

VFW Mid-Winter Conference

CHARITY / NON-PROFIT

FUNDAMENTALS

EXPENDITURES

REGULATION/ENFORCEMENT

Rodger L. Eckelberry

Albert Lin

Baker & Hostetler, LLP

Counsel for VFW Department of Ohio and VFW Ohio Charities

Intros

- Rodger Eckelberry
- Litigation partner focusing on class action defense and representation of charitable organizations, including VFW Department of Ohio, Global War on Terrorism Memorial Foundation, and the National Medal of Honor Museum and Memorial Foundation.

- Albert Lin
- Litigation Partner focusing on financial services, government enforcement, and appeals.
- Former General Counsel to the Ohio Attorney General's Office
- Oversight of Charitable Law Section

Why Are We Here?

- Confusion/misunderstanding of laws/regulations governing charitable expenditures
- Practices developed over time that, while well-intentioned, do not comply with applicable laws/regulations
- Nearly 9 years of little regulatory oversight of charitable gaming revenue expenditures due to temporary restraining order issued in 2013, which enjoined the Ohio Attorney General from taking “criminal or civil action with respect to the Electronic Raffle Machines and/or administrative action to suspend or revoke bingo licenses and/or liquor permits held by the veterans organizations and fraternal organizations utilizing the Electronic Raffle Machines. . . .

Why Are We Here?

- Temporary restraining order expired in late 2021 with the passage of HB 65, which legalized electronic bingo.
- With the expiration of the temporary restraining order, the Ohio Attorney General was again authorized to enforce Ohio's charitable gaming statutes and regulations.
- The Ohio Attorney General has received complaints of misuse of charitable gaming revenue by some VFW Posts.
- We are assisting VFWOC and VFW Department of Ohio in investigating such complaints, and also with identifying permissible and impermissible charitable expenditures, and best practices.

Fundamentals: Charity vs. Non-Profit

- A tax-exempt non-profit is *not* the same as a charity, though donations to some non-profits *may* be tax deductible.
- IRS regulations govern both, provide different requirements for their operation, and provide for different permissible expenditures.
- For our purposes we will focus on charities, established under IRS Section 501(c)(3) and veteran non-profit organizations established under IRS Section 501(c)(19).

Charities – IRC Section 501(c)(3)

- To be tax-exempt under section 501(c)(3) of the Internal Revenue Code, an organization must be organized *and operated exclusively* for exempt purposes set forth in section 501(c)(3), *and none of its earnings may inure inure to any private shareholder or individual*. <https://www.irs.gov/charities-non-profits/charitable-organizations/exemption-requirements-501c3-organizations>
- Exempt purposes under section 501(c)(3) are charitable, religious, educational, scientific, literary, testing for public safety, fostering national or international amateur sports competition, and preventing cruelty to children or animals. <https://www.irs.gov/charities-non-profits/charitable-organizations/exempt-purposes-internal-revenue-code-section-501c3>
- A section 501(c)(3) organization must not be organized or operated for the benefit of private interests, such as the creator or the creator's family, shareholders [*i.e.* members] of the organization, other designated individuals, or persons controlled directly or indirectly by such private interests. *No part of the net earnings of a section 501(c)(3) organization may inure to the benefit of any private shareholder or individual*. <https://www.irs.gov/charities-non-profits/charitable-organizations/inurement-private-benefit-charitable-organizations>

Non-Profit 501(c)(19)

- To be exempt under Internal Revenue Code section 501(c)(19), an organization must be either:
 1. a post or organization of past or present members of the United States Armed Forces
 2. an auxiliary unit or society of such post or organization
 3. or a trust or foundation for such post or organization
- A veterans' post or organization must meet the following requirements to be exempt under section 501(c)(19):
 1. It must be organized in the United States or any of its possessions
 2. At least 75 percent of its members must be past or present members of the United States Armed Forces
 3. At least 97.5 percent of its members must be:
 - present or former members of the United States Armed Forces,
 - cadets (including only students in college or university ROTC programs or at Armed Services academies) or
 - spouses, widows, widowers, ancestors, or lineal descendants of individuals referred to in the first or second bullet

Non-Profit 501(c)(19)

4. It must be operated *exclusively* for one or more of the following purposes:
 - to promote the social welfare of the community (e.g., to promote the common good and general welfare of the people of the community)
 - to assist disabled and needy war veterans and members of the United States Armed Forces and their dependents - and the widows and orphans of deceased veterans
 - to provide entertainment, care, and assistance to hospitalized veterans or members of the United States Armed Forces
 - to carry on programs to perpetuate the memory of deceased veterans and members of the United States Armed Forces and comfort their survivors
 - to conduct programs for religious, charitable, scientific, literary or educational purposes
 - to sponsor or participate in activities of a patriotic nature
 - to provide insurance benefits for members or their dependents or
 - to provide social and recreational activities for members

5. *No part of its net earnings may inure to the benefit of any private shareholder or individual.*

<https://www.irs.gov/charities-non-profits/other-non-profits/veterans-organizations>

Private Benefit / Inurement

- Both 501(c)(3) and 501(c)(19) provide: “No part of its net earnings may inure to the benefit of any private shareholder or individual.”
- A “private benefit” occurs when an individual receives a benefit, whether monetary or non-monetary, from the organization that is either not available, or not available on the same terms, to the public or subset of the public generally.
- Example: I establish an organization to assist with medical expenses of children with cancer. This is a charitable purpose, and the IRS certifies my organization as a 501(c)(3).

Private Benefit

- I fund the organization with \$50,000 of my own money, take a tax deduction for the donation, and have the organization pay my nephew's, and only my nephews, medical bills. This is a private benefit and the organization will lose its tax exemption and my deduction will be disallowed.
- Same scenario, except I pay \$500 of my nephew's medical bills, and \$500 of 99 other children's medical expenses. This is *not* a private benefit because it is available to all equally.

In Layman's Terms

- A 501(c)(19) organization may legally engage in activities that benefit *only* its members. A 501(c)(3) *must* provide a benefit to the public at large, or a large subset of the public.
- Example: A 501(c)(19) may legally operate a bar and engage in gambling, with the proceeds exempt from taxes. A 501(c)(19) may use its funds to pay for dinners or dances. But these *must* be limited to members. *See* IRS Publication 3386 (Rev. 4-2018) (page 9). A 501(c)(3) engaging in these activities, especially if limited to members of that organization, would violate the law and risk its tax-exempt status.

Private Inurement

- Private inurement is the same as private benefit, except private benefit can apply to “insiders” *and* those outside an organization. Private inurement refers only to “insiders” of an organization. Here, that would be members of a Post.

Incidental Benefit

- A charities' expenditures *may* provide an individual benefit *if* that benefit is “incidental” to the charitable purpose. Essentially, if the charitable purpose may not be accomplished without providing a small private benefit then the expenditure is permissible.

Private Benefit/Inurement

“Incidental” Benefit

- An organization was formed to preserve a lake as a public recreational facility and to improve the condition of the water in the lake to enhance its recreational features. Although the organization clearly benefited the public at large, there necessarily was also significant benefit to the private individuals who owned lake front property. The IRS determined that the private benefit was *incidental* in a qualitative sense, stating: “The benefits to be derived from the organization's activities flow principally to the general public through the maintenance and improvement of public recreational facilities. Any private benefits derived by the lake front property owners do not lessen the public benefits flowing from the organization's operations. In fact, it would be *impossible* for the organization to accomplish its purposes without providing benefits to the lake front property owners.” [Emphasis added.] Rev. Rul. 70-186, 1970-1 C.B. 128, at pages 6 and 7.

Non-Incidental Benefit

- An Association bought 2,200 acres of property and constructed an artificial lake on the site. The Association then sold lake front lots to individuals who became members of the Association by reason of their property ownership. The Association built its own private road and strictly limited access to the community to its members and their guests. The IRS revoked the Association's exemption because it *primarily* benefited its members. The Association paid taxes and sued for a refund. The Association argued that its activities were directed to all of the inhabitants of the community equally. There was no disproportionate benefit to some members at the expense of the community as a whole. The Court of Appeals rejected the argument, concluding that a “community” had to have some meaningful relationship to the general public. Since the Association's activities were directed to maintaining the lake for the *exclusive* use of its own membership, the Association's relationship with the general public was exactly the opposite of the relationship required to support exemption. Flat Top Lake Association, Inc. v. U.S., 868 F.2d 108 (4th Cir. 1989)

How Does this Relate to Charitable Gaming

- IRS Section 501(c)(19) permits qualified organizations to engage in gambling operations, federal income tax free, *if* gambling is authorized by state and local law.
- Because states are not required to allow 501(c)(19) organizations to engage in gambling at all, they may lawfully regulate such gaming, and place restrictions on the use of proceeds.
- So just because an activity is permissible under federal law, states are free to prohibit the activity, or place restrictions on such activities or the proceeds received. Ohio does.

Ohio Charitable Gaming Law

O.R.C. 2915.101

- (A)(1) If a veteran's organization, a fraternal organization, or a sporting organization conducted the instant bingo or electronic instant bingo, the organization shall distribute the net profit from the proceeds of the sale of instant bingo or electronic instant bingo, as follows:
 - (a) For the first two hundred fifty thousand dollars, or a greater amount prescribed by the attorney general to adjust for changes in prices as measured by the consumer price index as defined in section 325.18 of the Revised Code and other factors affecting the organization's expenses, as defined in division (GG) of section 2915.01 of the Revised Code, or less of net profit from the proceeds of the sale of instant bingo or electronic instant bingo generated in a calendar year:
 - (i) *At least twenty-five per cent shall be distributed to an organization described in division (V)(1) of section 2915.01 of the Revised Code or to a department or agency of the federal government, the state, or any political subdivision.*
 - (ii) Not more than seventy-five per cent may be deducted and retained by the organization for reimbursement of or for the organization's expenses, as defined in division (GG) of section 2915.01 of the Revised Code, in conducting the instant bingo or electronic instant bingo game.

O.R.C. 2915.01

- (V) "Charitable purpose" means that the net profit of bingo, other than instant bingo or electronic instant bingo, is used by, or is given, donated, or otherwise transferred to, any of the following:
 - (1) Any organization that is described in subsection 509(a)(1), 509(a)(2), or 509(a)(3) of the Internal Revenue Code and is either a governmental unit or an organization that is tax exempt under subsection 501(a) and described in subsection 501(c)(3) of the Internal Revenue Code;

O.R.C. 2915.01(V)

- (2) A veteran's organization that is a post, chapter, or organization of veterans, or an auxiliary unit or society of, or a trust or foundation for, any such post, chapter, or organization organized in the United States or any of its possessions, at least seventy-five per cent of the members of which are veterans and substantially all of the other members of which are individuals who are spouses, widows, or widowers of veterans, or such individuals, provided that no part of the net earnings of such post, chapter, or organization inures to the benefit of any private shareholder or individual, and further provided that the net profit is used by the post, chapter, or organization for the charitable purposes set forth in division (B)(12) of section [5739.02](#) of the Revised Code, is used for awarding scholarships to or for attendance at an institution mentioned in division (B)(12) of section [5739.02](#) of the Revised Code, is donated to a governmental agency, or is used for nonprofit youth activities, the purchase of United States or Ohio flags that are donated to schools, youth groups, or other bona fide nonprofit organizations, promotion of patriotism, or disaster relief;

O.R.C. 2915.01

- Note: 2915.01(A)(1)(a) requires 25% of the net proceeds to be donated to an organization listed in 2915.01(V)(1). Those are “any organization that is described in subsection 509(a)(1), 509(a)(2), or 509(a)(3) of the Internal Revenue Code and is either a governmental unit or an organization that is tax exempt under subsection 501(a) and described in subsection 501(c)(3) of the Internal Revenue Code.” Posts are *not* permissible recipients as they are not included in 2915.01(V)(1) – they are in 2915.01(V)(2).
- That 2915.01(V)(2) expressly mentions Posts demonstrates that the Legislature did not overlook Posts but, instead, expressly intended to prohibit that 25% from going to Posts.

Post-Directed Disbursements

“ Nothing in this section prohibits a veteran's organization, a fraternal organization, or a sporting organization from distributing any net profit from the proceeds of the sale of instant bingo or electronic instant bingo to an organization that is described in subsection 501(c)(3) of the Internal Revenue Code when the organization that is described in subsection 501(c)(3) of the Internal Revenue Code is one that makes donations to other organizations and permits donors to advise or direct such donations *so long as the donations comply with requirements established in or pursuant to subsection 501(c)(3) of the Internal Revenue Code.* ” O.R.C. 2915.101(C).

VFW Ohio Charities

- VFW Ohio Charities is a 501(c)(3), so donation of the required percentage of net proceeds to VFWOC complies with the statute.
- Under 2915.101(C), VFWOC allows Posts, as its agent, to “direct such donations. . . .”
- Per the statute, though, those directed donations *must* comply with the requirements of I.R.C. 501(c)(3) – this includes the prohibition against private benefit/inurement.

What the Law Prohibits Directly, You Cannot do Indirectly.

- O.R.C. 2915.101(A)(1)(a) and 2915.01(V)(1) prohibit Posts from receiving the 25% net gaming proceeds that must be donated to a 501(c)(3).
- Donating the money to a 501(c)(3), that then returns the money to the 501(c)(19), would indirectly do what the statute directly prohibits – this would be an unlawful “roundtrip” transaction, akin to money laundering.

Examples:

- Post donates 25% of net gaming proceeds to a 501(c)(3), then directs some of those funds back to the Post to pay for a weekly or monthly “veterans’ dinner” for its members.
- Dinners for members is a permissible, tax-exempt activity under 501(c)(19). BUT, it does not comply with 501(c)(3) or O.R.C. 2915.01(V)(1) because:
 - The Post Canteen makes a profit off the meals/drinks;
 - The expenditure is a “roundtrip transaction” circumventing the requirements of 2915.01(V)(1); and
 - Because only, or predominantly, members of the Post receive a benefit it violates the private inurement prohibition.
- There is no “charitable purpose” for such regular meals provided regardless of need or income. NOTE, a meal in support of a charitable purpose, such as commemorating Memorial Day or similar event, could qualify. BUT, the Post cannot profit from such a meal.

Examples:

- Post donates 25% of net gaming proceeds to a 501(c)(3), which then pays for Color Guard uniforms and burial flags for deceased veterans.
- This *is* a charitable purpose, the Post does not receive direct benefit so there's no violation of O.R.C. 2915.01(V)(1), and because *any* honorably discharged veteran is eligible to receive military honors at his or her funeral, there is no private inurement. That Post members are also eligible is an “incidental” benefit only, so there is no violation of I.R.C. 501(c)(3).

Example:

- Post donates 25% of net gaming proceeds to a 501(c)(3), and then directs payment of the rent for one month of a veteran in financial distress. This is available to all honorably discharged members and not just members of a particular Post.
- This is a permissible expenditure of charitable funds because the alleviation of poverty is a charitable purpose.
- There is no private inurement because the assistance is open to veterans generally on the same terms.
- NOTE, if Post members are eligible for higher amounts, or more frequent assistance, this would violate the private inurement prohibition and be illegal.

Example:

- Post donates 25% of net gaming proceeds to a 501(c)(3), and then directs a monthly \$100 payment to the church next door to the Post. “Donation” is written in the memo line of the check.
- In exchange for the “donation,” the church allows the Post to use its parking lot for Post members and guests.
- This is *not* a charitable purpose because the Post is receiving something of value for the “donation,” and it benefits only the Post. So it violates the private inurement prohibition *and* is a roundtrip transaction that violates O.R.C. 2915.01(V)(1).

Example:

- Post donates 25% of net gaming proceeds to a 501(c)(3), and directs the 501(c)(3) to pay \$25,000 in medical bills of one of the Post members because the member “does a lot” for the Post.
- The Post never approves payment of such a high amount for non-members of the Post, or for members who do not volunteer much at the Post.
- This is a private inurement that violates 501(c)(3) and is illegal because it is a benefit not available to the public generally, or to the charitable sub-set of the public, on the same terms.

Example:

- Post donates 25% of net gaming proceeds to a 501(c)(3), then directs money to its Color Guard. The Color Guard then puts that money in to the Post's General Fund.
- This is an illegal “roundtrip” transaction and violates O.R.C. 2915.01(V)(1), which prohibits these funds from going to a 501(c)(19). “Washing” the funds through the 501(c)(3) does not render this legal. And, unless the Color Guard is separately incorporated, a check written to the “Color Guard” is really a check written to the Post.

Example:

- Post donates 25% of net gaming proceeds to a 501(c)(3), then directs 25% of that to another VFW Post, 25% to an American Legion Post, and 50% to the Post Auxiliary – all three of which are 501(c)(19) organizations.
- The donations are intended to be used, and are used, to assist disabled veterans who are truly in need.
- The *purpose* is charitable and permissible under both 501(c)(19) and 501(c)(3). But the expense violates O.R.C. 2915.01(V)(1) because the net gaming proceeds are going to 501(c)(19) organizations.

Records

“Every organization must keep adequate records to establish liability for or exemption from taxes. Veterans’ organizations that are tax exempt need to maintain records to establish that their activities further exempt purposes.”

IRS Publication 3386 (Rev. 4-2018)(page 36)

Reporting Requirement

Every 501(c)(3) organization must include information in their annual returns information concerning direct *or indirect* transfers to, and direct *or indirect* transactions or relationships with, organizations described in IRC 527 (political organizations) and in IRC 501(c) other than 501(c)(3). The intended effect of the reporting requirement is that all direct *and indirect* transactions and transfers between the reporting organization and its related or affiliated organizations are to be reported.

See Overview of Private Inurement/Private Benefit (page 37), available at <https://www.irs.gov/pub/irs-tege/eotopicc90.pdf>

Reporting Requirement

- [A] section 501(c)(3) organization is considered to be affiliated with or related to another non-section 501(c)(3) organization if they share some element of common control **OR** if a historic and continuing relationship exists between the two organizations. An element of common control is present when one or more of the officers, directors, or trustees of one organization are elected or appointed by officers, directors, trustees, or members of the other. Similarly, an element of common control is present when more than 25 percent of the officers, directors, or trustees of one organization serve as officers, directors, or trustees of the other organization. A historic and continuing relationship exists when two organizations participate in a joint effort or work in concert toward the attainment of one or more common purposes on a continuous or recurring basis rather than on the basis of one or several isolated transactions or activities. Such a relationship also exists when two organizations share facilities, equipment, or paid personnel during the year, regardless of the length of time the arrangement is in effect.
- *See Overview of Private Inurement/Private Benefit (page 37), available at <https://www.irs.gov/pub/irs-tege/eotopicc90.pdf>*

What does this mean?

- The reporting requirement means that it does not matter if you use VFWOC as your 501(c)(3) charity recipient, some other charity, or establish your own – all the statutes and regulations still apply. And, when there is common control or an ongoing relationship between two organizations, scrutinize transactions and records much more closely.

Burden of Proof

- Under IRS regulations, the burden is on the charity or tax exempt entity to prove expenditures are appropriate and are for a permissible purpose.
- The absence of records is not a defense, and the failure to maintain records may be cause itself for revocation of 501(c) status. “They can’t prove. . . .” is a fool’s statement. “They” don’t need to prove an expense was improper – it is on the organization to prove that it was!
- The memo line of a check does not control the determination and will not fool investigators.

“How do I know. . .”

- There are countless scenarios, and admittedly some grey areas. So how do you know if an expense is permissible?
- If you *honestly* answer 2 questions, you will probably be alright:
 1. Is the true intent and purpose to help veterans or a charitable subset of the public?
 2. Will veterans generally, or the relevant subset of the public, have the same eligibility for the benefit, and receive the benefit on the same terms?

If the answer to both is yes, you will probably be ok, provided the money is *not* going to your Post.

Regulatory and Enforcement Authority

Albert Lin

Ohio Attorney General (OAG) & Charities

- The Ohio Attorney General has authority to regulate nonprofit organizations, charities, and charitable trusts.
- The OAG has authority over charities and charitable trusts. *In re Parkview Hosp.*, 211 B.R. 619, 630-31 (ND. Ohio Bankr. 1997); *Ohio Soc. For Crippled Children & Adults, Inc. v. McElroy*, 175 Ohio St. 49, 51 (1963).

OAG & Charities: Common Law

- The AG's oversight of the charities stems from British Common Law, prior to the founding of the USA.
- “The king, as *parens patriae*, has the general superintendence of all charities which he exercises by the keeper of his conscience, the chancellor. And therefore whenever it is necessary, the attorney-general . . . files ex officio an information in the court of chancery to have the charity properly established.” 3 William Blackstone, Commentaries *427.
- *Parens patriae*: “The state regarded as sovereign.” Black's Law Dictionary 1137 (7th Ed. 199).

OAG & Charities: Statutes

- The common law has been codified in the ORC
- ORC 1716.02 (Charitable Organizations)
 - (A) Every charitable organization, except those exempted under section [1716.03](#) of the Revised Code, that intends to solicit contributions in this state by any means or have contributions solicited in this state on its behalf by any other person, charitable organization, commercial co-venturer, or professional solicitor, or that participates in a charitable sales promotion, prior to engaging in any of these activities and annually thereafter, shall file a registration statement with the attorney general upon a form prescribed by the attorney general.

OAG & Charities: Statutes

- ORC 109.26 & ORC 1719 (Charitable Trusts)
 - Except as provided in this section, every charitable trust established or active in this state shall register with the attorney general. The attorney general shall prepare and maintain a register of such charitable trusts. *See* ORC 109.26.

Powers of the OAG re Charities: Registration

- Registration of the Charity
 - ORC 109.26 (charitable trusts)
 - ORC 1716.02 (charitable organizations)
- Information includes:
 - Name
 - Address and locations of financial documents
 - Officers, D&Os
 - Annual Report
 - Whether the charity was denied, suspended, revoked, or enjoined
 - The contact information for fund-raisers and professional solicitors
 - The charitable purpose

Powers of the OAG: Regulation

- The OAG can require Charities to perform an act, or prohibit an act.
- Perform an act:
 - Annual Report. ORC 1716.02.
 - Professional solicitors requirements. ORC 1716.07.
 - Contracts with professional solicitors. ORC 1716.08.
 - Maintaining records of the solicitation activities. ORC 1716.11
 - Other administrative rules. ORC 1716.13
- Prohibit an act:
 - Committing a deceptive act or practice
 - Misleading any person regarding a material fact relating to solicitations, charitable purpose, or charitable sales promotion
 - Filing false or misleading information filed with the OAG
 - ORC 1716.14

Powers of the OAG: Investigation

- The OAG can investigate Charities if there is “reasonable cause” to believe that any person is violating Ohio Charitable Law. ORC 1716.15(A).
 - This is the equivalent of “reasonable suspicion” under federal law. It can be satisfied by suspicious behavior or anonymous tips.
 - It is lower than “probable cause,” which requires a concrete fact that indicates that a crime is being committed.
- Actions the OAG can take to investigate.
 - Document subpoena
 - Testimony subpoena
 - Books and records production
 - Other law enforcement activity
- If you do not comply, you may be liable for civil or criminal contempt.

Powers of the OAG: Civil

- The OAG has the power to initiate civil actions to enforce Charitable Law. ORC 1716.16.
- Remedies include injunction, restitution, attorneys fee, costs of investigation, a civil penalty for each violation.

Powers of the OAG: Personal Liability

- All D&Os and solicitors are considered a fiduciary when soliciting or spending charitable funds. ORC 1716.17.
- This means that an individual can be personally liable for violations of Ohio Charitable Law.

Power of the OAG: Criminal

- Various criminal penalties are available to the OAG.
- This ranges from:
 - First degree misdemeanor (up to 180 days in prison)
 - Second degree felony (2-8 years in prison)

Secondary Effects from Negative Finding

- If the OAG determines that a violation occurred, there are many secondary effects. Some of these include:
 - Loss of liquor license
 - Loss of charitable gaming
 - Loss of bingo
 - Loss of tax exempt status
 - Local, state, and federal tax liability
 - Personal liability
 - Removal from the VFW

Why compliance is beneficial

- Operating well-inside the law is beneficial to organizations
- Avoids compliance costs
- Avoids legal costs
- Can plan for the future
- Put full focus on activities that are clearly permissible

Questions

- Thank You!
- Albert Lin
 - 614-284-1927
 - alin@bakerlaw.com
- Rodger Eckelberry

BakerHostetler
bakerlaw.com

Atlanta | Chicago | Cincinnati | Cleveland | Columbus | Costa Mesa

Dallas | Denver | Houston | Los Angeles | New York | Orlando

Philadelphia | San Francisco | Seattle | Washington, D.C. | Wilmington

These materials have been prepared by Baker & Hostetler LLP for informational purposes only and are not legal advice. The information is not intended to create, and receipt of it does not constitute, a lawyer-client relationship. Readers should not act upon this information without seeking professional counsel. You should consult a lawyer for individual advice regarding your own situation.

© 2024 BakerHostetler®