Presented by Don Kramer's *Nonprofit Issues®* &
The Pennsylvania Association of Nonprofit Organizations

Fundraising events, auctions, sponsorships and acknowledgments

Webinar

August 7, 2018

REPRINTED FROM *NONPROFIT ISSUES*® VOL. XXI NO. 9 Revised March 2016

READY REFERENCE PAGE NO. 119 FOR YOUR FILE

Charity Fundraisers Raise Many Legal Issues

From preparation, through running the event, and reporting the results careful lawyering can reduce the risks of liability and embarrassment

It isn't easy to run a successful charitable fundraising event. There is a lot of planning required, a lot of details to worry about, and a lot of people to coordinate. And, if you ask – and sometimes even if you don't – there are the lawyers.

A fundraising event presents a wide range of nonprofit legal issues. What follows is a checklist of some of them.

Preparing for the Event

Consultant. If you use a consultant, is the consultant a fundraising counsel, required to register under your state's charitable solicitation registration statute? What kind of contract do you have? Is the consultant being paid on a percentage basis, which would be considered unethical by the Association of Fundraising Professionals and other groups? Will the consultant collect payments, which might constitute acting as a professional solicitor and create other legal problems?

Name of Event. Does anyone else use the same or similar name for the event who may have a protectable right in the name?

Volunteers. If you are using volunteers, do they have clear job descriptions or a clear understanding of what they are supposed to do? Do you want a "volunteer contract" which spells out your relationship? (See Ready Reference Page: "Volunteer Contract Can Define Commitments") If there is a chance they will drive anywhere in their efforts, do they – and do you – have adequate insurance for automobile use and general liability? Will they be doing anything that requires background checks?

Soliciting for the Event

Registration. Is your organization required to be registered to solicit? Are you soliciting in more than your home state, where additional registrations may be required? Is your consultant required to be registered as a fundraising consultant in another state because of your event? (See Ready Reference Pages: "Compliance Assessments Protect Charities") Are you actively soliciting for the event over the Internet, which might require you to register in all of the states which have registration laws?

Quid Pro Quo Rules. If you are asking for contributions in excess of the value of the event, are you complying with the "Quid Pro Quo" rules in your solicitation materials, your tickets and receipts? For payments over $75, you have to advise the donors how much of the payment is applicable to the value of the goods or services received and therefore not deductible. Your organization can be fined by the IRS for failure to follow these rules. (See Ready Reference Page: "Charities Must Set Value on 'Quid Pro Quo' Gifts")

Sponsorships and Ad Books. Are you complying with the sponsorship rules so that you give your sponsors only appropriate "acknowledgments," and can treat the payment as a contribution? (See Ready

Reference Page: "IRS Finalizes Regs Covering Sponsorships") Or are you providing them with advertising space, which would not be a contribution to you and, under certain circumstances, could be considered unrelated business taxable income?

In-kind Gifts. Are donors of in-kind gifts aware of limitations on deductibility? There are particular limits on corporate contributions. (See Ready Reference Page: "Corporations Have Special Rules on Contributions") Are they aware that there is no deduction for services, such as free use of space?

Corporate Foundation Gifts. If a corporate foundation purchases a table for your fundraising dinner, are they aware that it may be a taxable event of self-dealing if they allow corporate employees – as opposed to foundation employees – to use the tickets for the event? Suggest that they let you use the tickets for constituents who otherwise might not be able to afford to attend.

Mailing Lists. Do you swap mailing lists with organizations that are not charities? If so, you may have to record the value of the "income" on your tax return, perhaps as unrelated business taxable income. If you have healthcare clients, are you using their names within the limitations of the HIPAA regulations?

Running the Event

Insurance. Do you have adequate insurance, and do you need special event insurance, to protect yourself from claims of injury? Do you have general liability insurance covering the activities of your volunteers on your behalf and providing medical payments coverage for them if they get hurt?

Renting Property. If you are running the event on someone else's premises, be sure your rights and obligations are spelled out in a written agreement, including the services that will be supplied by the owner of the property, if any. Be especially careful about any indemnification language in the agreement. Landlords will usually ask for indemnification against any liability caused by anybody in the world, but your insurance will provide coverage only for liability caused by your agents or employees. If the property is damaged by a patron, you may have no insurance to protect you. You will need to purchase event insurance to protect the landlord if you have an indemnification obligation. (See *Nonprofit Issues*®, Lessons from Litigation, 6/16/11.)

Employees. Are the non-exempt employees who staff the event "volunteers," or, more likely, are they under wage and hour protection requiring payment for overtime?

Accessibility. Is the space accessible to those with disabilities? You don't want the legal or public relations issues if it isn't.

Alcohol. If you are providing alcohol at the event, do you need a special permit? Does your insurance specifically cover alcohol-related liability? Is that insurance effective if you have not followed all the legal rules for serving alcohol? Does your caterer provide the alcohol license? Do you get a certificate of insurance naming your organization as an additional insured?

Permits. If you are running an event such as a run through the city or a picnic in the park, do you need a special permit to carry it out? Do you need a special food preparation permit?

Gambling. If you are having any gambling activity, such as a lottery, bingo, fifty-fifty drawing, do you comply with all local and other governmental regulations. U.S. Postal regulations are pretty strict about mailing invitations to illegal gambling operations. Although lottery regulations are seldom enforced, there is no defense if you violate the rules.

Auctions. Are you prepared to advise your donor-purchasers of the estimated fair market value of what they buy so that they can claim a deduction for the excess – and only the excess – of their payment over the value? (See Ready Reference Page: "Charities Must Set Value on 'Quid Pro Quo' Gifts")

Sales of Stuff. If you are intending to sell stuff, like books, tee-shirts, or other items, at the event, try to structure it so that it does not generate unrelated business taxable income. (See Ready Reference Pages: "Nonprofits Often Worry About UBIT") You also need to determine whether you are required to collect state or local sales taxes. The fact that you might be exempt from paying tax on your own purchases does not mean that you don't have to collect on tax on things you sell.

Obtaining Waivers. If your event involves the active participation of the participants, like a race or a hot dog eating contest, do you want to get a waiver of any claims against you? Such waivers are usually effective in preventing liability, although not always in cases of your gross negligence or willful misconduct. Does your state law permit parents to waive in advance claims of their children? Not all states allow it. Be sure the waiver is broadly written to cover your employees, agents, volunteers, sponsors and any other person who might be sued because they helped you out.

After the Event

Other Safety Issues. Do you have adequate security in place? Do you have someone assigned to deal with the major donor who drinks too much?

Substantiation. For those who have given you $250 or more, have you provided the required substantiation letter, saying what was received and what goods or services, if any, were provided in return? The charity won't be fined for failure to comply with this one, but the donor can't claim the charitable contribution deduction and may be unhappy to have it denied on a later audit. (See Ready Reference Page: "IRS Requires Substantiation of Contributions")

Use of Proceeds. Be sure to use the proceeds for the purposes you advertised for the event. It may be a breach of your fiduciary duty to your donors, and perhaps a violation of your solicitation registration law, to do otherwise. At the least, it is bad public relations.

Form 990 Reporting. Be sure that you have kept your records so that the accountant can report accurately on the Form 990 and Schedule G tax return the amount raised and spent at your fundraisers. As the 990s become generally available on the Internet and more donors become more sophisticated in reading them, it may be embarrassing if you don't show the results correctly as required by the form. (See Ready Reference Page: "Form 990 Reporting for Special Events Can Be Tricky – And Is Often Wrong")

Form 990 Reporting for Special Events Can Be Tricky – And Is Often Wrong

Many returns fail to separate contributions and other amounts because nonprofits fail to keep adequate records

In reviewing Form 990 tax information returns for nonprofit organizations, one of the most consistent areas of error seems to be reporting income from special events. Very seldom do you feel that things are listed correctly. And the benefit of accurately reporting a spectacularly successful event can be totally lost. Ask the accountants why the return is not correctly filled out and you often get the answer that the client hasn't given them the proper information.

Special event reporting is important because the Form 990 has special lines on the Part VIII Revenue Statement to report fundraising events. (Similar lines exist on the Form 990-EZ for smaller organizations.) Charities do not want their volunteers and donors to think that their efforts for the annual fundraising gala didn't produce any benefit for the organization. And yet, a poorly prepared return can do just that. It is another reminder that the Form 990 is an important public relations document.

Fundraising events include things like the annual gala dinner dance, concerts, carnivals, special sports events, and door-to-door sales of merchandise. They do not include events or activities that relate to the organization's charitable mission even if they produce revenue as part of the activity. They are, by definition, unrelated to the organization's exempt activity, but probably don't produce unrelated business taxable income because they are not "regularly carried on." (See Ready Reference Page: "Nonprofits Often Worry About UBIT")

The first key to correct reporting is to separate the amount paid by the patron/donor that represents the fair market value paid to attend the event from the additional payment that is actually a contribution to the organization. Say, for example, that the organization has an annual dinner dance for which it asks its supporters to pay $100 for a bronze ticket, $300 for a silver ticket, and $500 for a gold ticket. They all get to enjoy the same dinner worth $50. As a result, the bronze ticket purchaser is making a contribution of $50, the silver ticket purchaser a contribution of $250, and the gold ticket purchaser a gift of $450.

The organization should not have a hard time figuring out these numbers because it is required (if the total payment is more than $75) to notify the patron/donor of the amount of the payment that exceeds the value of the goods and services received in return and is deductible as a charitable contribution. (See Ready Reference Page: "Charities Must Set Value on 'Quid Pro Quo' Gifts")

The contribution amount for each ticket gets reported twice in the Statement of Revenue on the Form 990. It is reported as a contribution on line 1c under Fundraising events, and also in the parentheses outside the box for line 8a. (See copy of Form 990 on next page.)

To continue the simplified example, if the organization sold one ticket of each type, it would report a total contribution of $750 ($50 for the bonze ticket, $250 for the sliver ticket, and $450 for the gold ticket) on line 1c and outside the box by line 8a. Since each patron/donor in effect paid $50 for the dinner, it would report a total of $150 as the gross income paid for the dinners inside the box on line 8a.

If it paid $50 for each dinner and that was its only direct cost, it would report $150 on line 8b and show a zero gain or loss for the event. If the dinners were contributed to the organization entirely free by another donor, it would report no expense and have net other income of $150.

The net income must be allocated, since it is by definition not related or exempt function income, to either unrelated business income (“UBI”) or revenue excluded from UBI in columns C or D of Form 990. In the example, since the dinner is held only once a year and is not “regularly carried on,” the income would be excluded and listed in column D. If the dinner were held every month, or if members of a youth sports team sold wrapping paper to generate funds throughout the year, the income would probably be considered regularly carried on and taxable under column C.

Form 990 (2013) Page **9**

Part VIII **Statement of Revenue**

Check if Schedule O contains a response or note to any line in this Part VIII . . . . ☐

Contributions, Gifts, Grants and Other Similar Amounts			(A) Total revenue	(B) Related or exempt function revenue	(C) Unrelated business revenue	(D) Revenue excluded from tax under sections 512-514
1a	Federated campaigns . . .	1a				
b	Membership dues	1b				
c	Fundraising events	1c				
d	Related organizations . . .	1d				
e	Government grants (contributions)	1e				
f	All other contributions, gifts, grants, and similar amounts not included above	1f				
g	Noncash contributions included in lines 1a-1f: $					
h	**Total.** Add lines 1a–1f . . . . ▶					

Other Revenue			(A)	(B)	(C)	(D)
8a	Gross income from fundraising events (not including $ of contributions reported on line 1c). See Part IV, line 18 . . . . . . a					
b	Less: direct expenses . . . . b					
c	Net income or (loss) from fundraising events . ▶					

Only direct expenses, such as the cost of the dinner or production of the invitations should be deducted from the gross income. General overhead and other indirect costs are not accounted for here and show up in other appropriate lines on the Part IX Statement of Functional Expenses.

If it were as simple as the example above, charities would make fewer mistakes. But real life is not quite as simple. They tend to sell a lot of tickets. They have friends who pay to be known as “sponsors” of the event and get their name on the program book and a couple of free tickets to the event. Each of these “quid pro quo” gifts associated with the fundraising event has to be considered, valued, and included in the calculation.

Sometimes, with events such as a golf outing, they actually pay more for the event than they charge the guests. (They may also pay for some special guests who participate for free.) They may have to show a loss from the event. But with all of the sponsorships, perhaps revenue from a lottery (that has to be reported on Line 9 of the Form 990 and not as part of the fundraising event in line 8), and other benefits, it is still helpful to the organization.

The Form 990 also requires that charity auctions be included in the fundraising event reporting. The IRS Instructions provide an example of an auction of a donated home theater system with a fair market value of $5000. It assumes that the system sells at the auction for $7500, and that the organization spent $500 in direct costs of selling the system at the auction. In such case, the Instructions state that the charity would report the contribution amount of the sale ($2500, the excess of the purchase price over fair market value) on line 1c and outside the box of line 8a. It would report the income of $5000 paid for the system as gross revenue inside the box on line 8a. It would report its "cost" as the $5000 value of the donated system plus the $500 cost of making it ready for sale on the direct expense line 8b. The net result is a loss of $500 on line 8c.

(The donor of the system's contribution of an item worth $5000 is not reported under the fundraising event income anywhere in line 8, according to the IRS instructions, but is reported on line 1f as part of "all other contributions." If the system donor had paid less than $5000 for the system, of course, the donor's deductible amount would not be increased to the fair market value, even if held more than a year before the gift, because the item of personal property is not being used in the charity's charitable program. An item of personal property not used in the charity's program may be deducted only at the lesser of tax cost or fair market value.)

The IRS example goes on to show that if the system sells for only $2500, there is no contribution listed on line 1c and outside the box of 8a. There is a gross income amount of the $2500 paid for the system inside the box on line 8a. The direct costs of $5500 are reported on line 8b, and a net loss of $3000 is shown on 8c.

The net income or loss from line 8c is also reported as part of the aggregate of "other revenue" reported on the first page of the Form 990 in Part I, line 11.

If the total of the contributions reported on line 1c and the amounts paid by the patrons/donors and reported as gross income for the value of the goods and services on line 8a exceed $15,000, the organization is required to complete Schedule G to report each event separately.

With the Form 990 requiring this much work for what may seem to be merely peripheral information, it is no wonder that many of them simply don't make the effort. Even if the organization tries, by the time it goes through these calculations for all of its fundraising events during the year, and for all of the transactions related to each of the events, the numbers can be big and may not be very precise. But they still have to be reported.

READY REFERENCE PAGE NO. 21 FOR YOUR FILE

Volunteer Contract Can Define Commitments

A simple one-page document can formalize the relationship, help reduce potential for liability, and give a graceful way to decline help from problem people

Volunteers can be a great asset, or a great liability. You may be able to enhance their value by formalizing the mutual commitments in a clear and understandable document that provides the basis for their work. Volunteers can be a boon or a bane for a nonprofit. Sometimes they are both.

We had occasion to review recently a simple one-page "Volunteer Agreement" which was used by an organization to emphasize the seriousness of its commitment to the volunteer, to obtain a return obligation, and to get in writing some important commitments which can reduce the risk of liability for the agency. It also provides multiple bases to terminate the relationship if the volunteer turns out to be more trouble than he or she is worth.

We thought a slightly modified text, along with some comments (*in italics*) might be worth consideration.

VOLUNTEER AGREEMENT

This Agreement is intended to indicate the seriousness with which we treat our volunteers. The intent of the Agreement is to assure you both of our deep appreciation of your services and to indicate our commitment to do the very best we can to make your volunteer experience here a productive and rewarding one.

I. Agency.
We agree to accept the services of ___________________, beginning ____________ (*with no termination date*), and commit to the following:

1. To provide information, training, and assistance to aid you in meeting your responsibilities. (*You may want to provide specific volunteer job descriptions in the Agreement where the volunteer undertakes a specific position for which that is appropriate. In order to assure protection for the volunteer under the Federal Volunteer Protection Act [See Nonprofit Issues®, December1997], the volunteer must be acting within the scope of his or her responsibilities with the organization. You will want to spell out those duties in the training, in writing if possible, before the volunteer starts the work.*)

2. To provide you supervisory aid and to provide feedback on performance.

3. To respect your skills, dignity and individual needs.

4. To be receptive to any comments you may have regarding ways in which we might mutually better accomplish our respective tasks.

5. To treat you as a partner with our staff, jointly responsible for completion of our Mission. (*None of*

these commitments by the nonprofit is particularly onerous, but each is a good reminder of the factors which can make the experience a better one for both sides. You need to assure that your general liability insurance covers their actions because even though they may not be personally liable for their negligence, you may be liable when they are your agents.)

II. Volunteer.
I, _________________, agree to serve as a volunteer and commit to the following:

1. To perform my volunteer duties to the best of my ability.

2. To serve as a volunteer without receiving any monetary compensation or other financial benefits for my service. (*This provides the volunteer the lower standard of care for volunteers under volunteer protection acts and affirms that you have no financial responsibility to them. It also takes them out of the employee category for workers' compensation benefits if they are injured in their duties. Be sure that you are insured against claims. You may want to provide medical coverage as a secondary coverage for anyone who might not have his or her own insurance.*)

3. To adhere to your rules and procedures, including recordkeeping requirements and confidentiality of agency and client information. In particular, I affirm that all information I learn about the people you serve (including name, address, work or other affiliation) is deemed to be strictly confidential. I shall not disclose confidential information about agency clients to any other individual or organization. (*This gets two important commitments in writing, a commitment to follow your rules and a promise of confidentiality. It assures that the volunteer cannot claim lack of knowledge of the confidentiality requirement. You may need to spell out the details a little more clearly in the Agreement or in separate training, but the concept has been accepted.*)

4. To meet time and duty commitments, or to provide adequate notice so that alternate arrangements can be made. (*Reliability is now a matter of contract and a clear basis to terminate the relationship for breach*.)

5. My currently valid ___________ [state] driver's license number is ________. My automobile insurance is maintained with ___________. I will notify you if my license or insurance is suspended, revoked or not renewed at expiration. (*Assuring that those who drive in your program are licensed and insured is vitally important since they are now your agents. You may want to make a copy of the license and insurance card, not only to assure that they exist, but so that you have expiration dates so that you can follow up to assure that they are renewed. This provision includes an ongoing commitment of notice of any change, although you will probably want to obtain a separate periodic certification, at least annually, for long term volunteers. You still need insurance for non-owned automobiles, but the first line of defense in case of an accident should be the volunteer's insurance. Remember too that most of the volunteer protection acts do not limit liability when the volunteer is driving.*)

6. I hereby waive any claim I may now or hereafter have against you, your officers, directors, employees, or representatives including other volunteers, for personal injury or property damage arising out of my services as a volunteer. I make this waiver with full understanding that many of the people you serve are __________. (*A waiver of liability is always a good thing for the agency to have, although it may not be enforceable in all situations. Setting forth any particularly hazardous aspects of the position, however, reduces the risk that the volunteer will argue inadequate warning. The paragraph is not a substitute for adequate training, however.*)

This Agreement may be terminated by either party, with or without cause, at any time by notice to the other party. (*The "without cause" provision is important for the nonprofit because it may want to terminate the relationship quickly without unnecessarily alienating the volunteer by claiming a "default."*)
[Signature lines]

You may have other specific provisions you need to add because of the peculiarities in your own situation. This Agreement is not a substitute for careful recruiting, for required background checks, interviews and other careful screening procedures, for proper training, for meaningful work, or for appropriate recognition.

But it is also not a document to be put in the file and forgotten. It may help to formalize the relationship in plain English and increase the likelihood that the relationship will be beneficial to both parties.

YOU NEED TO KNOW

Volunteers can be a great asset, or a great liability. You may be able to enhance their value by formalizing the mutual commitments in a clear and understandable document that provides the basis for their work.

Charities Must Set Value on 'Quid Pro Quo' Gifts

Donors may deduct only the amount of the payment in excess of the value of the goods or services received

When somebody gives your charity a generous contribution, or pays far more than it is worth to attend the annual fundraising dinner, you want to be sure that you comply with the law and that your donors are able to claim an appropriate charitable contribution deduction.

In the early 1990's, Congress spelled our new rules for deductions. Donors must receive a written substantiation letter from a charity for any gift of $250 or more. Charities must determine the amount deductible if the donor makes a payment of more than $75 in return for goods or services.

The substantiation rules apply to donors, who may not claim a charitable contribution deduction without having received the written receipt. (See Ready Reference Page: "IRS Requires Substantiation of Contributions") The charity will not suffer a direct penalty for failing to give the receipt, although it may create a lot of unhappy donors.

The "quid pro quo" rules apply directly to charities, which can be fined $10 by the IRS for each contribution for which they fail to make the proper disclosure, not to exceed $5000 for any one fundraising event or mailing. (Tax Code Sec. 6714.)

The issue is one of public relations as well as law. The requirement was enacted in 1993 because Congress got fed up with the failure of charities to notify their donors of the amount which could be deducted. Therefore, it especially behooves charities to pay attention to the rules.

A quid pro quo contribution is a payment made partly as a contribution and partly in consideration for goods and services furnished to the donor. The annual fundraising dinner, where tickets are priced at various levels depending on the amount of support by the donor, is a typical example. The public radio or television on-air fundraiser, where they give a recording or a video of the show for higher level gifts, is another.

If an organization receives a quid pro quo contribution in excess of $75, it must provide the donor a written statement of the amount deductible for federal income tax purposes. Only the amount in excess of the value of the goods or services received in return for the gift is deductible. The organization must make a "good faith estimate" of the value of such goods or services. (Tax Code Sec. 6115.)

The disclosure may be made either in connection with the solicitation or with the receipt of the contribution. It generally makes sense to give the information with both the solicitation and the receipt, when possible, and even where the payment is less than $75.

The quid pro quo rules apply to donations of less than $75. A donor who receives a $20 lunch for a payment of $50 may deduct only $30. The charity has no legal obligation to tell the donor, but it is considered best practice to do so.

The statute specifically excludes payments to religious organizations where the donor receives "solely an intangible religious benefit that generally is not sold in a commercial transaction." This would include "pew fees" or charges for admission to certain religious ceremonies.

The valuation question can be tricky. It is not difficult to value the commercially available recording or video. It may be more difficult to value the formal dinner dance, or a tennis lesson, or a garden tour.

The Regulations make clear, however, that it is the value of the goods or services received by the donor, and not the *cost* to the charity, that is the measure for reducing the deduction. Even if the entire dinner and all of the services of the catering facility are donated to the charity for its dinner dance, the charity must estimate the value of the event and advise the donor how much is not deductible.

By the same token, it is not the cost to the charity which is necessarily the measure of the value to the donor. If the charity is able to buy the recording for $5, but the regular sale price in the stores is $12, the reduction in the contribution would be $12.

The only way the donor can avoid reducing the contribution deduction is by refusing to accept the quid pro quo benefits in advance. It is not sufficient merely to fail to attend the event. The donor must affirmatively decline to accept the ticket or otherwise advise the charity that he or she does not intend to appear.

The Regulations provide that a charity "may use any reasonable methodology in making a good faith estimate, provided it applies the methodology in good faith." If the estimate is not in good faith, however, the IRS can impose penalties.

The IRS has issued some regulations which help eliminate some types of benefits from the calculation.

Perhaps the most significant are those goods or services which have "insubstantial value" or fall within the "low cost items" exception. For 2018 an item is considered to be of insubstantial value if it is worth less than $109 or 2% of the gift, whichever is less. (The $109 figure is based on an IRS guideline amount of $50 as indexed for inflation.)

"Low cost items" typically include souvenir items including the organization's logo, like pens, key holders, coffee mugs, or calendars. For 2018, they can be disregarded if the gift is more than $54.50 and the cost of all the items given to the donor is less that $10.90. (These figures are also indexed for inflation based upon guideline and statutory amounts of $25 and $5) The low cost items provision is one of the very few situations where the cost to the charity (rather than the value to the donor) is the measuring figure.

Also excluded are certain "membership" benefits, such as free or discounted admissions to the organization's facilities or events, free or discounted parking, preferred access to goods or services, and discounts on the purchase of goods or services, so long as such benefits can be exercised freely during the membership period. Also excluded are events open only to members when the cost to the charity is less than the "insubstantial" amounts mentioned earlier. The Tax Code says these benefits are disregarded where the membership dues are $75 or less but an example in the IRS Regulations disregards such benefits upon the payment of higher dues as well. The charity is not required to value such benefits for members paying higher dues.

Where a celebrity is present at an event, the Regulations say to disregard the value of the celebrity's presence and value the event as if the celebrity were not there.

Newsletters which feature the President's message and pictures of donors but have no "commercial value" need not be considered. If they are separately sold, carry advertising, or pay writers other than staff, they probably have commercial value which should be determined in figuring the amount by which the gift should be reduced.

Charity auctions are another area in which the charity is required to make a good faith estimate of the value of the goods or services on which the participants bid. To the extent that the bidders pay more than the fair market value of the items, they may take a deduction for the difference. To the extent that they pay only the fair value or less, they are merely purchasing the items and have no deduction.

Charities normally do not place a value of gifts of property given to them by donors but they are required to estimate the fair market value of the donated items to be sold at the auction.

Since charities regularly say thanks to their major donors, they frequently ask whether a recognition from the charity is "in consideration for" the gift and thereby forces the donor to reduce the contribution deduction. The Regulations provide that goods or services will be deemed in consideration of payment "if, at the time the taxpayer make the payment…, the taxpayer receives or expects to receive the goods or services in exchange for that payment," even where the payment is in a year other than the year of the gift.

Therefore, if you always invite your $1000 donors to the President's tea after the Homecoming football game, the value of the tea would be deducted from the contribution. But if you surprise the $1000 donors with various recognitions in some years but not others, the gift will not be reduced.

IRS Requires Substantiation of Contributions

Donors must obtain acknowledgment from charity for gifts worth $250 or more, must file Form 8283 for gifts of property over $500, with appraisal over $5,000

It isn't as easy as it once was to claim a charitable contribution deduction for a gift to charity.

Because of perceived abuses by taxpayers claiming inflated deductions without adequate justification, Congress and the Internal Revenue Service have tightened the rules over the last several decades.

The rules apply to the taxpayers seeking the deduction. In most cases, they do not directly apply to the charities receiving the gifts and do not impose penalties on charities, but charities that want to assist their donors and receive additional gifts will want to be sure that the donors are in position to claim their deductions properly.

Cash contributions. For "cash" contributions of less than $250 made by currency, check, electronic funds transfer, credit card, debit card, or payroll deduction, the donor may not claim the deduction unless the donor has a cancelled check, bank record or credit card statement, an acknowledgment from the recipient charity, or a payroll record. The rule was changed by the Pension Protection Act of 2006 to require the written acknowledgment from the charity for gifts of currency, even for a gift of only $1.

For cash contributions of $250 or more, the donor must obtain a "contemporaneous" written acknowledgment from the recipient charity. The acknowledgement must include a statement of the amount of the gift, whether or not the donor received any goods or services in return, and if so, a description and good faith estimate of the value of such goods or services. Generally, a donor who receives goods or services in return, except for certain items of nominal value, is entitled to deduct only the amount of the payment that exceeds the value of the goods or services received. (See Ready Reference Page: "Charities Must Set Value on 'Quid Pro Quo' Gifts")

If the only benefit received is an "intangible religious benefit," such as that received by those who "rent" pews in church or pay extra dues to attend High Holy Day services in a synagogue, the organization does not have to place an economic value on the benefits.

The acknowledgment is considered contemporaneous if received by the earlier of the time the taxpayer files the tax return claiming the deduction or the date the return is due, including extensions.

In determining whether cash contributions are $250 or more, the IRS says a donor need not combine all of the contributions during the year. If a donor contributes $25 a week to a church, the payments need not be combined to require the written acknowledgement from the church (unless, of course, they are made in currency). The donor can utilize the bank or credit card statements as substantiation.

Noncash Contributions. For noncash contributions, Congress and the IRS have come up with what is essentially a three-tier system for donors to substantiate their claims for deductions. The valuation breakpoints are generally gifts worth $500 or less, gifts between $500 and $5000, and gifts for which a deduction is claimed for more than $5000. There are also special rules for gifts of certain types of property for which it is widely perceived that inflated contribution deductions have been claimed in the past.

The basic rule for noncash gifts of less than $250 is that the donor must obtain a written receipt from the charity containing the name of the charity, the date and location of the gift, and a "reasonably detailed description" of the property. The IRS says the donor doesn't have to obtain the receipt if it isn't practical to do so, such as for a gift left in a collection box in a shopping center. The receipt need not be as elaborate as the acknowledgment and need not contain a statement of whether or not goods or services were received in return for the gift.

In addition, however, the donor must maintain reliable written records for each item given, including the cost basis of the property, the estimated value, a statement of the method used to determine the value, and a statement of any conditions that may have been applied to the gift. For securities, the donor must also have the name of the issuer, the type of security, and whether it is regularly traded on an exchange or over the counter market.

For gifts with a value of at least $250 but not more than $500, the donor needs the records previously required and must obtain the contemporaneous written acknowledgement from the charity describing the property and stating whether any goods or services were received in return. Note that the acknowledgment need not put a value on the noncash gifts and a charity will not normally set the value of such gifts. Valuation is normally left to the donor and an appraiser where necessary. (The charity may use the donor's value for the charity's bookkeeping and reporting if the charity deems the value reasonable, but it has no obligation to do so.)

In determining the value of gifts, all items of similar property given to charity must be aggregated to determine the reporting requirements. A donor who gives a lot of books, for example, that have an aggregate value of more than $250 will be required to report based on the aggregate value of all the books given away, even though none of the individual items is worth $250, and even though the gifts are split among multiple organizations.

For gifts of property valued over $500 but not more than $5000 (including all publicly traded securities even if valued at more than $5000), the donor must file a Form 8283 with the tax return claiming the deduction. The Form must describe the property given, but does not require an acknowledgment of receipt by the charity. In addition, the donor must have records showing how the property was acquired (by purchase, gift, inheritance, etc.), the approximate date of acquisition, and the cost basis of the property.

For gifts of property worth more than $5000 (except for publicly traded securities and privately traded stock worth $10,000 or less), the Form 8283 must contain a summary of a "qualified appraisal" and an acknowledgment by the charity that it has received the items. The acknowledgment does not represent an agreement by the charity with the valuation claimed by the donor. The actual appraisal report must normally be attached to a claim of more than $500,000.

C corporations, other than personal service corporations and closely held corporations, are required to file Form 8283 only if claiming deductions of more than $5000. S corporations and partnerships must file the Form 8283 with their own S corporation or partnership returns if they claim more than $500 in deductions.

The IRS has the authority to deny *any* deduction, even up to $500, if a donor fails to file an accurate Form 8283 when claiming a deduction for which the Form is required. The IRS has been inconsistent on administering the rule, but the Courts have upheld the total denial in many cases.

Qualified Appraisals. Congress also tightened the rules for qualified appraisals and appraisers in the Pension Protection Act and increased the penalties for knowingly participating in a claim for an excessive deduction. (See Ready Reference Page: "Congress Passes Charitable Reforms")

A qualified appraisal must be made and signed by a qualified appraiser and must be made in accordance with generally accepted appraisal standards not more than 60 days before the date of the contribution. It must include a description of the property, its physical condition if tangible personal property, its estimated value, and a statement of the basis for the determination.

A qualified appraiser is a person who has earned an appraisal designation from a recognized society, regularly performs such appraisals for compensation, can demonstrate verifiable education and experience in the type of property being appraised, has not been prohibited from practicing before the IRS within the last three years, and is not excluded by Treasury regulations. The appraiser cannot be the donor or taxpayer claiming the deduction, the donee, a party to the transaction in which the donor acquired the property, an employee of any of these, or an appraiser who regularly performs appraisals for any of these persons and does not do a majority of his or her work for others.

Generally no part of the fee arrangement can be based on the amount of the appraised value or the amount of the deduction ultimately allowed by the IRS.

The "Squeal Rule". Normally a donor may claim a deduction only for the lower of cost basis or fair market value for a gift of tangible personal property to a charity, and may not claim an appreciated fair market value deduction for property held more than a year unless the property is actually used by the charity within its charitable purpose. Therefore, if the organization sells, exchanges, or otherwise disposes of property (other than publicly traded securities) valued on a Form 8283 at more than $5000 within three years of receipt of the gift, the organization is required to file a Form 8282 with the IRS (and give a copy to the donor) disclosing the disposition. The time period was increased by a year under the Pension Protection Act. For tangible personal property for which the donor claimed an appreciated fair market value deduction, the property will be considered not used in the charitable operation. The donor will have to reverse the claim and include the difference between the cost basis of the property and claimed deduction as income in the tax return for the year of the disposition. (See Ready Reference Page: "Congress Passes Charitable Reforms") For other types of property, the report will give the IRS an opportunity to see whether the claimed deduction seems reasonable.

Special Rules for Certain Types of Gifts.

Cars, boats and planes. In 2004, Congress changed the rules for deductions for gifts of automobiles, boats and airplanes. Because Congress was convinced that many donors deducted inflated amounts for such gifts, it provided that a donor may deduct only an amount equal to the gross proceeds of the sale of such property when the charity disposed of it after acquisition, usually for cars at auction. (The normal deduction rules apply if the charity uses the vehicle in its program or substantially repairs the vehicle.) The donor must file a Form 1098-C with the return claiming the deduction. The charity should supply the Form with a statement of the gross proceeds of sale. Generally the form must be dated within 30 days after the sale. (See *Nonprofit Issues*®, Tax Matters, 10/16/04.)

Clothing and household items. In the Pension Protection Act of 2006, Congress substantially tightened the rules for deducting gifts of clothing and household items. A donor may not deduct anything for the value of clothing or household items unless they are in "good used condition or better," and, if the donor claims a deduction, the donor must have all of the records required for noncash gifts for the level of deduction. The Secretary of Treasury has been authorized to deny, by regulation, deductions for contributions of "minimal value" but has not yet done so.

A donor may deduct for gifts of lesser quality, but only if the donor claims a deduction of more than $500 for a single item and includes a qualified appraisal of such item with the return. (See Ready Reference Page: "Congress Passes Charitable Reforms")

Household items include furniture and furnishings, electronics, appliances, linens and similar items. They do not include food, paintings, antiques and other artistic items, jewelry and collections.

Out-of-pocket expenses for volunteer services. No deduction is available for the value of services contributed to a charity, but volunteers may deduct their out-of-pocket expenses incurred in rendering volunteer services. To claim a deduction for out-of-pocket costs, a volunteer must have adequate records to substantiate the expenses, and for expenses of $250 or more, must obtain a written acknowledgment from the charity.

For more detailed information, see IRS Publication 526 on Charitable Contributions, and IRS Publication 561, Determining Value of Donated Property.

REPRINTED FROM *NONPROFIT ISSUES®* VOL. XII NO. 5 MAY/JUNE 2002

READY REFERENCE PAGE

NO. 56
FOR YOUR FILE
SUPERSEDES PAGE NO. 10

IRS Finalizes Regs Covering Sponsorships

Payments will be considered charitable contributions where there is no arrangement that the sponsor will receive 'any substantial return benefit in exchange for the payment'

The Internal Revenue Service has published final Regulations to determine whether sponsorship payments for charity fund raisers are considered charitable contributions or unrelated, and possibly taxable, income.

Based on the new section 513(i) of the Tax Code added in 1997, the final Regs have only minor modifications from the proposals published more than two years ago, but do add two modestly helpful examples to distinguish sponsorships from advertising on an Internet website. (Reg. 1.513-4, *Fed. Reg.*, 4/25/02.)

Generally, the rules provide that a sponsorship payment will be considered a charitable contribution where there is no arrangement or expectation that the sponsor will receive "any substantial return benefit in exchange for making the payment."

The sponsorship can be for a single event, like a bowl game, a walkathon or television program, a series of related events, such as a concert series or sports tournament, an activity of indefinite duration, such as an art exhibit, or an organization's general operations.

A substantial benefit means any benefit other than (a) an acknowledgment of the sponsor's name or logo in connection with the activity, or (2) the provision of certain goods or services that have an insubstantial value.

An acknowledgment permits use of logos or slogans that do not include "qualitative or comparative descriptions" of the sponsor's goods or services, although logos that are "an established part of a payor's identity" are not considered to contain qualitative or comparative descriptions no matter what they say.

The acknowledgment can also include a list of the sponsor's locations, phone numbers or Internet address, "value neutral descriptions" including displays or pictures, and the use of brand or trade names. "Mere display or distribution, whether for free or remuneration" of the payor's product at the sponsored activity will not be considered advertising.

Advertising is a message that "promotes or markets any trade or business, or any service, facility or product." The message is deemed to be advertising if it "includes messages containing qualitative or comparative language, price information or other indications of savings or value, an endorsement, or an inducement to purchase, sell or use" a product, service or facility.

Generally an inducement would require a "call to action." A message that contains both advertising and acknowledgment is considered to be entirely advertising.

A payment is not a sponsorship payment if it is contingent upon the level of attendance at the event, broadcast ratings or "other factors indicating the degree of public exposure to the sponsored activity." It may be a sponsorship if it is contingent on the event actually being conducted or being broadcast on radio or tv.

The charity may grant a sponsor exclusive sponsorship rights to the activity, or exclusive rights for a particular trade or business dealing with the activity, without converting the payment from sponsorship contribution to other income. But if the arrangement limits the sale, distribution, availability or use of competing products or services in connection with the exempt organization's activity, it will generally be considered a substantial return benefit.

This rule is in reaction to exclusivity arrangements prevalent in the 1990s, such as those in which soft drink companies "sponsored" activities on college campuses in return for the exclusive right to sell their products on campus.

If any part of the payment is deemed to be in return for substantial benefit, the charity must make a good faith estimate of the value of the benefit, and only the excess amount can be considered a contribution. Under a 1993 proposed Reg, issued prior to the 1997 statutory amendment, if any of the payment was not a sponsorship, the entire payment was "tainted" and considered to be other income. The tainting concept was eliminated in the proposed Regulations in 2000.

Return benefits can include not only the value of advertising, but also a sponsor's dinner for corporate executives, passes to an event, playing spots in a pro-am golf tournament, and other economically valuable benefits.

A return benefit is considered insubstantial, and therefore disregarded, if it is less than 2% of the payment from the sponsor. The proposed Regulation had defined insubstantial so that it could not exceed a value, indexed for inflation, of about \$79. The final Regs eliminate the ceiling and go with 2% of the payment, whatever the amount.

It is up to the exempt entity to determine the fair market value of the return benefit as of the date the benefit is provided, or if provided pursuant to a written contract, the date of the contract. If the parties make a "material change" to the contract, the date of the change will be the date of

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IRS Finalizes Regs Covering Sponsorships

the new valuation.

This is another version of the "quid pro quo" rules for valuing contributions in excess of the goods or services received in return, but disregarding de minimis benefits to the donor.

(The final Regs make clear that return benefit worth less than 2% of the payment will be disregarded in calculating the public support percentage of the charity. The entire payment will be considered a contribution.)

The final Regs add two new examples to deal with Internet issues. In the first, a symphony orchestra maintains a web site, which includes a list of its sponsors. The site does not promote the sponsors or advertise their products, but provides a hyperlink to the sponsors' web sites. The link alone is not a substantial benefit and the entire payment remains a sponsorship contribution.

In the second example, a health-based charity receives funding from a pharmaceutical company which manufactures a drug used in treating a particular medical condition. The manufacturer helps the charity prepare educational information for distribution and posting on the web site. The charity's web site provides a link to the manufacturer's web site, on which appears an endorsement by the charity, reviewed and approved by the charity, of the manufacturer's product. The IRS says that the endorsement is advertising and that only the portion of the sponsorship payment that exceeds the value of the advertising portion can be considered a qualified sponsorship payment and treated as a contribution.

The final Regs do not cover two important areas for many charities. They do not cover trade show income, or income from periodical publications. The term "periodical" means "regularly scheduled and printed material published by or on behalf of the exempt organization that is not related to and primarily distributed in connection with a specific event." For purposes of this definition of "printed," electronic publishing is included. Acknowledging sponsors in an organization's regular newsletter, therefore, can present problems.

Income from a payment is not necessarily taxable even if it is not considered a contribution. To be taxable, it must meet the definition of unrelated business taxable income, which is income from an unrelated trade or business regularly carried on. A one-evening fund raiser would not be regularly carried on and advertising income from that event alone would not be taxable. UBTI also has exclusions for activities that are carried on primarily by volunteers and other exclusions. (See Ready Reference Pages Nos. 13 and 15, June and September, 1998.)

The characterization of the income to the charity is generally immaterial to the payor. In most cases the payor is a business, which will deduct the payment as an ordinary and necessary business expense and will not need a charitable deduction. If the sponsor is an individual, the individual will not need "advertising" unless he or she is in business. An acknowledgment would be a contribution.

Don Kramer's
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Nonprofit Issues® is published monthly (except August) by Nonprofit Issues, Inc. It is available by subscription for $129 per year for nonprofit organizations, and $149 per year for others. Multi-year and group discount subscriptions are also available.

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REPRINTED FROM *NONPROFIT ISSUES*® VOL. X, NO. 6 JUNE 2000

READY REFERENCE PAGE NO. 35 FOR YOUR FILE

Corporations Have Special Rules on Contributions

Many in-kind contributions may be deducted as ordinary business expenses; certain gifts of inventory qualify for enhanced deduction above cost basis

Unlike individuals who may generally deduct contributions up to 50% of their adjusted gross income, a corporation is limited to 10% of its pretax income for the year in which the deduction was made. Like individuals, however, this limit is seldom a problem. Deductions in excess of the limit may be carried forward for five years.

Although generally a contribution must be made within the tax year in order to take the deduction, an accrual basis corporation (which includes most corporations) may deduct a contribution made within two and one-half months after the end of the tax year if the contribution was authorized by its board before the close of the year.

Business expense v. contribution

Because a corporation is allowed to deduct ordinary and necessary expenses of carrying on its trade or business, certain payments to or for the benefit of charities might be deductible either as charitable contributions or as ordinary business expenses. To be a business expense, the expense must bear a direct relationship to the corporation's trade or business and must be made with a reasonable expectation of commensurate financial return.

Because there is no limit on the amount of ordinary and necessary business expense deduction available, classification as an expense may be advantageous. The two deductions are mutually exclusive, however, and if a portion of a payment is deductible as a contribution, no part of the payment is deductible as an ordinary trade or business expense.

Most cause-related marketing expenses are probably deductible as business expenses. In 1963, the IRS published a revenue ruling (63-73) which held that payments to a charity for the use of its name and certain promotional efforts in connection with the company's advertising program were deductible as business expenses).

Services not deductible

As with individuals, contribution of services is not deductible. A newspaper's free advertisements for a charity, a carpenter's contribution of woodwork, or an attorney's contribution of a contract have all been ruled nondeductible contributions of services. (The donor does not have to recognize income for the value of such services, so the net effect is no tax impact at all.)

Expenses incidental to the performance of such services, however, are deductible. Most decided cases involve expenses such as travel, uniforms or meeting expenses. But the newspaper could deduct the cost of the paper used and a portion of the overhead and salaries. More likely, however, the newspaper would disregard the gift and deduct these costs as expenses in furtherance of its business.

No foreign contributions

As with individuals, contributions made to or earmarked for a foreign charity are generally not deductible. The earmarking may arise either from the donor's instructions or from the U.S. charity's representations. The key is whether the U.S. charity exercises control over how the contribution is used.

Foreign charities often create U.S. "Friends of" organizations to receive gifts. Where the U.S. charity maintains control over the use of the donated funds, a deduction is permitted. In addition, a U.S. charity may solicit deductible contributions for its subsidiary organized in a foreign country to carry out its exempt activities there.

Some corporations create their own private foundations in order to make gifts abroad. Foundations may make gifts to foreign charities if they follow certain procedures to assure that the organizations would be classified as charities if they were active in this country.

Contributions of property

Corporate contributions of personal property, such as office furniture, automobiles, or other goods, are subject to the regular rules governing deductibility at the fair market value of the property given, subject to the two major exceptions.

First, if the fair market value of the property is higher than the tax basis (generally cost) of the property, the deduction is reduced by the amount of the increase that would ***not*** have been long term capital gain if the property had been sold. That means that inventory and any other property held less than a year is deductible only up to the cost basis of the property (or fair market value if lower).

This is particularly significant for manufacturing or distribution corporations because the logical gift is inventory and inventory results in ordinary income, not capital gain, when sold. If a manufacturer wants to donate $8,000 worth of widgets, and the

continued on other side

YOU NEED TO KNOW

Charitable fundraisers who understand the legal issues affecting potential donors are often better able to suggest gifts that work well for both the donor and the charity. Since corporations operate under different rules than individuals, it is important to understand the differences.

continued from other side

Corporations Have Special Rules on Contributions

widgets cost $2,000 to make, the contribution is only $2,000.

Second, even if the property would be subject to long term capital gain when sold, it is deductible only up to the cost basis if it is not used by the charity in its exempt purpose or if donated to a private foundation.

Inventory and other exceptions

The Tax Code provides three important exceptions to the rule limiting deductions for gifts of personal property to the tax basis.

• **Inventory.** If certain requirements are met, a corporation may deduct up to twice its basis for property donated for the care of the ill, the needy, or infants.

The gift must be inventory or depreciable property given to a public charity or private operating foundation; it must actually be used within the charity's exempt purposes for the care of the ill (one who requires medical care), the needy (one who lacks the necessities of life as a result of poverty or temporary distress), or infants (minor children). The property must be so used from the date of the contribution to the date when the statute of limitations runs for the donor's tax return on which the deduction is claimed.

Neither the charity nor any transferee of the charity may receive money, property, or services in exchange for the property, although one organization may charge another a fee for administration, warehousing and similar items. By the due date for its return, the donor must receive from the charity a written statement describing the contributed property, stating the date of its receipt, and representing that the property will be used in the required manner and that adequate records will be maintained and made available to the IRS on request.

If the donated property is subject to the Federal Food, Drug and Cosmetic Act, the property must comply with the Act on the date of contribution and the immediately preceding 180 days.

The donor is entitled to a deduction equal to its basis plus one-half of unrealized appreciation, but not more than twice its basis.

• **Research Property for Educational Institutions.** A similar deduction is available for contributions of scientific equipment manufactured by the donor within two years of the gift if given to an institution of higher education or charity operated primarily for scientific research. The property must actually be used for research, experimentation or research training in the U.S. in the physical or biological sciences.

• **Computer Equipment for Educational Purposes.** Until December 31 of this year (if the statute is not renewed), a similar deduction is available for a contribution of computer equipment, software or fiber optic cable to an educational institution or related organization which is used within the U.S. in the recipient's educational plan for grades K-12.

— Virginia P. Sikes

Don Kramer's

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Nonprofits Often Worry about UBIT

A nonprofit is subject to unrelated business income tax if it earns income from a "trade or business" which is "regularly carried on" and "unrelated" to its mission

Nonprofits often become concerned about the impact upon their federal tax-exempt status when they consider new earned income projects.

Will they have to pay a lot of tax? Or, more importantly, will they jeopardize their exemption if they generate "too much" income?

Because of continuing concerns about "unfair competition" between small businesses and charities, Congress and the Internal Revenue Service have consistently scrutinized earned income activities to see that the charities do not abuse their status.

Charities have always earned income. Hospitals have charged their daily rate. Colleges have charged tuition. Museums have had entrance fees. No one has seriously questioned those activities.

Although the IRS has occasionally questioned the "commerciality" of a nonprofit operation, it has invariably lost when the income is earned from the nonprofit's mission-related activity. There is essentially no limit on the amount of income a nonprofit can earn from related business income.

The questions arise when the institution begins to stray beyond traditional realms and generates income which is considered unrelated business income.

The rules applicable to "unrelated business income tax" ("UBIT") are relatively simple and reasonably clear. The basic rules are set out in the Internal Revenue Code (Sections 511- 514) and amplified in the official Regulations. The IRS has also issued both public and private rulings which have been generally consistent in illuminating its thinking over the years.

Basically, an organization exempt from federal income tax because it is described in section 501(c) or 501(d) of the Tax Code, other than those chartered by Congress and certain governmentally related colleges and universities, is subject to UBIT if it earns income from a "trade or business" which is "regularly carried on" and which is "unrelated" to its exempt purpose. This includes 501(c)(4) social welfare organizations, 501(c)(6) trade associations and many others in addition to 501(c)(3) charities. Tax is owed only if the activity fits within all of the definitions. Therefore, it is important to understand each of the terms.

What is a "trade or business?"
A "trade or business" is "any activity carried on for the production of income from the sale of goods or the provision of services." (Reg. 1.513-1(b).) Any earned income activity is likely to fit within this broad definition, but there are certain specific exceptions which may exempt the activity from tax.

Congress has made clear that the sale or distribution of "low cost articles" in return for larger contributions is not a trade or business activity. The tradition of giving premiums, such as a key holder, greeting cards, name labels, pens, or other identifying souvenir items in return for contributions is specifically sanctioned in the Tax Code. (Sec. 513(h), Rev. Proc. 90-12.) To qualify, the items must cost less than $5 and the gift must be more than $25, as annually indexed for inflation after 1986. (The present figures for 2014 are $10.40 and $52.00, respectively and for 2015 $10.50 and $52.50)

Three other types of activity are also specifically excluded from the definition of "trade or business."

- Where substantially all of the work is done by volunteers, such as the operation of a gift shop solely by volunteers and without paid staff. The IRS interprets "substantially all" in this situation to mean at least 85% of all activity, including purchasing, selling and keeping records.
- Where the activity is carried on for the "convenience" of members, customers, or employees. This would cover the lunch room at the museum where it would be inconvenient to leave the facility to eat.
- Where substantially all the merchandise is received as contributions. This would include the typical thrift shop selling second hand goods that have been donated, for example, but not where they are to be sold on consignment where the "donor" receives some of the income from the sale.

(There are also some "modifications" to the UBIT concept which exclude certain types of passive activities, discussed below, from the kinds of trade or business activity which is subject to tax.)

What is "regularly carried on"?

The rules on this are a little less clear. The Regulations provide that activities are regularly carried on if they "manifest a frequency and continuity, and are pursued in a manner generally similar to comparable commercial activities of nonexempt organizations." (Reg. 1.513-1(c).)

The activities of a museum shop open all year are clearly regularly carried on. The once a year fund raising auction and the typical ad book at the annual fundraising dinner are clearly not.

The Regulations provide that operating a sandwich stand for two weeks at an annual fair is not regularly carried on, while selling food at each of the year's football games is regularly carried on.

Seasonal activity, if conducted for a significant part of the season, will be considered regularly carried on, according to the Regulations. Printing paid advertising in every issue of a quarterly publication would be regularly carried on.

The IRS has frequently taken a tougher line in this regard than the courts have upheld. In a case involving the National Collegiate Athletic Association Final Four basketball tournament, the IRS charged that several months spent selling ads and producing the program book constituted a business regularly carried on. The Tenth Circuit Court of Appeals said the book was distributed only three weekends a year and therefore was not regularly carried on. (*NCAA v. Commissioner,* 914 F.2d 1417, 1990.)

What is "unrelated" activity?

Two things are clear from the statute:

- An activity is not considered related simply because the proceeds are applied to the charitable activities of the organization. Operating a spaghetti factory and applying the profits to the charity would not make the factory income exempt.

- The activity itself must be substantially related to the charitable purpose for which the organization is exempt. Selling model space rockets at the farm museum would not be exempt; selling model tractors probably would be.

In addition, the U.S. Supreme Court has made clear that it will consider the manner in which the activity is operated in deciding whether or not it is related. The more the activity seems like a regular commercial venture rather than one intended to enhance the charitable purpose, the more likely it is to be considered unrelated.

The Court emphasized this point in deciding that drug and medical device advertising in the Annals of Internal Medicine published by the American College of Physicians was unrelated and subject to UBIT, even though medically related, because it was indistinguishable from traditional commercial advertising in competing publications. (*U.S. v. American College of Physicians*, 475 U.S. 834, 1986.)

It is also clear that the IRS will look at each activity separately to determine whether it is related. There is no *de minimis* rule which would exempt an activity merely because it is minor or included within other activities which may be clearly exempt. On the contrary,

According to the Regulations, an activity is deemed to be unrelated if it is "not substantially related," other than through the production of funds, to the exempt purpose of the organization. To be substantially related, the activity must "contribute importantly to the accomplishment" of the exempt purposes.

If the activity is related, the organization can make essentially unlimited amounts without paying tax. If it is "unrelated" (and regularly carried on) the net income will be subject to tax and the activity could possibly cost the organization its exempt status.

A series of IRS rulings on sales from museum gift shops illustrates its position on "related."

In a published ruling in 1973 (Rev. Rul. 73-194), the Service ruled that sales of greeting cards faithfully reproducing selected works of art from a museum's collection "contribute significantly" to the museum's educational function and are related. The Service found that the cards stimulated public awareness, interest and appreciation of the art.

In a companion ruling (Rev. Rul. 73-105), the IRS ruled that sales of scientific books and local souvenirs by a folk art museum had no relationship to the mission of the museum, were not related, and the net income was therefore taxable.

In a private letter ruling in 1980, the IRS considered a number of items in an aquarium gift shop. It drew a distinction between sale of natural sea shells, which was related and exempt, and sale of sea shell jewelry, which it called an "adaptation," and which was therefore unrelated and taxable. It said display of jewelry of the type for sale was not within the exempt purpose of the aquarium.

On the other hand, a sea horse encased in a glass paperweight was related and not subject to tax because similar items were displayed in the aquarium collection. The IRS taxed the sale of ashtrays and other souvenirs carrying the aquarium fish logo and the sale of pillows stuffed in the shape of fish. (PLR 8024111.)

About a year later, the Service determined that a wildlife preservation society need not pay tax on the sale of various stationery items, desk accessories, cuff links, tote bags, clothing, and pillows which were decorated with exact wildlife designs. Many of the items also carried educational messages or were sold with educational literature. (PLR 8107006.) The packaging and additional educational material provided with items which might alone be considered unrelated can sometimes make the entire transaction a related one.

In 1995, the IRS considered a series of items sold at an historic museum gift shop, stating that it sought to determine whether the "primary purpose" of the sale is to further the museum's exempt purpose or to generate income. If the primary purpose is exempt, the sale is exempt, even if the item has a "utilitarian function."

The factors it weighed in determining the primary purpose include: (1) the degree of connection between the item and the museum's collection; (2) the extent to which the item relates to the form and design of the original item in the museum's collection; and (3) the overall impression conveyed by the article. If the "dominant impression" is the subject matter of the original article, the IRS said, the item would be substantially related to the museum's exempt purpose. On the other hand, if non-charitable use or function is dominant, the sale of the item would be unrelated.

The IRS obviously has a difficult time determining the "primary purpose" of the sale and a nonprofit is wise to make clear the connection with its exempt purpose.

The IRS has made clear that the place of sale does not determine whether or not the sale is exempt. Sale of an exempt item at an off-site location or through a catalogue is still exempt.

Modifications

There are a few sources of "unrelated" income that Congress has exempted from tax. They tend to be "passive" income, which does not require the full attention of the nonprofit management, including investment income, royalties and certain rental income.

Dividends and interest income on money market funds, endowments, and other reserves is not taxed, nor is capital gain on investment property. (Interest on an exempt economic development loan fund would be deemed program related income to an economic development organization because it is the result of its charitable activity. It would not have to depend on the general investment income exclusion to avoid taxation.)

Royalty income is also not subject to tax, although the IRS has fought many battles arguing that a nonprofit's involvement in the activity producing the royalty is so great that the income is no longer passive. Where the royalty comes from related activity, such as sale of an orchestra's recordings, the issue does not arise. It arises in cases of unrelated activity, such as income from affinity credit cards or rental of mailing lists.

With unrelated activities, the IRS questions the degree of involvement of the nonprofit in developing the product, marketing and policing the use. The IRS often seeks to impose tax on these activities, although the courts are not always willing to agree.

Rental of land or buildings for unrelated purposes is generally not subject to tax so long as the rental does not include substantial personal property or personal services, and so long as the property is not subject to a mortgage or other acquisition indebtedness. Rental of property for related purposes, such as rental of college dormitory rooms to students, would not be subject to UBIT even if it is subject to a mortgage because its use is related to the exempt purpose of the organization.

Nonprofits which receive more than $1000 a year in gross receipts from unrelated business activities are required to file a separate Form 990-T income tax return with the IRS. The nonprofit is able to deduct normal and necessary business expenses from the income to determine whether there is any “net” unrelated business income. If there is, the nonprofit must pay income tax at the normal corporate tax rates for any net unrelated business income in excess of $1000. Form 990-T is now a public document like Form 990 itself.

Unrelated income might also be subject to state or local income taxes, so nonprofits should be sure to check their local law if engaged in unrelated business activities.

Having “too much “ unrelated business income (whether or not it generates net income) could ultimately cause the IRS to conclude that the nonprofit does not act “exclusively” for its exempt purposes and to revoke its exemption. The line at which such income becomes “too much” is not very clear. In one case, an organization which received more than 30% of its gross income from unrelated business activities had its exemption revoked. (*Orange County Agricultural Association v. Commissioner,* 893 F.2d 647, (2d Cir., 1990).)

We recommend that an organization consider establishing a separate entity to carry out an unrelated activity if it generates gross unrelated income of more than 10% of the organization’s total income. In general, however, it is hard enough to make money from related activities. It seldom makes sense to divert attention to unrelated activities.

REPRINTED FROM *NONPROFIT ISSUES*® VOL. XVIII NO. 2

READY REFERENCE PAGE

NO. 103
FOR YOUR FILE

Compliance Assessments Protect Charities

Proactive review can reduce the risks of waking up to adverse publicity and loss of trust

Hardly a day goes by without numerous newspaper articles and other media stories about real or perceived abuses in the nonprofit sector.

What's especially tragic about the vast majority of this negative media and Congressional scrutiny is that much of it could have been avoided had the organizations' boards, officers, employees, and/or volunteers simply fulfilled their fiduciary responsibilities. In fact, virtually every case prosecuted by state and federal regulators can ultimately be traced back to the organization's board, officers, employees, and/or volunteers failing to fulfill their basic fiduciary responsibilities. Had the individuals in question been more vigilant, the wrongdoing could have been detected, addressed, and, in most instances, the subsequent negative media and governmental scrutiny avoided, or at least minimized.

Therefore, it's crucial that every board institute appropriate procedural safeguards and that every board member pay attention to his or her fiduciary responsibilities so they don't wake up one morning and find their organization featured in a negative light on the local paper's front page— or, worse still, find that their organization is now under investigation by the IRS or one or more state regulators.

A comprehensive compliance assessment can help an organization discover actual or potential problems that, if not addressed in an appropriate and timely manner, could lead to damaging media stories and/or state or federal prosecutions that could seriously impair the organization's integrity and credibility and, therefore, its overall effectiveness and viability.

What follows are brief descriptions of just a few of the many items to review during such an assessment.

First, verify that your organization is in compliance with all applicable state charitable solicitation statutes.

Thirty-nine states and the District of Columbia have statutes governing the solicitation of charitable contributions. Unless an organization is excluded or exempted from the requirements, it must register with the state *before* it solicits charitable contributions from anyone in the state. Verify that your organization is properly registered in all states where it solicits that have registration requirements. Experience has shown that sometimes organizations that handle this time-consuming, confusing, and costly process in-house are not always in complete compliance like they thought they were. Very often the person tasked with this responsibility has many other job responsibilities that keep him or her from devoting the requisite amount of time to making sure that the organization is in compliance with these important legal requirements. A charity that solicits in a state that has a registration requirement without being properly registered risks having significant fines imposed against it if caught and many an organization has been shocked to discover that the person tasked with this important responsibility has either intentionally or unintentionally "dropped the ball." When this happens and is discovered by the media and/or one or more state regulators, the organization can be the recipient of not just negative publicity, but significant fines and penalties as well.

Second, verify that all of your organization's professional fundraisers are properly registered and have filed copies of their contracts with any appropriate state oversight agencies as required.

Not only do charities have registration requirements, any private for-profit professional fundraisers the charities hire (either those who help develop and manage campaigns as fundraising counsel or those who directly ask for funds, such as telephone solicitors) most likely also have to register and file copies of their contracts too. Failure to do so can again result in the unregistered entities being subjected to significant fines and penalties as well as other legal sanctions.

Third, verify that all your organization's solicitation materials are truthful and free of material false statements, misrepresentations, and/or omissions.

For example, one state oversight agency recently settled a case with a prominent regional charity that regularly represented to the public that it had given significantly more to a medical research center than it actually had. Some years the charity's founder would even hold a press conference where he would present one of those big, oversized checks to a representative of the research facility. The only trouble was that there wasn't always a real little check that actually transferred the entire sums in question to the research facility. As part of the Settlement Agreement, the charity was required to live up to the representations it had made over the years and, among other things, actually transfer $4 million to the research facility.

The subsequent negative media publicity about the organization damaged the organization's credibility with actual and potential donors as well. At a House Oversight and Government Reform Committee hearing held a few years ago, the head of a national veteran's charity admitted that his organization sometimes overstated how much it spent on program services in its various solicitation materials because, he claimed, if the organization didn't, donors would not give anything to the organization. That kind of statement eliminates trust with the donor and begs regulators to impose sanctions.

Fourth, verify that all your organization's solicitation materials contain all statutorily-required disclosure statements.

There are about thirteen states that currently have disclosure statement requirements. For example, Section 9(k) of Pennsylvania's solicitation law requires that every solicitation, written confirmation, receipt, and reminder of a contribution clearly and conspicuously state that the official registration and financial information concerning the soliciting charity is available by calling Pennsylvania's toll-free number and that registration does not imply endorsement.

Failure to include this statutorily-required disclosure statement is a fairly common violation and each solicitation, written confirmation, receipt, and reminder of a contribution made without the required disclosure statement could result in up to a $1,000 fine being imposed for each violation in certain states.

Fifth, verify that your organization is keeping true and accurate fiscal records.

This is a fairly uniform and commonsense requirement and, yet, unfortunately, it's also a very common violation for charities of all sizes— whether they're run completely by volunteers or by full-time paid professional staff. All charities soliciting contributions have to be able to clearly show exactly how much money they've collected and how they've spent it— even, in most cases, if they're exempt from the annual registration requirements. Therefore, a charity needs to make sure it can clearly account for every dollar collected and show it spent every dollar for purposes consistent with its charitable purposes and the solicitation request. In fact, the failure to keep "true and accurate" fiscal records is itself a violation in many states. In addition, experience has shown that an organization's failure to keep "true and accurate" records greatly facilitates the ability of individuals within the organization to defraud the organization itself.

Sixth, examine the IRS Form 990 tax information returns and other registration materials your organization files with the IRS and/or state registration offices to verify that they are accurate, complete, and free of material falsifications, misrepresentations, and omissions.

Both the states and the IRS are increasingly calling charities to account for making material false statements in registration materials and IRS 990 Returns — both of which are signed under penalty of perjury. (See *Nonprofit Issues*®, January 1, 2008.)

For example, in Pennsylvania, charities can be fined up to $1,000 for each false statement or omission; they can be prosecuted criminally for each intentional, material false statement or omission; and, perhaps most importantly, they can receive huge amounts of damaging, negative publicity that can seriously hinder their ability to raise contributions in the future and, therefore, threaten their very viability.

Several years ago, Pennsylvania collected a $41,000 administrative fine from a national charity that was found guilty of making 41 intentional, material false statements in its IRS 990 Return that totaled $1.2 million. More recently, Pennsylvania filed a 1,289 count Order To Show Cause against four related charities, their officers, and their CPA in connection with a series of allegedly falsified IRS 990 Returns. As a result, these four charities, their officers, and/or their CPA were potentially on the hook for fines and penalties in excess of $1.3 million. This case was settled after the organizations in question agreed to pay $150,000 and to permanently stop soliciting contributions in the state. The organizations claim that, in addition to the $150,000 they paid, they spent hundreds of thousands of dollars on legal fees in order to get the case resolved — a pretty hefty price to pay because the organizations submitted inaccurate IRS 990s.

Seventh, verify that your organization has not ignored correspondence and/or subpoenas from State or Federal oversight authorities.

You may find this hard to believe, but this type of violation occurs quite frequently. In some cases organizations deliberately and intentionally fail to respond to these official requests for information from oversight authorities. However, in most cases the failure to respond is usually attributable to one or more individual's simple negligence and inattention. The end result of failing to respond, however, is the same. For example, when a charity ignores document requests and subpoenas issued by Pennsylvania, Cease and Desist Orders are issued prohibiting the charity from soliciting contributions and the matter is referred to a Prosecuting Attorney. Once that happens, the charity will typically be on the hook for much more significant fines and will, in all likelihood, have to sign a formal Consent Agreement to avoid further legal proceedings.

In addition, both Cease and Desist Orders and Consent Agreements are routinely posted on Pennsylvania's website for all the world to see. This fact alone should make a charity do everything it can to keep from securing such a permanent and negative place on a state's official website. The donating public and reporters regularly, and increasingly, access the various state websites and it's really much better for both to see that your organization is in compliance rather than having been caught violating the law.

Eighth, verify that your organization is not improperly treating certain individuals as "independent contractors" when they're really "employees".

When you're treated as an "independent contractor," federal and state taxes aren't withheld from your pay and you necessarily take home more money. Most of us would prefer to take home more money each payday than have a major portion of it forwarded on to the government. However, if your organization is treating individuals as "independent contractors" who really aren't, it could be on the hook for significant fines and penalties because your organization has failed to properly withhold required payroll taxes and remit them to the IRS. (See Ready Reference Page: "Classify: Employee or Independent Contractor?")

Ninth, verify that your organization is properly forwarding required withholding taxes to the IRS and state taxing authorities.

You'd be surprised at how many organizations withhold the appropriate taxes from their employees' pay and then don't forward the taxes on to the IRS, state and local taxing authorities as required. In fact, failure to do so is one of the most common violations found by the IRS when it audits charities. The General Accounting Office (GAO) recently documented that over 55,000 charities had failed to remit over $1 billion of withholding taxes to the IRS.

Tenth, verify that your organization is paying your key executives only "reasonable compensation" and not "excessive compensation".

You don't have to take a vow of poverty when you work for a charity. You're allowed to be paid "reasonable compensation," which is what similarly-situated individuals running functionally equivalent organizations are paid. However, anything more than "reasonable compensation" can be considered to be "excessive" and isn't permitted. If it's subsequently determined that your organization has paid one or more employees "excessive compensation", both your organization managers as well as the employees in question can be liable for significant fines and penalties. (See Ready Reference Page: "Charities Must Avoid Excess Benefit Transactions.")

In 2007, the IRS assessed over $20 million in penalties against 41 individuals and organizations for "excess compensation" and other violations — and the IRS indicated it would routinely include excess compensation analyses in every future audit it conducts. (See *Nonprofit Issues*®, February 16, 2007.)

This is just a small sampling of the types of inquiries that experienced, knowledgeable professionals should make during a comprehensive charity compliance assessment to minimize the chances that your organization will become the subject of a federal or state investigation and/or get featured in one or more negative media stories that could seriously damage your organization's integrity and credibility and, therefore, its overall effectiveness and viability.

In light of the recently enhanced enforcement efforts by both the IRS and various state charity regulators, does your organization really want to take the chance that either the IRS or state charity regulators will uncover and prosecute your organization for any material irregularities they find? Wouldn't it be better to find any actual or potential problems yourself and correct the problems yourself?

Just as our most important asset as individuals is our personal integrity and credibility, the most important asset of any charity is its organizational integrity and credibility. Once these two valuable assets are called into question, a charity's ability to raise funds, function effectively, and accomplish its purposes is severely hindered.

Therefore, seriously consider performing a comprehensive compliance assessment for your organization so your donors can continue to give with confidence and your volunteers can be assured that they're giving their time to an organization that's accountable, transparent, and values its organizational integrity and credibility.

By doing so, you'll help protect not just your own organization's integrity and credibility, but that of the entire nonprofit sector as well.

--Karl E. Emerson

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Don Kramer's NONPROFIT ISSUES An Electronic Newsletter of "Nonprofit Law You Need to Know" www.nonprofitissues.com

Lessons from Litigation >> June 16-July 15, 2011

Nonprofit's cost of indemnification agreement is $700,000

The nonprofit Vermont Swim Association has been ordered to pay the City of Rutland $700,000 under the indemnification provision in the contract that allowed the Association to use a city park for its annual swim meet. The Association was ordered to pay the cost of the City's settlement of a claim brought on behalf of a child who fell from playground equipment while attending the meet.

The agreement provided that the Association would "defend, indemnify and hold harmless Rutland … from all claims for bodily injury or property damage arising from or out of the presence of [the Association], including its employees, agents, representatives, guests and others present because of the event or [the Association's] activities in or about [the park]…. [The Association] shall be responsible for all costs of defense, including reasonable attorney's fees, and shall pay all fines or recoveries against Rutland."

The Association argued, as indemnitors often do in cases such as this, that the indemnity clause did not cover the City's negligence, but a trial court said the agreement was "unambiguous" and did cover the City's negligence. The trial court ordered the payment. The state Supreme Court has affirmed.

The Association "cannot escape the plain language of its agreement with the City," the Supreme Court said. "The indemnification clause allocated responsibility to [the Association] for any negligence claims directly arising out of [the Association'] event at the City's park and pool facility…. The intent of the parties could not be more apparent — the City was willing to allow [the Association] to use Whites Park as long as it was completely insulated from liability due to [the Association's] use."

The Court also noted a separate reason for liability. The agreement called for the Association to obtain insurance for the event and to name the City as an additional insured, which the Association failed to do. (*Southwick v. City of Rutland*, No. 2010-128, 5/20/11.)

Don Kramer's An Electronic Newsletter of "Nonprofit Law You Need to Know"
NONPROFIT ISSUES
www.nonprofitissues.com

July 2010

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Triathlon Club Ordered to Indemnify New York City for Accident During Race

Court says nonprofit has obligation to pay any damages for which City may be ultimately responsible

When a bicyclist riding in Central Park in New York City was injured in an accident with a cyclist riding in a race organized by the New York Triathlon Club, he sued the City for damages. He claimed that the City failed to exercise reasonable care to prevent foreseeable dangers that arose from allowing the race to proceed on park roads while the roads were being used simultaneously by the general public. (Gortych v, Brenner, Supreme Court of NY, New York County, No. 102014/05, 6/9/10.)

The City filed an answer denying liability, but filed a cross claim against the Club. The City said the accident was the Club's fault for not running the race properly and also claimed that if the City was liable, the Club had agreed to indemnify it from any damages it might incur. After discovery, the City moved for summary judgment to dismiss the case against it, and, in the alternative, to force the Club to pay any damages for which the City might be liable.

The City argued that it had merely "furnished the occasion" for the race and that it had no liability to the citizen without a "special relationship" that did not exist in this case. The injured cyclist argued that the City had a general duty to protect all of its guests in the park.

A trial court in New York City has found that the City owed a general duty of care to the cyclist and that it was a question for the jury whether the City exercised reasonable and ordinary care to prevent the accident. Therefore the summary judgment on liability was denied and the case set for trial. The Court noted that the indemnification agreement with the Club did not relieve the City from potential liability; it merely required someone else to pay the damages if the City was determined to be liable.

On the indemnification issue, the Club argued that it could not be held liable if the City had been negligent. The Court recognized that indemnification agreements are "strictly construed" and protect against one's own or a third-party's negligence only when "the intent is clear." But the provision signed by the Club provided that the Club would indemnify and hold the City harmless from "any all [sic] claims whatsoever that may result from" the race. As a result, the Court said, the Club had to indemnify the City notwithstanding the City's possible negligence.

YOU NEED TO KNOW

One can only hope, for the sake of the Club, that it had named the City as an additional insured under its own insurance policy for the race. One's own insurance ordinarily does not defend or pay damages for liability caused by third parties, and does not cover the insured's liability to indemnify that is created solely by contract. (See Nonprofit Issues®, 5/16/06.) As we have said so many times, a nonprofit must be sure to name a third party as an additional insured if it is going to sign an indemnification clause in a contract. Otherwise, in the event of a claim, it will have to pay everything out of its own treasury.

Part VIII **Statement of Revenue**

Check if Schedule O contains a response or note to any line in this Part VIII . . . . ☐

					(A) Total revenue	(B) Related or exempt function revenue	(C) Unrelated business revenue	(D) Revenue excluded from tax under sections 512-514
Contributions, Gifts, Grants and Other Similar Amounts	1a	Federated campaigns . . .	1a					
	b	Membership dues	1b					
	c	Fundraising events	1c					
	d	Related organizations . . .	1d					
	e	Government grants (contributions)	1e					
	f	All other contributions, gifts, grants, and similar amounts not included above	1f					
	g	Noncash contributions included in lines 1a-1f: $						
	h	**Total.** Add lines 1a–1f . . . . ▶						
Program Service Revenue				Business Code				
	2a							
	b							
	c							
	d							
	e							
	f	All other program service revenue .						
	g	**Total.** Add lines 2a–2f . . . . ▶						
Other Revenue	3	Investment income (including dividends, interest, and other similar amounts) . . . . ▶						
	4	Income from investment of tax-exempt bond proceeds ▶						
	5	Royalties . . . . ▶						
			(i) Real	(ii) Personal				
	6a	Gross rents . .						
	b	Less: rental expenses						
	c	Rental income or (loss)						
	d	Net rental income or (loss) . . . . ▶						
	7a	Gross amount from sales of assets other than inventory	(i) Securities	(ii) Other				
	b	Less: cost or other basis and sales expenses .						
	c	Gain or (loss) . .						
	d	Net gain or (loss) . . . . ▶						
	8a	Gross income from fundraising events (not including $ ______ of contributions reported on line 1c). See Part IV, line 18	a					
	b	Less: direct expenses	b					
	c	Net income or (loss) from fundraising events . ▶						
	9a	Gross income from gaming activities. See Part IV, line 19	a					
	b	Less: direct expenses	b					
	c	Net income or (loss) from gaming activities . . ▶						
	10a	Gross sales of inventory, less returns and allowances	a					
	b	Less: cost of goods sold . . .	b					
	c	Net income or (loss) from sales of inventory . . ▶						
		Miscellaneous Revenue		Business Code				
	11a							
	b							
	c							
	d	All other revenue						
	e	**Total.** Add lines 11a–11d . . . . ▶						
	12	**Total revenue.** See instructions. . . . . . ▶						