

Business Entities Committee - The Life of a 501(c)(3) Organization

Julia Caputo Stift
Chino Hills, CA

Exhibit

Exhibit A PowerPoint Presentation 13-3

**Exhibit A
PowerPoint Presentation**

<h1>THE LIFE CYCLE OF A CHARITY</h1>	<p>Julia Caputo Stiff, Esq. 350 E. Orangethorpe Unit 18 Placentia, CA 92870 310-699-8560 jcestift@yahoo.com</p>
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<h2>THE LIFE CYCLE OF A CHARITY</h2>
<ul style="list-style-type: none">■ Preliminary Matters<ul style="list-style-type: none">■ This presentation addresses formation, operating, and dissolution requirements pertaining generally to organizations that are exempt from tax under Section 501(c)(3) of the Internal Revenue Code of 1986, as amended (the "Code").■ There are certain specific forms of organizations, such as hospitals, schools, churches, organizations that engage in international activities or grant making, "supporting organizations," and "private operating foundations," that either have additional requirements that must be met or that are not subject to certain of the requirements discussed herein. The specific requirements/exemptions of these organizations are beyond the scope of material that can be addressed in today's time frame.
<p>Julia Caputo Stiff, Esq.</p>

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■ Preliminary Matters

- What is the difference between “non-profit” and “tax-exempt”?

A “Non-Profit” entity is formed under a state statute that provides the profits of the entity benefit the entity itself rather than any owners of the entity.

A “tax-exempt” entity is exempt from federal income taxation. (Often, tax-exempt entities are also exempt from state income taxation and, in some cases, other state and local taxes such as property or sales taxes.) Tax-exempt entities are not exempt from employment taxes.

Commonly, an organization that qualifies as “tax-exempt” is formed pursuant to the “non-profit” laws of the state of formation.

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■ Pre-Formation Considerations

- What do you wish to accomplish? Can your goal be achieved through exempt purpose activities?
- Section 501(c)(3) of the Code states:

Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

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■ Pre-Formation Considerations

■ How do you plan to fund the organization's activities?

- ✓ **Public Charity v. Private Foundation:** The source of funding impacts the requirements to which the organization will be subject. Adequately broad public and/or government support will permit the organization to qualify as a public charity. Public charities are subject to less stringent reporting and operational rules than private foundations. Organizations without adequately broad sources of financial support are private foundations subject to additional reporting requirements and more restrictive operating requirements.
- ✓ **Fundraising Laws:** Most state and many local governments have fundraising laws. Many of them impact fundraising conducted out of state that reaches into the relevant jurisdiction. Many states have specific statutes that govern paid fundraisers. It is important to be cognizant of the relevant fundraising laws before determining an organization's fundraising strategy.

■ Why do you want to be a charity?

- ✓ Exemptions from taxes may maximize benefit the organization can provide.
- ✓ Charitable deductions to donors facilitates fundraising.

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■ Formation and Reporting

- Formation of non-profit corporation in accordance with state corporate statute. (Occasionally, single member limited liability companies or trusts may be used as the charitable entity.)

■ The Articles/Certificate of Incorporation must include:

- ✓ **The Purpose Clause:** A statement of the organization's tax-exempt purpose; recommend inclusion of authorizing language from Section 501(c)(3) of the Code.
- ✓ **The Dissolution Clause:** A statement of what will happen to the organization's assets upon dissolution (Generally, contribution of all organization assets to another charity with a similar exempt purpose.); not required where adequately governed by state law.
- ✓ **No Self-Dealing/No Tax on Undistributed Income:** In the case of private foundations, a provision that the organization shall not cause itself to be subject to the tax set forth in Section 4292 of the Code for failure to distribute income and a provision that the organization shall not engage in "self-dealing transactions" (i.e. transactions with persons deemed to have a close relationship with the private foundation that could result in inappropriate influence on the organization).

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■ Formation and Reporting

- Bylaws
 - ✓ Statement of Member/Non-Member Organization
- Federal Employer Identification Number (IRS Form SS-4)
- Federal Tax Exemption Application (IRS Form 1023)
- Applicable State Exemption Applications
- Applicable Fundraising Statute Registration(s)
- Annual Information Return (generally, IRS Form 990 or 990-PF)

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■ Operational Requirements

■ Prohibition on Private Inurement

- ✓ An organization only qualifies as a tax-exempt charity if:

“... no part of the net earnings [of the organization] inures to the benefit of any private shareholder or individual ...”

- ✓ An individual is not permitted to be unjustly enriched as a private person by the charity.
- ✓ The receipt of a benefit from a charity as a member of a charitable class does not constitute private inurement. (i.e. library board member may check out books)
- ✓ In order to avoid private inurement, the approval of all transactions involving the provision of funds to a private person or any benefit to a person with a relationship to the charitable organization should be approved in accordance with the organization's conflict of interest policy, by a disinterested board or board committee, in writing, prior to the transfer of any benefit. The writing approving the transaction should state that the basis for the transaction (i.e. the transaction was an arm's length transaction that represented the highest benefit to the charity or the recipient of a grant met the organization's grant making procedure requirements and was approved by a disinterested group of persons without regard to such person's relationship to the organization).

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■ Operational Requirements

■ Private Benefit Doctrine

Activity that results in non-incidental private benefit may result in the revocation of an organization's exempt status. Private benefit is activity of the organization that ultimately serves private rather than public purposes.

- ✓ Hot Topic: Individual student, player or scout accounts established in connection with school, team or troop fundraising.
- ✓ Hot Topic: Donor Advised Giving
- ✓ Hot Topic: Program Related Investments

■ Private Benefit v. Private Inurement

- ✓ Incidental private benefit does not violate the private benefit doctrine. ANY private inurement is prohibited.
- ✓ The private benefit doctrine applies to all persons. The private inurement prohibition only applies to persons with a close relationship to the organization.

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■ Intermediate Sanctions/Excess Benefit Transactions

- Section 4958 of the Code imposes punitive taxes on the management and "disqualified persons" equal to 25% of the "excess benefit" received by a disqualified person from a public charity. Section 4958 does not apply to private foundations.
- The "excess benefit" is the amount by which the benefit to the disqualified person exceeds the amount that would have been received in a fair market value, arm's length transaction.
- If the excess benefit transaction is not cured within the taxable period, the punitive tax is increased to 200% of the "excess benefit."
- "Disqualified persons" are persons deemed to have significant influence over the charitable organization by virtue of their economic contributions. There are significant attribution rules to controlled corporations and family members for purposes of determining who is a disqualified person.
- The taxes imposed under Section 4958 are commonly known as the "intermediate sanctions." While they are severe, they are designed to provide the Internal Revenue Service a mechanism for penalizing persons that impermissibly benefit from charitable assets without revoking the exemption of the charity, as is its only remedy under the private inurement and private benefit doctrines.

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■ Intermediate Sanctions/Executive Compensation

- Approval of all executive compensation arrangements by a disinterested board or compensation committee. A board or committee is disinterested if none of the members have a financial interest in the transaction or have their compensation/financial arrangements determined by someone with a financial interest in the transaction.
- Approval of all executive compensation arrangements in accordance with the organization's written conflicts of interest policy.
- The approving body considers comparability data in establishing compensation. Comparability data must be regionally relevant and relevant to the size, type and scope of the organization. (Source for comparability data: www.guidestar.org)
- The terms of approved executive compensation arrangements and the materials considered in connection with establishing fair market value of compensation must be in writing prior to the payment of any compensation.

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■ Lobbying and Political Activity

- **Political Activity**
 - ✓ Charitable entities may not engage in political activity. Political activity includes the support of or opposition to any candidate for any office. This is a complete prohibition with no *de minimis* exception.
- **Lobbying**
 - ✓ "... no substantial part of the activities [of a charity may be] attempting to influence legislation" (Section 501(c)(3) of the Code, in pertinent part)
 - ✓ For purposes of Section 501(c)(3) of the Code and the Treasury Regulations promulgated thereunder, lobbying is defined as activity in support of or in opposition to legislation, regulation, proposed legislation, or proposed regulation and including a call to action with respect to that legislation.
 - ✓ There is much uncertainty regarding what constitutes a "substantial part" of a charity's activities. Section 501(h) of the Code sets forth a safe harbor election that a charity may make. It establishes flat amounts of acceptable lobbying activity based on the size of the charity, its exempt activity expenditures, and the amount spent on lobbying activities. Separate standards are set for grass roots and direct lobbying. Grass roots lobbying is evidently considered more significant as a small monetary amount is permitted.
 - ✓ The determination of what activities constitute lobbying for purposes of Section 501(c) of the Code requires careful evaluation. The definition for 501(c)(3) purposes differs widely from the definition applied when lobbyists and other entities report their political and lobbying activities, therefore, lobbying reports cannot be relied upon to determine the organization's reportable lobbying activities.

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■ Unrelated Business Taxable Income (“UBTI”)

- Charities are subject to tax on income from activities that are not related to the performance of their tax-exempt functions
- Prevents charities from unfairly competing with for-profit entities that are subject to income tax.

An activity is an unrelated business if:

- 1) It is a trade or a business;
- 2) It is regularly carried on; and
- 3) It is not substantially related to furthering the exempt purpose of the organization.

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■ Unrelated Business Taxable Income, Exemptions

- **Volunteer Work Force**
Any trade or business in which substantially all the work is performed by volunteers is not an unrelated trade or business.
- **Convenience of Members**
Any trade or business conducted primarily for the convenience of its members is not an unrelated trade or business
- **Sale of Donated Merchandise**
The sale of donated merchandise does not constitute a trade or business
- **Sponsorship**
The receipt of consideration for qualified sponsorship is not an unrelated trade or business. Qualified sponsorship entitles the sponsor to display of its name and/or logo and recognition as a sponsor.
If the payment entitles the payor to advertisement of its products or depiction of its logo or product in a regularly published periodical, the payment is advertising income rather than qualified sponsorship income.

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■ Unrelated Business Taxable Income, Exclusions

■ Dividends, Interest, Annuities and Other Investment Income

■ Royalties

Royalties are defined as income from the use of a valuable right and are excluded from unrelated business taxable income. Examples of royalties include income from the use of copyrights, trademarks, patents, logos, mineral rights, etc. Royalties do not include income from services, therefore, personal appearance fees are not excluded from unrelated business taxable income as royalties.

■ Rents

Rents from the rental of real property for occupancy only are excluded from unrelated business taxable income.

Rents are not excluded from unrelated business taxable income if the rent is determined based upon the net profits of any person.

■ Gain from the Disposition of Property

Gain from the disposition of property, other than property held for sale in the ordinary course of business, is excluded from unrelated business taxable income.

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■ Unrelated Business Taxable Income

■ Where income from an activity is deemed to be unrelated business taxable income, the organization is entitled to deduct otherwise deductible expenditures incurred to produce the income from gross income in determining taxable income.

■ Income that otherwise would be excluded from unrelated business taxable income must be included to the extent it is derived from "debt-financed property." Debt-financed property is property with respect to which debt was incurred in order to acquire or improve the property.

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