

## FUNDRAISING ACTIVITIES BY EXEMPT ORGANIZATIONS : BEWARE OF INDIVIDUAL ACCOUNTS



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A common element of exempt organizations both in and out of the horse industry is the continuing need to raise monies. Oftentimes an exempt organization's fundraising efforts involve charitable gaming where permitted under state law, such as bingo, pull tabs and raffles, or the sales of merchandise, such as candy bars, cheese, wrapping paper, cookies, etc., or the use of merchant affiliation cards whereby a certain percentage of a customer's purchases at a merchant's business are donated to the exempt organization.

To induce members of an exempt organization to participate in these fundraising activities, many exempt organizations have evolved a practice whereby those who participate are credited with amounts based upon their level of participation at a predetermined rate. Such credits are then used by the participant to offset dues, defray the cost of attending an annual event or a myriad of other uses as the exempt organization may permit. Exempt organizations have found that the use of such "carrots" is beneficial to the organization by encouraging participation by a broader range of members or their relatives as well as reducing the overall costs of operations which benefits all members. The use of such individual fundraising accounts appears to be a pervasive practice especially among booster clubs, i.e., organization formed to contribute money to an associated club, sports team, or organization.

→ Nevertheless the use of such individual fundraising accounts is viewed with a jaundiced eye by the Internal Revenue Service ("IRS" or "Service") and may be considered grounds for revocation of an organization's tax exempt status. The concern of the government is whether the organization is in effect operated for the benefit of a few private interests such as the organization's members rather than for the greater public good. To date the IRS has issued little guidance as to the parameters of their concerns and what level, if any, the use of individual fundraising accounts is acceptable.

Insight into the Service's concerns with respect to such fundraising accounts is found in correspondence to a boy scout pack in 2002. The pack had sought guidance concerning a proposal whereby individual scouts who participated in certain fundraising activities of the scout pack would be allocated a portion of such revenues to be used for a scout's expenses, namely (1) scouting fees

such as organization dues and camp registration fees; (2) the purchase of items to be used exclusively for scouting such as uniforms and scouting books; and (3) the purchase of items to be used primarily for scouting such as camping equipment. The IRS stated that the use of fundraising accounts by exempt organizations raised "troublesome" tax issues and then went on to discuss whether the use of such accounts was violative of the "private benefit doctrine".

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Under the private benefit doctrine an organization is not organized or operated exclusively for exempt purposes unless it serves a public rather than a private interest. The amount of private benefit that will be permitted depends upon the magnitude of that benefit in relation to the public benefit derived from the organization's activities and whether the private benefit is necessary for the organization to achieve its exempt purpose. To avoid a finding of more than incidental benefit, the private benefit must be both qualitatively and quantitatively incidental. Qualitatively incidental means that the private benefit is merely a byproduct in that the exempt purpose cannot be achieved without necessarily benefiting certain individuals privately.

Quantitatively incidental means that the amount in question must be insubstantial. The Service in applying these tests to the scouting situation indicated that the private benefit may be small under a quantitative analysis but questioned whether such private benefit was necessary to fulfill the scout pack's goals thereby potentially failing the qualitative test. Unfortunately, the IRS did not issue any formal guidance to the scout pack saying the advice was merely "advisory" and not binding. Clearly the import was that the use of such accounts would be at the scout pack's own peril.

Recently the IRS issued an adverse determination revoking the exempt status of a booster club organized to provide financial support to school aged children competing in gymnastic competitions. In this case, the exempt organization required its parent members to participate in the fundraising events and partially credited each child's account on the basis of his or her parent's level of participation. In this case, a child would not be permitted to compete unless a parent either raised a certain amount of funds through fundraising events or paid upfront the anticipated cost of participation in the competition. In revoking the organization's exempt status, the IRS relied upon the "private inurement doctrine" as the basis for its determination that the organization did not serve the greater public good. Essentially the doctrine forbids the

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income or assets of exempt organizations to be used or benefit one or more persons who are in control of the organization. The IRS found that the parents of the booster club constituted a control group or “insiders” who used the assets of the exempt organization to their benefit in direct proportion to the amount of their respective fundraising efforts. It also noteworthy in this case that the Service pointed out that the organization provided no scholarship program for those children whose parents were unable to raise the money for them to participate and that another beneficiary of the booster club was a local gym owned by private interests.

Recently the author has been involved in the representation of a booster organization that supported a high school band . The booster club had for several years engaged in the practice of establishing fundraising accounts for those members who participated in fundraising events, such as bingo sessions, sales of raffle tickets, sales of cheese, wrapping paper and other seasonal items. The amounts credited to such accounts were used solely as an offset to a child’s annual band dues. The parents could not otherwise monetize these credits and if there was a balance at the time a child graduated or ceased to participate in the high school band, these credits were forfeited. The accounts were not used to purchase any specific items for the child or otherwise entitle the child to any other benefits. The booster organization waived annual fees for any child who qualified for the school’s free lunch program. Interestingly the booster organization had undergone an audit by the Service in 2003 and no questions were raised about the organization’s use of such fundraising accounts. Nevertheless, in the current audit the examining agent challenged the use of such accounts as a threat to the organization’s tax exempt status relying on both the private inurement doctrine and private benefit doctrine. In addition, the agent raised the spectre of whether the use of such accounts constituted income to the participants. Such a claim also raises whether the fundraising operations of the exempt organization would qualify for the “volunteer exception” from unrelated business taxable business income under Section 513(a)(1) of the Code.

The IRS certainly has an interest in insuring that the integrity of an exempt organization’s purpose remains intact, namely that the public good is served rather than the interests of a few private citizens. In the situation of the booster club for the band, the public good is served by the creation of a positive learning outlet for high school students. The band contributes to the positive image of the school, represents it and the local community at events around the country such as the Macy’s Day Parade. Further, the booster club essentially provides underwriting for an expense that the local school district given its budgetary constraints cannot afford to fund. Ultimately, the use of such accounts actually reduces the dues required of all of its members because otherwise the fundraising revenues are typically reduced and then dues must be raised for all members. Does this mean that activities supported by booster clubs such as the band in this example will only be offered to the affluent schools?

In spite of these legitimate arguments, there is little or no fact specific guidance from the IRS as to when the use of such fundraising accounts crosses the line other than the mantra that they should not be used at all. This area seems ripe for the IRS to issue guidance that would permit some safe harbor use of the accounts that exempt organizations can rely upon without the threat of adverse tax consequences or the incurring of substantial fees to defend themselves. Not surprisingly, such exempt organizations typically do not budget nor have the resources for professional fees.

Until such time as the IRS may issue some actual specific guidance, an exempt organization’s use of individual fundraising accounts is done so at its own peril. Such organization’s should review their practices and seek counsel for further advice as to what steps should be taken to thwart a challenge by the IRS of their continued exemption.

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