ASSOCIATION TAX COMPLIANCE GUIDE

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Resources -
Lobbying & 501c3/501c6

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will be permanently dedicated to a permissible tax-exempt purpose, the articles of organization must contain a provision ensuring their distribution for such purposes in the event of dissolution. If a named beneficiary is to be the distributee, it must be one that would qualify and would be tax-exempt under Section 501(c)(3) at the time of the dissolution. Since the named beneficiary at the time of dissolution may not be so qualified, may not be in existence, or may be unwilling or unable to accept the assets of the dissolving organization, a provision should be made for the distribution of the assets for one or more permissible tax-exempt purposes in the event of any such contingency.

Operational Test

The operational test examines whether the organization's activities and operations are consistent with Section 501(c)(3) and the Treasury regulations thereunder. The requirement in the operational test that the organization be operated exclusively for tax-exempt purposes has been defined by the IRS to permit a 501(c)(3) organization to engage in some activities that are not related to its tax-exempt purposes (as stated above, "exclusively" has been defined by the IRS as "primarily"). Such unrelated activities will not disqualify the organization from 501(c)(3) status so long as they do not constitute a substantial part of the organization's overall activities. However, income derived from certain unrelated activities may be subject to federal corporate income tax (see Section II.).

Private Benefit and Private Inurement

A 501(c)(3) organization is not operated for charitable purposes if it serves a private interest. In other words, the activities of the organization must not be conducted for the benefit of a private individual. Furthermore, in order to be recognized under Section 501(c)(3), "no part of the net earnings of" the organization may "inure to the benefit of [a] private shareholder or individual." For a full discussion of the prohibition on private benefit and private inurement with respect to 501(c)(3) organizations, see Section VII.B.

Limitations on Lobbying Activity

An organization will not qualify for tax exemption under Section 501(c)(3) if it devotes a substantial part of its activities to lobbying, propaganda, or attempting to influence legislation. For a full discussion of these limitations on lobbying activities, see Section VII.A.

Prohibition on Political Campaign Activities

A 501(c)(3) organization is prohibited from participating or intervening in any political campaign. A 501(c)(3) organization will lose its tax-exempt status if it participates or intervenes in a political campaign on behalf of, or in opposition to, a candidate for federal, state, or local office. Unlike the limitations on lobby-
IV
Lobbying Tax Law

A. OVERVIEW

In the Omnibus Budget Reconciliation Act of 1993 (OBRA '93), Congress declared that taxpayers no longer will be allowed to deduct for federal income tax purposes the expenses that taxpayers incur when they engage in lobbying. Tax deductibility also is disallowed by this law for a portion of membership dues paid to trade, professional, and similar membership associations if the associations engage in more than minimal amounts of lobbying.

1. Nondeductibility of Membership Dues

A percentage of each member’s dues is rendered nondeductible based on the relationship of the total dues and similar income of the association to the association’s total lobbying expenditures as defined in the law and Treasury regulations. An association that incurs lobbying expenditures must advise members at the time of dues assessment or payment what portion of their dues is nondeductible, and it must annually report to the IRS regarding lobbying expenditures and dues nondeductibility. As an alternative to notifying members of dues nondeductibility, an association can pay at the end of the year a flat 35% proxy tax on its annual lobbying expenditures.

2. In-house Lobbying Exception of $2,000

The exception for minimal lobbying expenditures is narrowly tailored. It exempts associations from the dues nondeductibility (or proxy tax) provisions only if in-house lobbying expenditures are $2,000 or less annually (for example, labor and material costs but with no need to include a general overhead amount). Amounts paid to engage outside lobbyists or lawyers, dues or other payments made to other organizations that lobby, grassroots lobbying expenditures, political expenditures, and foreign lobbying expenditures do not qualify
for this $2,000 exception; any amount of such expenditures triggers the dues nondeductibility (or proxy tax) provisions.

3. Determination of Lobbying Expenditures

The key to associations' compliance with the law is the determination of lobbying expenditures, which affects the amount of either members' dues that is nondeductible or the proxy tax. The information necessary to make such determinations is set forth below in the form of a lobbying tax compliance guide for association employees.

4. "Paid" Volunteers

The costs of "paid" volunteers to associations are allocated to whomever makes the payments. If the association pays the volunteers (such as reimbursing them for their travel and other expenses), the costs are attributed to the association. If the volunteers' employers pay them (such as for salaries as well as their expenses), the costs are attributable to the employers, not to the association.

5. Cost Allocation Methods

Treasury regulations provide detailed guidelines for allocating an association's costs to lobbying, including three illustrative, but not mandatory, cost allocation methods. The regulations also expressly permit the use of any reasonable cost allocation method. To be reasonable, the method must (1) be consistently applied; (2) allocate a proper amount of costs to lobbying activities (including labor costs, general and administrative costs, and outside third-party costs); and (3) be consistent with the specific rules provided in the regulations for de minimis activities. Of particular note is a de minimis rule that staff time spent on lobbying activities may be considered zero if it is less than 5% of that person's total overall time (although employees' direct contact lobbying time (defined to include meetings, telephone conversations, letters, and other similar means of communication) may not be apportioned to the 5%). Note also that if an association uses either the "Ratio" or the "225% Gross-Up" cost allocation method set forth in the regulations, then it may treat as zero the lobbying labor hours of staff engaged in secretarial, clerical, support, or other administrative activities that do not include significant judgment with respect to lobbying.

6. Dues and Similar Amounts

Once lobbying expenditures and the additional costs are determined, they are allocated to dues income from association members to determine the percentage of members' dues that are nondeductible, or, alternatively, they provide the basis for the 35% proxy tax. The IRS has offered these definitions with re-
spect to dues and similar amounts to which lobbying expenditures are allocated.

- Annual dues: The amount an organization requires a person, family or entity to pay to be recognized by the organization as a member for an annual period.
- Similar amounts: (1) voluntary payments made by persons, families, or entities; (2) assessments made by the organization to cover basic operating costs; and (3) special assessments imposed by the organization to conduct lobbying activities. Note that voluntary payments are not limited to those from members, but special assessments are limited to those made for lobbying activities.
- Member: Not limited to those with voting rights in the organization.

7. Reporting to the IRS

An association must report annually to the IRS the total amount of lobbying expenditures and the total amount of dues and similar income to which the lobbying expenditures are allocable to determine dues nondeductibility. Lobbying expenditures incurred in a year are allocated against dues and similar income received during the same year. If lobbying expenditures exceed dues and similar income, the excess is carried forward to increase dues nondeductibility for future years.

8. Notification to Members

In addition to IRS reporting, the association must advise members (and other contributors) of dues nondeductibility. The association must provide a notice to each person, family, or entity making payments of dues or similar amounts at the time of assessment or payment (e.g., on the dues invoice, on a dues receipt) of the portion of the dues or similar amounts that the association reasonably estimates will be nondeductible due to lobbying expenditures. The notice must be in a conspicuous and easily recognizable format.

9. Underestimation and Overestimation of Lobbying Expenditures

If the dues nondeductibility amount for which notice is provided proves to be too low, the association must pay the 35% proxy tax on the deficiency balance or seek IRS permission to carry forward the underestimated amount to future years’ nondeductibility notices. With respect to overestimated lobbying expenditures, the legislative history to OBRA ’93 directs the Treasury Department to issue regulations governing the treatment of associations that incur actual lobbying expenditures below the estimated amount. To date, such regulations have not been proposed or issued.
10. Elective Proxy Tax

As an alternative to disclosing what portion of dues is nondeductible because of lobbying expenditures, the association may elect to pay a proxy tax on the total amount of its lobbying expenditures (up to the amount of dues and similar payments received by the association) during the year. Any excess of lobbying expenditures over dues and similar payments is carried forward to the next year. The proxy tax is payable at the highest corporate income tax rate of 35% and reportable on Form 990-T, otherwise used as a tax return for unrelated business income taxation.

B. MODEL LOBBYING TAX COMPLIANCE GUIDE FOR ASSOCIATION EMPLOYEES

What follows is a model lobbying tax compliance guide for employees of a trade or professional association. It is association employees, more than anyone else, who must have a full understanding of exactly what is and is not considered a lobbying activity under the law, in order to accurately track and record their time devoted to lobbying activities. The model time log found in Appendix A is designed to be used in this regard. The capitalized term ASSOCIATION is used in this guide in place of an actual association name.

1. Overview

The Omnibus Budget Reconciliation Act of 1993 (OBRA '93) contained provisions that eliminated the business deductibility of lobbying expenses for federal income tax purposes. The law also contained special rules that render association membership dues nondeductible by members to the extent of associations' expenditures for lobbying (including compensation paid to ASSOCIATION employees).

This guide is designed to assist ASSOCIATION employees in recording their daily time spent on lobbying activities, in accordance with OBRA '93. This is important because ASSOCIATION's calculations of annual membership dues nondeductibility are determined in large part by the number of hours (and corresponding salary allocation) spent by ASSOCIATION staff on what the law defines as lobbying. Consequently, it is critical for staff to have a thorough understanding of what should and what should not be recorded as lobbying when completing daily time logs. This guide is designed to serve that function.

2. Time Logs

The attached time log is to be used by certain ASSOCIATION employees for recording daily activities under three general categories: (1) lobbying (as defined below); (2) regulatory nonlobbying (as described below); and (3) other (all activities that do not fall into the first two categories).
Guidebook for Directors of Nonprofit Corporations

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Committee on Nonprofit Corporations

Editors
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Section of Business Law
American Bar Association
A director should not assume that because the corporation is nonprofit it is exempt from any income tax whatsoever. Tax-exempt status is a privilege, not a right, which is conferred on an organization that meets and continues to meet certain requirements set out by the Code. Other than churches and very small organizations, organizations seeking exemption under Code § 501(c)(3) described in this chapter, must obtain IRS approval of their applications for exemption. The IRS lists 31 types of tax-exempt organizations in IRS Publication 557, Tax-Exempt Status for Your Organization, along with brief descriptions defining their activities. This list is set forth in Appendix B in this Guidebook.

A director should understand that exemption from federal income tax does not necessarily permit donors to the corporation to deduct gifts to it. The IRS permits donors to deduct gifts to tax-exempt corporations only if the corporation qualifies under § 501(c)(3). Payments to other types of tax-exempt corporations may be deductible by the donor only if the payment qualifies as a trade or business expense. While the ability to attract tax-deductible charitable contributions is essential for many organizations, it is not a primary or significant source of income for others. Directors should periodically evaluate whether the corporation is qualified under the appropriate category, or whether conversion to a different category or creation of an affiliate of a different category should be considered.

Corporations Exempt from Tax under § 501(c)(3)

Most public benefit and religious corporations, and any such corporation wishing deductibility of gifts as charitable contributions, will seek exemption under Code § 501(c)(3).

For a corporation to be exempt under § 501(c)(3) it must be organized and operated for a charitable purpose.

A nonprofit corporation may qualify for exemption from federal income tax as a § 501(c)(3) organization if it is organized and operated exclusively for charitable, religious, educational, literary, or scientific purposes. These general categories conform roughly to the traditional trust and corporate law definitions of “charity.”

Particular Advantages of § 501(c)(3) Status

In addition to exemption of the corporation itself from most federal income taxes, § 501(c)(3) organizations enjoy certain unique advantages. Contributions
made to them are tax-deductible by the contributors, up to the limits imposed by Code § 170(b). In addition, some § 501(c)(3) corporations may finance their exempt activities by issuing tax-exempt bonds, enabling these organizations to lower their borrowing costs. Other benefits may include exemption from state real property and sales and use taxes and reduced postal rates for mailings.

**General Requirements**

To achieve and maintain exemption under § 501(c)(3) the corporation must comply with explicit restrictions.

In order to be tax exempt under § 501(c)(3) a corporation must be *organized and operated* exclusively for exempt purposes. It must not allow any net earnings to inure to private individuals, as described in the section “Limitations on Private Benefit and Private Inurement” below. It also must not carry on substantial activities to influence legislation and must not participate, in *any* way, in any political campaign, as described in the sections “Limitations on Lobbying” and “The Absolute Prohibition on Political Campaign Activities” below. Furthermore, with limited exception, the IRS must approve an application for such exemption, as described in more detail in the section “Obtaining Tax-Exempt Status” below.

The requirement that the corporation be organized exclusively for exempt purposes means that the articles of incorporation (and any amendments thereto) must contain appropriate restrictions on the corporation's purposes, activities and use of assets, including ultimate disposition of assets upon a dissolution of the corporation. A director should bear this in mind in considering any amendments to the articles. It is not sufficient that the corporation merely operate in an appropriate manner.

**Limitations on Unrelated Business Activities**

The conduct of unrelated business activities may not disqualify an otherwise exempt § 501(c)(3) corporation if the unrelated activities do not constitute the organization's primary purpose; however, the corporation may be taxed on income from the unrelated activity.

A § 501(c)(3) corporation may engage in some activities that are not related to its exempt purposes. For example, the corporation may own property that it leases to commercial tenants when the property is not needed by the corporation. Such activities will not disqualify the corporation from tax-exempt status so long as the corporation's unrelated activities do not constitute the corporation's primary purpose.

Income derived from certain unrelated activities may be subject to federal tax. See the discussion in the section “Unrelated Business Income” below.
Limitations on Private Benefit and Private Inurement

The activities of a § 501(c)(3) corporation must not be for the benefit of a shareholder or individual.

A § 501(c)(3) corporation is not operated for charitable purposes if it serves a private interest. This is the general standard applicable to all charitable corporations and simply incorporates into the Code the trust law standards of a charity. Further, in order for the corporation to be recognized as a § 501(c)(3) organization “no part of the net earnings of” a corporation may inure “to the benefit of any private shareholder or individual.” Private benefit or private inurement may occur, for example, when a § 501(c)(3) corporation pays for goods or services in sums in excess of their fair market value, when assets of a corporation are given to or used for the benefit of an individual who gave less than fair consideration for the same, or when an individual or corporation is paid by the exempt organization on a percentage of the tax-exempt organization’s net income. As discussed below in the section “Intermediate Sanctions: Excise Tax on Public Charities’ Excess Benefit Transactions below,” the payment of other than fair market value for items or services may also raise excess benefit transaction excise tax issues.

Limitations on Lobbying

A corporation will not qualify as a § 501(c)(3) organization if it devotes a substantial part of its activities to lobbying, propaganda or attempting to influence legislation. Section 501(h) of the Code provides a safe harbor for certain corporations that wish to regularly engage in some lobbying. Although § 501(h) clarifies the scope of permitted activities, it can impose strict penalties on the corporation and its directors if these safe harbor limits are exceeded.

As a general rule, a corporation will not be considered to be engaging in substantial lobbying if less than five percent of its activities are devoted to such activity. Whether or not more than five percent constitutes a substantial amount of activities is determined based on all the facts and circumstances.

Certain qualifying organizations may file a special election under § 501(h) of the Code to allow them to spend up to a specified dollar amount (which may represent a larger percentage of total activities) for lobbying without fear of adverse tax consequences from such activities. While persistent lobbying in excess of that permitted by § 501(h) will lead to a loss of both the protection of the § 501(h) safe harbor and a loss of the corporation’s basic tax exemption, isolated instances of lobbying in excess of permissible amounts will not cost the organization its tax-exemption. Instead, an excise tax will be applied against the organization. In addition, penalty taxes may be imposed on any officer, director, or responsible employee of the organization involved in the excessive lobbying activ-
ities. In some cases, the definition and measurement of lobbying activities will be easier than in others; for instance, as discussed in Chapter 6, “Supervision of Internet Activities,” lobbying activities on the Internet pose challenging questions both for tax-exempt organizations trying to comply with § 501(h) and the IRS.

The Absolute Prohibition on Political Campaign Activities

A § 501(c)(3) corporation cannot support, participate or intervene in any election for public office.

A § 501(c)(3) corporation will lose its tax-exempt status if it participates or intervenes in a political campaign on behalf of, or in opposition to, a candidate for public office, through financial support, endorsements, or other actions directly or indirectly advocating the election or defeat of a candidate. In addition it will be subject to an excise tax of 10 percent of such political expenditures. Unlike the restrictions on lobbying, the prohibition on political activities is absolute, and applies to any such activities, no matter how small. There are severe penalties imposed on the corporation and, in some instances, its directors, if prohibited political activities continue.7

Special Rules Relating to § 501(c)(3) Corporations: Public Charities and Private Foundations

All § 501(c)(3) corporations are regarded as private foundations unless they demonstrate that their activities or the nature of their financial support conform to certain defined exceptions. Private foundations are subject to various restrictions and excise taxes not applicable to other § 501(c)(3) corporations (commonly referred to as public charities).

The Code classifies certain § 501(c)(3) organizations as “private foundations,” in contrast to “public charities,” the latter being the term commonly used to refer to those § 501(c)(3) organizations that are not private foundations, although this term does not appear in the Code. A director should understand that all § 501(c)(3) corporations are treated as private foundations unless they can demonstrate that they meet one of the definitions of a public charity, as described below. Since private foundations are subject to greater restrictions and certain excise taxes not applicable to public charities, a § 501(c)(3) corporation should make sure that the classification of the organization as a public