

# nonprofit Navigator

## FEC Proposes New Definition of a Member, Guidelines on “Membership Organizations”

In December of 1998, the FEC issued proposed regulations which modify its earlier proposal on the definition of a “member” of an organization [NN, 1/98, p.2]. The new proposal also adds required characteristics of a membership organization.

These definitions are critical to the political activities of many nonprofits. Only members may be solicited for PAC contributions, and a membership organization’s communications with its members are entitled to an exemption from the general prohibition on electoral advocacy.

The December 1998 proposal resembles the requirements suggested in Alternative C of the earlier version of the regulations; namely, that a member must either have significant financial attachment to the organization (other than the payment of dues), pay annual dues that are predetermined by the organization, **or** have a ‘significant organizational attachment’ to the membership organization. Such attachments include the right to: vote for organization officers; vote for at least one individual on the organization’s highest governing board; vote on policy questions where that highest governing body is bound to the outcome of that vote; or participate directly in similar aspects of the governance of the organization.

Unlike earlier versions, the new proposal has no minimum dues amount, but adds a requirement that members affirm their membership on at least an annual basis. Thus, memberships of long duration, such as the lifetime memberships given to generous donors, are likely not to be recognized by the FEC. Additionally, cause-related groups that participate in direct mail campaigns may have difficulty with this requirement, as this practice traditionally depends on a 24-month cycle of membership renewals.

*Only members may be solicited for PAC contributions.*

The new proposal also provides greater guidance on the attributes of a ‘membership organization.’ It adds several important items: that the organization is self-governing, so that the power and authority to direct it are vested in some or all members; that it makes its articles, bylaws and other formal documents freely available to its members (so that the members are informed of their rights, qualifications, and obligations under these documents); and that it is not organized primarily for the purpose of

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# Election Connection

In two recent actions, the Supreme Court has again entered the highly contentious arena of campaign finance reform.

## Supreme Court Rejects Ballot Initiative Regulations

In the last few years, ballot initiatives have become increasingly popular in the twenty-four states that allow them. Ballot initiatives have been used by voters for everything from giving themselves tax cuts to enacting term limits for elected officials. At the same time, many states have been enacting regulations on how petitions for ballot initiatives may be circulated. These regulations have proven to be contentious, and critics have suggested that they are an impediment to free speech. Last month, in what many were watching as a test case for campaign finance reform, the Supreme Court struck down several such regulations as unconstitutional.

The regulations at issue were enacted by the State of Colorado in the interest of, as Justice Ginsburg noted, "administrative efficiency, fraud detection and informing voters." The regulations mandated that

petition circulators file with the state, wear identification badges and be registered voters in the state. In a 6-3 decision, the Court held that Colorado's identified goals did not warrant the limitations being placed on the public's right to free speech through popular enactment of ballot initiatives. The majority opinion states that the Colorado regulations "significantly inhibit communication with voters about proposed political change." The Court noted that Colorado had less cumbersome means at its disposal to ensure a fair and fraud-free voting process.

In an partial dissent, Justices O'Connor and Breyer found only the identification badge requirements unconstitutional. Chief Justice Rehnquist filed a separate dissent finding the restrictions legitimate and claiming that the Court's reasoning "calls into question a host of other [similar] regulations."

## Supreme Court to Revisit Campaign Contribution Limits

The Supreme Court has agreed to review the contribution limits mandated by a state campaign finance law. Observers note that this gives the Court an opportunity, if it wishes, to modify its previous rulings on campaign contribution and spending limitations. The pivotal case in this area is the Court's 1976 decision in *Buckley v Valeo*, which examined the constitutionality of federal limits on both campaign spending and campaign contributions.

*Buckley* found strict contribution limits for federal elections to be constitutional.

While noting that such limits restrict a contributor's rights of free speech and free association, the Court found these restrictions permissible when balanced against the government's interest in limiting the actuality and appearance of corruption.

The more controversial legacy of *Buckley* is its characterization of campaign spending as a form of free speech entitled to First Amendment protections. The Court again balanced the governmental interests in stemming corruption, but found that those interests were inadequate to support a limitation which

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# Appeal Decision Upholds Denial of Exemption for Kemp Fund

The U.S. Court of Appeals for the DC Circuit has affirmed a District Court decision denying tax-exempt status to The Fund for the Study of Economic Growth and Tax Reform [the Fund] [NN, 4/98, p. 3]. The Fund was established in 1995 to fund the Kemp Commission, which was created by the Republican leadership to make recommendations on reforming the Tax Code.

*The Fund was characterized as an ‘action’ organization.*

The Fund was characterized by the IRS as an ‘action’ organization, because its goal, to bring about a change in Federal tax law, could only be achieved through the passage of legislation, and that it advocated for this goal.

The decision concluded “that the [Kemp] Commission had not set out to study tax reform generally...the indications are that the [Kemp] Commission assumed a

conclusion...and then tried to sell this conclusion both to Congress and the President, and to the public more broadly.”

*The Court of Appeals pointed out that its decision should not be broadly applied.*

The Court of Appeals was careful to point out that its decision was not to be applied broadly, and that it is not appropriate to classify as an ‘action’ organization any group that studies an issue touching on legislation, reaches a conclusion, and argues that conclusion’s merits. Specifically in Fund’s case, however, the Court held “that an organization which assumes a conclusion with respect to a highly...controversial legislative issue and then goes into the business of selling that conclusion may properly be designated an ‘action’ organization.”

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## Supreme Court

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“heavily burdens core First Amendment expression.”

In the current case, *Nixon v Shrink Missouri Government PAC*, the Court will decide if the contribution limit imposed in Missouri is too low to be Constitutional under the First Amendment. The state limit was established in 1994 at \$1,000; the contribution limit upheld in *Buckley* was \$1,000 as well, which is roughly equivalent to \$2,500 in today’s dollars. The lower court found that, due to inflation, a limit which made sense in 1976 now impermissibly restricts “meaningful

participation in protected political speech and association.”

While it is possible that the Court may simply agree that the \$1000 limit is an impermissible restraint on free speech and suggest that a higher limit would not be, there is also the potential that the Court could modify its holding in *Buckley* to a more substantial degree. So far, the Court has consistently refused to disturb that decision. The Court will not actually hear arguments until next term—October, 1999 or later.

## To 403(b) or To 401(k), That is the Question

*The Nonprofit Navigator is pleased to present a guest column from David W. Powell, a principal in the Groom Law Group, Chartered, a Washington, D.C. law firm specializing in tax and employee benefits.*

Charitable organizations, also known by their Internal Revenue Code designation as "501(c)(3)" organizations, have long had the ability to establish salary reduction pension plans under Code section 403(b). Since 1997, however, following the Small Business Job Protection Act of 1996, these organizations have had the ability to sponsor a 401(k) plan as well. To date, though, there has been no groundswell of charities dropping their 403(b) plans and moving to 401(k) plans. There are a number of reasons for this, which will become evident as we explore in this article the main pros and cons of 403(b) plans and 401(k) plans:

### Some factors favoring 403(b) plans.

#### 1. The 401(k) ADP test.

401(k) plans are subject to complex nondiscrimination testing known as the "average deferral percentage" or "ADP" test. Testing is not a great burden, because it is usually done by the administrator using software and (since 1997) prior year data, but as a practical matter, the test often results in executives of an organization being limited to salary reduction contributions less than the \$10,000 maximum. 403(b) plans, on the other hand, are not subject to this particular nondiscrimination test, and so long as the ability to make salary reduction contributions to the 403(b) plan is available to all employees normally working 20 hours or more a week, executives can generally put the full \$10,000 contribution in the 403(b) plan, subject to the other general contribution limits.

#### 2. Special 403(b) "catch-up" contributions.

Employees of hospitals, churches, and educational institutions with students and faculty, that maintain 403(b) salary reduction plans may be eligible for a special "catch-up" salary reduction contribution of up to an additional \$15,000 over a period of years (usually in the form of an additional \$3000 a year for 5 years) to a 403(b) plan. Participants in 401(k) plans are not permitted this catch-up rule.

#### 3. Combining plans for 415 limit purposes.

For purposes of the Code section 415 limits on annual additions to defined contribution plans (generally, the lesser of 25% of compensation or \$30,000 per year), 401(k) plans are aggregated with other 401(a) defined contribution plans of the employer, such as qualified profit sharing or money purchase plans (and, through the 1999 limitation year, are also aggregated with qualified defined benefit plans). This can further reduce the amount of contributions that some employees may be able to make or have made to their accounts. Generally, 403(b) plan contributions are not aggregated with 401(a) plans of the employer for purposes of the 415 limits (there are some exceptions to this), and thus it may be possible to make higher contributions through a combination of a 403(b) plan and a qualified plan than there would be from a combination of a 401(k) plan and another qualified plan.

### Factors that cut both ways.

#### 4. The "MEA" limit for 403(b) plans, and special elections.

403(b) plans are subject to an additional contribution limit known as the "maximum exclusion allowance" or "MEA". Although this limit rarely reduces the amount

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## To 403(b)

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which may be contributed below the 415 limit mentioned above, the calculation is an additional administrative burden. However, certain 403(b) plans may also provide certain elections which can increase the amount of contribution that employees can make to the 403(b) plan (allowing contributions in excess of the 415 general limits in some cases. 401(k) plans may not offer such elections, though that does simplify their administration.

### 5. **Non-ERISA 403(b) plans.**

403(b) plans which permit only salary reduction contributions, and have only limited employer involvement in their administration, may be exempt from ERISA, simplifying their administration. Such plans need not, for example, file annual Form 5500 information returns, or comply with spousal consent rules. This special exception is not available to 401(k) plans.

### 6. **Current nontransferability of money.**

Even if a charity wishes to terminate its 403(b) plan and move to a 401(k) plan, the 403(b) monies cannot currently be transferred or rolled over to the 401(k) plan. There are legislative proposals to permit such portability, but until then, the 403(b) monies will have to be kept separate, which presents an additional administrative burden.

### **Factors favoring 401(k) plans.**

#### 7. **Uniformity of benefits with non-charities.**

Since non-charities may not sponsor 403(b) plans, if a group of employers consisting of both charities and other tax-exempt or taxable entities (for example, a

charity with a related, but not controlled, lobbying entity, or a for-profit subsidiary) wishes to maintain uniform benefits across the board among all of the employers, a 403(b) plan will not serve this purpose, but a 401(k) plan (perhaps a multiple employer one) would. (Note also that off-the-shelf “master and prototype” [M & P] qualified plans cannot be used as multiple employer plans. Either each entity not in the controlled group must adopt a separate M&P plan, or a multiple employer plan document must be individually designed.)

#### 8. **403(b) investments limited to insurance and mutual funds; 401(k) investments unlimited.**

403(b) plan assets (except for certain church plans and grandfathered arrangements) must be invested in either mutual funds or annuities. 401(k) plan assets, on the other hand, can be invested in any other assets (such as individual stocks) consistent with ERISA fiduciary and prohibited transaction constraints. Because many 401(k) plans voluntarily offer only mutual fund investments, however, this has not proven to be a significant difference.

Finally, it should be noted that there were a number of legislative proposals made in the last Congress to generally modify and increase the limits on contributions to pension plans, and which would have the effect of narrowing some of the differences between 403(b), 401(k) and 457(b) plans. Whether any of these proposals will eventually make it into law, and in what form, remains to be seen.

## New Charity Tax Credit Brings Problems

Have you ever had a great idea, but when you tried to implement the idea problems arose? Well, Congress has run into that trap with the new tax credit for charitable contributions to direct human services organizations. As part of the Community Services Block Grant, states are now able to offer tax credits against state income tax for contributions to “qualified” direct human services charities. The tax credit was implemented to encourage more donations to charities that provide services to poor people in the United States, thereby lessening some burdens otherwise put on local, state and national governments and the private sector. It seemed like a good idea at first.

Critics, however, claim that the tax credit discriminates against many types of charities, educational and cultural institutions, and even those that help the poor by lobbying for better services without serving as a direct provider of those services. In order to be a qualified charity, an organization generally needs to spend 75% or more of its money on direct services to people whose income is no more than 185% of the official poverty line. The

term “direct services” is narrowly defined, excluding, for instance, the provision of legal services or advocacy efforts.

*Critics argue that the new bill discriminates against lobbying and advocacy charities.*

Advocates for charitable organizations are worried about the dangers of creating different classes of charities (in this case delineated by type of service provided). Some critics argue that the new tax credit is part of a Congressional attempt to limit advocacy by charities.

The new bill also requires the qualified charities to submit substantial information about themselves, including budget information, management expense reports and fundraising reports. These requirements make it less likely that small charities will participate in the program and therefore limits access to the tax credit.

It is possible that the bill will be revised in the current Congress.

## DC Tracks Down Non-Filers

The District of Columbia has found an easy way to track down tax-exempt organizations who have not obtained local tax exemption. Last year, the D.C. Office of Tax and Revenue compared a list of tax-exempt organizations with an address in D.C. (obtained from the IRS Web site) with its own list of organizations with D.C. tax-exempt status. It found that approximately 1,100 organizations had failed to apply for tax-exempt status with the D.C. government.

While it has always been necessary in most jurisdictions to apply for state and local exemption separately from the federal process, many organizations’ failure to comply has slipped through the cracks. New improvements in information technology make it much easier for local governments to identify non-filers. State governments may well follow DC’s example if they have not done so already.

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# Congress Responds to Nonprofit / For-Profit Competition

A nasty fight is happening in Washington pitting nonprofit health and education organizations against for-profit health clubs and tour companies. The for-profit companies, jealous of the tax benefits enjoyed by their nonprofit peers, convinced Congress last year that a review of the services offered by nonprofit health organizations (like JCCs and YMCAs) and colleges and universities (through their alumni associations) was necessary. The IRS is currently finishing its review of the services offered by nonprofit organizations that substantially mimic those offered by for-profit companies in the health and tour industries.

Many years ago, an executive at a nonprofit college or university came up with a great way to expand the services of the college: offer educational tours to alumni. It seemed to make sense; alumni of universities are likely to be interested in intellectually stimulating trips. Indeed, the idea worked. Currently hundreds, perhaps thousands, of colleges, universities, and other educational institutions offer educational trips that

combine leisure, travel, seminars and, sometimes, classes.

The proposed new regulations from the IRS have provoked a flurry of comments from nonprofit organizations ranging from museums to small liberal arts colleges. At press time, the IRS was planning a hearing on its proposed regulations for early February.

*Congress forces the IRS to examine regulations on tours offered by nonprofit organizations.*

The IRS is to submit to Congress a report on the health industry by April 1, 1999 that identifies any changes that may be needed “to assure that tax-exempt health clubs are not unfairly competing against private sector organizations.” IRS officials are not offering any comment at this time about what they might propose to Congress except to say that they “are always mindful of directives from [Capitol] Hill.”

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## Membership Organization

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influencing Federal elections. The proposal also requires that a membership organization be “composed of members”, but gives no further definition of this phrase.

An important new element to the proposed regulations states that the membership communications exemption would only apply “to those communications made at the direction and control of the membership organization, and not of any other person.” The proposal also seeks commentary about the application of this exemption to unincorporated associations.

Comments were due to be received on or before February 1, 1999. However, the FEC has been known to consider comments submitted late, so check with the FEC to see if there is any leeway. Written comments may be faxed to (202) 219-3923, but the hard copy should also be mailed. Comments may be e-mailed to members@fec.gov. Comments received by e-mail will not be considered unless the name of the commenter, an e-mail address and a postal address are included within the text of the e-mail.

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- Co-author, *Maximize Your Grassroots Power: Legal Guide to List Enhancement and Citizen Contact* (1996)
- Editor, *Nonprofit Navigator*, formerly *Tax Monthly for Exempt Organizations* and *Tax Monthly for Associations*
- Columnist, *The Non Profit Times*

Gail is a nationally recognized authority on exempt organization law, having advised in this field for 20 years. She provides strategic advice to a wide range of progressive foundations, charitable and lobbying organizations, associations, and political action committees on federal tax law, federal election law, and other legal issues. Gail is a frequent speaker, writer and commentator on issues affecting the nonprofit sector and an active participant with the legal and nonprofit community in developing the law in this area.

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