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• Winter 2006 •

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Should Your Not-for-Profit Consider a For-Profit Business?

A growing number of not-for-profits are establishing for-profit or taxable subsidiaries. Perhaps the biggest driver of this trend is not-for-profits' need for more reliable and steady income streams. With federal and state budget cuts continuing to erode funding, few organizations today manage to thrive on traditional funding sources alone.

4 reasons

At first glance, the idea of not-for-profits initiating profit-making businesses may seem at odds with their exempt status. But not-for-profits are allowed to generate surpluses (or net revenue), which are the equivalent of profits, as long as they don't distribute them to board members or employees, a practice known as private inurement.

By setting up a for-profit subsidiary, not-for-profits don't have to worry about crossing the line and risking their exempt status or incurring UBIT.

Let's look at the four key reasons why not-for-profits establish a for-profit subsidiary:

1. Generate additional revenue. Just as individuals need a financial cushion as a safety net, not-for-profits need surplus funds for emergencies and special expenditures, and to even out cash flows. Some of the most successful examples of for-profit ventures are those that enable an organization to further its mission while generating revenue to support it.

For example, a theater company, in conjunction with a local children's theater, established a costume rental business as a means of promoting the arts and subsidizing the high costs of costume storage. With the income generated from the costume-rental business, the theater is now able to cover its costume-storage costs and generate extra cash for its core operations.

2. Protect the not-for-profit's tax-exempt status. A common reason organizations create a for-profit subsidiary is to avoid jeopardizing their tax-exempt status. Although not-for-profits can engage in some degree of profit-

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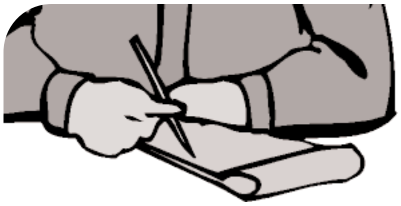


More Than Just a Tax Form

Completed Properly, Form 990 Can Be A Valuable Public Relations Tool

IRS Form 990 has always been an important document, but it's become even more so in recent years as calls for accountability in the not-for-profit sector have increased.

For many not-for-profits, the 990 is one of their first opportunities to make a good impression. Prospective donors and funders, charity evaluators, government regulators, competitors and the media frequently read them. And because the Internet has made these widely available, public inspection of your not-for-profit's 990 is easier than ever.

Avoiding problem areas

The common pitfalls in completing the 990 often fall into one of these general categories:

Inadequate disclosure.

Many organizations miss an opportunity to sell their mission and convey their successes. Some give only cursory details, particularly in Part III, "Statement of Program Service Accomplishments," which asks for a statement of purpose and a list of program activities. In completing this section, remember that grant makers, the media and others will make judgments about your not-for-profit based on the quality of information presented.

Rather than simply abbreviating your mission (such as "provide services to the elderly") and using lump sum amounts to describe various activities (for instance, meals: $70,000), be specific and tell how many individuals your organization helped and how many meals you distributed.

Also, avoid the temptation to simply duplicate the language in this section from year to year. Make a fresh appraisal of any new programs or services offered and present it in the strongest way, much as you would if you were applying for a grant.

Too much information.

On the flip side, some organizations divulge unnecessary, even confidential information on their Form 990s, such as private details pertaining to board members and donors. Even if these disclosures are innocent mistakes, they still represent breaches of privacy and carelessness on the filer's part. They not only can upset the people whose information has been disclosed, but also leave prospective board members, donors and others a bad impression.

Not-for-profits are required to report on the 990 certain information about sizable donations, such as dollar amounts if contributions exceed a certain level. (This information is always excluded from online reports.) But be careful not to provide unsolicited information about contributors that is confidential in nature. For instance, GuideStar, the national database of not-for-profits, reports some organizations have been known to inadvertently include details such as donors' bank account information and aid recipients' Social Security numbers.

In addition, make sure you don't divulge unnecessary personal information about officers, directors, trustees and key employees as requested in Part V of the 990. For example, home addresses aren't required; the not-for-profit's business address can be used instead.

Before submitting your form, check that you have disclosed what is required without including any confidential or sensitive information.

Nonfunctioning numbers.

Part II of the 990, "Statement of Functional Expenses," requires not-for-profits to classify expenses into three categories:

- Program services,
- Management and general, or
- Fund raising.

Regulators, watchdog groups and the public scrutinize this section to ensure organizations are appropriately using funds to further their charitable purpose.

A common problem is that not-for-profits often don't have a good system in place for assigning expenses to one of these categories. As a result, they lump them together. This can make the percentage amounts in a category seem unusually high, suggesting that a not-for-profit is either trying to hide something or isn't able to properly classify its expenses.

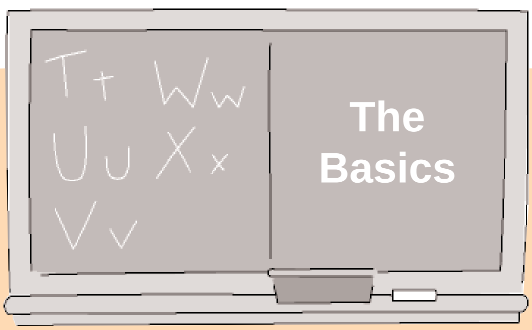
If your organization's percentages seem out of line with acceptable ranges, review the guidelines for classifying expenses to make certain they're properly allocated. You may also need to make changes in how you record and classify expenses.

Oversights.

Some of the most common errors found on 990s are also the easiest to avoid. For instance, organizations often list the wrong tax year or forget to have an officer sign the form. The best way to avoid these mistakes is to have several staff and board members and your CPA review the form before you file it.

Checking it twice

Keep in mind that the way your not-for-profit completes your 990 can influence external perceptions about your organization. With so much riding on this critical document, review it carefully for accuracy and completeness. ■



Form 990 is the information return most public charities are required by law to submit annually to the IRS. Because the 990 is filed by tax-exempt organizations, it's considered a reporting form rather than a tax return. The IRS uses this form to evaluate compliance with tax laws.

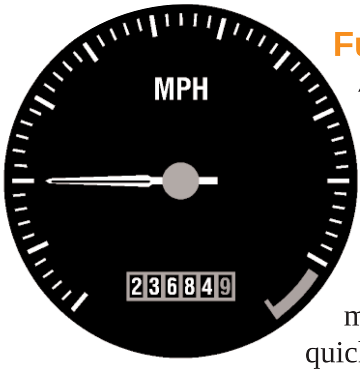
In a nutshell, the 990 provides information about an organization's:

- Activities,
- Assets,
- Receipts,
- Expenditures, and
- Compensation to key people.

Most not-for-profits file the 990, 990-EZ or 990-PF (the form for private foundations). Some that generate income unrelated to their primary exempt purpose are also required to file Form 990-T, which doesn't have to be made publicly available.

Certain not-for-profits aren't required to file Form 990. They include those with annual incomes of $25,000 or less, most faith-based organizations and subsidiaries whose parent organizations assume filing responsibility. All private foundations must file the 990-PF, regardless of their size.

Organizations have 4 1/2 months after the end of their fiscal year to file Form 990 — for example, a not-for-profit with a fiscal year ending Dec. 31 has until May 15. ■



Full Speed Ahead

A Dashboard Gives You a Quick Status of Your Not-for-Profit

Board members must keep a close eye on whether their not-for-profits are meeting key goals and furthering their missions. One of the easiest, quickest ways for boards to do this is to periodically receive a "dashboard" of key performance indicators. Just as an automobile dashboard gives drivers a quick glimpse of their car's status, a performance dashboard provides an at-a-glance look at an organization's current health.

By using a dashboard to check your not-for-profit's vital signs, board members can detect trends more quickly and take corrective action as necessary.

Although most boards regularly receive financial reports to review, a dashboard can be more effective because it's designed to be concise and focused on the measures that boards are most interested in. Plus, the information is displayed in a format that all board members can easily understand — even if they aren't well versed in analyzing financial statements.

For instance, one organization that had diversification of revenue sources as a primary goal added that measure to its dashboard. It used a pie chart to display the percentage of income from each source, enabling the board to easily monitor whether the slices of the pie were becoming more equal in size. Other examples of performance indicators a not-for-profit might track are the number of new clients served, volunteer hours, and new individual and corporate donors.

If you're interested in developing your own dashboard, consider these questions:

- What are your not-for-profit's top priorities or objectives?
- What key aspects of your operations do you want to monitor?
- What is the best way to display progress toward goals in key areas?
- How often do you want board members to receive the dashboard for review, such as at every meeting?

One of the most important roles of not-for-profit boards is to set strategic direction and establish priorities for their organizations. To carry out this duty, boards need relevant information that is easy to monitor and understand. The dashboard approach to tracking key performance indicators can help them keep their not-for-profits focused on those measures that are most crucial to success. ■

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making activities without losing their exempt status, they do need to pay unrelated business income tax (UBIT) on the profits from that activity. Plus, an organization can potentially lose its exempt status if the gross revenue, net income or staff time devoted to unrelated business activities becomes too substantial in the eyes of the IRS.

By setting up a for-profit subsidiary, not-for-profits don't have to worry about crossing the line and risking their exempt status or incurring UBIT. Although a for-profit subsidiary, which can be either wholly or partly owned by the parent organization, will owe corporate income tax on its net income, it can pass the after-tax profits on to the parent organization.

3. Reduce liability. A not-for-profit that wants to offer consulting services related to its mission (similar to associations) or that owns real estate or other tangible assets may want to establish an entity that operates separately from the main organization, thereby insulating it from liability risks. Placing certain assets or higher risk activities under the umbrella of a corporate subsidiary can protect a not-for-profit from the risk of lawsuits alleging negligence, accidental injury and similar claims.

4. Obtain funding from untapped sources. In some cases, organizations find that setting up a for-profit business enhances their ability to receive funding from sources such as banks and private investors. Certain grants are now available to not-for-profits adopting more business-like models.

Although for-profit ventures are becoming more common with organizations seeking to establish steady revenue streams and improve their financial position, they aren't without risks. If you do create a for-profit entity, don't allow it to consume too great a share of resources. Otherwise, it may undermine your ability to carry out your primary mission.

A complex decision

Setting up a for-profit venture can lead to additional revenue, but there are many factors to consider — we've touched on only a few here. So before taking action, examine the legal and financial implications of establishing a for-profit business and discuss any issues that may be unique to your organization. Although for-profit subsidiaries can be a fruitful source of income for some not-for-profits, they may not make sense for every organization. ■

How to Ensure Your Website Lives Up to its Potential

Websites have tremendous potential to help not-for-profits expand both their reach and their revenues, so it's important not to treat yours as an afterthought. How can you ensure your website is as good as possible? Answer these questions to see if it contains the features found in effective websites.

Does it further your mission by advancing key goals?

Your organization may have strategic goals relating to solicitation, volunteer recruitment, communication, education and acquisition of resources. Your website should advance them where possible. For instance, if a goal is to increase the number of volunteers in the 65-plus age group, you might have a section on volunteer opportunities for senior citizens.

Or if you're trying to generate more in-kind donations, feature information about the value of in-kind giving and the types of items your organization needs.

Does it have a mechanism for taking action?

A 2004 survey of more than 10,000 Internet users by Network for Good, a not-for-profit processor of online donations for charities, underscored the importance of making your website work for you. The survey found that 75% of respondents had visited a charitable website. Among the half who said they had taken some action as a result:

- 40% donated offline,
- 24% donated online,
- 11% volunteered offline, and
- 9% volunteered online.

The same survey also found that online giving is growing at a much faster rate than traditional forms of giving, especially with donors in their 20s and 30s — a demographic not-for-profits are striving to cultivate. The growing acceptance of Internet giving was seen in the response to the tsunami disaster. According to the Direct Marketing Association's Not-for-profit Federation, 39% of all tsunami gifts originated online.

Even if online donation processing isn't feasible for your organization, a less sophisticated procedure can be used that allows donors to fill out an on-screen commitment. When you receive the information, you can process a credit card transaction or bill the donor.

Does it encourage repeat visits?

Research by Network for Good also found that visitors to charitable sites are most interested in information about an organization's cause, followed by data on how donations are spent. You can increase your site's appeal by:

- Changing content frequently,
- Using photos and video clips to bring your mission alive,
- Incorporating interactive features such as polls, message boards and online communities, and
- Giving visitors an opportunity to sign up for a mailing list.

Keep in mind, your website should be designed with the user — not just your not-for-profit — in mind.

Does it increase transparency and accountability?

In the virtual world of philanthropy, good disclosure is critical to establishing trust and securing donations. You can demonstrate openness and responsibility by prominently displaying information about how you spend donations.

It's also a good idea to put your annual report and Form 990 on your site (or provide a link to where individuals can access them). (For information about Form 990, see the article "More Than Just a Tax Form" in this issue.) You should also include detailed contact information, including a physical address.

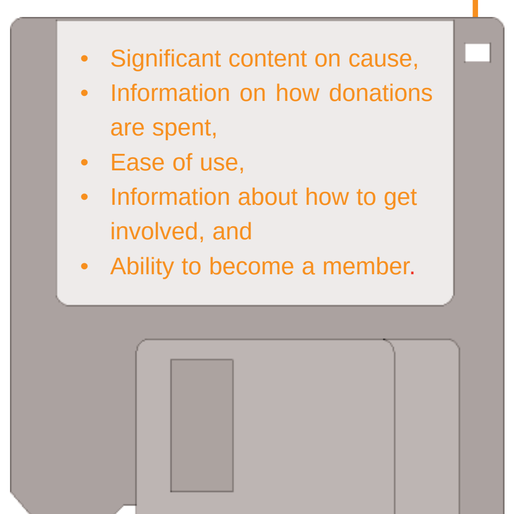
Are you gaining the most you can?

The Internet continues to gain power as a tool for philanthropy, something savvy not-for-profits recognize and strive to take advantage of. Take the time to review your Web strategy to ensure you're getting the most from this medium. ■

What Online Users Desire in a Website

In a recent survey of 10,000 Internet users, Network for Good discovered what online users want.

Respondents indicated the top five hallmarks of a good not-for-profit website:



- Significant content on cause,
- Information on how donations are spent,
- Ease of use,
- Information about how to get involved, and
- Ability to become a member.

NEWSBITS

IRS clarifies lobbying guidance

With the recent Supreme Court vacancies, politically minded 501(c)(3) organizations may want to review federal guidelines for lobbying on judicial appointments. A recent IRS statement, *Attempts to Influence Judicial Appointments by Exempt Organizations*, clarified the rights of not-for-profits in this area. Keep in mind that most campaign intervention is strictly forbidden, but lobbying to influence Senate confirmation of judicial appointments is permissible; the extent allowed depends on the IRS code under which an exempt organization operates.

Section 527 political organizations face no limits on lobbying, while 501(c)(3) not-for-profits can conduct limited lobbying, subject to existing IRS rules on lobbying by charities.

Sec. 501(c)(3) rules state organizations can engage in lobbying in furtherance of their exempt purposes, but the lobbying can't be a "substantial" part of the organization's activities. To find out more about what qualifies as substantial and limited lobbying, consult the IRS rules on lobbying by not-for-profits.

New trend in grass-roots philanthropy

Donors are continually on the lookout for new ways to help their favorite charities. One emerging trend is the giving circle, which is a group of individuals who pool their money to make one large contribution to a not-for-profit.

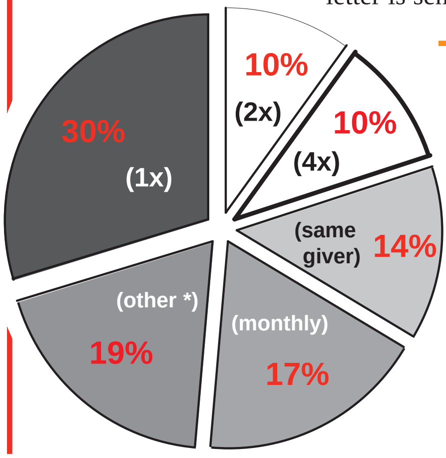
They have donated to organizations that support mental health/crisis intervention, human services, youth development, and women and girls. Giving circles range from a few members to hundreds of donors, and they're located in many states.

Do you use the same thank-you letter?

That was the question posed to monthly readers of an online monthly newsletter published by GuideStar.org, the national database of not-for-profit organizations.

Respondents to the GuideStar poll noted that acknowledgment letters are a powerful way to connect with donors. Several reported concerns about turning donors off with letters that sounded overly formal or formulaic or, worse, that are identical to ones they received earlier in the year thanking them for a donation.

One survey respondent said, "If one is to expect positive responses to fund raising, the donor needs to feel more than a 'gimme, gimme' attitude, which happens when the same letter is sent time after time, and the same to every donor."



How often survey respondents changed their thank-you letter

30% - once a year
19% - "other"*
17% - monthly
14% - each time they received a donation from the same giver
10% - four times a year
10% - twice a year

* *explanations for this response ranged from "with each appeal" to "whenever someone thinks about it, which is usually every one or two years."*

Not-For-Profit Services at Holtz Rubenstein Reminick

As pioneers in this rapidly-growing financial service area, our comprehensive approach to the Not-For-Profit sector is virtually unmatched. In addition to the traditional CPA services of accounting, auditing and taxation, we provide data processing consulting, rate reimbursement consulting, management consulting, and strategic planning.

Contact Us

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