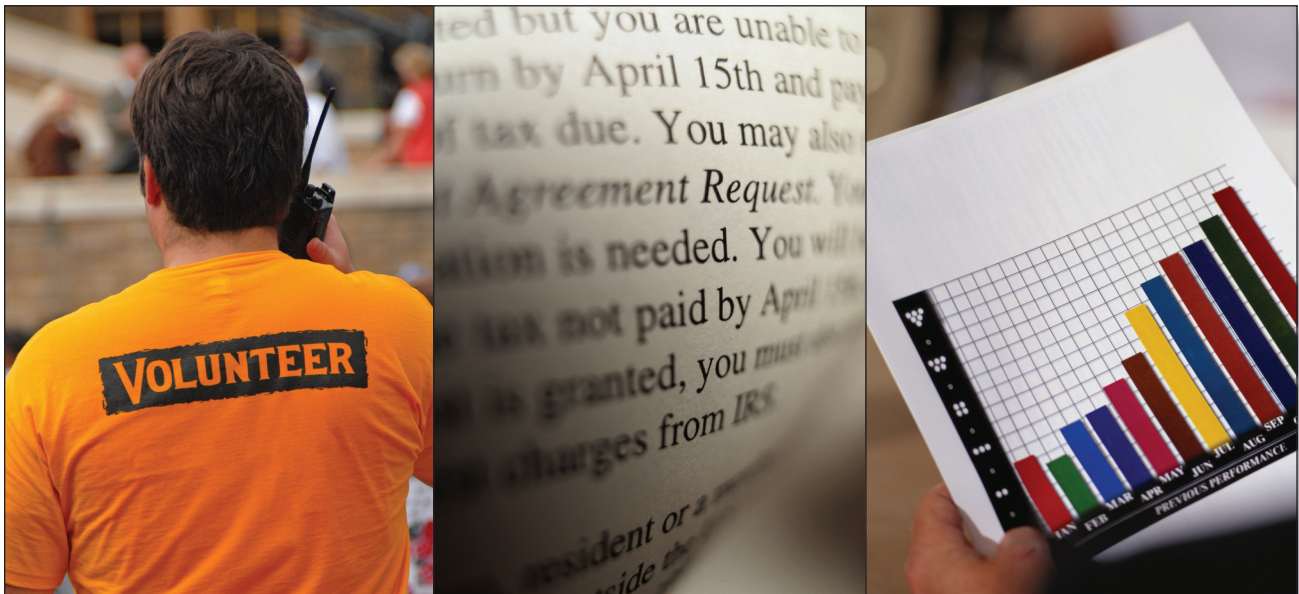


TAX ISSUES FOR EXEMPT ORGANIZATIONS

A PRIMER

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Tax-exempt organizations frequently ask "Can we receive business income without endangering our tax-exempt status?" The answer is most definitely "Yes." Certain limitations apply, but the rules are not overly complex. The plain truth is that a vast number of the tax-exempt organizations in the United States are currently receiving business income without any threat to their tax-exempt status. In fact, a good percentage of the charitable, educational, social welfare, association, and professional work in this country could not be carried out unless tax-exempt organizations in those areas were permitted to earn business income.

The purpose of this primer is to present, as simply as possible, the rules on business income for tax-exempt organizations. The primer should assist any tax-exempt in measuring a proposed business project against the rules. In addition, the use of alternative structures will be explained, since there is almost always a way to structure a business or other project for a tax-exempt organization so that it can be done without jeopardizing the organization's exempt status.

CHAPTER I: WHAT IS A TAX-EXEMPT ORGANIZATION?

As long as there have been federal income taxes, there have been many levels of organizations declared exempt from those taxes. Congress decided that the work carried on by some organizations was so important that it wanted them to keep their funds to carry out their work, rather than paying part of it to the federal government as income taxes.

Congress established several categories of organizations which are exempt from federal income taxes. Today, those categories are usually referred to by the sections of the Internal Revenue Code which grant them tax-exempt status. The more common ones, which are reviewed in this primer, are:

Section 501(c)(3) organizations - charitable, educational and religious organizations

Section 501(c)(4) organizations - social welfare organizations

Section 501(c)(5) organizations - agricultural organizations

Section 501(c)(6) organizations - trade associations, professional societies, and chambers of commerce

CHAPTER II: ARE TAX-EXEMPT ORGANIZATIONS EXEMPT FROM ALL TAXES?

A. Applicable exemptions

One of the most common misconceptions about tax-exempt status is that it exempts an organization from all taxes. This is not the case. Tax-exempt status means that an organization does not pay corporate federal

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income tax on income from activities that are substantially related to the purposes for which the organization was given exempt status. The organization does pay that tax on other types of income, which is called "unrelated business income."

B. Congressional reasoning

The reason for this split-level taxing system is to be fair to tax-paying businesses. For example, if business activities were not taxed, a tax-exempt museum could use its extra space to operate a drug store. It could afford to sell goods cheaper than the other drug stores in town, because it would not have to pay federal income taxes on its profit. Congress did not think it would be fair to tax-paying businesses to give tax-exempt organizations a competitive advantage in operating a regular business. Instead, Congress imposed a tax on unrelated business income.

While most tax-exempt organizations view the tax on unrelated business income as a curse, it can also be viewed as a blessing. The other choice for Congress was to prohibit tax-exempt organizations from engaging in any business activities at all. This would have greatly limited the possible activities of tax-exempts. Instead, Congress chose to specifically permit some business activity of tax-exempt organizations, but to tax it like any other for-profit business.

This last point bears emphasis. The imposition of a tax on the unrelated business income of tax-exempt organizations is the best evidence that tax-exempt organizations can engage in business activities, within certain limits. If business activities were prohibited, Congress and the Internal Revenue Code would say so. Instead, the Code contains specific sections on how unrelated business income is taxed. The obvious intent of Congress, which is clear in the legislative history and in the IRS regulations, is that tax-exempt organizations are permitted to earn income from a business unrelated to its exempt purpose, so long as the business is not the primary thrust of the organization or a "substantial part of its activities," as this primer will discuss in detail.

CHAPTER III: WHAT IS UNRELATED BUSINESS INCOME?

It is important to remember that not all business income is subject to taxation or to limitations: only "unrelated business income" as defined in the Internal Revenue Code. To determine whether an organization has unrelated business income, three factors must be present. The income must be:

- A. from a business**
- B. that is regularly carried on, and**
- C. that is unrelated to the organization's exempt purpose.**

Each one of those factors will be examined separately.

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A. Income from a business

Not all income-generating activities constitute a "business." A business is generally an activity carried on for the production of income from the sale of goods or the performance of services. This excludes many types of activities carried on by tax-exempts without charge, because they are not carried on for the production of income. For example, a charity that distributes toys to children in hospitals free-of-charge is not engaged in a business, because the activity is not carried on for the production of income.

Note that, to be a business, the activity must produce income, but it does not have to produce a profit. An activity can be a business even if it loses money every year. The organization may not have any tax liability from a business operated at a loss, but it is still a business.

For tax-exempt organizations, one of the most important aspects of the definition of a business is that the income generation must be "active." The definition of a business refers to the "sale of goods or the performance of services." What this means is that the organization must take an active role in the generation of the income for the activity to be a business. Income from a passive activity is not a business.

Many types of passive activity income are specifically excluded from the definition of unrelated business income in the Internal Revenue Code: dividends, interest, rents, and royalties. These are the types of activities in which the tax-exempt organization simply lets someone else use its money, its property, or its name and receives some payment back for the privilege, without actually becoming involved as an organization. (A different set of rules apply if the activity is "debt-financed," i.e., if the tax-exempt organization uses borrowed money to engage in the activity.)

The exclusion of "royalties" from unrelated business income is noteworthy. It permits a tax-exempt organization to let other businesses use its name in return for a fee (called a "royalty") without any taxation to the exempt organization. For example, endorsement of a service or product offered by a commercial company can be structured so that the tax-exempt organization can take only a passive role and receive back a royalty for the use of its name by the commercial company. Because the involvement by the tax exempt organization is passive, it would not be a business; and any income in the form of a royalty would not be subject to tax.

B. A business regularly carried on

Even if an activity of a tax-exempt organization constitutes a "business," the income will not be unrelated business income unless two other factors are present. One of them is that it must be an activity which is "regularly carried on." The regulations state that activities which are carried on only "discontinuously or periodically" will not be considered regularly carried on.

This exemption is intended to permit a tax-exempt organization to engage in "one-shot" activities without being involved in an unrelated business. An activity occurring once per year, even if it occurs at the same

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time every year, may not be considered "regularly carried on." For example, holding a fund-raising dance every spring, or operating a sandwich stand at a state fair for two weeks every summer, are not considered to be activities "regularly carried on." The sale of advertising in a yearbook for an annual charity event is also considered not to be regularly carried on.

Note that these types of activities are all of short duration. In contrast, activities have been found to be "regularly carried on" where the preparation or follow-up stretches over a long period of time. For example, a post of the Disabled American Veterans mailed out pamphlets twice a year offering to sell books and maps for a stated price. The activity was found to be "regularly carried on" because the follow-up on the responses stretched virtually throughout the year.

An activity occurring only once per year might also be considered regular if a commercial company performing the same activity would also be active only once per year. For example, the operation of a racetrack by a charity for a few weeks every year was found to be regularly carried on, because commercial racetracks in the area only operated for a few weeks every year.

These rules generally permit exempt organizations to carry on occasional fund-raising activities of short duration without paying any unrelated business income tax on the profit.

C. A business unrelated to the organization's exempt purpose

Even if an activity constitutes a "business," and even if it is "regularly carried on," it will not be subject to the tax on unrelated business income if it is "substantially related" to the exempt function of the organization. The regulations explain this by stating that a "related" activity helps to cause the achievement of the exempt purpose; it must help to fulfill the exempt purpose in an important way for the activity to be "substantially related."

A few examples help explain the concept. A tax-exempt university holds math, science, and other classes and charges tuition. The activity constitutes a business, because it produces income for the sale of a service. It is also regularly carried on. But it is not an unrelated business activity because it is related to the university's, exempt function of education. It contributes importantly to the achievement of that exempt function.

It is easy to think of many other examples of activities which produce income and are regularly carried on by tax-exempt organizations, but which are substantially related to their exempt purposes. Not-for-profit hospitals charge daily room rates. Trade associations charge registration fees for their conventions. Museums charge fees for admissions. Neighborhood block clubs charge admission to social events. But the hospital care, the business meetings, the art shows, and the neighborhood socials all contribute importantly to the exempt purposes of those organizations. The activities are not unrelated business activities.

It is important to note that the substantial relation to the organization's exempt function cannot come solely from the organization's need for money. The income that the organizations receive may be vital to their exis-

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tence. They may not be able to carry on their charitable and other work without it. But the Internal Revenue Service takes the position that income production is not enough to save an activity from unrelated business status.

An activity may be related to one tax-exempt organization's purpose, but not to another's. For example, the sale of maps was not related to the exempt function of the veteran's post as mentioned earlier, but the sale of local maps might be related to the exempt function of a chamber of commerce or other local booster organization. A local garden club's sale of flower bulbs may be related to its exempt function; but the same sale by a symphony orchestra might not be. (Note, though, that an occasional bulb sale by the symphony would probably escape taxation because it is not regularly carried on.)

Sometimes an activity that would otherwise be unrelated to an organization's exempt purpose can be modified to make it related. For example, the sale of stationery, serving items, and desk accessories would not normally be related to the exempt function of a wildlife conservation society. But because the items were decorated with wildlife drawings and contained or were sent with a message about wildlife, the activity was found by the Internal Revenue Service to be related to the society's function of stimulating public interest in wildlife.

The judgment as to whether an activity is related or unrelated can only be made on a case-by-case basis. These examples provide guidelines to help determine whether a proposed activity might be considered an unrelated business.

CHAPTER IV: ARE THERE SPECIAL EXCEPTIONS?

Yes, the Treasury Regulations provide several special exceptions to the general rules on which unrelated business activities of tax-exempt organizations are subject to tax. Some of the most important ones are for:

- A. **Volunteer activities**
- B. **Low-cost merchandise**
- C. **Donated merchandise**

Each of these three exceptions is reviewed separately below.

A. Volunteer activities

The Treasury Regulations make a special exception for activities if substantially all the work is done without compensation. This level of activity is not considered an unrelated business. For example, a charity thrift store run by volunteers was found not to be an unrelated business. A weekly dance run by a volunteer fire department was exempt from tax because all the work was done by volunteers. This was true even though the dances were regularly carried on and, obviously, unrelated to fire-fighting.

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The volunteers must do "substantially all" of the work for the exception to apply. This means that the compensated labor can only constitute a small portion of the total work done for the activity. The Treasury Regulations limit the paid labor to 15% of the total labor.

This exception is sometimes hard for a tax-exempt organization to use if its members are geographically dispersed and it has a paid staff. The paid staff usually does most of the work. Even if a staff member "volunteers" to work on the activity, he or she will still be counted as paid labor.

One way to apply the percentage test is to count all the hours worked, and measure the paid hours against the total hours. The Internal Revenue Service, however, has also looked to the relative importance of the services. For example, a charity held a lottery and all the ticket sellers were volunteers. The Internal Revenue Service exempted the activity from tax, even though janitors and guards were paid for their work on the night of the drawing, because their services were incidental. The Internal Revenue Service also exempted cookbook profits from tax because the cookbook was entirely written by volunteers. The activity met the volunteer test even though the organization paid an outside printer to print and bind the cookbook.

On the other hand, the work done by the volunteers must make an important contribution to the production of income. In the previous example, if the volunteers had simply stuffed envelopes, and the paid staff had written and edited the cookbook, the volunteer exemption might not apply, because the volunteers might not have made an important contribution to earning the profits, compared to the work done by paid staff.

The Internal Revenue Service will permit volunteers to be reimbursed for out-of-pocket expenses without losing their "volunteer" status. If the volunteers are reimbursed at a flat rate - whether or not they really incurred the expenses - the amounts would be considered compensation and the hours worked by them could be counted as paid labor.

B. Low-cost merchandise

The Internal Revenue Code exempts from unrelated business income tax any income from the distribution of low-cost articles incidental to the solicitation of charitable contributions. For example, many organizations send out return address stickers or pencils printed with the homeowner's name, along with a solicitation letter. An item is considered "low-cost" if it costs the organization less than \$5.00.

The Internal Revenue Service will apply this exception where the person solicited can keep the item whether he returns a donation or not. The Internal Revenue Service also looks to see whether the contributions, less a reasonable administrative fee, go to benefit the tax-exempt organization.

The organization will not need to come within this exception if the articles distributed promote its exempt purpose, such as in the case of the wildlife society which distributed items with pictures of wildlife. This exemption may be useful, however, if the distributed items have no relation to the tax-exempt purpose of the organization.

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C. Donated merchandise

Another exemption from tax applies to the sale of donated items. If a tax-exempt organization resells items which have been donated to it, it does not have to pay tax on the profit.

This is true even if the resale activity is regularly carried on and unrelated to the organization's exempt purposes. For example, many hospitals and other charities run "thrift shops" where they resell donated items. The sale of used toys or clothes has nothing to do with a hospital's exempt purpose, but the profit is exempt from tax under this special exception. The Internal Revenue Service has indicated that it will not apply the exception if the charity only receives a fee for sponsoring the thrift store, and a commercial company actually runs it.

"Substantially all" of the items sold must be donated. This would permit an organization, for example, to purchase and resell sweet rolls and coffee at a thrift shop and still come under the exemption.

CHAPTER V: HOW ARE THE RULES APPLIED TO TYPICAL ACTIVITIES?

A. Insurance

Insurance services are not usually associated with the functions of exempt associations, and are not normally carried on by exempt organizations in furtherance of their exempt purposes. The Internal Revenue Service takes the position that income received by an exempt organization because it provides insurance services to its members will be deemed unrelated business income and will be subject to the tax on unrelated business income. This has been the case with respect to professional associations, business leagues, trade associations, agricultural organizations, and other types of membership organizations.

Many tax-exempt organizations structure insurance programs to take advantage of the exclusion of royalties from unrelated business income. The exempt organization can license the right to use its name and logo to an insurance administrator. The insurance administrator would then use the name and logo in conjunction with an insurance program. In return for the right to use the name and logo, the insurance administrator makes payments to the exempt organization. Because the payment to the exempt organization is for the use of the name and logo, it constitutes a royalty payment and should be exempt from tax on unrelated business income.

B. Credit cards

The Internal Revenue Service takes the position that arranging to have credit cards issued to the members of a tax-exempt organization does not "contribute importantly" to the accomplishment of the tax-exempt organization's purpose. Therefore, income received through such an arrangement will be considered unrelated business income.

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A tax-exempt organization, however, can structure a credit card program so that it will produce royalty income and have it excluded from the tax on unrelated business income. The tax-exempt organization licenses the use of its name and/or logo to a taxable organization which contracts with a financial institution to issue bank credit cards to its members. The exempt organization then receives royalty payments for the use of its name and logo in the credit card program. While the activity is still unrelated, the income is not taxable because royalties are specifically excluded from the tax on unrelated business income.

When the tax-exempt organization receives a royalty, it must not engage in sales or administrative activity with the commercial company. The activities of the program must remain separate from the activities of the exempt organization. If this is not done, part of the payment made by the company to the exempt organization would be for services the exempt organization performed. This amount would not be a royalty payment and would be subject to the tax on unrelated business income.

C. Mailing lists

The Internal Revenue Service takes the position that payments received by an exempt organization from the sale of its mailing list are subject to unrelated business income tax. Similarly, receipts from the rental of a mailing list are not related to the exempt purpose of the organization and are therefore unrelated business income.

There is a special rule which governs the exchange of donor or member lists between exempt organizations. When a tax-exempt organization also qualifies to receive deductible charitable contributions, then it can rent or exchange its member or donor lists with other tax-exempt organizations that also qualify to receive deductible charitable contributions. This special rule does not apply to any sales of mailing lists, and it does not apply to any rental of mailing lists to commercial organizations.

In the past, the Internal Revenue Service took the position that when an exempt organization entered into a licensing agreement to allow a commercial organization to use its name and logo, and also agrees to license its mailing list to the commercial organization, then the money received and attributable to the licensing of the mailing was treated like a royalty. For example, when a tax-exempt organization entered into an agreement with a financial institution to allow the financial institution to use its name and logo in connection with the issuance of affinity credit cards, the money it received from the financial institution so that it could use the mailing list was treated as a royalty.

Recently, however, the Internal Revenue Service has changed its position on this type of mailing list income. It now considers all mailing list income which is not covered by the special rule for charitable tax-exempt organizations to be taxable as unrelated business income. This decision was based on the conclusion that by making a special exception from taxation for one type of mailing list income, Congress must have meant to tax other mailing list income. The Internal Revenue Service reached this conclusion even though Congress said that it did not mean to imply that all other mailing list income was taxable.

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The courts, however, have not supported the Internal Revenue Service position as of the date of this printing. Be sure to check the current state of the law on this point.

If an exempt organization permits a commercial company to use its mailing list in connection with an activity that otherwise pays royalties, the agreement should state how much, if any, of the payments are being made for use of the mailing list.

D. Group purchasing services

Group purchasing services are services in which an organization purchases large quantities of items and then sells them to its members at a discount price. The purchase and sale of items is a business of a kind ordinarily carried on for profit. The Internal Revenue Service generally views the operation of a group purchasing program an unrelated trade or business. Because of this, income received by an exempt organization when it bought hospital supplies and sold them to its members were unrelated business income and subject to tax. Similarly, an exempt organization which had as its purpose the advancement of agriculture received unrelated business income when it purchased agricultural supplies and then sold them to its members.

An exempt organization should exercise caution with group purchasing programs. If large amounts of cash flow through the organization, its gross receipts from unrelated activities could be substantial, which could jeopardize its tax-exempt status. The organization may be better off having the members send the payments directly to the supplier, or organizing the activity through a for-profit subsidiary.

CHAPTER VI: WHAT LIMITATIONS APPLY TO AN UNRELATED BUSINESS?

If an activity of a tax-exempt organization is a business that is regularly carried on, that is unrelated to the organization's exempt purposes, and that does not fit under any of the exceptions (such as royalties), what happens? Two main limitations apply to the operation of such an unrelated business. First, the exempt organization must pay tax on the profit. Second, the unrelated activities cannot be substantial in relation to the exempt activities of the organization.

A. Paying the tax

Even in this day and age, there are occasionally exempt organizations that say "If we have to pay a tax, we don't want to get involved in the activity." If this made sense, American industry would shut its doors and all workers would apply for welfare. It is almost always better to earn income and pay a tax, than it is to forego any income in the first place.

This is especially true in light of the lowering of tax rates in recent years. Unrelated business income is generally taxed at regular corporate rates, which are now much lower than they were a few years ago.

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In addition, the tax-exempt organization may deduct from revenue the expenses allocable to the unrelated business activity before arriving at taxable income. Deductible expenses include expenses directly connected with the unrelated business, including the cost of goods or services sold. It also includes allocable portions of expenses incurred jointly for exempt and non-exempt activities. For example, if a staff person spends half of his or her time on exempt functions, and the other half on an unrelated business, one half of the salary should be deductible in arriving at unrelated business taxable income. If the staffers working on an unrelated business use one room out of four in an organization's rented offices, a quarter of the rent should be deductible in arriving at unrelated business income.

The deductions, of course, are subject to the same substantiation requirements as deductions by a for-profit business. This means that if the organization is audited, it must show proof to the Internal Revenue Service which will convince the auditor that the deduction is legitimate. Memoranda from employees on how they spent their time, notes on space allocation, notations on bills for supplies and similar records will help separate unrelated business expenses from exempt function expenses.

B. When an unrelated business becomes substantial

If an unrelated business becomes substantial in relation to the exempt function of an organization, the organization could lose its tax-exempt status. Loss of tax-exempt status due to business activities is a fairly rare occurrence. It is important to be aware of the rules, but to work within them, so as not to hastily dismiss a potentially profitable activity.

One test applied to determine whether an activity is substantial is the "gross receipts" test. If an organization's gross receipts from an unrelated business are "substantial" in relation to its total receipts, the organization could lose its exempt status.

This general rule sounds worse in theory than it is actually applied in practice. For example, an Internal Revenue Service letter ruling states that an organization was entitled to keep its tax-exempt status even though 39% of its gross receipts came from an unrelated business. Another ruling states that an organization was not entitled to keep its tax-exempt status when more than 50% of its gross receipts was from an unrelated business. The permissible percentage of gross receipts from an unrelated business is much higher than the word "substantial" implies.

The Internal Revenue Service will also look to the percentage of time devoted to an unrelated business to see if it is substantial. The rules are somewhat vague, but an exempt organization should not let its paid staff devote more than half of their aggregate time to an unrelated business, in any event.

Some of the special exceptions applicable for determining whether an activity is subject to tax will not necessarily apply for purposes of determining whether an activity is "substantial" and threatens tax exemption.

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The rules excepting activities which are not regularly carried on, or done by volunteers or with donated or low-cost merchandise, may exempt the activity from tax. But if the activity is unrelated and substantial, tax-exempt status could still be threatened.

In evaluating a business proposal, an exempt organization's primary criteria should be "Is it good for the organization?" Tax planning can almost always accommodate a venture that will otherwise benefit an exempt organization.

One of the most useful tax planning techniques for a not-for-profit organization is to establish a for-profit subsidiary to carry on the unrelated business, as discussed further in the next chapter.

CHAPTER VII: WHEN IS IT USEFUL TO ESTABLISH A SEPARATE ENTITY?

One of the most useful planning tools available to not-for-profit organizations is the use of related entities to carry on activities. Many of the reasons for establishing a separate entity focus on federal income taxes. They are frequently used to avoid tax problems or to take advantage of opportunities. Some of the reasons for establishing related entities, however, focus on legal or practical problems. The most common situations in which the establishment of a related but separate entity can offer a solution to a problem are reviewed below.

A. Exemption-threatening activities

It is very common for an organization to want to carry on an unrelated activity that will threaten its tax exemption. The most common example is an activity which constitutes an unrelated business. If the revenue, net income, or staff time devoted to an unrelated business reaches the danger point discussed earlier, the not-for-profit organization can carry on the activity in a separate, but related entity which will pay income tax on the net income from the activity, and which can then pay a dividend to the not-for-profit parent. Dividends received by tax-exempt organizations are considered passive income, and not subject to the unrelated business income tax.

The Internal Revenue Service generally does not attribute the activities of a separate legal entity to the sponsoring organization. This means that, if a tax-exempt organization owns or is otherwise related to an entity which carries on an unrelated business, the Internal Revenue Service will not attribute the unrelated business activities of the other entity to the tax-exempt organization. The tax-exempt organization can enjoy the after-tax profits of the business activity, while protecting its tax-exempt status.

B. Reducing unrelated business taxable income

In some cases, the Internal Revenue Service will only let a tax-exempt organization deduct the expenses of the unrelated part of an activity from the income of the unrelated part of an activity. For example, advertis-

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ing income is considered unrelated business income. The Internal Revenue Service applies a complicated formula to determine what expenses of a publication can be deducted against the advertising income to compute net taxable income from advertising. In many cases, the formula only permits advertising expenses to be deducted from advertising income. This means that a publication as a whole could be losing money, but the tax-exempt organization could be paying substantial income tax on its advertising income, because the expenses which are directly related to the generation of the advertising income are nominal.

If the entire publishing activity is put in a separate taxable entity which is related to the tax-exempt organization, all expenses will be deductible from the total revenue generated by the publication to determine whether the publication is operating at a profit or loss. The very same revenue and expenses which can result in significant taxable income when an advertising activity is kept in a tax-exempt organization, can result in little or no taxable income when the entire publishing activity is carried on in a separate taxable entity.

C. Protection from liability

Sometimes new ventures can have legal liability potential, especially if a product is being sold or other business activity is being undertaken. A separate subsidiary could protect the assets of the sponsoring tax-exempt entity from liability.

For example, many associations are engaging in the development and distribution of software programs which focus on the special needs of their members. Sometimes these software programs are highly technical, and an error in the program or in the instructions could carry significant liability potential. If the activity is carried on through a separate legal entity, the sponsor's assets could well be protected from liability, even if the two entities are related.

D. Raising tax deductible contributions

Only Section 501(c)(3) organizations are eligible to receive voluntary contributions on a tax deductible basis. Other tax-exempt organizations, such as 501(c)(6) organizations, can receive dues or other payments which will be deductible to the donor if they serve a business purpose. It is common, however, for organizations other than Section 501(c)(3) organizations to want to solicit voluntary contributions. The potential donor may be concerned that it will not be able to show a direct business relationship between the voluntary contribution and its own business, and the amount paid would therefore not be deductible.

For example, if a 501(c)(6) organization carries on a fund raising drive to add a wing to its headquarters building, a potential donor may be concerned that it will not be able to prove to the Internal Revenue Service that a contribution for the new wing serves the company's business purposes. If the tax-exempt entity soliciting the contribution is a Section 501(c)(3) organization, however, the donor need not prove any business purpose. The donation will be deductible as a charitable contribution.

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Many tax-exempt organizations establish related 501(c)(3) organizations to accept tax deductible charitable contributions. The funds raised in a 501(c)(3) organization must be used for charitable, educational, or research purposes, but, very often, the sponsoring entity is already carrying on significant charitable, educational, or research activities which can be housed in the Section 501(c)(3) organization. For example, educational seminars which are being sponsored by a 501(c)(6) organization can be moved to a new Section 501(c)(3) organization, which will be eligible to accept charitable contributions. Scholarship grants and research activities are other obvious candidates for moving to a related 501(c)(3) organization.

An important point on this topic is that "educational" activities need not be educational to the entire general public. In other words, they can educate a special segment of the general public, such as those members of the trade or profession which is furthered by the sponsoring organization. The educational programs carried on by the related Section 501(c)(3) organization cannot be limited to members of the sponsoring 501(c)(6), but they can focus on the interests of the members. In addition, if persons who are not members of the 501(c)(6) attend conferences or educational programs sponsored by the related 501(c)(3), the 501(c)(6) may have a perfect opportunity to solicit new members.

E. Removal of tax-exempt organization from activity for non-legal reasons

Certain activities which a tax-exempt organization may wish to sponsor may not be popular with all members. The use of a separate, but related entity permits the sponsoring organization to take a step back from the new activity, and to remove itself from some of the political pressure.

For example, the tax-exempt organization may wish to sponsor a new insurance program, but it may be clear from the start that many members will be excluded because of previous insurance losses. The use of a separate but related entity will permit the establishment of another board of directors or trustees which can make the tough calls. A separate board can lend some objectivity to the process and, at the same time, take the board of the sponsoring organization out of the direct line of fire when difficult choices must be made which will not be popular with all segments of an organization.

F. Delineating fiduciary responsibility

The officers and directors of a tax-exempt organization have a duty to serve all of the members of the organization -- or all of its constituents, if it is a non-member organization -- equally. Sometimes activities which would be profitable or beneficial to the organization will not always benefit all members equally. An organization may wish to ensure that the persons in charge of directing that activity will owe their fiduciary responsibility only to those benefitted by the activity.

Again, an insurance program is a convenient example. If not all members of an organization are participating in an insurance program, there will be inevitable tension between who are covered and those who are not. An

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organization may want to appoint a separate board of directors or trustees to govern the insurance program, so that they will owe their fiduciary responsibility only to the insureds. The decisions made with respect to the insurance program will be the best ones for the insureds, even if the non-insured members of the sponsoring organization might otherwise disagree with the decisions.

G. Lobbying

Section 501 (c)(3) organizations can engage in lobbying only within very narrow boundaries. A Section 501(c)(3) organization can only carry on lobbying if it is "insubstantial," and the definition of insubstantiality has never been made clear by the Internal Revenue Code or the courts. Section 501(c)(3) organizations can make a special election to devote a certain small percentage of their assets to lobbying each year, but the rules are complicated and the penalties for stepping over the boundaries are quite severe.

For this reason, many Section 501 (c)(3) organizations set up related entities which separately solicit donations for lobbying purposes. The funds of a 501(c)(3) cannot flow to this separate entity, but they can be affiliated. The other tax-exempt entity, such as a 501(c)(6) organization, can solicit and use its own funds to lobby on issues which are of interest to the related 501(c)(3) organization.

H. Use for chapters or divisions.

Many organizations cannot or do not want to control the finances and activities of regional divisions or chapters. If the divisions or chapters are established as separate legal entities, the national organization can shield itself from tax and other liabilities. This topic has received a significant amount of attention on IRS audits in the recent past. It is not uncommon for a national organization which has been established for some time to have no clear conception of whether its chapters or other affiliates are a part of its legal structure or whether they are separate legal entities. This makes a great deal of difference on audit. If they are part of the same legal entity, the national organization is responsible for reporting all income and expenses on its Form 990 every year and paying tax on any unrelated business taxable income. In addition, lawsuits against a chapter would automatically jeopardize the assets of the national organization if they are part of the same legal structure.

If chapters or divisions are to be established as separate legal entities, it is important for the by-laws of the national organization to so state. Clear evidence of separateness in the national organization's own organizational documents may well stop an Internal Revenue Service auditor from pursuing this line of inquiry without calling for all of the organizational documents and books and records of the chapters and divisions.

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CHAPTER VIII: WHAT TYPES OF ENTITIES CAN BE USED?

A. Not-for-profit subsidiary

The term not-for-profit "subsidiary" refers to a separate not-for-profit organization which is controlled by the sponsoring organization. These are not true "subsidiaries" because the controlled not-for-profit organization usually does not issue stock. The organizational documents of the controlled not-for-profit organization provide that the board of directors of the sponsoring organization has the power to appoint or elect the board of directors of the controlled organization. In addition, the organizational documents of the controlled organization should provide that the articles of incorporation and by-laws cannot be amended without the consent of the sponsoring organization. This makes the control feature permanent, unless the sponsoring organization approves the change.

This type of structure is useful when the activity to be carried on in the separate organization will also qualify for tax-exempt status, but the separation is desired for other legal or for practical reasons. Protecting the sponsor's assets from liability, removal of the sponsor from the activity for internal political reasons, and use for chapters or divisions are common reasons for establishing not-for-profit subsidiaries.

The not-for-profit subsidiary is also useful when the separate organization is needed to take advantage of a different category of tax exemption. This would be the structure used, for example, when a Section 501(c)(6) organization desires to solicit charitable contributions through a Section 501(c)(3) organization. This would also be the structure used when a Section 501(c)(3) organization needs to establish a related Section 501(c)(6) organization which can engage in lobbying.

B. For-profit subsidiary

A for-profit subsidiary is a taxable business corporation, the stock of which is owned by the not-for-profit sponsoring organization. For-profit subsidiaries are used chiefly to solve tax problems. They are used to carry on activities that would otherwise cause the loss of tax exemption or to lessen an unrelated business tax burden. These are situations in which a not-for-profit subsidiary cannot be used because, when the activity is looked at standing alone, it would not entitle the separate organization to exemption.

Tax-exempt organizations which encounter this concept for the first time sometimes express skepticism. How can the Internal Revenue Service permit a tax-exempt organization to carry on an impermissible level of business activities, simply because they are being carried on in a for-profit subsidiary? It seems like a prime example of form over substance. The Internal Revenue Service not only permits such legal divisions, it often recommends them during the audit process. It is common, for example, for an Internal Revenue Service auditor to spot a substantial business being carried on in a tax-exempt organization, and recommend to the organization that it "spin off" the business activity into a for-profit subsidiary.

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C. Separate not-for-profit organization

A separate not-for-profit organization is one that is not controlled by the sponsoring organization. In other words, the sponsoring organization would establish the separate not-for-profit organization, but not maintain control over the appointment of future boards of directors.

This structure is useful when independence is important. Many Section 501(c)(6) organizations, for example, establish separate not-for-profit organizations to house certification programs. They want the certification program to appear, and to be, independent from the parent association, to give credibility in the eyes of the public.

One danger of establishing a separate not-for-profit organization is that it may become too independent, and take on activities opposed by the sponsoring organization. This is especially likely to happen if the separate not-for-profit organization will have its own source of funding. Extreme caution should be exercised in establishing any separate not-for-profit organization, recognizing that with independence can come opposition.

D. Trust

A trust is a separate legal entity that is not incorporated. It can be taxable or tax-exempt. It is most often used when the sponsoring organization wants to emphasize a fiduciary responsibility running from the persons in charge of the particular activity to those who will benefit from it. By far, the most common use of trusts in the association world is in connection with insurance programs. Many association-sponsored insurance programs are carried on through taxable trusts, which are legally separate from the sponsoring organization. The trustees hold the premium funds and insurance policies "in trust" for the benefit of the insureds.

One benefit of using a trust to house an insurance program is that the courts have sanctioned the application of the "conduit" theory of taxation to insurance trusts. This means that the premium dollars which flow from the insureds through the trust to the insurance company are not treated as taxable income to the trust. Only administrative fees and investment earnings are taxable to the trust. Although the "conduit theory" is theoretically applicable to corporations, it has not been as commonly applied to corporations as it has been to trusts. Most sponsoring organizations choose to take the safer approach and utilize a trust structure when they plan to rely on the conduit theory of taxation.

CHAPTER IX: WHAT ARE THE MECHANICS OF ESTABLISHING A SEPARATE ENTITY?

A. The separate legal entity must be validly established

To achieve the legal and tax protection from establishing a separate entity, it is first necessary to ensure that the separate entity is validly established. For a not-for-profit corporation, this means incorporation under

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the not-for-profit laws of a state, and adoption of by-laws. In addition, the not-for-profit corporation will be required to obtain confirmation of its own tax-exempt status from the Internal Revenue Service. If separate not-for-profit corporations are being used for chapters or regional divisions, an expedited "group exemption" process can be utilized.

If the separate organization is a for-profit corporation, it must be incorporated under business laws of a state, adopt by-laws and issue stock to the sponsoring parent. It need not file any application with respect to its tax status with the Internal Revenue Service.

If the organization is a trust, it need only execute a trust agreement. The trust agreement need not be filed with any state. If the trust is tax-exempt, it must file its own application for tax-exempt status with the Internal Revenue Service.

B. The new entity must be operated separately from the sponsor

In order to protect the separateness of the new entity for tax and other legal purposes, it is imperative that the new entity be operated separately from the sponsor. This means that it must maintain its own bank account, write letters on its own stationery, conduct its own board meetings, and keep its financial records separate from those of the sponsoring organization. The board meetings of the new entity can be held immediately after those of the sponsoring organization, but separate minutes must be kept. Office space can be shared, and staff can perform the same functions for both organizations, but it will be important to allocate the costs attributable to each organization and insure that the financial burden attributable to the separate entity is borne by it.

C. Benefits vs. burdens

Whether the benefits of establishing a separate entity will outweigh the burdens will differ in each case. There is no question that it is burdensome to keep separate minutes at meetings, retain separate financial records, and allocate expenses. The question to be asked is whether the tax, legal, or practical benefit from establishing the separate entity will serve such an important purpose for the sponsoring organization that the cost and trouble will be worthwhile.

Some organizations will have no choice. If the organization is carrying on a substantial unrelated business, and relies on the income from that business for its continued existence, it will have no choice but to spin off the business into a for-profit subsidiary so that it can maintain both its income and its tax exemption.

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CHAPTER X: WHAT PROCEDURES SHOULD BE FOLLOWED FOR AN IRS AUDIT?

A. How to prepare

The best time to prepare for an IRS audit is before the auditor ever knocks on the door. Books and records of tax-exempt organizations should be maintained on the theory that no member of the current staff will be available to make explanations to the auditor. The records should be clear on their face. This is particularly important with respect to allocations of expenses among sponsoring organizations and separate entities. The basis for the allocation, such as time records of shared staff, notations as to percentage of office space utilized, etc., should be maintained with the records of the allocation. The auditor will be impressed with careful recordkeeping practices and may be less likely to challenge the validity of the allocations.

When a tax-exempt organization is first notified that an audit is imminent, it is wise to have an accountant or an attorney who is an expert in tax exemption and unrelated business income conduct a dry run of the audit. This will help the organization spot problems and permit the correction or supplement of records prior to the visit by the auditor.

B. What to disclose.

Many tax-exempt organizations feel that they have "nothing to hide" and give an Internal Revenue Service auditor a free hand to rummage through records and interview staff. This is not advisable. Even the most informed executive may not be up-to-date on changes in tax law or the Internal Revenue Service position on issues, and may not know of a lurking problem. The audit forum should be tightly controlled. If possible, the audit should take place in the office of the organization's attorney or accountant. This will limit access of the auditor to staff and prevent damaging answers to questions, no matter how innocently given. If the auditor insists on meeting at the organization's headquarters, the auditor should be given a workspace in an isolated area with no access to files. Only those items which he specifically requests should be delivered, and only after careful review by someone familiar with tax issues. The auditor should never be given access to correspondence, as the files might contain privileged communications from the organization's attorneys. Staff should be instructed to politely decline to answer any questions but to offer to speak to the auditor in the presence of the executive.

Many organizations are reluctant to take these simple steps. They fear that the auditor will think they have something to hide. This is not true. Internal Revenue Service auditors are accustomed to dealing with business persons who routinely follow these same procedures. These procedures will be viewed as a mark of cautious professionalism, rather than lack of cooperation.

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C. Settlement options

It is important to keep in mind that the tax-exempt status of an organization is usually its most valuable asset. Loss of tax-exempt status cannot only have an adverse financial impact, but can be extremely embarrassing in the community. Because revocation of tax-exempt status is such a serious step, Internal Revenue Service auditors do not usually recommend it lightly. They are frequently open to promises of reform as an alternative to revocation of tax-exempt status. For example, an organization which has been determined to be engaging in a substantial amount of unrelated business activity may offer to spin off the activity into a for-profit subsidiary and provide the auditor with evidence of the spin off within a short period of time. Auditors often look kindly on this type of settlement proposal, as they know that a tax-exempt organization is likely to fight for retention of its tax-exempt status as it would fight for its life. A structured settlement may be acceptable to the Internal Revenue Service in these situations as an alternative to years of litigation, especially if the organization might win sympathy from a court or jury because of its other worthy activities.

If the issue on audit is a failure to pay unrelated business income tax, the organization should make sure it takes advantage of all possible allocations. An auditor may uncover an activity which is truly an unrelated business but the organization may be able to show, through allocation of staff time, rent, and other expenses, that it did not produce a profit and that no tax is due.

SUMMARY

The rules that govern tax-exempt organizations are complex but manageable. An understanding of the rules will permit an organization to retain its tax-exempt status while engaging in many worthwhile and profitable activities. The keys to success are careful planning and a thorough knowledge of the governing rules.

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