

Nonprofit Organizations Update

About our Nonprofit Practice Group

Arnstein & Lehr LLP provides legal services to trade associations, professional societies, public charities, private foundations, fraternal organizations, group insurance trusts, political action committees, schools, hospitals, medical staffs, "captive" insurance companies, and other organizations exempt from federal income tax under Section 501(c) of the Internal Revenue Code. The Firm's attorneys help such clients deal with a wide array of issues, including:

- Corporate and trust formation and maintenance
- Development of bylaws
- Obtaining and maintaining federal and state tax exemptions
- Avoiding and minimizing unrelated business income taxes
- Registrations and annual filings with attorneys general and other government officials
- Proper conduct of organization elections
- Avoiding antitrust problems
- Fund raising campaigns, including use of professional fundraisers
- Self-dealing, inurement and intermediate sanctions
- Relations with subsidiary groups, including group tax exemptions
- Protection of intellectual property
- Charitable gaming
- Limitations on political and legislative activity
- Professional ethics matters
- Public and member disclosure requirements
- Deductions for donors
- Nonprofit mailing permits
- Partnerships and joint ventures with for-profits
- Employment issues
- Insurance issues

Internal Revenue Service Denies Federal Income Tax Exemption for Organization That Changed Purposes and Projected Programs Repeatedly During Application Process

The Internal Revenue Service has denied a federal income tax exemption to a nonprofit organization under Section 501(c)(3) of the Internal Revenue Code after that entity changed its purposes and projected programs numerous times during the course of the exemption application process and failed to provide the IRS sufficient detailed information to allow the Service to conclude that it would be operated for exempt purposes. The nonprofit was properly organized for charitable and educational purposes, namely, "to create and foster high quality educational programs that enriched the lives of children and adults." But it then changed its purposes solely to building a Christian theme park that would "support outreach ministries that teach the gospel of Jesus Christ worldwide as well as help children and adults in need."

In rejecting the nonprofit's application for recognition of exempt status, the IRS noted that the nonprofit's articles of incorporation had never been amended to change its original purposes. The IRS also pointed out that, during the three years in which the IRS was considering the nonprofit's application, the organization's originally intended class of beneficiaries, "children and adults," had not been benefited at all from the minimal progress the organization had made in the activities and programs it had originally proposed to undertake so as to achieve the purpose stated in its articles of incorporation, namely, developing drafts of an educational game and book for retail marketing.

On the other hand, the organization had engaged in certain outreach activities while the exemption application was being processed, involving the collection of shoes and clothing for orphans in Haiti and assistance to victims of a hurricane in Haiti, as well as tsunami survivors. While these activities were charitable and worthy, the Service said that they had no connection to the organization's original purposes, and the Service could not conclude that the nonprofit was continuing to perform charitable, educational or religious purposes, or that it would continue any activities that it had performed in the past.

As for the religious purposes the organization purposed to achieve through the development and operation of a Christian theme park, the IRS pointed out that the nonprofit had provided the Service only some broad ideas concerning the park, including no plans for the location of the park, no projected date for construction of the park, and no tangible plans for its construction. All the organization had done was to state to the IRS that it was "securing a committed, working board of directors to help plan, organize, fund raise, oversee operations and maintain" the theme park, and this showed the nonprofit had done very little toward the realization of the theme park, in the opinion of the IRS.

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The IRS further advised that details of fundraising projects and funds to be raised from the public were not provided by the nonprofit, and the information submitted to the Service showed that funds for completed projects had been, in large part, provided by the organizers of the nonprofit. Especially for the theme park, which the IRS thought would be a complex and expensive undertaking, the Service felt that budgets and financial information submitted by the nonprofit provided insufficient detail.

Finally, while the organization's bylaws required a board consisting of seven Christian ministers and business people, the Service noted that the nonprofit had identified only two board members for the Service. One of those identified individuals, furthermore, appeared to be ineligible for service as a board member under the bylaws.

For all of the above reasons, the IRS concluded that the nonprofit had not presented the standards, criteria, procedures, or other means by which it intended to effectuate its purposes, the anticipated sources of receipts, or the nature of contemplated expenditures, as required by law for recognition of exempt status. Because the IRS concluded that the organization had failed to demonstrate that it would be operated for exempt purposes, within the meaning of Section 501(c)(3) of the Code, the IRS refused to recognize the nonprofit as a Section 501(c)(3) organization.

Nonprofit Assisting Charitable Donors by Selling Donated Personal Property and Distributing Funds to Charity Denied Tax Exemption

In a private letter ruling, the Internal Revenue Service has denied a federal income tax exemption under Section 501(c)(3) of the Internal Revenue Code for a nonprofit organization created "to benefit the public" by accepting donations, selling donated property, and disbursing funds to the charity of the donor's choice. The IRS noted that the organization solicited photographs of personal property, other than automobiles, from individuals who wished to have the items sold and the proceeds disbursed to charity. The nonprofit sold the donated items over the Internet through a commercial website.

Analyzing the activities of the nonprofit, the IRS said that it was performing services for the donors as their agent in a way that was characteristic of a trade or business ordinarily carried on by for-profit commercial businesses. In fact, all the individuals associated with the nonprofit were working for a for-profit Internet business that carried on essentially the same activities as the nonprofit performed for donors.

Because the nonprofit's primary purpose was to provide personal services for individuals, the IRS concluded that it did not operate for a public purpose, as required for exemption under Section 501(c)(3). The IRS further stated that the presence of this substantial, single, nonexempt purpose preventing the nonprofit from qualifying for exemption.

Merger of Hospital Organizations Controlled by Same Parent Does Not Result in Adverse Tax Consequences

In a pair of identical private letter rulings, the Internal Revenue Service has held that two health care provider organizations exempt from federal income tax under Section 501(c)(3) of the Internal Revenue Code, both of which were controlled by another Section 501(c)(3) parent organization that provided services to both health care providers, as well as other controlled exempt health care provider organizations, could merge without adverse tax consequences to any of the participating entities. The entities represented to the Service that the merger of one of the subsidiary entities into the other would enable the surviving entity to expand its acute care services to a broader community, eliminate duplication of services within the parent's system of health care provider organizations, and create a more synergistic integration of the organizations' strengths for the benefit of residents of the areas served by the organizations.

In this case, both of the subsidiary organizations operated hospitals. Under the terms of the merger, all of the assets and liabilities of one subsidiary were to be merged with and into the surviving entity of the merger, the surviving entity was to use all of the assets of the other merging entity in continuation of its tax-exempt purposes, and the surviving entity was to continue to perform its activities and those of the merging entity that the two corporations had performed prior to the merger.

After the merger, the surviving entity would continue to be governed by a board of directors, a majority of its members would be appointed by the parent organization, and the board would be representative of the community. The surviving entity would continue to maintain a compensation committee that would approve executive compensation and review its reasonableness. Also, the surviving entity would continue to maintain a conflict of interest policy, a charity care policy, and an uninsured discount policy, and would continue to make available and promote its charity care policy and uninsured discount policy to all patients regardless of their ability to pay. Finally, the survivor would continue to maintain an open medical staff for a majority of its departments, impose reasonable eligibility criteria for medical staff members of

other departments, and maintain emergency rooms at the two hospitals operated previously by the merging entities, which would be available to all patients regardless of their ability to pay.

Considering the facts as presented by the parent organization and the surviving entity, the Internal Revenue Service gave them the rulings they requested regarding the merger. The IRS held that the merger would not adversely affect the tax-exempt status of the two merging entities under Section 501(c)(3) of the Code and would not adversely affect their nonprofit foundation status under Code Section 509(a). Further, the IRS held that the transfer of assets and liabilities from one of the merging entities to the other pursuant to the merger would not produce unrelated business income to either merging entity, because the merger was a one-time event, and thus not a "regularly carried on" business activity.

Reorganization of Hospital, Supporting Organization and Fund-raiser for Hospital Will Not Affect Their Exempt Status

The Internal Revenue Service, in a pair of private letter rulings, has held that a reorganization of a hospital, its fund-raising organization and a supporting entity providing management, administrative and marketing services for the hospital will not adversely affect the exempt status of the participating entities. These nonprofits represented to the IRS that the reorganization, which basically allowed the supporting organization to control both the hospital and its fund-raising entity, would ease management of the existing organizations, promote cost savings, slow the increase in community health care costs, and facilitate the expansion of programs and services through additional entities that might be added to this group of related organizations in the future.

The hospital, in this case, provided specialized health care in the areas of rehabilitation, arthritis treatment, and specialized psychiatric care for geriatric patients and for children and adolescents. The hospital also provided hospice and home health care services for patients in the community.

Prior to the reorganization, the hospital was managed by its Board of Trustees, which also composed the membership of the hospital corporation. The hospital corporation controlled the fund-raising entity through its board of directors, and the supporting entity, which was a nonmember nonprofit, was managed by its own board of directors. All of the entities were recognized as exempt from federal income tax under Section 501(c)(3) of the Internal Revenue Code.

In order to effectuate the reorganization, the governing documents of the hospital and its fund-raising organization were to be restated to provide for control of the hospital by the supporting entity, which would be the sole member of the hospital corporation and would elect all of its board members. The hospital would provide operating capital to the supporting organization, the costs incurred by the supporting organization from providing services to the other two entities would be allocated to those entities based on their relative budgets, and, after the reorganization, the hospital and its fund-raiser would continue to have the same purposes and conduct the same activities as before it.

Considering the facts regarding the reorganization, as presented by the participating entities, the Internal Revenue Service gave them the rulings they requested. The IRS ruled that, following the reorganization, the participating entities would remain tax-exempt under Section 501(c)(3), and contributions to them by the public would continue to be deductible under Code Section 170.

Private Foundation's Grant to Educational Organization Employing the Spouse of Foundation's Manager Not Self-Dealing

In a private letter ruling, the Internal Revenue Service has held that a private foundation did not engage in self-dealing by making a grant to a publicly supported educational organization that was the employer of the foundation manager's spouse. The foundation was created to make charitable grants and awards, among other things, and the grant was in support of the educational organization's operation of certain facilities providing a learning environment for academic innovation, where students would undertake and complete assignments with assistance from one or more learning facilitators.

Key to the IRS decision was the fact that the terms of the grant indicated that grant funds were to be used exclusively for the educational facilities, and no portion was to be used to provide any form of compensation or benefits to the foundation manager's spouse, or for the educational organization's general operating expenses other than the facilities that could include payments to the spouse. Also important was the fact that the spouse was not in a position to exercise substantial influence over the educational organization's affairs or expenditures, and the educational organization had no director, officer, employee or other person in a position to exercise substantial influence over its affairs or expenditures who was a disqualified person with respect to the foundation within the meaning of Internal Revenue Code Section 4946.

IRS Revokes Exemption of Social Club Conducting Annual Street Festival

The Internal Revenue Service has revoked a nonprofit organization's federal income tax exemption under Section 501(c)(7) of the Internal Revenue Code, finding that it no longer qualifies as a social club. The IRS noted that the organization conducted an annual street festival, which raised money from the general public, and which was not an incidental, trivial or nonrecurrent activity. Because the IRS concluded that the street festival was "not a traditional social club activity within the meaning of Section 501(c)(7)," and because the income earned by the organization from its street festival was far in excess of 35% of the nonprofit's total income - the maximum amount of income from the public allowed for social clubs - the IRS concluded that the nonprofit was no longer operated as a social club, and revocation of its exemption was required.

Nonprofit Community-Based Primary Care Clinic Denied Property Tax Exemption Due to Insufficient Provision of Free or Reduced Fee Medical Services

The Appellate Court of Illinois, Third District, has upheld a decision by the Illinois Department of Revenue denying a property tax exemption to the nonprofit Community Health Care, Inc., which operates a community-based primary care clinic in Rock Island, Illinois. The nonprofit applied for the exemption on the basis of the property's alleged use for charitable purposes, contending that it met the definition of "charitable" by providing free or reduced-fee medical care to any patient unable to pay the clinic's regular fees, and the organization did not set a limit on the number of people who could receive free or reduced-fee services. But the Department denied the exemption because it judged that the clinic's primary purpose was to serve patients paying the clinic's regular fees.

On appeal of a lower court decision reversing the Department's refusal of the property tax exemption, the Appellate Court reversed the lower court and upheld the Department's decision. The Appellate Court noted that a property could not be entitled to a charitable use tax exemption unless the primary purpose for which the property was used was a charitable or benevolent purpose. However, in this case, by the nonprofit's own admission, it used the property to provide discounted or free medical service only 27% of the time, and the Appellate Court held that 27% use was insufficient to entitle the property to a charitable use tax exemption.

Golf Organization for Minority Youths Loses Tax Exemption

The Internal Revenue Service has revoked a federal income tax exemption under Section 501(c)(3) of the Internal Revenue Code for an organization created to instruct individuals, primarily minority youths, to develop and improve their capabilities in the game of golf, through clinics, workshops, lessons and seminars, using sites at schools, playgrounds, municipal golf courses, parks and other recreation areas. Key to the IRS decision was the fact that the organization was paying money to its president for access to a golf course he owned, as well as instruction fees and tournament expenses, none of which could be substantiated, while the exempt entity was allowing golf course patrons to use its driving range and receiving no payments at all from the president or his golf course in return. Further, the president was found to be commingling funds of the exempt organization with those of his for-profit businesses, and he had purchased insurance for his for-profit businesses under the name of the exempt entity. All these factors indicated that the exempt organization was providing a private benefit to its president and his businesses.

Dismissal of Church's Attack on Legality of Zoning Ordinance Affirmed After Ordinance Was Amended to Eliminate Constitutional and Statutory Problems

The Appellate Court of Illinois, Second District, has affirmed a lower court's dismissal of a church's action to obtain relief from a zoning ordinance that was alleged to be unconstitutional and in violation of the federal Religious Land Use and Institutionalized Persons Act of 2000. The All Nations Worship Center had begun conducting worship services in Elgin, Illinois in a business district where a church was not a permitted use under the local zoning ordinance, and the City of Elgin filed a complaint against the church in the circuit court, which prompted the church to file a counterclaim alleging the zoning ordinance was unconstitutional and in violation of the Act. In support of its counterclaim, the church alleged that the zoning ordinance discriminated against churches because property could be used in that particular business district by nonreligious organizations, such as membership organizations and sports and recreation clubs. In addition, the church argued that the zoning ordinance unreasonably restricted churches from locating in the city of Elgin, because churches were permitted in only one of thirty zoning categories, and as conditional uses in two more.

While this action was pending, the City of Elgin amended its zoning ordinance, and the church did not dispute that the amendments cured all perceived constitutional and statutory problems with that ordinance. As a result of the amendments,

the trial court dismissed the church's counterclaim, and the church appealed.

In the Appellate Court, the church alleged that the counterclaim should not have been dismissed because, by demonstrating that the original ordinance was unconstitutional and in violation of the Act, the church could show its entitlement to a vested right to operate in the business district without the necessity of applying to the City for a right to operate there under the amended ordinance. The Appellate Court rejected that argument, however, noting that, at best, the law allowed a property owner vested rights in a continuing use only if the property owner was violating an ordinance that was illegal ab initio or if the property owner was attempting to comply with an ordinance that was then amended, in which case the property owner might acquire a vested right to proceed under the old ordinance. But neither one of those situations appeared to apply in this case, since the ordinance was not unconstitutional or otherwise illegal on its face, the illegality in the ordinance appearing only in connection with its application to a church, and the church was proceeding in violation of the original ordinance, not attempting to comply with it.

In this case, the City of Elgin said that it had amended the zoning ordinance so that it no longer had any legitimate basis to oppose a conditional use permit for the subject property if the church applied for one. That being the case, the Appellate Court could find no reason why the church should not be required to apply for such a permit.

Funding of Scholarship Program by Set-Asides Approved in Order to Give Private Foundation Time to Evaluate Reports and Requests from Ultimate Individual Scholar Grantees in Remote Locations

The Internal Revenue Service, in a private letter ruling, has held that a private foundation could support a scholarship program through set-aside funds because funding by set-asides would facilitate the foundation performing due diligence by reviewing reports and requests from ultimate individual scholar grantees living throughout the world. The IRS said that the circumstances presented by this request were "unique and unusual" because of the magnitude of the scholarship program - involving the direct support of dozen of students across the globe - which was an unfamiliar undertaking for the foundation. Given the remote locations and difficult conditions under which the grantees were residing, the foundation had determined that it would be most prudent to retain funds until it had time to evaluate requests from a number of grantee scholars and get a sense of the bona fides of the program and its charitable outcomes.

Considering the facts as presented by the foundation, the IRS concluded that funding by a set-aside could better accomplish the purposes of the scholarship program, rather than immediate payment of expenses, because of the difficult communications problems involved in the funding of the program. The IRS also conditioned its ruling on the foundation representing that all income set aside for the program would be paid out within 60 months from the time when the first amount was set aside.

Foundation Organized by Tribe Not Entitled to Exemption for Land Used as Ceremonial Grounds

The Florida Court of Appeal, Fourth District, has held that a foundation organized by a Native American tribe was not entitled to an exemption from State property taxes on a portion on its land that was used for the "green corn dance" ceremony. The foundation had previously been granted an exemption for a large tract of vacant land that had been used for conservation purposes, because such purposes were considered charitable. But the clearing of thirty acres for use as ceremonial grounds was found inconsistent with leaving the property in its "natural state," so that the portion of the property used to hold the "green corn dance" could not be considered exempt as used for charitable conservation of land.

Employee Training Scholarship Plan Approved for Employee Welfare Trust

The Internal Revenue Service has held that a trust exempt from federal income tax under Section 501(c)(5) of the Internal Revenue Code as a labor organization will not lose its exempt status through implementation of a scholarship plan established under a collective bargaining agreement between an employer and a local union. The scholarship plan was created to pay the training cost and reimburse employees for loss wages due to time off for training. The employer contributed to the trust to provide training for its employees who were union members in order to improve their job skills, but participation in the program was voluntary.

Considering that the scholarship plan would improve employees' job skills and conditions, improve the grade of the employer's product and develop a higher degree of efficiency in the industry, the IRS concluded that the plan would further the trust's exempt purposes as a labor organization under Section 501(c)(5) of the Code. Also key to the IRS ruling that the plan would not have an impact on the trust's exempt status was the fact that the plan did not discriminate in favor of higher paid employees

IRS Finds No Adverse Tax Consequences in Private Foundation Corporation's Transfer of Assets to Trust for Purposes of More Effective Asset Management

In a private letter ruling, the Internal Revenue Service has held that a private foundation established as a nonprofit public benefit corporation could transfer all of its assets to a trust, established for the same charitable purposes and controlled by the same persons as the corporation, without any adverse tax consequences for either entity. The transfer of assets was proposed because it was believed that the trust format of the receiving entity would allow for a reduction in administrative expenses and for more effective management and ultimate distribution of assets than the corporate structure used for the transferring entity, and it was thought that the trust format of the receiving entity would allow for more flexibility in the appointment of successor trustees.

Considering the proposed transfer, the IRS ruled that the transfer should be considered one governed by Internal Revenue Code Section 507(b)(2), which would not constitute a termination of the transferring entity's private foundation status, giving rise to imposition of a termination tax. Furthermore, the transfer would not cause the receiving entity to be treated as a newly created organization and, after the transfer, the qualifying distribution and net investment income histories of both entities will be aggregated for purposes of determining whether the receiving entity qualified for reduced taxes on its investment income under Code Section 4940(e).

The IRS further concluded that the proposed transfer would not constitute self-dealing with respect to the receiving entity, any foundation manager, or other disqualified persons. Further, because control of the receiving foundation was effectively in the hands of the same persons as controlled the transferring foundation, the transferred assets would be counted towards the satisfaction of the transferring foundation's distribution requirements under Code Section 4942 to the extent that the receiving entity met the requirements of that section.

Finally, the proposed transfer and the legal and accounting expenses related thereto were found to be "qualifying distributions" under Code Section 4942 and not taxable expenditures under Code Section 4945(d). The transferor foundation was not required to exercise expenditure responsibility under Section 4945(h) with respect to the transfer of assets, except that it would be required to exercise such responsibility over any outstanding grants until the time it disposed of all of the assets and it would be required to satisfy the Section 4945(h) reporting requirements for the taxable year in which the transfers were made.

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