

Exempt Organizations

A Tax Primer for CPAs Volunteering at Nonprofit Organizations

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CPAs working with charitable organizations should be aware of the Code's rules governing nonprofit organization behavior, to avoid liability and maintain the entity's Sec. 501(c)(3) status. This article provides a general overview of the tax risks and issues facing nonprofits.

Because of their expertise and standing in the community, CPAs are often asked to serve as board members or officers of local churches, charities and other small- to medium-sized nonprofit organizations. While such service can be personally rewarding, it may come with unexpected risk. Many CPAs tapped for nonprofit service have strong tax and business experience, yet may be unfamiliar with the tax rules governing nonprofit organizations. Understanding these tax rules is critical, however, because the Federal government uses the Code to regulate nonprofit behavior. CPAs may well find themselves working with a nonprofit that has unwittingly run afoul of the Code, subjecting officers and board members to possible penalties or even putting the organization's Federal tax exemption in jeopardy.

The nonprofit provisions of the Pension Protection Act of 2006 (PPA '06), coupled with an already complex array of nonprofit rules, make it all the more important for CPAs to understand the Code's rules as they assume key roles in local nonprofit organizations. This

article highlights some of the important tax issues that a CPA officer/director¹ of a local nonprofit may encounter, suggests questions he or she may want to research and provides examples of potentially problematic situations.

Qualifying for and Maintaining Exempt Status

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Sec. 501(c) lists the various types of nonprofit organizations that may qualify for exemption from Federal income tax. The most important type are organizations that qualify under Sec. 501(c)(3).² Such organizations are not only eligible for Federal tax-exempt status, but in most cases are also eligible to receive tax-deductible contributions under Sec. 170(c)(2)(B). Sec. 501(c)(3) organizations include educational institutions (including private schools and museums), religious organizations (including churches and synagogues), certain organizations that foster amateur sports competitions, and a variety of other, more specialized organizations. They do not include social clubs, homeowners'

¹ This article assumes that a CPA is acting as an officer (such as a treasurer) or a board member of a nonprofit organization, rather than an independent service provider/adviser. CPAs acting as external advisers to nonprofits will find the information in this article helpful, but will not be subject to the same level of liability as those serving as officers/directors.

² A CPA volunteer is most likely to be working with a Sec. 501(c)(3) organization, but should be aware that

there are numerous specialized nonprofits—such as social clubs, fraternal organizations, veterans' organizations, etc.—governed by other subcategories of Sec. 501(c) and subject to different rules from those discussed here. Further, this article assumes that the nonprofit is a "public" charity and, thus, is not subject to the special rules applicable to private foundations under Sec. 509.

associations or business leagues (including chambers of commerce).

For most nonprofits, maintaining Sec. 501(c)(3) status is paramount.³ If lost, the nonprofit's income (if any) would become subject to Federal income tax, donors would be unable to deduct their contributions (making fundraising difficult) and valuable state and local tax exemptions (such as property tax exemptions) might be lost. Also, loss of the Federal government's tax-exempt "stamp of approval" would be embarrassing to the organization and its managers.

Prior to taking office at a Sec. 501(c)(3) organization, a CPA should assess the organization's records and operations to ensure that it has properly established, and is continuing to maintain, Sec. 501(c)(3) status. First, he or she should look at the organizing documents (articles of incorporation, bylaws and other governing instruments) and check that the entity has met the "organizational test" necessary for treatment as a Sec. 501(c)(3) organization.

Organizational Test

Under Regs. Sec. 1.501(c)(3)-1(b), the nonprofit's articles of organization must limit the entity's activities to exempt purposes (as enumerated in Sec. 501(c)(3)) and cannot empower the entity to carry out any substantial, nonexempt activities. Specifically, under Regs. Sec. 1.501(c)(3)-1(b)(4), the entity's articles of incorporation must require that the organization's assets be remitted to another charitable organization or the government on dissolution; distribution to the

organization's members or shareholders must be prohibited.

Example 1: Gymnastics Club of Idaho, Inc. (B) is a parent-controlled athletic booster club established several years ago as a nonprofit corporation under Idaho laws. Parents of gymnasts become members of B by paying a \$25 annual fee. Once they become members, parents are expected to participate in various B fundraising activities. B's articles of incorporation state that its purpose is "to further the competitive experience of amateur youth gymnasts, by providing additional opportunity for training and education, encouraging active participation in national gymnastic competition by the parents and guardians of the gymnasts, and promoting fundraising projects to assist gymnasts with the costs of competing, including, but not limited to, transportation, housing, equipment, uniforms, and meet fees." Further, the articles of incorporation note that in the event of dissolution, all of B's assets will be transferred to another local Sec. 501(c)(3) entity.

B meets the organizational test, because its organizational documents indicate that (1) its primary activities are exempt purposes under Sec. 501(c)(3)—education and the support of amateur athletics⁴ and (2) all of B's assets would be remitted to another Sec. 501(c)(3) entity on dissolution.

Determination letter: Once the CPA has reviewed the Sec. 501(c)(3) organization's documents, he or she should find out if the organization applied for exempt status with the IRS. This is generally done on Form 1023, Application for Recognition Under Section 501(c)(3) of the

EXECUTIVE SUMMARY

■ Prior to taking office at a Sec. 501(c)(3) organization, a CPA should assess its records and operations, to ensure that it has properly established (and is continuing to maintain) Sec. 501(c)(3) status.

■ Insiders may be subject to excise tax sanctions if any part of the net earnings of the organization inure to the benefit of private shareholders or individuals.

■ CPAs should be familiar with a number of other issues, including lobbying and political campaign restrictions, reporting requirements and UBIT.

³ For a provocative argument that certain churches can afford to lose their Sec. 501(c)(3) status, see Hatfield, "Ignore the Rumors—Campaigning from the Pulpit Is Okay: Thinking Past the Symbolism of Section 501(c)(3)," 20 *Notre Dame J.L., Ethics & Pub. Pol'y* 125 (2006).

⁴ Technically, the club qualifies as a Sec. 501(c)(3) organization in two ways. First, it can simply be considered "educational" because it teaches a sport to youth. Second, it also would likely be a qualified amateur sports organization as defined in Sec. 501(j). Sec. 501(c)(3) indicates that organizations are exempt if they "foster national or international amateur sports competition," as long as they do not pro-

vide athletic facilities or equipment. Sec. 501(j) indicates, however, that qualified amateur sports organizations can still qualify under Sec. 501(c)(3), even if they provide facilities and equipment and even if their activities are local. The club would likely qualify for Sec. 501(j) because it helps "support and develop amateur athletes for national or international competition in sports." Further discussion is beyond the scope of this article. For more details on booster club issues, see Cowen and Sack, "IRS Exempt Organizations CPE Technical Instruction Program Textbook: Chapter A: Athletic Booster Clubs: Are They Exempt?," 94 *Tax Notes Today* 70-15 (10/1/92) (hereinafter cited as "CPE Text").

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Internal Revenue Code.⁵ Some organizations are exempt from completing the application because of their activities or size. Under Sec. 508(c)(1), very small nonprofits (generally, those with \$5,000 or less in annual gross receipts) and churches (regardless of receipts) are not required to file Form 1023 to attain Sec. 501(c)(3) status.⁶

Form 1023 asks a number of questions designed to inform the Service whether the organization's activities will meet Sec. 501(c)(3)'s numerous requirements (discussed below). It also clarifies whether the organization is a public charity or private foundation.⁷ The submitted Form 1023 is open for public inspection, under Sec. 6104. If the Service approves it, the organization will receive a determination letter and be listed in IRS Pub. 78, which contains the names of organizations eligible to receive deductible contributions.⁸

The CPA should also review the determination letter, as it will indicate whether the organization is a public charity or a private foundation. In many situations, the Service will grant public charity status under an advance ruling. The organization will be deemed to be a public charity for five years. At the end of the five-year ruling period, the organization will need to show the IRS that it is truly publicly supported. The CPA will want to determine if the organization satisfied the five-year advance-ruling-period requirements.

Once the CPA has determined that the organization has been properly organized and properly attained Sec. 501(c)(3) status, he or she must also

ensure that it is continuing to maintain such status. The following paragraphs summarize these requirements.

Operational Test

It is not enough that the organization's articles and Form 1023 be in order. Sec. 501(c)(3) also requires that the organization be *operated* in accordance with those documents. Specifically, the entity must operate "exclusively" for a nonprofit purpose: charitable, educational, religious or another of the categories enumerated in Sec. 501(c)(3). Regs. Sec. 1.501(c)(3)-1(c) makes it clear that "exclusively" really means "primarily." Thus, a nonprofit may engage in some insubstantial activities unrelated to its mission, yet still maintain Sec. 501(c)(3) status. As long as the organization does not steer too far away from its charitable mission, the operational test should not pose a problem.

Inurement and intermediate sanctions: Inherent in the operational test is the requirement in Regs. Sec. 1.501(c)(3)-1(c)(2) that no part of the organization's net earnings inure to the benefit of private shareholders or individuals. This "nondistributional constraint" is the hallmark of nonprofit status. It is also the area that poses the greatest risk of inadvertent noncompliance.

Example 2: *B*, the club in Example 1, runs several fundraisers throughout the year. For example, it may ask the gymnasts and their parents to sell items such as cookie dough or holiday wreaths. The funds generated by these efforts are used to defray the gymnasts' travel expenses

and entry fees. *B* wants to give the gymnasts and their parents an incentive to participate more aggressively in these fundraising activities. To this end, *B* decides to allocate funds to individual athletes based on the amount that particular athlete and his or her parents were able to raise. Thus, if gymnast *X* and his parents raise \$100 for *B* by selling cookie dough, *B* will allocate \$100 to help pay for *X*'s travel expenses and entry fees. If *Y* and her parents raise only \$50 in the cookie dough sale, *B* will allocate only \$50 to help pay for *Y*'s travel expenses and entry fees.

If *B* allocated funds in this manner, it would violate the nondistributional constraint. Inurement would result, because *B*'s earnings would be directly benefiting specific members, rather than the athletes as a whole. *B*'s exempt purpose is education and the fostering of amateur athletic competition. It is advancing such purposes only if it uses its earnings to benefit the gymnasts as a group. If the funds generated were allocated to all athletes equally to help defray costs, the athletes as a class would be benefiting and no inurement would result.⁹

Technically, *any* inurement, regardless of amount, can trigger the loss of Sec. 501(c)(3) status. Congress, recognizing the harshness of this result, enacted Sec. 4958 to impose excise taxes on those who received or approved the inurement. They are meant to apply in lieu of revoking an organization's Sec. 501(c)(3) status. These rules, known as "intermediate sanctions," are designed to punish those responsible for the inurement, rather than the organization, its

⁵ If the organization filed Form 1024, Application for Recognition of Exemption Under Section 501(a), it applied for exemption as a noncharitable organization, and will not be eligible to receive deductible contributions.

⁶ Such organizations may still wish to file Form 1023, however, to get their names in IRS Pub. 78, *Cumulative List of Organizations described in Section 170(c) of the Internal Revenue Code of 1986*, so that potential donors are reassured that their contributions will be deductible.

⁷ The status of a public charity or a private foundation is based on where the organization receives its funding; see Sec. 509. Under Sec. 4940, private foundations are subject to an excise tax on their net investment income and, under Sec. 4942, are required to distribute a certain amount of their assets for charitable use. Under Sec. 4941, there are very strict rules on how board members/officers can interact

with each other. For example, under Sec. 4941(d)(1)(B), board members are prohibited from borrowing money from the organization. Further, under Sec. 170(b)(1)(B), contributions to private foundations are subject to lower adjusted-gross-income limits and may be limited to the donor's basis under Sec. 170(e)(1)(B)(ii), rather than the fair market value (FMV) of the asset being contributed. As noted previously, this article assumes that the CPA is working with a public charity, rather than a private foundation.

⁸ See note 6 supra. A searchable version of Pub. 78 is available on the IRS's website (www.irs.gov).

⁹ Adapted from an extended example and discussion in CPE Text (Example 1), note 4 supra.

donors and charitable recipients. Except in egregious cases, the IRS is more likely to impose intermediate sanctions than to revoke Sec. 501(c)(3) status.

Definitions: The intermediate sanctions apply to “excess benefits” provided to “disqualified persons.”¹⁰ Under Sec. 4958(f)(1), a disqualified person generally is someone in a position to “exercise substantial influence” over the nonprofit, such as an officer or a board member. An “excess benefit” is defined under Sec. 4958(c)(1) as an economic benefit provided by a nonprofit to a disqualified person, which is in excess of the value of the services provided by such person. Thus, intermediate sanctions apply when an influential person at the nonprofit is given excess compensation.

Sec. 4958(a) imposes an initial tax on disqualified persons of 25% of the excess benefit received. If the disqualified person does not “correct” the problem, generally by repaying the excess benefit to the nonprofit, Sec. 4958(b) imposes an additional tax of 200% of the excess benefit. This two-tier tax is designed to force the recipient of the excess benefit to restore such benefit to the organization.

Sec. 4958(a) also imposes a tax on organization managers who knowingly participate in providing a disqualified person with an excess benefit.¹¹ The tax is 10% of the excess benefit. Under the PPA '06, effective for tax years beginning after Aug. 17, 2006, the maximum tax on managers for any one excess-benefit transaction is \$20,000.¹²

A CPA serving as an officer or director is likely to be considered both a disqualified person and a manager. Thus, he or she must ensure that the organization is not paying excess compensation or other benefits to individuals with substantial

influence over the organization.

Example 3: *B*, the club in Example 1, has a long-time president, *R*, who has been instrumental in *B*'s success. Up until this year, *R* was paid a \$2,000 annual salary. Recently, she demanded that her salary be raised to \$15,000 per year, or she would resign. The board of directors quickly entered into a new multi-year contract with *R* at the new rate of compensation. The FMV of *R*'s services to *B* is \$3,000.

R is a disqualified person under Regs. Sec. 53.4958-3(c)(2), and the board members who approved the new contract would be considered managers under Regs. Sec. 53.4958-1(d)(2). The amount by which *R*'s salary exceeds FMV, \$12,000 (\$15,000 - \$3,000), is an excess benefit. If the IRS applied the intermediate-sanctions rules, she would be subject to an initial \$3,000 tax (25% × \$12,000) and the board would collectively be responsible for a \$1,200 tax (10% × \$12,000). *R* would need to return the \$12,000 excess benefit to *B* to avoid an additional 200% tax (\$24,000).

The situation could have been avoided had the contract been approved by a committee of the board consisting of disinterested persons who obtained and relied on data on presidential salaries at booster clubs, then documented the basis for their decision to approve the contract.¹³ Further, if a particular board member (such as a CPA volunteer) disagreed with the decision to raise *R*'s salary, under Regs. Sec. 53.4958-1(d)(3), he or she could have avoided a share of the manager penalty by distancing himself or herself from the transaction and documenting the disapproval of the transaction in the board minutes.

Private benefit: The inurement and intermediate-sanctions rules discussed

above serve to prevent a nonprofit's net earnings from falling into the hands of the organization's *insiders/disqualified persons*. The tax law, however, is also concerned with benefits flowing to *outsiders*. Under the so-called “private benefit” doctrine in Regs. Sec. 1.501(c)(3)-1(d)(1)(ii), a nonprofit's Sec. 501(c)(3) status can be revoked if a substantial part of its operations benefit private interests. The private benefit must be substantial for this doctrine to be invoked.

Example 4: *B* from Example 1 often uses a local for-profit gym, *L*, for training and to hold competitions. This raises *L*'s profile and helps it to sign up additional members. *L* does not have a seat on *B*'s board of directors, nor exercise significant influence over *B*'s affairs. Thus, any benefit *L* derives from *B* activities would not be subject to scrutiny under the inurement or intermediate-sanctions rules.

Nonetheless, the benefit accruing to *L* may trigger the private-benefit doctrine. In this case, however, it is likely that the benefit to *L* from *B*'s activities is incidental—a natural by-product of *B* conducting its exempt-function activities. As such, the use of *L*'s gym is unlikely to jeopardize *B*'s Sec. 501(c)(3) status.¹⁴

Lobbying Restrictions

Sec. 501(c)(3) organizations are prohibited from engaging in substantial lobbying. This is normally not an issue for small, local nonprofits, because such organizations are unlikely to be engaged in substantial lobbying. However, under Regs. Sec. 1.501(c)(3)-1(c)(3)(ii)(b), the definition of “lobbying” includes attempts to influence local legislation or referenda.

Unfortunately, the definition of “substantial” is unclear. An organization planning a lobbying campaign

¹⁰ Regs. Sec. 53.4958-1 through 8 provide the complex details behind these terms. Only a general introduction is provided here.

¹¹ If more than one manager approved the excess benefit, only one tax results, but the managers are joint and severally liable for that tax under Sec. 4958(d)(1).

¹² See Sec. 4958(d)(2), as amended by PPA '06 Section 1212(a)(3). For tax years

beginning before Aug. 18, 2006, the maximum tax on managers for any one excess-benefit transaction was \$10,000.

¹³ See Regs. Sec. 53.4958-6(a). This approach establishes a rebuttable presumption that the salary in the contract was set at FMV.

¹⁴ Adapted from an example provided in CPE Text (Example 2), note 4 supra.

that is unsure whether it would be considered substantial (and, thus, whether its Sec. 501(c)(3) status would be in jeopardy) has a couple of options. First, it can form a separate entity, not qualified under Sec. 501(c)(3), to run the lobbying campaign. The separate entity cannot receive deductible contributions and its records must be kept separate from those of the Sec. 501(c)(3) entity. Second, the nonprofit may consider making an election under Sec. 501(h). This allows it to determine the exact amount it is permitted to spend on lobbying.¹⁵ If this amount is exceeded, the nonprofit would be subject to an excise tax under Sec. 4911. If it repeatedly exceeded its Sec. 501(h) limit, its Sec. 501(c)(3) status would be revoked.

Example 5: The state legislature is considering a bill that would change the classification of gymnastics from an "extracurricular activity" to a "sport" in the state's public primary and secondary schools. If gymnastics is classified as a sport, such programs would receive more funding and enjoy a much higher profile in the community. *B* from Example 1 takes out a small ad in the local newspaper indicating its support for the gymnastics sport bill and urging the public to contact representatives in the legislature and express support for the bill.

The ad would be lobbying, but would likely be insignificant compared to the club's overall activities. Because the lobbying is not substantial, it should not put the club's Sec. 501(c)(3) status in jeopardy.

Political Campaign Restrictions

Sec. 501(c)(3) organizations are absolutely prohibited from engaging in political campaigns. If the nonprofit intervenes in a political campaign for or against any candidate, its

Sec. 501(c)(3) status may be revoked. In addition, if the organization spends any funds on the campaign, the organization and its managers will be subject to a special excise tax under Sec. 4955. Many small organizations, particularly churches, have come under scrutiny for political activity in recent election cycles. This issue has been highly publicized in the media; the IRS has been stepping up its enforcement efforts.¹⁶

Example 6: A candidate for the legislature has promised to vote for the bill described in Example 5, which would designate gymnastics as a sport. *B*'s president, *R*, on behalf of *B*, publicly endorses the candidate at a gymnastics competition.

B has now intervened in a political campaign and the Service may revoke its Sec. 501(c)(3) status. Had *R* endorsed the candidate in her personal capacity—not on *B*'s behalf and not at an official *B* event—*B*'s Sec. 501(c)(3) status would not have been put in jeopardy.¹⁷

Reporting Requirements

In addition to ensuring that a nonprofit's operations do not jeopardize its Sec. 501(c)(3) status, a CPA should also ensure that the organization is properly complying with all reporting requirements.

Form 990

Most Sec. 501(c)(3) organizations are required to file annually Form 990, Return of Organization Exempt From Income Tax. If the organization's gross receipts for the year are less than \$100,000 and its total assets at the end of the year are less than \$250,000, the organization may use Form 990-EZ, Short Form Return of Organization Exempt from Income Tax. Form 990 or 990-EZ is due the 15th

day of the fifth month after the organization's year end (May 15 for calendar-year nonprofits). An automatic three-month extension and an additional three-month extension (with reasonable cause) are available by filing Form 8868, Application for Extension of Time to File an Exempt Organization Return. Under Sec. 6652(c)(1)(A), late filing will result in a penalty of \$20 a day (with a maximum penalty equal to the lesser of 5% of the entity's gross receipts or \$10,000). Under Sec. 6104, Forms 990 and 990-EZ are subject to public disclosure and, under Sec. 6652, penalties may apply to organization managers who refuse to make the returns available for public inspection.

Churches and certain church-related organizations are not required to file an annual return, under Sec. 6033(a)(2)(A)(i). In addition, organizations with annual gross receipts normally \$25,000 or under are exempt from filing.¹⁸

Small nonprofits: While nonprofits with \$25,000 or less in annual gross receipts need not file Form 990, they are subject to new reporting requirements under the PPA '06. Effective for tax years beginning after 2006, Sec. 6033(i), as amended by PPA '06 Section 1223(a), requires that such organizations electronically file the following information with the IRS each year:

- Its legal name;
- Any name under which it operates or does business;
- Its mailing address and website address (if any);
- Its taxpayer identification number;
- The name and address of a principal officer; and
- Evidence of the continuing basis for the organization's exemption from the filing requirements (i.e., that it continues to have \$25,000 or less in annual gross receipts).

¹⁵ The complexities of the Sec. 501(h) election are beyond the scope of this article; see Regs. Secs. 1.501(h)-1 through 3 and 56.4911-1 through 7 for further details.

¹⁶ See, e.g., "Taxing an Unfriendly Church," *NY Times*, 11/22/05, Section A, p. 22 (describing an IRS audit of a church whose pastor gave an anti-war sermon on the eve of the 2004 election).

¹⁷ For further examples, see IRS Fact Sheet 2006-17, available at www.irs.gov.

¹⁸ Sec. 6033(a)(2)(A)(ii) provides an exception for organizations with annual gross receipts that are not normally more than \$5,000. The IRS, however, used its discretionary authority granted by Sec. 6033(a)(2)(B) to raise this threshold to \$25,000; see Ann. 82-88, IRB 1982-25, 23.

In addition, the organization must notify the Service if it terminates its existence.

Like the material on Form 990, the above information is subject to public disclosure. Per Sec. 6033(j), if the organization fails to file the above information for three consecutive years, its Sec. 501(c)(3) status will be revoked. The due date and manner for filing the above information will be determined by regulations.¹⁹

Small nonprofits, not accustomed to filing annual reports, could easily overlook these new requirements and, thus, jeopardize their Sec. 501(c)(3) status.

UBIT and Form 990-T

While Sec. 501(c)(3) organizations are generally exempt from Federal income tax, they may need to pay tax on any net income realized from business activities unrelated to their exempt mission. This tax, known as the unrelated business income tax (UBIT),²⁰ applies at the same rate as the corporate income tax.²¹ Under Sec. 513(a), UBIT generally applies only if the organization engages in a trade or business that is regularly carried on and unrelated to its exempt mission.²²

Businesses "related" to the organization's exempt mission are not subject to UBIT. To be "related" under Sec. 513(a) and Regs. Sec. 1.513-1(d)(2), the activity must contribute importantly to the organization's exempt purpose; merely providing funds for use in the organization's charitable work is not sufficient. Under Sec. 512(b), UBIT generally does not apply to investment income such as interest, dividends, real estate rents and royalties.²³

Example 7: *B* from Example 1 runs a churro stand for 10 days during the state fair to raise money to defray athletic competition-related travel expenses and entry fees.

The income from the stand would not be subject to UBIT, because the churro business is not "regularly carried on" by *B*. A commercial churro stand would normally operate year-round. Thus, *B* would need to operate the stand year-round before it would be deemed "regularly carried on."²⁴

Example 8: *B* from Example 1 routinely puts on gymnastics demonstrations for the public and sells admission tickets to raise additional funds. The demonstrations are an important part of the gymnasts' education, in that they must train for them and learn to perform in front of an audience.

The earnings from the demonstrations would not be subject to UBIT, because they contribute importantly to—and thus, are "related to"—the club's exempt mission.²⁵

Example 9: *B* sells advertising space in the programs distributed at the demonstrations described in Example 8.

The selling of advertising is usually considered a trade or business separate from the publication or event with which it is associated, according to Regs. Sec. 1.513-1(b). Because *B* regularly carries on the business (it routinely sells ads in programs distributed at demonstrations) and ad selling is not related to its educational mission, the net income from the advertising business would be subject to UBIT.

Example 10: *L's* gym (from Example 4) pays *B* a fee to sponsor demonstrations. In connection with the sponsorship, *B* agrees to hang a large banner over each demonstration that says "L's Discount Gymnasium." *L's* gym receives no other benefits from this arrangement.

While this may appear to be advertising, it would be considered a qualified sponsorship payment, exempt from UBIT. Sec. 513(i)(2)(A) defines a qualified sponsorship payment as one made by a business to a nonprofit for which the sponsor receives no "substantial return benefit other than the use or acknowledgment of [its] name or logo."²⁶ Under Sec. 513(i)(2)(A), such acknowledgment cannot rise to the level of an advertisement—i.e., no qualitative or comparative information may be provided. Because *L's* gym is merely receiving acknowledgment for its sponsorship, the payment is not subject to UBIT.

Example 11: *B* enters into a license agreement with a T-shirt company, *Z*. *B* grants *Z* a right to use its name and logo on T-shirts. Under the agreement, *Z* will produce and market the shirts and remit 5% of the gross sales to *B*. All of the production and administrative work related to the agreement is done by *Z*. The 5% payment would be considered a royalty to *B* and, thus, would be exempt from UBIT.

While insubstantial unrelated business activity may trigger UBIT, it is generally not a threat to an organization's Sec. 501(c)(3) status. However, if the nonprofit's unrelated business ventures become substantial in relation to its overall activities, there is the risk the organization

¹⁹ Such regulations had not been issued at press time.

²⁰ See Secs. 511-514.

²¹ See Sec. 511(a)(1) (referring to the corporate tax rates contained in Sec. 11).

²² There are numerous special exemptions and exclusions from the UBIT, which are beyond the scope of this article.

²³ However, see Sec. 512(b)(13) (recently amended by PPA '06 Section 1205(a)) for special rules for certain payments received from controlled subsidiaries, and Sec. 514 for special rules for income generated by debt-financed property.

²⁴ See Regs. Sec. 1.513-1(c)(2)(i) (reaching the same result with regard to a hospital auxiliary's operation of a sandwich stand for two weeks at a state fair).

²⁵ See Regs. Sec. 1.513-1(d)(4)(i), Example 1 (reaching the same result with income from performances put on by students at a performing arts school).

²⁶ There are other specific exemptions/exceptions from UBIT that are beyond the scope of this article. See, e.g., Sec. 513(a)(1) (exemption when substantially all the work is done by volunteers); Sec. 513(a)(2) (exemption for a business carried on primarily for the convenience of members, students, patients, officers or employees, such as a hospital cafeteria); Sec. 513(a)(3) (exemption for thrift stores); Sec. 513(f) (exemptions for certain bingo games); Sec. 513(h) (exemption for the distribution of low-cost articles in connection with charitable solicitations).

could lose its exempt status, by failing the operational test previously discussed.

An organization that has at least \$1,000 in gross income from an unrelated trade or business must file Form 990-T, Exempt Organization Business Income Tax Return. The return is due at the same time as Form 990 (May 15 for calendar-year organizations). If an organization expects to have a tax liability of \$500 or more, it must make estimated tax payments. According to PPA '06 Section 1225(a), effective for returns filed after Aug. 17, 2006, Form 990-T must be made available for public inspection.²⁷

Other Issues

Payroll Taxes

If the nonprofit has employees, the usual Federal and state income tax and FICA withholding requirements generally apply.²⁸ Nonprofits, like their for-profit counterparts, have run into problems over whether workers should be classified as independent contractors (not subject to payroll withholding) or employees (subject to withholding). A recent IRS audit involving a nonprofit youth soccer league in Connecticut illustrates the potential significance of the employee/independent contractor issue. The soccer league may owe over \$300,000 in back taxes and fines for failing to withhold taxes for paid coaches and referees in 2003 and 2004. The league treated the coaches and referees as independent contractors; the Service claims they were employees.²⁹

State Taxes

States vary in their tax treatment of nonprofits. A CPA working with a nonprofit must be cognizant of any state reporting requirements (in addition to Federal Form 990). If the

nonprofit owns property, the CPA should research the procedures needed to obtain property exemptions. The property tax exemption is often more valuable to a nonprofit than a Federal tax exemption, especially if it earns little income, but owns real estate. States often have more stringent requirements for property tax exemptions than for income tax exemptions. Further, the CPA should research whether the nonprofit is liable for sales/use taxes on its purchases and sales/use tax collection on its sales.

Example 12: Under Idaho law, most nonprofits are subject to sales and use tax just like any other taxpayer.³⁰ Thus, when B from Example 1 buys supplies (such as chalk, athletic tape, water bottles, heat wraps and wrist/ankle supports) for the athletes to use, it must pay Idaho sales tax. Some other states may exempt these purchases, because the supplies would be used as part of the organization's exempt activities.

Substantiation

To take a deduction for a contribution to a Sec. 501(c)(3) organization, a donor must maintain certain documentation. The CPA should ensure that the nonprofit has procedures in place to provide such documentation. The rules regarding substantiation of gifts have become increasingly complex; a detailed review is not provided here.³¹

Local Solicitation Rules

Charities are often subject to various state rules on their ability to solicit funds from the public. The CPA should check to ensure that the organization is properly registered with his or her state (i.e., the attorney general's office, revenue department or secretary of state) and is in good standing to solicit funds. Some states, such as

Idaho, outlaw misleading solicitation, but do not require charities to formally register before soliciting.³² Many states also have annual filing requirements. Some require audited financial statements to be included with the annual registration. For example, Minnesota's threshold for an audited financial statement is only \$350,000 in gross receipts.³³

Further Study

This article provides only a general overview of the tax risks facing nonprofits. CPAs need to research their particular nonprofit's tax issues. The following resources may aid in this endeavor:

- The IRS website contains tax information specifically for nonprofits and includes links to forms and Service publications (www.irs.gov/charities/index.html).
- Guidestar contains detailed information on actual nonprofits, including copies of their Forms 990 as filed with the IRS (www.guidestar.org/).
- Hill and Mancino, *Taxation of Exempt Organizations* (Warren, Gorham & Lamont, 2005) is a detailed treatise on nonprofit tax issues.

Conclusion

Nonprofit service can be ideal for CPAs and for the organizations that need their expertise. To avoid liability and maintain the organization's Sec. 501(c)(3) status, however, CPAs must be aware of the Code's rules governing nonprofit behavior. By carefully navigating the tax rules, CPA volunteers can help nonprofit organizations stay on mission and out of the tax collector's way.

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²⁷ See Sec. 6104(d)(1)(A)(ii). Previously, Form 990-T was considered private.

²⁸ There are exceptions for certain religious organizations; these are beyond the scope of this article.

²⁹ See Kelley, "It's Goalkeeper vs. Bookkeeper as I.R.S. Audits Youth Soccer," *NY Times*, 6/25/06, Section 1, p. 25.

³⁰ Some nonprofits are exempt, but only if specifically listed in the Idaho statutes;

see Idaho Code Section 63-3622O.

³¹ For a current, comprehensive summary of the detailed rules, see Krumweide and Witner, "Substantiation Rules for Charitable Gifts," 37 *The Tax Adviser* 724 (December 2006).

³² See www2.state.id.us/ag/consumer/tips/charities.htm.

³³ See www.ag.state.mn.us/charities/CharitableGiving.htm.