Skadden

NONPROFIT NOTES

Issue 3 | January 2013

INSIDE

Raising Funds Without Raising Problems: Commercial Co-Ventures and Corporate Sponsorships

Charities are constantly seeking new sources of charitable funds. At the same time, corporations are eager to find new ways to support charities while deriving associated public relations benefits. Corporations increasingly approach charities with ideas for such cause-related marketing. Because of state and federal regulations, however, these ventures must be carefully structured.

National Commercial Co-Venture: A Portion of the Proceeds Goes To …

Commercial co-ventures are widely used charitable promotions that present a win-win scenario for businesses that wish to support charitable causes, gain goodwill and increase sales, as well as for the charities that the businesses choose to support. Although the definition of a commercial co-venture varies slightly from state to state, it generally includes any promotion that represents to the public that the purchase or use of goods or services offered by a business — the commercial co-venturer — will benefit a charitable organization. Currently, more than 20 states regulate the activities of commercial co-venturers and subject commercial co-venturers to various registration, contract, reporting and disclosure requirements. The commercial co-venture rules are designed to protect the charity and the public from false advertising and to make sure that monies claimed to be going to charity actually get there. Although the requirements vary among states, they generally include: (1) a written agreement between the charity and the commercial co-venturer (which may need to be filed with the state); (2) registration requirements (which may include the posting of a bond); (3) disclosure requirements for all advertising materials; and (4) financial recordkeeping and reporting requirements.

Investigation Into Commercial Co-Ventures by New York Attorney General.

Because of the increase in cause-related marketing, this type of charitable solicitation has not escaped scrutiny by regulators. At the end of 2011, the Charities Bureau of the New York State Attorney General's Office (the AG) sent questionnaires to approximately 130 companies and 40 charities involved in cause-related marketing campaigns that represent that a portion of the sale of a product or service will support breast cancer research or screening. The questionnaires requested detailed information about advertising, promised donations, campaign duration and donation limits. As a result of this investigation, the AG released in October a list of five best practices for "Transparent Cause Marketing" designed to increase disclosure to consumers:

1. Clearly Describe the Promotion — Consumers should be provided with key information before making a purchase, including the name

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and mission of the charity, the specific dollar amount per purchase that will go to charity, any caps on the donation, whether any consumer action is necessary to trigger a donation, and the start and end dates of the promotion.

2. Allow Consumers to Easily Determine the Donation Amount — Instead of using vague language like "a portion of proceeds" will go to charity, companies should use a fixed dollar amount or percentage for every purchase in advertisements, marketing and product packaging.
3. Be Transparent About What Is Not Apparent — The AG urges companies to maintain consumers' trust by disclosing information that may not be obvious to them. For example, if using a ribbon, color, logo or other indicia commonly associated with a particular charitable cause, companies should clearly indicate if the purchase of a product or service will trigger such a donation.
4. Ensure Transparency in Social Media — Increasingly, companies are using social media to promote their products and contribute to charities. Companies often make donations to charities when a user "likes" a company on Facebook or follows a company on Twitter. Companies should operate campaigns through social media with the same standards of transparency they would use in traditional promotions.
5. Tell the Public How Much Was Raised — After the conclusion of a promotion, the company should clearly display the amount of the charitable donation generated by the promotion on its website.

Corporate Sponsorship: Brought to You By …

Another popular fundraising tool is corporate sponsorship, where a corporation will support a charitable event in exchange for public acknowledgment of such support, resulting in increased goodwill and exposure for the corporation. As explained below, charities must be careful in structuring and controlling the benefits offered to such corporations. Otherwise, what are intended as charitable contributions may be treated as taxable income to the charity.

Unrelated Business Taxable Income

In general, tax-exempt organizations must pay tax on income received from "trade or business" activities that are "unrelated" to the organization's mission and are "regularly carried on." These rules must be considered when structuring corporate sponsorships such that the Internal Revenue Service (IRS) will not consider the sponsored charity to be providing advertising services — an unrelated trade or business — to the corporate sponsor.

Qualified sponsorship payments: acknowledgment vs. advertising. The IRS has published regulations outlining the requirements for exempting corporate sponsorship payments from the tax on unrelated business activities. The regulations provide that "qualified sponsorship payments" are not subject to the tax on unrelated business income. For a payment to be a "qualified sponsorship payment," there must be no arrangement or expectation that the corporate sponsor will receive any "substantial return benefit" in exchange for making the payment.

If the sponsor receives the benefit of having it or its product advertised, then that is considered a substantial return benefit and the sponsorship payment to the charity will be taxable to the charity. On the other hand, the sponsor is not considered to receive a substantial return benefit merely because the charity acknowledges the sponsor or uses the sponsor's name or logo in connection with the charity's activities. Statements on signs, banners, t-shirts or other locations indicating that a particular corporation is a sponsor of a charity and displaying the corporation's logo would not constitute advertising under the regulations. However, any material distributed by the charity describing the sponsor would have to be carefully crafted so as not to constitute "advertising" under the regulations, which would cause the sponsorship payments to be taxable income. Advertising includes qualitative or comparative language, price information or other indications of savings or value, and endorsements of products or services.

If managed properly, charities may generally enter into sponsorship arrangements with for-profit entities without generating taxable unrelated business income. However, such sponsorships should be governed by a written agreement between the parties setting forth the obligations of the parties and the terms and conditions upon which the sponsorship will be conducted, to ensure that no advertising is provided to the sponsor.

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IRS Issues Clarification Regarding Contributions to Single-Member LLCs

Internal Revenue Code (the Code) Section 501(c)(3) organizations often establish one or more single member limited liability companies (SMLLC), wholly owned and controlled by the 501(c)(3) organization, to assist the organization in carrying out certain activities and operations. Such SMLLCs may be formed for a variety of reasons, including to hold and protect real

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> Two relatively recent New York State Appellate Court decisions have important implications for New York nonprofit corporations that operate nationally or regionally through unincorporated chapters.

estate or other assets and to isolate certain activities that could potentially result in liability for the parent organization. Unless the SMLLC elects to be treated as a corporation, the SMLLC is considered a disregarded entity for most federal tax purposes and its operations and finances are treated as those of the parent organization for tax and information reporting purposes. (The SMLLC is considered to be separate from the parent organization for employment and certain excise tax purposes.)

On July 31, 2012, the IRS issued long-awaited guidance regarding the deductibility of contributions to a domestic SMLLC that is wholly owned and controlled by a Section 501(c)(3) organization. In IRS Notice 2012-52, the IRS confirms that, if all other requirements with respect to the deductibility of contributions under Code Section 170 are met, a contribution to a disregarded domestic SMLLC that is wholly owned and controlled by a Section 501(c)(3) organization will be treated as a charitable contribution to a branch or division of the Section 501(c)(3) organization. An SMLLC is considered a domestic SMLLC if it is created or organized in or under the laws of the United States, a United States possession, a state or the District of Columbia.

In Notice 2012-52, the IRS also confirms that the Section 501(c)(3) organization bears the responsibility for acknowledging the donor's contribution for the purposes of substantiating the contribution under Code Section 170(f) and complying with the disclosure rules for *quid pro quo* contributions under Code Section 6115. The IRS recommends that the Section 501(c)(3) organization disclose in the acknowledgement or other statement that the SMLLC is wholly owned by the organization and treated by the organization as a disregarded entity.

Notice 2012-52 is effective for charitable contributions made on or after July 31, 2012. However, taxpayers may rely on the Notice for charitable contributions made prior to the Notice's effective date for the taxable years in which the taxpayer still may file a claim for a credit or refund of an overpayment of tax under Code Section 6511 (generally, such a claim must be filed within three years from when the return was filed or two years from the time the tax was paid, whichever expires later).

Appellate Decisions Impact NY Nonprofit Chapter Organizations

Nonprofit corporations that operate nationally or regionally through unincorporated chapters typically view such chapters as operational units or divisions within the corporation and not as entities having a legal existence separate from that of the corporation. Accordingly, many such corporations simply identify their chapters as units or divisions of the parent in the corporation's bylaws and/or in a chapter manual or chapter bylaws. In light of the chapters' assumed status as units or divisions of the parent, such governing documents often provide little detail as to the specific rights, privileges, obligations and duties of the parent and chapter, either during the relationship or upon its termination.

Two relatively recent New York State Appellate Court decisions[1] have important implications for New York nonprofit corporations that operate nationally or regionally through such unincorporated chapters. One of these decisions challenges the typical view of the parent/chapter relationship and suggests that simply identifying unincorporated chapters as units or divisions of the parent will not be sufficient to ensure that they are treated as such by the courts. Rather, the level of autonomy granted to the chapter under the governing documents will determine whether or not a chapter is afforded such treatment. Both decisions highlight the importance of clearly defining the relationship between a parent corporation and its chapters, particularly with respect to ownership of assets received, held or managed by a chapter.

In both the *Craine* and *Resource Center* cases, the courts concluded that the provisions set forth in the parent corporation's bylaws, the chapter manual, the chapter bylaws and other documents defining the relationship between the parent corporation and chapter govern the chapter's activities. Such governing documents will be viewed by a court as a contract between the parent corporation and its chapter defining each party's privileges and duties. Accordingly, nonprofit corporations that operate through unincorporated chapters should ensure that the relationship between the corporation and its chapters, including the rights, privileges, responsibilities and obligations of each party, is fully defined in one or more governing documents. Those rules should clearly articulate, at a minimum:

- the parent corporation's authority over the chapter;
- the nature and extent of the chapter's authority over its day-to-day operations;

1 *Craine v. NYSARC, Inc.*, 931 N.Y.S.2d 143 (App. Div. 3d Dep't 2011); *Resource Center v. NYSARC, Inc.*, 905 N.Y.S.2d 806 (App. Div. 4th Dep't 2010).

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- the ownership of assets, including real property, personal property, funds and other assets, received, held or managed by the chapter; and
- the rules governing the disaffiliation or dissolution of a chapter (or other termination of the parent/chapter relationship), including detailed rules addressing the disposition of the various types of assets that chapters may receive, hold or manage.

The chapter's acceptance of, and obligation to act in accordance with, such rules as they may be amended from time to time by the parent corporation should be spelled out in the documents articulating these rules.

Both cases also highlight the importance not only of clearly articulating and documenting the nature of and rules governing the relationship between the parent corporation and its chapters but also ensuring that those rules are implemented and enforced. Parent corporations should have procedures in place to ensure that all chapters are aware of and agree to the rules governing the parent/chapter relationship and are abiding by them. The governing documents also should be reviewed from time to time and, if necessary, updated to ensure that they continue to accurately reflect the parent/chapter relationship.

In the *Craine* case, the Appellate Court also held that an unincorporated chapter of a nonprofit corporation had sufficient "separate legal existence" to be considered an unincorporated association and, as such, had capacity to sue its parent corporation. In reaching this decision, the Court reviewed the documents governing the relationship between the parent and chapter — the parent corporation's bylaws, chapter bylaws and chapter manual — focusing on the autonomy granted to the chapter pursuant to those documents. To determine that the chapter had sufficient "separate legal existence" to be considered an unincorporated association, the court looked at "markers of autonomy," including the fact that the chapter:

- elects its own board of directors and officers;
- has its own EIN, state operating licenses and tax exempt status;
- files its own fiscal reports and tax returns and maintains its own bank accounts;
- hires, trains and pays its own employees; and
- operates its own programs and purchases real property from its own revenues, independent of any financial contribution from the parent.

In light of this decision, New York nonprofit corporations operating nationally or regionally through unincorporated chapters or other units of the corporation should review the documents governing their relationships with their chapters to assess the likelihood that their chapters would be viewed as having a legal existence separate from that of the parent corporation. The greater autonomy that a chapter is granted over the chapter's day-to-day operations, the greater the chance that such chapter would be viewed by a court as having a legal existence separate from that of the parent. As noted above, simply identifying chapters in the governing documents as units or divisions of the parent will not be sufficient to avoid that result.

Nonprofit corporations may wish to assess whether and to what extent it is in their best interests to curtail the scope of authority they grant to their chapters, taking into account that, in certain respects, doing so could lead to less efficient day-to-day management of their chapters. Such corporations also may wish to consider adding provisions to the governing documents that limit a chapter's authority to bring any legal action without approval of the parent corporation, should the chapter be viewed as having a legal existence of its own.

In our experience, nonprofit corporations operating nationally or regionally through unincorporated chapters often do not adequately document the nature of the parent/chapter relationship in organizational documents, nor do they regularly review those organizational documents to ensure that they are updated as the parent/chapter relationship evolves. The *Craine* and *Resource Center* cases suggest that failure to engage in such "corporate housekeeping" may pose serious risks to organizational integrity. To mitigate those risks, parent corporations should clearly document their rules governing the parent/chapter relationship and ensure that such rules, in addition to being implemented and enforced, are updated as needed.

We would be happy to assist you should you have any questions regarding the impact of these cases on your organization's structure or operations.

The Emergence of Hybrid Models With Dual Purposes: Doing Well While Doing Good

During the last two decades, we have seen a new movement around the country in support of sustainable, or socially or environmentally responsible, businesses. One of the outgrowths of this national

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trend is the emergence of hybrid companies that have a "dual purpose" — for profit companies that are permitted to pursue both financial returns for their shareholders as well as social or environmental objectives. Examples of such hybrids include the benefit corporation, the flexible purpose corporation and the low-profit limited liability corporation (L3C).

Rationale for the Hybrid Form

Traditionally, there has been a clear separation between the primary mission of for-profit and nonprofit corporations. Although conventional for-profit corporations have been known to support environmental or socially beneficial causes, these activities must advance their shareholders' long-term economic interests or else their directors and officers may face legal liability. In contrast, a traditional nonprofit corporation's primary legal objective must be achievement of a social or public benefit.

For-profits and nonprofits also have divergent approaches to raising revenue. For-profit corporations sell shares or memberships, may seek equity investors to partner with and may distribute profits to their owners. However, their profits are taxed, and they are not eligible for tax-deductible contributions. On the other hand, since nonprofits generally do not have owners and are prohibited from distributing profits, equity capital is not available to them. Nonprofits that qualify for tax exemption as organizations described in Section 501(c)(3) of the Internal Revenue Code have the advantage of being eligible for tax-deductible contributions, but this eligibility comes with regulation of their activities, including reasonable compensation standards, among other things.

The benefit corporation, the flexible purpose corporation and the L3C are designed to bridge this historical divide. These organizations are typically for-profit entities, but they offer liability protection to directors and officers who sacrifice corporate profits in favor of social or environmental objectives. In addition, according to proponents, these models also expand the pools of funds that social enterprises may tap into by giving social enterprises access not only to conventional capital markets but also to socially motivated funding sources. Set forth below is a brief description of some of the typical features of these three models.

Unlike benefit corporations, a flexible purpose corporation is not obligated to assess its performance against any third-party standard.

1. The Benefit Corporation

Benefit corporations are required to pursue and identify in their articles of incorporation a "general public benefit," which is defined as a "material, positive impact on society and the environment, taken as a whole." A benefit corporation also may identify and pursue one or more narrowly defined "specific public benefits," though doing so is not a requirement. In considering the best interests of a benefit corporation, directors must consider certain nonfinancial stakeholders and the ability of the corporation to accomplish its public purposes, as well as the financial interests of its shareholders.

Benefit corporations must adhere to an independent third-party standard for defining, reporting and assessing their social and environmental accomplishments. To preserve their status, benefit corporations must complete annual comprehensive assessments, measured against the third-party standard, of the corporation's impact on society and the environment. These "benefit reports" must be delivered to shareholders and disclosed on the web. Benefit corporation statutes typically do not identify organizations that develop and make available such third-party standards. However, there are several well-known organizations that have served this purpose, including B Lab, Green America and the Global Reporting Initiative.

The benefit corporation is currently available in California, Hawaii, Illinois, Louisiana, Maryland, Massachusetts, New Jersey, New York, Pennsylvania, South Carolina, Vermont and Virginia. Legislation to enact the benefit corporation is still pending in other states, including Michigan and Washington, D.C.

2. The Flexible Purpose Corporation

The flexible purpose corporation is a structure that is currently only available in California, though this concept is under consideration in Colorado.

According to the authors of the California statute, the flexible purpose corporation was structured to meet the needs of larger, often public companies interested in a safe harbor to pursue special purposes other than maximizing shareholder value. It is structured to allow companies more flexibility in their pursuit of such purposes than is possible under other structures.

Unlike benefit corporations, a flexible purpose corporation is not required to identify a broad, general public benefit. Instead, it need only specify at least one "special purpose" that it will pursue, which may be narrowly defined and limited in duration. Such special purpose(s) must be described in its articles, and must comply with certain guidelines set forth in the statute. These guidelines require that the special purpose(s) fall under one or more of the following umbrellas: (1) one or more charitable objectives that a nonprofit is

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authorized to carry out; or (2) promoting positive short- or long-term effects of — or minimizing adverse short- or long-term effects of — the corporation's activities on its employees, customers, suppliers, community, society or the environment. In discharging their duties, directors of a flexible purpose corporation may, but are not required to, consider factors that they deem relevant, such as the short- and long-term prospects of the corporation, the best interests of the corporation and its shareholders, and the purposes of the corporation as set forth in its articles.

Unlike benefit corporations, a flexible purpose corporation is not obligated to assess its performance against any third-party standard. However, a flexible purpose corporation must deliver to shareholders, and publish on its website, detailed annual and current reports regarding its special purposes, and, if requested, must provide financial information to certain shareholders. A flexible purpose corporation with fewer than 100 shareholders need not comply with certain of these reporting requirements if its shareholders elect to waive them.

3. The Low-Profit Limited Liability Corporation (L3C)

The L3C possesses many characteristics of a traditional limited liability company, except that it is not primarily concerned with making money. An L3C's primary purpose, which must be identified in its articles, must be charitable or educational, with profit as a secondary goal.

The L3C was specifically structured to make program-related investments (PRI) easier for private foundations. Many foundations avoid making PRIs because the legal requirements can be complex and failure to comply may result in the imposition of excise taxes. To address these concerns, a foundation may secure a legal opinion that a proposed investment will qualify as a PRI. However, this is an expensive and time-consuming process. The IRS has not yet ruled on whether investments in L3Cs will automatically qualify as PRIs.

For the first time since the 1970s, however, in April 2012, the IRS proposed new regulations on PRIs. These proposed regulations add nine new examples of acceptable PRIs, along with several general principles. Included as general principles are: (1) the existence of a high potential rate of return on an investment does not, by itself, prevent the investment from qualifying as a PRI; (2) the recipients of PRIs need not be within a charitable class if they are the instruments for furthering a charitable purpose; and (3) PRIs can be achieved through a variety of investments, including equity investments in for-profit organizations. According to proponents of the L3C, if foundations were to invest in L3Cs, their doing so may incentivize social entrepreneurs and traditional private investors to invest in L3Cs as well.

> The social impact bond has a hybrid structure that allows private investors to partner with social enterprises to finance solutions to social problems, and potentially receive a return on their investment.

Unlike benefit corporations, there is no requirement that an L3C's charitable activities be assessed by a third-party standard. In addition, unlike benefit corporations and flexible purpose corporations, L3Cs are free to determine the extent to which they report their activities to the public.

So far, legislation creating the L3C has been enacted in a number of states, including Illinois, Louisiana, Maine, Michigan, North Carolina, Rhode Island, Utah, Vermont and Wyoming. A number of other states currently are considering similar legislation, including California, Georgia, Hawaii, Iowa, Massachusetts, New York and Oklahoma.

New Hybrid on the Horizon

We would be remiss if we concluded without mentioning a recent development in this trend toward hybrid structures that is garnering considerable interest in the philanthropic world: the social impact bond. Unlike the structures we discuss above, the social impact bond is a financial instrument as opposed to a corporate form. However, like the hybrid entities discussed above, the social impact bond has a hybrid structure that allows private investors to partner with social enterprises to finance solutions to social problems, and potentially receive a return on their investment.

The typical social impact bond involves a contract between a government agency and a private-sector organization in which the government's payment for services is entirely conditioned on the program achieving measurable, positive social outcomes. In some cases, the private-sector organization may need private investors to cover up-front capital, including the operating costs of service providers (typically nonprofits) who will actually deliver the services. In such cases, the private-sector organization acts as an intermediary between such service providers and the private investors, who, in exchange for paying upfront costs, receive a share of the government payments that become available if the performance goals are met. If the performance goals are met, these investors would be repaid their principal and a rate of return, which may be structured on a sliding scale — the more positive the outcome, the higher the return, up to an agreed cap. According

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to proponents, social impact bonds are particularly designed to fund prevention and early intervention programs that decrease the need for subsequent and more costly remediation services.

New York City recently announced its launch of one of the first social impact bond agreements to be executed in the United States. The city contracted with MDRC, a nonprofit social research organization, to reduce the recidivism rate by at least 10 percent over four years among adolescent males released from incarceration at Rikers Island. To achieve the performance target, MDRC will manage two nonprofit service providers — the Friends of Island Academy and the Osborne Association. Operating costs are being provided by Goldman Sachs through a $9.6 million loan to MDRC. In a feature unique to this agreement, Bloomberg Philanthropies will provide a $7.2 million loan guarantee to MRDC to back the loan from Goldman Sachs. If recidivism is not reduced by at least 10 percent, MDRC can use this loan guarantee to repay Goldman Sachs a portion of its principal. Goldman will be repaid its full principal of $9.6 million if the program reaches the 10 percent target and will profit up to $2.1 million if the success of the program exceeds the target. The Vera Institute of Justice will evaluate the results of the program to determine whether MDRC has achieved the recidivism target.

Recent reports have announced that the federal government; Connecticut and Massachusetts; Cuyahoga County, Ohio; and Fresno, California, also are introducing or considering social impact bonds.

Preliminary Results of 990 Governance Check Sheets

On April 19, 2012, Lois Lerner, the director of exempt organizations for the Internal Revenue Service (IRS), announced the preliminary findings from the IRS' governance check sheets (IRS Form 14114) to attendees of an educational conference sponsored by the Georgetown University Law Center. The findings support the direct relationship between an exempt organization's good governance practices and its compliance with the tax code — a correlation that the IRS long has promoted. Revenue agents have been completing these governance check sheets following every examination of a 501(c)(3) public charity since October 2009. The findings, taken from over 1,300 check sheets, reveal the connection between certain indicators of good corporate governance and tax compliance. Much of the information requested on the check sheets tracks the questions in Part VI of the IRS Form 990.

In her comments, Ms. Lerner emphasized that the results of the study are preliminary as the data came from organizations that were already selected for exam for reasons unrelated to their governance structure — that is, not from a statistically representative survey of the exempt organization population. While not every question showed a positive correlation between governance and tax compliance, a statistically significant correlation was revealed for:

- Organizations that have a written mission statement,
- Organizations that always use comparability data when making compensation decisions,
- Organizations that have procedures in place for the proper use of charitable assets, and
- Organizations where the Form 990 was reviewed by the organization's entire board of directors.

Ms. Lerner brought the audience's attention to the last item, stating that it "indicates that having your entire board engaged in what is being reported on the 990 is not only helpful, but it correlates to better compliance."

Conversely, Ms. Lerner reported that among the organizations examined, those that said control was concentrated in one individual or a small, select group of individuals, were <u>less</u> likely to be tax-compliant.

Recognizing the limitations of a study not based on a statistically representative survey of the exempt organization population, Ms. Lerner has asked her strategic planning group to verify whether the information from this select group also is true for the larger exempt organizations population. Still, she believes that the results seem "to be generally consistent with the premise that good governance and tax compliance go hand in hand."

The results of this initial study provide the IRS with further support of their proposition that good governance practices enhance the likelihood of compliance with the tax code. With new confidence in this correlation, the IRS may push organizations to enhance their governance practices by, among other things, drafting a written mission statement, adopting procedures for the proper use of charitable assets and having their board of directors not simply receive, but also review, their Form 990 prior to filing.

Oversight Subcommittee Examines Nonprofits

In May and July 2012, the House Ways and Means Subcommittee, led by Chairman Charles Boustany (R-LA), held the first two of what will be a series of hearings on tax-exempt organizations. Expert testimony from the hearings of representatives from the Internal Revenue Service (IRS) and nonprofit organizations, as well as exempt organization lawyers and professors, provides insight into the issues on which the various players — IRS, Congress and the nonprofit sector — are focused.

The May hearing included testimony on:

- the IRS compliance initiative related to universities;
- reporting requirements for tax-exempt hospitals;
- good governance standards for tax-exempt organizations; and
- the redesign of the Form 990.

Discussions of good governance and the existing transparency of the nonprofit sector dominated the hearing and seemed to be used by the witnesses to urge Congress to pass only tax reform measures that would

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help, and not burden, the nonprofit sector. Diana Aviv, president and CEO of the Independent Sector (a national leadership network for nonprofits) testified to the greatly increased number of nonprofits adhering to published best practices as evidence of the sector's good governance.

The July hearing focused on:

- the increased complexity of public charities;
- the rules governing unrelated business income tax; and
- whether the redesigned Form 990 promotes increased compliance and transparency.

The discussion of the increased complexity of public charities explored how the IRS can best respond to, and keep on top of, these changes. In questioning, concerns were raised about whether the IRS is equipped to handle and adequately oversee this ever-changing landscape of nonprofits. Steven T. Miller, deputy commissioner of services and enforcement for the IRS, suggested that the IRS Application for Recognition of Exemption (Form 1023), which has been in its current form since June 2006, might be revised as the Form 990 has been in order to expand the information gathered by the IRS from organizations seeking tax exemption. Mr. Miller also discussed challenges faced by the continually shrinking Exempt Organizations (EO) division of the IRS, which continues to lose funding and agents while the sector grows in size and complexity. There seemed to be an underlying tension between, on the one hand, the need to reassure lawmakers that the IRS is sufficiently staffed to maintain adequate oversight over the nonprofit sector and, on the other hand, the desire to quietly bid for more resources to be allocated to the EO office.

Another major topic of the hearings that is a natural outgrowth of the increasingly complicated and sophisticated nonprofit world is unrelated business taxable income (UBIT). In general, tax-exempt organizations must pay tax (at corporate tax rates) on income received from trade or business activities that are both unrelated to the organization's mission and carried on regularly. University of Illinois College of Law Professor John D. Colombo testified about what he sees as the confused and contradictory rules governing UBIT, particularly the question of whether an activity is related or unrelated to an organization's charitable mission. Professor Colombo gave examples of the types of commercial activities — activities that might also be conducted by businesses — in which charities engage, such as performance ticket sales and housing construction, and discussed the confused treatment of such activities by the IRS and courts. He suggested several different alternatives for reform, including taxing all commercial activities of tax-exempt organizations, whether "related" to the organization's charitable purposes or not, as a way to prevent unfair competition by nonprofits. The topic of UBIT also was pursued with Mr. Miller by Chairman Boustany. Mr. Miller acknowledged that the relatedness issue is "remarkably difficult" and a "soft sort of issue" but that the IRS currently lacks the resources to work on and revise the UBIT regulations despite a great need to do so.

The topic of the increasingly complex Form 990 continued to be discussed at the July hearing, as did the currently controversial §501(c)(4) social welfare organizations. Following testimony by Mr. Miller on §501(c)(3) organizations and the IRS Exempt Organizations office, questions repeatedly returned to §501(c)(4)s, indicating that those entities continue to be a cause for concern in Washington. It was clear from the representatives' questions to Mr. Miller that a specific interest exists surrounding the political activities of §501(c)(4) organizations and how the IRS will monitor and respond to such activities.

IRS Begins Voluntary Compliance Check of Central Organizations Holding Group Exemption Rulings

The Internal Revenue Service (IRS) recently sent a "Group Rulings Questionnaire" to more than 2,000 randomly selected central organizations holding group exemption rulings. The information gathered from the completed questionnaires is intended to assist the IRS to better understand the relationships between central organizations and their subordinates and how such organizations satisfy the group ruling exemption and annual filing requirements. The impetus for this initiative is a set of recommendations in a June 2011 report by the IRS Advisory Committee on Tax Exempt and Government Entities (ACT).

Under the current rules governing group exemptions, an organization, generally referred to as the "central organization," may request and obtain recognition of tax-exemption for a group of organizations that are affiliated with and under the general supervision or control of the central organization. The group exemption option is available to any central organization recognized as tax-exempt or seeking recognition of tax-exemption as an organization described under Section 501(c) of the Internal Revenue Code (the Code) and, accordingly, a central organization may be, among others, a public charity, social welfare organization, business league, labor organization, social club or fraternal organization. Only the central organization requesting the group exemption ruling is required to submit an application for recognition of tax-exemption to the IRS.

All of the affiliated organizations, typically referred to as "subordinate organizations," must be exempt under the same paragraph of Code Section 501(c). However, no subordinate may be a private foundation or organized and operated in a foreign country. If the group exemption is granted, the central organization may add similar subordinate organizations to its group exemption, as well as remove from its group exemption subordinate organizations that no longer meet the group exemption requirements. Central organizations, with the exception of churches, must notify the IRS annually of any additions to or

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deletions from their group exemption. While both the central organization and its subordinate organizations generally are required to comply with the applicable IRS annual reporting requirements, a central organization, in addition to filing its own annual return, if required, may file a group return on behalf of its subordinate organizations that elect to file on a group basis.

While the ACT report recommends that group exemptions be retained, it also suggests a number of changes to the current group exemption rules and procedures in order to enhance transparency, accountability and responsibility by central and subordinate organizations. These recommendations include, among others, (1) eliminating the option to file group returns; (2) providing guidance to central organizations on the level of on-going general supervision or control that they must exercise over their subordinates; and (3) requiring group exemption holders to disclose on their annual returns information regarding the composition of their group and how the central organization exercises general supervision or control over its subordinate organizations.

The central organizations selected to complete the Group Rulings Questionnaire have already received letters from the IRS explaining the purpose of the questionnaire and providing instructions for completion of the questionnaire, which must be completed online. An organization has 60 days from the date of the IRS letter to complete and submit the questionnaire, although additional time to do so may be requested from the IRS. The IRS notes in its website materials that completion of the questionnaire is "optional but encouraged."

The Group Rulings Questionnaire is comprised of 80 questions relating to the central organization's practices and procedures with respect to: (i) including subordinates in, and removing subordinates from, the group ruling; (ii) governance and supervision of subordinates; (iii) communication with subordinates; (iv) the provision of services and financial support to subordinates; and (v) completing the annual group exemption update. The questionnaire also seeks information regarding the manner in which the central organization and its subordinates satisfy IRS annual reporting requirements.

The IRS also has indicated that, in addition to conducting this compliance check, it will expand its efforts to educate central and subordinate organizations regarding group exemption requirements.

Issuance of Type III Supporting Organization Regulations

In December 2012, the Internal Revenue Service (IRS) released final, temporary and proposed regulations affecting Type III supporting organizations and the organizations they support. The regulations became effective as of December 28, 2012, and reflect changes to the law made by the Pension Protection Act of 2006.

Based largely on comments received, the regulations make several revisions and clarifications to the 2009 proposed regulations on this subject, including, most notably, the following:

Significant Voice Responsiveness Test

The final regulations provide that all Type III supporting organizations must, among other requirements, satisfy what is known as the "significant voice" responsiveness test. To satisfy this test, the organization must (1) demonstrate one of three necessary relationships between its officers, directors or trustees and those of its supported organization(s) and (2) show that this relationship results in the officers, directors or trustees of the supported organization having a significant voice in directing the use of the income and assets of the supporting organization.

Definition of 'Functionally Integrated'

Like the 2009 proposed regulations, the final regulations provide that one way for a Type III supporting organization to be deemed functionally integrated, and thus not subject to a distribution requirement, is if it engages in activities substantially all of which directly further the exempt purposes of the supported organization(s) to which it is responsive by performing the functions of, or carrying out the purposes of, such supported organization(s) and which, but for the involvement of the supporting organization, would normally be engaged in by the supported organization(s). The IRS likens direct furtherance activities in this context to the similar concept used in defining private operating foundations as conducting direct charitable programs rather than, for example, grantmaking, which is an indirect way of furthering an exempt purpose.

Proposed Payout Requirements for Type III Supporting Organizations That Are Not Functionally Integrated

The 2009 proposed regulations provided that a non-functionally integrated (NFI) Type III supporting organization annually would have to distribute a "distributable amount" equal to 5 percent of the fair market value of its non-exempt-use assets. The Treasury Department and the IRS have now proposed a lower percentage equal to the greater of 85 percent of adjusted net income or 3.5 percent of the fair market value of the supporting organization's non-exempt-use assets. Because this distributable amount is significantly different than the distributable amount described in the 2009 proposed regulations, the Treasury Department and the IRS have issued the provisions describing the distributable amount as temporary and proposed regulations to provide an opportunity for comment.

Reliable Tools to Research Exempt Organizations

Exempt Organizations Select Check

The Internal Revenue Service (IRS) has launched a new online search tool, Exempt Organizations Select Check (Select Check), which allows users to more easily find

This new tool combines three former IRS search sites into one, providing an expanded and more efficient search capability.

important information about tax-exempt organizations. This new tool combines three former IRS search sites into one, providing an expanded and more efficient search capability. Users are now able to go to IRS.gov, choose a tax-exempt organization and check to see if an organization:

- is eligible to receive tax-deductible charitable contributions and whether the organization is a public charity or private foundation;
- has had its federal tax exemption automatically revoked for not filing a Form 990-series return or notice for three consecutive years; or
- has filed a Form 990-N annual electronic postcard (tax-exempt organizations whose annual gross receipts are normally $50,000 or less may file a postcard instead of filing a Form 990 or Form 990-EZ).

Select Check improves upon Pub. 78 (Cumulative List of Organizations Described in §170(c) of the Internal Revenue Code) in several ways. Data is updated monthly rather than quarterly and users can search by Employer Identification Number (EIN). Additionally, it is now possible to search for organizations that have lost their tax exemptions by EIN, name, city, state, zip code, exemption type and revocation posting date, rather than just by state. To help users understand the significance of auto-revocation search results, Select Check provides pop-up help text, including the meaning of and distinctions between revocation effective dates and revocation posting dates. In addition to searching for a particular organization, users can download complete lists of the three types of organizations listed above.

To use Select Check, visit IRS.gov, click on "More" under the "Tools" heading and then click on "Exempt Organizations Select Check" under the "Other Helpful Tools" heading. Alternatively, searching "select check" on IRS.gov will bring up the correct link as the first result.

Exempt Organizations Select Check and the Reliance Rules for Contributors (Rev. Proc 2011-33)

In June 2011, the IRS published Rev. Proc. 2011-33, Updated Reliance Rules for Contributors, which provides the extent to which contributors and foundation grantors may rely on the listing of an organization in Pub. 78, or on the IRS Business Master File (BMF), for purposes of deducting contributions under Internal Revenue Code (the Code) §170 and for purposes of making grants. Rev. Proc. 2011-33 was issued prior to the introduction of Select Check. Because the new Select Check tool contains all Pub. 78 data, the IRS has assured contributors and grantors that they can rely on either Select Check or the BMF to determine whether contributions to an organization are deductible and to confirm an organization's classification as a public charity or private foundation.

When the IRS revokes a ruling or a determination letter previously issued to an organization included in Pub. 78 or the BMF, grants and contributions made to the organization by persons unaware of such change in the organization's status generally will be considered as made to the type of organization listed if the contribution is made on or before the date of an appropriate public announcement stating that the organization ceases to qualify as an organization eligible to receive deductible contributions. Publication may be in the Internal Revenue Bulletin, on the IRS.gov website or by such other means designed to put the public on notice of the change in the organization's status.

With regard to an organization's public charity status under Code §509(a)(1), (2) or (3), grantors and contributors may rely on the classification of an organization listed in or covered by Pub. 78, which has been incorporated into Select Check, or the BMF for such purpose to the same extent as for deductibility purposes. This includes whether a Code §509(a)(3) organization is a Type I, Type II, Type III or Type III functionally integrated supporting organization. Private foundations and sponsoring organizations of donor-advised funds may rely on an organization's foundation status (or supporting organization type) set forth in Pub. 78 or the BMF for grant making purposes except where the grantor (1) had knowledge of the revocation of the ruling or determination letter classifying the organization; or (2) was in part responsible for, or was aware of, the act or the failure to act that gave rise to the revocation of the ruling or determination letter classifying the organization.

GuideStar

GuideStar USA, Inc. (GuideStar) remains another useful online source for gathering information about nonprofits. GuideStar is itself a 501(c)(3) public charity, whose mission is to provide information that advances transparency in the nonprofit sector and encourages charitable giving. GuideStar's website contains comprehensive, up-to-date data on more than 1.8 million nonprofits and provides much of it at no cost. Users can register for free at www.guidestar.org to access information about a nonprofit's programs, leadership and financial data and to view a recent IRS Form 990 (Annual Information Return). For more robust search capabilities, users can subscribe to GuideStar Premium, which, among other things, provides more in-depth information about an organization's operations and allows users to create downloadable comparisons of various nonprofits.

For a separate fee, GuideStar's Charity Check tool enables users to keep track of information about certain organizations by sending alerts regarding automatic revocations of exemption and changes in IRS classification. Charity Check also indicates if an organization is a subordinate organization and provides links to its parent organization's reports. Additionally, Charity Check can be used to identify supporting organizations and, where available, the type classification of a supporting organization using the IRS' BMF data.

All of these search tools create efficiencies for those working in the nonprofit world as well as for prospective donors looking to vet organizations for compliance.

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