

**2013
Nonprofit and
Association
Roundtable
Series**

October 2

**Avoiding Form
990 Pitfalls
Part II**



Presented by:

**Linda Geery,
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Avoiding Form 990 Pitfalls Part II

October 2, 2013

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Agenda

- **Unrelated Business Income (UBI)**
 - Income and Activities Exempt from UBI
 - Limitations on Deductions
 - Dual Use of Facilities and Personnel
 - Advertising Income and Costs
 - Net Operating Loss (NOL) Deductions

- **Political Activity**
 - Form 990, Schedule C
 - General Lobbying vs. Grassroots Lobbying
 - Lobbying Limitations
 - Dues Notifications

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Unrelated Business Income (UBI)

➤ An activity is an unrelated trade or business, if all of the following conditions exist:

- **Trade or Business:** Conducting a trade or business for production of income from selling goods or performing services; If lacking a profit motive, normally not a trade or business
- **Regularly Carried On:** Trade or business is regularly carried on. If an activity's frequency, continuity, and manner of conduct are comparable to the commercial operations of similar nonexempt entities, it normally is considered regularly carried on
- **Unrelated to Exempt Purpose:** Activity is “not substantially related” to the carrying out of the organization's exempt purpose. To determine whether an activity is “unrelated,” its relationship to the organization's exempt purpose must be analyzed

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Definition

- An unrelated trade or business is any trade or business, the conduct of which is not substantially related to exercise or performance of organization's exempt purpose
- The fact that organization needs or uses profits from a business activity to support its program services has no bearing on determination of whether activity is unrelated

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Example



- Bedford Humane Society, an exempt organization, is organized and operated for the prevention of cruelty to animals
- Receives approximately 80%-85% of funds needed to maintain its program services from City of Bedford and public donations
- To generate the rest of revenue needs, the Society provides boarding and grooming services for the general public
- Services are unrelated trade or business because they are not related to the Society's *exempt purpose*, even though without this business activity the Society would be unable to fully fund its program services

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Common Types of UBI

- Advertising income
- Trade or business operated by non-profit that is unrelated to exempt purpose
- Rental of Debt-Financed Property



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Income Exempt from UBI

- Interest, dividends, and similar income
 - Unless income is from debt-financed property, interest or annuities from a controlled organization
 - Unless recipient organization is a social club, voluntary employees' beneficiary association or supplemental benefit trust

- Royalties
 - Unless produced by debt-financed property or received from controlled organization
 - Unless recipient organization is a social club, voluntary employees' beneficiary association or supplemental benefit trust

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Income Exempt from UBI

➤ Rental Income

- Many exceptions including:
 - Property is debt financed
 - Rent is from controlled corporation
 - Rent is calculated as a percentage of the tenant-lessee's net income
 - Payment includes compensation for services rendered to lessee
 - More than 50% of rent is attributable to personal property leased with the real property
 - Owner-lessor is a social club, voluntary employees' beneficiary association or supplemental benefit trust

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Rental Income Example 1

- United Charities, Inc., a 501(c)(3) organization, owns a dining room facility used on weekdays for its exempt purpose
- Facility is rented to the public on weeknights and weekends. United regularly rents facility at fair market value
- United's only responsibilities in the rental agreements are to provide utilities and janitorial services



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Rental Income Example 2

- United Charities, Inc., a 501(c)(3) organization, owns a dining room facility used on weekdays for its exempt purpose
- Facility is rented to the public on weeknights and weekends. United regularly rents facility at fair market value
- United's responsibilities in the rental agreements are to provide utilities, janitorial services, personnel to set up room and kitchen staff to prepare food for events held at facility

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Income Exempt from UBI

- Gains or losses from disposition of property
 - Exceptions: property that is debt-financed, is S Corporation Stock, or to inventory sold during the ordinary course of a trade or business
- Research income
 - Exceptions: research income of tax exempt social clubs, voluntary employee's beneficiary associations, or supplemental unemployment benefit trusts
- Qualified sponsorship payments

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Activities Excluded from UBI

➤ Volunteer Labor

- Any activity in which substantially all of the work is performed by unpaid volunteers is not an unrelated trade or business
- An organization's paid staff may be directly involved with an activity that is exempt under this exception, provided sufficient volunteer effort is also present (about 85% volunteer work)



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Example 1

- Kindwill Industries, Inc., a public charity, operates a thrift store. Store is open during normal business hours throughout year and sells items obtained from general public
- Some items are donated, but most are received on consignment. Kindwill and consignor agree on retail price of item, Kindwill's share of price if item sold, and disposition of item if not sold within stated period
- Substantially all work in operating store is performed by volunteers, and all profits go to support Kindwill's program services

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Activities Excluded from UBI

➤ Member Convenience

- An activity carried on by a 501(c)(3) entity or by a governmental college or university, primarily for the convenience of its members, students, patients, officers, or employees is not an unrelated trade or business

➤ Donated Merchandise

- The sale of merchandise, substantially all of which has been received by organization as a gift or contribution, is not an unrelated trade or business (some guidance notes 85% as percentage to use when considering “substantially all”)

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Example 2



- Goodewell, Inc., a public charity, operates a thrift store unrelated to its exempt purpose
- Store is open to public during normal business hours throughout year and sells only donated items
- Paid employees staff store, and prices are comparable to those of for-profit second-hand stores in the vicinity

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Activities Excluded from UBI

➤ Public Entertainment Activities

- Excluded when conducted by a qualifying organization – a 501(c)(3), (4) or (5) that regularly conducts, as one of its substantial exempt purposes, an agricultural *and* educational fair or exposition
- Exemption from the UBI rules requires an activity to be:
 - Staged in conjunction with a fair or exposition
 - Operated under state law that allows only qualifying organizations or state political subdivision or agency to conduct activity
 - Conducted under state law permitting qualifying organization to receive a license to conduct not more than 20 days of such activity on payment to the state of a lower percentage of the revenue from such licensed activity than the state requires from an entity that is not a qualifying organization

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Activities Excluded from UBI

➤ Conventions and Trade Shows

- Excluded when conducted by a qualifying organization – a 501(c)(3), (4) or (5) that regularly conducts, as one of its substantial exempt purposes, a qualified convention or trade show
- A qualified convention or trade show is:
 - Conducted by qualifying organization for educating its members, promoting products or services of its members' industry, or educating attendees on new developments, products or services related to exempt activities
 - Designed to achieve this purpose through the character of a significant portion of the event's exhibits or the character of the conferences and seminars held at event
- Qualified convention or trade show activities are
 - Traditional convention or trade show activities
 - Carried out by a qualified organization in conjunction with a qualified convention or trade show

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Activities Excluded from UBI

➤ Certain Types of Retail Sales

- If significant relationship exists between organization's exempt purpose or mission, and merchandise, the income from such sales is not UBI
- Gift shops of museums, zoos, and other tax-exempt entities frequently sell a wide variety of items. Each type of merchandise potentially can result in UBI and must be evaluated to determine if substantially contributes to exempt purposes
- Organizations that sell items having both a utilitarian function and cultural or historical significance have successfully avoided UBI by accompanying sale with an explanation of such significance



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Example

- Large City Zoo is widely known for its collection of animals, birds, and reptiles. It operates a gift shop on its premises. Some items sold by the shop are:
- Stationery, desk accessories, jewelry, tote bags, and clothing that bear detailed images of the animals
 - Film, videotape, and batteries
 - Sundries such as newspapers, magazines, candy, and aspirin

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Activities Excluded from UBI

➤ Games of Chance

- To avoid having gaming activities classified as UBI, an organization typically operates the games with unpaid volunteers or conducts the games to qualify them as bingo



➤ Bingo

- A bingo game is usually not UBI if:
 - Game type in which wagers normally are made, winners generally determined, and prizes typically disbursed in the presence of all players
 - Conducted where no commercial competition exists
 - Legal under state and local law

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Activities Excluded from UBI

➤ Other Exempt Activities:

- Distributions of low-cost items in return for donations
- Qualified pole rentals
- Charitable organizations exchange or rental of a mailing list containing donors or members
 - Must be with another charitable organization, when both are eligible to receive tax deductible contributions
 - List containing organization's *prospects* is not covered by this exception
- Furnishing certain services by one hospital to another
- Disposition of Brownfield Property
 - Located in a brownfield site according to Comprehensive Environmental Response, Compensation, and Liability Act of 1980
 - Must have acquired property from unrelated person and incurred certain remediation expenditures

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UBI Allocation of Expense

- Tax-exempt organizations have the same burden as other taxpayers to substantiate the amount and purpose of any deduction claimed in computing Unrelated Business Taxable Income (UBTI)
- To be deductible as a trade or business expense, the expenditure must be both ordinary and necessary in relation to taxpayer's trade or business

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Directly Connected Expense



- Deductions allowed in determining UBTI include the ordinary and necessary expenses that are directly connected with the unrelated business income (UBI)
- To be directly connected, an expense must bear a primary relationship to the conduct of the activity
- Example: Individuals who work full-time in the activity or an entire building used in the conduct of the activity would be directly connected
 - The expenses deductible in computing UBTI would be the salaries and fringe benefits paid to the individuals, as well as all costs attributable to the building (including depreciation)

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Limitations on Certain Deductions

➤ Related Party Rules

- In general, losses or deductions from expenses related to amounts owed to related parties are not allowed until the other taxpayer also has to recognize the income/loss

➤ Uniform Capitalization (UNICAP) rules

- The UNICAP rules require organizations to capitalize or include in inventory certain costs that would otherwise be immediately deductible.
- The rules apply to the production of real and personal tangible property held for sale (or used) in an unrelated trade or business

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Limitations on Certain Deductions

➤ Meals & Entertainment Deduction

- Deduction for meals and entertainment expenses directly connected to unrelated business activity normally is reduced by 50% of the expenditure
- For the remaining 50% to be deductible, a bona fide business discussion normally must occur during, or immediately before or after the meal or entertainment
- No deduction allowed for the portion of a business meal that is lavish or extravagant under the circumstances
- No deduction allowed for a business meal unless an employee of the organization (or independent contractor) is present at the meal



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Limitations on Certain Deductions

➤ Travel

- Travel expenses of individual accompanying officer or employee cannot be deducted, unless individual is employee and travel is for bona fide business purpose and would otherwise be deductible by that individual

➤ Property leased to exempt entities

- Deductions related to property leased to governmental or other tax-exempt entity cannot exceed amount of income from lease payments
- Limitation also applies to certain property that is treated as tax-exempt use property other than by reason of lease
- Any amount disallowed in current year treated as deduction with respect to property in next tax year

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Limitations on Certain Deductions

➤ Lack of Profit Motive

- Organization cannot claim a loss on Form 990-T for activity lacking a profit motive

➤ Fines & Penalties

- No portion of fine or penalty paid in connection with unrelated business activity is deductible in determining an organization's UBTI

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Other Allowable Deductions

➤ In addition to directly connected expenses, an organization may be allowed to claim:

- Charitable contribution deduction
- Net operating loss deduction
- \$1,000 specific deduction



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Dual Use: Facilities & Personnel

- Allocate the expenses of facilities and personnel used to conduct both exempt function and unrelated business activities between the two uses on a reasonable basis
- Keep adequate records to support the allocation method used

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Dual Use: Facilities & Personnel

➤ Rensselaer Method:

Days facility is used for unrelated business activities in year

Total days facility is used for all purposes in year

- This approach treats the fixed expenses incurred during the period the facility is not in use as being allocable to both exempt and nonexempt uses. Consequently, it maximizes the fixed expenses allocable to the unrelated business activities

➤ IRS Method:

Days facility is used for unrelated business activities in year

Total days facility is available for use in year

- This method treats the fixed expenses related to the portion of the year the facility is not in use as being solely exempt function expenses.

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Dual Use: Facilities & Personnel

- Other reasonable methods would be to allocate expenses:
- Based upon employee use of time (portion of time performing UBI activity)
 - Based upon square footage of the facility used exclusively for the UBI activity
 - Any other reasonable method which accurately and reasonably estimates the portion of expenses that relate to the UBI activity

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Example

- The Law Enforcement Center (LEC), a tax-exempt organization, conducts exhibits and shows throughout year in its multipurpose auditorium, which are exempt function activities
- When auditorium is not needed for exempt function activities, LEC regularly stages special events (e.g., concerts, plays) in it that produce UBI
- In current year, LEC conducted exempt function activities in the facility for 150 days and unrelated business activities for 75 days for a total of 225 days of use

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Example

- The gross UBI totaled \$355,000, while the expenses attributable solely to this revenue were as follows:

Fees paid to performers	\$ 143,300
Movie rental fees	39,700
Legal fees related to preparing or reviewing performers' contracts	3,750
Salary of special events manager	28,000
Allocable portion of the \$50,000 salary of LEC president (spent 10% of time on special events matters)	5,000
Fringe benefit costs associated with manager and president's time devoted to facility matters:	
Health insurance costs	3,200
Payroll taxes	2,200
Pension contribution	<u>1,300</u>
Total Direct Expenses	\$ 226,450

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Example

- In addition, LEC incurred the following expenses for operating the auditorium for the entire year (including the 140 days when the facility was not in use):

Salaries of facility manager and security personnel	\$ 67,000
Fringe benefit costs for these employees:	
Health insurance costs	9,800
Payroll taxes	6,100
Pension contribution	4,300
Repairs and maintenance	17,900
Depreciation	26,500
Utilities and other operating expenses	<u>38,450</u>
Total Indirect (Fixed) Expenses	\$ 170,050

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Exploited Exempt Activity

- Organization's exempt function activities may generate goodwill that can be exploited commercially
- Resulting income may be UBI, unless activity significantly contributes to accomplishment of organization's exempt purpose
 - Expenses and depreciation attributable to conduct of exempt activity are generally not deductible in computing UBTI

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Advertising Income

➤ UBTI produced by advertising revenue in organization's periodical normally is determined by calculating four amounts:

- Gross advertising income
- Direct advertising costs
- Circulation income
- Readership costs



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Direct Advertising Costs

- Periodical's direct advertising costs are all expenses directly connected with sale and publication of its advertising
- Such costs normally do not include any deductions attributable to the production, distribution, or readership content of periodical
- Expenses that generally qualify as direct advertising costs include:
 - Selling expenses
 - Office overhead expenses of organization directly connected with sale of advertising
 - Artwork and copy preparation expenses related to preparing advertising for publication

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Advertising Readership Costs & Circulation Income

- When calculating advertising income, can deduct any excess readership costs of periodical, up to amount of net advertising income. Excess readership cost is the amount by which its readership costs exceed its circulation income
- Readership costs are all expenses other than direct advertising costs. Includes costs directly connected with production and distribution, as well as mechanical and distribution expenses that are not attributable to advertising activity
- Circulation income includes all non-advertising revenue and income generated by sale of back issues



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Net Operating Loss Deduction

- Net Operating Loss (NOL):
 - Total deductions exceed its unrelated business income
 - Generally, NOL may be carried back 2 tax years and forward for up to 20 years from the year of the loss.
 - NOL is allowed as deduction in computing UBTI in the year (or years) to which it is carried, up to the amount of the organization's taxable income in those years.
- Form 990-T should be filed even when unrelated business activities produce loss for year. Filing return will establish loss and help ensure that organization can carry it forward to a year in which taxable profit or gain is generated
- Although it may be possible to file all of the prior “loss year” Forms 990-T in the year a profit occurs to establish the loss, this has several risks, plus the cost and difficulty of filing old returns

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Net Operating Loss Deduction

➤ Certain items do not create a NOL for the year of loss:

- For advertising income, if readership costs exceed circulation income and create loss in the advertising activity, the loss created from excess readership costs does not create NOL deduction
- The \$1,000 specific deduction taken on return does not create NOL that can be utilized

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Political Activity



- Many organizations are established with some sort of political involvement necessary for accomplishment of their exempt purpose *Ex: 501(c)(5) and (c)(6)*
- *501(c)(3)* organizations are strictly prohibited from any political involvement no matter how substantial or insubstantial. This prohibition is absolute and the participation does not have to form a substantial part of organization's activities
- Political activity is defined as:
 - Political campaign intervention or participation, either direct or indirect, in the campaigns of candidates for public office

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Political Organizations

- A "separate fund" may be established under IRC Section 527. Such funds refer to separate segregated fund setup by tax-exempt organization
- Exempt purpose of organizations is to influence selection, nomination, or appointment of individual for any public office in any election, meeting or caucus of a political party. Any attempt to influence selection process qualifies as an exempt purpose
 - Political Action Committees (PACs) are most common of these organizations. PACs are governed by specific rules and regulations that govern these political organizations. Its funds are held separate from the NP organization and funds are requested for the PAC separately from the organization.

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990 Pitfalls
Part II**



Presented by:

**Linda Geery,
CPA**

**Cathy Hudak,
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**Amanda
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CPAs and Advisors

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Form 990 Schedule C, Part I-A

➤ Is completed by all 501(c) and Section 527 organizations

- Include detailed description of political campaign activities and their exempt function activities
- Include all political expenditures
- Include total volunteer hours used

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Definitions

- Political campaign activity is defined as any activity that supports or opposes a candidate for elective federal, state or local public office
- Political expenditures are defined as follows:
 - Amounts paid or incurred to candidate for speeches or other services
 - Travel expenses of candidate
 - Expenses of conducting polls, surveys or other studies, or preparing papers or other materials for use by candidate
 - Expenses of advertising, publicity and fundraising for candidate
 - Any other expense that has primary effect of promoting public recognition

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Form 990 Schedule C, Parts I-B & C

- Line B discloses excise tax incurred during the year by 501(c)(3) organizations
 - Imposes initial tax on organization equal to 10% of amount of any political expenditure
 - Imposes initial tax on any organization manager, equal to 2.5% on any expenditure, knowing it was a political expenditure
- Line C is used to report Section 527 exempt function activity for 501(c) organizations, other than 501(c)(3)s

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Form 990 Schedule C Part II-A

➤ Only completed by 501(c)(3) organizations that have filed a 501(h) election. Rules of the election are as follows:

- Use form 5768 to elect the election. Once filed, the election is effective until revoked. It may be voluntarily revoked any time using form 5768.
- Private foundations, churches, integrated auxiliaries of a church, conventions or associations of churches, supporting organizations exempt under (c)(4), (c)(5) or (c)(6), members of affiliated groups or organizations are prohibited from making this election

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General Lobbying

➤ IRS defines lobbying as:

- Any attempt to influence legislation through communication with any member or employee of a legislative body, or with any government official or employee who may participate in formulation of legislation
- Any attempt to influence legislation through attempt to affect the opinions of the general public and any segments thereof
- Participation or intervention in political campaign on behalf of, or in opposition to, any candidate for public office
- Any direct communication with covered executive branch official in attempt to influence positions or actions of official

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Grassroots Lobbying

- Grassroots lobbying is defined as contacting the general public in an attempt to influence legislation from the "grassroots" level
- A communication is treated as grassroots lobbying if it:
 - Refers to specific legislation
 - Reflects a view on the legislation
 - Encourages recipients to take action with respect to the legislation



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Lobbying Limitations

- 501(c)(3) organizations have 2 methods of measuring allowable amount of lobbying :
 - "No Substantial Part" Test
 - Burden of proof of this test lies with organization
 - Generally held that 5% - 15% of organization's budget is a permissible range for lobbying expenditures
 - Section 501(h) Limitations
 - 501(h) election designed to quantify limitations. Recommended that charities file 501(h) election rather than use "no substantial part" test
 - No increased risk of audit for charities that elect the 501(h) election
 - Indirect expenses must be allocated using rational and logical method

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Lobbying Limitations

- For purposes of 501(h) election, lobbying expenditures cannot exceed sum of:
 - 20% of first \$500,000 of exempt purpose expenditures
 - 15% of next \$500,000 of exempt purpose expenditures
 - 10% of next \$500,000 of exempt purpose expenditures
 - 5% of excess over \$1,500,000 of exempt purpose expenditures to the maximum lobbying allowance of \$1,000,000
- In addition, no more than 25% of total lobbying may be spent on grassroots lobbying

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Dues Notification

- NP organizations may not use any part of member dues for lobbying purposes without consent of the dues payer
- The organization must provide the dues payer with estimate of amount of their dues used for lobbying purposes. This amount is non-deductible to payer and must be disclosed to the dues payer
- If organization does not choose to notify members of non-deductible portion of dues, then organization may pay a 35% proxy tax on amount of lobbying expenditures not disclosed to members
- 501(c)(4), (c)(5) and (c)(6) must follow these requirements. However, they are exempt if:
 - 90% or more of dues are received from persons who pay \$581 or less
 - 90% or more of all dues are received from 501(c)(3) organizations, state or local governments, entities with income exempt from tax

**2013
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Roundtable
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Questions?



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