

SELF-STUDY CONTINUING PROFESSIONAL EDUCATION

Companion to PPC's

**Nonprofit Tax and
Governance Guide:
Helping Organizations
Comply**



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Interactive Self-study CPE

**Companion to PPC’s Nonprofit Tax and Governance Guide:
Helping Organizations Comply**

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INTRODUCTION

Companion to PPC's Nonprofit Tax and Governance Guide: Helping Organizations Comply consists of one interactive self-study CPE course. This is a companion course to *PPC's Nonprofit Tax and Governance Guide: Helping Organizations Comply* designed by our editors to enhance your understanding of the latest issues in the field. To obtain credit, you must complete the learning process by logging on to our Online Grading System at **OnlineGrading.Thomson.com** or by mailing or faxing your completed **Examination for CPE Credit Answer Sheet** for print grading by **April 30, 2011**. Complete instructions are included below and in the Test Instructions preceding the Examination for CPE Credit Answer Sheet.

Taking the Course

Each course is divided into lessons. Each lesson addresses an aspect of Nonprofit and Tax Governance. You are asked to read the material and, during the course, to test your comprehension of each of the learning objectives by answering self-study quiz questions. After completing each quiz, you can evaluate your progress by comparing your answers to both the correct and incorrect answers and the reason for each. References are also cited so you can go back to the text where the topic is discussed in detail. Once you are satisfied that you understand the material, **answer the examination questions which follow each lesson**. You may either record your answer choices on the printed **Examination for CPE Credit Answer Sheet** or by logging on to our Online Grading System.

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CPE requirements are established by each state. You should check with your state board of accountancy to determine the acceptability of this course. We have been informed by the North Carolina State Board of Certified Public Accountant Examiners and the Mississippi State Board of Public Accountancy that they will not allow credit for courses included in books or periodicals.

Obtaining CPE Credit

Online Grading. Log onto our Online Grading Center at **OnlineGrading.Thomson.com** to receive instant CPE credit. Click the purchase link and a list of exams will appear. You may search for the exam using wildcards. Payment for the exam is accepted over a secure site using your credit card. For further instructions regarding the Online Grading Center, please refer to the Test Instructions preceding the Examination for CPE Credit Answer Sheet. A certificate documenting the CPE credits will be issued for each examination score of 70% or higher.

Print Grading. You can receive CPE credit by mailing or faxing your completed Examination for CPE Credit Answer Sheet to the Tax & Accounting business of Thomson Reuters for grading. Answer sheets are located at the end of all course materials. Answer sheets may be printed from electronic products. The answer sheet is identified with the course acronym. Please ensure you use the correct answer sheet for each course. Payment of \$79 (by check or credit card) must accompany each answer sheet submitted. We cannot process answer sheets that do not include payment. Please take a few minutes to complete the Course Evaluation so that we can provide you with the best possible CPE.

You may fax your completed **Examination for CPE Credit Answer Sheet** to the Tax & Accounting business of Thomson Reuters at **(817) 252-4021**, along with your credit card information.

If more than one person wants to complete this self-study course, each person should complete a separate **Examination for CPE Credit Answer Sheet**. Payment of \$79 must accompany each answer sheet submitted. We would also appreciate a separate **Course Evaluation** from each person who completes an examination.

Express Grading. An express grading service is available for an **additional \$24.95** per examination. Course results will be faxed to you by 5 p.m. CST of the business day following receipt of your Examination for CPE Credit Answer Sheet. Expedited grading requests will be accepted by fax only if accompanied with credit card information. Please fax express grading to the Tax & Accounting business of Thomson Reuters at (817) 252-4021.

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**COMPANION TO PPC'S NONPROFIT TAX AND GOVERNANCE GUIDE:
HELPING ORGANIZATIONS COMPLY**

COURSE 1

**REPORTING REQUIREMENTS AND TAX CONSEQUENCES FOR CONTRIBUTIONS,
FUNDRAISING, AND POLITICAL ACTIVITIES (NPHTG101)**

OVERVIEW

COURSE DESCRIPTION:	This interactive self-study course discusses issues that should be considered by a nonprofit organization in order to comply with IRS requirements. The course highlights the rules regarding accepting contributions and substantiation and reporting requirements; compliance with fundraising policies, procedures, and controls; the basic reporting requirements to apply and maintain tax-exempt status and an organization's other potential submissions; and the various prohibitions, excise taxes, filing obligations and other rules that apply to nonprofit organizations that engage in political or lobbying activities.
PUBLICATION/REVISION DATE:	April 2010
RECOMMENDED FOR:	Users of <i>PPC's Nonprofit Tax and Governance Guide: Helping Organizations Comply</i>
PREREQUISITE/ADVANCE PREPARATION:	Basic knowledge of tax preparation
CPE CREDIT:	5 QAS Hours, 5 Registry Hours 5 CTEC Federal Hours, 0 CTEC California Hours Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at www.nasba.org for a listing of states that accept QAS hours. Enrolled Agents: This course is designed to enhance professional knowledge for Enrolled Agents. PPC is a qualified CPE Sponsor for Enrolled Agents as required by Circular 230 Section 10.6(g)(2)(ii).
FIELD OF STUDY:	Taxes
EXPIRATION DATE:	Postmark by April 30, 2011
KNOWLEDGE LEVEL:	Basic

Learning Objectives:

Lesson 1—Reporting Requirements and Tax Consequences for Contributions

Completion of this lesson will enable you to:

- Identify best practices used to create policies related to contributions, including gift acceptance policies and internal controls.
- Recognize the tax consequences of donations for both donors and donees.
- Determine the reporting requirements of noncash contributions, donated services, and other contributions.
- Recognize an organization's substantiation requirements for cash and noncash contributions received.

Lesson 2—Reporting Requirements and Tax Consequences for Fundraising

Completion of this lesson will enable you to:

- Identify the tax and financial reporting requirements regarding fundraising events, professional fundraising, and fundraising revenue and costs.
- Determine whether an organization generates unrelated business income through gaming activities, and determine its reporting requirements related to these activities.

Lesson 3—Reporting Issues for Nonprofit Organizations

Completion of this lesson will enable you to:

- Recognize how an organization can achieve tax-exempt status, a nonprofit's public disclosure requirements, and the penalties assessed for failure to comply.
- Identify the appropriate tax forms for reporting the unrelated business tax, employment tax, contributions, and other miscellaneous reporting.

Lesson 4—Reporting Requirements and Tax Consequences for Political Activities

Completion of this lesson will enable you to:

- Classify an organization's activities as campaign participation and intervention or as activities that will not affect the tax-exempt status of the organization and determine the penalties for political campaign involvement.
- Identify the organizations that are eligible to make a valid lobbying election, and calculate an organization's lobbying nontaxable amount, excise tax on lobbying activities, and proxy tax on dues or member's deductibility of dues.

TO COMPLETE THIS LEARNING PROCESS:

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation**, and payment to:

**Thomson Reuters
Tax & Accounting—R&G
NPHTG101 Self-study CPE
36786 Treasury Center
Chicago, IL 60694-6700**

See the test instructions included with the course materials for more information.

ADMINISTRATIVE POLICIES:

For information regarding refunds and complaint resolutions, dial (800) 431-9025 for Customer Service and your questions or concerns will be promptly addressed.

Lesson 1: Reporting Requirements and Tax Consequences for Contributions

INTRODUCTION

While a nonprofit organization may plan fundraising events throughout the year to raise cash for its exempt purpose, it generally expects donations, either through membership dues or charitable contributions, to provide funds for its activities. This lesson discusses issues that should be considered by the organization before any contributions are accepted. The lesson also provides information about the reporting and substantiation required by the IRS for a donor to receive an income tax charitable deduction for donations to a charitable organization.

Completion of this lesson will enable you to:

- Identify best practices used to create policies related to contributions, including gift acceptance policies and internal controls.
- Recognize the tax consequences of donations for both donors and donees.
- Determine the reporting requirements of noncash contributions, donated services, and other contributions.
- Recognize an organization's substantiation requirements for cash and noncash contributions received.

POLICIES RELATED TO CONTRIBUTIONS

Gift Acceptance Policy

Each organization needs a gift acceptance policy as it grows. An organization needs to decide before gifts are offered whether it is equipped to handle gifts other than cash and, if so, the procedures to follow in accepting them. It is equally important to have policies to identify gifts that should not be accepted.

A gift acceptance policy helps an organization in numerous ways. Creating a gift acceptance policy educates the staff, volunteers, and the governing board about critical issues triggered by certain kinds of gifts. The discipline that results from such a policy should help prevent the acceptance of gifts that could cost the organization time, money, and possibly its reputation.

An organization should not wait until a noncash or property donation is offered before it considers the practical issues associated with accepting the gift. With a gift acceptance policy in place, an organization is prepared to discuss the issues, with experts if necessary, and arrive at a decision that is right for the organization. A policy also defines the roles of the people who will make the decisions and process the gift if it is accepted so that communications with the donor will go smoothly and efficiently.

In addition, if a gift is not accepted, a gift acceptance policy depersonalizes the organization's refusal and reduces the risk that the organization will hurt feelings and be considered "unfair" in its dealings with donors. Rather than being based on a particular individual's decision, the refusal is based on the board's policy.

To develop a gift acceptance policy, follow these steps:

- a. Identify the proper people to participate.
- b. Draft the policy and have it reviewed by legal counsel.
- c. Submit the drafted policy to the board of directors for approval and adoption. Include the governing board's adoption date on the policy to show that the instructions have the board's authority.
- d. Identify the group of experts (e.g., appraisers, brokers, lawyers, and environmental analysts) with whom the organization will consult as it applies the acceptance policies. An organization cannot respond to the donor's offer on a timely basis if it does not know who to call for assistance.

A gift acceptance policy should be reviewed about six months after its adoption and at least annually thereafter. The review committee should look through the minutes of the gift acceptance committee meetings to decide if certain types of gifts have occurred so frequently that the processing of those gifts can be built into the policy rather than treated as exceptions. An organization should also adjust the policy as it gains experience in this area.

An organization should consider including the following sections in its gift acceptance policy:

- a. The organization's mission statement.
- b. The purpose of the policy.
- c. A promise to protect its donors.
- d. A description of the donor recognition programs (if any).
- e. A description of acceptable gifts.
- f. A description of the gift acceptance process.
- g. Policies for use of legal counsel.

Real Estate Donation Policy. Gifts of real estate can be troublesome because often they cannot be quickly sold, they may not generate cash flows during the holding period, and they can expose the organization to third-party liability.

Improved Relationship with Donor. Not all donors are well-informed about the tax rules related to certain types of donations, nor do they necessarily have access to legal counsel or a tax professional. A gift acceptance policy may be useful to donors in deciding what type of assets to give and what form of gift to make.

If the gift acceptance policy is made publicly available, either by providing it to donors as part of the solicitation or posting it on the organization's website, it is a good practice to state that the organization intends to protect the donor. To do so, the organization promises that it will be ethical, competent, and professional in all dealings with the donor.

Nonprofit organizations act as stewards of donors' gifts. Accordingly, donors trust nonprofit organizations to comply with the donor's restrictions. Restrictions generally require special use of the donated property (e.g., the stipulation that donated land must be used for agricultural purposes, or prohibiting the future transfer of property by the charity). Organizations should perform the following steps before accepting restricted contributions:

- a. Clarify all restrictions and expectations with the donor.
- b. Consider carefully all restrictions.
- c. Consider whether there are any implied restrictions associated with the gift.
- d. Determine if the organization can meet the restrictions.

After the restricted contribution is accepted, the nonprofit organization should monitor compliance with the restrictions.

Internal Controls

Internal controls are intended to encourage and protect sound management practices. It is the organization's system of internal checks and balances. Internal controls include both general and financial management practices that must be integrated into the organization's general policies and procedures. The objectives of a sound internal control system include:

- a. preventing the loss or theft of an organization's assets;

- b. minimizing the opportunity for employees or volunteers to steal, misuse, or accidentally destroy the organization's assets or records;
- c. providing timely and accurate information to management, board members, donors, and other users of financial statements; and
- d. ensuring compliance with laws, regulations, and donor-imposed restrictions.

The goal of internal control is effective management—balancing asset protection with efficient operation. Selecting the appropriate mix of controls often depends on factors such as the type of accounting system, the nature and volume of accounting transactions, and staffing levels.

A significant part of the internal control system is the controls over cash receipts and contributions. These controls should focus on ensuring that the nonprofit organization—

- a. properly records all cash contributions received;
- b. complies with restrictions on contributions;
- c. complies with endowment terms and board designations;
- d. acknowledges contributions;
- e. properly values and records promises to give;
- f. properly values and records contributed securities, services, and gifts-in-kind; and
- g. complies with the IRS's substantiation and disclosure requirements.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. ABC Organization is a new non-profit organization and is in the process of writing its gift acceptance policy. Which of the following should ABC include in its policy that will prove helpful to the organization?
 - a. Professional advice for donors regarding legal consequences of donations.
 - b. A statement that makes an individual responsible for rejecting a gift, rather than the Board.
 - c. A definition the roles of people who will make gift policy decisions.
 - d. Current tax law to prevent donors from making a mistake.

2. ABC Organization is designing its internal control system. Which of the following should be included in ABC's policies and procedures to achieve the objective of a sound internal control system?
 - a. Policies that eliminate the opportunity for employees to steal ABC's assets.
 - b. Procedures that provide timely information to ABC's management.
 - c. Procedures to take after donor-imposed restrictions have not been complied with.
 - d. Policies and procedures where the cost does not outweigh the benefits.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. ABC Organization is a new non-profit organization and is in the process of writing its gift acceptance policy. Which of the following should ABC include in its policy that will prove helpful to the organization? **(Page 3)**
 - a. Professional advice for donors regarding legal consequences of donations. [This answer is incorrect. Through the gift acceptance policy, the organization should encourage the donor to seek professional advice regarding legal consequences of making a gift. The gift policy itself should not serve as the advice.]
 - b. A statement that makes an individual responsible for rejecting a gift, rather than the Board. [This answer is incorrect. If the gift is not accepted, a gift acceptance policy depersonalizes the organization's refusal and reduces the risk that the organization will hurt feelings and be considered unfair in its dealings with donors. Rather than being based on a particular individual's decision, the refusal is based on the board's policy.]
 - c. **A definition the roles of people who will make gift policy decisions. [This answer is correct. With a gift acceptance policy in place, an organization is prepared to discuss the issues, with experts if necessary, and arrive at a decision that is right for the organization. A policy also defines the roles of the people who will make the decisions and process the gift if it is accepted so that communications with the donor will go smoothly and efficiently.]**
 - d. Current tax law to prevent donors from making a mistake. [This answer is incorrect. A gift acceptance policy may be useful to donors in deciding what type of assets to give and what form of gift to make. However, donors can make mistakes if not adequately familiar with tax laws. The organization should encourage the donor to seek professional tax advice, but the organization should not take the risk of offering advice that applies to some but not all taxpayers.]
2. ABC Organization is designing its internal control system. Which of the following should be included in ABC's policies and procedures to achieve the objective of a sound internal control system? **(Page 4)**
 - a. Policies that eliminate the opportunity for employees to steal ABC's assets. [This answer is incorrect. One of the objectives of a sound internal control system include *minimizing* the opportunity for employees or volunteers to steal, misuse, or accidentally destroy the organization's assets or records. Both for-profit and non-profit entities will find it impossible to completely eliminate asset misappropriation.]
 - b. **Procedures that provide timely information to ABC's management. [This answer is correct. Internal controls include both general and financial management practices that must be integrated into the organization's general policies and procedures. The objectives of a sound internal control system include preventing the loss or theft of an organization's assets; minimizing the opportunity for employees or volunteers to steal, misuse, or accidentally destroy the organization's assets or records; providing timely and accurate information to management, board members, donors, and other users of financial statements; and ensuring compliance with laws, regulations, and donor-imposed restrictions. Timely communication of information to management helps ensure that when information does not look correct, it can be investigated in a timely manner and if there is an issue, it can be discovered and rectified.]**
 - c. Procedures to take after donor-imposed restrictions have not been complied with. [This answer is incorrect. One of the objectives of a sound internal control system includes ensuring compliance with laws, regulations, and donor-imposed restrictions. The internal control system should prevent non-compliance, not provide procedures for what to do when laws, regulations, and donor-imposed restrictions have not been complied with.]

- d. Policies and procedures where the cost does not outweigh the benefits. [This answer is incorrect. Many smaller entities must run a cost-benefit analysis when determining the internal control policies and procedures the entity will put in place. Some organizations will find that they must do without certain controls because the cost of the control is greater than the amount the organization believes it would lose should financial statement fraud or asset misappropriation occurs due to the lack of control.]

CONTRIBUTIONS IN GENERAL

Generally

A nonprofit organization may receive contributions of cash, property, or services. The amount reportable by the organization on its books may not equal the amount deductible by the donor. This discrepancy occurs when a receipt is required to be valued at fair market value on the organization's books, yet under current tax law, the donor's deduction is limited to cost basis.

Corporate Sponsorships

A payment made by a corporation (or other business entity) to sponsor an organization's activity is often referred to as a corporate sponsorship payment. This payment may be (a) entirely a contribution, (b) part contribution and part exchange, or (c) entirely an exchange. A sponsorship payment may be preferable to the paying corporation if the payment can be deducted in full during the current year as an advertising expense, and thus not subject to the taxable income limitation on charitable contributions.

The IRS provides guidelines for determining whether recognition of sponsorship income is a mere acknowledgment of a contribution or whether it is value received in an exchange (advertising).

The transfer is all or in part an exchange if there are assets, rights, or privileges given up by the nonprofit organization to the sponsor. Such items can include free tickets to an event, meals, etc. When the sponsorship arrangement provides intangible benefits, such as valuable marketing services, in addition to or instead of other benefits like tickets and meals, the sponsorship payments are more difficult to analyze. If the fair value of the assets, rights, and privileges provided by the nonprofit organization equal or exceed the cash transferred from the sponsoring business entity, there is no contribution at all.

Taxability to the Nonprofit Organization. An organization's receipt of the sponsorship payment is excluded from unrelated business income (UBI) if it is a *qualified sponsorship payment (QSP)*. A QSP is a payment (whether in money, property, or services) by an entity engaged in a trade or business (i.e., the sponsor) to a nonprofit organization (i.e., the recipient) without an arrangement or expectation that the sponsor will receive any *substantial return benefit*. This is the only requirement for exclusion from UBI. It does not matter whether the sponsored activity is related or unrelated to the recipient's exempt purpose or whether the sponsored activity is temporary or permanent.

A substantial return benefit includes:

- a. advertising, as defined in the regulations;
- b. an exclusive provider arrangement;
- c. providing facilities, services, or other privileges to the payer or persons designated by the payer (subject to a *de minimis* exception); and
- d. granting the payer or persons designated by the payer an exclusive or nonexclusive right to use an intangible asset, such as a trademark, patent, logo, or designation of the nonprofit organization.

A substantial return benefit does not include the recipient's use or acknowledgment of the sponsor's name, logo, or product lines in connection with its activities. The nonprofit organization may also mention the sponsor's location(s), telephone numbers, Internet address, slogans, and value-neutral descriptions of the sponsor's goods or services in acknowledgment of the sponsor's support. In addition, the sponsor's products can be displayed or distributed to the general public at the sponsored activity without disqualifying a payment as a QSP. However, an acknowledgment cannot contain any element of advertising such as price information, endorsements, or inducements to use the sponsor's products or services.

Even when an organization's actions go beyond mere acknowledgment, the sponsorship income is not UBI unless it is produced in an unrelated business activity (i.e., unrelated to the exempt function of the organization and

regularly carried on for the production of income). Finally, sponsorship income from an unrelated business activity is not UBI if it fits one of several exceptions or exclusions related to the tax.

Valuing Charitable Gifts

A donor must determine a property's fair market value (FMV) on the date of contribution before he or she can figure how much may be deducted as a charitable contribution. For gifts of property, a donor may not know the FMV of the gifted item.

Often, the donor will look to the nonprofit organization to provide an estimate of the FMV of donated property. However, an organization is not required to, and should not provide to the donor the FMV of the property. Doing so may create ill will with the donor if the IRS later disputes the FMV of the charitable contribution. Additionally, certain contributions require qualified appraisals to substantiate the FMV of the property. The recipient organization is precluded from providing a qualified appraisal under current IRS rules.

A better approach for the organization is to inform donors when an appraisal may be required to substantiate the FMV of a donated item. The organization should notify the donor at the time the gift is received so that the donor has sufficient time to obtain an appraisal, if one is required. Additionally, since some donors may not know who to contact, the organization may wish to provide a list of local appraisers.

Quid Pro Quo Contributions

A *quid pro quo contribution* is a payment made partly as a contribution and partly for goods and services provided to the donor by the nonprofit organization. Only the amount of the donation that exceeds the FMV of any property or services received in return is deductible by the donor as a charitable contribution.

For all *quid pro quo* contributions over \$75, nonprofit organizations must provide donors a disclosure statement with the estimated FMV of the goods or services provided to the donor in return for the contribution. A donor may rely on the nonprofit organization's good faith estimate of their value.

In addition to the good faith estimate of the goods or services provided, the disclosure statement must also notify the donor that the charitable contribution is limited to the value of the cash or other property donated over the value of the goods received.

A disclosure statement is not required if any of the following is true:

- There is no donative element involved in the particular transaction (e.g., a visitor's purchase from a museum gift shop).
- There is only an intangible religious benefit provided to the donor.
- The goods or services given to a donor have token or *de minimis* value.
- The donor makes a payment of \$75 or less per year and receives only limited membership benefits.

Goods or services provided in return for charitable contributions are ignored if they have insubstantial value. Each year, the IRS sets dollar values (indexed for inflation) to determine what is insubstantial. For 2010, items are considered to have an insubstantial value if:

- a. the FMV of all benefits received for the donation does not exceed the lesser of (1) 2% of the contribution or (2) \$96; or
- b. the contribution is \$48 or more and the only benefits received are token items, such as posters, mugs, or T-shirts with the nonprofit organization's name or logo, which cost the nonprofit organization \$9.60 or less.

Member Benefits. The disclosure rule does not apply if the *quid pro quo* benefits are certain membership benefits provided in return for an annual membership payment of \$75 or less. Membership benefits are disregarded if they

consist of admission to members-only events costing no more per person (not including allocable overhead) than the amount for “low cost articles” established by the IRS (i.e., \$9.60 for 2010). Also disregarded are rights or privileges that members can exercise frequently during the membership period, such as free or discounted admission or parking, preferred access to goods or services, and discounts on the purchase of goods or services. There are special rules for payments for the right to purchase tickets to collegiate athletic events.

Nondeductible Contributions, Gifts, or Dues

If an organization is not eligible to receive contributions deductible as charitable contributions for federal income tax purposes, any fundraising solicitation must include a disclosure that contributions to the organization are not deductible for federal income tax purposes (i.e., disclosure rule). The disclosure may be in written or printed form, by television or radio, or by telephone, but the statement must be in an easily recognizable format.

The potential penalty for failure to comply with the disclosure rule is substantial—\$1,000 per day for a solicitation that is made without the required disclosure, with a maximum penalty in any calendar year of \$10,000. If an organization intentionally disregards the disclosure requirement, the annual ceiling of \$10,000 is removed, and the penalty for each day a solicitation is made without proper notice becomes the greater of \$1,000 or 50% of the cost of all solicitations made that day without the proper disclosure.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

3. Books for Kids Organization is organizing its annual golf tournament. ProBalls, Inc., a C corporation, paid \$25,000 to sponsor the Books for Kids event in exchange for having the ProBalls banner displayed in the dining room for the after-event dinner. ProBalls has also provided a set of its golf balls to be handed out to each golfer at the start of the event. Which of the following is correct regarding the tax situation for either Books for Kids or ProBalls?
 - a. Books for Kids receipt of the sponsorship payment is excluded from unrelated business income.
 - b. It is more advantageous for the payment to be deducted as a charitable contribution on ProBalls tax return.
 - c. The payment is taxable to Books for Kids because the sponsored activity is not related to the organization's exempt purpose.
 - d. There is a substantial return benefit because ProBalls distributed its product to the golfers.

4. Ralph donated \$125 to the Nature Organization and in return received a tote bag valued at \$25 and an annual subscription to the organization's quarterly magazine which has a fair market value of \$15. The tote bag cost the organization \$10 to produce, and the magazines cost \$5. How much can Ralph deduct as a donation on his tax return?
 - a. \$0.
 - b. \$75.
 - c. \$85.
 - d. \$125.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

3. Books for Kids Organization is organizing its annual golf tournament. ProBalls, Inc., a C corporation, paid \$25,000 to sponsor the Books for Kids event in exchange for having the ProBalls banner displayed in the dining room for the after-event dinner. ProBalls has also provided a set of its golf balls to be handed out to each golfer at the start of the event. Which of the following is correct regarding the tax situation for either Books for Kids or ProBalls? **(Page 10)**
 - a. **Books for Kids receipt of the sponsorship payment is excluded from unrelated business income.** [This answer is correct. An organization's receipt of the sponsorship payment is excluded from unrelated business income if it is a qualified sponsorship payment (QSP). A QSP is a payment by an entity engaged in a trade or business to a nonprofit organization without an arrangement or expectation that the sponsor will receive any substantial return benefit. It does not matter whether the sponsored activity is related or unrelated to the recipient's exempt purpose or whether the sponsored activity is temporary or permanent. A substantial return benefit does not include the recipient's use or acknowledgement of the sponsor's name, logo, or product lines in connection with its activities. The nonprofit organization may also mention the sponsor's location, telephone numbers, internet address, slogans, and value-neutral descriptions of the sponsor's goods or services in acknowledgement of the sponsor's support. The sponsor's products may also be distributed at the sponsored activity without disqualifying a payment as a QSP.]
 - b. It is more advantageous for the payment to be deducted as a charitable contribution on ProBalls tax return. [This answer is incorrect. Corporations are subject to the taxable income limitation on charitable contributions. Corporations can only deduct up to 10% of its taxable income (before the charitable contribution deduction) as charitable contributions. A sponsorship payment may be preferable to paying corporations if the payment can be deducted in full during the current year as an advertising expense.]
 - c. The payment is taxable to Books for Kids because the sponsored activity is not related to the organization's exempt purpose. [This answer is incorrect. The only requirement for the payment to be excluded from unrelated business income is if there is no arrangement or expectation that the sponsor will receive any substantial return benefit. It does not matter whether the sponsored activity is related or unrelated to the recipient's exempt purpose or whether the sponsored activity is temporary or permanent.]
 - d. There is a substantial return benefit because ProBalls distributed its product to the golfers. [This answer is incorrect. The sponsor's products can be displayed or distributed to the general public at the sponsored activity without disqualifying a payment as a qualified sponsorship payment. However, an acknowledgment cannot contain any element of advertising such as price information, endorsements, or inducements to use the sponsor's products or services.]
4. Ralph donated \$125 to the Nature Organization and in return received a tote bag valued at \$25 and an annual subscription to the organization's quarterly magazine which has a fair market value of \$15. The tote bag cost the organization \$10 to produce, and the magazines cost \$5. How much can Ralph deduct as a donation on his tax return? **(Page 11)**
 - a. \$0. [This answer is incorrect. A quid pro quo contribution is deductible by the donor as a charitable donation. Goods or services provided in return for charitable contributions are ignored if they have insubstantial value.]
 - b. \$75. [This answer is incorrect. For all quid pro quo contributions over \$75, nonprofit organizations must provide donors a disclosure statement with the estimated FMV of the goods or services provided to the donor in return for the contribution. The \$75 is the threshold for providing this information to the donor, not the amount the donor can deduct on his or her tax return.]
 - c. **\$85.** [This answer is correct. A quid pro quo contribution is a payment made partly as a contribution and partly for goods and services provided to the donor by the nonprofit organization. Only the

amount of the donation that exceeds the FMV of any property or services received in return is deductible by the donor as a charitable contribution. Goods or services provided in return for charitable contributions are ignored if they have insubstantial value. Each year the IRS sets dollar values to determine what is insubstantial. However, the neither of the goods Ralph received meet the requirements. Therefore, Ralph can deduct \$85 (\$125 – \$25 – \$15)].

- d. \$125. [This answer is incorrect. The goods received in return for Ralph's donation do not meet the requirements for what the IRS considers insubstantial. For 2010, items are considered to have an insubstantial value if the FMV of all benefits received for the donation does not exceed the lesser of (1) 2% of the contribution or (2) \$96; or the contribution is \$48 or more and the only benefits received are token items, such as posters, mugs, or T-shirts with the nonprofit organization's name or logo, which cost the nonprofit organization \$9.60 or less.]

NONCASH CONTRIBUTIONS

Generally

Noncash contributions are any items other than cash, checks, money orders, credit card charges, wire transfers, contributed services, and transfers and deposits to a cash account of the organization.

Valuation

Generally, the starting point for valuing contributions of property is the fair market value (FMV) of the property on the date of contribution. However, a donor's deduction may be less than FMV because of limitations imposed under current tax laws.

Depending on the type of property gifted and the amount of the contribution claimed, an appraisal may be required to determine the property's FMV.

Reporting

Noncash contributions are reported by the nonprofit organization on Form 990, Part VIII, line 1g. In addition, organizations must complete Schedule M if the amount of noncash gifts is greater than \$25,000. Schedule M must also be completed by organizations that receive contributions of art, historical treasures, other similar assets, or qualified conservation contributions, regardless of the value of those contributions. The value of a contributed item is included in Schedule M even if it is sold immediately upon receipt, either by the organization or its agent.

To properly complete Schedule M, the organization must have detailed information about contributions received. Schedule M identifies two dozen different types of contributed items and provides additional lines for organizations to describe other types. For each type of contributed item, the organization must indicate the number of contributions or the number of items contributed (determined in accordance with the organization's recordkeeping practices), the contribution revenue amount included in Form 990, Part VIII, line 1, and the method used to determine the fair value of the contributed item. In addition, the organization's information system must tally the number of Forms 8283 (Noncash Charitable Contributions) received by the organization during the tax year.

The organization must indicate on Schedule M whether it has a gift acceptance policy that requires the review of any nonstandard contributions. A *nonstandard contribution* includes the contribution of any item that is not reasonably expected to be used to satisfy or further the organization's exempt purpose if the item has no ready market in which the organization may sell it and thereby convert it to cash, and the value of the item is highly speculative or difficult to ascertain.

An organization must also provide the following information in Schedule M:

- a. Whether the quantities reported in Schedule M, Part I, for each type of contribution are based on the number of contributions made, number of items contributed, or a combination of both methods.
- b. A description of any agreement with a donor that requires the organization to hold the contributed property for at least three years from the date of the initial contribution, but does not require the organization to use the contributed item for exempt purposes for the entire holding period.
- c. A description of any arrangements the organization has with third parties or related organizations to solicit, process, or sell noncash contributions.
- d. An explanation of why the organization did not report contributions as revenue because of the type of property it received (e.g., a museum that did not capitalize its collections in accordance with GAAP).

DONATED SERVICES

Generally

One of the difficulties nonprofit organizations have is capturing and documenting volunteer hours and contributed services. Generally accepted accounting principles (GAAP) require certain contributed services received by the

nonprofit organization to be recorded in the general ledger. In addition, FASB ASC 958-605-50-1 (formerly SFAS No. 116) encourages financial statement disclosure of the fair value of contributed services not required for GAAP reporting. To help capture contributed services, the accounting department must be informed of the organization's receipt of such services. Accordingly, the departments receiving contributed services must communicate with the accounting department. The accounting department should document on the form whether the services meet the criteria for recording in the general ledger.

Valuing Donated Services

Donated services that meet the criteria for financial accounting recognition as contributions should be recorded on the nonprofit organization's books at their fair value. Fair value may be estimated based on fees or hourly rates charged for similar services under similar conditions. Donated services that create or enhance a nonfinancial asset may be recognized at the fair value of the donated services or the fair value of the asset created (or the increase in fair value of an enhanced asset).

Reporting

Financial Accounting Reporting. Organizations often receive significant amounts of donated volunteer services, including accounting and legal services, assistance in fundraising activities, and participation in program activities. Contributed services relate to an individual's personal services, and they may or may not qualify for recognition as contributions. Current financial standards require the fair value of donated services to be recognized in the financial statements if the services either:

- a. create or enhance a nonfinancial asset, or
- b. require specialized skills, are provided by entities or persons possessing those skills, and would be purchased if they were not donated.

Services that do not meet either of the preceding criteria should not be recognized on the books. (However, the organization is encouraged to disclose the value of services received in the footnotes to the financial statements.) The criteria have been established to limit recognition to only those services that are clearly relevant and measurable at a cost that does not exceed the benefits of the information.

IRS Form 990 Reporting. The value of donated services is not included on Form 990 as contribution revenue. Instead, the organization may indicate on Form 990, Part III, the value of such donated services received and used in each program service. However, the applicable amounts are entered only on the lines provided for the descriptions of the program services. They should not be included in the amounts entered as revenue, expenses, or grants even if prepared in accordance with GAAP.

OTHER CONTRIBUTIONS

Unreimbursed Volunteer Expenses

Unreimbursed volunteer expenses, including the deduction available to donors for charitable mileage, are not reported on a nonprofit organization's tax return as contribution revenue. However, a donor may request a written acknowledgment from the organization to substantiate the donor's charitable expenses.

Interest-free Loans

Occasionally, an organization may enter into a loan that allows the organization to pay a below-market-interest rate or no interest at all. An AICPA Technical Practice Aid addresses accounting for interest-free or below-market-interest loans. Following the guidance in the Technical Practice Aid, a nonprofit organization should recognize interest expense and contribution revenue related to an interest-free or below-market-interest loan as follows:

- a. If the loan is a term loan due in more than one year, the organization should record the loan payable at the fair value of the loan based on the market interest rate (that is, the rate charged in similar transactions with

nonprofit organizations). The difference between the amount recorded as loan payable and the fair value of the loan at the stated rate (or the face value of the loan for loans that are interest-free) is contribution revenue. At the end of each year, the organization should record accretion of the loan using the effective interest method by recognizing interest expense and increasing the loan payable. (The organization could choose to use the straight-line method if the results would not be materially different than the effective interest method.) As interest expense is recognized, the organization should reclassify net assets from temporarily restricted net assets to unrestricted net assets.

- b. If the loan is payable on demand, the organization should record the loan payable at face value. Each period until the demand loan is repaid, the organization should recognize interest expense and contribution revenue for the difference between the market interest rate and the rate the organization is charged for the loan.

Use of Property

A taxpayer who permits a nonprofit organization to use his or her property without charge (or at a minimal charge) is not entitled to a charitable deduction. The taxpayer is considered to have made a contribution of a partial interest in property, which is a nonqualifying, nondeductible contribution.

Credit Card Rebates

Many credit card companies routinely offer rebates as a method of enticing customers. The customer is often given the choice of either receiving the rebate in cash or credit, or donating the rebate to a particular nonprofit organization.

In Ltr. Rul. 200228001, the IRS explained the tax rules that apply when a credit card rebate is donated to a charitable organization on a cardholder's behalf. The ruling addresses four key issues:

- a. Qualifying charitable donations.
- b. Timing of rebate deductions.
- c. Required documentation.
- d. Taxation of rebates to the cardholder. This issue does not affect the recipient nonprofit organization.

Although the ruling addresses the tax implications to the donor, it also provides useful information to the nonprofit recipient.

Qualifying Charitable Donations. In the ruling, the credit card company's program is expected to help organizations raise funds in two ways:

- a. The issuing bank automatically donates a small percentage of each credit card transaction to a charitable organization designated by the cardholder (i.e., the cardholder cannot take the cash in lieu of the donation).
- b. The participating retail merchants rebate a portion of their charges to the credit card company, which, in turn, allows the cardholder to take the rebate in cash or request that it be given to a particular charitable organization. (When applying for the credit card, cardholders choose whether to keep the rebates or donate them to a nonprofit organization; failure to choose is considered a choice to donate the rebates to a charitable organization.)

The rebate, regardless of the method used to fund the donation, is reported by the organization as contribution revenue.

Timing of Rebate Deduction. The credit card company is acting on behalf of the cardholder, not the recipient organization. Contribution revenue is not recognized by the organization until the merchant rebates are transferred to the organization. Likewise, assuming the cardholder has properly elected to donate the rebate to a qualified

charitable organization, the cardholder is entitled to claim a charitable deduction for the tax year in which the company transfers the rebates to the organization, rather than for the year (if earlier) the rebate was earned.

Required Documentation. If a credit card company makes a lump sum transfer of \$250 or more to a charitable organization on behalf of a cardholder, the cardholder/donor will need a receipt from the organization providing (a) the date and amount of cash donated, and (b) whether the organization provided any goods or services in return for the donation and, if so, their value.

Although the ruling does not address it, an organization is not relieved of its disclosure requirement for certain *quid pro quo* contributions because the payment was made by the card company rather than directly by the cardholder. Thus, if a credit card company transfers \$75 or more to the organization on behalf of a cardholder, and the organization provides goods or services in return, the organization must provide the cardholder with the required acknowledgment unless one of the exceptions discussed previously.

As a practical matter, it is doubtful that an organization will provide goods or services in return for a donation forwarded by a credit card company. However, an organization should have procedures in place to ensure its disclosure obligation is met.

Commodities

A donor may contribute farm commodities to a nonprofit organization to reduce both income tax and self-employment tax. While the transfer of the commodities generally does not result in a charitable deduction for the farmer, transfer of the commodities prior to their sale reduces the farmer's income.

The *written acknowledgment* rules and the requirement to use Form 8283 should not apply to charitable contributions of farm-raised commodities because no charitable contribution deduction is claimed by the taxpayer (as the taxpayer's basis in the commodities is zero).

Requirements for Charitable Transfer. To receive the benefit of the donation of raised commodities, the unsold commodities must be inventory of an active cash-basis farmer. In addition, the contribution of raised commodities should first be made to the organization (with evidence that title is transferred to the organization), followed by a sale of the commodities by the organization. To avoid having the IRS treat the transfer as if the raised commodities were sold by the farmer, followed by a cash contribution to the organization, the following steps should be followed:

- a. The commodity should be delivered to the grain elevator, with a storage receipt issued to the nonprofit organization.
- b. The receipt should then be delivered to the organization with a letter from the donor indicating that the commodity belongs to the organization and may be sold by the organization as it desires.
- c. Before sending payment to the organization, the buyer/grain elevator should await specific instructions from the organization to sell the commodity.

Contributions of Inventory

Businesses that donate certain types of property (e.g., inventory and other ordinary or short-term capital gain property) normally are limited to a charitable deduction equal to the property's basis, even if the property's FMV is a greater amount. However, corporate donors (other than S corporations) may deduct the property's basis and a portion of the excess of its FMV over basis if it is donated to a public charity or private operating foundation and certain other requirements are met.

The recipient organization must provide the donor corporation a written statement that the organization intends to comply with certain restrictions on the use and the transfer of the donated property. The statement, which must be furnished by the due date (including extensions) of the donor's federal income tax return for the year of the donation, must:

- a. describe the donated property and indicate the date it was received;

- b. state that the property's use will be related to the organization's tax-exempt purpose for the care of the ill, needy, or infants;
- c. state that the organization will not exchange the donated property for money, other property, or services;
- d. state that the organization is (1) described in IRC Sec. 501(c)(3), (2) exempt under IRC Sec. 501(a), and (3) not a nonoperating private foundation; and
- e. state that adequate books and records will be maintained and made available to the IRS upon request (to support the organization's compliance with items a–d).

If the organization transfers the donated property to another organization rather than using it for the care of the ill, needy, or infants, the entity receiving the transferred property must furnish the first organization with a written statement similar to what was furnished to the original corporate donor.

Contribution of Scientific Property Used for Research

Corporate donors of certain types of tangible personal property can deduct the property's basis and a portion of the excess of its FMV over basis if it is donated to an institution of higher education or a public charity organized and operated primarily to conduct scientific research. S corporations, personal holding companies, and service corporations are not eligible for this extra deduction.

To receive the additional deduction, the contributed property must be scientific equipment or apparatus constructed by the corporation within two years prior to the donation, and the recipient organization must be the original user of the property.

The recipient nonprofit organization must provide the donating corporation with a written statement that it intends to comply with certain restrictions on the use and transfer of the property. The statement furnished to the corporation must state that the property:

- a. will be used for research and experimentation, or for research training in the U.S. in physical or biological sciences; and
- b. will not be transferred by the donee in exchange for money, property, or services.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

5. Loretta donated a painting to her local library. The painting has been appraised at \$10,000, and will be used as artwork in the library's conference room. What is one of the library's reporting requirements regarding this painting?
 - a. It must provide a qualified appraiser's report to Loretta.
 - b. It must send a disclosure statement to Loretta.
 - c. It must report the cost of the painting on Form 990.
 - d. It must file Schedule M with Form 990.

6. A soup kitchen enlists several volunteers throughout the year to serve food to its patrons. Occasionally the organization must hire help when there are not enough volunteers. During the current year, the value of the services donated to the soup kitchen amounted to \$80,000, and it paid \$2,000 to hired help for the same type of services. How much does the organization report on its Form 990 as contribution revenue?
 - a. \$0.
 - b. \$2,000.
 - c. \$80,000.

7. Frank owns an office building and rents the first floor to a charitable organization. The organization pays an annual rental fee of \$12,000. The current FMV of this office space is \$36,000. How much can Frank deduct as a charitable deduction?
 - a. \$0.
 - b. \$12,000.
 - c. \$24,000.
 - d. \$36,000.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

5. Loretta donated a painting to her local library. The painting has been appraised at \$10,000, and will be used as artwork in the library's conference room. What is one of the library's reporting requirements regarding this painting? **(Page 16)**
 - a. It must provide a qualified appraiser's report to Loretta. [This answer is incorrect. An organization is not required to, and should not provide to the donor the FMV of the property. Additionally, certain contributions require qualified appraisals to substantiate the FMV of the property. The recipient organization is precluded from providing a qualified appraisal under the current IRS rules.]
 - b. It must send a disclosure statement to Loretta. [This answer is incorrect. An organization is required to send a disclosure statement to donors for quid pro quo donations over \$75.]
 - c. It must report the cost of the painting on Form 990. [This answer is incorrect. The *value* of noncash contributions are reported on Form 990, Part VIII, line 1g. The cost of the donated item does not matter to the organization, as it may to the donor.]
 - d. **It must file Schedule M with Form 990. [This answer is correct. Organizations must complete Schedule M if the amount of noncash gifts is greater than \$25,000. Schedule M must also be completed by organizations that receive contributions of art, historical treasures, other similar assets, or qualified conservation contributions, regardless of the value of those contributions. The value of a contributed item is included in Schedule M even if it is sold immediately upon receipt, either by the organization or its agent.]**

6. A soup kitchen enlists several volunteers throughout the year to serve food to its patrons. Occasionally the organization must hire help when there are not enough volunteers. During the current year, the value of the services donated to the soup kitchen amounted to \$80,000, and it paid \$2,000 to hired help for the same type of services. How much does the organization report on its Form 990 as contribution revenue? **(Page 17)**
 - a. **\$0. [This answer is correct. The value of donated services is not included on Form 990 as contribution revenue. Instead, the organization may indicate on Form 990, Part III the value of such donated services received and used in each program service.]**
 - b. \$2,000. [This answer is incorrect. The amount reported would be based on the value of the services, not on the amount the organization had to pay for the services when volunteers were not available.]
 - c. \$80,000. [This answer is incorrect. Although these services would be purchased if they were not donated, they do not require specialized skills. The organization may wish to disclose this information in its notes to the financial statements.]

7. Frank owns an office building and rents the first floor to a charitable organization. The organization pays an annual rental fee of \$12,000. The current FMV of this office space is \$36,000. How much can Frank deduct as a charitable deduction? **(Page 18)**
 - a. **\$0. [This answer is correct. A taxpayer who permits a nonprofit organization to use his or her property without charge (or at a minimal charge) is not entitled to a charitable deduction. The taxpayer is considered to have made a partial interest in property, which is a nonqualifying, nondeductible contribution.]**
 - b. \$12,000. [This answer is incorrect. This is the amount that the organization paid as rent to Frank, and is the amount Frank will report as rental income. Because Frank made a contribution of a partial interest in property, he will not deduct this amount as a charitable contribution.]

- c. \$24,000. [This answer is incorrect. The organization may report \$24,000 as contribution revenue and \$24,000 as rent expense, as this portion is an in-kind contribution. However, because Frank made a contribution of a partial interest in property, he will not deduct this amount.]
- d. \$36,000. [This answer is incorrect. Frank received rental income for the office space; therefore, he cannot deduct the entire FMV as a charitable deduction.]

SUBSTANTIATION OF CONTRIBUTIONS

Receipt of Contributions

The recordkeeping and filing requirements for charitable contribution deductions vary based on the type and amount of the contribution. The IRS issued Publication 1771, "Charitable Contributions—Substantiation and Disclosure Requirements," to help taxpayers and organizations understand the rules for documenting charitable deductions on federal tax returns. A copy of the publication is available on the IRS website at www.irs.gov/pub/irs-pdf/p1771.pdf.

Cash Gifts of Less than \$250. The nonprofit organization is not required to provide a written contemporaneous acknowledgment for cash gifts of less than \$250 unless the contribution is a *quid pro quo* contribution of \$75 or more.

The \$250 threshold is applied to each contribution separately. Therefore, if a donor makes multiple contributions to the same organization totaling \$250 or more in a single year, but each gift is less than \$250, written acknowledgment is not required.

Although the organization is not automatically required to provide the acknowledgment, the donor is required to have written proof and should request the acknowledgment if not provided by the organization. Also, if the donor has made several cash gifts throughout the year, the organization may prefer to send out one acknowledgment that includes a list of all contributions received from the donor during the year.

Cash Gifts of \$250 or More. A donor will need written contemporaneous acknowledgment from the organization for a gift of \$250 or more. Although the responsibility for obtaining this documentation lies with the donor, many donors mistakenly believe the responsibility lies with the organization to provide the acknowledgment. As a practical matter, an organization should be prepared to provide the acknowledgment required for the donor to deduct the charitable gift. However, the organization is not required to record or report this information to the IRS on behalf of the donor.

An organization can provide either a paper copy of the acknowledgment to the donor or it can provide the acknowledgment electronically, such as in an email addressed to the donor. Since there is no prescribed format for such acknowledgments, letters, postcards, and computer-generated forms are also acceptable. The acknowledgment must indicate:

- a. the amount of cash contributed;
- b. a description (but not an estimate of value) of any property contributed;
- c. whether the organization provided any goods or services to the donor in exchange for the contribution; and, if so,
- d. a description and good faith estimate of the value of the goods or services provided or, if the only goods or services provided were intangible religious benefits, a statement to that effect.

Quid Pro Quo Contributions. Organizations must provide a written disclosure statement to donors who make a *quid pro quo* contribution in excess of \$75. The written disclosure should inform the donor that the charitable deduction is limited to the excess of the contribution over the value of the goods or services provided by the organization (with a good faith estimate of the value of the goods or services provided). There is no need to assign a value to intangible religious benefits. Penalties apply to the donee organization for failure to provide the necessary written disclosure. This requirement is separate from the donor's contemporaneous written substantiation requirement for deductibility purposes as discussed previously.

Payroll Deduction. An organization should provide pledge cards for employees that make donations through payroll deductions. The pledge card is considered written communication from the organization that satisfies part of the donor's substantiation requirements. (The donor should also retain copies of payroll stubs reflecting the withheld donation.)

If the contribution is \$250 or more, the pledge card (or other receipt prepared by the organization) must state that the organization does not provide goods and services in whole or partial consideration for any contributions made by payroll deduction.

Out-of-pocket Expenses. A volunteer who incurs out-of-pocket expenses may request a written receipt from the organization describing the volunteer services provided and whether he or she received any goods or services (including value) from the organization in consideration. The amount of out-of-pocket expenses does not need to be shown on the receipt provided by the organization.

Property Contributions under \$250. The organization's substantiation requirement for property gifts under \$250 is the same as cash gifts under \$250. However, the donor may request an acknowledgment from the charity to satisfy the donor's substantiation requirement. The donor may request a receipt showing the organization's name, the date and place of the contribution, and a description of the property.

Property Contributions of \$250 or More. The rule requiring written acknowledgment by the organization for gifts of \$250 or more also applies to property contributions. For those contributions, a receipt containing the information described previously must be obtained. The organization must provide a description of the donated property but is not required to estimate its value.

Property Contributions over \$500. Although a donor has additional reporting requirements for property donations over \$500, the organization's responsibilities are generally the same as cash or property contributions of \$250 or more. However, if the property contributed is a vehicle, boat, or airplane, or the donor is claiming a deduction of \$5,000 or more, additional responsibilities are placed on the organization.

Vehicles, Boats, and Airplanes. Deductions for charitable contributions of vehicles, boats, and airplanes that have a claimed value exceeding \$500 depend on how the donated asset is used by the recipient organization. As a result, additional reporting rules are placed on the organization.

When the claimed value exceeds \$500, the organization must provide a contemporaneous written acknowledgment of the contribution. Additionally, the organization is required to file Form 1098-C (Contributions of Motor Vehicles, Boats, and Airplanes) to report to the IRS the receipt of vehicle donations in excess of \$500.

To be considered contemporaneous, the acknowledgment must be provided to the donor within 30 days of the sale of the asset. If the organization intends to use or materially improve the asset, or sell the asset significantly below FMV to a needy individual, the acknowledgment must be within 30 days of the date of contribution.

Form 1098-C may be used, but is not required to be used, to provide the donor with a contemporaneous written acknowledgment of the contribution if the value of the contribution is \$500 or less. Otherwise, an organization must provide a written acknowledgment identifying the following:

- a. The donor's name and taxpayer identification number.
- b. The vehicle identification number.
- c. The date of the contribution.
- d. If the organization intends a significant intervening use or material improvement, the acknowledgment must contain a certification stating:
 - (1) the intended significant use by the donee organization and the intended duration of the use, or
 - (2) the intended material improvement by the donee organization, and
 - (3) that the qualified vehicle will not be sold before the completion of the use or improvement.
- e. If the organization has sold the asset, the acknowledgment must contain a certification stating:
 - (1) the date the qualified vehicle was sold,

- (2) that the vehicle was sold in an arm's-length transaction to an unrelated party,
 - (3) the gross proceeds of the sale, and
 - (4) that the deductible amount may not exceed the amount of the gross proceeds.
- f. If the organization intends to sell the vehicle at a price significantly below FMV or gratuitously transfer the vehicle to a needy individual in direct furtherance of its charitable purpose, the acknowledgment should state this fact.
- g. If the donee organization provided any goods or services in consideration for the vehicle, a description and good faith estimate of the value of any goods or services should be provided.

Property Contributions over \$5,000. If an organization receives a contribution of property from a donor who will claim a deduction over \$5,000, the recipient organization must complete Form 8283 (Noncash Charitable Contributions), Section B, Part IV. By completing Part IV, the organization is acknowledging:

- a. it is a qualified organization under IRC Sec. 170(c);
- b. it received the donated property as described in Section B, Part I of Form 8283; and
- c. in the event the organization sells, exchanges, or otherwise disposes of the property within three years after the date of receipt, the organization will file Form 8282 (Donee Information Return) with the IRS and provide a copy to the donor.

The organization should also indicate whether it intends to use the property for a use unrelated to its charitable purpose.

The organization is not acknowledging agreement with the claimed FMV of the property when signing Form 8283.

Patents or Other Intellectual Property. Because a donor may intend to claim additional charitable deductions over the next 10 years for the portion of the net income earned by the organization from patents or other intellectual property (i.e., the portion that exceeds the initial deduction), additional substantiation is necessary. The organization is required to file an annual information report, Form 8899 (Notice of Income from Donated Intellectual Property), with the IRS that identifies:

- a. the name, address, and taxpayer identification number of the donor;
- b. a detailed description of the qualified intellectual property;
- c. the date of the contribution to the donee; and
- d. the amount of the net income allocable to the donated property.

The organization must annually furnish a copy of the report to the donor, which the donor can use to substantiate an additional charitable deduction for the amount of income earned for the ten years following the initial donation (but only for the amount of income exceeding the initial charitable deduction).

Special Rules for Gifts of Securities. Although the substantiation rules for donors of securities are generally more relaxed than for other types of property donations, the acknowledgment rules applicable to the organization still apply. Thus, if the donation is valued at more than \$5,000, Section B, Part IV of Form 8283 should be completed by the organization.

Dispositions of Contributed Property

An organization must acknowledge receipt of property with a claimed value over \$5,000 and agree to notify the IRS and the donor if the property is sold, exchanged, or otherwise disposed of within three years of receipt. Form 8282 (Donee Information Return) is used by the organization to provide this notification.

Form 8282 requires the organization to provide information on the donated property, including:

- a. a description of the organization's use of the property,
- b. whether the use of the property was related to the organization's charitable purpose (the basis for its tax exemption), and
- c. if tangible personal property, the certification of any such use that it provided (under the exception to the recapture rules).

Form 8282 is not required if the organization consumes or distributes (rather than sells or exchanges) the property in fulfilling its tax-exempt purpose. Additionally, the organization does not have to file the form if the donor had signed a statement on Form 8283 that the appraised value of the specific item was not more than \$500.

Certification of Use for Exempt Purpose or Function. If the property sold, exchanged, or otherwise disposed of is tangible personal property (other than publicly traded securities) for which the donor claimed a deduction of more than \$5,000 for use in the recipient's exempt purpose, the organization must certify to the IRS (and to the donor) that:

- the use of the property was related to its exempt function (and that such use was substantial), or
- there was intended use at the time of the contribution that has become impossible or infeasible to implement.

The certification must be signed under penalty of perjury by an officer of the organization. The organization must furnish a copy of the certification to the donor (for example, as part of the Form 8282).

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

8. On March 1, 20x0, Andrea donated \$400 to her favorite charitable organization and in return received a book that has a FMV of \$20. On December 31, 20x0, Andrea received an email from the organization which reads:

Thank you for your generous donation of \$400 on March 1, 20x0. We hope you enjoyed the book that we sent to you earlier this year. We hope you can join us at our next event where we will be discussing the book. Thank you for your continued support!

Which of the following is true regarding this communication sent to Andrea?

- a. Andrea does not need an acknowledgment for this donation.
 - b. The organization must mail a paper copy of the acknowledgment.
 - c. The acknowledgment should provide an estimate of the value of the book.
9. Dan donated his used minivan to an organization which will use the vehicle to pick up kids for the organization's after-school program. The van has a value of \$4,000. Which form will the organization use to report this donation to the IRS?
- a. Form 1098-C.
 - b. Form 8282.
 - c. Form 8283.
 - d. Form 8899.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

8. On March 1, 20x0, Andrea donated \$400 to her favorite charitable organization and in return received a book that has a FMV of \$20. On December 31, 20x0, Andrea received an email from the organization which reads:

Thank you for your generous donation of \$400 on March 1, 20x0. We hope you enjoyed the book that we sent to you earlier this year. We hope you can join us at our next event where we will be discussing the book. Thank you for your continued support!

Which of the following is true regarding this communication sent to Andrea? **(Page 24)**

- a. Andrea does not need an acknowledgment for this donation. [This answer is incorrect. A donor will need contemporaneous written acknowledgment from the organization for a gift of \$250 or more. Although the responsibility for obtaining this documentation lies with the donor, many donors mistakenly believe the responsibility lies with the organization to provide the acknowledgment.]
 - b. The organization must mail a paper copy of the acknowledgment. [This answer is incorrect. When acknowledgment is required, an organization can provide either a paper copy of the acknowledgment to the donor or it can provide the acknowledgment electronically, such as in an email addressed to the donor.]
 - c. **The acknowledgment should provide an estimate of the value of the book. [This answer is correct. A donor will need written contemporaneous acknowledgment from the organization for a gift of \$250 or more. An organization can provide either a paper copy of the acknowledgement to the donor or it can provide the acknowledgment electronically. The acknowledgment must indicate (a) the amount of cash contributed; (b) a description of any property contributed; (c) whether the organization provided any goods or services to the donor in exchange for the contribution; and, if so, (d) a description and good faith estimate of the value of the goods or services provided.]**
9. Dan donated his used minivan to an organization which will use the vehicle to pick up kids for the organization's after-school program. The van has a value of \$4,000. Which form will the organization use to report this donation to the IRS? **(Page 25)**
- a. **Form 1098-C. [This answer is correct. When the claimed value of a vehicle exceeds \$500, the organization must provide a contemporaneous written acknowledgment of the contribution. Additionally, the organization is required to file Form 1098-C, Contributions of Motor Vehicles, Boats, and Airplanes, to report to the IRS the receipt of vehicle donations in excess of \$500.]**
 - b. Form 8282. [This answer is incorrect. Form 8282 is used to report property with a claimed value over \$5,000 and the property is sold, exchanged, or otherwise disposed of within three years of receipt.]
 - c. Form 8283. [This answer is incorrect. Form 8283, Section B, Part IV is prepared by the organization to report a contribution of property from a donor who will claim a deduction over \$5,000.]
 - d. Form 8899. [This answer is incorrect. Form 8899 is used to substantiate an additional charitable deduction for the amount of income earned by an organization from patents or other intellectual property for the ten years following the initial donation of that property.]

EXAMINATION FOR CPE CREDIT**Lesson 1 (NPHTG101)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. XYZ Organization has finalized its gift acceptance policy and is ready to put it in place. Which of the following is **not** acceptable for XYZ regarding its gift acceptance policy decisions?
 - a. XYZ posted the policy on its website.
 - b. XYZ intends to protect the donor.
 - c. XYZ decided to not accept real estate donations.
 - d. XYZ reviewed the policy about one year after its adoption.

2. Tina, an employee of XYZ Organization, enters all donations received into the organization's accounting software. Robert, another employee of the organization, has the responsibility of bank reconciliations. Which of the following does this internal control ensure regarding XYZ's cash receipts and contributions?
 - a. Proper recording of all cash contributions received.
 - b. Acknowledgement of contributions.
 - c. Proper valuation of contributions.
 - d. Compliance with substantiation and disclosure requirements.

3. Food For Everyone Organization is organizing its gala event to raise money for local food banks. A local television station made a \$15,000 payment to sponsor the event. In return, Food For Everyone has reserved a table for the television station, with a fair market value of \$20,000, in order to promote the event using local news anchor celebrities that will be in attendance. What is a tax consequence of this sponsorship?
 - a. The television station can deduct \$5,000 of the payment as an advertising expense.
 - b. The sponsorship payment is excluded from Food For Everyone's unrelated business income.
 - c. The entire \$15,000 payment is not a contribution.
 - d. The television station must include \$5,000 in income.

4. Melissa donated \$200 to the Bird Watchers Organization. In return she received a pair of binoculars valued at \$50 from the organization. What is Melissa's contribution called?
 - a. A donation in-kind.
 - b. A quid pro quo contribution.
 - c. A restricted donation.
 - d. A substantial return benefit contribution.

5. Based on the information from the previous question, how much can Melissa report as a charitable contribution on her tax return?
- \$0.
 - \$50.
 - \$150.
 - \$200.
6. QRS Organization engaged Roger, CPA to perform the organization's annual financial statement audit. Roger would normally charge \$10,000 for this type of audit. However, Roger charged the organization \$7,000 with the remainder provided pro bono. What amount does QRS report as contribution revenue on its Form 990 related to this transaction?
- \$0.
 - \$3,000.
 - \$7,000.
 - \$10,000.
7. Furniture Maker, Inc., a S corporation, donated a new conference table and chairs to be used in the home office of Kid Art Organization, an organization that brings art instruction to kids throughout New England. The furniture cost Furniture Maker \$3,000 to make, and has a FMV of \$5,500. How much can Furniture Maker deduct as a charitable contribution for this donation?
- \$0.
 - \$2,500.
 - \$3,000.
 - \$5,500.
8. Judy volunteers 20 hours a week at a clinic for a nonprofit organization. Her out-of-pocket expenses include office supplies, toys and activities for children at the clinic, and coffee and pastries for patients at the clinic. Which of the following is true regarding Judy's out-of-pocket expenses?
- The amount of the expenses must be shown on a receipt to Judy provided by the organization.
 - The organization may provide a written acknowledgment for these expenses.
 - The organization should report Judy's expenses as contribution revenue on its tax return.
 - Judy cannot take a deduction for these expenses.
9. Kathryn donated shares of publicly traded stock valued at \$15,000 to ABC Organization. Kathryn purchased the stock 50 years ago and she has a basis of \$475 in the stock. ABC sold the stock soon after receipt for \$15,000. What form must ABC complete regarding this gift?
- Form 990.
 - Form 1098-C.
 - Form 8282.
 - Form 8283.

Lesson 2: Reporting Requirements and Tax Consequences for Fundraising

INTRODUCTION

Fundraising is central to a nonprofit organization's survival. The IRS encourages organizations to establish and monitor policies to ensure that fundraising solicitations meet federal and state law requirements and solicitation materials are accurate, truthful, and candid. In addition, the IRS is concerned that organizations keep fundraising costs reasonable and provide information about fundraising costs and practices to donors and the public. Both Forms 990 and 990-EZ (one of which will be the form the nonprofit organization will file annually with the IRS) require specific information about fundraising activities; thus, this information is annually disclosed. These forms often represent an essential part of the public perception of an organization's stewardship and effective use of funds.

In addition, an organization provides information about fundraising revenues and costs for accountability purposes. Various watchdog groups (e.g., the American Institute of Philanthropy and the BBB Wise Giving Alliance) provide standards that measure a nonprofit organization's effectiveness based on the percentage of expenses spent on the exempt mission and the reasonableness of fundraising costs.

Thus, organizations not only need to raise money to support their programs, they must develop policies, procedures, and controls to ensure that fundraising solicitations comply with various regulations, costs associated with fundraising are reasonable and properly identified, no unrelated business income or private inurement results from fundraising, and reporting requirements (e.g., financial statement and tax) are met.

Completion of this lesson will enable you to:

- Identify the tax and financial reporting requirements regarding fundraising events, professional fundraising, and fundraising revenue and costs.
- Determine whether an organization generates unrelated business income through gaming activities, and determine its reporting requirements related to these activities.

WHAT IS FUNDRAISING?

Fundraising includes activities undertaken to encourage potential donors to contribute money, securities, services, materials, facilities, other assets, or time to finance the organization's exempt function. They include publicizing and conducting fundraising campaigns; maintaining donor mailing lists; conducting fundraising events; preparing and distributing fundraising manuals, instructions, and other materials; and conducting other activities involved with soliciting contributions from individuals, foundations, governments, and others.

To better understand fundraising and the rules about fundraising, it is helpful to distinguish fundraising revenue from other sources of income (i.e., charitable contributions, sponsorship income, and program service revenue).

While distinguishing the sources of income may be confusing, keeping the sources distinct is important for several reasons. The reasons that apply specifically to fundraising income include the following:

- a. Donors will want to know if their contributions to fundraising events are efficiently used and yield actual financial support for the organization.
- b. The IRS requires separate identification of fundraising income and expenses and is concerned that fundraising costs are reasonable.
- c. Proper financial statement reporting requires the separation of income types.

Exhibit 1-1 summarizes the types of revenue that are typical for a nonprofit organization.

Exhibit 1-1**Types of Nonprofit Organization Income**

Type of Income	Examples
Charitable Contribution Income	Voluntary cash and noncash gifts, and grants (even if donor receives prize or gift of nominal value in conjunction with the contribution)
Sponsorship Income	Payment from a corporation or business entity to sponsor an organization's activity (for which the business receives a <i>de minimis</i> benefit; i.e., acknowledgment in advertising or the privilege of displaying its products at the activity)
Program Service Income	Revenue from activities that form the basis of the organization's tax-exempt status (i.e., gross receipts from admissions, performance of services, or furnishing facilities)
Fundraising Income	Income from activities undertaken to encourage potential donors to contribute money (i.e., fundraising campaigns, concerts, carnivals, dinners, balls, and auctions)

* * *

Fundraising Compared to Charitable Contribution Income

Fundraising income is derived from activities that include dinners/dances, door-to-door sales of merchandise, concerts, carnivals, sporting events, auctions, and other similar activities.

Fundraising activities *do not* include sales or gifts of goods or services of only nominal value, lotteries, or raffles that involve the following:

- a. Prizes that have only nominal value,
- b. The names of contributors or event attendees entered in a drawing for prizes without the purchase of a raffle ticket, or
- c. Solicitation campaigns that generate only contributions. These are considered to be contributions instead.

Contributions consist of voluntary cash and noncash, gifts, grants, and similar amounts received during the year from the general public, governmental units, foundations, and other organizations.

Example 1-1: Donor only receives an item of nominal value.

One of United Charity's annual campaigns is a mail solicitation to previous donors. In return for a contribution of any amount, donors receive a keychain with United's logo. Even though the donors receive an item of nominal value, all amounts received should be considered contributions.

Example 1-2: Income from fundraising event.

United Charity conducts a theater gala each year to raise funds for its charitable programs. The income from this event represents fundraising income.

Fundraising Compared to Sponsorship Income

A payment received from a corporation (or other business entity) to sponsor an organization's activity is often referred to as corporate sponsorship income. Thus, an organization may conduct a fundraising event and receive, in part, sponsorship income. The taxability of sponsorship income depends upon several rules set forth in IRC Sec. 513(i)(2).

A *qualified sponsorship payment* (QSP) is excluded from unrelated business income (UBI) if it meets certain requirements. A QSP is a payment (whether in money, property, or services) by an entity engaged in a trade or

business (i.e., the sponsor) to an organization (i.e., the recipient), without an *arrangement or expectation* that the sponsor will receive any *substantial return benefit*. This is the only requirement for the payment to be considered a QSP and, therefore, excluded from UBI. The relationship of the sponsored activity to the recipient's exempt purpose (or whether the sponsored activity is temporary or permanent) is unimportant.

Example 1-3: Receipt of qualified sponsorship payment.

Cancer Support Organization (CSO) holds an annual fun run to raise money for cancer patient education. Smith and Smith, LLC, a law firm, contributes funds to the event to cover the cost of t-shirts. CSO will prominently display Smith and Smith's name and logo on the t-shirt. In addition, CSO will list the corporation's name in promotional fliers and in newspaper advertisements. However, CSO will not include any quantitative or qualitative information about Smith and Smith in any of these acknowledgments. The amount received from Smith and Smith is a qualified sponsorship payment. The income that CSO receives from the fun run participants is income from a fundraising event.

A *substantial return benefit* includes any benefit to the sponsor (such as advertising, an exclusive arrangement, or privileges or services) other than the recipient's use or acknowledgment of the sponsor's name, logo, or product lines. A *de minimis* exception allows a recipient to provide a sponsor with benefits that have an aggregate fair market value (FMV) of not more than 2% of the sponsor's payment. A recipient may also mention the sponsor's location(s), telephone numbers, internet address, slogans, and value-neutral descriptions of the sponsor's goods or services in acknowledging the sponsor's support. In addition, the sponsor's products can be displayed or distributed to the general public at the sponsored activity without disqualifying a payment as a QSP.

Example 1-4: Sponsorship payment with substantial return benefit.

Assume the same facts as in Example 1-3. After the fun run, CSO hosts a sponsor dinner for the Smith and Smith partners. The FMV of the dinner exceeds 2% of the total payment CSO received from Smith and Smith. Because the FMV of the dinner does not meet the *de minimis* exception, the dinner is a substantial return benefit. Only that portion of the Smith and Smith payment to CSO, if any, that exceeds the FMV of the dinner is a qualified sponsorship payment.

Fundraising Compared to Program Service Income

Program service income is revenue from activities that form the basis of the organization's tax-exempt status (e.g., gross receipts from admissions, sales of merchandise, performance of services, or furnishing of facilities). Fundraising events only incidentally accomplish an exempt purpose by generating additional funds.

Example 1-5: Program service revenue or fundraising income.

The Philip Philatelic Memorial Museum (PPMM) was organized to promote stamp collecting as a hobby and to educate the general public on the historical significance of stamps. PPMM maintains an extensive collection of stamps that is open to public viewing for a small admission charge. The admissions income is considered program service revenue.

Variation: PPMM conducts an annual Stamp Festival to raise funds to support its programs and facilities. The income from the festival represents income from a fundraising event.

Fundraising and Implications for Unrelated Business Income (UBI)

Organizations must ensure that any activities undertaken to raise funds for the organization do not result in unrelated business income that will be subject to the unrelated business income tax. An activity is an unrelated trade or business if three conditions exist:

- a. *Trade or Business.* The organization is conducting an income-producing trade or business by selling goods or performing services.
- b. *Regularly Carried On.* The trade or business is regularly carried on.

- c. *Unrelated to Exempt Purpose.* The activity is “not substantially related” to carrying out the organization’s exempt purpose.

An annual fundraising event will not be treated as a regularly carried on business activity. In addition, infrequent fundraising events will not be treated as *regularly carried on* merely because they are conducted annually.

Example 1-6: Conducting an annual fundraising activity is not UBI.

The United Charities, Inc. (United) operates an ice cream stand at the county fair during the fair’s two-week run each year. Proceeds from the activity support United’s program services. Operation of the ice cream stand is not considered regularly carried on. Commercial ice cream stores are normally open throughout the year, or at least for a substantial part of the year. Thus, the operation of an ice cream stand for a two-week period once a year is not an activity that is regularly carried on, even if several more weeks are involved in preparation activities (*National Collegiate Athletic Association*).

Certain activities are statutorily excluded from the UBI rules though they may meet the definition of an unrelated trade or business. In addition, case law provides other exclusions for specific activities. The most common statutory exclusions include activities related to the following concepts: volunteer labor, members’ convenience, donated merchandise, public entertainment, conventions and trade shows, games of chance, and sponsorship payments.

PROFESSIONAL FUNDRAISING

Organizations may contract with outside service providers for assistance with fundraising activities. Professional fundraising services include services performed for the organization by an outside person or company (i.e., not an officer, director, or employee of the organization) that require certain expertise to plan or manage events, or prepare materials for fundraising. A professional fundraiser may, for example, prepare direct mail solicitations, provide advice and consulting services for contribution solicitation, or directly solicit contributions.

When an organization incurs expenses associated with professional fundraisers, the total amount must be set out on the organization’s Form 990 (Return of Organization Exempt from Income Tax). The form requires disclosure of the amount of fees specifically paid to professional fundraisers. In addition, if the total professional fundraising expenses exceed \$15,000, the organization must complete Form 990, Schedule G (Supplemental Information Regarding Fundraising or Gaming Activities). Schedule G requires certain information about professional fundraisers, including whether the organization has oral or written agreements with any individual or entity in connection with professional fundraising services; and, if so—

- a. a list of the ten highest paid individuals or entities subject to such an agreement who received at least \$5,000 from the organization for the services;
- b. the type of fundraising activity;
- c. whether the fundraiser had control of the contributions;
- d. the gross receipts from the activity;
- e. the amount paid to (or retained by) the fundraiser; and
- f. the amount paid to (or retained by) the organization.

FUNDRAISING EVENTS

Fundraising events generally:

- a. fulfill a primary purpose of raising additional funds for the organization;
- b. are planned and executed on an irregular basis (i.e., events that are not regular program events implemented as part of the exempt function); and

- c. include an exchange of a fair value item (i.e., a *quid pro quo* element, or “something for something”).

Thus, these are special events that occur infrequently and are not pursued in a manner similar to comparable commercial enterprises.

Nongaming fundraising events may include concerts, carnivals, dinners, theater parties, balls, auctions, and symposia. Because these events may involve an exchange transaction (i.e., the donor receives something of value), additional reporting and filing requirements may be required.

Tax Reporting

If an organization receives more than \$15,000 from fundraising events, the organization must complete Schedule G to file with Form 990 or Form 990-EZ.

For some events, participants are offered something of value (e.g., a meal, theater ticket, entertainment) for a payment that exceeds the costs of the benefits provided to the participant. Transactions in which the donor makes a payment partly in return for some type of goods or services (a benefit received) and partly as a contribution are referred to by the IRS as *quid pro quo* contributions. The value received is the *quid pro quo* element. (*Quid pro quo* means “something for something.”) The difference between the amount paid by the participant and the fair market value (FMV) of the direct benefits received by the participant is the contribution component, which is deductible by the participant. The IRS has specific substantiation rules requiring nonprofit organizations to report to participants the amount of the deductible component.

If, after purchasing tickets for an event, a donor is unable to attend, he or she is still only entitled to a deduction for the excess paid over the FMV. (But if the donor indicated that he or she would be unable to attend and still sent a contribution, the donor would be entitled to a deduction for the full amount contributed. In this case, the purchaser of the ticket expected nothing in return.)

To facilitate the acknowledgment process, for each fundraising event, a list of contributors must be compiled that includes names, addresses, contribution amounts, type of contributions, a description of goods or services furnished to the donor, and a FMV for each.

For Form 990 reporting, the organization breaks out the elements of *quid pro quo* contributions as follows. The amounts the organization receives that represent gratuitous or voluntary payment (i.e., the amounts received that are in excess of the FMV of the goods or services provided) are reported as contributions from fundraising events on Form 990, Part VIII, line 1c. (These amounts are also recorded parenthetically on line 8a, but not included in the reported revenue there.) The amounts received in exchange for the goods and services related to the event (the *quid pro quo* element) are reported on Part VIII, line 8a (and the expenses paid by the organization are reported on line 8b). (For further details about reporting on Form 990, see *PPC's Form 990 Deskbook*.)

Example 1-7: Contributions received from a fundraising event.

United Charities, Inc. (United) annually sponsors a concert to raise funds for its charitable programs. United contracts with the local symphony to provide the performance. Tickets are \$100 for the orchestra circle seating and \$75 for the balcony. They contain a notation that the concert is sponsored by and for the benefit of United. (Tickets for normal symphony concert performances are \$50 and \$25, respectively.)

The \$50 difference (\$100 – \$50 and \$75 – \$25) between the ticket price and the retail value of the performance is reported as a contribution from a fundraising event on line 1c of Part VIII and again on line 8a (within the parentheses of the description). The balance of the revenue from each ticket and United's payment to the symphony for out-of-pocket expenses are reported on lines 8a and 8b of Part VIII, respectively.

Charity Auctions. Donors who purchase items at a charity auction may deduct the excess of the amount paid for an item over its FMV. The donor must be able to substantiate the FMV of the item and that he or she knew that the amount paid was greater than its value.

When an organization receives donated property that is later auctioned to raise money, the fair market value of the item is reported as a general contribution on Form 990, Part VIII, line 1f (and as a noncash item on line 1g). When

the item is sold, the gross proceeds from the sale are reported as gross income from fundraising on line 8a, and the FMV of the item (i.e., its basis) plus any associated selling expenses are reported as direct expenses on line 8b. For more information on Form 990 reporting, see *PPC's 990 Deskbook*.

Example 1-8: Reporting income from auction of donated property.

Central Mission (CM), a Section 501(c)(3) organization, received a donation of a painting appraised at \$5,000 at the time of the donation. CM sells the painting for \$7,500 at an auction, and incurs \$500 in expenses related to the sale. CM should report \$5,000 as a contribution.

The sale of the painting at auction should be reported as follows: \$7,500 of gross proceeds as gross income from fundraising events, \$5,500 direct expense (\$5,000 cost basis plus \$500 selling expense) as direct fundraising expenses, and \$2,000 net proceeds (\$7,500 less \$5,500) as net income from fundraising events.

CM may also need to report the contribution of the painting on Schedule M, Noncash Contributions, if it received over \$25,000 in noncash contributions during the year.

If a donor contributes goods for a charity to sell at an auction, the donor's income tax charitable contribution deduction is limited to his or her basis in the item donated. The organization must provide the donor with an acknowledgment of the item donated.

Financial Reporting

The items given to the donor in a *quid pro quo* contribution are often referred to as direct benefits to donors. *Direct benefits to donors* are the actual costs (not the fair market value required by the IRS to be reported to the donors) of the items and services furnished to the attendees as inducements to attend the special event. They are the dinner, ballroom, orchestra, decorations, and refreshments in the case of a ball, the theater tickets if the event is a theater party, and the items raffled in the case of a raffle. According to an AICPA Technical Practice Aid, when significant, costs of direct benefits to donors are not reported as fundraising expenses since they are incurred in an exchange transaction (e.g., the portion of the ticket price that covers the cost of the dinner).

According to another AICPA Technical Practice Aid, the costs of direct donor benefits that are not program related and are provided in exchange transactions should be reported as a separate supporting category (such as cost of sales) and not as fundraising expenses. Organizations may want to report the costs of direct benefits to donors as a separate functional category in the statement of activities or deduct them from the related revenues.

Fundraising Revenue from Special Events. Fundraising revenue from special events (e.g., revenue from dinners, benefits, concerts, or charity auctions) should be recognized as two separate transactions:

- a. An exchange transaction equal to the fair value of the item received by the donor (i.e., the dinner, concert, etc.) and
- b. A contribution for the excess (total amount paid less fair value of goods and services received).

Donated Materials Used in Special Events. Items are often contributed by donors to sell to purchasers during fundraising events. For example, an organization may receive noncash contributions (such as tickets, gift certificates, or merchandise), then sell them during a fundraising auction. When an organization initially receives an item to be used for fundraising purposes, it is recognized as a contribution and recorded at fair value. When the organization later sells that item, the difference between the fair value amount reported at the time of the contribution and the amount received for those items from the ultimate recipient (i.e., the purchaser at the auction) should be recognized as an adjustment to the original contribution amount. No cost of goods sold is reported in the financial statements.

POLICIES AND PROCEDURES FOR FUNDRAISING EVENTS

The organization should establish policies and procedures to ensure that fundraising activities align with the mission of the organization and are implemented with integrity. Truthfulness and responsible stewardship are hallmarks of such integrity. The policy should address some or all of the following:

- a. The staff's responsibilities and capabilities.
- b. Responsible officers to approve activities.
- c. Coordination between staff and fundraisers.
- d. Compliance with state and local ordinances.
- e. Publicity, marketing, and media coverage (including the use of the organization's logo).
- f. The use of professional fundraisers.
- g. Donor relationships.
- h. Solicitation language (including any statutory requirement about the location of registration and financial information of the organization).
- i. Budgeting.
- j. Processing of cash, checks, and noncash donations.
- k. Compliance with federal tax requirements (including necessary acknowledgments).
- l. Legal liability and insurance issues.

State and Local Government Requirements for Fundraising

States, counties, and municipal governments may impose regulations on organizations that solicit funds within their jurisdictions. Compliance with these requirements may include registering with the state prior to solicitation, obtaining a permit or license, and filing an annual report and financial statement with the governing body.

As a result, states may create a repository of information about nonprofit organizations to facilitate better, more informed charitable giving decisions by donors. In addition, state solicitation statutes may serve to protect the state's residents from charitable solicitation fraud or misrepresentation. For access to further state specific information, the National Association of State Charity Officials (NASCO) website (www.nasconet.org/agencies) provides links to state offices that regulate charitable organizations and charitable solicitations.

There may be some question about when an organization is required to register in a certain state when online solicitations are made. NASCO provided advisory guidelines for solicitations using the Internet in *The Charleston Principles*, adopted in 2001. These guidelines provide that an entity that is not domiciled in a particular state should register with that state if:

- a. its non-Internet activities would be sufficient to require registration;
- b. the organization solicits donations through an interactive website and specifically targets persons physically located in that state and receives contributions on a regular or substantial basis through that website; or
- c. the organization solicits through a non-interactive website, but also solicits through other means such as sending email messages or other communications that promote the website.

FUNDRAISING REVENUE AND COSTS

The income and expense associated with fundraising events must be captured for the IRS as well as in the financial statements or notes to the financial statements. For tax reporting and financial statement reporting, income and expenses should generally be categorized functionally (i.e., classifications that tell *why* resources were spent, rather than *what* they were spent for). Thus, the organization must maintain separate, complete, and accurate records for fundraising events and activities.

Tax Reporting

The organization's gross income from activities and events conducted for the primary purpose of raising funds to finance the exempt activities is reported separately from contributions on Form 990, Part VIII (or Part I of Form 990-EZ). (This revenue is reported net of direct expenses. Functional expenses allocated to fundraising are reported on Form 990, Part IX.) If the fundraising income exceeds \$15,000, the organization must also complete Schedule G (to attach to Form 990 or Form 990-EZ). The Schedule G requires specific information about:

- professional fundraisers (the related activity, whether the fundraiser had control of contributions, gross receipts, and the amount paid to the fundraiser);
- the states in which the organization is registered to solicit funds;
- gross receipts and direct expenses for fundraising events and activities (with the largest two events reported separately);
- gross receipts and direct expenses for gaming activities; and
- other specific information about gaming activities (licensing information, third-party contracts, manager, etc.).

If an organization is required to file a Schedule G, information about the largest two fundraising events with gross receipts greater than \$5,000 must be detailed separately.

Financial Statement Reporting

For fundraising revenue and expenses (just as for all other revenue and expense of the nonprofit organization), the emphasis for financial reporting purposes should be on the financial statement user. Accounting rules require all nonprofit organizations to provide financial statement users with information about expenses by functional classifications. This classification of revenue and expenses helps donors, creditors, and others assess an organization's service efforts.

Financial statement users of nonprofit organizations focus on amounts reported as program, management, and fundraising expenses. Charity watchdog groups that provide standards for a nonprofit organization's use of funds include the American Institute of Philanthropy (AIP) and the BBB Wise Giving Alliance (Alliance). In addition to various other standards, each of these groups has established what it believes to be a reasonable standard for fundraising expenses as a percentage of related contributions. For example, the Alliance standard states that fundraising expenses should not exceed 35% of the related contributions.

Fundraising Expenses. Fundraising expenses include all costs of seeking contributions, such as salaries, rent, printing, and postage. Some costs can be directly identified as fundraising, such as the cost of a mailing list of potential contributors and expenses related to a direct contact solicitation. Other costs must be allocated to fundraising, such as rent and the salaries of employees who devote part of their time to fundraising. Other rules concerning financial accounting for fundraising expenses include the following:

- *Do not net fundraising expenses against contribution revenue.* Financial accounting standards require reporting the revenue and expenses related to fundraising activities on a gross basis. (However, if a special event is an incidental or peripheral activity, the organization can choose to report an amount for the net

receipts or net costs of the event. The frequency of the event and the materiality of the revenue determine if a special event is peripheral or a major, ongoing event.)

- *Expense fundraising costs in the period they are incurred.* This is true even if the fundraising costs are expected to result in contributions in future periods. That is, fundraising costs are never deferred to future periods.
- *Record the cost of soliciting donated services as fundraising expenses.* If the organization incurs costs to solicit volunteers, those costs are fundraising expenses even if the donated services do not meet the criteria for recording as contributions. However, if the nonprofit organization incurs costs to train or manage the volunteers, those costs should be expensed in the appropriate functional category. For example, an after-school mentor organization incurs \$2,000 in expenses to find volunteers for its program. The organization also incurs \$1,500 in expenses to train those volunteers on how the program is run. The organization records the \$2,000 as fundraising expenses and the \$1,500 as program expenses.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

10. The Sunshine Organization was involved in all of the following activities during the year. Which of these activities is considered fundraising income?
 - a. Sunshine mailed solicitations to previous donors at the beginning of January. Sunshine had a drawing that included all the donors that contributed by the end of February. The winner received a Sunshine Organization T-shirt.
 - b. Sunshine held a concert in the park to raise funds for its programs by selling tickets to the general public. The event included a silent auction to have dinner with the performer after the concert.
 - c. Sunshine collected money from patrons for the admission to its hands-on child activity center. Sunshine's mission is to inspire children's learning through play and exploration.
 - d. Sunshine generated money from sales made through its gift shop. The gift shop carries a line of active wear, mugs, pencils, notepads, bumper stickers, and educational toys. None of these items were donated to the organization.

11. Which of the following is true regarding professional fundraising?
 - a. Organizations need to disclose whether they had control the contributions received as a result of professional fundraising activities or the fundraiser had control of the contributions.
 - b. Organizations cannot pay a single individual or entity in excess of \$5,000 for professional fundraising services.
 - c. Organizations cannot incur expenses in excess of \$15,000 for professional fundraising expenses.
 - d. Organizations must contract with outside service providers for assistance with fundraising activities.

12. Stella purchased two tickets to Friends Organization's fundraising dinner event. Each ticket cost \$200. The organization sent her the tickets along with an acknowledgment letter that stated the fair market value of each ticket is \$75. As the date of the dinner approached, Stella realized she would not be able to attend and gave both tickets to her friend. How much can Stella deduct as a charitable contribution on her tax return?
 - a. \$0.
 - b. \$150.
 - c. \$250.
 - d. \$400.

13. Every year on New Year's Eve, New Organization holds its annual gala event. This event raises the largest amount of funds for the organization compared to the organization's general contributions or other events that raise contributions. As of December 31, 20x0, New Organization paid for half of the costs of the event and the other half was paid in early January 20x1 (total cost incurred for the event was \$280,000). The organization received 90% of its contributions related to this event by the end of 20x0, and received the remaining 10% by the end of February 20x1 (total contributions received related to the event was \$700,000). New Organization spent \$3,000 in 20x0 recruiting volunteers to work at and plan the event. Which of the following is true regarding New Organization's financial reporting in 20x0 related to this event?
- a. New Organization should report \$420,000 as its net contributions from fundraising.
 - b. New Organization should expense \$252,000 of the costs.
 - c. New Organization should report the \$3,000 on soliciting donated services as program expense.
 - d. New Organization should allocate the salaries of employees that devoted part of their time to this event.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

10. The Sunshine Organization was involved in all of the following activities during the year. Which of these activities is considered fundraising income? **(Page 34)**
 - a. Sunshine mailed solicitations to previous donors at the beginning of January. Sunshine had a drawing that included all the donors that contributed by the end of February. The winner received a Sunshine Organization T-shirt. [This answer is incorrect. All of the amounts received are considered contributions because fundraising activities do not include prizes that have only nominal value.]
 - b. Sunshine held a concert in the park to raise funds for its programs by selling tickets to the general public. The event included a silent auction to have dinner with the performer after the concert. [This answer is correct. Fundraising income is derived from activities that include dinners/dances, door-to-door sales of merchandise, concerts, carnivals, sporting events, auctions, and other similar activities. Fundraising activities do not include sales of gifts or goods or services of only nominal value, lotteries, or raffles that involve prizes that have only nominal value, the names of contributors or event attendees entered in a drawing for prizes without the purchase of a raffle ticket, or solicitation campaigns that generate only contributions.]**
 - c. Sunshine collected money from patrons for the admission to its hands-on child activity center. Sunshine's mission is to inspire children's learning through play and exploration. [This answer is incorrect. This would be considered program service revenue.]
 - d. Sunshine generated money from sales made through its gift shop. The gift shop carries a line of active wear, mugs, pencils, notepads, bumper stickers, and educational toys. None of these items were donated to the organization. [This answer is incorrect. This is considered unrelated business income.]

11. Which of the following is true regarding professional fundraising? **(Page 36)**
 - a. Organizations need to disclose whether they had control the contributions received as a result of professional fundraising activities or the fundraiser had control of the contributions. [This answer is correct. A nonprofit organization must disclose certain information on Schedule G of Form 990 when professional fundraising expenses exceed \$15,000. This information includes whether the organization has a written or oral agreement with any individual or entity in connection with professional fundraising services; and if so, (1) a list of the ten highest paid individuals or entities subject to such an agreement who received at least \$5,000 from the organization for the services; (2) the type of fundraising activity; (3) whether the fundraiser had control of the contributions; (4) the gross receipts from the activity; (5) the amount paid to (or retained by) the fundraiser; and (6) the amount paid to (or retained by) the organization.]**
 - b. Organizations cannot pay a single individual or entity in excess of \$5,000 for professional fundraising services. [This answer is incorrect. Form 990 filers that are required to complete Schedule G must include a list of the ten highest paid individuals or entities subject to a written or oral agreement with the organization in connection with professional fundraising services, who received at least \$5,000 from the organization for the services, but there is not a limit set on how much can be paid for professional fundraising by an organization.]
 - c. Organizations cannot incur expenses in excess of \$15,000 for professional fundraising expenses. [This answer is incorrect. If the organization's total professional fundraising expenses exceed \$15,000, the organization must complete Form 990, Schedule G (Supplemental Information Regarding Fundraising or Gaming Activities), but there is not a limit set on expenses for professional fundraising by an organization.]
 - d. Organizations must contract with outside service providers for assistance with fundraising activities. [This answer is incorrect. Organizations *may* contract with outside service providers for assistance with

fundraising activities, but it is not required. Professional fundraising services include services performed for the organization by an outside person or company that require certain expertise to plan or manage events, or prepare materials for fundraising. However, these same activities can be performed by employees or volunteers.]

12. Stella purchased two tickets to Friends Organization's fundraising dinner event. Each ticket cost \$200. The organization sent her the tickets along with an acknowledgment letter that stated the fair market value of each ticket is \$75. As the date of the dinner approached, Stella realized she would not be able to attend and gave both tickets to her friend. How much can Stella deduct as a charitable contribution on her tax return? **(Page 37)**
- a. \$0. [This answer is incorrect. Even though this is a fundraising event, Stella's payment is considered a quid pro quo contribution.]
 - b. \$150. [This answer is incorrect. The fair market value of the benefit received is the quid pro quo element. The deductible component would typically not include the fair market value of the benefit received, unless the benefit is considered insubstantial.]
 - c. **\$250. [This answer is correct. The difference between the amount paid by the participant and the fair market value of the benefits received by the participant (the quid pro quo element) is the contribution component, deductible by the participant. If, after purchasing tickets for an event, a donor is unable to attend, he or she is still only entitled to a deduction for the excess paid over the fair market value. The fact that the benefit received is related to a fundraising event has no bearing on the rules regarding quid pro quo contributions.]**
 - d. \$400. [This answer is incorrect. Even though Stella was unable to attend, she intended on going to the event. She cannot fully deduct the payment because she expected something in return from the organization.]
13. Every year on New Year's Eve, New Organization holds its annual gala event. This event raises the largest amount of funds for the organization compared to the organization's general contributions or other events that raise contributions. As of December 31, 20x0, New Organization paid for half of the costs of the event and the other half was paid in early January 20x1 (total cost incurred for the event was \$280,000). The organization received 90% of its contributions related to this event by the end of 20x0, and received the remaining 10% by the end of February 20x1 (total contributions received related to the event was \$700,000). New Organization spent \$3,000 in 20x0 recruiting volunteers to work at and plan the event. Which of the following is true regarding New Organization's financial reporting in 20x0 related to this event? **(Page 40)**
- a. New Organization should report \$420,000 as its net contributions from fundraising. [This answer is incorrect. Financial accounting standards require reporting the revenue and expenses related to fundraising activities on a gross basis according to FASB ASC 958-225-45.]
 - b. New Organization should expense \$252,000 of the costs. [This answer is incorrect. Financial accounting for fundraising expenses includes expensing fundraising costs in the period they are incurred. This is true even if the fundraising costs are expected to result in contributions in future periods.]
 - c. New Organization should report the \$3,000 on soliciting donated services as program expense. [This answer is incorrect. The costs of soliciting donated services should be recorded as fundraising expenses. The costs are fundraising expenses even if the donated services do not meet the criteria for recording contributions.]
 - d. **New Organization should allocate the salaries of employees that devoted part of their time to this event. [This answer is correct. Fundraising expenses include all costs of seeking contributions, such as salaries, rent, printing, and postage. Some costs can be directly identified as fundraising, like the cost of a mailing list of potential contributors and expenses related to a direct contact solicitation. Other costs must be allocated to fundraising, like rent and salaries of employees who devote part of their time to fundraising.]**

PARTICIPANT DESIGNATED ACCOUNTS

Some organizations may include fundraising activities in which participants volunteer to work at a selected fundraiser in return for receiving credit that will be applied against the costs of future activities. When the fundraising activities require supervision of the workers that determines when and how the work will be accomplished, the workers are more likely to be considered employees rather than independent contractors. The IRS has begun to scrutinize the nature of these activities with a primary focus on potential payroll tax avoidance.

The fundraising activity may also result in unrelated business income (UBI) to the organization. UBI does not generally include income where substantially all of the work is performed without compensation (the volunteer labor exception). If the workers are considered employees, the activity no longer falls under the volunteer labor exception.

Example 1-9: Volunteer may be considered an employee.

Every year the local band booster club operates a Christmas tree lot. Volunteer workers receive credit for hours worked toward the student's designated account for the cost of band camp, uniforms, and instruments. Because these fees are required to participate in the band program, parents would otherwise be responsible for these expenses. The Christmas tree lot requires supervision and an organized schedule that results in the classification of the workers as employees.

The hours credited to the participant's designated account are considered by the IRS to be compensation. Although the lot is only operated once a year, it is a seasonal activity and can be construed by the IRS to be regularly carried on. Because the workers are considered employees (and the volunteer exception no longer applies), the proceeds from tree sales may be UBI to the booster club.

GAMING

Some organizations host raffles, bingo, casino nights, pull tabs/instant bingo, card games, coin-operated gambling devices, and similar gaming activities. Organizations that conduct or sponsor gaming activities must become familiar with the federal income, employment, and excise tax implications (and related tax withholding issues) for gaming, as well as any state requirements for registration or licensing.

Avoiding Unrelated Business Income (UBI)

Although an organization may use the proceeds from gaming to pay for expenses associated with conducting its exempt function or charitable purpose, gaming is not a charitable activity. An organization is subject to tax on unrelated business income (UBI) from revenues derived from conducting a regularly carried on trade or business that is not substantially related to its exempt function. Thus, conducting gaming activities on a regular basis may subject an organization to tax on UBI unless one of the following specific exclusions applies:

- a. Bingo games.
- b. Volunteer labor exception.
- c. Qualified public entertainment activities (i.e., an activity conducted at fairs or expositions promoting agricultural or educational purposes.
- d. North Dakota exception.

Bingo Exception. *Bingo* is defined as a game of chance played with cards that are generally printed with five rows of five squares each. Participants place markers on the cards for randomly called numbers in an attempt to form a preselected pattern (e.g., horizontal, vertical, or diagonal line). The first participant to form the preselected pattern wins the game.

Unlike other games of chance, an exempt organization's conduct of a bingo game is usually not an unrelated trade or business if the game is:

- a. of a type in which wagers normally are made, winners generally are determined, and prizes typically are disbursed in the presence of all players;
- b. conducted where no commercial (for-profit) competition exists (this generally means within the same state; however, depending on state law, it can be limited to something as small as the local area where the games are conducted); and
- c. legal under state and local law. (If a law prohibiting bingo exists, but is not enforced against exempt organizations, the game will still fail this requirement.)

Example 1-10: Bingo games in jurisdiction where commercial bingo is permitted.

Local Veteran's Charity (LVC), a tax-exempt organization, is organized in State Y, a state that permits bingo games to be conducted by tax-exempt organizations. State Y also permits for-profit (commercial) bingo games to be conducted in Silver City. Because LVC conducts bingo games in Silver City, LVC's bingo games in Silver City are an unrelated trade or business, and subject to tax from UBI.

Volunteer Labor Exception. Any activity in which substantially all of the work is performed by unpaid volunteers is not an unrelated trade or business. An organization's paid staff may be directly involved with an activity that is exempt under this exception, provided sufficient volunteer effort is also present.

Tippling. Even though the workers receive nothing other than tips for their services, the IRS asserts that tipping by patrons makes the volunteer labor exception inapplicable (IRS Pub. 3079, "Gaming Publication for Tax-Exempt Organizations"). Therefore, tipping must be prohibited for income to be excluded from UBI under the volunteer labor exception.

Tuition Reduction or Waiver of Fees. If volunteer workers receive a reduction in fees that are normally charged to non-workers, these amounts are considered to be compensation (subjecting the organization to UBI rules).

Example 1-11: Tuition reduction for school's bingo volunteers.

The Windwood School, a private school, conducts gaming activities to raise funds for the school. Parents who work at the gaming activities receive a \$75 tuition reduction each time they volunteer. The tuition reduction is considered to be compensation to the parents, making the volunteer labor exception inapplicable.

Other Exceptions to Avoid UBI. Outside of North Dakota, an organization's conduct of a game of chance (except for bingo games) with paid workers generally must rely on one of the other exceptions to Section 513 to avoid classification as an unrelated trade or business. For example, horse racing with pari-mutuel betting or gaming activities as part of a qualified public entertainment activity (e.g., a state fair or agricultural exposition) would not be UBI. However, if none of the Section 513 exceptions apply, an organization may still avoid UBI classification if the gambling activity is only conducted on an infrequent basis or is substantially related to its exempt purpose.

Example 1-12: Pull tabs, raffles, and other games of chance.

The Loyal Order of Water Buffalos (LOWB), a Section 501(c)(10) organization, offers pull tabs, raffles, and other games of chance (none of which qualify as bingo) at its regular weekly meetings. To comply with state law, all of the games are conducted by LOWB paid staff members.

Providing social and recreational activities to members is one of the traditional functions of Section 501(c)(10) fraternal associations. Thus, to the extent of member participation, operation of a game of chance is substantially related to LOWB's exempt social and recreational purposes.

The conclusion in Example 1-12 also applies to:

- a. clubs organized for pleasure, recreation, and other nonprofit purposes, substantially all of the activities of which are for such purposes and no part of the net earnings of which inures to the benefit of any private shareholder;
- b. fraternal beneficiary societies, orders, or associations operating under the lodge system or for the exclusive benefit of the members of a fraternity itself operating under the lodge system; or
- c. a post or organization of past or present members of the Armed Forces of the United States, or an auxiliary unit or society of any such post or organization.

In contrast, the “substantially related to an exempt purpose” exception normally would not apply to a Section 501(c)(4) organization (civic leagues or organizations operated exclusively for the promotion of social welfare) because gambling activities do not promote the general welfare of the community.

Recordkeeping and Internal Controls

Because of the amount of cash generated from gaming activities, organizations should be actively involved in the oversight and control of each facet of the activity to ensure funds are not diverted, and maintain books and records sufficient to substantiate the information returns provided to the IRS. According to IRS Publication 3079, “Gaming Publication for Tax-Exempt Organizations,” the following internal controls are examples of controls for a bingo operation:

- The manager should control the execution of the game, including payouts, and record game transactions on a daily report.
- The cashier should receive funds and record the serial number of cards (games) sold.
- A separate cash controller should prepare the inventory/paid out reports and independently count cash receipts, comparing the cash on hand to the reports.
- A separate inventory controller should review the daily reports and reconcile receipts from the daily reports to the bank deposits per the bank statement. The inventory controller should also determine the inventory of games used and the profit achieved.
- A separate person should write all checks (make all payments) related to the bingo expenses.
- The board of trustees should review the bingo daily reports (or summary reports) and compare them with prior reports for consistency. In addition, the board should be responsible for monitoring internal controls to ensure they are functioning properly.

Records of gross income, prize payouts, and disbursements must be maintained to provide the proper categorical data for Form 990 and Form 990-T. Gross income is determined prior to any deductions for prizes, taxes, or other related expenses. State and local laws may also impose additional recordkeeping and licensing requirements. (See www.irs.gov/charities/article/0,,id=129028,00.html for links to state requirements for charities.)

IRS Filing Requirements for Gaming Activities

An organization that conducts gaming activities will have additional IRS forms to complete. In addition to the annual form (Form 990 or Form 990-EZ), the following forms may also be required:

- a. Form 990-T (Exempt Organization Business Income Tax Return) is required when gross UBI from gaming activities is over \$1,000.
- b. Form W-2G must be filed to report gambling winnings.

- c. Form 845 is required to report and pay income tax withheld from gambling winnings.
- d. Forms 730 and 11-C may be required to report wagers and pay applicable excise taxes.

These forms are in addition to employment tax returns.

Form W-2G. Wagering transactions that result in winnings (and income tax withheld on the winnings) are reported on Form W-2G. The requirements for reporting and withholding income tax depend on the type of gambling, the amount of the gambling winnings, and generally the ratio of the winnings to the wager. The winner must provide the game operator with proper identification, including his or her social security number. Form W-9 may be used to record the identification information.

If a Form W-2G is required, it should be completed when the prize is paid to the winner. Copies B, C, and 2 may be given to the prize winner at that time, although the general instructions for Form W-2G require that the statement be provided to the recipient by January 31 of the following year. The other form copies should be retained by the organization. The W-2G (Copy A), along with the transmittal Form 1096, must be filed with the IRS by February 28 of the year following the year the winnings were paid.

Withholding and Backup Withholding. Organizations that conduct gaming activities may be required to withhold income tax on the winnings and report these amounts on Form W-2G. There are two types of withholding: *regular gambling withholding* and *backup withholding*. If a payment is already subject to regular gambling withholding, it is not subject to backup withholding.

Regular Gambling Withholding. An organization must withhold 25% of gambling winnings for federal income tax if the winnings are more than \$5,000 and are from:

- sweepstakes,
- wagering pools,
- lotteries, or
- other wagering transactions if the winnings are at least 300 times the amount wagered.

Raffles are considered lotteries for the purpose of withholding or backup withholding. Regular gambling withholding is calculated on the total amount of proceeds (winnings less the amount wagered), not only on the amount in excess of \$5,000.

Example 1-13: Withholding required from bingo winnings.

The local hospital charity held a fundraiser and paid a bingo prize of \$5,500. Sheila, the winner, completed a Form W-9 and provided her social security number. The charity must withhold \$1,375 ($25\% \times \$5,500$) and pay Sheila only \$4,125.

If the winnings are in the form of a noncash payment (i.e., a car in a raffle), and the FMV of the prize after deducting the price of the wager exceeds \$5,000, the winnings are subject to the 25% regular gambling withholding rate. The tax withheld may be computed and paid in either of the two following ways:

- a. The winner pays the withholding tax to the organization [i.e., $25\% \times (\text{FMV of the noncash payment minus the amount of the wager})$].
- b. The organization pays the withholding tax at 33.33%, which is then added to the value of the recipient's winnings for reporting purposes [i.e., $33.33\% \times (\text{FMV of the noncash payment minus the amount of the wager})$]. The sum of the withholding tax and the noncash payment are reported separately as the gross winnings on the Form W-2G.

Backup Withholding. Backup withholding, calculated as 28% of the total winnings reduced (at the option of the payer) by the amount of the wager, is required if:

- a. the prize winner fails to provide a correct taxpayer identification number,
- b. 25% has not been withheld, and
- c. the winnings are at least \$600 and at least 300 times the wager amount (or the winnings are at least \$1,200 from bingo or slot machines, \$1,500 from keno, or more than \$5,000 from a poker tournament).

Example 1-14: Backup withholding required from bingo.

The local hospital charity held a fundraiser and paid a bingo prize of \$1,275. The winner refused to provide his social security number. The charitable organization must withhold \$357 (28% × \$1,275) and pay the winner only \$918. If the winner had supplied the correct taxpayer identification number, no withholding would have been required.

The organization reports the withholding from gaming winnings on Form 945, filed annually by January 31 of the following year. The tax must be deposited using either the Electronic Federal Tax Payment System (EFTPS) or by depositing at an authorized financial institution using Form 8109. Generally there are two deposit schedules (monthly or semiweekly) for depositing federal income tax withheld.

Multiple Winners. If the organization pays winnings to a member of a group of two or more winners on a single wager, or to a person who is not the actual winner, Form 5754 [Statement by Persons(s) Receiving Gambling Winnings] must be completed. The prize recipient must provide the information required by Form 5754 (i.e., information about the person to whom the winnings are paid and information about each of the actual winners). The organization uses this information to complete Form W-2G and determine any withholding requirements. Form 5754 is not submitted to the IRS, but should be kept by the organization for its records.

The total amount of the winnings less the amount wagered (i.e., not an individual's share of the prize) will determine the proceeds for withholding and reporting thresholds.

Example 1-15: Withholding requirements for shared winnings.

Jane and Ed together purchase a sweepstakes ticket for \$1. Each contributed \$.50 and agreed to split any winnings equally. The ticket won \$6,000. Because the winnings are in excess of \$5,000 (\$6,000 – \$1), the organization must withhold 25% of \$5,999 and prepare separate Forms W-2G for each winner, using the information they provided on Form 5754.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

14. Saint High School conducts a casino night for the parents of students every quarter to raise funds for the school. Parents volunteer to work at the event without any type of payment. Teachers may also volunteer to work at the event, and although they do not receive compensation for working on the casino night. Does Saint High School's casino night generate unrelated business income (UBI), and why or why not?
 - a. Saint High School's casino night generates UBI because teachers are paid employees.
 - b. Saint High School's casino night does not generate UBI because parents volunteer to work at the event.
 - c. Saint High School's casino night generates UBI because it is running games other than bingo.

15. The highest paid winner was Steve, who won \$7,000 in a roulette game. Steve filled out a Form W-9 and provided his social security number to the organization. Using the information from the previous question, how much is Steve paid related to his winnings?
 - a. \$1,750.
 - b. \$5,040.
 - c. \$5,250.
 - d. \$7,000.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

14. Saint High School conducts a casino night for the parents of students every quarter to raise funds for the school. Parents volunteer to work at the event without any type of payment. Teachers may also volunteer to work at the event, and although they do not receive compensation for working on the casino night. Does Saint High School's casino night generate unrelated business income (UBI), and why or why not? **(Page 47)**
- Saint High School's casino night generates UBI because teachers are paid employees. [This answer is incorrect. An organization's paid staff may be directly involved with an activity that is exempt under the unpaid labor volunteer exemption, provided sufficient volunteer effort is also present.]
 - Saint High School's casino night does not generate UBI because parents volunteer to work at the event. [This answer is correct. Saint High School's casino night meets the UBI exclusion because all of the work for this activity is performed by unpaid volunteers. Therefore, the casino night is not an unrelated trade or business and would not generate UBI. An organization's paid staff may be directly involved with an activity that is exempt under this exception, provided sufficient volunteer effort is also present.]**
 - Saint High School's casino night generates UBI because it is running games other than bingo. [This answer is incorrect. Although bingo has its own exception from UBI under IRC Section 513(f), other exclusions may apply to Saint High School to avoid UBI.]
15. The highest paid winner was Steve, who won \$7,000 in a roulette game. Steve filled out a Form W-9 and provided his social security number to the organization. Using the information from the previous question, how much is Steve paid related to his winnings? **(Page 50)**
- \$1,750. [This answer is incorrect. This is the amount Saint School will apply to federal income tax on Steve's winnings.]
 - \$5,040. [This answer is incorrect. Saint School would withhold 28% of Steve's winnings if he refuses to provide his social security number.]
 - \$5,250. [This answer is correct. Organizations that conduct gaming activities may be required to withhold income tax on the winnings and report these amounts on Form W-2G. An organization must withhold 25% of gambling winnings for federal income tax if the winnings are more than \$5,000 and are from sweepstakes, wagering pools, lotteries, or other wagering transactions if the winnings are at least 300 times the amount wagered.]**
 - \$7,000. [This answer is incorrect. Because Steve's winnings are greater than \$5,000, Saint High School is required to withhold income tax.]

EXAMINATION FOR CPE CREDIT**Lesson 2 (NPHTG101)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

10. Which of the following activities would generate fundraising income?
- a. A Organization sends a vehicle sticker for every membership payment made to the organization.
 - b. B Organization receives payments for advertisement placement in its monthly magazine.
 - c. C Organization mailed pamphlets to area residents to promote interest in the organization's programs along with information on how to donate money to the organization.
 - d. D Organization held a dinner dance to raise money and promote awareness of its cause.
11. Brad makes several contributions throughout the year to Super Organization. The organization sent Brad a letter that it will be holding a fundraising gala event on August 15th and a ticket will cost \$150. Brad would like to attend, but has a prior commitment. Brad sends \$300 to the organization which represents a ticket for his wife and himself along with a letter to Super that states they cannot attend the event. Super sends Brad a thank you letter, and also informs him that the fair market value of each ticket is \$50. How much can Brad and his wife deduct as a charitable contribution on their joint return?
- a. \$0.
 - b. \$100.
 - c. \$200.
 - d. \$300.
12. Regina, a famous actress, donated a dress she wore to an awards ceremony for a nonprofit organization's auction. The dress cost Regina \$10,000. The value of the dress on the day she donated it was \$20,000. The winner of the auction paid \$100,000 for the dress. How much can Regina deduct as a charitable contribution on her tax return?
- a. \$0.
 - b. \$10,000.
 - c. \$20,000.
 - d. \$100,000.
13. DEF Organization raised \$20,000 in fundraising income. The organization paid ABC, Inc. a professional fundraising entity, \$7,000 to raise these contributions. Which of the following is true regarding DEF's tax reporting requirements related to these fundraising activities?
- a. Information about ABC must be reported on DEF's return.
 - b. DEF will report what it will spend \$13,000 on Form 990 Part IX.
 - c. DEF will report gross income from this fundraising activity with other contributions.
 - d. DEF is not required to complete Schedule G.

14. Scott School PTA conducts a pizza and bingo night during the school year to raise funds for the school. Raffle tickets are also sold at the event, and all prizes (for both bingo and raffle ticket winners) are gift baskets with values of about \$50 each. Parents and PTA members volunteer to run the event. Does Scott School PTA generate unrelated business income (UBI) from this event, and why or why not?
- a. Scott School PTA generates UBI because bingo is prohibited from the UBI exclusions.
 - b. Scott School PTA does not generate UBI because it meets the volunteer labor exception.
 - c. Scott School PTA does not generate UBI because it sells raffle tickets.
 - d. Do not select this answer choice.
15. Use the information from the question above. What additional filing requirements does Scott School PTA have regarding its bingo night?
- a. Winners should receive form W-2G.
 - b. Scott School PTA should list all the winners on its Form 990.
 - c. Scott School PTA must file Form 990-T.
 - d. This event does not require any additional filing requirements for Scott School PTA.

Lesson 3: Reporting Issues for Nonprofit Organizations

INTRODUCTION

Nonprofit organizations face challenges similar to many other businesses regarding the large number of tax filings and disclosures required. The volume of filings is complicated by various reporting periods (i.e., monthly, quarterly, annually) and the related due dates of these forms or returns. Penalties can be assessed on both the organization and its managers for failing to comply with the reporting requirements. Knowing what and when to file requires careful planning and monitoring by employees and/or volunteers of all nonprofit organizations.

This lesson discusses the information a nonprofit organization may be required to submit. Potential submissions include: (a) annual information returns, (b) unrelated business income tax returns, (c) employment tax reports, (d) political organization forms and returns, (e) contribution reports, and (f) other miscellaneous reports. This lesson covers the reports most commonly encountered by organizations, and is not intended to be a comprehensive how-to guide.

Completion of this lesson will enable you to:

- Recognize how an organization can achieve tax-exempt status, a nonprofit's public disclosure requirements, and the penalties assessed for failure to comply.
- Identify the appropriate tax forms for reporting the unrelated business tax, employment tax, contributions, and other miscellaneous reporting.

BASIC REPORTING

Applying for Tax-exempt Status

Application. Form 1023 is the application form used by organizations to request tax-exempt status from the IRS under IRC Sec. 501(c)(3). Form 1024 is the application to request tax-exempt status under IRC Sec. 501(a), which generally includes most other exempt organizations. Upon approval, the IRS will issue a determination letter (also called an exemption letter) providing written assurance about the organization's tax-exempt status and its qualification to receive tax-deductible charitable contributions.

No Private Benefit. Most organizations seeking a Section 501(c) tax exemption must be formed and operated so that no part of their net earnings inure (i.e., provide an advantage) to the benefit of any private shareholder or individual who has a personal and private interest in the activities of the organization (i.e., an insider). Organization insiders are normally in control of the decisions of the entity and can include trustees, officers, members, founders, and even contributors or other third parties. Examples of prohibited inurement include unreasonable compensation, unreasonable fringe benefits, personal use of an organization's assets, forgiveness of debt owed by insiders, payment of personal expenses by the organization, low-interest or unsecured loans to insiders, unreasonable housing allowances, and other than arm's-length purchases, sales, or property rental between the organization and insiders.

Political Activities. Political organizations have special tax status under IRC Sec. 527. They are exempt from income tax on contributions as well as income from political fundraisers and bingo games (e.g., "exempt function income"). However, their net income from investments and nonpolitical fundraising events is taxable at the highest corporate income tax rate (presently 35%).

The Annual Return

Most tax-exempt organizations must meet annual IRS information reporting obligations to ensure that they continue to be recognized as tax exempt. The type of form or notice required is typically determined by the amount of the organization's gross receipts or total assets. Generally, a tax-exempt organization must file Form 990 (Return of Organization Exempt From Income Tax), Form 990-EZ (Short Form Return of Organization Exempt From Income

Tax), or, for organizations with gross receipts of \$25,000 or less, an annual electronic notice on Form 990-N [Electronic Notice (e-Postcard) for Tax-Exempt Organizations Not Required To File Form 990 or 990-EZ].

Other Returns. Certain organizations must file a specific annual return, such as the following:

- a. A black lung benefit trust should use Form 990-BL (Information and Initial Excise Tax Return for Black Lung Benefit Trusts and Certain Related Persons).
- b. A religious or apostolic organization should use Form 1065 (U.S. Return of Partnership Income).
- c. A stock bonus, pension, or profit-sharing trust should use Form 5500 (Annual Return/Report of Employee Benefit Plan).

How to File. Forms 990 and 990-PF must be filed electronically if the organization files at least 250 returns of any type (e.g., W-2, 1099) during the calendar year. If an organization does not file at least 250 returns, it may file either electronically or by mailing the return to the IRS.

Public Disclosure

Forms 990, 990-EZ, 990-PF, 990-N, and 990-T are subject to public disclosure and inspection. Organizations must make available for public inspection a copy of their exemption applications (Form 1023 or Form 1024) and their annual returns for the preceding three years. The returns must (a) generally be furnished to anyone who requests them in person or in writing, (b) be made available for inspection or the copy provided must be an exact copy of the return filed with the IRS, (c) include all attachments, and (d) be made available during regular business hours at the organization's principal office and at each of its regional or district offices that has at least three paid employees.

As an alternative to providing paper copies, an organization can make its return available on its website. Copies of many organizations' returns are posted on the websites of other entities (e.g., www.guidestar.org). Some states also provide online access to organizations' returns.

The schedule of contributors (Schedule B) attached to Form 990 or 990-EZ showing contributor names and addresses does not have to be publicly disclosed unless it is filed by a Section 527 political organization. Private foundations filing Form 990-PF must also publicly disclose their schedule of contributors.

Penalties. A person responsible for a failure to comply with any of the disclosure requirements is personally liable for a penalty of \$20 per day, limited to \$10,000 per return. However, a failure to disclose the organization's exemption application upon request draws a \$20 per day penalty that applies for as long as the failure continues.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

16. Jones & Jones, CPAs has a client that is in the early stages of forming a nonprofit organization. The organization will meet the requirements under IRC Section 501(c)(3). What form does Jones & Jones prepare for the organization to apply for tax-exempt status?
 - a. Form 990.
 - b. Form 990-N.
 - c. Form 1023.
 - d. Form 1024.

17. After filing its first Form 990, XYZ Organization posted the form on its website. Which of the following is true regarding this action taken by XYZ as it relates to the public disclosure requirements?
 - a. XYZ is in compliance with the disclosure requirements.
 - b. XYZ can be fined \$20 per day for as long as the form is on its website.
 - c. The person responsible for posting the form on its website will be fined \$10,000.
 - d. XYZ must also post Schedule B.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

16. Jones & Jones, CPAs has a client that is in the early stages of forming a nonprofit organization. The organization will meet the requirements under IRC Section 501(c)(3). What form does Jones & Jones prepare for the organization to apply for tax-exempt status? **(Page 57)**
- a. Form 990. [This answer is incorrect. This is the annual information return required by the IRS to ensure the organization can continue to be recognized as tax exempt.]
 - b. Form 990-N. [This answer is incorrect. Organizations with gross receipts of \$25,000 or less file this annual electronic notice which provides certain information to the IRS.]
 - c. **Form 1023. [This answer is correct. Form 1023 is the application form used by organizations to request tax-exempt status from the IRS under IRC Section 501(c)(3). Upon approval, the IRS will issue a determination letter providing written assurance about the organization's tax-exempt status and its qualification to receive tax-deductible charitable contributions.]**
 - d. Form 1024. [This answer is incorrect. Form 1024 is the application to request tax-exempt status under IRC Section 501(a).]
17. After filing its first Form 990, XYZ Organization posted the form on its website. Which of the following is true regarding this action taken by XYZ as it relates to the public disclosure requirements? **(Page 58)**
- a. **XYZ is in compliance with the disclosure requirements. [This answer is correct. Form 990 is subject to public disclosure and inspection. Organizations must make available for public inspection a copy of their exemption application and their annual returns for the preceding three years. As an alternative to providing paper copies, an organization can make its return available on its website.]**
 - b. XYZ can be fined \$20 per day for as long as the form is on its website. [This answer is incorrect. A person responsible for failing to disclose the organization's *exemption application* upon request draws a \$20 per day penalty for as long as the failure continues.]
 - c. The person responsible for posting the form on its website will be fined \$10,000. [This answer is incorrect. A person responsible for a failure to comply with any of the disclosure requirements is personally liable for a penalty of \$20 per day, limited to \$10,000 per return.]
 - d. XYZ must also post Schedule B. [This answer is incorrect. The schedule of contributors (Schedule B) attached to Form 990 showing contributor names and addresses, does not have to be publicly disclosed unless it is filed by a Section 527 political organization or a private foundation that files Form 990-PF.]

FILING FORM 990-T FOR UNRELATED BUSINESS INCOME

Reporting on Form 990-T

An organization that engages in trade or business activities unrelated to its tax-exempt purpose must file Form 990-T (Exempt Organization Business Income Tax Return) when its gross income (gross receipts minus cost of goods sold) is equal to or greater than \$1,000. Even if a tax-exempt organization is not required to file a Form 990 or Form 990-EZ, it must file a Form 990-T if its unrelated business income is \$1,000 or more. Organizations are taxed on their unrelated business taxable income (UBTI) at the same rates that apply to for-profit entities, using the applicable rates for trusts if the organization is an exempt trust, or the corporate tax rates if it is a corporation.

Unrelated Business Income Defined

For an activity to be taxable, all three of the following conditions must exist: conduct of a trade or business, regularly carried on, and unrelated to exempt purpose.

Trade or Business. The organization must conduct a trade or business for the production of income from selling goods or performing services. Activities that do not make a profit may still be a trade or business if the goal is to produce a profit.

Example 1-1: Activity lacking a profit motive.

Theatre Association, a Section 501(c)(3) organization, operates a school for training children in the performing arts, such as acting, singing, and dancing. It presents performances by its students and earns gross income from admission charges for the performances. The students' participation in performances before audiences is a part of their training. Since the income from the performances relates to activities that contribute importantly to the accomplishment of Theatre's exempt purposes, it is not considered gross income from an unrelated trade or business.

Regularly Carried on. The trade or business must be regularly carried on. Whether an organization meets this condition can be determined by comparing the frequency of an activity to similar activities performed by for-profit businesses.

Example 1-2: Special event versus year round business.

Fortress Youth (Fortress) operates an ice cream stand at the county fair during the fair's two-week run each year. Proceeds from the activity support Fortress's program services. Operation of the ice cream stand is not considered regularly carried on because retail ice cream stores are normally open all year or for a substantial part of the year.

Variation: Each Saturday through the year, Fortress allows visitors of a nearby museum to use its parking lot for a market rate fee. The parking fees would be from the regular conduct of a trade or business because it occurs consistently through the year.

Example 1-3: Casual sales.

The bookstore at Tarrant College sells textbooks and supplies to its students. Although the bookstore does not advertise off-campus or otherwise encourage sales to the general public, such sales occasionally occur since a student or faculty ID is not required to make a purchase. Most of these sales are to individuals visiting the campus for a reason other than to shop at the bookstore. The sales should be considered casual and not from an unrelated trade or business that is regularly carried on.

Unrelated to Exempt Purpose. For an activity to be classified as unrelated to the exempt purpose, it must be "not substantially related" to the execution of the organization's exempt purposes. To be substantially related to an organization's exempt purposes, an activity that generates business income normally must "contribute importantly" to the accomplishment of those purposes.

Example 1-4: An activity's profits fund program services.

The Hoosiers Boys Club (H) operates an inner-city sports program for boys from low-income families. A significant portion of the funding for this program comes from the profits made at a year-round car wash facility the club owns. The car wash facility is operated on a regular basis and is a trade or business. Although the funds from the activity provide critical support for H's program services, the car wash is not otherwise related to H's accomplishing its exempt purpose. Thus, the activity is an unrelated trade or business.

Example 1-5: Income from the performance of an exempt function.

Alaska University operates a ski facility for its physical education program. The facility is also available for recreational purposes to its students. For recreational purposes, students must pay slope and ski lift fees comparable to nearby commercial facilities. The operation of the ski facility for physical education classes and for the recreational use of the students contributes importantly to the accomplishment of the school's exempt purpose. As a result, the income from the facility is not unrelated business income.

Exceptions to Unrelated Business Income (UBI)

Income from certain business activities is excluded from the definition of unrelated business income and is not subject to tax. The most common exceptions to UBI include activities that involve volunteer labor, donated merchandise sales, conventions and trade shows, sponsorship payments, conveniences to members, games of chance, and bingo games.

Volunteer Labor. Activities with volunteer labor include those in which substantially all of the work is performed by volunteer workers. The meaning of *substantially all* is unclear, but the IRS has indicated that using 88% volunteer labor will qualify.

Example 1-6: Activity staffed with volunteers.

Youth Education Center (YEC), a public charity, operates a thrift store, not substantially related to its exempt purpose, where it sells both donated items and items received on consignment. There is an agreed arrangement with consignors on the selling price and disposition of goods. Substantially all of the work performed to operate the store is performed by volunteers, and all profits go to support YEC's program services.

The thrift store operation is an unrelated trade or business that is regularly carried on. However, the thrift store income is not unrelated business income because substantially all of the work is performed by volunteers.

Donated Merchandise Sales. Sales of merchandise are not an unrelated trade or business if substantially all of the merchandise was received as contributions.

Example 1-7: Activity involving the sale of donated merchandise.

Second Look (Second), a public charity, operates a thrift store unrelated to its exempt purpose. The store is open to the public during normal business hours throughout the year and sells only used clothing and furniture that Second receives as donations. Second uses paid employees to staff the store, and its prices are comparable to those of other (privately owned) second-hand stores in the area.

The store appears to be an unrelated trade or business because it is a regularly carried on trade or business that is unrelated to Second's exempt purpose. However, the store's income is not taxable because it involves selling only donated merchandise.

Conventions and Trade Shows. Activities that include conventions and trade shows must be conducted at least partly to educate members, promote products and services of its members' industry, or educate persons attending the show concerning new developments or products and services related to its exempt activities.

Example 1-8: Annual trade shows.

Plumbers Association (Plumbers) is a Section 501(c)(6) organization. It conducts an annual show at which its members exhibit their products and services to promote public interest in its products. Potential customers

are invited to the show, and sales and order placement are permitted. The organization secures the exhibition facility, undertakes the planning and direction of the show, and maintains exhibits designed to promote the business in general. The show generates revenue from admission charges, rental of display space and refreshment stands, and is a qualified convention or trade show. Providing exhibition space to individual members is a qualified trade show activity and is not an unrelated trade or business.

Sponsorship Payments. A payment received from a corporation (or other business entity) to sponsor an organization's activity is often referred to as corporate sponsorship income. Such a payment to an exempt organization (i.e., the recipient) without an "arrangement or expectation" that the sponsor will receive any "substantial return benefit" is excluded from unrelated business income.

Example 1-9: Nontaxable sponsorship income.

Cab's Burger Company (Cab's) makes significant contributions each year to be listed as the sole sponsor of the Fort Worth Flag Football Association (FWFFA), a Section 501(c)(3) organization. As part of its agreement, FWFFA must prominently feature Cab's logo on the playing field and scoreboard. Free samples of mini-burgers are distributed to everyone attending the game.

The payments FWFFA receives from Cab's are not unrelated business income. Sponsorship income is not taxable when there is no arrangement or expectation that the sponsor will receive any substantial return benefit. The types of recognition given Cab's (including the opportunity to distribute free samples of its product) are excluded from the definition of substantial return benefit.

Members' Convenience. An activity carried on primarily for the convenience of members, students, patients, officers, or employees is not an unrelated trade or business. Frequently, a single activity is substantially related to an organization's exempt purpose and is for the convenience of its members, patients, etc. To be substantially related, an activity must contribute importantly to the organization's exempt function, but to meet the convenience exception, an activity only has to provide convenience.

Example 1-10: Activity for the convenience of patients and their visitors.

Park Place Hospital constructed a parking garage next to its facilities. Although public parking is available nearby, the purpose of the garage is to provide convenient, secure parking for the hospital's patients and their visitors. A fee is charged to park in the garage, and all profits are placed in the hospital's general operating fund. Because of the availability of other parking nearby, the operation of the garage does not qualify as substantially related (i.e., contributing importantly) to the hospital's exempt purpose.

Although Park Place's parking garage fails the substantially related test, it qualifies under the convenience exception, and the activity is exempt from the unrelated business income rules. If, however, the parking lot is also used by private patients of doctors in a nearby medical building, the convenience exception does not apply, and that portion of the income is considered unrelated business income.

Games of Chance. Exempt organizations frequently conduct games of chance such as bingo, pull tabs, raffles, video games, poker, and lotteries. To avoid having the conduct of such games classified as an unrelated trade or business, an organization typically operates the games with volunteers or conducts the games in such a manner as to qualify them as bingo.

Bingo Games. To be excluded, the games must be of a type where wagers are normally made, winners are generally determined, and prizes given are distributed in the presence of all players.

EMPLOYEE AND INDEPENDENT CONTRACTOR REPORTING

Nonprofit organizations that pay wages are responsible for withholding, depositing or paying, and reporting federal income tax, social security and Medicare (FICA) taxes, and federal unemployment tax (FUTA) unless specifically excluded. Organizations may also be required to report payments to nonemployees (independent contractors) when the amount is \$600 or more.

Federal Unemployment Tax (Form 940)

The Federal Unemployment Tax Act (FUTA), along with state unemployment systems, provides for payments of unemployment compensation to workers who have lost their jobs. Only the employer pays FUTA tax. An organization [other than a Section 501(c)(3) organization] is subject to FUTA for each employee if, during the current or prior year, it had one or more employees at any time in each of 20 calendar weeks or the organization paid wages of \$1,500 or more in any calendar quarter. Deposits of FUTA tax are required before the return is filed when the quarterly liability is greater than \$500. The deposit is due by the last day of the month after the end of the quarter.

Income Tax Withholding (Form 941)

Organizations must withhold federal income and FICA taxes from employee wages. Employment taxes are reported on Form 941 (Employer's Quarterly Federal Tax Return). The organization and individuals responsible for collecting and paying employment taxes may be subject to penalties for failure to withhold and pay employment taxes. The taxes may have to be deposited before the quarterly return is due, depending on the amount withheld. Deposit of taxes withheld may be required either with the quarterly return, on a monthly or semiweekly basis, or even the next day if taxes are \$100,000 or more.

Nonpayroll Payments (Form 945)

Nonpayroll payments include pensions, gambling winnings, and backup withholding. All federal income tax withholding reported on Forms 1099 or Form W-2G must be reported on Form 945 (Annual Return of Withheld Federal Income Tax). Deposit of taxes withheld may be required with (a) the annual return, (b) on a monthly or semiweekly basis, or (c) even the next day if taxes are \$100,000 or more.

W-2/W-3 Reporting

Employers annually prepare for each employee a Form W-2 (Wage and Tax Statement), which reports the employee's wages and the amount of tax withheld. This statement is furnished to both the employee and the Social Security Administration. There is no minimum dollar amount that triggers the employer's reporting obligation. Copy A of each Form W-2 is mailed to the Social Security Administration (SSA) or filed electronically. The paper forms are submitted with a single Form W-3 (Transmittal of Wage and Tax Statements). Form W-3 contains totals of the dollar amounts reported in most boxes of the Forms W-2, and so acts as a reconciliation of those forms to the employer's other tax returns (e.g., Forms 941, 943, and 944). Employers that file 250 or more Forms W-2 are required to transmit the information to the SSA electronically (paper forms can still be provided to employees).

Independent Contractors

Form 1099-MISC (Miscellaneous Income) is used to report payments to independent contractors who provide trade or business services. Specifically, it is used to report amounts paid as nonemployee compensation, including fees, commissions, prizes, awards, or other forms of compensation for services rendered to the payer's trade or business by someone who is not an employee. Generally, payments to each person in the course of a trade or business of \$600 or more must be reported on Form 1099-MISC and provided annually to persons not treated as employees. The recipient must be furnished a statement by January 31 of the year following the payments, and a copy must be filed with the IRS by February 28. Form 1096 is the transmittal form that must accompany the form sent to the IRS. If a taxpayer files at least 250 Forms 1099-MISC during a calendar year, the form must be filed electronically.

POLITICAL REPORTING

In addition to the filing of the annual return (Form 990 or 990-EZ), political organizations may be required to file several other forms to report political activities. Exhibit 1-2 summarizes the filing requirements that are discussed further in this section.

Form 8871 (Notice of Section 527 Status)

Political organizations must use Form 8871 to notify the IRS that the organization is to be treated as a tax-exempt Section 527 organization. The form must be filed electronically within 24 hours of the date on which the organiza-

tion was established. Organizations will not be treated as tax-exempt Section 527 organizations before Form 8871 is filed. The IRS provides the ability for political organizations to file these forms electronically with a web-based filing application available at www.irs.gov/charities/political/article/0,,id=109644,00.html.

Political organizations not required to file Form 8871 include:

- organizations with expected annual gross receipts of less than \$25,000,
- a political committee required to report under the Federal Election Campaign Act,
- a political committee of a state or local candidate,
- a state or local committee of a political party, or
- an organization treated as having political organization taxable income under IRC Sec. 527(f)(1).

Form 8872 (Report of Contributions and Expenditures)

Every Section 527 political organization that accepts a contribution or pays an exempt function (i.e., political campaign activity support) amount during the year must file Form 8872 unless:

- it is not required to file Form 8871,
- it is subject to tax on its income, or
- it is a qualified state or local political organization.

Those tax-exempt political organizations required to file Form 8872 that have, or expect to have, more than \$50,000 in contributions or expenses for the year must file Form 8872 electronically. The due date for filing Form 8872 depends on whether the reporting period occurs during an even-numbered or odd-numbered year. For even-numbered years, the organization may file on either a quarterly or monthly basis. For odd-numbered years, the organization may file on either a semiannual or monthly basis.

Form 1120-POL

A political organization must file Form 1120-POL (U.S. Income Tax Return for Certain Political Organizations) if it has political organization taxable income greater than \$100. Exempt organizations treated as having political organization taxable income under IRC Sec. 527(f)(1) must also file Form 1120-POL. The Form 1120-POL must be filed by the 15th day of the third month after the end of the tax year (March 15 for calendar year organizations).

Generally, a tax-exempt political organization that has gross receipts of \$25,000 or more for the tax year must file Form 990 (or 990-EZ) as well as Form 1120-POL. However, a qualified state or local political organization is not required to file unless its gross receipts are \$100,000 or more. Certain other organizations are exempt from filing, including an organization required to report under the Federal Employees' Compensation Act (FECA), a state or local committee of a political party, and a political committee of a state or local candidate.

OTHER FILING REQUIREMENTS

Contributions

In certain circumstances, organizations must report their receipt of donated property, information about the disposition of contributed property, and/or their contribution of property (other than cash) using one of the following forms:

- a. Form 8282 (Donee Information Return). Used to report information to the IRS and donors about dispositions of certain charitable deduction property made within three years after the donor contributed the property.

- b. Form 8283 (Noncash Charitable Contributions). Completed and attached to Form 990-T if an organization contributes more than \$5,000 in property during the year.
- c. Form 8899 (Notice of Income from Donated Intellectual Property). Required by organizations receiving gifts of intellectual property (e.g., patents, copyrights, trademarks, trade names, trade secrets, know-how, certain software, or similar property) that produces net income.
- d. Form 1098-C (Contribution of Motor Vehicles, Boats, and Airplanes). Required by organizations receiving a qualified vehicle that has a claimed value of more than \$500.

Foreign Accounts

An organization with foreign accounts exceeding \$10,000 anytime during the calendar year may be required to file Form TD F 90-22.1 (Report of Foreign Bank and Financial Accounts) by June 30 of the following year. File with the Department of the Treasury, P.O. Box 32621, Detroit, MI, 48232-0621.

Other Miscellaneous Federal Forms

Racial Nondiscrimination for Exempt Private School. Any religious organization or church that operates, supervises, or controls a school must file an annual certification of racial nondiscrimination with the IRS. If the organization is required to file Form 990, the certification must be made on Schedule E. If the organization does not file Form 990, the statement is made on Form 5578 (Annual Certification of Racial Nondiscrimination for a Private School Exempt From Federal Income Tax). The certification must be filed by the 15th day of the fifth month after the end of the organization's tax year. For calendar year organizations, the form must be filed by May 15.

Prohibited Tax Shelter. An organization must file Form 8886-T to specifically report its participation in a prohibited tax shelter transaction. Form 8886-T is due on or before May 15 following the close of the calendar year during which the organization entered into the prohibited tax shelter transaction or after the close of the calendar year during which the transaction was identified as a listed transaction.

Personal Benefit Contract. An organization must report detailed information concerning the premiums it paid and the premiums paid by others on any personal benefit contract, but treated as paid by it, on Form 8870 (Information Return for Transfers Associated With Certain Personal Benefit Contracts). A personal benefit contract is generally any life insurance, annuity, or endowment contract that benefits, directly or indirectly, a transferor, a transferor's family member, or any other person designated by the transferor. Form 8870 is generally due by the 15th day of the fifth month after the end of the organization's tax year (May 15 for calendar year organizations).

State Filing Requirements

Organizations may have specific filing requirements in each state where it does business. Doing business may include soliciting contributions or grants, conducting programs, having employees, and holding a bank account or other property. State taxing authorities should be consulted to determine specific filing requirements, and the following topics should be considered:

- a. *Monetary Tests.* Some of the Form 990 or 990-EZ federal dollar limitations may not apply at the state level, such as the Form 990 minimum threshold for filing.
- b. *Additional Information.* State or local filings may require additional attachments to the Form 990, such as financial statements or schedules, accountant reports, or added questions.
- c. *Audit Guides.* Many states require contributions, gifts, grants, and functional expenses to be reported according to AICPA industry standards.
- d. *Donated Services and Facilities.* Many states do not allow donated services and use of facilities to be included in their annual return.
- e. *Method of Accounting.* Most states require that all amounts be reported based on the accrual method of accounting.

- f. *Filing Deadline.* The filing deadlines for some states differ from the IRS deadline.
- g. *Public Inspection.* In some states, the forms made available for public inspection may differ from the ones required by the IRS.

EXCISE TAXES AND PENALTIES

Penalties and excise taxes can be assessed against tax-exempt organizations for a variety of reasons. For example, there are penalties for the late filing of tax or information returns, late payment of any tax liability, and solicitation of nondeductible contributions without disclosing the nondeductibility to donors. In the same way, excise taxes can be imposed on several types of transactions, most notably those involving excess benefits, certain distributions from donor advised funds, and political activities. The assessment of many of the penalties and excise taxes, both on the organization and individuals, can be avoided if there is reasonable cause for the action (or lack of action) that caused the alleged violation. A complete discussion of penalties and excise taxes is beyond the scope of this lesson. For additional information, see *PPC's 990 Deskbook*.

Form 4720

Nonprofit organizations report and pay excise taxes using Form 4720 (Return of Certain Excise Taxes Under Chapters 41 and 42 of the IRC), which is due by the 15th day of the fifth month after the organization's tax year end. Managers, disqualified persons, donors, donor advisers, and related persons who owe excise tax and have the same accounting year as the organization may report any tax owed individually on the Form 4720 filed by the organization. Those individuals who do not have the same tax year must file a separate Form 4720 showing the tax owed and the name of the organization for which the tax is owed.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

18. Which of the following nonprofit organizations is required to file Form 990-T?
- a. High School PTA runs a school store. None of the items sold in the store are for the students' educational purpose, and the students are not required to make any purchases. The store is fully staffed with volunteer workers.
 - b. Activities For Kids Organization operates an educational toy store that is open to the public year-round. The funds from this activity are used to support the organization's after school activity programs. The toy store has not yet turned a profit.
 - c. Jobs America operates a thrift store which is open to the public during normal business hours throughout the year and sells only clothing that the organization receives as donations. The store is staffed by paid employees. The organizations purpose is to increase job skills of men and women in need.
 - d. State Hospital operates an on-site cafeteria which is mainly used by the hospital staff, patients, and visitors, but is also open to the general public. The cafeteria has consistently earned a profit of \$100,000 or more for the last three years.
19. Action, Inc. a nonprofit organization, paid \$25,000 each to two employees during 20x0. Its total FUTA tax liability for the year is \$112. Which of the following is true regarding Action's FUTA tax liability?
- a. Action should have deposited the FUTA liability by the last day of each month.
 - b. Action is not subject to FUTA tax because there are less than five employees.
 - c. The employees are responsible for depositing with the state the FUTA tax that is withheld from their gross pay.
 - d. Action is not subject to FUTA tax if it is a 501(c)(3) organization.
20. Fresh Start, Inc. is a nonprofit organization that also files Form 990-T. Fresh Start purchased new furniture for its unrelated business and donated its old furniture, which is in very good condition, to a women's shelter, which is an unrelated nonprofit organization. The furniture is valued at \$10,000. What form does Fresh Start use to report this donation?
- a. Form 8282.
 - b. Form 8283.
 - c. Form 8899.
 - d. Form 1098-C.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

18. Which of the following nonprofit organizations is required to file Form 990-T? **(Page 61)**
- High School PTA runs a school store. None of the items sold in the store are for the students' educational purpose, and the students are not required to make any purchases. The store is fully staffed with volunteer workers. [This answer is incorrect. Income from certain business activities is excluded from the definition of unrelated business income and is not subject to tax. One of the most common exemptions is activities that involve volunteer labor. Activities with volunteer labor include those in which substantially all of the work is performed by volunteer workers.]
 - Activities For Kids Organization operates an educational toy store that is open to the public year-round. The funds from this activity are used to support the organization's after school activity programs. The toy store has not yet turned a profit. [This answer is correct. An organization that engages in trade or business activities unrelated to its tax-exempt purpose must file Form 990-T. For an activity to be taxable, the organization must conduct a trade or business which is regularly carried on and is unrelated to its exempt purpose. The organization must conduct a trade or business for the production of income from selling goods or performing services. Activities that do not make a profit may still be a trade or business if the goal is to produce a profit.]**
 - Jobs America operates a thrift store which is open to the public during normal business hours throughout the year and sells only clothing that the organization receives as donations. The store is staffed by paid employees. The organizations purpose is to increase job skills of men and women in need. [This answer is incorrect. One of the exceptions to unrelated business income is donated merchandise sales. Although the store appears to be an unrelated trade or business because it is regularly carried on and is unrelated to the organization's exempt purpose, the store's income is not taxable because it involves selling only donated merchandise.]
 - State Hospital operates an on-site cafeteria which is mainly used by the hospital staff, patients, and visitors, but is also open to the general public. The cafeteria has consistently earned a profit of \$100,000 or more for the last three years. [This answer is incorrect. One of the common exceptions to unrelated business income is when the activities involve conveniences to members. To meet this exception, an activity only has to provide convenience to members, students, patients, officers, or employees. An on-site hospital cafeteria meets this criteria.]
19. Action, Inc. a nonprofit organization, paid \$25,000 each to two employees during 20x0. Its total FUTA tax liability for the year is \$112. Which of the following is true regarding Action's FUTA tax liability? **(Page 64)**
- Action should have deposited the FUTA liability by the last day of each month. [This is answer is incorrect. If an organization is subject to FUTA tax, deposits of FUTA tax are required before the Form 940 is filed when the quarterly liability is greater than \$500. That deposit is due by the last day of the month after the end of the quarter.]
 - Action is not subject to FUTA tax because there are less than five employees. [This answer is incorrect. An organization is subject to FUTA tax for each employee if, during the current or prior year, it had one or more employees at any time in each of 20 calendar weeks, or the organization paid wages of \$1,500 or more in any calendar quarter.]
 - The employees are responsible for depositing with the state the FUTA tax that is withheld from their gross pay. [This answer is incorrect. The Federal Unemployment Tax Act (FUTA), along with state unemployment systems, provides for payments of unemployment compensation to workers who have lost their jobs. Only the employer pays FUTA tax.]

- d. Action is not subject to FUTA tax if it is a 501(c)(3) organization. [This answer is correct. The Federal Unemployment Tax Act (FUTA), along with state unemployment systems, provides for payments of unemployment compensation to workers who have lost their jobs. Only the employer pays FUTA tax. An organization, other than a Section 501(c)(3) organization, is subject to FUTA for each employee if, during the current or prior year, it had one or more employees at any time in each of 20 calendar weeks, or the organization paid wages of \$1,500 or more in any calendar quarter. Section 501(c)(3) organizations are no subject to FUTA tax and do not have to file Form 940.]**
20. Fresh Start, Inc. is a nonprofit organization that also files Form 990-T. Fresh Start purchased new furniture for its unrelated business and donated its old furniture, which is in very good condition, to a women's shelter, which is an unrelated nonprofit organization. The furniture is valued at \$10,000. What form does Fresh Start use to report this donation? **(Page 65)**
- a. Form 8282. [This answer is incorrect. Form 8282, Donee Information Return, is used to report information to the IRS and donors about dispositions of certain charitable deduction property made within three years after the donor contributed the property.]
- b. Form 8283. [This answer is correct. Form 8283, Noncash Charitable Contributions, must be completed and attached to Form 990-T if an organization contributes more that \$5,000 in property during the year.]**
- c. Form 8899. [This answer is incorrect. Form 8899, Notice of Income from Donated Intellectual Property, is required by organizations receiving gifts of intellectual property (e.g., patents, copyrights, trademarks, trade names, trade secrets, know-how, certain software, or similar property) that produces net income.]
- d. Form 1098-C. [This answer is incorrect. Form 1098-C, Contribution of Motor Vehicles, Boats, and Airplanes, is required by organizations receiving a qualified vehicle that has a claimed value of more than \$500.]

EXAMINATION FOR CPE CREDIT**Lesson 3 (NPHTG101)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

16. ABC Organization was involved in all of the following transactions during the year. Which of these transactions may cause the organization to lose its 501(c) tax exemption status?
- a. Phil, an officer, paid for expenses of the organization with his personal funds.
 - b. Cameron, a director, earned \$1,000,000 for this position. Directors of similar size organizations earn about \$100,000.
 - c. Sara, a print shop owner and relative of the organization's founder, gave a heavy discount to ABC on printing costs.
 - d. Jane, a director, was elected to a political office in the state ABC is organized.
17. A political organization under IRC Section 527 raised \$100,000 in contributions and from political fundraisers. Assuming this amount is net of deductible expenses, what is the tax liability for this organization?
- a. \$0.
 - b. \$10,000.
 - c. \$25,000.
 - d. \$35,000.
18. A nonprofit youth sports organization owns an ice skating rink which it uses in its programs. The majority of the time the organization rents the rink to the public at rates comparable to what for-profit ice rinks charge. The organization uses the money earned from the rink towards its purpose of involving lower income children in sports. The income earned from the ice rink is considered unrelated business income. During 20x0, the organization raised \$100,000 in gross receipts from the ice rink, incurred \$45,000 of costs of goods sold, and incurred another \$60,000 in general and administrative costs. Is the organization required to file Form 990-T, and why or why not?
- a. No, it is not required to file Form 990-T because the organization has an overall net loss in the unrelated business activity.
 - b. Yes, it is required to file Form 990-T because the organization's gross receipts exceeded \$25,000.
 - c. No, it is not required to file Form 990-T because the organization uses the money earned towards its nonprofit purpose.
 - d. Yes, it is required to file Form 990-T because the organization's gross income was greater than \$1,000.
19. Ready, Inc., a 501(c)(3) organization, has six employees. Which of the following is true regarding Ready's responsibility for reporting employment taxes?
- a. Ready is not required to file Form 941.
 - b. Ready's employees are responsible for remitting employment taxes themselves.
 - c. Ready may be required to deposit employment taxes on a monthly basis.
 - d. Ready may be required deposit taxes the next day if the liability is \$50,000 or more.

20. Ready, Inc., a 501(c)(3) organization, paid a non-employee consultant \$1,000 for services during 20x0. What form does the organization use to report this payment to the consultant?
- a. Form 1099-MISC.
 - b. Form W-2.
 - c. Form 943.
 - d. Form 942.

Lesson 4: Reporting Requirements and Tax Consequences for Political Activities

INTRODUCTION

Various prohibitions, added taxes, filing obligations, and other rules apply to nonprofit organizations engaging in political and/or lobbying activities. These rules apply differently to organizations, depending on which Internal Revenue Code section controls how they are organized. Lack of knowledge of the relevant rules can result in substantial excise taxes and even a termination of the organization's tax-exempt status. Increased IRS enforcement in this area means it is more important than ever for everyone in the organization to understand the rules for political and lobbying activities.

Generally, the discussion of political activities is broken down between the following two types of expenses: (a) political campaign expenses and (b) lobbying/other legislative activity expenses. The effects of an organization's activities often depend on what type of organization it is and the reasons it is recognized as tax-exempt. Political campaign activities involve the support of or opposition to a political candidate for public office. Lobbying activities attempt to influence existing legislation and/or the legislative process by either direct lobbying (i.e., trying to influence legislators) or grassroots lobbying (i.e., trying to affect the general public's opinions).

Several excise taxes may apply depending on the organization's activities. Section 501(c)(3) organizations are prohibited by statute from participating in political campaigns. The organization and its managers are subject to an excise tax on amounts paid to political campaigns (i.e., political expenditures). If the expenditure is not corrected within a certain period, additional excise taxes also apply. However, Section 501(c)(3) organizations can spend limited amounts on lobbying activities but are subject to tax when the limit is exceeded. If lobbying expenses exceed a particular limit for a number of years, the organization's exempt status will be revoked. Other types of tax-exempt organizations, such as certain membership organizations, must notify their members of any lobbying expenses that would not be deductible as dues on the members' individual tax returns or pay a separate tax instead of giving notice.

Organizations engaging in political or lobbying activities have additional filing requirements on their annual return. Schedule C, Form 990 or 990-EZ, is used to record the organization's political expenditures and provide other information related to political campaigns and lobbying activities during the year.

Completion of this lesson will enable you to:

- Classify an organization's activities as campaign participation and intervention or as activities that will not affect the tax-exempt status of the organization and determine the penalties for political campaign involvement.
- Identify the organizations that are eligible to make a valid lobbying election, and calculate an organization's lobbying nontaxable amount, excise tax on lobbying activities, and proxy tax on dues or member's deductibility of dues.

CAMPAIGN PARTICIPATION AND INTERVENTION—SECTION 501(c)(3) ORGANIZATIONS

Direct Participation

Section 501(c)(3) organizations are strictly prohibited by statute from participating in or intervening in political campaign activities that support or oppose a candidate for federal, state, or local public office. Direct participation or intervention activities in a political campaign include but are not limited to (a) giving a candidate or political party cash, property, the free use of facilities, free services, or payment of expenses; (b) publishing or distributing written or printed statements or making oral statements on behalf of or in opposition to candidates; and (c) analyzing candidates' qualifications and publishing the names of those thought to be most qualified.

Two of the most common violations involve personal endorsements and candidate appearances. These activities may be allowable, but strict guidelines must be followed.

A determination that direct support or political intervening has occurred for a candidate depends on the particular circumstances of each case. Rev. Rul. 2007-41 presents 21 examples of common political participation activities and identifies proper and improper involvement by the organization. The issues in these examples are discussed in this lesson. The examples are broken out by the following topics: (a) voter education, voter registration, and get-out-the-vote drives; (b) individual activity by organization leaders; (c) candidate appearances; (d) issue advocacy versus political campaign intervention; (e) business activity; and (f) websites.

Indirect Participation

Certain activities and expenses are allowed without affecting the tax-exempt status of the organization. In general, when activities are conducted in a nonpartisan manner without favoring any specific candidates, they are acceptable campaign activities. Examples include business activities, candidate speaking engagements, issue advocacy, loans and fund transfers, newsletters, personal views (as opposed to official views), public opinion polls, voter guides, voter registration activities, and websites.

Business Activities. An organization can be guilty of political campaign participation or intervention if there is bias in certain parts of its business activities, such as the selling or renting of mailing lists, the leasing of office space, or the acceptance of paid political advertising. To protect business activities from being considered campaign intervention, the organization should:

- a. make the same goods, services, or facilities available to all candidates on an equal basis;
- b. make the same goods, services, or facilities available to the general public;
- c. charge fees to candidates at the customary rates; and
- d. not perform activities for a candidate outside of the normal activities conducted by the organization.

Example 1-1: Building rental.

The Ace Carter Museum, a Section 501(c)(3) organization, owns a historic building that it rents to the public for dinners and receptions at standard fees based on the number of persons in attendance and on a first-come, first-served basis. Candidate P rents the building for a fundraising dinner, pays the standard fee for the evening, and is not given preferential treatment. Based on these facts, the museum is not considered involved in political campaign intervention as a result of renting its facilities to the candidate for use as the site of a campaign fundraiser.

Candidate Speaking Engagements. Churches and other charitable organizations often invite political candidates to speak. The candidate may be invited to speak as an individual or in his or her capacity as a candidate. The difference is significant, and separate restrictions apply to each of these possibilities.

Candidate Speaking as an Individual. IRS Pub. 1828, "Tax Guide for Churches and Religious Organizations," lists factors that determine whether a candidate's appearance results in political campaign intervention. To avoid being treated as prohibited campaign intervention, a candidate's speaking engagement should include the following factors:

- a. The individual must be chosen to attend for reasons other than candidacy for public office and may only speak in a noncandidate capacity.
- b. The individual or organization representatives cannot mention the candidacy or the election.
- c. No fundraising or other campaign activity is allowed.
- d. No mention of the candidacy or the election is allowed in any communication announcing the event.
- e. A nonpartisan atmosphere must be present on the premises or at the event.

Speaking as a Candidate. When a church or other organization invites candidates to speak at events as candidates, the following requirements must be met for the organization to avoid prohibited campaign intervention:

- a. An equal opportunity must be provided to other candidates seeking the same office.
- b. There must be no indication of support or opposition to any candidate. This neutrality must be clear in any introductions and in all communications concerning the event.
- c. No fundraising is allowed.
- d. The invitation to speak must be for reasons other than candidacy for office.
- e. The atmosphere at the event must be nonpartisan in all respects.
- f. No mention of the candidacy or the upcoming election may be made in the communications announcing the candidate's attendance at the event.

Issue Advocacy. Many Section 501(c)(3) organizations focus on moral, social, or economic issues of considerable public interest. An organization can continue to conduct mass media advocacy on an issue when a candidate has become closely identified with that issue during a campaign, but certain precautions are necessary to prevent issue advocacy from becoming campaign intervention.

A determination that issue advocacy has become campaign intervention requires more than just a positive or negative relationship between an organization's position and a candidate's position. The test is whether the organization is commenting on a candidate rather than speaking about an issue. The IRS warns that words such as "conservative," "liberal," "pro-life," or "pro-choice" cannot be used in lieu of a candidate's name to subliminally support or oppose a candidate. Therefore, advocacy communication must not reflect an organization's position on a candidate or slate of candidates, even though names are not mentioned.

The following are key factors in determining whether a communication on an issue is treated as political campaign intervention:

- a. It identifies one or more candidates for a given public office.
- b. It expresses approval or disapproval for one or more candidates' positions and/or actions.
- c. It is delivered close in time to the election.
- d. It makes reference to voting or an election.
- e. The issue addressed in the communication has been raised as an issue distinguishing candidates for a given office.
- f. The communication is part of an ongoing series of communications by the organization on the same issue that is independent of the timing of any election.
- g. The timing of the communication and identification of the candidate are related to a nonelectoral event, such as a scheduled vote on specific legislation by an officeholder who also happens to be a candidate for public office.

A communication is particularly at risk of political campaign intervention when it makes reference to candidates or voting in a specific upcoming election. Nevertheless, the communication must be considered in context before arriving at any conclusions.

Example 1-2: Education advocacy.

Better Education (BE) is a Section 501(c)(3) organization that educates the public about the need for improved public education. BE prepared and paid for a radio ad urging an increase in state funding, although

the legislature is not scheduled to discuss public education in the near future. The ad is broadcast before the governor's election and cites statistics arguing that public education is underfunded. The ad ends with the words, "Tell Governor X what you think about our underfunded schools." The governor's opponent has made public education funding an issue in the campaign, citing the governor's veto of an income tax increase where the funds would have been used for public education.

BE has engaged in prohibited political campaigning because the ad (1) identifies Governor X who is running for reelection, (2) is broadcast shortly before the election, (3) is not part of an ongoing series of similar communications by BE on the same issue, (4) is not timed to coincide with a nonelection event such as a legislative vote or other legislative action, and (5) takes a position on an issue that the opponent has used to distinguish himself from Governor X.

Loans and Fund Transfers. The IRS has ruled that where a loan is made to a related taxable entity, the lending organization must take reasonable steps to ensure the funds will not be used for political campaign contributions. Contributions to a political organization that were designated to be used only for administrative purposes have been ruled acceptable.

Example 1-3: Loan to related organization.

Organization B, a Section 501(c)(6) life insurance trade association, contributed \$5,000 to Organization C whose purpose is to elect national and state political candidates who support the free enterprise system for businesses. C's written policy is to use contributions received by individuals for the direct support of candidates and use contributions received by other organizations only for the administrative expenses. The contributions are deposited in two separate bank accounts depending on the type of donor. Because B is an organization (not an individual donor) and its contribution will be used only for C's administrative expenses rather than direct support of a candidate, the contribution is not campaign intervention by Organization B.

Newsletters. There are circumstances where a charitable organization may publish a newsletter of incumbents' voting records on selected issues when certain limitations are observed. Rev. Rul. 80-282 discusses a factual situation in which a newsletter's contents are not prohibited because (a) all incumbents' records are reported, (b) candidates for reelection are not identified, (c) no endorsement or rejection of any candidate is made, (d) it is distributed to normal readership and not targeted to specific areas where an election may be pending, and (e) no comparison of incumbents with other candidates is present. As in most cases, the determination depends on all the facts and circumstances of each case.

Example 1-4: Organization publication.

The abortion views of two candidates are printed in a magazine issued by Organization A. One candidate is pro-choice, and the other is pro-life. In a local TV interview, an Organization A leader said that the organization's mission cannot support abortion; thus, the organization has identified the favored candidate and this could be considered political campaign intervention.

Personal Views versus Official Views. An organization's officers, directors, or other leaders may express their personal views, as individuals, on a candidate, a political party, or a campaign. However, they should not use the organization's financial assets, facilities, or personnel in any way and should clearly indicate that their actions or statements are entirely their own and not the organization's. In addition, they cannot express their views in official organization publications or at official organization functions.

Example 1-5: Endorsements made in personal capacity.

Dan is an executive of B, a Section 501(c)(3) organization, and is well known in the community. With B's permission, a mayoral candidate publishes a full-page ad in the local newspaper listing five prominent community leaders who have personally endorsed him, including Dan, who is identified in the ad as an executive of B. The ad states, "Titles and affiliations of each individual are provided for identification purposes only." The ad is paid for by the candidate's campaign committee. Because the ad was not paid for by B, the ad is not in an official publication of B, and the endorsement is made by Dan in a personal capacity, the ad is not campaign intervention.

Public Opinion Polls. Polling by organizations is often used to express concern over particular issues. This is generally allowed for Section 501(c)(3) organizations if:

- a. the focus is on the issues,
- b. questions are fair and neutral,
- c. the polling methods are scientific, and
- d. the questions do not address the records or positions of particular candidates or parties.

Voter Guides. Section 501(c)(3) organizations sometimes prepare and distribute voter guides that contain candidates' voting records, their responses to questionnaires, and other information. Distributing voter guides will not be treated as prohibited campaign intervention if the guide is neutral in its content and distribution.

Example 1-6: Voter guides.

Church C publishes a voter's guide for its members and others concerned with separation of church and state issues. The guide is a compilation of incumbents' voting records on selected separation of church and state issues of importance to the church and is factual in nature. It is widely distributed among the electorate during an election campaign. By concentrating on a narrow range of issues and widely distributing the publication during an election campaign, the church is directly participating in a political campaign, a prohibited activity.

Voter Registration Activities. Voter education, registration, and get-out-the-vote drives are not political activities if conducted in a nonpartisan manner. But such activities will be deemed to be prohibited participation or intervention if conducted with evidence of bias that:

- a. favors one candidate over another,
- b. opposes a candidate in some way, or
- c. favors or opposes a candidate or group of candidates.

Example 1-7: Permissible voter registration activities.

Everybody Vote (EV), a Section 501(c)(3) organization that promotes community involvement, set up a booth at the State Fair of Texas to register voters for the next election. The signs in and around the booth only identified EV, showed the date of the election, and urged those who were not registered voters to register. Neither EV's personnel who were staffing the booth, nor materials in the booth, mentioned any candidate or political party.

EV did not engage in political campaign intervention by operating the booth.

Websites. The IRS examines the websites of Section 501(c)(3) organizations for signs of political activity. An organization that posts material on its website favoring or opposing a candidate for public office will be treated the same as if it distributed printed material, oral statements, or broadcasts that favored or opposed such candidate. An organization may be guilty of political intervention if its website contains a link to a political organization. All the facts and circumstances must be taken into account when assessing whether a link produces that result, including the context for the link on the organization's website, whether all candidates are represented, any exempt purpose served by offering the link, and the directness of the links between the organization's website and the web page containing information that favors or opposes a candidate for public office.

Example 1-8: Website links.

Organization D publishes a voter's guide on its own website and provides links to the websites of all candidates in a local council race on a consistent basis with the statement, "For more information on Candidate X, you may consult (website)." The organization did not intervene in a political campaign in this

example because the links were provided for the purpose of educating voters and were presented in an unbiased manner that included all the candidates for a particular office.

Variation: D's website includes the biographies of its staff members and details of community outreach programs and other activities of D. One staff member, Mary, is running for a seat on the town council. Shortly before the election, D posts the following message on its website: "Lend your support to Mary, your community partner, in Tuesday's election for town council." D has intervened in a political campaign on behalf of the staff person.

Political Campaign Penalties

Both the organization and the organization's management are automatically subject to an initial excise tax on prohibited campaign activities and potentially to a second level of excise tax if the political expenses are not corrected within the required time period. Political expenses include funds paid or incurred by the organization to a candidate for public office to be used for—

- a. speeches or other services;
- b. travel expenses;
- c. expenses of conducting polls, surveys, or other studies, or preparing papers or other materials, for use by the candidate;
- d. expenses of advertising, publicity, and fundraising; or
- e. any other expense that promotes public recognition and benefits the candidate (including the publication or distribution of statements).

Organization Penalties. A Section 501(c)(3) organization is subject to a 10% excise tax on amounts spent in participating or intervening in a political campaign [i.e., political expenses in (a) through (e) listed above].

An additional excise tax of 100% of the political expense is due if the amount is not corrected within the taxable period. The taxable period is the period beginning with the date on which the expense occurs and ending on the earlier of the mailing of a notice of deficiency or the date the initial 10% excise tax is imposed on the organization.

Management Penalties. An organization's manager who agrees to an expense while being aware that it is a political expense is subject to a 2.5% excise tax (up to a maximum, for each prohibited expense, of \$5,000 for all managers combined). An *organization manager* includes individuals who are authorized to approve, or recommend approval of, political expenses and individuals who are members of a group (such as the entity's board of directors or employees) with the same authorization powers.

If one or more of the organization's managers refuse to correct the expenditure, an additional excise tax equal to 50% of the political expense can apply (subject to a maximum penalty of \$10,000, for each prohibited expense, for all managers involved). If more than one manager is involved, the penalties are joint and several liabilities.

Reporting the Penalties. Form 4720 (Return of Certain Excise Taxes on Charities and Other Persons Under Chapters 41 and 42 of the Internal Revenue Code) is used by both the organization and its managers to calculate and pay the initial excise tax on political campaign expenditures.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

21. A nonpartisan think tank Section 501(c)(3) organization publishes a monthly magazine about issues affecting its state. There are three candidates running for mayor in the state's capitol. Which of the following activities could affect the tax-exempt status of the organization?
- a. In its latest issue, the magazine included three one page articles about each of the candidates.
 - b. The organization conducted and posted a public opinion poll on its website.
 - c. An officer of the organization endorsed a candidate at the organization's latest fundraiser.
 - d. The organization asked all three candidates to speak at a forum as candidates. Only two of the candidates attended the event.
22. Frank, a director of a nonpartisan think tank, decides to endorse Sara for mayor. Frank runs an ad promoting Sara in the organization's magazine. A typical ad placement in the magazine costs \$4,000. Frank is aware the ad is a political expense. Assuming that Frank corrects the expenditure, what is Frank's maximum excise tax penalty?
- a. \$100.
 - b. \$400.
 - c. \$2,000.
 - d. \$5,000.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

21. A nonpartisan think tank Section 501(c)(3) organization publishes a monthly magazine about issues affecting its state. There are three candidates running for mayor in the state's capitol. Which of the following activities could affect the tax-exempt status of the organization? **(Page 78)**
- a. In its latest issue, the magazine included three one page articles about each of the candidates. [This answer is incorrect. Although it depends on the facts and circumstances in each case, publications are normally acceptable if there are no endorsements or rejections of any candidate, candidates for reelection are not identified, the publication is distributed to normal readership and not targeted to specific areas where an election may be pending, and no comparison of incumbents with other candidates is present.]
 - b. The organization conducted and posted a public opinion poll on its website. [This answer is incorrect. Polling by organizations is often used to express concern over particular issues. This is generally allowed for Section 501(c)(3) organizations if the focus is on the issues, questions are fair and neutral, the polling methods are scientific, and the questions do not address the records or positions of particular candidates or parties.]
 - c. **An officer of the organization endorsed a candidate at the organization's latest fundraiser. [This answer is correct. An organization's officers, directors, or other leaders may express their personal views, as individuals, on a candidate, a political party, or a campaign. However, they should not use the organization's financial assets, facilities, or personnel in any way and should clearly indicate their actions or statements are entirely their own and not the organization's. In addition, they cannot express their views in official organization publications or at official organization functions.]**
 - d. The organization asked all three candidates to speak at a forum as candidates. Only two of the candidates attended the event. [This answer is incorrect. When an organization invites candidates to speak at events as candidates, the organization must meet certain requirements to avoid prohibited campaign intervention. There must be an equal opportunity provided to candidates seeking the same office, there must be no indication of support or opposition to any candidate, no fundraising is allowed, the invitation to speak must be for reasons other than candidacy for office, the atmosphere at the event must be nonpartisan in all respects, and no mention of the candidacy or the upcoming election may be made in the communications announcing the candidate's attendance at the event.]
22. Frank, a director of a nonpartisan think tank, decides to endorse Sara for mayor. Frank runs an ad promoting Sara in the organization's magazine. A typical ad placement in the magazine costs \$4,000. Frank is aware the ad is a political expense. Assuming that Frank corrects the expenditure, what is Frank's maximum excise tax penalty? **(Page 80)**
- a. **\$100. [This answer is correct. An organization's manager who agrees to an expense while being aware that it is a political expense is subject to a 2.5% excise tax (up to a maximum, for each prohibited expense, of \$5,000 for all managers combined.)**
 - b. \$400. [This answer is incorrect. A Section 501(c)(3) organization is subject to a 10% excise tax on amounts spent in participating or intervening in a political campaign.]
 - c. \$2,000. [This answer is incorrect. If one or more of the organization's managers refuse to correct the expenditure, an additional excise tax equal to 50% of the political expense can apply.]
 - d. \$5,000. [This answer is incorrect. This is the maximum excise tax, for each prohibited expense, for all managers combined.]

LOBBYING—SECTION 501(c)(3) ORGANIZATIONS

A Section 501(c)(3) organization cannot devote a substantial part of its efforts to influencing legislation (i.e., lobbying). Substantial lobbying activities can jeopardize an organization’s tax exemption and cause it to be treated as an action organization. Legislation includes actions by Congress, state legislatures, local councils, or similar governing bodies. It also includes actions by the public in a referendum, initiative, constitutional amendment, or similar procedure. Exhibit 1-1 summarizes activities and related expenses that are not considered lobbying activities or expenses.

Exhibit 1-1

Activities Not Considered Lobbying Activities

Activity	Explanation
Nonpartisan analysis, study or research	Must be independent and well documented activities that allow users to form an opinion or conclusion. This is usually distributed in speeches, articles, reports, and conference presentations.
Technical advice communications	A written request from a governmental body or committee asking the organization to provide technical advice or assistance to the government body or committee.
Self-defense communications	Communication with any legislative body concerning a possible action by the body that might affect the organization’s existence, its power or duties, its tax-exempt status, or the deductibility of contributions to the organization.
Membership communications	Communications that (1) are directed to an organization’s members, (2) refer to legislation of direct interest to the organization and its members, and (3) does not encourage member lobbying.
Broad social and economic issues	Communications with legislators or government employees on these kinds of issues that do not discuss the merits of particular legislation or urge members to take action on a proposal.
Routine communications	Routine communication with governmental officials or their employees when the principal purpose of the communication is not to influence legislation.

* * *

Because a limited amount of lobbying is permitted, Section 501(c)(3) organizations can choose either of the following methods to determine if substantial portions of their activities are used to influence legislation:

- a. A facts and circumstances type test, referred to as the *substantial part test*.
- b. A safe harbor election specifically allowed, referred to as the *expenditure test*.

Substantial Part Test

There is no guidance in the Internal Revenue Code or regulations defining when attempts to influence legislation are considered a *substantial part* of an organization’s overall activities. The IRS has stated it will determine whether an organization’s involvement in legislation is substantial on the basis of all the facts and circumstances. Two important factors that may be considered are (a) time devoted by employees and volunteers of the organization, and (b) the amount of expenses. In several instances, the courts have gotten involved with differing results. For example, in *Seasongood*, the court held that an expenditure of 5% of an organization’s overall budget was not substantial. The test used by the court in its decision measured the level of expenses allocable to activities

influencing legislation as a percent of total organization expenses over the same period. In *Haswell*, the court found expenditures to be substantial when they were 20% of total expenditures and legislative activities accounted for the primary part of the overall activities of the organization. In *Christian Echoes National Ministry*, the court rejected using a percentage test to define *substantial*, stating that it was more important to consider an organization's overall objectives and circumstances.

Example 1-9: Substantial involvement.

Over the Top (OTT) is a Section 501(c)(3) public charity that engages in a minimum amount of lobbying activity. OTT calculates that total employee time spent on lobbying is 4% and lobbying expenses make up 7% of total expenses by OTT. Documents are maintained that support the calculations. Although all the facts and circumstances will be considered by the IRS in determining if lobbying activities are substantial, it is likely in this example that the amounts are reasonable with no effect on the organization's tax-exempt status.

Variation: Assume that OTT hires an additional employee who spends more than 50% of his time in the state's capital, lobbying legislators on issues of significance to OTT. Lobbying expenses increase to 25% of total expenses by OTT. It is likely that the lobbying expenses in this example will be considered substantial and a cause for the organization to lose its tax-exempt status.

Safe Harbor Election—Expenditure Test

Expenditure Test under Section 501(h). To allow certain organizations the opportunity to do a limited amount of lobbying, Congress enacted lobbying guidelines an eligible organization may elect to use. This is also known as the lobbying election. Electing organizations are allowed to spend a portion of their funds to influence legislation without risking loss of tax-exempt status. If an organization makes the election, a percentage of its expenses is considered a nontaxable lobbying amount. If lobbying expenses are greater than the calculated nontaxable amount, then the excess is subject to tax.

Eligible Organizations. Section 501(c)(3) organizations eligible to make the lobbying election include the following:

- Educational institutions.
- Hospital and medical research organizations.
- Organizations supporting a public college or university.
- Publicly supported charities, whether by contribution or fee income.
- Organizations supporting a public charity.

Ineligible Organizations. Section 501(c)(3) organizations that cannot make the lobbying election include the following:

- Organizations that test for public safety.
- Private foundations.
- Section 509(a)(3) organizations that support civic leagues and social welfare organizations; labor, agricultural, or horticultural organizations; or business leagues or associations.
- Certain governmental organizations.
- Churches and integrated auxiliaries of churches or of conventions or associations of churches.
- Any member of an affiliated group of organizations if one member is either a church or an integrated auxiliary of a church or of a convention or association of churches.

Types of Lobbying. Nontaxable amounts are computed separately for grassroots lobbying and for total lobbying (grassroots and direct lobbying combined). Under this test, nontaxable amounts automatically avoid being considered substantial and do not result in an excise tax or potential loss of tax-exempt status. Separate limits apply to each of the following types of lobbying:

- a. *Direct Lobbying.* Communicating with a member or employee of a legislative body or a government official or employee who may participate in the formulation of the legislation. To be considered direct lobbying, the communication must refer to, and reflect a view on, specific legislation. If the lobbying is in connection with a referendum, initiative, or similar procedure, the general public is considered members of the legislative body.
- b. *Grassroots Lobbying.* Attempting to affect the opinions of the general public or a certain segment of the general public. Communicating with the general public is not grassroots lobbying unless it refers to, and reflects a view on, specific legislation and encourages the recipient to take action with respect to the legislation.

Dollar Limits. Organizations that make the Section 501(h) safe harbor election are allowed annual lobbying expenses (i.e., the lobbying nontaxable amount) equal to the sum of:

- a. 20% of the first \$500,000 of the organization's total exempt purpose expenses;
- b. 15% of the next \$500,000;
- c. 10% of the next \$500,000; and
- d. 5% of the remaining expenses.

Regardless of the amount of an organization's total exempt purpose expenses (which include lobbying expenses), the amount spent for legislative activities in any one year may not exceed \$1 million. Using the calculation above, this \$1 million annual limitation is reached when an organization's total exempt purpose expenses exceed \$17 million.

In addition to the overall nontaxable annual limitation of \$1 million for total lobbying expenses, a separate limitation is imposed on grassroots lobbying expenses. The nontaxable amount for grassroots expenses is 25% of the lobbying nontaxable amount in any given year. As a result, the maximum nontaxable amount for grassroots lobbying expenses in any year is \$250,000 (25% × \$1 million overall annual limitation amount).

Affiliated Groups. Members of an affiliated group are treated as a single organization when computing the two separate dollar limitation amounts. Organizations are affiliated if one is bound by the other organization's decisions on legislative issues through a governing instrument or if the governing boards of both organizations have sufficient mutual directors. Affiliation may also exist indirectly, as in the case of a brother-sister relationship, where two organizations are controlled by a common entity, but not by each other.

Exempt Purpose Expenses. *Exempt purpose expenses* are expenses paid to accomplish the organization's exempt purpose. Also included are amounts paid or incurred for administrative and other general expenses allocable to the organization's exempt purpose; lobbying, depreciation, and amortization (on a straight-line basis); and fundraising expenses. Items that are excluded from the calculation generally involve expenses that are unrelated to the organization's exempt purpose, amounts paid to or incurred for a separate fundraising unit, certain other transfers within an affiliated group, unrelated business income tax expense, or other expenses incurred in the production of income (e.g., expenses to manage an endowment).

Organizations may not have any lobbying expenses in some years. Keeping track of the expenses necessary is still strongly advised because it is often difficult to obtain the information in later years. An organization's lobbying expenses are also subject to a four-year test on the cumulative expenses over that period. Thus, organizations must capture this information on an ongoing basis.

Making the Lobbying Election. The election is made by filing a completed Form 5768 [Election/Revocation of Election by an Eligible Section 501(c)(3) Organization To Make Expenditures To Influence Legislation]. The election

is effective beginning with the tax year the form is filed. The election may be easily revoked (also by filing Form 5768) with the revocation applying to the tax year following the tax year the revocation notice is filed. In addition, the election can be made again even after a voluntary revocation but is not valid until the first tax year following the year a revocation was in effect.

Advantages of Making the Election. Advantages of making the election include the following:

- The lobbying election provides a mechanical test for determining allowable lobbying, which avoids reliance on the subjective *substantial part* test.
- Volunteer time spent on lobbying activities is not taken into consideration.
- The four-year averaging test under the lobbying election enables organizations to monitor their lobbying activities and minimize the risk of losing their tax exemption.

Disadvantages of Making the Election. Disadvantages of making the election include the following:

- If the organization's lobbying activities focus on grassroots lobbying, the election could limit allowable expenses.
- The lobbying election rules for affiliated organizations may decrease allowable lobbying expenditures for a member of an affiliated group.
- The lobbying election rules cap total lobbying nontaxable expenditures at \$1 million annually, regardless of the size of the electing organization.

Excise Tax on Electing Organizations. When amounts spent on lobbying activities are greater than the dollar limits allowed, the amount spent over the limit is taxed at 25%. The tax is reported on Form 4720, Schedule G. There is no loss of tax-exempt status for organizations that must pay this 25% excise tax unless the organization normally has lobbying expenses exceeding certain amounts.

Example 1-10: Computing nontaxable lobbying and excise taxes.

Help for Africa (Africa), a Section 501(c)(3) organization, has a valid lobbying election in effect for the year. Africa's expenses during the year were as follows:

Program related expenses	\$ 1,500,000
Administrative expenses	75,000
Direct lobbying expenses	200,000
Grassroots lobbying expenses	50,000
Fundraising expenses	<u>125,000</u>
Total expenses	<u>\$ 1,950,000</u>

The nontaxable lobbying amount and excise taxes are calculated as follows:

Step 1 Categorize and compute lobbying expenses.

(1) Direct lobbying expenses	\$ 200,000
(2) Grassroots lobbying expenses	<u>50,000</u>
(3) Total lobbying expenses	<u>\$ 250,000</u>

Step 2 Compute the total nontaxable amount and the grassroots nontaxable amount.

Total expenses for the organization	\$ 1,950,000
Less: Amounts not related to exempt purpose	<u>—</u>
(4) Total exempt purpose expenses	<u>\$ 1,950,000</u>

If (4) is over \$1,500,000, but not over \$17,000,000, the nontaxable amount is \$225,000 plus 5% of the excess over \$1,500,000.)

Total exempt purpose amount (4)	\$ 1,950,000	
Less:		
Rate schedule amount	(1,500,000)	
Excess	450,000	
5%	× .05	\$ 22,500
Table amount		225,000
(5) Nontaxable lobbying amount		\$ 247,500

Step 3 Compare (3) to (5). If (5) is greater, there is no excise tax on total lobbying. (See test for grassroots lobbying.) If (3) is greater, the excise tax is 25% × [(3) – (5)].

Total lobbying expenses (3)		\$ 250,000
Less:		
Nontaxable lobbying amount (5)	(247,500)	
Excess	2,500	
25%	× .25	625
(6) Excise tax on total lobbying expense		\$ 625
Nontaxable lobbying amount (5)	\$ 247,500	
25%	× .25	61,875
(7) Grassroots nontaxable amount		\$ 61,875

Step 4 Compare (2) to (7). If (7) is greater, there is no excise tax on grassroots lobbying. If (2) is greater, the excise tax is 25% × [(2) – (7)].

There is no excise tax on grassroots lobbying because total grassroots expenses of \$50,000 are less than the grassroots nontaxable amount of \$61,875. Therefore, the total excise tax is \$625 on total lobbying expense.

Loss of Tax-exempt Status. Organizations making the safe harbor election for lobbying expenses can lose their tax-exempt status if lobbying expenses over a four-year period exceed 150% of the lobbying nontaxable amounts, or if the grassroots lobbying expenses for the four-year period exceed 150% of the grassroots nontaxable amounts for the same period.

Example 1-11: Determining the 150% ceiling amount.

No Limits (NL), a Section 501(c)(3) public charity, has a lobbying election in place. Because of a major campaign to defeat legislation aimed at registering all voters with valid drivers licenses, NL's grassroots lobbying expenses increased substantially during the year, resulting in total grassroots expenses for the last four years of \$150,000. NL's tax-exempt status is jeopardized if its total lobbying expense or grassroots lobbying expense exceeds the 150% ceiling limitation.

Assume NL's lobbying nontaxable amount for the four-year base period is \$500,000, and its grassroots nontaxable amount is \$125,000 (\$500,000 lobbying nontaxable amount multiplied by 25%). Therefore, its total lobbying ceiling amount is \$750,000 (\$500,000 × 150%). The ceiling for grassroots lobbying expenses is equal to 150% of NL's grassroots nontaxable amounts for the base years. Therefore, NL's ceiling for its grassroots expenses is \$187,500 (\$125,000 × 150%).

NL's exempt status is not jeopardized because total grassroots expenses for the base years (\$150,000) do not exceed the ceiling amount of \$187,500.

Variation: Assume the same facts, except that NL's total lobbying expenses (direct plus grassroots expenses) over the base period are \$800,000. In this case, lobbying expenses are in excess of the ceiling amount (\$750,000) and cause a loss of tax exemption.

LOBBYING AND POLITICAL ACTIVITIES—NON-SECTION 501(c)(3) ORGANIZATIONS

Political Organizations (Section 527)

A political organization's purpose is to accept contributions for the support of political campaign activities, including the selection, nomination, and election to office. Political organizations (also known as tax-exempt Section 527 organizations) are exempt from income tax on "exempt function income," such as income from contributions and fundraisers. They are taxable on net investment income including interest, dividends, rents, and royalties at the highest corporation tax rate (currently 35%). Political organizations include political party committees; federal, state, and local candidate committees; and other political committees, such as political action committees (PACs).

Political Action Committees. Political action committees can either stand alone or be what is known as a "separate segregated fund" (SSF) created by a Section 501(c) organization. A standalone PAC is able to solicit funds from the general public, while an SSF may only solicit from members connected with the organization. The organization must be one of the membership organizations discussed below and must have enough members for an SSF to be effective.

It is common for Section 501(c)(3) organizations to establish related Section 501(c)(4) organizations to conduct greater lobbying activities and for the Section 501(c)(4) organization to establish a PAC to support or oppose candidates. These arrangements should be monitored so that separate records are strictly maintained with no commingling of funds or other resources.

Tax Filings. Political organizations may be subject to several filing requirements, depending on whether they are organized as federal or state and local organizations. Exhibit 1-2 summarizes possible filings required.

Exhibit 1-2

Political Organization Filing Requirements

Form	Requirements
8871 (Notice of 527 Status)	Generally must be filed electronically within 24 hours of the political organization's establishment.
8872 (Report of Contributions and Expenditures)	Used to disclose information concerning: <ul style="list-style-type: none"> • expenditures that aggregate \$500 or more per person, per calendar year; and • contributions that aggregate \$200 or more per person, per calendar year.
1120-POL (U.S. Income Tax Return for Certain Political Organizations)	Must be filed by political organizations with taxable income of more than \$100.
990 or 990-EZ (Return of Organization Exempt from Income Tax)	Unless excepted, must be filed if the organization has gross receipts of \$50,000 (for years beginning in 2010) or more for the taxable year.

* * *

Member Organizations

Social welfare organizations; labor, agricultural, and horticultural organizations; and business leagues or trade associations may engage in unlimited lobbying as long as it is related to the exempt purpose of the organization. However, these organizations must notify members about the nondeductible portion of their dues. They must also be careful to avoid participating in political campaigns; such participation will result in a tax equal to 35% of the lesser of its net investment income or the amount of its political campaign expenses.

Permitted advocacy communications can be difficult to distinguish from prohibited campaign activities. Communications (that are deemed to be political campaign participation) are not permitted and are therefore subject to the excise if they—

- a. identify a candidate,
- b. coincide with an electoral campaign,
- c. target voters in a particular election,
- d. identify the candidate's position on the public policy issue that is the subject of the communication,
- e. distinguish that candidate from others in the campaign by his or her position on the public policy issue, and
- f. are not part of a series of similar communications on the same issue.

On the other hand, the following characteristics tend to show that an advocacy communication is not a political campaign intervention:

- a. One (or more) of the six factors identified above is absent.
- b. The communication either identifies or coincides with specific legislation (or a specific event outside the organization's control) that the organization seeks to influence.
- c. The communication identifies the candidate (1) solely as a government official who is in a position to act on the public policy in connection with a specific event (e.g., a legislative vote) or (2) solely in a list of key sponsors of the legislation that is the subject of the communication.

Dues Notification and Proxy Tax for Member Organizations

Generally, members of an organization cannot deduct the portion of their dues (or other similar payments) that is allocable to the organization's lobbying and political activities. This amount can be an estimate. The organization must notify its members of the nondeductible portion. However, instead of providing notice, an organization can pay a proxy tax equal to 35% of the lesser of (a) its lobbying and political expenditures for the year or (b) the dues and similar payments it received during the year.

By paying the proxy tax instead of notifying its members, an organization allows members to deduct 100% of their dues. In some cases, it may be better for an organization to pay the proxy tax rather than cause a portion of its members' dues to be nondeductible. Examples of such instances include the following:

- a. Where most members can deduct the dues for state (in addition to federal) income tax purposes and the organization itself is not subject to a state-level proxy tax.
- b. Where the proxy tax liability is relatively small and the organization wants to avoid the administrative costs or the public relations problem of notifying its members of the nondeductible costs.
- c. Where members are likely to have a tax rate that approaches or exceeds the 35% proxy tax rate.

Only Section 501(c)(4), (c)(5), and (c)(6) organizations must notify their members of the nondeductible portion, if any, of their dues. Even these types of organizations are not required to provide the nondeductibility notice if more than 90% of their dues are received from certain organizations.

Example 1-12: Sample notice and disclaimer.

XYZ engages in lobbying activities on behalf of its members. It provides the following notification on its dues statement: "XYZ engages in lobbying activities on behalf of its members. Approximately 30% of your dues contribution goes to support these lobbying activities, and, we believe, is not deductible as a business

expense under Section 162(e) of the Internal Revenue Code. Please consult your tax advisor regarding your own unique situation.”

This statement should satisfy the member notification requirement.

Example 1-13: Exemption from notice requirement.

The Better Housing Group, a Section 501(c)(4) organization, carries out activities to promote more affordable housing in the state. The organization received \$150,000 of dues during the year from several labor organizations representing the construction industry, city governments, and various Section 501(c)(3) organizations. The total dues received from these three groups totaled \$137,000. Because the \$137,000 received from these qualified organizations is greater than 90% of total dues received (90% of \$150,000, or \$135,000), the organization is not required to provide a nondeductibility notice to its members.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

23. A nonpartisan think tank nonprofit organization devotes part of its efforts to influencing legislation. The organization's total exempt purposes expenses were \$12,000,000. What is the maximum nontaxable amount for grassroots lobbying expenses, assuming the organization made the Section 501(h) safe harbor election?
- a. \$187,500.
 - b. \$250,000.
 - c. \$750,000.
24. Which of the following is a disadvantage of making the lobbying election?
- a. The lobbying election allows a four-year averaging test for determining tax-exempt status.
 - b. The time that volunteers spend on lobbying is not considered when determining substantial involvement.
 - c. If the focus of the organization's lobbying activities is grassroots lobbying, the allowable expenses for the lobbying election could be limited.
 - d. The lobbying election allows organizations to steer clear of the subjective substantial part test.
25. A trade association collected \$1,500,000 in dues during the year and spent \$300,000 on lobbying and political expenditures. How much is the proxy tax if the trade association decides to pay the tax instead of notifying members of the nondeductible portion of their dues?
- a. \$60,000.
 - b. \$105,000.
 - c. \$300,000.
 - d. \$525,000.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

23. A nonpartisan think tank nonprofit organization devotes part of its efforts to influencing legislation. The organization's total exempt purposes expenses were \$12,000,000. What is the maximum nontaxable amount for grassroots lobbying expenses, assuming the organization made the Section 501(h) safe harbor election? **(Page 85)**
- \$187,500. [This answer is correct. The nontaxable amount for grassroots expenses is 25% of the lobbying nontaxable amount in any given year. The organization's allowed annual lobbying expenses are calculated as 20% of the first \$500,000 of the organization's total exempt purpose expenses, 15% of the next \$500,000, 10% of the next \$500,000, and 5% of the remaining expenses [(20% × \$500,000) + (15% × \$500,000) + (10% × \$500,000) + (5% × \$10,500,000) = \$750,000].]**
 - \$250,000. [This answer is incorrect. This is the maximum nontaxable amount for grassroots lobbying expenses in any year, for any organization.]
 - \$750,000. [This answer is incorrect. This is the total annual lobbying expense amount allowed for both direct lobbying and grassroots lobbying.]
24. Which of the following is a disadvantage of making the lobbying election? **(Page 86)**
- The lobbying election allows a four-year averaging test for determining tax-exempt status. [This answer is incorrect. An advantage of making the lobbying election is that it allows a four-year averaging test to determine the tax-exempt status. This enables organizations to monitor their lobbying activities and minimize the risk of losing their tax exemption.]
 - The time that volunteers spend on lobbying is not considered when determining substantial involvement. [This answer is incorrect. Volunteer time spent on lobbying activities is not taken into consideration when making a lobbying election. This is an advantage because the time devoted by employees and volunteers of an organization is taken into account when determining the substantial part test.]
 - If the focus of the organization's lobbying activities is grassroots lobbying, the allowable expenses for the lobbying election could be limited. [This answer is correct. If the organization's lobbying activities focus on grassroots lobbying, the election could limit the allowable expenses because the nontaxable amount for grassroots expenses is 25% of the lobbying nontaxable amount in any given year.]**
 - The lobbying election allows organizations to steer clear of the subjective substantial part test. [This answer is incorrect. An advantage of an organization making the lobbying election is to provide a mechanical test for determining allowable lobbying and avoiding reliance on the subjective substantial part test since there is no guidance in the Internal Revenue Code or regulations defining when attempts to influence legislation are considered a substantial part of an organization's overall activities.]
25. A trade association collected \$1,500,000 in dues during the year and spent \$300,000 on lobbying and political expenditures. How much is the proxy tax if the trade association decides to pay the tax instead of notifying members of the nondeductible portion of their dues? **(Page 89)**
- \$60,000. [This answer is incorrect. If the proxy tax was not paid, the trade association would send notification to its members that approximately 20% of their dues contributions went to support lobbying activities. However, the proxy tax is not 20% of the lobbying activities.]
 - \$105,000. [This answer is correct. A proxy tax equal to 35% of the lesser of the association's lobbying and political expenditures for the year or the dues and similar payments it received during the year, can be paid instead of notifying members of the nondeductible portion of their dues. By paying the proxy tax, an organization allows members to deduct 100% of their dues.]**

- c. \$300,000. [This answer is incorrect. This would be the nondeductible portion to the trade association's members if the proxy tax was not paid.]
- d. \$525,000. [This answer is incorrect. The proxy tax is paid on the lesser of the association's lobbying and political expenditures for the year *or* the dues and similar payments it received during the year.]

EXAMINATION FOR CPE CREDIT**Lesson 4 (NPHTG101)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

21. Earth 2020 is a nonprofit organization that promotes sustainable living. There is currently a run for governor in the state where Earth 2020 is organized. Tom, one of the candidates, is the only candidate that seems to care about the environment the same way as Earth 2020. Which of the following activities could affect the tax-exempt status of the organization?
- Earth 2020 allowed Tom to use its auditorium for a fundraising event at no charge.
 - Earth 2020 invited only Tom to speak at an event as an individual.
 - Earth 2020 handed out voter guides after its latest forum.
 - Earth 2020's website contains links to all the candidates' websites.
22. What is the maximum excise tax an organization would be subject to if it does not correct a political expenditure within the taxable period?
- 2.5% of the political expense.
 - 10% of the political expense.
 - 100% of the political expense.
 - \$10,000 for each prohibited expense.
23. Which type of organization is eligible to make the lobbying election?
- Organizations that test for public safety.
 - Churches.
 - Private foundations.
 - Educational institutions.
24. We Care for Pets, a Section 501(c)(3) organization, has a valid lobbying election in effect for the year. We Care for Pet's expenses during the year were as follows:

Program related expenses	\$1,000,000
Administrative expenses	100,000
Direct lobbying expenses	450,000
Grassroots lobbying expenses	45,000
Fundraising expenses	150,000

What is the excise tax on We Care for Pet's lobbying activities?

- a. \$11,250.
 - b. \$59,313.
 - c. \$64,438.
 - d. \$123,750.
25. Sheila, a sole proprietor, paid \$500 in trade association dues. The trade association engages in lobbying, and sent Sheila a letter stating that approximately 20% of dues contributions go to support their lobbying activities. How much of Sheila's dues are nondeductible as a business expense?
- a. \$0.
 - b. \$100.
 - c. \$175.
 - d. \$500.

GLOSSARY

Corporate sponsorship payment: A payment made by a corporation (or other business entity) to sponsor an organization's activity.

De minimis exception: Allows a recipient to provide a sponsor with benefits that have an aggregate fair market value of not more than 2% of the sponsor's payment.

Direct lobbying: Communicating with a member or employee of a legislative body or a government official or employee who may participate in the formulation of the legislation.

Exempt purpose expenses: Expenses paid to accomplish the organization's exempt purpose.

Fair market value (FMV): The amount that could reasonably be expected to be received in a current sale between a willing buyer and a willing seller (i.e., in an arm's-length transaction other than a forced or liquidation sale).

Federal Unemployment Tax: Is federal legislation that:

- provides temporary economic security for workers who lose their jobs by being laid off (quitting is *not* covered immediately) and who meet minimum requirements,
- is a form of insurance,
- is organized and administered by the various states at federal instigation, and
- is financed by employer contribution only. The federal rate is 6.2% on the first \$7,000 paid to each employee, reduced by up to 5.4% of state unemployment tax (SUTA) paid.

Its purpose is to compensate unemployed workers for the period of time that is presumably needed to find a new job. The fund accumulates in periods of economic prosperity and is depleted in periods of economic recession, and is designed to act as a stabilizer of consumer consumption by supporting consumption during recessions.

Form 8282: Donee information return.

Form 8283: Noncash charitable contributions.

Form 8899: Notice of income from donated intellectual property.

Form 990: Return of organization exempt from income tax.

Form 990-T: Exempt organization business income tax return.

Fundraising: Includes activities undertaken to encourage potential donors to contribute money, securities, services, materials, facilities, other assets, or time to finance the organization's exempt function.

Gift acceptance policy: Policy created to educate the staff, volunteers and governing board about critical issues triggered by certain kinds of gifts.

Grassroots lobbying: Attempting to affect the opinion of the general public or a certain segment of the general public.

Internal control: An organization's practices, policies, and procedures to safeguard its assets, detect and prevent errors and irregularities, check the accuracy and reliability of accounting information, promote operational efficiency, and ensure that such management practices are properly adhered to.

Noncash contributions: Any items other than cash, checks, money orders, credit card charges, wire transfers, contributed services, and transfers and deposits to a cash account of an organization.

Nonpayroll payments: Include pensions, gambling winnings, and backup withholding.

Nonstandard contribution: Includes the contribution of any item that is not reasonably expected to be used to satisfy or further the organization's exempt purpose if the item has no ready market in which the organization may sell it and thereby convert it to cash, and the value of the item is highly speculative or difficult to ascertain.

Professional fundraising: Includes services performed for the organization by an outside person or company (i.e., not an officer, director, or employee of the organization) that require certain expertise to plan or manage events, or prepare materials for fundraising.

Program service income: Revenue from activities that form the basis of the organization's tax-exempt status (e.g., gross receipts from admissions, sales of merchandise, performance of services, or furnishing of facilities).

Qualified sponsorship payment: A payments (whether in money, property or services) by an entity engaged in a trade or business (i.e., the recipient) without an arrangement or expectation that the sponsor will receive any substantial return benefit.

Quid pro quo contribution: A payment made partly as a contribution and partly for goods and services provided to the donor by the nonprofit organization.

Substantial return benefit: Includes any benefit to the sponsor (such as advertising, an exclusive arrangement, or privileges or services) other than the recipient's use or acknowledgment of the sponsor's name, logo or product lines.

Unrelated business income (UBI): In a nonprofit organization, unrelated business income refers to income derived from an unrelated activity. It must be received from an activity that is an on-going trade or business and is not substantially related to the organization's tax-exempt purpose. Unrelated business income is usually subject to tax for most exempt organizations.

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TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC's Nonprofit Tax and Governance Guide: Helping Organizations Comply—Reporting Requirements and Tax Consequences for Contributions, Fundraising, and Political Activities (NPHTG101)

1. Following these instructions is information regarding the location of the **CPE CREDIT EXAMINATION QUESTIONS** and an **EXAMINATION FOR CPE CREDIT ANSWER SHEET**. You may use the answer sheet to complete the examination consisting of multiple choice questions.

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EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Nonprofit Tax and Governance Guide: Helping Organizations Comply—Reporting Requirements and Tax Consequences for Contributions, Fundraising, and Political Activities (NPHTG101)

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