

# nonprofit Navigator

## Them's Fightin' Words

IRS hands down first set of 501(c)(3) excess benefit sanctions.

Although final regulations are still a few months away, the IRS recently handed down a spate of section 4958 excise taxes against a group of affiliated 501(c)(3) Mississippi home-healthcare providers and their principal managers to the tune of \$83 million. This first case has received wide attention among nonprofits concerned with how the so-called "intermediate sanctions" provisions will be applied. Each of the charities involved also lost their exempt status. The organizations and individuals have filed suit in the Tax Court challenging both the sanctions and the revocations. The Tax Court's decisions could be the first judicial analyses of the intermediate sanctions regulations and laws.

Congress passed section 4958 to provide the Service with an alternate enforcement mechanism against insider benefit short of revoking a nonprofit's exemption. The stated intent was to make the sanctions the first step in punishing excess benefit transactions, with the IRS contemplating exemption revocation only when the violation was serious enough to call into question whether the organization could even be called a charity. The provision also enables the IRS to pursue penalties against insiders who use their control over charities to receive undue financial benefits.

The present cases arose from the conversion of a group of affiliated health care nonprofits into a for-profit corporation. The IRS took exception to the bargain sale of the nonprofits' assets to the new corporation, claiming it resulted in a multi-million dollar

*Lending a novel meaning to the definition of "intermediate," each of the charities involved also lost their exempt status in addition to the penalties.*

excess benefit to the owners of the successor corporation. The defendants have petitioned the U.S. Tax Court arguing, among other things, that they relied on the opinion of an independent CPA that the value of the assets transferred was actually negative and so the assumption of liabilities by the new corporation was more than adequate consideration for the sale. The Tax Court complaint also points out that numerous similar conversions had taken place in the state under similar terms.

Ordinarily, both these factors (reliance on an independent third-party determination of fair market value for a transaction and conducting

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# Election Connection

## Some Raffles Are Luckier Than Others

The IRS issued a memo on December 1 clarifying when money raised by PACs in raffles will be considered exempt function income and therefore not taxable. Sentiment within the PAC community is that the memo represents a victory for organizations concerned about IRS treatment of raffle proceeds in recent rulings.

*PAC money raised from political fundraising and entertainment events is not taxable.*

The IRS memo makes clear that money raised from fundraising and entertainment events is eligible for treatment as exempt function income *if* the events are political in nature. While the memo did not describe what facts and circumstances will make an event “political,” it did state that one factor is the extent to which the event is related to a political activity aside from the need of the organization for income.

### Fightin’ words, cont.

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the deal on terms similar to those used by nonprofits in similar situations) would be expected to weigh heavily against the imposition of sanctions. Unfortunately, organizations seeking a clue from these cases as to how the IRS will exercise its new powers may be disappointed, because information made publicly available so far does not provide much detail about the IRS’ reasoning.

Soon-to-be departing IRS Exempt Organizations Director Marc Owens is on the record stating that any organization that subjects itself to intermediate sanctions puts its exemption “on the table” if it fails to make meaningful efforts ensure future compliance.

Marcus Owens, IRS EO Division Director, has indicated that when a raffle is held in conjunction with a fundraising or entertainment event, the raffle sponsors merely need to make the political purpose clear to ticket buyers in order to avoid being taxed. This could be done by putting up a sign where tickets are sold or printing on the tickets themselves words to the effect that the money is being raised to support political goals. It is unclear whether income from a PAC raffle that makes clear its political purpose but that is not connected with a specific event is taxable.

Many PACs became concerned last year after the IRS ruled that a PAC’s raffle proceeds were not exempt function income. In that case, the IRS determined that since the raffle was sponsored in conjunction with a non-political event and only brief mention of the PAC was made on the raffle tickets, the proceeds raised by raffling off a car were taxed at the top corporate rate.

Still, it is unclear what level of excess benefit transaction would trigger intermediate sanctions but fall short of exemption revocation.

From what we have seen thus far, the IRS is in a fighting mood over excess benefit transactions. In light of this, exempt organizations must tread very gently when transacting business with disqualified persons. Every decision should be documented, with supporting data on comparable market-rate services or products. If an organization finds itself in a questionable situation, it should immediately consider correcting the arguably excess benefit. As the most recent cases have shown, a lot more than a financial penalty is at stake.

## Down for the Count

### IRS give up the goat on mailing list rentals, for now

On the heels of its most recent loss in the related affinity credit card cases, [NN 11/99, p. 1], the Internal Revenue Service decided not to appeal its defeat in the Tax Court against Planned Parenthood and Common Cause on the issue of mailing list rentals. [NN 7-8/99, p. 6] The 90-day appeal period ended November 14.

The Service's position was that in the event an exempt organization provided any services at all to users of its mailing list, the entire transaction was tainted, rendering all income received subject to the unrelated business income tax.

Some observers have suggested that the IRS will switch gears to a "reasonable allocation" approach in UBIT determination. Under that system, payments for services, such as physical preparation of lists for mailers, would be considered unrelated business income, while payments for property rights would be sheltered under the royalty exemption.

Even this approach, however, seems at odds with Judge Thomas Wells' reasoning in the original decision categorically defending each stage of a list rental transaction as an effort to protect or exploit an intangible property right.

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## More Flexible Rules for Nonprofit Mail

A new rule recently went into effect amending the standards for determining what mail may be sent at the Nonprofit Standard Mail (A) rates. The new rule allows nonprofits to use the standard rate for mail seeking or soliciting membership dues payments that also contain promotional announcements of membership benefits.

Federal law provides that otherwise eligible mail may be sent at nonprofit rates even if it contains references to membership services or benefits so long as it does not cross the line into advertising. Prior to the new rule, the Postal Service interpreted the law to permit references to membership benefits as long as no additional information concerning the benefits was included. Under this standard, known as the "no adjectives" rule, nonprofits could list a product or service available to members but could not provide additional information concerning the product, such as a description, brand name, price, or

other terms of purchase that would be promotional in nature. For example, the Postal Service considered the description of a credit card as "low cost" or as having "no annual fee" or a "five percent interest rate," to be prohibited advertising, promotional, or application materials.

*Certain solicitations describing membership benefits may be mailed at nonprofit rates.*

Nonprofits complained that the Postal Service's application of the rules hindered their efforts to attract and retain members and that the success of such efforts hinged on their ability to provide a favorable description of the nonprofit's membership benefits.

While the new rule is considered more flexible and favorable to the nonprofit

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# IRS Update

## The Accidental Private Foundation

### How to maintain, restore, or borrow public support

Although nonprofits come in many forms, many 501(c)(3)s prefer to be public charities to receive the benefit of preferential deductibility of contributions and because they are less strictly regulated than private foundations. An organization which has received a determination that it is a public charity needs to be vigilant about maintaining that status. Without losing its (c)(3) status, a public charity can inadvertently become a private foundation. If this occurs, there are a few options to escape the consequences.

*By default, the tax code assumes that all 501(c)(3) organizations are private foundations.*

#### Background

By default, the tax code assumes that all 501(c)(3) organizations are private foundations. Organizations which are not private foundations are often called “public charities.” The most common way an organization becomes a public charity is to receive at least one-third of its financial support from “public sources,” typically gifts, grants from the government or other 501(c)(3) public charities, contributions and membership fees. Excluded from this calculation are investment income, business income and the portion of large grants which is more than 2 percent of the organization’s total support.

If an organization’s public support slips below the 33 1/3 percent threshold, it may still qualify as a public charity based on “all the facts and circumstances,” so long as its public support is at or above 10 percent of its total

If public support is under the 10 percent threshold (measured by looking at the four years preceding the year in question), the organization becomes a private foundation. The various requirements imposed on a private foundation immediately apply: 990-PF filing, the 2 percent tax on investment income, complications on certain transactions with disqualified persons, and other complexities. Purposeful private foundations are reluctant to make grants to other private foundations. Three options present themselves.

#### I was wrong, I’ll try to do better ...

The first option is straightforward. If the organization slipped into private foundation status inadvertently—say, a few weak fundraising years—it may apply for an IRS ruling that it is likely to qualify again as a public charity. The ruling covers a five-year period starting the year after the application is filed, and will be based on the organization’s structure, proposed programs and activities,

*Purposeful Private Foundations may be reluctant to return phone calls, as donations to the troubled organization generally no longer count toward their disbursement requirements.*

intended method of operation, and projected sources of support. Donors may rely on this ruling in computing their own taxes, so long as they are not aware of any information that would make recognition unlikely. After the five years are up, if the organization turns out

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# IRS Update

## Accidental Private Foundation

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to be a private foundation based on its sources of support during the ruling period, it will be liable for back reporting, payment of the investment income tax, and subject to the prohibition on any lobbying activities.

### The Sugar Daddy approach

Sometimes the public has lost interest in the organization's issue (say, Free Silver), or perhaps the issue was too esoteric or obscure to attract broad public support. If private support is enough to fund the organization's budget, there is another option.

Accidental private foundations can elect to structure themselves as a "supporting organization." This step requires giving up some independence to a compatible organization, but lets the supporting organization rely on its partner's public support calculation, allowing it to agitate freely on the virtues of bimetallic currency without the onerous consequences of private foundation status.

*Accidental private foundations can regain public charity status as a section 509(a)(3) supporting organization.*

There are three broad types of supporting/supported organization relationships loosely described as: parent-subsidiary, sister organizations, and programmatic interlock. In each case the supporting organization must operate to support or for the benefit of a specific supported organization(s). Generally the relationship is described in the supporting organization's articles of incorporation. Becoming a supporting organization is not a step to take lightly, as the requirements are

exacting and complex, so it is necessary to seek out professional assistance in constructing the arrangement.

### The So-What Approach

As mentioned, the biggest concern for accidental private foundations may be the difficulty obtaining grants from purposeful private foundations.

*If the inadvertent foundation is unconcerned with the other private foundation rules, it may choose to be a private operating foundation.*

If the inadvertent foundation is unconcerned with the other private foundation rules, it may choose to be a private operating foundation. An operating foundation is an organization which spends most of its funds directly for the active conduct of charitable activities (as opposed to making grants to other organizations). Private foundations may make grants to private operating foundations more easily than to other foundations.

### Conclusions

No matter which route an accidental foundation takes, it needs to let donors know what happened and what steps the organization is going to take to rectify the situation. Failure to do so would be a breach of faith with damaging repercussions to the organization's reputation.

This is an extremely complex area of law. Organizations in this situation need to contact a professional to make sure the transition goes smoothly.

# IRS Update

## Oliver North's Group Regains (c)(3) Status

The Freedom Alliance, a conservative nonprofit group founded by Oliver North, recently regained its 501(c)(3) tax-exempt status after having lost its exemption in 1998 for engaging in political activity and serving a private interest. Those who follow carefully the IRS rulings on prohibited political activity by charities were interested that the Freedom Alliance was not sanctioned for criticizing the views of certain incumbents who subsequently became candidates. Now, in characteristic IRS fashion, the letter re-granting the group's tax exemption tries to rebut the inference some readers had drawn: it notes that mention of a person's candidacy may not be necessary to transform a communication into prohibited

political intervention. The letter should remind (c)(3) organizations once again that the IRS interprets the political campaign intervention prohibition very broadly.

*Mention of a person's candidacy may not be necessary for political campaign intervention.*

Last March, the Alliance challenged its exemption revocation in a U.S. district court.

To regain its 501(c)(3) tax exemption, the group had to file a new exemption application and remove its web site, which contained a link to a politically partisan organization, from the Internet.

## Nonprofit Mail, cont.

*Continued from page 3*

community, many do not believe it goes far enough to allow nonprofits to describe membership benefits in mailings. One perceived shortcoming of the new rule is that it only applies to membership solicitations and renewals, not to other types of communications such as periodicals. In addition, the new rule requires that the listing and announcement of benefits be in the form of a letter or a one-sheet list; no other formats, such as flyers, brochures, or other "separate, distinct, or independent documents," are permitted. Finally, adjectives, terms, conditions, and brand names are permitted but only as long as the description is only a "minor part" (defined as "less than half") of the solicitation or renewal request.

The Postal Service does not appear to be willing to address these perceived shortcomings anytime soon.

### Nonprofit postal rate eligibility criteria for membership solicitations:

- Adjectives, terms, conditions, and brand names must be less than 50% of the entire mailing;
- The description of benefits must be in the body of a membership solicitation letter;
- A separate one-sheet document will be considered part of the solicitation letter if the solicitation letter refers to it; and
- Any non-permissible material will make the whole mailing ineligible for nonprofit postal rates.

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# Court Upholds Limits on the Deductibility of Dues Paid to Lobbying Organizations

The U.S. Court of Appeals for the District of Columbia recently issued an opinion rejecting the American Society of Association Executives' (ASAE) constitutional challenge to provisions in the Omnibus Budget Reconciliation Act of 1993 ("OBRA") limiting the deductibility of dues paid to certain exempt membership organizations conducting lobbying activities.

*An exempt membership organization that engages in lobbying can "sidestep" the tax provisions of OBRA by splitting into two organizations, one that lobbies exclusively and one that does not lobby at all.*

Under OBRA, a 501(c)(4), 501(c)(6) or other exempt organization—except a (c)(3) charity—that engages in lobbying activities and is funded in part by membership dues and other contributions must either pay a tax on its lobbying activities (the "proxy tax") or follow "flow through provisions" aimed at making sure no contributor or dues payer takes a deduction for the portion of dues used for lobbying. The proxy tax is imposed at the highest marginal rate of the corporate income tax, now at 35 percent. If the organization chooses the flow through alternative, the law dictates that lobbying expenditures will be considered as paid out of membership dues or other similar amounts to the extent that such revenues exist. The association is required to provide donors with a reasonable estimate of the portion of the dues or contributions that is allocable to lobbying expenditures and inform them that that amount may not be deducted as a business expense.

ASAE's argument that the tax scheme placed a burden on its freedom of expression and discriminated against lobbying associations in favor of individual businesses and individual persons failed to convince the court, which did not address the constitutional issues and instead noted that a business association could "altogether sidestep the specified dilemmas" by "splitting itself into two 501(c)(6) organizations, one that engages exclusively in lobbying on behalf of its members and one that completely refrains from lobbying."

ASAE President and CEO Michael S. Olson was surprised by the decision, commenting that "the ruling did not address our concerns that the current law penalizes associations for exercising their right to petition the government." For now, ASAE intends to review the viability of the court's recommendation that the organization split in two.

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## IRS Eyes Tax Sheltered 403(b)s

The FY 2000 IRS Employee Plans Workplan will include increased scrutiny for 403(b) tax-sheltered annuity plans. Each of the IRS key districts has been asked to open new 403(b) audits: five of public school districts, two of public colleges or universities, and two (non-Coordinated Examination Program audits) of hospitals; in addition, the districts will maintain their regular case inventory. To increase compliance, the EP Division will participate in educational seminars and workshops. Finally, the Treasury and IRS reportedly are working on an update of Rev. Proc. 98-22, which provides guidance on Employee Plans Compliance Resolution System.

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## Getting to Know Harmon, Curran, Spielberg & Eisenberg, LLP

### We are pleased to announce that:

Elizabeth J. Kingsley has become a partner. Many of you are familiar with Beth, who has brought her keen intelligence, sharp analytical skills and superior writing style to address a wide variety of legal issues for the past five years. Like the other members of the firm, Beth focuses on legal issues raised by our client's advocacy agendas. She also specializes in the emerging laws applicable to the Internet and other electronic technologies.

Lynn Westenberg has joined our firm as an associate. Lynn joins us after many years of experience as in house counsel to nonprofit organizations. Most recently she was assistant general counsel at the National Wildlife Federation, where she specialized in tax and intellectual property issues.

We are glad to start the new year with these additions to our team and look forward to continuing our work with you.

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