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Joseph L. Fink III
University of Kentucky, jfink@uky.edu

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Pharmacy Law Brief: Contemporary Legal Issues for Leadership in Non-Profits - III

Author: Joseph L. Fink III, B.S.Pharm., J.D., Professor of Pharmacy Law and Policy and KPhA Professor of Leadership, Department of Pharmacy Practice and Science, UK College of Pharmacy

Question: I am new to serving on the board of a nonprofit community health agency in my area. During one of the meetings an experienced board member mentioned something called “fiduciary obligations” that I have in that role. We had no orientation session for new board members. What is that?

Response: At the outset it should be noted that an earlier column in this series, appearing in the November 2008, issue, was entitled "Potential Legal Exposure with Community Service as a Board Member of a Non-Profit Agency." Further, a column entitled “Contemporary Legal Issues for Leadership in Non-Profits-I” appeared in the September 2012, issue and that was followed with “II” during November which addressed fiduciary obligations. One who serves in a leadership role with a non-profit organization should have a basic understanding of the legal environment within which such entities operate. This installment addresses issues related to the distinction between being categorized as nonprofit versus being considered tax exempt and supplements or extends those earlier discussions.

At the outset of this discussion it is important to emphasize that an organization’s status as a non-profit entity is quite separate from its classification as being a tax exempt organization. As a side note, today’s phrasing can be either “nonprofit” or “not-for-profit”; they are used interchangeably. So it is noteworthy that a nonprofit organization need not have a charitable purpose. That charitable purpose relates to the tax exempt classification, not to the non-profit status of the entity.

To illustrate this with a local example, think of the nonprofit organization that is KPhA and contrast that with the non-profit and tax exempt entity that is the Kentucky Pharmacy Education and Research Foundation, Inc. (KPERF). The former falls under §501(c)(6) of the Internal Revenue Code because it is an association of persons with common or shared interests. It must be supported by membership dues and other income from activities substantially related to its exempt purpose.

Contrast and compare that with KPERF, which falls under §501(c)(3) because it engages in activities with an educational purpose. What are some important features of this distinction? The most widely acknowledged distinction is that donations to a 501(c)(3) organization are tax deductible by the donor, whereas that advantage does not apply to contributions to a 501(c)(6) entity. The value of having the donations be tax deductible to the donor cannot be understated. Many, if not most, individuals and business entities have a strong preference for donating where a tax deduction results.

Organizations classified under 501(c)(6) may engage in political activities such as lobbying whereas 501(c)(3) have their activities in this area limited by a provision that specifies that no “substantial part” of their activities may be for “carrying on propaganda or otherwise attempting to influence legislation.” If a 501(c)(3) group were to engage in political activity to too large an extent it is likely its tax exempt status, a very valuable asset, would be revoked. Congress has provided an alternative to handle such situations. Section 501(h) of the Internal Revenue Code allows a 501(c)(3) organization to elect to be covered under §501(h), a provision that permits a non-profit to spend funds for that purpose. The total that can be so spent varies with the amount of the exempt purpose expenditure.

Another issue for nonprofit tax exempt organizations is unrelated business income tax (UBIT). The organization must have a tax exempt purpose stated in its charter or other formative papers. It can generate an excess of revenue over expenses and incur no tax liability if those “retained earnings” are applied to advancing the charitable purpose of the organization. If the organization engages in activities deemed “unrelated” to its exempt purpose then it may incur liability for paying taxes on that income, something that does not generally occur with tax exempt organizations. Income generated by business activities unrelated to the tax exempt purpose of the organization can create tax liability which is sometimes surprising to those without extensive experience dealing with nonprofit tax exempt organizations.

Disclaimer: The information in this column is intended for educational use and to stimulate professional discussion among colleagues. It should not be construed as legal advice. There is no way such a brief discussion of an issue or topic for educational or discussion purposes can adequately and fully address the multifaceted and often complex issues that arise in the course of professional practice. It is always the best advice for a pharmacist to seek counsel from an attorney who can become thoroughly familiar with the intricacies of a specific situation, and render advice in accordance with the full information.