

# POSSIBILITIES

INSIGHTS FOR NON-PROFITS

OCTOBER 2011

## IRS Highlights Private Benefit Concerns in Use of Fundraising Accounts

Youth activity organizations or booster clubs that are 501(c)(3) public charities provide a multitude of opportunities for today's youth, including theater, dance, sports clubs and scouting. These organizations know all too well that fundraising is vital to their ability to carry out their exempt purpose. But, could the way in which an organization allocates its fundraising proceeds be endangering its tax-exempt status?

IRS rules for charities state all of an organization's proceeds must be used for the tax-exempt purposes of the organization. In many youth activities, a common requirement of membership is for children or parents to participate in fundraising to help offset the cost of membership, including dues, equipment, uniforms or travel costs. An organization can use raised funds to reduce

or eliminate these costs. An organization could also use its funds to provide assistance to individual members in cases of financial hardship.

However, when the distribution method of the fundraising proceeds is the creation of an "account," whereby, the money an individual member raises during a fundraising event is reserved for that member alone or when records are kept showing how much each parent or student contributed to the fundraising efforts, these records are considered individual fundraising accounts (IFAs) and potentially cross the line by providing more than just an insubstantial accrual of private benefit to an individual. The IRS has stated IFAs may disqualify an organization from tax-exemption as a public charity. Treasury regulations state, "An organization is not organized or operated exclusively for one or more of the purposes specified ... unless it serves a public rather than a private interest." Thus, when an organization credits specific fundraising accounts, it is operating for the benefit of private interests, such as the designated individuals.

Private benefit is at the forefront of the IRS' radar. A June 2011 directive to IRS field agents issued by Lois Lerner, the IRS director of exempt organizations, stated "if a booster club confers benefits on a participant in return for



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How to Properly Apply for a Loan and Enhance Chances for Approval



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CPAs & BUSINESS ADVISORS

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## How to Properly Apply for a Loan and Enhance Chances for Approval

Many non-profit organizations have needs for various types of credit facilities from a financial institution. Credit needs vary from operating lines of credit, to long-term financing for buildings and equipment. As in any sector, there are those organizations that are debt adverse and others that use substantial debt to leverage growth. Regardless of where your organization is on the debt continuum, there is a common thread when it comes to requesting a loan from any financial institution—the underwriting process from the lender.

To help you and your organization increase the chance of success in obtaining a loan and shorten the time for a decision, there are a number of things you, as the borrower, can do.

### Tell Your Story

When obtaining a loan, your organization now has a new business partner, and with any new partners the more information you provide upfront, the better their understanding of the needs and activities that exist before they “invest.” To help in creating this understanding, you should first prepare a document that contains:

- A short history of your organization
- A short and easy to follow description on the core programs

- A copy of the Articles of Incorporation and By-laws
- An organizational chart(s) of both management and the Board of Directors
- Biographies or resumes of key management and officers of the organization
- A description of the competitive landscape in which the organization operates, including a list of organizations that provide similar programs
- A description of the purpose for the loan and what the outcomes would be if the loan is obtained

For some of the above, the inclusion of charts, graphs and pictures are encouraged to assist the reader to more easily become familiar with your organization.

Now, we move on to preparing a complete and easy to follow financial information reporting package. This package needs to be well-organized and complete, and contain:

- Three most current years of audited financial statements, or any level of outside CPA prepared financial statements
- Most current interim/internal financial statement
- Three most current years of 990s
- A current detailed listing and aging report for pledges and receivables of any kind
- A current detailed listing and aging of accounts payable and other outstanding debt
- A description of the major revenue sources, including a discussion of any unusual timing of the revenue streams
- A description of the major expense items

While preparing these two information packages, it would be helpful to understand the key elements that go into the underwriting process at any financial institution. The cornerstone of underwriting is characterized by the five Cs of credit. These five Cs assist the underwriter in determining two things: the credit worthiness of the organization and, most importantly to the lender, your ability to repay the debt. The five Cs are:



**Character = Integrity**

This is the general impression you and the organization make on the potential lender. The lender will form a subjective opinion as to whether or not the organization is sufficiently trustworthy to repay the loan. The educational background and experience of the management team in the industry will be reviewed. The quality of your references, if any, and the background, tenure and experience levels of your Board of Directors will also be taken into consideration.

**Capacity = Sufficient Cash Flow to Service the Obligation**

The ability to repay is often viewed as the most critical factor. The prospective lender will want to know exactly how you intend to repay the loan. The lender will consider the cash flow from the organization, the timing of the repayment and the probability of successful repayment of the loan. Payment history on existing credit relationships is considered an indicator of future payment performance. Lenders will also want to know about additional sources of repayment, also known as a secondary source of repayment.

**Capital = Net Worth**

This is the net cash and other assets in the organization, and is often an indication of how well it's been managed from a fiscal perspective in the past. Capital is often referred to as, "skin in the game," meaning, the organization has assets at risk along with the lender, thus ensuring a motivation and desire to have successful operations.

**Collateral = Assets to Secure Debt**

Also known as guarantees, these are additional forms of security you can provide the lender. Providing collateral means an owned asset or assets are pledged to the lender with the agreement it will be the repayment source in case you can't repay the loan. A guarantee, on the other hand, is just that. Some other person or entity signs a guarantee document promising to repay the loan if you can't. Personal guarantees are more often used in general commercial

lending to privately owned businesses. Most often, loans to non-profits do not contain these guarantees; however, in some circumstances, a lender may require such a guarantee, in addition to collateral, as security for a loan. This may be a requirement for an organization that has had some difficult financial history.

**Conditions = Of the Borrower and the General Economy**

This C focuses on the intended purpose of the loan. What will the loan proceeds be used for? Working capital? Additional equipment? Property? The lender will also consider the local economic climate and conditions, both within the industry and in other industries that could affect your organization, such as funding or contracting sources.

By contemplating and considering the five Cs of credit, the preparation of your loan "package" will provide the lender and its underwriting group with sufficient information to have a clear picture of your organization.

The preparation of these two documents should be completed before any meetings with a potential lender. A complete, well-organized package will demonstrate to the lender the understanding you have of your organization. It will indicate you are approaching the loan request in a thoughtful and professional manner.

While the preparation and delivery of this package does not guarantee a loan will be approved, it does, however, make it easier for the lender to provide an answer more quickly. By always viewing the lender as a "partner" in your organization, the process will be less painful and generally more successful. ■

By contemplating and considering the five Cs of credit, the preparation of your loan "package" will provide the lender and its underwriting group with sufficient information to have a clear picture of your organization.

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his/her fundraising activities, such as crediting amounts raised by a participant toward that participant's dues requirement, or by crediting amounts raised against the cost of a trip, the booster club is providing a private benefit to that participant. Consequently, such practices could result in the organization failing to be described in § 501(c)(3)." The IRS has also rejected recent applications for tax-exemption of youth athletic organizations on this same premise.

Because of the complexity of the private benefit rules, there is no bright line determination of when private benefit has been provided. However, an important consideration for your organization is if you are earmarking funds for the benefit of a specific member or to a specific member's required fundraising account, this practice

may be jeopardizing the organization's tax-exempt status.

If you have questions regarding your organization's fundraising practices, please contact your Eide Bailly representative. ■



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