobbying Issues**

In general restrictions on lobbying and political activities apply to an organization's web based activities in the same manner that they apply to communication from the organization in other media. See Section IV. Lobbying and Political Activities. Specifically, if your organization has made a section 501(h) election, be aware of the differences between grassroots lobbying and direct lobbying. Items that appear on your organizations website and are available to the general public will likely be deemed grassroots lobbying if the items include a "call to action." To convert such communications to direct lobbying, consider moving such "calls to action" to a members only portion of the website. This issue is discussed more completely below.

### **1. Affiliated Organizations**

If an organization is comprised of several organizations organized under different IRC sections, the most prudent behavior would be to maintain separate websites for the organizations. The lobbying and political campaigning restrictions are different for 501(c)(3) organizations than they are for other exempt organizations. For example, a Section 501(c)(4) organization may engage in unlimited legislative lobbying as long as such activity does not violate the organization's exempt purpose. And, the only exempt function of a Section 527 organization is the influence of a political campaign. Therefore, many 501(c)(3) organizations affiliate with 501(c)(4) and 527 organizations to carry on their political or lobbying activity.

501(c)(3) organizations should not share a website with their non 501(c)(3) affiliates and the 501(c)(3) should be careful to only link to the website of a 501(c)(4) or 527, which has political content, through an intervening home page, preferably maintaining at least a two link distance.

### **2. Political Campaigning**

The IRS has not issued any guidance with respect to what website activities constitute political campaigning by an exempt organization. The Committee Members suggest that an organization should be permitted to link to candidates' websites as part of voter education activities so long as the links are established on a non-partisan basis. Additionally, an organization should be able to link to a broad range of politically diverse political action committees (PACs) or other political organizations that provide

candidate profiles, voting history and records, and similar information. The key, they believe, should be to provide access to a broad range of websites representing the full spectrum of views. One thing is certain, a 501(c)(3) may not support or oppose a candidate for office on its website or anywhere else.

The IRS revoked the exempt status of an organization called the Freedom Alliance for engaging in political campaigning. The basis for the revocation was extensive political campaigning by criticizing a candidate in a radio commentary and serving a private interest through radio broadcasts, newsletter articles, and direct mail communications. In its ruling letter restoring the exemption, the IRS said its determination was based in part on the Freedom Alliance's "representation that you have taken steps to remove, from the Internet, the web site formerly maintained by you that among other things contains a link to a politically partisan organization." It is not clear what significance this has for organization's linking to politically partisan organization's, but the prudent course of action says don't do it.

### **3. Lobbying**

Lobbying activity on a website should not be thought of any differently than lobbying through any other medium. The only difference is that a website can have links and, therefore, an organization must be concerned about attribution of the activities on linked to websites back to the organization, as discussed above in the general attribution section.

#### **“Substantial Part” Test**

The IRS has asked for comments regarding what facts and circumstances are relevant in determining whether lobbying communications made on the internet are a substantial part of the organization's activities. The Committee Members indicated that they believe the same type of test that applies in a non-internet setting should apply to a website analysis. They argue that charities should not be penalized for using the internet if they spend the same amount of activity and energy on a lobbying activity that has a broader impact than a non-internet activity. Currently, the analysis for whether lobbying is a substantial part of the organization's activities in the non-internet context is not clear.

#### **“Section 501(h) Expenditure” Test**

An organization making a Section 501(h) election will need to allocate the direct, grassroots, and non-lobbying expenses incurred when creating, maintaining and updating its website. As discussed in Section IV of this outline, the key to determining grassroots lobbying is whether the organization has issued a “call to action” to the general public. If your organization encourages the general public to contact legislators, then the expense of that portion of the website must be allocated to grassroots lobbying; in contrast, if your organization sends the same message only to members, the costs of the message can be allocated only to direct lobbying. Additionally, if your organization communicates with a member about both non-lobbying and lobbying information, then you should allocate the costs of the communication between both categories.

#### **“Paid Mass Media Advertisements”**

As discussed in Section IV of this outline, a call to action is not a necessary element of grassroots lobbying where the communication occurs via paid mass media and is regarding a highly publicized legislation within two weeks of a vote on such legislation. The IRS has not issued guidance regarding whether publication on the internet is the equivalent of a paid mass media publication. If the IRS were to amend the Treasury Regulation to include publication on the internet in the definition of mass media the ability of organizations to use the internet to convey their message would be severely limited. In its E-Advocacy article, the Alliance for Justice provides several arguments that the internet is not within the definition of mass media; nevertheless, it may be most prudent to treat communications appearing within two weeks of a vote on highly publicized legislation as grassroots lobbying. If you can argue that the communications were part of a regularly scheduled publication of public policy materials and that they were not timed to coincide with the pending vote, then you may not need to treat the expenditures as grassroots lobbying.

## **C. Fundraising**

With the arrival of the Internet, the fundraising efforts of the exempt organization can often extend beyond the organization's geographical boundaries. The exempt organization must be aware of the possible effects of these new revenue streams.

### **1. Solicitation of Donations on the Internet**

EOs can fundraise on the internet through two means. The EO can either solicit donations directly at its own website or the EO can benefit from a donation to a third party donation site, such as a charity mall or internet retailer. A charity mall is a website that lists a selection of charitable organizations that a user can select from to make a donation to. The website provides the mission statement of each organization and a link to the organization's website. The contributor can charge the donation to his or her credit card and he or she will receive an immediate e-mail acknowledgement. The internet retailer is a storefront operation where the contributor makes a purchase from the retailer and a portion of the purchase price is donated to a charitable organization.

The primary issue with both the charity mall and the internet retailer is whether or not the contributor made a donation to the EO and therefore may deduct funds paid to the intermediary as if made directly to the charitable organization. This generally turns on whether the website operator is acting as an "agent" for the EO. So long as the agent does not exercise dominion and control over the funds, the contributor should be able to receive a charitable deduction. This may not be an issue in the case of the internet retailer because there the contributor/purchaser is likely going to be unable to demonstrate that they paid in excess of fair market value for the product they received.

### **2. Substantiation Issues**

Exempt organizations can solicit donations on their own websites. Many smaller exempt organizations may not have the ability to accept contribution through their website, and will instead require the donor to send in a contribution. In such cases the exempt organization will send a written acknowledgement as required under the substantiation rules. However, where the EO has the ability to accept a contribution via its website, the contributor may receive confirmation via email or immediate confirmation on a webpage the contributor can print out. The permissibility of electronic acknowledgement and substantiation is confirmed by IRS publication 1771

### **3. Sales of Goods**

The sale of goods will be subject to UBTI in the same manner that they are in the non-internet context. The general rules discussed in Section VI continue to apply. An additional complexity is presented by internet sales because the exempt organization has the ability to make sales to people in many different states, which may cause the exempt organization to have a significant contact with more than one state. Depending on the frequency of sales made in a particular state the state may be able to assert that the exempt organization has a nexus with the state and is subject to their corporate income tax on UBTI or must register as a charitable organization in their state. This is very troublesome for the small exempt organization which likely has only applied for exemption from state taxes in one or two states. The webmaster should track the state of residence where goods are sold so that if necessary the organization can consider applying for exemption in additional states.

### **4. State Registration Issues**

The National Association of State Charity Officials released a proposal to govern fundraising solicitations on the Internet. They propose that charities should register in their own states when they set up fund-raising Web sites, but should not have to register in any additional states unless the organization specifically

targets people in a specific state through email or direct communication. To view a copy of the proposal, see [http://www.nasconet.org/stories/storyReader\\$10](http://www.nasconet.org/stories/storyReader$10).

## **5. Advertising and Corporate Sponsorship**

As described in Section VI, advertising is subject to UBTI, but qualified sponsorship payments (“QSP”) are not. A QSP is any payment made by a person engaged in a trade or business where is no expectation or arrangement that the person will receive a substantial benefit in return for the payment. The use of the sponsor’s name, logo or product lines is not a substantial benefit unless it includes any qualitative or comparative language or price information. The use may include a list of the sponsor’s locations, phone number, or internet address. The use of the sponsor’s logo or information must appear in connection with a specific event that is conducted by the exempt organization and not in regularly scheduled and printed material.

Comments to the IRS suggest that QSPs on an exempt organizations website should be evaluated under an adaptation of existing guidance.<sup>39</sup> According to Michelson, the display of a sponsor’s product at an event is the same as a link to a sponsor’s website on an exempt organization’s site and neither should be treated as advertising. He suggests that providing a phone number in the real world is the same as providing a link on the internet – both require the viewer to take additional action. Michelson does report that it seems the IRS is focusing on whether the link leads to a webpage of the sponsors where business can be transacted. If so, then the link is more likely to qualify as an advertisement than a QSP.

## **6. Internet Sites as Periodicals: E-Zines?**

If your organization’s website is characterized as a periodical, then any acknowledgement to a sponsor will not qualify as a QSP because it appears in regularly scheduled and printed material published on behalf of the organization. IRS sources suggest that the periodical decision will be made based on a review of the methodology used in preparing the site materials, such as whether there is an editorial staff, a market program and a budget independent of the organization’s main site. Michelson, et al. provide a more in depth analysis of the propriety of the IRS making such an argument and the following list of proposed criteria to determine whether a website is a periodical:

1. the material is updated on a regular, quarterly, or more frequent basis, with announcements, new articles and other editorial content of the sort commonly found in printed periodicals distributed to members and other constituents.
2. There is an editor or editorial board with the traditional responsibilities (such as selection, solicitation and editing of content) of editors in print publications, and
3. A portion of the website is clearly separated from other, non-periodical sections of the website.

An example of an online periodical or E-Zine is <http://www.salon.com>.

## **7. Practical Suggestions**

Although the IRS is still considering how to apply the QSP guidelines in the internet context, the following are some prudent suggestions:

1. Provide a link to a sponsors website but not a moving banner. This will help with the argument that the acknowledgement is passive and more along the lines of a corporate sponsorship and not advertising.

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<sup>39</sup> Id.

2. Limit information regarding a sponsor to its name, location, telephone number and internet address.

Do not put sponsorship links on any webpages that may qualify as periodicals or E-zines.

#### **D. Bibliography**

For more information on the topics in this section:

Alice Anderson and Robert Wexler, "Internet Issues for Tax-Exempt Organizations," December 05, 2000, available at <http://www.techsoup.org/articlepage.cfm?ArticleId=258&topicid=5>.

Elizabeth Kingsley, Gail Harmon, John Pomeranz, & Kay Guinane, "E-Advocacy for Nonprofits: The Law of Lobbying and Election Related Activity on the Net," available at <http://www.afj.org/eadvocacy/index.htm>.

Louis E. Michelson, Jennifer S. Gorovitz, & Cynthia S. Rowland, "Getting Connected: Business and Politics of Charities on the Internet," paper presented in connection with the 2001 Washington, D.C. delegation of the State Bar of California Taxation Section Exempt Organizations Committee and the Los Angeles County Bar Association Taxation Section Tax-Exempt Organizations Committee, on file with Alexis Neely.

<http://www.abanet.org/tax/pubpolicy/2001/0102cmt2000-84irs/home.html> – ABA EO Committee Members' comments on IRS Announcement 2000-84.

<http://www.iGive.com> – a popular charity mall website. For a list of charity malls and internet retailers please see the bibliography section provided in Section \_\_\_ of this outline.

<http://www.nasconet.org> - National Association of State Charity Officials.

<http://www.afj.org/fai/irs/index.cfm> - draft comments by the Alliance for Justice to IRS announcement 2000-84.

[http://www.independentsector.org/programs/gr/IRS\\_Internet\\_Announ.htm](http://www.independentsector.org/programs/gr/IRS_Internet_Announ.htm) - for a copy of IRS announcement 2000-84.

<http://www.actknowledgeworks.net/ephil> - Published by the W.K. Kellogg Foundation, in Battle Creek, Mich., "e-Philanthropy v.2.001: From Entrepreneurial Adventure to an Online Community," this report provides a snapshot of online philanthropy ventures both for and by nonprofit organizations. Following up on the foundation's February 2000 report identifying and classifying 140 Web sites, it summarizes trends in charitable activity on the internet over the past year. Among those discussed: the demise of several dot-com philanthropy ventures and the growing number of online services that help charities in other areas of their work, such as advocacy and volunteerism. The report also discusses the results of a survey in which the foundation asked 418 nonprofit organizations in six states about their online activities. Seventy-five percent of the organizations surveyed reported that they had functioning Web sites, and 32 percent described their Web sites as "dynamic," or offering visitors ways to get involved in the work of the organization. Of those groups that described their site as dynamic, 44 percent are able to accept charitable donations through their Web sites and 54 percent are able to recruit volunteers online. A database that accompanies the report describes and provides links to 315 Web sites on fund raising, advocacy, volunteerism, and other topics of interest to nonprofit groups.

<http://www.nsfre.org/> - National Society of Fundraising Executives.

Guidebook for Directors of Nonprofit Corporations, Chapter 6, "Supervision of Internet Activities" (2<sup>nd</sup> ed., G. Overton and J. Frey, eds., American Bar Association 2002).

<http://techupdate.zdnet.com/techupdate/stories/main/0,14179,2853146,00.html> - an article about how one nonprofit has made use of the internet to increase its fundraising ability.

## **Section XIV. Trademark and Copyright<sup>40</sup>**

This section provides an overview of the basics of copyright and trademark law. Because both of these topics are very broad and can present some complex technical issues, this section only provides an introduction to the basic legal and regulatory concepts. Patents, which are another form of intellectual property, are less common for exempt organizations and are not covered in this section.

### **A. Trademark**

#### **1. What Is A Trademark?**

The term trademark is used to refer to any mark that is used to identify the source (such as the manufacturer or provider) of particular goods or services and to distinguish them from goods and services sold by others. To be technical, however, the term “trademark” refers only to marks that are used to identify and distinguish the source of products. When a mark is used to identify the source of services, it is called a service mark. Certification marks are used to indicate compliance with certain standards regarding the quality of goods or services. For the purpose of this section, the term “trademark” is used in its generic sense to refer to all different types of marks.

Typically, trademark may be a word, phrase, symbol, design or any combination of words, symbols, or designs. Occasionally, protection also extends to characteristics of the product itself or the packaging it is being sold in, such as the shape (the Absolute Vodka bottle) or color (the pink color of Owens-Corning insulation). Because this aspect of trademark, known as “trade dress,” will rarely arise in the nonprofit context, it is not covered extensively here. However, it is useful to understand that anything that helps identify the source of a specific product or service could fall under the general term “trademark.”

#### **2. Trademark Law**

Both federal and state law cover trademark. While state common law was the initial source of trademark protection in this country until the end of the 19<sup>th</sup> century, federal trademark law has expanded tremendously since then and has replaced state law as the primary source of protection for trademarks today. The main federal statute on trademark is the Lanham Act, which was enacted in 1946 and most recently amended in 1996 (15 U.S.C. §§ 1051, et seq.). While both systems generally protect the same rights, since it is the predominant source of protection for trademarks, the federal system is the main focus of this section. However, state common law actions to protect trademark rights are still available and should be considered where federal protection is not available.

#### **3. The Purpose of Trademark**

The purpose of trademarks is to make it easier for consumers to identify who makes or provides a specific good or service. When consumers see the word “Nike” or the swoosh on a shoe or a t-shirt or a pair of shorts, they know that it has been produced by the Nike Corporation without having to read the label or the fine print on the packaging. If a consumer purchases a Nike product and finds that she likes it, trademark makes it easier for her to buy Nike products again in the future. If the consumer dislikes Nike, trademark will also make it easier for her to avoid that brand in the future. This encourages producers to invest in the quality of their goods and services. Trademark law ensures that this system works and is not exploited by unscrupulous businesses.

#### **4. What Trademark Law Protects**

Because the focus of trademark is to prevent consumer confusion, trademark rights may be used to prevent others from using a confusingly similar mark to identify similar goods or services. Trademark does not prevent others from making the same goods or from selling the same goods under a clearly different mark.

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<sup>40</sup> This section was prepared by Andrew Schulz.

Nor does it prevent another manufacturer from marketing completely different goods or services under the same mark. For example, the mark “Domino” is used to sell both pizza and sugar and “Champion” is used to sell both spark plugs and athletic gear. If there is no likelihood of consumer confusion, there is no trademark infringement.

## **5. Minimum Requirements**

Not just any word, symbol or phrase associated with a product or service can qualify for trademark protection. In order for trademark rights to kick in, the mark must be distinctive. That is, the mark must be original enough so that it can actually be used to identifying the source of the particular good or service. The amount of protection a mark is entitled to depends on how distinctive the mark is. If a mark is completely original and does not suggest or describe the actual product being sold (such as “Kodak” or “Pepsi”), the mark is called arbitrary or fanciful and is given broad protection under the law. Suggestive marks, those that hint at the characteristics of the underlying product (Coppertone, Frigidair) are also inherently distinctive and entitled to a high degree of protection.

Marks that describe the product being sold (Chapstick, EggBeaters) are called descriptive marks and are afforded less protection under the law. While trademark protection is still available for descriptive marks, it only exists if consumers actually associate that mark with a specific source. This is called “secondary meaning”. Secondary meaning does not necessary mean that purchasers actually know who the specific producer is; only that they know that a product or service comes from a single producer.

## **6. When Trademark Protection Starts**

Under both the federal and the state law systems, trademark protection generally begins with use of the mark. Use simply means offering the product or service for sale with the mark attached to it. For fanciful or and suggestive marks, protection is available immediately upon such use. For descriptive marks, however, there will typically be a period of time between when a mark is first used in commerce and when it actually acquires secondary meaning. During this time, no protection is available for the mark.

Trademark protection may also be available before use if the mark is registered with the United States Patent and Trademark Office (PTO). In order to obtain such protection, you must file an application with the PTO indicating a genuine intent to actually use the mark in commerce in the near future. Although extensions are available, generally, once the PTO approves the application, the mark must be used in commerce within six months or protection will be lost.

## **7. Trademark Claims**

In order to protect a mark, the mark’s owner must be vigilant in making sure that others are not improperly using the mark. This means periodically checking to make sure no one is infringing on your rights and taking legal action when appropriate. The two most common actions to protect trademark rights are claims of infringement and claims of dilution. Infringement exists whenever there is likelihood that consumers will be confused about the source of those goods. Infringement may also exist where there is a chance that consumers may mistakenly believe that the owner of the infringed mark has somehow sponsored or endorsed another party’s goods or services. Relevant factors in determining whether infringement exists include:

- the strength of the mark being infringed
- the similarities between the marks
- the sophistication or care typically exercised by the consumer
- the similarities of the markets,

- the intent of the party being charged with infringement.

In the absence of infringement, a claim of dilution may be made instead. Unlike infringement, dilution does not require that there be a likelihood of consumer confusion. Rather, a claim of dilution exists where use of that mark dilutes the distinctive quality of that mark, either by weakening the power of the mark through use with dissimilar goods (blurring) or through use of the mark in a way that is unflattering or offensive (tarnishment). Unlike infringement, however, a claim of dilution is not available for all marks. Under federal law, dilution is only available for famous marks, that is, marks that are very well known. Pepsi, Nike, Exxon and Xerox are all examples of famous marks.

## **8. Federal Registration**

While registration is required in order to protect a mark before use, federal registration is not necessary to protect marks that are already in use. However, registration does offer certain benefits that lead many to register their marks anyway. One such benefit is that registration greatly expands the geographic scope in which a mark is protected. Unregistered marks are only protected within the geographic areas in which the mark is actually being used. Once a mark is registered, however, the owner has the right to use the mark nationwide. Registration also offers other benefits, including the right to sue for infringement in federal court and the right to seek triple damages and attorney fees. In addition, after five years, a registered mark becomes “incontestable” and the owner’s exclusive right to use the mark cannot be challenged.

## **9. Registering a Mark**

In order to register a mark, the individual or entity claiming ownership of the mark must complete and submit an application along with a filing fee (currently \$325) to the PTO. You can either file electronically or by mailing or delivering a paper copy of the application to the PTO. To file electronically, trademark owners must use the Trademark Electronic Application System (TEAS). TEAS is available either at <http://www.uspto.gov/teas/index.html>, or at any Patent and Trademark Depository Library (PTDL) throughout the United States. For filing a paper copy, you can call the PTO’s automated telephone line, at (703) 308-9000 or (800) 786-9199 to obtain a printed form. While hiring an attorney is not required in order to file a trademark application, it is generally advisable to ensure that you comply with all requirements of the trademark statute and rules.

## **10. The Application Review Process**

Once a completed application is received by the PTO, it is forwarded to an examining attorney for review. This review includes both an examination of the application and a search of the PTO database to see if the application conflicts with any existing marks. If the PTO decides that a mark should not be registered, a letter is issued explaining any reasons for refusal, and any technical or procedural deficiencies in the application. The applicant then has six months to correct any problems or provide any additional information requested. If the applicant does not respond or the response does not overcome all objections, the PTO will issue a final refusal.

If there are no objections, or if all objections are resolved, the PTO then publishes the proposed mark in the *Official Gazette*, a weekly publication of the PTO. The purpose of this publication is to give members of the general public the opportunity to object if they believe that registration of the mark will infringe their rights or otherwise harm them. If no one files an objection within 30 days after the mark has been published in the *Official Gazette*, the PTO will issue either a Certificate of Registration (if the mark is already being used) or a Notice of Allowance (if the application was based on intent-to-use).

## **11. Duration of Protection**

There is no limit to the length of time that protection exists for a trademark. However, because protection is predicated on use, it will only exist so long as the mark continues to be used. If you stop using a mark

for a long enough period of time, protection will cease. For registered marks, the PTO periodically requires that the owner file an affidavit of continued use to ensure that the mark is still being used.

## **12. Trademark Symbols**

Anyone who thinks that they are entitled to trademark protection may use the symbol TM (trademark) or SM (service mark) after the mark to notify the public of their claim. These marks may be used at any time and do not require federal registration. Use of these marks does not necessarily mean that a valid claim exists. Accordingly, in some cases, the TM symbol may appear after a mark that is not actually entitled to trademark protection. The ® symbol may only be used when the mark has been registered with the PTO. It is improper to use the ® symbol at any time before registration has actually been issued.

## **B. Copyright**

### **1. What is Copyright?**

Copyright describes the bundle of rights that the author of an “original work of authorship” enjoys with respect to that work. Works of authorship generally include

- Literary works – novels, poetry, newspaper and magazine articles, and computer software
- Musical works – songs and music
- Dramatic works – plays and operas
- Pantomimes and choreographic works – ballet, modern dance
- Pictorial, graphic, and sculptural works – photographs, paintings and statues
- Motion pictures and other audiovisual works – movies, television shows and commercials
- Sound recordings – CD’s and audio tapes (the rights in the recording are separate from the rights to the song or music that has been recorded)

The specific rights that fall under the term “copyright” are the right to

- make reproductions or copies of the work
- create derivative works (such as translations or revised volumes) based upon the original work
- distribute the work to members of the public such as by sale rental or lending
- display the work
- perform the work publicly

These rights exist regardless of whether the work has been published or not. Although limitations exist, the author is the exclusive owner of these rights and no one else may exercise them without the permission of the author.

## **2. Copyright Law**

Unlike trademark law, which is governed by both state and federal law, copyright is exclusively covered by the federal system. Federal authority for the U.S. Copyright Act (17 U.S.C. §§ 101 – 810) comes directly from Article I, Section 8 of the United States Constitution. While the Constitution refers specifically to the writings of authors, changes in technology have led to a broad interpretation of the word “writings” and copyright protection now extends beyond traditional writings and includes such things as architectural design, software, sound recordings and motion pictures. Because federal copyright protection is so broad and the Copyright Act specifically precludes inconsistent state law, there are no relevant state law issues.

## **3. Minimum Requirements**

Copyright protects “original works of authorship” that are fixed in a tangible form of expression. In order to merit copyright protection, a work must have a sufficient element of newness or creativity such that it can be said to be original. Originality is not a stringent test. The work does not need to be unique, novel, or artistic. It just needs to be original enough so that the work owes its creation to the author. Works that consist entirely of information that is common property, such as standard calendars or height and weight charts, do not contain any original material and do not merit copyright protection. While there is no minimum length above which a work must be in order to merit copyright protection, as a practical matter, there are some items that generally don’t have enough “there” to trigger copyright. These include titles, names, short phrases, slogans, and mere listings of ingredients or contents.

In addition to being original, a work must also be recorded in a tangible form. That is, it must be fixed in some sort of medium. Works that have not been fixed, such as improvisational speech or dance that has not been notated or recorded, do not qualify for copyright protection. Once they have been fixed, however, they are protected. Fixation need not be directly perceptible so long as it may be communicated with the aid of a machine or device. The fact that no one can hear the music on a compact disc without the aid of a CD player is irrelevant and the music so recorded will qualify as being fixed.

## **4. What Copyright Does Not Protect.**

Copyright protects expression of ideas but not the underlying ideas themselves. Thus, while copyright law prohibits someone from copying whole sections of *The Firm* for use in another novel, but does not prevent someone else from writing a book about a young lawyer representing organized crime. Other ideas that are not protected by copyright include procedures, discoveries, or devices. Protection for ideas, if available, may come from patent law or other laws governing trade practices, but not from copyright law.

## **5. Who Can Claim Copyright**

Only the author or those deriving their rights through the author can rightfully claim copyright. In simple cases, the author is the individual who puts pen to paper to write a poem or who puts paint on canvas to create a portrait. More complex issues of ownership arise where multiple people contribute to a work. If two or more authors contribute to a work and that work is not divisible into distinct parts for which each individual was responsible, all of the authors of that joint work are co-owners of the copyright in the work. If a joint work is divisible into distinct parts, each of which is attributable to a specific author, then each author owns copyright in the piece that they contributed. Ownership of the collective work as a whole, however, is distinct from ownership of each piece and typically belongs to someone like an editor or publisher who assembled the collective work.

## **6. Works Made For Hire**

Another exception to the general rule that the author owns copyright in a work is when a work is considered a “work made for hire.” With a work made for hire, the employer or patron who commissions the work, not the author, owns the copyright. Any work created by an employee in the course of employment is a “work made for hire.” If the author is not an employee, but is an independent contractor

or other individual who has been hired to create a work, that work will only be a work made for hire if two conditions are met. First, the work must have been ordered or commissioned for use as one of the following:

- A contribution to a collective work
- A part of a motion picture or other audiovisual work
- A translation
- A supplementary work
- A compilation
- An instructional text
- A test or answer material for a test
- A sound recording
- An atlas

Second, the author and the individual ordering the work must sign a written agreement that expressly states that the work will be considered a work made for hire.

## **7. Copyright Infringement**

Because the rights that make up copyright belong exclusively to the author, infringement occurs when anyone else exercises one of these rights. Making a copy of a magazine article, downloading music from the internet onto a CD or playing the radio in a store all involve exercising one or more of the various rights that make up copyright. Unless the author has granted permission for such use or unless an exception or defense applies, such use will constitute infringement.

## **8. Transfer of Copyright**

One way to ensure that use of protected material will not constitute copyright infringement is to have the author grant you the right to use the material. This can be done in a variety of ways, including obtaining limited permission to use the work ( a license) or even purchasing specific rights (such as the exclusive right to reproduce the work). Copyright can be transferred as a whole or can be broken down into specific rights. It can be transferred permanently or for a limited period of time and can be transferred exclusively to one person or to numerous people to use simultaneously. In order to be valid, transfers of exclusive rights must be in writing while transfers of nonexclusive rights do not require a written agreement. Copyright ownership is separate from ownership of the work itself and does not automatically transfer along with ownership of the work. Therefore, purchasing a book or a painting does not convey the right to copy that work, make derivative works or give others permission to do so. Because the transfer of copyright is so flexible, it is important to be very explicit about the terms of the transfer.

## **9. Fair Use**

In the absence of permission from the copyright owner, use of protected material does not constitute infringement if a specific exception permitting such use exists. While there are numerous limited exceptions (such as the right of libraries or archives to make certain copies) the most significant exception is fair use. Under the fair use provisions of the copyright law, it is not an infringement of copyright to use a protected work for certain purposes such as for news reporting, teaching, or research. Rather than provide an exhaustive list of what uses constitute fair use, the Copyright Act lists four factors that are relevant in

determining whether a particular use is “fair use” and will therefore not violate the authors copyright. These factors are:

- the purpose and nature of the use, such as whether it is commercial in nature or whether the use is for nonprofit educational purposes;
- the nature of the copyrighted work;
- the amount and substantiality of the part of the work used compared to the whole work; and
- the effect of the use upon the potential market for or the value of the protected work.

The analysis of these factors is not a straight forward checklist that is designed to create a simple yes or no answer. Rather, it is important to carefully evaluate the specifics of each particular situation and balance the rights of the author against the needs of the individual who wants to use the work. Because this evaluation can be quite complex, you should tread carefully when you believe the copyright permission is not required because of “fair use”. As always, it is wise to consult with someone who is knowledgeable about copyright law if you have any questions.

#### **10. When Copyright Protection Starts**

Copyright protection exists at the instant a work is created in a fixed form. It does not require that the work be registered or that any other formalities occur before protection is available. As soon as the work of authorship is created and fixed, the copyright immediately becomes the property of the author. If a work is prepared over a period of time, the part of the work that is fixed on a particular date constitutes the created work as of that date.

#### **11. Registering a Copyright**

The way in which copyright protection is secured under the present law is frequently misunderstood. As explained above, copyright protection exists instantly and automatically as soon as an original work is fixed in a tangible medium. There are no additional requirements for protection. The work does not have to be published, nor does the work have to be registered with the Copyright Office. Older versions of the copyright act did require that certain formalities (such as publication and registration) be observed in order for a work to qualify for protection. Those requirements no longer exist. While copyright registration is not required, it is available and offers certain advantages.

Registration can occur at any time during the life of the copyright. In order to register, the author must complete an application form and submit it, along with a filing fee (currently \$30) and a copy of the work being registered. A copyright registration is effective on the date the Copyright Office receives all the required elements, regardless of how long it then takes to process the application and mail the certificate of registration. All Copyright Office forms are available on the Copyright Office Website at [www.loc.gov/copyright/forms/](http://www.loc.gov/copyright/forms/) or by calling (202) 707-9100.

#### **12. Duration of Copyright**

The Copyright Act has changed significantly over the past 100 years. As a result, there is no simple answer to how long copyright lasts. For newer works the answer is relatively straightforward. Works created on or after January 1, 1978, enjoy copyright protection for the duration of the author’s life plus an additional 70 years. If there are multiple authors, copyright expires 70 years after the death of the last author. For works made for hire, copyright last either 120 years from the time the work was created or 95 years after it is published, whichever is shorter.

For older works, no such simple answer exists. In fact, there are enough variables, such as which version of the Copyright Act was in effect at the time of creation, whether the work was published, whether the

work was registered and whether copyright was properly renewed, that even a lengthy explanation may do little to clear up the confusion. Accordingly, a comprehensive explanation of how long a copyright last in each case is beyond the scope of this section.

### **13. The Copyright Symbol**

Prior to March 1, 1989, every published work had to be accompanied by copyright notice or the copyright would be lost. Today, however, the use of the copyright symbol or other forms of copyright notice is purely voluntary. Nonetheless, many choose to use copyright notice as a way of informing the public that the work is protected and who owns those rights. A copyright notice typically includes the © symbol or the word “copyright”, the date the work was first published and the name of the copyright owner.

### **C. Bibliography**

#### **Trademark**

<http://www.uspto.gov/web/menu/tm.html> – A wealth of information from the U.S. Patent and Trademark Office on trademark including good general information as well as useful legal resources.

<http://cyber.law.harvard.edu/metaschool/fisher/domain/tm.htm> – An extensive primer on trademark law from [The Berkman Center for Internet & Society at Harvard Law School](#).

<http://www.law.cornell.edu/topics/trademark.html> – An overview of trademark law from Cornell University’s Legal Information Institute. This site includes a very brief outline of the law, but also contains an extensive menu of sources, including federal, state and international materials.

<http://www4.law.cornell.edu/uscode/15/ch22.html> – Copy of the Lanham Act, (15 U.S.C. §§ 1051 et seq.) available through Cornell University’s Legal Information Institute.

#### **Copyright**

<http://lcweb.loc.gov/copyright/> – The U.S. Copyright Office at the Library of Congress includes numerous resources, including excellent general information, forms, relevant legal links and a searchable database of copyright records.

<http://www.law.cornell.edu/topics/copyright.html> – An overview of copyright law from Cornell University’s Legal Information Institute. This site includes a very brief outline of the law, but also contains an extensive menu of sources, including federal, state and international materials.

<http://fairuse.stanford.edu/> – Useful material and links maintained by Stanford University.

<http://www4.law.cornell.edu/uscode/17/> – The Copyright Act of 1976 via Cornell’s Legal Information Institute.

## Section XV. Guide to Vendor Contracts<sup>41</sup>

Nonprofit organizations routinely engage vendors to provide a wide array of goods and services. Although every vendor and every situation is different and may require special contract provisions, many of the legal issues will be substantially the same from contract to contract. This section, and the accompanying Model Vendor Contract, have been prepared to explain and define clauses frequently used in contracts and to assist nonprofit organizations in negotiating and developing such contracts. The section is arranged in the same order as the Model Vendor Contract and each subsection begins by providing the actual contract language as it appears in the Model Vendor Contract. The Model Vendor Agreement is for reference purposes only and should not be submitted as a contract document without modification for a particular use.

### A. What Is a Contract?

A contract is an agreement enforceable under the law. The core of a contract is that it reflects an *agreement* between the parties. The bulk of contract law is focused on determining what the agreement between the parties actually was.

One cornerstone in establishing whether a binding agreement exists is that the parties involved **intended** to enter into the agreement. In theory, this would mean that each party must subjectively intend to enter into the agreement and there must be a total “meeting of the minds” between the parties on each and every term of the agreement. In practice, however, courts use a much more lenient approach when evaluating whether the requisite intent existed to form a binding contract.

In evaluating a party’s intent, courts look at objective manifestations of intent such as what has been said or done rather than trying to delve into the actual thoughts, beliefs, and assumptions of the party. If the words and actions would lead a reasonable person to conclude that the party intended to enter into the agreement, then intent exists, even if the party claims that he or she did not expect to enter into the agreement. However, the actions and words which show intent must be voluntary; intent will not exist if the agreement is the result of fraud, duress, or other coercion.

Courts do not require agreement on each and every term. Rather, courts require that the parties agree on enough **material** (significant) terms that it is fair to say that an agreement actually existed. However, if the parties do not agree to enough terms, or if they do not agree on the important parts of a contract, the court will typically find that there was no “meeting of the minds” and therefore no agreement. If an agreement does exist, the court will then enforce only those terms about which the parties agree and will ignore the other terms.

It is commonly thought that a contract is a formal written document that all the parties have signed. While a large number of contracts are reduced to a written form, many more are oral or simply *implied through conduct*. Although oral and implied agreements may present difficult problems of interpretation and proof, whether a particular contract is written is usually irrelevant to its validity so long as there is evidence that the required elements of a contract exist. However, because specific interpretations may be critical to one party and because proof of what terms were actually agreed to can be difficult, agreements should always be reduced to writing.

One noted exception to the general rule that form is irrelevant to a contract’s validity is the requirement that certain contracts are only valid if they are in writing. Under the “statute of frauds,” a doctrine of contract formation, contracts that **must** be in writing include contracts that involve land, contracts that involve money or goods **greater than \$500**, and contracts that cannot be performed in less than a year. Many contracts that nonprofit organizations enter into have a value greater than \$500, requiring that the terms be written and the contract signed.

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<sup>41</sup> This section was prepared by Susan Dorn.

## **B. What Do Some Commonly Used Contract Clauses Mean?**

### **1. Description Of Work**

This is the core of any contract. In this clause, the nonprofit organization should describe every aspect of the goods and services that it wishes to receive. The descriptions should be clear, concise, and written so that anyone can understand the purpose of the contract—even people not familiar with nonprofit organization, the vendor, or the type of work being done.

To the extent that nonprofit organization requires the vendor to adhere to certain quality standards and time schedules, these standards and schedules should be described in this clause. Although industry standards and reasonable quality standards will often be implied if the agreement is silent, failure to include a specification in the description of the work could result in that specification not being a part of the agreement. If this is the case, nonprofit organization might not receive exactly what it intended to purchase, but would still be responsible for paying in full.

### **2. Independent Contractors**

This clause defines the relationship between nonprofit organization and the vendor as that of independent contractors, rather than that of employer/employee. This is critical to other legal questions that could arise from the contract. Some of the most important legal issues involve tax responsibilities, insurance liabilities, and labor rights. Although the language in this clause indicates what the nonprofit organization and the vendor believed at the time the agreement was made, the ultimate determination of the nature of the relationship between the parties is made by the IRS, courts, Department of Labor, insurers, and others. Please note that, it is possible that the IRS (or others) will conclude that the nonprofit organization has an employer/employee relationship with the vendor even if this clause is part of the contract.

### **3. Term**

In this clause, the nonprofit organization needs to indicate how long the contract is going to last. The duration of a contract can be expressed in terms such as a period of time, a number of units of a product, the occurrence of a specific event, or even a combination of several factors. Generally, the contract term should be long enough to ensure that nonprofit organization obtains value from the agreement, but not so long that nonprofit organization may be locked into an unfavorable situation. Further, in addition to laying out the initial term of the agreement, this clause should also indicate whether the contract can be **renewed**, what the **length** of renewal will be, and **what** must be done (and by **whom**) for the contract to renew.

### **4. Schedule Of Deliverables**

Any relevant “schedule” of goods or services needs to be articulated in this clause. Such schedules are particularly helpful in agreements that involve a project of an extended duration or that involves multiple stages of development. By having a schedule in the agreement, nonprofit organization ensures that it will be able to recover any damages resulting from the vendor’s failure to meet the schedule. Without this clause, it will be more difficult for a nonprofit organization to prove that the schedules were agreed to, and that adherence to the schedules was important.

### **5. Project Fee And Expenses**

In this clause, the amount that will be paid under the agreement needs to be set out. This amount can be expressed in a variety of ways, such as a flat amount, amounts based on phases of completion or an hourly rate. Regardless of how the amount due is calculated, the agreement should always state a maximum “not-to-exceed” amount above which the nonprofit organization will not pay. Further, to the extent that the agreement includes the use of personnel, an hourly rate should always be specified in the agreement.

In addition to indicating the amount of payment, this clause should also describe the method of payment and any applicable payment schedules. Although payment methods and schedules will vary depending on the specific nature of the agreement, the best possible type of arrangement for nonprofit organization is one in which nonprofit organization must pay the full amount at the time the vendor fulfills its side of the agreement. However, should the vendor refuse such a plan, as is often the case, nonprofit organization should arrange a payment schedule based on the completion of discrete tasks by the vendor. Nonprofit organizations should retain the right to approve in writing any change in the rates or fees.

## 6. Additional Charges

This clause is essential to indicate that you are not required to pay any charges which are not explicitly mentioned in the agreement. Having said that, nonprofit organization should list all expenses that it is willing to pay in this clause. Most notably, this clause should indicate the nonprofit organization's policies for reimbursing travel and related expenses. If a nonprofit organization allows an expense for which it does not have a prescribed policy, the acceptable rates should be spelled out in the agreement. At the very least, they should be limited to "reasonable rates."

## 7. Termination And Default

This clause is critical in that it provides the conditions under which either party can be **released** from the agreement. Under general contract law, the fact that one party has failed to perform its responsibilities of the bargain **does not** automatically excuse the other party from having to perform its obligations. Rather, the innocent (or "nonbreaching") party must continue to perform the agreement and then sue for damages. While this is the rule, it can be overcome by explicitly stating that the occurrence of certain events will excuse one or both parties from performing under the agreement. Although the content of this clause is negotiable, nonprofit organization must be certain to specify any and all situations in which they want to be able to stop their obligations (usually payment).

The most important instance in which you should specify a right to terminate without penalty is when the vendor **is in default**. While the parties can specify that almost anything constitutes default, typically default involves situations such as where the vendor has failed to perform a significant part of the agreement, has become bankrupt, or has gone out of business. Termination of the agreement by nonprofit organization after the occurrence of one of these events is said to be "for cause." Nonprofit organizations should retain the right to terminate "**for cause**" without being required to give the vendor any advance notice and without being penalized for terminating. In negotiating this clause, many vendors may demand a provision that allows them to "cure" or fix the problem within a set amount of time after being notified by nonprofit organization of the existence of the problem. Vendors may also require that the language granting nonprofit organization the right to terminate "for cause" also grants the vendor the right to terminate "for cause." Both of these requests are reasonable and can be conceded by nonprofit organization when negotiating the agreement.

In addition to termination "for cause," nonprofit organizations should also retain the right to terminate **without cause** simply by giving the vendor sufficient advance notice of its intention to terminate. This allows a nonprofit organization to get out of the agreement if the conditions of the agreement become unfavorable or if the relationship between the parties deteriorates. Because few vendors will agree to such a provision unless they are granted similar rights, you should be prepared to recognize the right of the vendor to terminate the agreement without cause. In setting the period of notice required before a party can terminate without cause, the prime consideration should be how much notice is necessary in order to minimize the disruption that may result from the vendor's termination.

## 8. Force Majeure

This clause contains standard contract language. A "Force Majeure" clause (also known as an "Act of God" clause) excuses a party from meeting its obligations if an event outside its control, such as fire, flood, earthquake, or any other unforeseeable or unavoidable event prevents or inhibits it from performing under

the contract. The language of this clause extends equal protection to both parties and should not be a source of controversy.

## 9. Return Of Materials

In the event that the agreement is terminated, this provision grants the nonprofit organization the right to claim any and all materials created by the vendor for the nonprofit organization. This clause should be included whenever a vendor borrows any equipment from or has access to important data of the nonprofit organization. The clause will assist in obtaining in a court-ordered return of these materials.

## 10. Confidentiality And Nondisclosure

While performing under the agreement, the vendor may have access to information pertaining to nonprofit organization's business, finances, or operations. This clause is essential in protecting the nonprofit organization from the release of that information by the vendor both **during** the course of the agreement and **after** termination. Although this clause cannot actually prevent the vendor from releasing any such information, it puts the vendor on notice that the nonprofit organization considers nondisclosure to be important. If the vendor does release information, that release constitutes a "material breach" of the agreement and the agreement may be terminated "for cause" without penalty. Without this clause, there is a risk that the release of such information might not be considered a material breach and that the nonprofit organization would not be justified in terminating the agreement.

## 11. Ownership And Intellectual Property

This clause is vital to retaining nonprofit organization's right to various intellectual property. Under copyright law, the author of a work is the owner of the copyright, which includes the rights to reproduce, distribute, modify, and display the work. These rights exist independently from ownership and possession of the physical work. In certain circumstances, simply stating that materials are the exclusive property of nonprofit organization will not be sufficient to grant nonprofit organization full rights to use those materials. To ensure that the nonprofit organization does have the right to own and use all materials it pays others to create, this clause requires the vendor to agree to **assign** (give) nonprofit organization all of the rights to the materials.

One noted exception to the general rule that the author of a work is the owner of all the rights in the work are "**works-for-hire.**" If a company hires the author to create the work, and the work qualifies as a "work-for-hire," the company, not the author, owns the copyright. A work can only qualify as a "work-for-hire" if a written agreement exists that explicitly states that a certain item is a "work-for-hire." This clause is necessary to satisfy that statutory requirement.

Further, to the extent that the vendor creates materials that are not covered by copyright law or which do not constitute "works-for-hire," this clause requires the vendor to assign any rights (copyright, trademark, or otherwise) in those materials over to the nonprofit organization. Without this clause, nonprofit organization could end up purchasing goods under the agreement that it only has limited rights to use.

## 12. Indemnification

This clause provides that, in the event that a third party sues the nonprofit organization based on the vendor's negligent acts or misconduct, the vendor is required to pay all of the nonprofit organization's costs in defending the lawsuit. Further, if the case is lost, the vendor is responsible for paying any judgements that are entered against the nonprofit organization. This paragraph is critical in protecting nonprofit organizations from situations in which the actions of the vendor could subject them to potential liability. Because the actions of the vendor are, to a large extent, out of a nonprofit organization's control, there is little else a nonprofit organization can do to insulate itself from such unexpected liability.

Often vendors will insist that the nonprofit organization indemnify them from the nonprofit organization's negligent acts or misconduct. Generally, this is acceptable but should only be included at the insistence of a vendor.

### **13. Insurance**

Much like indemnification, this clause helps protect a nonprofit organization from occurrences that are beyond its control. By ensuring that the vendor meets certain minimum insurance requirements and that the nonprofit organization is named as a beneficiary of those policies, nonprofit organization is protected in at least two ways. In the absence of this clause, a nonprofit organization would be limited to trying to recover damages from the vendor if the vendor made a mistake. This clause enables a nonprofit organization to recover from an insurance company, as well as the vendor, if the vendor damages nonprofit organization. In addition, the nonprofit organization receives the benefit of insurance for situations it could not otherwise insure against.

The clause also prohibits the vendor from seeking compensation from the nonprofit organization for losses or damages that are covered by an active insurance policy.

### **14. Warranty**

The nonprofit organization should describe all expectations of qualifications and training of individuals performing work under the agreement in this clause. The inclusion of relevant "warranties" establishes the expectation that if certain quality standards are not met, nonprofit organization will have the right to terminate the agreement without penalty and seek damages for inferior performance. Without this clause, it could be very difficult for a nonprofit organization to prove that any but the most severe deficiencies in quality were substantial enough to justify terminating the agreement.

Any additional performance or quality control standards that the nonprofit organization believes are essential to an acceptable product or service furnished by the vendor should be added to this clause.

### **15. Assignment**

This clause essentially provides that only the parties who signed the agreement can perform the work under the agreement (and/or collect money due under the agreement). Without this clause, once the agreement is made, the vendor could turn around and pay a third party to do the work instead of doing it itself as nonprofit organization expected. Given the importance of personal characteristics of specific vendors, such as their reputation for quality work, fairness, and reliability, this clause is vital to ensuring that a nonprofit organization receives the service for which it has bargained.

### **16. Notice**

This clause contains relatively standard but important contract language. Throughout this agreement there are provisions that require the nonprofit organization, the vendor, or both to **notify** (communicate with) each other before certain actions are taken, after certain events occur, or if problems arise. In interpreting contracts, disputes often arise regarding whether a specific attempt by one party to communicate with the other party was sufficient to fulfill its notice obligation under the agreement.

One of the most common disputes in contract litigation is whether notice is considered given within the window of time specified in the contract. In this clause nonprofit organization and the vendor agree that notice is considered given at the time that it is **deposited** in certified U.S. mail and is addressed exactly as indicated in this clause. Therefore, if written notice is required within thirty days of the occurrence of an event, that notice is valid so long as it is **deposited** in certified mail by the end of the thirtieth day, even if it is not received until several days later. If the notice never arrives, and the sending party transmits the notice again (so that the receiving party can actually receive it), the notice will be considered given at the time it was first sent.

## 17. Nondiscrimination

As a recipient of federal funding, a nonprofit organization is required to have this provision in all agreements with vendors (at least in contracts entered into pursuant to government funding). For this reason, this clause is not negotiable.

## 18. Survival Of Rights And Obligations

This clause specifies that, unless specified elsewhere in the agreement, obligations and rights under this agreement **will not end** when the contract expires or is terminated. This is particularly important with regard to a nonprofit organization's intellectual property rights and the vendor's duty not to disclose information. For example, without this clause, once the term of the agreement ended the vendor would no longer have a duty to keep the nonprofit organization's information confidential. Failure to extend such protection beyond the term of the agreement would result in essentially no protection at all. Therefore this clause is essential to fully protect a nonprofit organization's rights.

## 19. Waiver

Over the course of the agreement, the vendor may violate (breach) one provision of the contract, and nonprofit organization may decide to ignore the breach. Under general contract law, such a decision not to enforce a particular violation (**waiver**), could be interpreted as waiver of the right to enforce future violations. This clause is essential to indicate that, even though the nonprofit organization may waive its right to enforce a provision of the agreement once, it fully maintains its right to enforce all future violations of the agreement.

This clause gives nonprofit organization the flexibility to decide that it is better not to enforce a particular violation of the agreement or that given the circumstances in place at a particular time, it is better not to terminate the agreement even though nonprofit organization has the right to do so.

Further, to the extent that a nonprofit organization **does** decide to waive its right to enforce the agreement, such waiver is only valid if it is expressed in writing and signed by the nonprofit organization. This clause has been written to protect both parties equally.

## 20. Headings Not Controlling

This clause is a standard contract provisions that simply indicates that the headings of the clauses are not terms of the agreement and only exist to provided organization and reference points in the agreement. Given the innocuous nature of the headings in this particular agreement, omission of this clause would not cause any serious problems.

## 21. Merger

This clause is a standard contract provision and its inclusion is extremely important. By the express provisions of this clause, the parties agree that this signed, written contract constitutes the entire agreement between nonprofit organization and the vendor. This means that no documents, oral communications, or other evidence relating to matters discussed in this agreement can be used to modify or otherwise challenge terms expressly agreed to in the written contract. The only way to change the agreement is through a written document signed by both nonprofit organization and the vendor that expressly indicates that it is a modification of the agreement. This clause assures that both parties are aware of this interpretation of the contract and that they understand that in the event of litigation the court will be bound by such an interpretation.

## **22. Severability**

This clause ensures that the agreement is enforceable even if it contains a bad clause. For example, if the agreement mistakenly contains a clause requiring the vendor to deliver the first installment of the work three years ago, that clause may be considered invalid. In such a situation, it is much better to have only the bad clause considered invalid, and not the entire agreement. In litigation, if a provision of an agreement is found to be unenforceable, the court may also hold that the entire agreement is invalid and unenforceable. On the other hand, the court could also decide to strike the invalid provision and enforce the remainder of the agreement as if the invalid provision had never been a part of the contract. Rather than risk a court interpretation that the entire agreement is invalid, this clause expresses that it is the parties' intent to strike any invalid provisions and enforce the remainder of the agreement.

Similarly, it is also possible that in litigation the court could be faced with two possible interpretations of what a particular provision in the agreement means. If one interpretation of a provision would render that provision invalid while the other interpretation would render it valid, this clause requires the court to apply the interpretation that keeps the provision valid.

## **23. Governing Law**

This clause indicates that should this agreement ever be litigated the court in which the contract is being litigated must apply the laws of the District of Columbia. This clause is important because certain provisions in this agreement have been drafted using language that is subject to specific interpretations under the District of Columbia law. If the agreement is litigated under the laws of another state, the agreement could be subject to different interpretations. However, the agreement has been carefully drafted so that it will be valid in any state. This clause is more of a convenience than a necessity, and can be left out or changed to designate another state's law.

## **C. Conclusion**

The preceding information has been prepared as an overview to explain commonly used contract clauses, as illustrated by the Model Vendor Agreement. Both documents are offered for reference purposes only. Competent legal counsel should be sought to answer specific questions about negotiating and drafting specific contracts.

**[Please note: Bold language requires choice among the options presented. Instructions are in bolded italics. Brackets, unused options, and instructions need to be deleted before draft contract is sent to vendor.]**

**MODEL VENDOR CONTRACT**

This Agreement is made this \_\_ day of \_\_\_\_\_, 20\_\_, by and between \_\_\_\_\_ (“Vendor”), a \_\_[state of incorporation]\_\_ corporation [**OR: limited liability company, partnership, sole proprietorship, or an individual**], with its principal place of business at \_\_\_\_\_ (EIN **OR** SSN: \_\_\_\_\_), and the Good Works Society, Inc. (“Society”), a District of Columbia nonprofit corporation, with its principal place of business at \_\_\_\_\_, Washington, D.C.

WHEREAS, Vendor is in the business of \_\_\_\_\_; and

WHEREAS, Society desires Vendor to \_\_\_\_\_;

NOW THEREFORE, in consideration of the terms herein contained, the parties hereto agree as follows:

1. DESCRIPTION OF WORK: Vendor agrees to perform the following duties in accordance with this Agreement [***if Exhibit will be attached*** and the Work Statement attached hereto as Exhibit A, which Exhibit is hereby incorporated by reference and made a part of this Agreement ](“Project”):

***[Insert basic description of work to be performed and all relevant warranties and representation]***

2. INDEPENDENT CONTRACTORS: The parties are independent contractors with respect to each other, and nothing herein shall create any association, partnership, joint venture or agency relationship between the parties. All persons employed in connection with Vendor’s performance hereunder shall, as between Society and Vendor, be Vendor’s employees. Vendor shall pay all amounts due for materials in connection with Vendor’s performance hereunder; further, Vendor agrees that it shall be solely responsible for compensation and any and all taxes related thereto due its employees for the performance of Vendor rendered hereunder to Society. Neither party has any right or authority to assume or to create any obligation or responsibility on behalf of the other party.
3. TERM: The term of this Agreement shall be effective from [**Day, Month, Year**] through [**Day, Month, Year**] (“Term”). [***Optional:*** This Agreement may be renewed for successive [**one-year OR one-month**] terms by mutual written agreement of the parties.]
4. SCHEDULE OF DELIVERABLES: Vendor shall deliver to Society the following deliverables on or before the dates specified below:

**Schedule of Deliverables**

Deliverable	Delivery Date

Society shall have the right, in its sole discretion, to request revisions or modifications to any deliverable. All requested revisions or modifications shall be completed and approved by Society prior to the start of next step of the Project. Failure by the Vendor to furnish any deliverable as specified in this Section on or before the date specified shall constitute a material breach of this Agreement.

5. PROJECT FEE AND EXPENSES: As consideration for Vendor’s work in connection with the Project, Society shall pay Vendor according to the following schedule of payments. In no event shall the total cost of the Project exceed \$\_\_\_\_\_.

**[Choose either Schedule of Payments or Hourly Rate payment terms:]**

Schedule of Payments	
Invoice Date	Payment

**[OR Hourly Rate:** Society and Vendor will agree in writing on a not to exceed price for each specific task to be performed by Vendor prior to the beginning of work on the task. In determining the fees for each task, Vendor agrees that the hourly rate to be used is \$\_\_\_\_\_. Vendor shall keep a daily timesheet of hours worked. The timesheet will be presented to Society weekly for review and signature approval. Itemized invoices setting forth the work performed on the Project shall be submitted on a monthly basis.]

Society shall pay the undisputed portion of invoices within thirty (30) calendar days of receipt of the invoice.

6. ADDITIONAL CHARGES: There shall be no charges to Society other than those charges specifically set forth in this Agreement, unless expressly agreed to in advance in writing by Society. In addition to the hourly fee, Society will pay only those travel and related expenses that are approved in writing in advance by Society. Vendor is responsible for transportation to Society’s D.C. location and Society will not reimburse Vendor for such transportation and expenses. Approved travel and related expenses to other areas will be reimbursed by Society consistent with the Society travel policy then currently in effect. No other costs or expenses incurred by Vendor shall be advanced or reimbursed to the Vendor without prior advance written consent by Society.

7. TERMINATION AND DEFAULT: ***[Please note: It is preferred to have a shorter notice period for termination with cause than without cause. When selecting the with cause notice period, please be aware that this time will be in addition to any time allowed to cure under subsection A(1) below. For example, if Society may terminate with cause upon fourteen days’ notice, but subsection A(1) requires allowing Vendor five days to cure the violation, then Society will need to give notice and wait nineteen days before the termination may be effective.]*** Either party may terminate this Agreement, without cause, by giving the other party **[fourteen (14) OR thirty (30)]** calendar days’ written notice of termination. Further, in the event that one of the parties is in default as defined below, the non-breaching party may, in its sole reasonable discretion, **[immediately OR upon fourteen (14) calendar days’ notice]** terminate the Agreement without penalty by giving the breaching party written notice of such termination which shall not excuse breaches of this Agreement which may have already occurred.

A. VENDOR DEFAULT: Default on the part of Vendor shall include, without being limited to, the occurrence of the following events:

- (1) failure by Vendor to comply with any of the provisions of this Agreement in a satisfactory manner as reasonably determined by Society; ***[Optional; allowing a cure period is recommended but not required]*** and failure to cure such violation within **[twenty-four (24) hours’ OR five (5) calendar days’]** written

notice of said violation;]

- (2) filing by Vendor of a voluntary petition under any bankruptcy, reorganization, insolvency, or any other law for the relief of, or relating to debtors; the filing against Vendor of an involuntary petition in bankruptcy or a receiver or trustee is appointed to take possession of Vendor's property, any of Vendor's property is subjected to levy, seizure, assignment, application or sale for or by any creditor or governmental agency, and such action is not dismissed within thirty (30) calendar days thereafter; or Vendor becomes insolvent; or
- (3) dissolution of Vendor voluntarily, involuntarily or by operation of law.

B. SOCIETY DEFAULT: Default on the part of Society shall include, without being limited to, the occurrence of the following events:

- (1) failure by Society to make any payments to Vendor within [**twenty-four (24) hours' OR five (5) business days'**] written notice from Vendor of failure to comply with the specifications described in this Agreement; or
- (2) dissolution of Society voluntarily, involuntarily or by operation of law.

8. FORCE MAJEURE: Either party may terminate or suspend its obligations under this Agreement if such obligations are delayed, prevented or rendered impractical by any of the following events to the extent such event is beyond the reasonable control of the party whose performance is prevented or rendered impractical:

Fire; flood; earthquake; civil commotion; insurrection; Act of God; labor disputes; strikes; curtailment of transportation facilities; war; shortage or inability to obtain materials, supplies or utilities (including a shortage or inability to meet needs for materials or supplies); economic factors that would make it impracticable for Association to hold an Event identified herein as scheduled or to otherwise perform its obligations hereunder (including but not limited to the unavailability or inadequacy of any convention center, headquarters, hotel or necessary expansion space); any law, ordinance, rule or regulation which becomes effective after the date of the execution of this Agreement, or other exigent circumstance or emergency making it inadvisable, impracticable, illegal, or impossible to perform its obligations hereunder.

The non-performing party shall give written notice of termination to the other party within ten (10) business days of any such event, or this provision shall be invalid. The non-performing party shall not be liable to the other for delay or failure to perform its obligations, except there shall be a pro rata reduction in the consideration which would otherwise be payable or due under this Agreement.

9. RETURN OF MATERIALS: In the event of termination of this Agreement, the materials produced under this Agreement (including any materials used in preparation of the Project) will become the sole property of Society and Vendor shall immediately deliver such materials to Society in such form as reasonably requested by Society.
10. CONFIDENTIALITY AND NONDISCLOSURE: Vendor agrees to keep confidential and not use or disclose any information acquired in the performance of this Agreement concerning Society, its business, finances or operations. [**Optional** If approved by Society in writing, Vendor may keep copies of certain records and/or notes in order to be able to answer future technical questions from Society.]
11. OWNERSHIP AND INTELLECTUAL PROPERTY: Materials prepared or delivered by Vendor to Society under the terms of this Agreement shall be works made for hire created for and owned

by Society and are the exclusive property of Society. To the extent that any material does not constitute work made for hire as a matter of law, Vendor hereby grants and assigns to Society all exclusive rights to the material under United States copyright law and all international copyright conventions including the right to copyright the material and any renewals thereof in the name of Society. Vendor also hereby assigns to Society and/or waives any and all claims that Vendor may now or hereafter have in any jurisdiction to so-called “moral rights” or rights of “droit morale” in connection with the Work and shall secure the same agreement from all employees and independent contractors performing services in connection with Vendor’s performance under this Agreement.

12. **INDEMNIFICATION:** Vendor agrees to defend, indemnify and hold harmless Society, its officers, employees, and agents from and against any and all claims, demands, actions, causes of action, penalties, judgements and liabilities (including court costs and reasonable attorney’s fees) based upon or arising out of any act, omission, negligence, misconduct, or breach of any material condition of this Agreement by Vendor, its subcontractors, or their respective employees, representatives, servants, agents, invitees, licensees or contractors. However, this Agreement shall not provide any right for any person, firm, corporation, or association who is not a party to this Agreement.

**[Optional:** Society, its officers, employees, and agents agree to defend, indemnify and hold harmless Vendor from and against any and all claims, demands, actions, causes of action, penalties, judgements and liabilities (including court costs and reasonable attorney’s fees) based upon or arising out of any act, omission, negligence, misconduct, or breach of any material condition of this Agreement by Society, its officers, employees, representatives, and agents. However, this Agreement shall not provide any right for any person, firm, corporation, or association who is not a party to this Agreement.]

13. **INSURANCE:** *[If the not-to-exceed cost is less than \$50,000, use this sentence and the final paragraph]* Vendor warrants that it shall procure, pay for, and maintain for the Term of this Agreement (i) worker’s compensation as required by law and (ii) comprehensive general liability insurance in such amounts as are adequate to cover matters arising out of this Agreement, but in no event less than one million U.S. dollars (\$1,000,000) combined single limit for both bodily injury and property damage.] *[If the not-to-exceed cost is \$50,000 or more, greater insurance coverage is necessary and use all the following language in this section:* Vendor warrants that it shall procure, pay for and maintain for the Term of this Agreement the following insurance. Said insurance shall be in minimum amounts approved by Society as set forth below and shall name Society as an additional insured.]

***[Select coverage appropriate to nature of service].***

<b><i>[all]</i></b> Worker’s Compensation Employers’ Liability	Statutory No less than \$100,000/\$500,000/\$100,000
<b><i>[all]</i></b> Comprehensive General Liability Insurance written on an occurrence basis including “aggregate limits of insurance (per location)” endorsement CG2504 or its equivalent and also including Blanket Contractual Liability, Broad Form Property Damage, Personal Injury, Completed Operations - Products Liability, Fire Damage Legal	Not less than \$1 million Combined Single Limit for both bodily injury and property damage
<b><i>[on-site and construction]</i></b> All risk (or special causes of loss) basis property insurance including theft protecting leasehold improvements	\$5 million
<b><i>[advertising, public relations, graphic and web designers, and other media-related vendor]</i></b> Media liability insurance written on an occurrence basis including open risk coverage for media liability	\$1 million

Said insurance shall contain an endorsement that such policy shall remain in full force and effect notwithstanding that the insured has waived its right of action against any party prior to the occurrence of a loss, and shall require the insurer to waive all rights of subrogation against Society. Vendor hereby waives any and all rights of recovery against Society, its officers, employees, agents and representatives for loss of or damage to Vendor, its property and/or the property of others under its control to the extent that such loss or damage is insured against under any insurance policy in force at the time of such loss or damage and such loss or damage has been paid by the insurance company.

- 14. **WARRANTY:** All supervisors, employees and authorized representatives assigned to perform services under this Agreement shall be fully qualified and specially trained in their respective responsibilities and shall perform the assigned services with care and diligence. ***[If Vendor is subject to bonding or licensing requirements, include: Vendor warrants that all vendor personnel furnishing services to Society shall be licensed to the extent required by law and bonded for at least \$25,000.]***
- 15. **ASSIGNMENT:** Neither this Agreement nor any interest in this Agreement, including any interest in the Project, may be assigned or transferred by either party without the prior written authorization of the other party. Violation of this Section shall constitute a material violation of this Agreement.
- 16. **NOTICE:** All notices required under this Agreement shall be considered given when deposited in the U.S. mail, certified, return receipt requested, addressed to the respective parties as follows. Notice shall also be required to be given by telephone, facsimile, and electronic mail on the same date as deposited in the mail. Notice given by mail alone shall not be sufficient.

Society: Attention: \_\_\_\_\_  
\_\_\_\_\_

Vendor: Attention: \_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_  
P: \_\_\_\_\_  
F: \_\_\_\_\_  
E: \_\_\_\_\_

- 17. **NON-DISCRIMINATION:** Vendor agrees not to discriminate against any employee or any applicant for employment because of race, religion, sex, national origin, sexual preference or handicap.
- 18. **SURVIVAL OF RIGHTS AND OBLIGATIONS:** Vendor and Society agree that all rights and obligations provided in this Agreement (including but not limited to those articulated in the clauses entitled "Return of Materials," "Confidentiality and Nondisclosure," and "Ownership and Intellectual Property") which do not expressly terminate pursuant to this Agreement, shall survive beyond the Term of this Agreement and shall remain in full force and effect in perpetuity.
- 19. **WAIVER:** The waiver of a breach of any of the terms hereof or of any default hereunder, shall not be deemed a waiver of any subsequent breach or default, whether of the same or similar nature, and shall not in any way affect the other terms hereof. No waiver or modification shall be valid or binding unless in writing and signed by the waiving party.
- 20. **HEADINGS NOT CONTROLLING:** Headings used in this Agreement are for reference purposes only and shall not be deemed as part of this Agreement.

21. **MERGER:** This Agreement represents the entire agreement of the parties and supersedes any other understanding of the parties concerning the subject matter herein. There are no other representations, covenants, arrangements, or understandings, either written or oral, between the parties relating to the subject matter which are not fully expressed herein or have been relied upon in entering into this Agreement. This Agreement may be modified only by the written consent of both parties.
22. **SEVERABILITY:** All provisions of this Agreement shall be severable and no provision shall be affected by the invalidity of any other provision to the extent that such invalidity does not also render such other provision invalid. In the event of the invalidity of any provision of this Agreement, it shall be interpreted and enforced as if all provisions thereby rendered invalid were not contained herein. If any provision of this Agreement shall be susceptible of two interpretations, one of which would render the provision invalid and the other of which would cause the provision to be valid, such provision shall be deemed to have the meaning which would cause it to be valid.
23. **GOVERNING LAW:** This Agreement and any addenda or amendment attached hereto, shall be governed exclusively by the laws of the District of Columbia.

IN WITNESS WHEREOF, the parties have executed this Agreement by their duly authorized representatives as of the day and year first above written.

**[NAME OF VENDOR]**

BY: \_\_\_\_\_ DATE: \_\_\_\_\_  
 Its \_\_\_\_\_

Good Works Society, Inc.

BY: \_\_\_\_\_ DATE: \_\_\_\_\_  
 Its \_\_\_\_\_

## Section XVI. Overall Website Bibliography

This section will provide a bibliography of helpful websites for the EO. Please note that some of these websites are provided at the end of the other sections in this outline. The list is grouped below by topic and provides a short description of the website is provided. Please note that this list is not an endorsement or recommendation of any website, entity, or individual. This bibliography is merely a helpful list of the information that was viewed in preparing this outline.

### A. Accounting and Tax Information

<http://www.aicpa.org/index.htm> - The American Institute of Certified Public Accountants.

<http://accounting.rutgers.edu/raw/fasb> – Financial Accounting Standards Board

[http://www.irs.ustreas.gov/prod/forms\\_pubs/index.html](http://www.irs.ustreas.gov/prod/forms_pubs/index.html) - IRS Publications and Forms.

<http://www.genie.org> – A project of the California Management Assistance Partnership and the Support Center for Nonprofit Management, this site contains a wealth of nonprofit experts' opinions, publications, links, and answers to frequently asked questions, including 22 FAQ's pertaining specifically to Form 990.

<http://www.guidestar.org> -- Guide star has compiled a database of all 501(c)(3) charities that submit 990 forms to the IRS.

<http://www.nonprofitfinancial.org> - Nonprofit Financial Center is a nonprofit financial resource organization formed to help nonprofit organizations develop sound financial management. NFC also gives loans to Illinois nonprofits and provides valuable links for Illinois nonprofits.

<http://www.wiley.com> - This website provides information on the following publications which are for sale: Jody Blazek, Tax Planning and Compliance for Tax-Exempt Organizations: Forms, Checklists and Procedures, John Wiley & Sons, Third Edition, 1999, Jody Blazek 990 Handbook: A Line-by-Line Approach, John Wiley & Sons, 2000, Jody Blazek, Tax Planning and Compliance for Tax-Exempt Organizations: Forms, Checklists and Procedures, John Wiley & Sons, Third Edition, 1999.

<http://www.1800net.com/nprc> – 1800net.com (for-profit entity) provides a website called the Non-profit Resource Center that provides an overview of accounting standards and regulations that apply to nonprofits with links to particular pronouncements, and regulations.

<http://www.990accountant.com> - A guide to form 990s and other IRS nonprofit related forms.

<http://www.qual990.org/links.htm> – This site provides information about the Form 990, nonprofit accountability, and other accounting/tax issues.

<http://www.form990.org> - This site is a prototype of an electronic or magnetic filing system that when enabled will allow the user to complete a Form 990 and submit it to the appropriate agencies. Additionally the site will enable the public to view any Form 990 on record. The form 990 will be a smart form and will signal the user when calculation, ratio, and omission errors are made

### B. Business Leagues and Trade association – 501(c)(6)

<http://www.asaenet.org> - American Society of Association Executives provides a general website with information for 501(c)(6) organizations.

<http://www.ncna.org> – The National Council on Nonprofit Associations' website. This organization is a network of state and regional associations with a collaborative membership of more than 20,000 community nonprofits.

### C. Charity Malls and Internet Retailers

<http://www.amazon.com/exec/obidos/subst/associates/join/associates.html> – This website is an internet retailer. Amazon's "Associates Program" includes books, as well as much of the other merchandise Amazon offers via their Web site. Amazon.com Associates is free to join. As an Associate, the organization must place links to Amazon.com on its website. Each time a visitor clicks from the EO's site to Amazon.com to purchase items, the EO earns referral fees.

<http://www.charityamerica.com> – This website provides a charity mall and internet mall services to over 400 charities. The organization keeps a small processing fee for its services.

<http://www.charitywave.com> – Charitywave.com provides a charity mall. 100 percent of every donation is passed to the charity. All processing fees are paid by Wave Systems Corp

<http://www.createhope.com> – This website provides a charity mall.

<http://www.donate.net> – Donate.net provides a charity mall. Charities may pay a monthly fee for being listed on the website or have take a reduced amount (for processing fees) from the actual donation made.

<http://www.donateto.com> - DonateTo.com will place a link or donation button on a company's website. The button enables a company's online audience to make a gift to one or dozens of charities that have been selected by the company. DonateTo.com will charge a fee of 6.5 percent of the amount of each gift made through its site or a flat fee of \$7, whichever is lower.

<http://www.donationdepot.com> – This website provides a charity mall. Charities must pay a fee to be listed on this website.

<http://www.egrants.org> - eGrants.org is a nonprofit-run service that combines the power of the Internet with social change philanthropy. It helps 501(c)(3)'s set up online donations through their own website. eGrants.org is a project of Tides, a major progressive nonprofit incubator based in San Francisco

<http://www.entango.com> - Entango is a for-profit online donation processing company that provides a charity mall. Entango provides a secure, customizable giving page and charges a 5% fee, which includes credit card processing costs.

<http://www.ExcessAccess.com> - ExcessAccess offers services linking business and household item donations with a nonprofit wish list. There is a fee associated for being listed. Also, some items may be distributed to 501(c)(4) and (c)(6) organizations. ExcessAccess will handle all of the written acknowledgements/substantiation requirements for the EO.

<http://www.givedirect.com> – This website provides a charity mall. It is run by Independent Givers of America.

<http://www.givenation.com> – Givenation.com (a for-profit company) provides a charity mall. The organization keeps a portion of the donations as processing fees.

<http://www.givingcapital.com> – Givingcapital.com provides a charity mall that also provides donor-advised-fund programs for charities and financial advisers.

<http://www.givingnetwork.com> – This website provides on-line donation services. The site has a registry over 30,000 charities. Givingnetwork.com keeps a portion of the donation as processing fees.

<http://www.greatergood.com> – Greatergood.com is an internet retailer. Up to 15% of each purchase goes to benefit the charity of choice.

<http://www.helping.org> – Helping.org is a non-profit created by the AOL/TimeWarner Foundation in

partnership with the Benton Foundation. This website is a charity mall. Helping.org has partnered with GuideStar, which has compiled a database of all 501(c)(3) charities that submit 990 forms to the IRS. This means that your organization is already "pre-registered" with Helping.org. Helping.org passes through 100% of the donated amount to their organization

<http://www.iGive.com> – iGive.com is an internet retailer. Up to 26% of each purchase goes to benefit the charity of choice.

<http://www.justgive.org> – Justgive.org is a non-profit that provides a charity mall. Donors can choose from over 700,000 charities (from IRS list) or from Justgive.com's prescreened list of approximately 2000 charities. 100% of the donations are passed to the EO (several for-profit sponsors pay the processing fees for the website). Also allows the website has links to charity malls and internet retailers.

<http://www.makeadonation.com> – This website provides a charity mall. It allows the EO to accept the donations directly on the EO's website. Makeadonation.com keeps a processing fee.

<http://mycause.com> - This website is an internet retailer. Depending on what is purchased 2-13% of the purchase will be passed to the charity.

<http://npsmall.com> – This website is an internet retailer. All the non-profits affiliated with this website have their own charity malls.

<http://www.powells.com/partners/partners.html> – This is an internet retailer. This website allows non-profits to partner (for no fee) with online bookstore Powells.com and earn rebates (generally from 5-15%) on merchandise that customers buy through links on the EO's website.

<http://www.workingforchange.com> – This website is maintained by Working Assets, a socially responsible credit card and long distance phone company. This website provides an example of using advocacy on the internet and has several donation type services (a charity mall and an internet retailer) such as:  
**GiveforChange.com** - an online donation catalog of carefully screened social change nonprofit groups and  
**ShopforChange.com** – consumers can shop from over 100 online stores and 5% of every purchase is donated to the charity of

#### **D. Churches**

<http://www.deathandtaxes.com/pub1828.htm> - Tax Guide for Churches and Other Religious Organizations (not yet issued by the IRS)

#### **E. Copyright**

<http://lcweb.loc.gov/copyright/> -- The U.S. Copyright Office at the Library of Congress includes numerous resources, including excellent general information, forms, relevant legal links and a searchable database of copyright records.

<http://www.law.cornell.edu/topics/copyright.html> -- An overview of copyright law from Cornell University's Legal Information Institute. This site includes a very brief outline of the law, but also contains an extensive menu of sources, including federal, state and international materials.

<http://fairuse.stanford.edu/> -- Useful material and links maintained by Stanford University.

<http://www4.law.cornell.edu/uscode/17/> -- The Copyright Act of 1976 via Cornell's Legal Information Institute.

#### **F. Employment Issues**

<http://charitychannel.com/> - charityChannel provides an on-line professional community that exceeds

45,000 nonprofit-sector professionals. The site has many discussion forums on various topics of interests to EOs, including a human resources discussion forum called CharityHR.

<http://www.employers.gov> - This website is called Firstgov for Employers and is a joint effort among the Department of Labor, Internal Revenue Service, Small Business Administration, Social Security Administration, Treasury, States, and Simplified Tax and Wage Reporting System. The site provides resources and cross-agency information for employers, as well as new and established businesses. It provides helpful information on hiring employees, including links to forms and explanations of payroll taxes.

[http://www.irs.ustreas.gov/prod/forms\\_pubs/index.html](http://www.irs.ustreas.gov/prod/forms_pubs/index.html) - IRS publications and forms, including Publication 505, *Tax Withholding and Estimated Tax*; Form SS-8, *Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding*; Publication 15, *Employer's Tax Guide*, Publication 1976, *Employee or Independent Contractor*; Form W-2, *Wage and Tax statement*; and Form 1099MISC, *Miscellaneous Income*.

[www.noacentral.org](http://www.noacentral.org). National Organizers Alliance, a non-profit group with 1,000 members that represents the interests of people who work in fields as disparate as homelessness, race relations, the environment, and labor activism. NAO formed a coalition in 1992 to form a joint pension plan for many small nonprofit organizations that could not afford to do so on their own. Non-profit organizations that join must contribute at least 5 per cent of employees' total annual salary to the retirement plan, and workers must have at least one year's employment at a social-justice organization to be eligible.

## **G. Fundraising**

<http://www.actknowledgeworks.net/ephil>. - Published by the W.K. Kellogg Foundation, in Battle Creek, Mich., "e-Philanthropy v.2.001: From Entrepreneurial Adventure to an Online Community" provides a snapshot of online philanthropy ventures both for and by nonprofit organizations - A database that accompanies the report describes and provides links to 315 Web sites on fund raising, advocacy, volunteerism, and other topics of interest to nonprofit groups.

<http://www.bbb.org/pas/srp/-Council> of Better Business Bureau's Standards for Charitable Solicitations. The BBB outlines activity standards to promote ethical practices by philanthropic organizations. Subject areas range from governance to public accountability. This site also provides definitions of activities and could be useful in developing by-laws.

<http://www.charityweb.com> - CharityWeb is an e-commerce Application Service Provider (ASP) that provides custom e-commerce solutions for non-profit organizations. For a fee, CharityWeb will set up a merchant credit card account for on-line processing for the EO; thereby allowing the EO to accept on-line credit card payments.

<http://www.nsfre.org> - The National Society of Fundraising Executive's website. This website provides news, professional certification information, fund-raising resource center, and a directory of consultants.

<http://www.nasconet.org> - The Board of Directors of the National Association of State Charity Officials.

## **H. General Nonprofit Information**

<http://www.abanet.org/tax/groups/eo/> - The American Bar Association Section of Taxation Committee on Exempt Organizations.

<http://www.abanet.org/buslaw/catalog/pubs.html/> The American Bar Association Section of Business Law website to review and order Business Law Section publications on nonprofit governance and management issues, as well as general business issues. This site provides information on how to order The Guidebook for Directors of Nonprofit Corporations (2<sup>nd</sup> ed., G. Overton and J. Frey, eds., American Bar Association 2002) and Nonprofit Governance and Management (V. Futter, et. al., eds., American Bar Association and American Society of Corporate Secretaries 2002).

<http://www.boardsource.org/> – BoardSource (formerly the National Center for Nonprofit Boards) publishes books and provides other resources for nonprofit directors.

<http://charitychannel.com/> - charityChannel provides an on-line professional community that exceeds 45,000 nonprofit-sector professionals. The site has many discussion forums on various topics of interests to EOs , including a legal discussion forum called CharityLaw

<http://cof.org> - Council on Foundations website that provides a wealth of information for foundations and provides information on obtaining The Rules of The Road, A Guide to the Law of Charities in the United States by Betsy Buchalter Adler.

<http://danenet.wicip.org/snpo> - The Society For Nonprofit Organizations is an organization that serves as a resource for Board members, paid staff, and volunteers who lead or help nonprofit organizations. The site features a bi-monthly magazine on relevant nonprofit issues and a monthly report on funding opportunities for nonprofits.

<http://www.deathandtaxes.com/nptoc.htm> – This website provides general information about nonprofits.

<http://iciclesoftware.com/vlh> – This website provides a legal handbook for volunteers.

<http://www.idealists.org> – Action without Borders runs this website connecting over 22,00 nonprofit organizations with volunteers, career connections and other resources and services including legal information for nonprofit organizations.

[http://www.irs.ustreas.gov/prod/bus\\_info/eo/index.html](http://www.irs.ustreas.gov/prod/bus_info/eo/index.html) – The IRS provides general information for EOs on this website.

[http://www.irs.ustreas.gov/prod/bus\\_info/eo/fy2000cpe.html](http://www.irs.ustreas.gov/prod/bus_info/eo/fy2000cpe.html) – The IRS provides Continuing Professional Education (CPE) Technical Instruction Program (i.e., articles on various subject of interest to EOs).

[http://www.mapnp.org/library/strt\\_org/strt\\_np/strt\\_np.htm#anchor797218](http://www.mapnp.org/library/strt_org/strt_np/strt_np.htm#anchor797218) - This is a link to an article about starting a nonprofit. This website also provides sample articles and bylaws for nonprofit corporations, at <http://www.mapnp.org/library/boards/boards.htm>.

<http://nonprofit.about.com/careers/nonprofit/> - This website is About.com's guide to nonprofit organizations

<http://www.nonprofit.gov/> - This website provides a network of links to Federal government information and services.

<http://www.nonprofit-info.org/> The Internet Nonprofit Center is a website covering a myriad of issues for nonprofits, including sample bylaws and articles of incorporation..

<http://www.nonprofitissues.com> - Don Kramer's Nonprofit Issues is a very-readable legal newsletter on current legal developments and basic legal issues of crucial importance to all nonprofit organizations.

<http://www.nptimes.com>- The Nonprofit Times is a bi-weekly published newspaper for nonprofit managers.

<http://www.not-for-profit.org> - Nonprofit Resource Center's website provides a comprehensive list of links to websites of interest to nonprofits.

<http://www.philanthropy.com> - The Chronicle of Philanthropy is a bi-weekly newspaper for charity leaders, fund raisers, grant makers, and other people involved in the philanthropic enterprise

<http://www.usps.gov> –This is the United States Parcel Service website with a link to PS Form 3624,

*Application to Mail at Nonprofit Standard Mail Rates.*

## **I. Intermediate Sanctions**

[http://www.access.gpo.gov/su\\_docs/aces/aces140.html](http://www.access.gpo.gov/su_docs/aces/aces140.html) – This website contains the final intermediate sanction regulations in the Federal Register. The regulations took effect January 10 and will expire January 9, 2004.

<http://philanthropy.com/free/update/2001/05/2001051401.htm> – A free copy of Steve Miller's practical suggestions for intermediate sanction rules may be obtained from this website.

## **J. Lobbying and Political Activities**

<http://www.independentsector.org> – The Independent Sector sponsors this website and it provides a wealth of information on lobbying and advocacy activities including: Bob Smucker, "The Nonprofit Lobbying Guide," 2nd Ed and a copy of the IRS lobbying letter mailed to nonprofits answering nine common questions regarding lobbying activities.

<http://www.givevoice.org> – This website discusses advocacy issues for nonprofits.

<http://www.ombwatch.org/las> – Let America Speak! is a coalition of community and national organizations working to defend the advocacy rights of the nonprofit community. This web site contains articles and reports on lobbying and advocacy issues.

<http://www.afj.org/eadvocacy/index.htm> – The Alliance for Justice sponsor this website. It contains an article by Elizabeth Kingsley, Gail Harmon, John Pomeranz, & Kay Guinane, on "E-Advocacy for Nonprofits: The Law of Lobbying and Election Related Activity on the Net". It also provides a wealth of information on lobbying and advocacy issues.

## **K. Public Disclosure Rules**

<http://www.990online.com> – This is Eric Mercer's website on how to fulfill requirements of the new IRC Section 6104 (d) through online publication.

<http://www.muridae.com/publicaccess/index.html> – The U.S. Nonprofit Organization's Public Disclosure Regulation Site, Eric Mercer, Manager, DU Consulting and Development Division developed this site as a resource guide for information access. This site provides valuable links to publish Form 990 online, federal rules regarding disclosure and financial analysis of tax returns.

## **L. State Compliance**

<http://www.NASCONet.org> – This website provides links to regulators of charities in all states.

<http://www.nonprofits.org/library/gov/urs> – The Unified Registration Statement (URS) represents an effort to consolidate the information and data requirements of all states that require registration of nonprofit organizations performing charitable solicitations within their jurisdictions. The effort is organized by the National Association of State Charities Officials and the National Association of Attorneys General, and is one part of the Standardized Reporting Project, whose aim is to standardize, simplify, and economize compliance under the states' solicitation laws.

[http://www.irs.gov/bus\\_info/eo/fy2001cpe.html](http://www.irs.gov/bus_info/eo/fy2001cpe.html) – IRS Continuing Professional Education article on state solicitation laws.

<http://www.law.state.ak.us/consumer/charities.html> – Alaska Attorney's General Charity website

[http://www.sosaz.com/Business\\_Services/Charities.htm](http://www.sosaz.com/Business_Services/Charities.htm) – Arizona Secretary of State Charity website

<http://www.ago.state.al.us> – Alabama Attorney General website

<http://www.ag.state.ar.us> – Arkansas Attorney General website

<http://caag.state.ca.us/charities> – California Attorney General Charity website

<http://www.sos.state.co.us> – Colorado Secretary of State website

<http://www.cslib.org/attygen/mainlinks/tabindex8.htm> – Connecticut Attorney General website

<http://www.state.de.us/attgen> – Delaware Attorney General website

<http://www.dcpso.org/index.html> – District of Columbia Public Service Commission

<http://legal.firn.edu> – Florida Attorney General website

<http://www.sos.state.ga.us> – Georgia Secretary of State website

<http://www.cpja.ag.state.hi.us> – Hawaii Attorney General website

<http://www2.state.id.us/ag> – Idaho Attorney General website

<http://www.ag.state.il.us/charitable/charity.html> – Illinois Attorney General charity website

<http://www.state.in.us/attorneygeneral> – Indiana Attorney General website

<http://www.state.ia.us/government/ag/index.html> – Iowa Attorney General website

<http://www.kssos.org/main.html> – Kansas Secretary of State website

<http://www.law.state.ky.us/cp/charity.htm> – Kentucky Attorney General website

<http://www.ag.state.la.us> – Louisiana Attorney General website

<http://www.state.me.us/ag> – Maine Attorney General website

<http://www.sos.state.md.us/sos/charity/html/cod.html#other> – Maryland Secretary of State Charity website

<http://www.ago.state.ma.us/charity.asp> – Massachusetts Attorney General website

<http://www.ag.state.mi.us> – Michigan Attorney General website

<http://www.ag.state.mn.us/charities/Default.htm> – Minnesota Attorney General Charity website

<http://www.sos.state.ms.us> – Mississippi Secretary of State

<http://www.ago.state.mo.us/index.htm> – Missouri Attorney General website

<http://sos.state.mt.us/css/index.asp> – Montana Secretary of State website

<http://www.nol.org/home/SOS> – Nebraska Secretary of State website

<http://ag.state.nv.us> – Nevada Attorney General website

<http://www.state.nh.us/nhdoj/CHARITABLE/char.html> – New Hampshire Attorney General Charity website

<http://www.state.nj.us/lps/ca/ocp.htm> – New Jersey Consumer protection website

<http://www.sos.state.nm.us> – New Mexico Secretary of State website

<http://www.oag.state.ny.us/charities/charities.html> – New York Attorney General Charity website

<http://www.secretary.state.nc.us/sls/default.asp> – North Carolina Secretary of State Charity website

<http://www.state.nd.us/sec> – North Dakota Secretary of State website

<http://www.ag.state.oh.us> – Ohio Attorney General website

<http://www.sos.state.ok.us> – Oklahoma Secretary of State website

<http://www.doj.state.or.us/ChariGroup/welcome2.htm> – Oregon Attorney General Charity website

<http://www.dos.state.pa.us/charities/charities.html> – Pennsylvania Department of State Charities website

<http://www.dbr.state.ri.us> – Rhode Island Department of Business Regulation

<http://www.scsos.com> – South Carolina Secretary of State website

<http://www.state.sd.us/attorney/index.html> - South Dakota Attorney General website

<http://www.state.tn.us/sos/charity.htm> – Tennessee Secretary of State Charity website

<http://www.oag.state.tx.us> - Texas Attorney General website

<http://attygen.state.ut.us> – Utah Attorney General website

<http://www.state.vt.us/atg> - Vermont Attorney General website

<http://www.vdacs.state.va.us/consumers/oca-regulatory.html> – Virginia Office of Consumer Affairs Charity website

<http://www.secstate.wa.gov> – Washington Secretary of State website

<http://www.state.wv.us/sos/charity/default.htm> – West Virginia Secretary of State Charity website

<http://www.doj.state.wi.us> – Wisconsin Attorney General website

[http://soswy.state.wy.us/index\\_1.htm](http://soswy.state.wy.us/index_1.htm) – Wyoming Secretary of state website

## **M. Technology Issues**

<http://www.techsoup.org/> – The Technology Place for Nonprofits offers a list of discounts offered by hardware and software companies, and by technology assistance agencies. The website provides message boards and stories where nonprofits can share various technology experiences. Also provides links to numerous technology related websites and articles.

<http://www.nonprofitmatrix.com> – This organization helps EOs build and maintain their website. It

provides many services including, donations, e-mails, affinity shopping, affinity portals, and event management.

<http://www.communitytechnology.org/asp-oss> - This website provides articles and information on internet and software issues for nonprofits.

<http://www.4Charity.com> – The organization helps the EO build it's website and including setting up many services such as donations, e-mails, volunteers, etc.

## **N. Trademark**

<http://www.uspto.gov/web/menu/tm.html> – A wealth of information from the U.S. Patent and Trademark Office on trademark including good general information as well as useful legal resources.

<http://cyber.law.harvard.edu/metaschool/fisher/domain/tm.htm> – An extensive primer on trademark law from The Berkman Center for Internet & Society at Harvard Law School.

<http://www.law.cornell.edu/topics/trademark.html> – An overview of trademark law from Cornell University's Legal Information Institute. This site includes a very brief outline of the law, but also contains an extensive menu of sources, including federal, state and international materials.

<http://www4.law.cornell.edu/uscode/15/ch22.html> – Copy of the Lanham Act, (15 U.S.C. §§ 1051 et seq.) available through Cornell University's Legal Information Institute.