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FIVE FEDERAL TAX ISSUES TO CONSIDER WHEN SERVING ON THE BOARD OF A PUBLIC CHARITY

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Being invited to serve on the board of a charity you care about is often a wonderful honor and an exciting opportunity. Nonprofit organizations are well-served to include an attorney on the board who can help identify, among other legal threats, potential threats to the organization's tax exemption.

In order to best support the nonprofits they serve, board members should have some understanding of the tax laws that apply to Section[1] 501(c)(3) public charities. Key issues include: private benefits, private inurement, lobbying limitations, prohibitions on political campaign intervention, and unrelated business income tax. This is not an exhaustive list of tax-exempt issues that are of concern to 501(c)(3) public charities. It is also important to note that a director or trustee of a *private foundation* has many additional tax-exempt issues that do not apply to *public charities*.[2] Most private foundation issues are not discussed in this article. Likewise, Section 501(c) specifies 27[3] other tax-exempt organizations that are subject to different rules that are also not addressed in this article.

As a fiduciary, a board member will participate in board meetings, review budgets, financial reports, and the organization's annual Form 990.[4] Each of these provides board members an opportunity to identify the following potential issues with the activities of the organization.

ONE: PRIVATE INUREMENT

An organization can only qualify under Section 501(c)(3) if "no part of the net earnings…inures to the benefit of any private shareholder or individual."[5] These rules are complex. At a high level, it may be helpful to frame this analysis as determining whether an insider to the organization is using their position of control to unfairly enrich themselves or their business interests.

Whereas many tax-exempt issues impact tax exemption or tax obligation of the *organization*, as discussed below private inurement can also impact the individuals involved in the inurement and the *management* of the organization, including members of the board of directors.

Background on Private Inurement and Excess Benefit Transactions

Ultimately private inurement can result in the loss of tax exemption to an organization. However, either in addition to the loss of exemption, or often in lieu of it, the Internal Revenue Service (IRS) can impose intermediate sanctions on transactions that involve private inurement, so-called "excess benefit transactions," under Section 4958. These intermediate sanctions can give the IRS a way to penalize those who have engaged in private inurement, short of the harsh result of penalizing the organization itself.

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However, the IRS may impose intermediate sanctions while at the same time revoking an organization's tax exemption. There may be extreme cases where both consequences are warranted.

Intermediate Sanctions Involve Potentially Severe Penalties

Intermediate sanctions penalize the person who engaged in an excess benefit transaction. The initial penalty to such person is 25 percent of the excess benefit.[6] If the excess benefit transaction is not corrected, a penalty of 200 percent of the excess benefit applies.[7] Intermediate sanctions also penalize any organization manager that participated in the excess benefit transaction, imposing a tax of 10 percent of the excess benefit on each participating manager.[8]

What Is an Excess Benefit Transaction?

An excess benefit transaction occurs when a person in a position to exercise control over the organization (a "disqualified person")[9] engages in a transaction with the organization in which they receive an economic benefit in excess of the value of consideration they provide to the organization. This can arise in key employee compensation or transactions between the organization and a disqualified person in an independent contractor capacity if the compensation exceeds the market value of the services. Likewise, a purchase of property by the organization from a disqualified person, or by the disqualified person from the organization, can be an excess benefit transaction if the price is not fair (or better than fair) to the organization. Loans can also be the source of an excess benefit transaction if the disqualified person charges interest in excess of market rates, or if the disqualified person borrows from the organization at below market rates. In some cases, the board can use the threat of reporting excess benefit transactions to the IRS as a helpful means to induce a disqualified person to return the organization's property. However, there is a real potential for the IRS to impose intermediate sanctions where the organization has insufficiently documented its expenditures to show that they were appropriate and in furtherance of the organization's exempt purpose.

Avoiding Excess Benefit Transactions

Board members are the fiduciaries of the organization. They should review the organization's financial transactions. Where a transaction with an insider is proposed, the board must determine whether the transaction is *fair* to the organization. The Regulations helpfully provide a rebuttable presumption that the compensation is not an excess benefit transaction if certain comparability data is gathered and reviewed and voted on by an authorized body (i.e., the board or a committee) that excludes individuals with a conflict of interest.[10] The organization must also substantiate its intent to treat an economic benefit as compensation, which can be shown through reporting of the payments to the IRS on Form W-2 or 1099, through an employment contract, or in certain other ways.[11] Included in the compensation arrangement that must be considered are taxable fringe benefits and expense reimbursement arrangements that fail to meet certain requirements regarding showing the business purpose of the expense, substantiation of the expense, and the returning of amounts in excess of expenses.[12]

Taking care to identify possible conflicts of interest and ensure that they do not become excess benefit transactions requires that board members understand the applicable body of tax law, which imposes penalties, but also provides guidance and safe harbors that can protect the organization by forcing its board to follow processes and to carefully consider the fairness of transactions.

A Note About Private Foundations

Stricter rules apply to private foundations, under which even certain transactions with disqualified persons that are *fair or better than fair* to the foundation constitute "self-dealing" and are subject to a 10 percent tax on the self-dealer.[13] Under these rules, self-dealing includes sales, exchanges or leasing of property (including gifts of property that are subject to a mortgage placed on the property within 10 years of the transfer),[14] and loans unless they are

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interest-free and the funds are used for appropriate 501(c)(3) purposes.[15] Accordingly, additional care needs to be taken to avoid self dealing between disqualified persons and foundations.

TWO: PRIVATE BENEFIT

A Section 501(c)(3) organization cannot more than incidentally benefit private persons. The doctrine of private benefit derives from the necessity of an organization to serve certain public rather than private interests, and private benefits have been described as "nonincidental benefits conferred on disinterested persons that serve private interests."[16] The private benefit prohibition, though similar to the private inurement prohibition, is distinct. The most notable difference between private inurement and private benefit is that a prohibited private benefit may accrue to a person who *is not an insider* to the organization.

In practice, consideration of private benefit issues is often an issue at the time of forming a new organization, in determining whether it fundamentally qualifies under Section 501(c)(3). Consideration of these issues may also be necessary when an organization changes its purpose and its activities. The IRS gave a useful example of private benefit that prevented qualification under Section 501(c)(3), where an organization formed to beautify a city block was determined to primarily serve the private interests of residents in their property values.[17] However, private benefits that are incidental to the organization's purpose can be permissible. In another IRS ruling, an organization was formed for purposes of maintaining and improving a lake for recreational use by the community.[18] Lakefront property owners would benefit significantly from the maintenance and improvements by increased property values. However, the purpose of the organization was to benefit the general public through the recreational facilities, and that purpose could not be achieved without the benefits to the lakefront property owners. The IRS treated the benefit to lakefront property owners as *incidental* and the organization was not precluded from exemption under Section 501(c)(3).

Another fact pattern where private benefit might arise is an educational organization (education being an exempt purpose under Section 501(c)(3)) that serves specific private interests, such as providing education only with respect to the use of a certain company's product, or providing education only to specified children.[19] When considering proposed activities of a charity they serve, board members should ask and analyze who benefits from the activity. If someone benefits other than as part of a charitable class,[20] it will be important to determine whether that benefit is incidental. If it is not, the charity's exemption may be at stake.

THREE: LOBBYING LIMITATIONS

Section 501(c)(3) provides that "no substantial part" of the activities of a 501(c)(3) can be "carrying on propaganda, or otherwise attempting, to influence legislation." The meaning of "no substantial part" is based on the facts and circumstances and no bright line rules are provided unless the Section 501(h) election (discussed below) is made.

No Substantial Part

An organization will be treated as an "action" organization and will cease to be recognized as a Section 501(c)(3) organization under the Treasury Regulations if a substantial part of its activities includes contacting members of a legislative body to propose, support, or oppose legislation, or if it urges the public to do so. Legislation includes action by Congress, state legislature, local councils or similar, as well as the general public by referendum.[21] Note that the Code and Regulations look to the *activities* of the organization (not only the expenditures as provided for organizations making a Section 501(h) election, as discussed below), but neither the Code nor the Regulations provide guidance as to what will be treated as substantial. Case law interpreting the "no substantial part" test also has failed to provide a bright line rule. Courts may rely on measuring the organization's lobbying expenditures as a percentage,[22] considering the time allocated by the organization to lobbying activities,[23] or considering the percentage of expenditures while also focusing on whether the lobbying activity was a primary

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objective of the organization.[24] It can be hard for an organization that engages in lobbying to know where it stands when a clear test has not been developed.

Section 501(h) Election—Expenditure Test

Because a facts-and-circumstances test under which a charity could lose its exemption may make many organizations uneasy, charities can elect, under Section 501(h), to have their lobbying activities measured by the organization's lobbying expenditures relative to the exempt purpose expenditures. The 501(h) election comes with calculations of the "lobbying non-taxable amount," based on the total "exempt purpose expenditures" of the organization, which look somewhat similar to tax brackets.[25] Electing organizations are further subject to a limitation on grassroots lobbying, with the "grassroots non-taxable amount" that equals 25 percent of the lobbying non-taxable amount. As the name suggests, lobbying and grassroots lobbying expenditures within the lobbying non-taxable amount and the grassroots non-taxable amount are not subject to any tax, but "excess lobbying expenditures" are subject to a 25 percent tax.[26] In determining excess lobbying expenditures for a taxable year, an organization must compare (i) the amount by which its lobbying expenditures exceeded its lobbying non-taxable amount to (ii) the amount by which its grassroots expenditures exceeded its grassroots nontaxable amount, and the *greater of the two* will be the amount subject to the 25 percent tax.[27]

Willingness to pay a 25 percent tax on the excess lobbying expenditures does not, however, allow an organization to engage in unlimited lobbying. An organization that has made a Section 501(h) election will lose its exemption if it makes (i) lobbying expenditures that normally exceed the "lobbying ceiling amount" or (ii) grassroots expenditures that normally exceed the "grassroots ceiling amount."[28] The ceiling amounts are both calculated over a four-year period, by adding 150 percent times the lobbying (or grassroots) ceiling amount for the year in question with 150 percent of the lobbying (or grassroots) ceiling amounts for the immediate prior three years.[29] If total lobbying (or grassroots) expenditures added together from that four-year period exceed the four-year calculation of the lobbying (or grassroots) ceiling amount, the organization will lose its exemption.[30]

Because grassroots lobbying is more limited than the total lobbying amount (which includes both grassroots lobbying and "direct lobbying"), it is important for electing organizations to distinguish grassroots lobbying from direct lobbying. There are nuances to the rules, but in general, direct lobbying involves the organization (through its employees, independent contractors, or members, for example) contacting legislators directly about legislation, whereas grassroots lobbying involves the organization encouraging the general public to contact legislators about legislation.[31]

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Another Note about Private Foundations

Whereas public charities can engage in an insubstantial amount of lobbying, a private foundation is subject to a 20 percent tax on any lobbying expenditure that the foundation makes, which can be increased to a 100 percent tax if not corrected within the taxable period, *and its managers* may be jointly and severally subject to a five percent tax (up to $10,000), which can be increased to a 50 percent tax (up to $20,000).[32] Accordingly, it is critical that a private foundation not engage in any lobbying, and organizations for whom some amount of lobbying is important must take care to avoid being reclassified as private foundations.

FOUR: PROHIBITIONS ON POLITICAL CAMPAIGN INTERVENTION

While lobbying activities for a public charity are permissible if not substantial, political campaign intervention is strictly prohibited, *even where a candidate's success or failure is relevant to the charitable purpose of the organization.* [33] Accordingly, it is important to distinguish political campaign intervention from lobbying activities.[34] A public charity cannot contribute to a political campaign, publish or distribute written materials against or on behalf of any candidate for public office, or make any

statements against or on behalf of any candidate for public office.[35]

Non-Partisan Election Activities

Certain election-related activities are permissible for 501(c)(3) organizations. In particular, a 501(c)(3) organization may engage in non-partisan activities, such as non-partisan voter registration or get out the vote drives,[36] the hosting of debates or forums where all candidates are invited,[37] or the creation and dissemination of voter guides.[38] Careful analysis of these activities is critical to ensure that they are actually non-partisan and show no bias toward or against any candidate.

Criticism of Sitting Elected Officials

A candidate may be an incumbent elected official. In this case, a nonprofit organization may be able to criticize the individual in their capacity as an elected official, especially if the organization has a history of doing so.[39]

First Amendment Rights

The prohibition on 501(c)(3) intervention in political campaigns does not extend to prohibit individuals who are employees, board members, or other representatives from exercising their right to free speech with respect to political campaigns.[40] It is important to distinguish *in which capacity* these individuals are acting. They should ensure that it is clear that they are acting in their personal capacity and not as a representative of the organization.

In general, given the strict prohibition on campaign intervention, special caution is advisable for organizations engaging in election-year activities.

FIVE: UNRELATED BUSINESS TAXABLE INCOME

A Section 501(c)(3) organization that regularly carries on a trade or business not related to its exempt purpose must pay tax on its unrelated business taxable income (UBTI).[41] If organized as a corporation, the organization will pay tax on its UBTI at the corporate rate (now reduced to 21%), and if organized as a trust, it will pay tax on its UBTI at the (currently higher) rate applicable to trusts. Income is not related to an organization's exempt purpose solely because the income from the organization supports the exempt-purpose activities of the organization. In addition to income from a business that is regularly carried on by the organization directly, an organization may have UBTI from certain investment activities. For example, an organization may have UBTI from interests in businesses that it owns through entities that pass through income to their owners, such as partnerships (or LLCs taxed as partnerships) if those partnerships conduct a business.

Dividends, interest, payments with respect to securities loans, annuity payments, royalties, real property rent, and certain other categories are excluded from UBTI.[42] However, an organization will also generally have UBTI from debt-financed investments that it makes.[43] Accordingly, even if the organization holds corporate stock, if the stock is treated as debt financed, dividends will be UBTI. Rental income will be UBTI if it is debt financed, subject to an exception for certain types of organizations (including schools) that invest in real property that meets a set of complex criteria.[44]

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UBTI Silos

In 2017, the Tax Cuts and Jobs Act[45] (TCJA) added a nuance to the taxation of UBTI for a tax-exempt organization. Organizations with multiple trades or businesses are not allowed to offset gains from one business with losses from another,[46] subject to Regulations that provide guidance as to how to delineate between multiple businesses and that allow for the aggregation of passive investment activities that meet certain requirements.[47]

CONCLUSION: SPOTTING ISSUES AND ADDING VALUE

The decision to join a board of directors is an important one for the prospective board member, as well as for the organization. It is a significant responsibility, and merits careful consideration by the lawyer invited to join the board. Many organizations appreciate having a lawyer on the board to spot potential legal pitfalls, and a lawyer who is aware of potential

tax-exemption issues can be of tremendous value to the organization. If you understand that private inurement, private benefit, lobbying, political campaign intervention, and UBTI issues are lurking, you can identify situations in which further analysis is needed. That might be the ounce of prevention your organization needs to avoid loss of exemption or severe penalties.

Notes

1 Section references refer to the Internal Revenue Code of 1986, as amended, and Regulation references refer to the Treasury Regulations promulgated thereunder.

2 A Section 501(c)(3) organization must continually meet a public support test in order to avoid classification as a private foundation. In order to avoid treatment as a private foundation, a Section 501(c)(3) organization must either be a supporting organization to a public charity under Section 509(a)(3) or meet the public support test of either Section 509(a)(1) or Section 509(a)(2).

3 I.R.C. § 501(c)(1) through (29), with 501(c)(20) for group legal services organizations having been repealed in 2014. Pub. L. 113-295, § 221(a)(19)(B)(iii).

4 With the exception of churches, all 501(c)(3) organizations must file an annual Form 990 (which may be a Form 990, 990-EZ, 990-N, or 990-PF). Note that a failure to file Form 990 for three years in a row can result in loss of exemption. I.R.C. § 6033(j).

5 I.R.C. § 501(c)(3) (providing exemption for organizations "organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes…or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual…").

6 I.R.C. § 4958(a)(1).

7 I.R.C. § 4958(b).

8 I.R.C. § 4958(a)(2).

9 I.R.C. § 4958(f)(1) defines disqualified persons as "(A) any person who was, at any time during the 5-year period ending on the date of such transaction, in a position to exercise substantial influence over the affairs of the organization, (B) a member of the family of an individual described in subparagraph (A), (C) a 35-percent controlled entity, (D) any person who is described in subparagraph (A), (B), or (C) with respect to an organization described in section 509(a)(3) and organized and operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of the applicable tax-exempt organization, (E) which involves a donor advised fund (as defined in section 4966(d)(2)), any person who is described in paragraph (7) with respect to such donor advised fund (as so defined), and (F) which involves a sponsoring organization (as defined in section 4966(d)(1)), any person who is described in paragraph (8) with respect to such sponsoring organization (as so defined)." Of course, as with any good tax provision, buried within this definition are further definitions. In the context of a proposed transaction, if an organization's advisers are parsing through the definition of a disqualified person, and whether there is an excess benefit transaction hinges on whether the definition of disqualified person applies, you would be well-advised to adjust the transaction.

10 Treas. Reg. § 53.4958-6.

11 Treas. Reg. § 53.4958-4(b)(3).

12 Treas. Reg. § 53.4958-4(a)(4). Note that the expense reimbursement arrangements must meet the requirements of an accountable plan under Treas. Reg. § 1.62-2(c).

13 I.R.C. § 4941.

14 I.R.C. § 4941(d)(2)(A).

15 I.R.C. § 4941(d)(2)(B).

16 Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii); Am. Campaign Acad. v. Comm'r, 92 T.C. 1053 (1989).

17 Rev. Rul. 75-286, 1975-2 C.B. 210.

18 Rev. Rul. 70-186, 1970-1 C.B. 128.

19 See, e.g., Determination Letter 202110034 (Dec. 15, 2020), available at https://www.irs.gov/pub/irs-wd/202110034.pdf (denying tax exemption in a particularly egregious example involving a home school established for one child by their parents, which would have resulted in both private benefit and private inurement).

20 Private persons benefit from the activities of a charity when they are members of a charitable class. This is, of course, permissible. See, e.g., Rev. Rul. 75-196, 1975-1 CB 155 ("What is of importance is that the class benefited be broad enough to warrant a conclusion that the educational facility or activity is serving a broad public interest rather than a private interest, and is therefore exclusively educational in nature.").

21 Treas. Reg. § 1.501(c)(3)-1(c)(ii).

22 Seasongood v. Comm'r, 227 F.2d 907 (6th Cir. 1955), but see Christian Echoes Nat'l Ministry, Inc. v. U.S., 470 F.2d 849 (10th Cir. 1972) (rejecting a straight percentage of expenditure test where the court found the lobbying activity was substantial and continuous).

23 League of Women Voters v. U.S., 180 F. Supp. 379 (Ct. Cl. 1960), cert. denied, 364 U.S. 822 (1960).

24 Haswell v. U.S., 500 F.2d 1133 (Ct. Cl. 1974), cert. denied, 419 U.S. 1107 (1975).

25 See I.R.C. § 4911(c)(2).

26 I.R.C. § 4911(a)(1).

27 I.R.C. § 4911(b).

28 I.R.C. § 501(h)(1).

29 Treas. Reg. § 1.501(h)-3(b).

30 Id.

31 I.R.C. § 501(h)(2); I.R.C. § 4911(d).

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32 I.R.C. § 4945.

33 I.R.C. § 501(c)(3)(providing that a 501(c)(3) must be an organization "which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office." See also Treas. Reg. § 1.501(c)(3)-1(c)(3)(iii).

34 See, e.g., Rev. Rul. 2007-41, 2007-1 C.B. 1421 (identifying whether various examples constitute campaign intervention).

35 Id.

36 Rev. Rul. 2007-41, 2007-1 C.B. 1421.

37 Rev. Rul. 2007-41, 2007-1 C.B. 1421; Rev. Rul. 86-95, 1986-2 C.B. 73. *See also*, Rev. Rul. 66-256, 1966-2 C.B. 210 (treating debates as educational activities); and Rev. Rul. 74-574, 1974-2 C.B. 160 (allowing a 501(c)(3) organization to provide a forum for candidates in which each candidate was offered equal time).

38 Rev. Rul. 2007-41, 2007-1 C.B. 1421, Situation 19; Rev. Rul. 80-282, 1980 C.B. 178; Rev. Rul. 78-248, 1978-1 C.B. 154.

39 See, e.g., Rev. Rul. 2007-41, 2007-1 C.B. 1421, Situation 14 (criticizing an incumbent candidate in their capacity as a legislator, in the context of lobbying in favor of legislation on which the organization sought the legislator's vote).

40 Rev. Rul. 2007-41, 2007-1 C.B. 1421.

41 I.R.C. §§ 511-513.

42 I.R.C. § 512(b)(1) and (2).

43 I.R.C. § 512(b)(4); I.R.C. § 514.

44 I.R.C. § 514(c)(9).

45 Though originally introduced as the "Tax Cuts and Jobs Act," it was ultimately signed into law under the more cumbersome name "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018." Pub.L. 115–97.

46 I.R.C. § 512(a)(6).

47 Treas. Reg. § 1.512(a)-6.

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