PERKINS LAW PLLC

# FUNDAMENTALS OF NONPROFIT ORGANIZATIONS IN VIRGINIA

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# OUTLINE OF TOPICS

## I. Introduction

### A. Historical Background

Charitable organizations have existed for over 4,000 years. The concept of charitable activity has been an integral part of cultures and religions around the world since the early stages of civilization.

Exemptions from income taxes for charitable organizations have existed since medieval times. When Congress passed the first income tax law in 1894, it included a statutory exemption for nonprofit corporations and charitable organizations. Recent estimates suggest the total annual revenues of charitable organizations in the United States exceed $500 billion. Over ten percent of all property in this country is owned by charitable organizations and over five million people are employed by charitable organizations. The IRS approves over 36,000 charitable organizations for tax-exempt status each year. Thus, the nonprofit sector plays a major role in our economy and culture in providing services and benefits to society that otherwise would not be available.

### B. Tax-Exempt vs. Nonprofit

Most people use the terms "nonprofit" and "tax-exempt" interchangeably. Legally speaking, however, the terms have different meanings. The term "nonprofit" generally refers to provisions of state law that authorize the formation of nonprofit or nonstock corporations. In this context, the term "nonprofit" indicates a specific organizational structure recognized under state law.

The term "tax-exempt" relates to certain provisions of the Internal Revenue Code of 1986, as amended (the "Code"), which describe the requirements for obtaining and maintaining exempt status.

It is important to note that not all nonprofit organizations qualify for tax-exempt status. Further, not all tax-exempt organizations are nonprofit.

As discussed below, qualification for tax-exempt status does not require incorporation under a state's nonprofit or nonstock statutes.

### C. Basic Questions

There are several fundamental issues that should be addressed in deciding whether to form a tax-exempt organization. Not every proposed activity or organization is suitable for tax-exempt status.

1. Why are we forming a new organization?

   - Could the proposed activity be carried out by an existing organization?

   - What are the short- and long-term plans for this organization?

2. Which category of exemption is appropriate?

   - Section 501(c)(3) status is not an option for every organization, but there are dozens of other categories of tax-exempt status that might be available.

3. What are the expected sources of revenue?

   - An exempt organization does not want to look too much like a for-profit business.

4. What is in it for the founders of the organization?

   - Generally speaking, tax-exempt organizations cannot be formed or operated to serve the interests of its creators or any other group of private individuals.

## II. Organizational Issues

### A. Choice of Entity

For the most part, if you want to form a tax-exempt organization in Virginia, you have two forms of entity from which to choose: (i) the nonstock corporation and (ii) the unincorporated association. The relative advantages and disadvantages of both are discussed below.

#### (i) Advantages of Nonstock Corporations

- No personal liability (with very few exceptions) for debts of the corporation.

- Perpetual existence (i.e., the corporation survives the founders).

- Statutory (the Virginia Nonstock Corporation Act) and judicial guidance and certainty (state law provides a reasonably clear road map concerning the formation, management, and operation of the corporation).

- This is the most common form of tax-exempt organization.

ii. Disadvantages of Nonstock Corporations

- Costs (state filing fees, annual fees), while not a major burden, are still higher than for unincorporated associations.

- Corporate formalities must be followed (minutes, annual consents, etc.) in order to preserve the corporate shield.

(iii) Advantages of Unincorporated Associations

- Simplicity (no state filing or fee is necessary for formation).

- Lack of state regulation, not governed by the Virginia Nonstock Corporation Act.

(iv) Disadvantages of Unincorporated Associations

- Members, directors, and officers could face personal liability for debts and liabilities of the association. While the association could purchase insurance, the risk of personal liability would still remain. Some protection from personal liability exists under Virginia statute, but not the same degree of protection as exists for nonstock corporations.

- Ambiguities exist under various state laws as to the legal status of an unincorporated association.

B. Categories of Tax-Exempt Entities

There are dozens of categories of tax-exempt organizations recognized under the Internal Revenue Code. Two of the more common categories of tax-exempt organizations are Section 501(c)(3) (public charities) and Section 501(c)(4) (social welfare) organizations.

(i) Section 501(c)(3) Organizations

- Must be organized and operated exclusively, with few exceptions, for one of the following purposes: charitable, educational, scientific, literary, or religious purposes.

- "Charitable" is generally defined to mean "providing services beneficial to the public interest."

- Activities must benefit an indefinite class of people, not particular individuals (i.e., no private inurement or private benefit).

- Contributions to Section 501(c)(3) entities are tax deductible by the donors (subject to certain limitations).

- Cannot engage in extensive lobbying efforts or get involved in political campaigns.

- Must permanently dedicate assets in a manner consistent with its charitable mission or to another Section 501(c)(3) entity.

- Must meet one of several support tests to avoid classification as a private foundation.

(ii) Common Types of Section 501(c)(3) Public Charities

(a) Publicly Supported Organizations (Section 509(a)(1))

- Normally receives at least one-third of its total support from governmental units or public contributions.

- The so-called "facts and circumstances test" provides that an organization may qualify as publicly supported if it can establish that it normally receives at least 10% of its total support from governmental units and public contributions and it maintains a continuous program for the solicitation of funds from the public, governmental units, or other charities.

- Contributions from the public are only includible as public support to the extent that total contributions from any one individual or entity, during the 4-year period immediately prior to the current tax year, are not more than 2% of the organization's total support (the so-called "Two Percent Cap").

- To soften the effect of the Two Percent Cap, an organization may exclude unusual grants from the public support calculation so long as such grant is attracted by the publicly supported nature of the organization, is unusual or unexpected in amount, and would adversely affect the organization's publicly supported status.

(b) Gross Receipts Charities (Section 509(a)(2))

- An organization that normally receives more than one-third of its support from gifts, grants, contributions, and membership fees, or gross receipts from admissions, sales, or the performance of services that are related to its exempt purpose AND receives no more than one-third of its support from gross investment income and unrelated business income.

(c) Supporting Organizations (Section 509(a)(3))

- Organization organized and operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more Section 509(a)(1) or (a)(2) organizations.

(iii) Section 501(c)(4) Organizations

Section 501(c)(4) provides tax-exempt status to a wide variety of organizations referred to generically as "social welfare organizations" as well as civic leagues and local employee associations. Typical groups that fall under this category include volunteer fire departments and homeowners associations. Basically, if an organization is formed for the purpose of promoting community welfare through educational, charitable, or recreational means, it may qualify as a Section 501(c)(4) social welfare organization.

(iv) Choosing Between 501(c)(3) versus 501(c)(4)

As stated above, the terms "charitable" and "social welfare" are often defined interchangeably so it is common for organizations to have the choice of applying for tax-exempt status under Section 501(c)(3) or Section 501(c)(4). The two types of organizations are similar in many ways (e.g., cannot be operated for profit, must benefit the community, no private inurement or benefit to a select group of insiders is allowed); the primary difference is that donations to 501(c)(4) entities are NOT tax-deductible by the donor.

In most situations, there is no compelling reason to choose Section 501(c)(4) status over 501(c)(3) status. If the IRS does not believe an applicant meets the requirements for Section 501(c)(3) status, it will often grant the applicant 501(c)(4) status instead.

C. Form 1023

This is the form used to request recognition from the IRS of an organization's status as a Section 501(c)(3) tax-exempt organization. It generally must be filed within 15

months after the formation of the organization, although extensions are possible under certain circumstances. The form also serves as your opportunity to demonstrate to the IRS that your organization is a public charity as opposed to a private foundation. For various business, tax, accounting, and administrative reasons, you generally do not want your organization to be classified as a private foundation.

Technically, the following types of tax-exempt organizations are not required to file Form 1023:

(i) a group which qualifies as a public charity and normally has gross receipts of not more than $5,000 per year;

(ii) churches; or

(iii) a subordinate organization covered by a group exemption letter.

However, filing Form 1023 is recommended for all public charities in order to confirm its tax-exempt status as a Section 501(c)(3) entity. Otherwise, even if an organization falls within one of the above-referenced categories, it risks being second guessed by the IRS at some point. Further, an IRS determination letter is the best evidence to convince the rest of the world that an organization is a bona fide Section 501(c)(3) entity. Without such a determination letter, an organization may have serious trouble raising funds and soliciting charitable gifts from the public and other charitable organizations.

A few years ago the IRS unveiled an abbreviated version of Form 1023 called Form 1023-EZ. This version is much shorter and easier to complete, it must be filed electronically, and it requires payment of a lower user fee ($275) than the regular Form 1023 ($400 or $850). Generally speaking, small nonprofit organizations with gross receipts of $50,000 or less and assets of $250,000 or less are eligible to utilize Form 1023-EZ. The Form 1023-EZ instructions include a simple eligibility worksheet to determine whether an applicant can file Form 1023-EZ or has to file the regular Form 1023.

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D. Form 1024

This is the form for applying for Section 501(c)(4) status. It is very similar to Form 1023, but a little shorter. Unlike 501(c)(3) entities and Form 1023, an organization that meets the qualifications of Section 501(c)(4) is entitled to 501(c)(4) status regardless of whether it ever files Form 1024. That is to say, filing Form 1024 is not required; however, most organizations seeking 501(c)(4) status will file Form 1024 to receive IRS confirmation and eliminate the risk of being second guessed later.

## III. Directors and Officers

### A. Selecting Directors and Officers

The success of a tax-exempt organization depends heavily upon the commitment, dedication, and talent of its directors and officers. Therefore, an effective officer or director should possess most of the following attributes:

1. He or she should have a good understanding of the responsibilities of serving as a director of a tax-exempt organization.

2. He or she should ask relevant questions before agreeing to serve as an officer or director, such as:

    - What is the mission of the organization?
    - What is the organizational structure and history of the organization?
    - Why me?
    - What is expected of the board as a whole and of each member?
    - What are the organization's short range and long range goals?

3. He or she must be willing to attend meetings on a regular basis and contribute a reasonable amount of time to the organization.

4. He or she must work well with others and be willing to share his or her talents and creativity, while being accepting of other people's ideas at the same time.

### B. Educating Directors and Officers

Every nonprofit organization should prepare and maintain a Board Manual. The Board Manual serves as a useful reference and educational resource for both directors and officers of the organization.

A Board Manual should be circulated to every member of the organization's board of directors, preferably at an orientation session for newly elected officers and directors before they assume their official positions. The Board Manual should contain the following documents and information:

(i) a copy of the Articles of Incorporation, Trust Document, or Constitution;

(ii) a copy of the Bylaws or Standing Orders;

(iii) a copy of the IRS determination letter granting the organization its 501(c) status;

(iv) a short description of the roles and responsibilities of the Board;

(v) a copy of the organization's Code of Ethics and Code of Conduct (including a conflict of interest policy);

(vi) brief job descriptions of officers and board members;

(vii) brief descriptions of the various committees of the organization and how they operate;

(viii) guidelines for recruiting, selecting, and removing board members;

(ix) board meeting attendance and reimbursement policy;

(x) guidelines for evaluating directors and officers;

(xi) guidelines for evaluating staff;

(xii) list of board members, staff, and brief biographical histories and background information on each person;

(xiii) board and committee meeting minutes for the preceding year;

(xiv) short and long range planning summaries;

(xv) brief description of programs and services;

(xvi) the most recent budget and financial statement for the organization; and

(xvii) a brief description of the organization's fiscal policies and internal control policies.

C. Duties and Responsibilities

(i) Standard of Conduct. Under the Virginia Nonstock Corporation Act, a director must discharge his or her duties in accordance with such director's good faith judgment of the best interests of the corporation. Generally speaking, this is a lenient standard and will not result in directors being liable for mistakes or bad decisions.

(ii) Assets Held in Public Trust. A recent Virginia Supreme Court case confirmed that, under Virginia law, the property of a charitable corporation is held in trust for benefit of the public. Thus, directors of a tax-exempt organization in Virginia arguably have a fiduciary duty to the public separate and apart from the statutory standard of conduct discussed above. This also means that the Virginia Attorney General's Office and local Commonwealth's Attorney offices can assert jurisdiction over the affairs and assets of a tax-exempt organization in Virginia that is suspected of breaching this duty owed to the public.

(iii) Conflicts of Interest. Each director and officer should understand that he or she cannot personally profit or benefit as a result of his or her status as a director or officer. Full and fair disclosure of conflict of interest transactions is essential. Individuals with a conflict of interest relating to a particular matter or transaction should not be involved in the discussion, approval, or disapproval of that matter (other than to describe his or her connection or interest in the transaction giving rise to the conflict). An organization may enter into transactions where conflicts of interest exist, but only if all relevant facts are disclosed ahead of time and the transaction is deemed to be fair to the organization. Every tax-exempt organization should have a written conflicts of interest policy and each director and officer should pledge in writing to adhere to such policy upon taking office.

## IV. Employees

### A. Board-Staff Relationships

The relationship between volunteer directors and paid staff in theory should be a harmonious relationship between two groups of people pursuing the same mission. In reality, however, tensions often arise in this relationship and resulting effects can include inefficiencies, poor morale, and high employee/volunteer turnover rates. The three keys to maintaining efficient board-staff relationships are:

1. Communication
2. Clarity
3. Consistency

Staff and volunteer roles should be communicated to everyone on a regular basis and applied consistently throughout the organization.

Although different organizations have different policies, procedures, and organizational structures, it is common for staff to be concerned with day-to-day details and implementation of programs while the board of directors assumes responsibility for setting policies, establishing broad plans and goals, devising an annual budget, and providing general direction to the organization.

## V. Tax Issues

### A. Reporting Requirements and Filings

(i) IRS Form 990. Most tax-exempt organizations are required to file IRS Form 990 (or the shorter Form 990-EZ or Form 990-N (e-Postcard)) each year. Form 990 is due on or before the 15th day of the fifth month following the end of the organization's tax year (e.g., May 15 for calendar-year organizations). Exempt organizations with annual gross receipts greater than or equal to $200,000 or total assets greater than $500,000 must file Form 990.

(ii) IRS Form 990-EZ. Tax-exempt organizations with annual gross receipts of more than $50,000 but less than $200,000 and total assets of less than $500,000 may file Form 990-EZ instead of the longer Form 990. Form 990-EZ is shorter and simpler to complete than Form 990.

(iii) Form 990-T. This form relates to the reporting and payment of unrelated business income tax ("UBIT"). Basically, a tax-exempt organization will be taxed (at regular corporate income tax rates) on income derived from any trade or business that is regularly carried on and not substantially related to the organization's tax-exempt purpose. UBIT issues are very fact specific and must always be closely examined on a case-by-case basis.

(iv) IRS Form 990-N (the e-Postcard). Tax-exempt organizations with annual gross receipts less than $50,000 are not required to file either Form 990 or Form 990-EZ. However, the Pension Protection Act of 2006 added a new filing requirement on these organizations. Form 990-N (e-Postcard) is a short, simple form that must be filed electronically by exempt organizations with gross receipts that are normally less than $50,000 per year. The e-Postcard is due every year by the 15th day of the 5th month after the close of its tax year. Failure to file for three consecutive years will result in automatic loss of tax-exempt status. Additional information can be found at http://epostcard.form990.org.

B. Intermediate Sanctions

The term "intermediate sanctions" refers to certain sections of the Code that impose penalties on tax-exempt organizations and personal liability on certain "insiders" (e.g., directors and officers) who engage in so-called "prohibited transactions." While a detailed discussion of these issues is beyond the scope of this outline, private inurement and personal benefit are typically involved in these transactions.

C. Public Disclosure Rules for Tax-Exempt Organizations

Tax-exempt organizations (other than private foundations) are required to make certain records available to the public. These rules were promulgated as part of the Taxpayer Bill of Rights 2, enacted on July 30, 1996, and the Tax and Trade Relief Extension Act of 1998, which amended Section 6104(d) of the Code. The final regulations provide guidance concerning the information a tax-exempt organization must make available for public inspection and supply in response to requests for copies. The final regulations also provide guidance on the following issues: (i) the place and time the organization must make these documents available for public inspection; (ii) conditions the organization may place on requests for copies of the documents; and (iii) the amount, form, and time of payment of any fees the organization may charge.

(i) Availability of Information. The rules require all tax-exempt organizations (other than private foundations) to make their three most recent annual information returns and their application for tax exemption

available to the public. An exempt organization is not required, however, to disclose the parts of the return that identify names and addresses of contributors, nor is it required to disclose Form 990-T.

(ii) Place and Time of Availability. A tax-exempt organization must make the required documents available for public inspection, and provide copies upon request, at its principal office and at certain regional or district offices (i.e., places where the organization maintains management staff). Requests made in person must be fulfilled immediately unless unusual circumstances exist, in which case the request must be fulfilled no later than the next business day following the day the unusual circumstances cease to exist. In no event may the delay exceed five business days. Written requests must be answered within 30 days of receipt. If, however, the organization requires advance payment of a reasonable fee for copying and postage charges, it may provide the copies within 30 days from the date payment is received, rather than from the date it received the initial request.

(iii) Permissible Charges. Section 6104(d)(1)(B) of the Code permits an organization to charge a reasonable fee for the cost of copying and mailing documents in response to requests for copies. The regulations state that a fee is reasonable only if it does not exceed the fees the IRS charges for copies of tax-exempt organization tax returns and related documents. This fee is currently $1.00 for the first page and $0.15 for each subsequent page. The regulations also allow a charge for actual postage costs. Organizations are permitted to collect payment in advance of providing requested copies, but the organization must request advance payment within seven days from the date the original request is received. Cash, money orders, and personal checks must be accepted. If, however, the organization accepts payment by credit card, then it does not have to accept personal checks. In addition, an organization must receive consent from the requester before providing copies for which the copying and postage fees will exceed $20.

(iv) "Widely Available" Alternative. The regulations provide that an exempt organization is not required to comply with requests for copies if the organization has made the requested documents widely available. Documents can be made "widely available" by posting them on the Internet in a format prescribed by the regulations.

(v) Protection from Harassment Campaigns. The regulations provide that an exempt organization may suspend compliance with a request for information if the organization reasonably believes the request is part of a harassment campaign. Generally speaking, the regulations provide that a harassment campaign exists where relevant facts and circumstances show that the purpose of a group of requests was to disrupt the operations of the tax-exempt organization rather than to obtain information. A tax-exempt organization that believes it is the subject of harassment should file an application for a harassment determination within ten business days after suspending compliance with an information request. In addition, a tax-

exempt organization can disregard requests for copies in excess of two per month or four per year made by a single individual or sent from a single address.

(vi) Penalties. If an organization fails to comply with the above-referenced requirements, the penalty provisions of Sections 6652(c)(1)(C), 6652(c)(1)(D), and 6685 apply. A summary of these provisions is set forth below.

- Section 6652(c)(1)(C) and (D): Violations of the public inspection rules shall be subject to a penalty of $20 per day so long as noncompliance persists (up to a maximum of $10,000, or in some situations as much as $50,000 with respect to any one return). Such penalty shall be paid by each person who violates the public disclosure requirements.

- Section 6685: Any person who is required to comply with the requirements of Section 6104(d) and who willfully fails to so comply shall pay a penalty of $5,000 with respect to each return or application.

An aggrieved party whose disclosure request has been denied or ignored may alert the Internal Revenue Service as to the possible need for enforcement action by providing a statement to the applicable district director describing the reason why the individual believes the denial was in violation of Section 6104(d).

## VI. Frequently Asked Questions

*1. What records are we required to make publicly available? Under what circumstances can we refuse a request for documents? What are the penalties for failure to comply with the public inspection requirements?*

Answer: Documents that must be publicly available include the exempt organizations ("EO's") exemption application (Form 1023 or Form 1024) and its three most recently filed annual information returns (e.g., Form 990 or Form 990-EZ). An EO is required to make a copy of these documents available for inspection during regular business hours at its principal office. If an EO maintains one or more regional or district offices having at least three employees, documents must also be available at each office.

If a request is made in person, the request should be honored the same day. If a request is made in writing, the EO has 30 days to respond. The EO may charge reasonable copying costs and actual cost of postage if it provides timely notice of the approximate cost and the acceptable form of payment. The EO must fulfill a request for a copy of the organization's

entire application or annual information return or any specific part or schedule of its application or return.

An EO is not required to disclose the names or addresses of its contributors. Trade secrets, patents, and other confidential information may also be withheld. Furthermore, an EO does not have to comply with individual requests for copies if it makes the documents widely available, such as posting them on the Internet in accordance with applicable IRS Regulations.

Responsible persons of an EO who fail to comply with the public inspection requirements may be subject to a penalty of $20 per day for as long as the failure to comply continues. A maximum penalty of $10,000 may be levied for each failure to provide a copy of an annual information return. However, there is no maximum penalty for the failure to provide a copy of an exemption application.

2. *What organizations are not required to file an annual return on Form 990?*

Answer: The following organizations are not required to file Form 990:

(i) churches, conventions or associations of churches, or integrated auxiliaries of churches;

(ii) government units and certain affiliates;

(iii) church affiliated organizations that are exclusively engaged in managing funds or maintaining retirement payments;

(iv) schools (below college level) affiliated with a church or operated by a religious order;

(v) foreign organizations (other than private organizations) that normally do not have more than $25,000 in annual gross receipts from sources within the U.S.; and

(vi) exempt organizations (other than private foundations) whose gross receipts are normally not more than $50,000 annually (gross receipts are the total amount received from all sources during its annual accounting period, without subtracting costs or expenses).

An EO otherwise exempt from the filing requirement may voluntarily choose to file Form 990 (simply complete the top

portion of the return and check the box on line K). An organization that had been filing Form 990 and subsequently becomes exempt from the filing requirement should notify the IRS of the change in filing status. As noted earlier, smaller exempt organizations may be required to file Form 990-N.

*3. Are we required to give donors written receipts? If so, when?*

Answer: Charities need to provide written receipts for contributions of $250 or more. The IRS recently tightened the rules on donors concerning requirements for documenting cash contributions. A donor cannot deduct a cash contribution, regardless of the amount, without keeping one of the following: (i) a bank record (e.g., a canceled check, bank statement, or credit card statement) that shows the name of the organization, the date of the contribution, and the amount of the contribution, or (ii) a receipt (or a letter or other written communication) from the charitable organization showing the name of the organization, the date of the contribution, and the amount of the contribution.

If the donation is in the form of property, the receipt must describe, but need not value, the property. The receipt should also note whether the organization provided any goods or services in consideration, in whole or in part, for the contribution and, if so, must provide a description and good faith estimate of the value of the goods or services. The organization must provide written disclosure to a donor who receives goods or services in exchange for a single payment over $75 (see #4 below). Organizations that provide knowingly false written substantiation to a donor may be subject to penalties.

From a timing perspective, donors need to receive the requisite written acknowledgement from the organization the earlier of the date they file their tax return for the year in which the donation was made, or the due date (including extensions) for filing the return.

There are special substantiation requirements for donations of property with a fair market value of $5,000 or more. Please consult with an accountant or attorney in such situations.

4. *What happens if we give donors something of value in exchange for their contribution (e.g., a souvenir or commemorative gift, dinner, etc.)? Is the donor entitled to fully deduct his or her charitable donation if he or she receives something of value in return?*

Answer: The concept of quid pro quo concerning charitable gifts is a common source of confusion. Fundamentally, a charitable gift is a transfer of money or property from a donor to a charitable organization with no strings attached and nothing received in return (other than a tax deduction and the emotional satisfaction of helping a worthy cause). In other words, the donor should not receive any tangible benefit in exchange for the donation. When a donor receives something of value in exchange for his or her donation, then the transaction may not be deemed a charitable gift or the deductibility of the gift may be affected.

If a donor makes a quid pro quo contribution in excess of $75, the EO must provide a written statement that:

(i) informs the donor that the amount of the contribution that is deductible is limited to the excess of the amount of any money and the value of any property (other than money) contributed by the donor over the value of goods and services provided by the organization; and

(ii) provides the donor with a good faith estimate of the value of the goods or services.

For example, where a donor donates $100 to a charity and receives in return a concert ticket valued at $40, the deductible amount of that $100 donation would be $60. Because the donor's payment exceeds $75, the charity must provide a disclosure statement that complies with the above-referenced requirements.

Failure to comply with these disclosure rules can result in penalties of $10 per violation, up to a maximum of $5,000 for all violations relating to a single fundraising event.

5. *If we sell raffle tickets, can the buyers treat their purchases as tax-deductible charitable contributions?*

Answer: The price paid for raffle tickets is not deductible as a charitable contribution.

6. *Are prizes awarded in a raffle or drawing subject to tax reporting? If so, what are the relevant requirements and forms?*

Answer: The prize value is reportable as taxable income by the winner. The EO sponsoring the raffle or drawing also has reporting and tax withholding obligations.

The fair value of the prize must be reported on Form W-2G. A prize received in a drawing for which no separate ticket was purchased to be eligible is reported on Form 1099 Miscellaneous.

If the prize is $600 or more, Form W-9 requesting the winner's federal taxpayer identification number should be completed and signed by the winner before awarding the prize. The EO must file either Form W-2G or 1099 Miscellaneous. If the winner fails or refuses to give his taxpayer identification number, the EO is required to pay 31% of the prize to the IRS as backup withholding.

If the prize is more than $5000, Form W-9 should be completed and signed by the winner before awarding the prize. If it is a cash prize, 28% of the net prize value must be subtracted and withheld from the prize. (Net prize value equals the fair market value of prize less the wager paid.) If it is a non-cash prize (i.e., automobile), the winner should pay the EO 28% of the net prize value before the prize is awarded. If winner refuses or fails to furnish his or her taxpayer identification number, the withholding rate is 31%. Form W-2G or 1099 Miscellaneous must be filed by the EO and furnished to the winner by January 31 of the following year.

7. *After receiving an IRS determination letter recognizing our status as a Section 501(c)(3) charitable organization, do we need to register with the Commonwealth of Virginia or local government?*

Answer: A charitable organization which intends to solicit contributions, or have contributions solicited on its behalf, may be required to file an initial registration statement (Form 102) with the Commissioner of Agriculture and Consumer Services. The initial registration fee is $100. Thereafter, registration statements must be filed on or before May 15 of each following year. Please call the Virginia Department of Agriculture and Consumer Services at (804) 786-2042 or visit its website at www.state.va.us/~vdacs/vdacs.htm to obtain copies of the relevant forms and other information.

Some county and city governments also impose separate registration or filing requirements for charitable solicitations (e.g., Henrico County does not impose any such

requirements, but Chesterfield County requires a permit for door-to-door solicitation). Please check with your local government office or contact an attorney for specific requirements in your area.

*8. Can the organization compensate its directors and officers? What does "private inurement" mean?*

Answer: An EO may provide reasonable compensation (including salary and benefits) to its directors and officers. It may also reimburse its volunteers for expenses incurred while doing work for the organization (e.g., mileage reimbursement). The EO must be able to substantiate that the compensation is not excessive or unreasonable for the services provided.

As a general rule, a tax-exempt organization must operate exclusively in furtherance of its charitable mission. Private inurement occurs when a person receives funds or property from an EO without justifiable reason. Private inurement generally (but not always) involves so-called "insiders." This term includes (i) someone with the power to authorize payments, such as a board member, trustee, or officer; (ii) a relative of such person; (iii) a substantial contributor able to influence the organization; and (iv) a business controlled or owned by one of the above individuals.

Penalties referred to as "intermediate sanctions" may be imposed in situations involving private inurement, including repayment of the excessive compensation/benefit and a 25% penalty tax. The manager (officer, director, or trustee) who participated in the transaction may also be liable for tax equal to 10% of the excessive benefit (up to a maximum penalty of $10,000). An additional 200% tax can be assessed if the transactions in questions are not "undone" or corrected in a timely fashion. It is important to note, however, that these intermediate sanction penalties result in personal liability to the offending individuals, not the organization.

In addition to intermediate sanctions, an EO may lose its tax-exempt status in egregious cases of private inurement.

*9. What is the unrelated business income tax? What constitutes an "unrelated business"?*

Answer: Income received by an EO is subject to the unrelated business income tax if the following three factors are present:

(i) the income is from a trade or business,

(ii) the trade or business is regularly carried on by the organization, and

(iii) the activity is not substantially related to the organization's exempt purposes.

A trade or business includes any activity conducted on a regular basis and carried on for the production of income from the sale of goods or the performance of services. The frequency of the activity is compared to the same or similar business activities of nonexempt organizations. The activity is related to the EO's exempt purposes if it bears a causal relationship to achieving the exempt purpose. The production of goods or the performance of services must contribute significantly to the accomplishment of the organization's exempt purposes.

Examples of unrelated business income include: (i) the operation of dining facilities for the general public by a tax-exempt social club, (ii) the operation of a miniature golf course in a commercial manner by an EO providing for the welfare of teenagers, and (iii) the presentation of commercial programs and the sale of air time by a tax-exempt broadcasting station. Examples of related business income include: (i) a furniture shop operated by an exempt halfway house and staffed by residents, (ii) the sponsorship of championship tournaments by an EO organized to promote a sport, and (iii) the provision of veterinary services by a tax-exempt humane society.