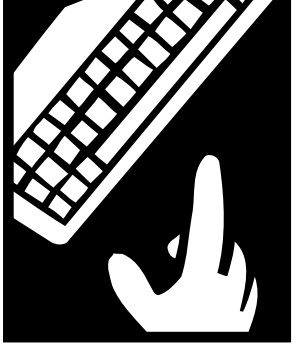

Warning: Use of the Internet May Be Hazardous to Your Organization's Health

The "wrong" click of a mouse can threaten your organization's exempt status. Keep these tax issues in mind, and look before you leap.

BY MARIE ARRIGO

The Internet can help your organization raise funds, communicate its mission to the public, register meeting attendees, and disclose financial information. But with those opportunities come traps for the unwary. Before you plunge too deeply into the Internet, keep in mind that the "wrong" click of a mouse can put your exempt status in danger.

The IRS is looking into how tax laws affect Internet transactions but has not yet provided much needed guidance. You're usually safe if you apply the same rules to the Internet that you do to other media. But the Internet has created a new paradigm. Some of the questions raised in this article don't have answers—yet! It pays to proceed cautiously, with the following issues in mind:

Exempt Status Issues

To maintain tax-exempt status, your organization must devote its primary activities to its exempt purpose. Thus, the following can be done on the Internet without jeopardizing exempt status:

- Publish your organization's mission and program activities.
- Describe services and programs.
- Provide a bulletin board for constituent communications. (An example would be a student-teacher internal forum run by a university.)
- Furnish information on grant applications and deadlines or admission standards.
- Link to the Web sites of other nonprofits to disseminate information about resources, as long as this link is in conjunction with your organization's exempt purposes. Before you create such a link, answer the following questions:
  - What is the purpose of the link?
  - Will your organization's exempt purpose be furthered by the link?
  - If revenues are generated, is this unrelated business income?
  - Does the link promote private benefit to "insiders," such as managers of your organization? If so, this may be viewed as an excess-benefit transaction, which is prohibited by intermediate sanctions rules. It could result in severe penalties and revocation of exempt status.

Charitable Contributions

When soliciting donations on the Internet, you must disclose the extent to which contributions are tax deductible. If donors receive goods or services in exchange for donations, you must explain that they can deduct only the amount over the value of the goods and services received. For instance, if your Web site provides a way for donors to sign up for a fundraising dinner, the value of the meal (which is not deductible as a charitable contribution on the donor's income tax return) must be indicated on your Web site's solicitation or receipt.

Further, if donors give $250 or more in a single transaction, you must furnish written, contemporaneous acknowledgment, indicating the date and amount of the contribution, as well as whether the donors received any goods or services. Donors need this written acknowledgment to claim an income tax deduction. If a donor makes a charitable contribution with a credit card, it would appear that an "e-receipt" printed off the donor's home computer may be sufficient to comply with this rule. However, the IRS has not yet ruled on this issue.

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With Internet opportunities come traps for the unwary.

If your organization receives dues, you must disclose that these payments aren't deductible as charitable contributions, although they may be deductible as business expenses. When putting this disclosure statement on your Web page, you must place it so that viewers will be sure to read it before they make a payment. The statement must be visible without following a link, and it must appear before the "submit" button. Noncompliance can mean onerous penalties.

UBIT Issues

Revenue for a trade or business that is regularly carried on and isn't substantially related to your organization's exempt purposes is unrelated business income. Income from such activities is subject to the unrelated business income tax (UBIT). While a small amount of UBIT shouldn't be a problem, too much UBIT could endanger your exempt status.

Many activities have traditionally been subject to UBIT. But the Internet brings a myriad of new tax issues into play. Here are some questions to consider:

- **Will continuous availability of a Web site make most activities "regularly carried on"** and thus subject to UBIT? Will a time limit change the result?
- **What happens if you sell goods over the Internet?** Whether such sales are subject to UBIT depends on the nature of the items sold. If the items are substantially related to your organization's exempt purpose, there will be no UBIT. Otherwise, sales will result in unrelated business income. For instance, if a museum sells art history books on line, the income won't result in UBIT. On the other hand, sales of souvenirs by the same museum will be subject to UBIT. Because you must decide what constitutes unrelated business activities on an item-by-item basis, it is essential that you have an accounting system capable of classifying revenues based on the nature of the items sold.
- **What happens if you earn advertising income on the Internet?** Advertising includes messages containing price information, qualitative or comparative language, endorsements, or inducements to purchase or use products. Income from advertising is subject to UBIT. Clearly, if you let for-profits advertise on your Web site, you are engaging in unrelated business activities. But other Internet opportunities aren't as clear-cut. What if, for instance, a for-profit pays to link to your Web site? In a typical arrangement, you display the business's logo with a link to its home page in exchange for a percentage of resulting sales. Such payments are often based on the number of hits to the site or purchases made. Would such fees be classified as royalties (which aren't taxable) or unrelated business income? Or what if your organization receives revenue from licensing the use of its name and logo on some other site? Many nonprofits are proceeding as if such revenue is royalty income and thus not taxable.

However, the answer is still uncertain. Much depends on what the underlying contractual agreements indicate.

• **What if a corporate sponsor makes a donation and you wish to thank the sponsor over the Internet?** Mere acknowledgment of a corporate sponsor or link to the sponsor's main Web site will probably not cause UBIT issues. But, what if there are links to the corporate sponsor's products—which are advertised and sold on the site—complete with rolling banners and bright colors? Will this be considered an unrelated business activity? Further, how can you control the content of a hot link? Can you be held responsible for this content? These issues have not yet been resolved.

• **What if your organization puts on a "virtual trade show"?** The law provides that certain qualified convention or trade show activities carried on by a qualifying organization won't be subject to UBIT. You can qualify in one of two ways: (1) Hold your show in conjunction with a convention or annual meeting. (2) Prove that one of the purposes of the show is to educate people about your industry or stimulate interest in the products and services of your industry. A year-round virtual trade show probably wouldn't meet these criteria and would therefore be subject to UBIT. Again, however, the answer is unclear.

Lobbying Issues

Section 501(c)(3) organizations can devote no more than an insubstantial part of their activities to attempts to influence legislation. This is a rather subjective test—measured by such factors as the number of hours devoted to lobbying activities and the visibility and frequency of the activities. Thus, it can be difficult to determine whether the IRS would consider your lobbying activities substantial.

As an alternative, you can elect to provide for certain monetary thresholds as to how much lobbying activity will be allowed. In this case, you have limits on direct lobbying (contacts with legislators and officials) and grassroots lobbying (call to action to the public to write to their legislators and officials) for any taxable year of the lesser of (1) $1 million or (2) the sum of 20% of the first $500,000 of exempt purpose expenditures, 15% of the next $500,000, 10% of the third $500,000 and 5% of the remainder of exempt purpose expenditures. Further, no more than 25% of your organization's total lobbying expenditures can be derived from grassroots lobbying activities. If your organization exceeds these thresholds, a 25% excise tax is imposed on the excess expenditures, and you could lose your exempt status.

If you post Internet content that may constitute lobbying, questions arise. If you haven't made an election, how will the posting be measured as substantial or insubstantial? There is potential for much visibility since the posting will be seen frequently. The staff needed to work on this activity will be less. Thus, the measure of lobbying will become even more subjective.

If an election is in place, an Internet posting can have new implications. Since the posting is in the public domain, reaching the public rather than an exclusive audience of legislators, it can result in grassroots lobbying.Your organization may end up having more grassroots lobbying than you anticipated. This could be a problem since the threshold for allowable grassroots lobbying is much lower than the threshold for direct lobbying expenditures. However, if your organization's purpose is to educate voters, then communicating information about all candidates would be furthering your exempt purpose. In that case, there would probably be no problem.

Also consider the impact of mass media advertisements. They can be labeled as grassroots lobbying activities if issued within two weeks before a vote by a legislative body. Mass media include television, radio, billboards, newspapers and magazines. Currently, an Internet posting doesn't fall within this definition, but what happens if the posting is linked to a newspaper or magazine? Would it then be considered to be mass media? This is another unanswered question.

Political Activity Issues

Section 501(c)(3) organizations are prohibited from participating or intervening in any campaign for public office. A 10% penalty is imposed on each such expenditure. Even a small amount of political activity can result in revocation of exempt status.

Hot links to Web sites of political parties or candidates could result in a major problem for your organization. On the other hand, if you post information on all individuals running for office and that activity furthers your organization's exempt purpose, there should be no problem.

Disclosure Rules

According to recent rules, you must make copies of certain documents (such as the last three years' Form 990 and your exemption application) available to the public. An easy way to comply with the regulations is to post these documents on your Web site.

State Issues

When you solicit donations in a particular state, you must register with that state's attorney general. Annual reporting may also be required, depending on the state. What happens when you solicit on your Web site, which can reach possible donors in all 50 states? Must you now register and file in all 50 states?

Consider the additional administrative costs of complying with this requirement! This is yet another unanswered question which may require legislative action to resolve.

Still another issue revolves around whether state and local jurisdictions can impose sales and use taxes on Internet sales. States and cities usually impose such taxes on sales of goods when the seller has a liability for collection. Generally, this situation (commonly referred to as "nexus") can result when the organization is conducting its activities in a particular state. Does the mere existence of a Web site, which can reach anyone in any state, constitute nexus, thereby allowing for the imposition of such taxes? Which state is entitled to the sales tax when the organization is in Ohio, the Web server is in New Jersey, the warehouse storing the item is in Michigan, and the purchaser lives in Hawaii? This is yet another difficult question with no immediate answer. For this reason Congress has imposed a three-year moratorium on state taxes on Internet transactions and appointed a commission to propose a solution to this problem.

Until this and the other issues discussed here are resolved, use caution. By all means, take advantage of the Internet's wonderful opportunities to further your exempt purpose. But take care that your Internet activities don't put your exempt status at risk. ■

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These resources are available through the Society for Nonprofit Organizations' Resource Center (608-274-9777, www.danenet.org/snpo).

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