

Nonprofit Compliance Update 2020

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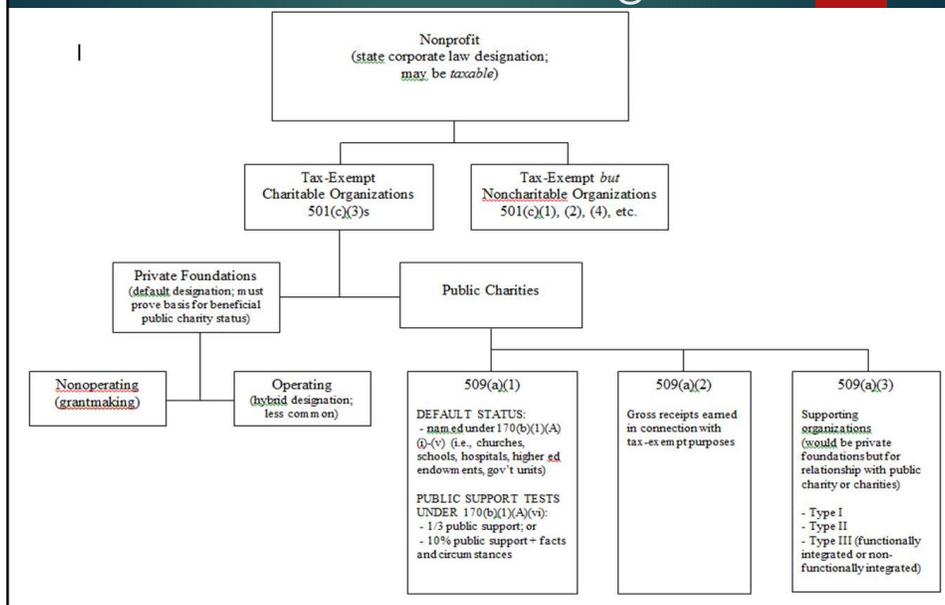
A Few Introductory Thoughts

- ▶ Scope of presentation:
 - ▶ Public charities
 - ▶ Operating in North Carolina
- ▶ Necessarily general
- ▶ Ask questions
- ▶ Consult legal and tax experts, as needed

What We'll Cover

- ▶ Critical paperwork (articles, bylaws, 1023, 990)
- ▶ Tax exempt purposes
- ▶ Private Inurement v. Excess Private Benefit
- ▶ Key policies for all exempt orgs
- ▶ Lobbying and political activity
- ▶ Unrelated business income tax
- ▶ Governance Best Practices

How All the Labels Fit Together



What Paperwork Does a New 501(c)(3) Organization Have to File?



- ▶ Articles of Incorporation
- ▶ Bylaws
- ▶ Form 1023/Form 1024 used to file for exempt status
- ▶ State filing for exemption
- ▶ IRS Determination Letter
- ▶ Annual Form 990s

Articles of Incorporation

- ▶ Filed with North Carolina Secretary of State and available to the *public* on its website
- ▶ Retain in corporate record book with bylaws and key governance policies
- ▶ Required language:
 - ▶ state requirements on Sec. of State website
 - ▶ IRS required provisions on private inurement and distribution of assets upon dissolution- follow the language in IRS Pub. 557
- ▶ *Optional* limitation of liability for directors

Corporate Bylaws

- ▶ Topics typically covered:
 - ▶ Board member numbers, duties and organization
 - ▶ Officers of the organization
 - ▶ Whether your organization has members and if so, what their rights are
 - ▶ Meetings of members and/or board
 - ▶ how often they occur
 - ▶ required numbers for approval of various items
 - ▶ How the bylaws may be amended
- ▶ When you amend the bylaws, notify IRS on 990

IRS Form 1023 and 1023-EZ

- ▶ Filed to obtain IRS determination of tax-exempt status as a IRC Section 501(c)(3) public charity
- ▶ Exceptions for:
 - ▶ Small organizations (gross receipts less than \$5,000)
 - ▶ Churches
- ▶ Check determination letter for IRC Section (509(a)(1), (2) or (3))
- ▶ North Carolina Center for Nonprofits has excellent materials, as does the IRS website

State Corporate Income and Franchise Tax Exemption

- ▶ Provide articles of incorporation, certified copy of bylaws, and IRS determination letter to NC Department of Revenue
- ▶ Brief description of charitable purposes and dissolution provision
- ▶ Granted liberally

Annual Filing of Form 990 to promote:

- ▶ Transparency
- ▶ Tax compliance
- ▶ Past three years must be publicly available

Who Files a Form 990 and When?

Form	Gross Receipts	Total Assets
990	\$200,000+	\$500,000+
990-EZ	<\$200,000	<\$500,000
990-N	<\$50,000	N/A

Either test triggers filing requirement

DUE on the 15th day of the 5th month after your fiscal year ends

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Who Does Not File the IRS Form 990?

- ▶ Certain religious organizations
- ▶ Private foundations (Form 990-PF)
- ▶ Governmental units and certain governmental affiliates (Rev. Proc. 95-48)

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Revocation of Tax-Exempt Status for Failure to File IRS Forms 990

- ▶ Failure to timely file for 3 consecutive years = automatic revocation
- ▶ Consequences:
 - ▶ Tax liability for nonprofit
 - ▶ Loss of charitable deduction for donor
- ▶ Retroactive reinstatement for “reasonable cause” possible (see Rev. Proc. 2014-11)

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Mandatory Public Disclosure of IRS Forms 1023 and 990

- ▶ “Widely available” by posting on own website or a third party website (such as www.guidestar.org)
- ▶ Alternatively, available for public inspection at the principal place of business and provide copies upon request within 30 days

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Tax Exempt Purposes

- ▶ Primary purpose test for all exempt orgs, not just 501(c)(3)s
- ▶ Must further legally recognized tax exempt purposes, “charitable” purposes for 501(c)(3)
- ▶ For 501(c)(3)'s, the presence of a single nonexempt purpose, if substantial, will destroy exemption

Inurement and Excess Private Benefit

- ▶ Excess private benefit- more than an insubstantial amount of private benefit to anyone
- ▶ Private Inurement- financial benefits to board members, founders and other insiders in a position to exercise legal control over the organization or a family member of such a person

Something Short of Revocation...

- ▶ The penalty for inurement is total loss of exempt status
- ▶ Ex: University pays its President a huge salary. Are you going to revoke its exemption?
- ▶ That left the IRS with no real stick
- ▶ Solution: "**Intermediate sanctions**" to impose a monetary penalty on "excess benefit transactions" with "disqualified persons" who are in a position to exercise substantial control over organization

To Whom Do Intermediate Sanctions Apply?

- ▶ Applies to:
 - ▶ 501(c)(3) and (c)(4) orgs
 - ▶ individuals who improperly benefitted
 - ▶ Managers of the exempt organization who participated in the transaction knowing it was improper
- ▶ Even if the IRS revokes the exemption of an organization due to inurement, the org will also be subject to intermediate sanctions

Excess Benefit Transaction Defined

- ▶ Any transaction in which an economic benefit is provided by an exempt org directly or indirectly to or for the use of an "disqualified person" if the value of the benefit exceeds the value of the consideration received for providing the benefit
- ▶ Paying excessive compensation is the most common example

Disqualified Persons (DQP's)

- ▶ Defined as person who, within 5 yr period ending on date of transaction, was:
 - ▶ In a position to exercise substantial influence over the affairs of org
 - ▶ A family mbr of someone in a position to influence org
 - ▶ An entity in which individuals described above own >35% interest

“In a Position to Exercise Influence...”

- ▶ Voting member of governing body or
- ▶ President, CEO, COO or CFO
- ▶ Facts and circumstances show substantial influence:
 - ▶ Founder
 - ▶ Substantial contributor
 - ▶ Managerial control over part of org
 - ▶ Key advisor to someone with managerial authority, such as attorney

Persons who don't have influence...

- ▶ Employees paid less than the amount shown on 990 for highly compensated employees

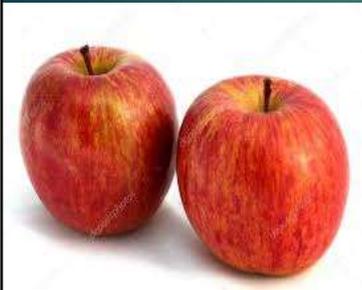
What's Reasonable Comp?

- ▶ Amount that would ordinarily be paid for like services by like entities under like circumstances
- ▶ Factors:
 - ▶ Levels of comp paid by similar orgs for similar positions
 - ▶ Background, experience, training of the individual
 - ▶ Size and complexity of organization
 - ▶ Prior comp for the individual
 - ▶ Amounts paid others in org
 - ▶ Amount of time the person devotes to job

Compensation > Salary

- ▶ Cash and non-cash salary, bonuses, severance
- ▶ Deferred comp
- ▶ Payments for insurance coverage
- ▶ Other benefits like expense allowances, forgoing interest on loans, favorable rent arrangement, etc.

Sources of Comparability Data



- ▶ Forms 990
- ▶ NC Center for Nonprofits salary survey
- ▶ Consultants
- ▶ Data must be apples to apples!

Case Study

WNC Charity has hired a new leader who is charismatic and well-connected to potential donors in the community, Alice Jones. In determining what Ms. Jones' compensation should be, ABC's board evaluates what leaders of other similarly sized nonprofits doing similar types of work around the nation are paid. They are eager to get Ms. Jones, so they offer a salary at the upper end of the range they've established based on their research.

Over the next few years, the board increases Ms. Jones' salary and adds additional benefits, such as a car lease, as incentives to assure she stays with WNC. Meanwhile, Ms. Jones' fundraising is going very well and WNC is bringing in record amounts of contributions. At the same time, the WNC board has grown from 18 members to about 30 members, as the board has sought to get influential people in the community to get involved in WNC.

- 1) What legal principles apply to the compensation decision?
- 2) How should the board determine if her compensation is excessive?
- 3) What liability, if any, do the organization and Ms. Jones have if the compensation is excessive?

What Policies Do Exempt Orgs Need?

ALL:

- ▶ Conflict of interest

MOST:

- ▶ Whistleblower
- ▶ Document retention and destruction
- ▶ Periodic compensation review for highly compensation individuals to determine fair market value

SOME:

- ▶ Gift acceptance if your organization will accept gifts of property
- ▶ Form 990 review

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Conflict of Interest Policy



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- ▶ Covers financial transactions between nonprofit and its insiders
- ▶ Should include insiders' family and "closely associated" businesses
- ▶ Helps the organization avoid excess benefit transactions and associated penalties
- ▶ Form 1023 Instructions have sample Conflicts of Interest Policy

What Should Your Conflicts Policy Do For Your Organization?

- ▶ Manage conflicts to create safe harbor (“rebuttable presumption of reasonableness”)
 - ▶ Disclosure of the conflict
 - ▶ Use of Independent board or committee studies comparability data
 - ▶ Recusal of board members with conflict
 - ▶ Contemporaneous documentation
- ▶ Monitor and enforce compliance

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Managing Conflicts Beyond the Written Policy

- ▶ Board members should always disclose a possible conflict of interest for themselves or another board member
- ▶ The Board can then discuss whether the potential conflict is actually a conflict and choose to:
 - ▶ Decide and reflect in the minutes that the issue was raised and it was determined there was no conflict
 - ▶ Waive the potential conflict for a good reason
 - ▶ Ask the board member not to participate in discussion about the issue or vote on it
 - ▶ Allow the director to participate in discussion but not vote

Director Fiduciary Duties – Why are they important?

- ▶ Limitation of liability under NC law where
 - ▶ volunteer acted in good faith and
 - ▶ Actions were reasonable under the circumstances
 - ▶ Acting consistently with fiduciary duties shows reasonableness
- ▶ Preserve indemnification under bylaws
- ▶ Directors and Officers (D&O) liability insurance

Director Fiduciary Duties

- ▶ **Due Care**
 - ▶ Business judgment rule -good faith is key
 - ▶ Standard is that of a reasonably prudent person
 - ▶ N/A in case of criminal activity, fraud or willful misconduct
 - ▶ Higher standards for persons with special skills and expertise?
- ▶ **Loyalty**
 - ▶ Conflicts of interest
 - ▶ Confidentiality
- ▶ **Obedience**
 - ▶ Obedience to the corporate governing principles and documents

Director Fiduciary Duties – Who owes duty and to whom?

- ▶ Governing board-acting on behalf of taxpayers and the community generally
- ▶ Different from for-profit companies where duty is to shareholders

Director Fiduciary Duties – When Do They Apply?

- ▶ Employing the chief executive officer
- ▶ Strategic planning
- ▶ Managing finances
- ▶ Developing financial and other resources
- ▶ Managing risk (inc. legal compliance)

Who Enforces the Duties?

- ▶ NC law allows nonprofits to sue directors who breach their duties
- ▶ Members can sue
- ▶ NC Attorney General can sue

Case Study #2

Think again about the facts in Case Study #1 about compensation for the CEO. How do the various board members' duties we've discussed affect your view of that situation? Have the WNC board members fulfilled the duties of care, loyalty and obedience under these circumstances?

Unrelated Business Taxable Income: UBIT and UBTII

- ▶ Three part test:
 - ▶ Not substantially related, and
 - ▶ Trade or business, and
 - ▶ Regularly carried on
- ▶ Lots of exceptions and modifications

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Understanding Unrelated Business Income Tax



“Substantially Related”

- ▶ Generally, an exempt organization's income must be “substantially related” to its exempt purposes
- ▶ Simply needing revenue doesn't make income related
- ▶ Look at “primary” purpose in conducting the activity– is to fulfill exempt purpose or to raise \$?

Lots of Revenue excluded from Definition of UBTI

- ▶ Donated work or merchandise
- ▶ Convenience rules
- ▶ Dividends
- ▶ Interest
- ▶ Rents (real property and incidental personal property; watch debt-financed property rules)

Must Pay Tax When...

- ▶ UBTI of \$1,000 or more:
 - ▶ IRS Form 990-T
 - ▶ NC Form CD-405

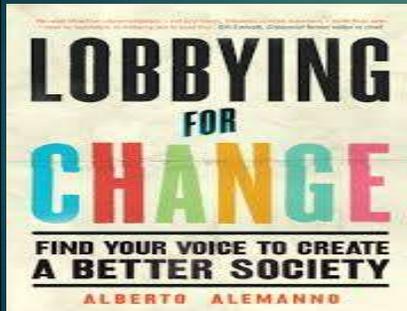
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Lobbying and Political Campaign Activity



- ▶ 501(c)(3)'s can't engage in political campaign activity on behalf of or in opposition to a candidate
- ▶ Facts and circumstances test: Does the communication as a whole express support or opposition to a candidate for public office?
- ▶ Can advocate for policy positions and nonprofit leaders can speak as individuals
- ▶ President Trump has proposed removing the limitations on political activity (Johnson Amendment); many nonprofits favor limitations so nonprofits remain largely nonpartisan

Some Lobbying Is Allowed



- ▶ 501(c)(3) organizations can engage in no more than an insubstantial amount of lobbying
- ▶ Types of lobbying:
 - (1) Direct Lobbying for or against specific legislation or ballot measure, and
 - (2) Grassroots or Indirect Lobbying for or against specific legislation or ballot measure (“call to action”)

What is NOT Lobbying

- ▶ Public policy, social advocacy and educational activities
- ▶ Executive, administrative or judicial communication
- ▶ Action in personal capacity
- ▶ Responses to written requests for assistance

How Much is Too Much for a 501(c)(3)?

- ▶ Insubstantial Part Test
 - ▶ Facts and circumstances
 - ▶ Violation = 5% excise taxes on all lobbying expenditures and *revocation* of tax-exempt status
- ▶ 501(h) Expenditure Test- specific limits on \$ amounts
 - ▶ Elect by filing Form 5768
 - ▶ Violation = 25% excise tax on excess expenditures (revocation only if exceed limit by 50% averaged over four-year period)

501(c)(4) Organizations

- ▶ Can engage in some political activity but that can't be the organization's primary activity
- ▶ No limit on lobbying and other legislative activity
- ▶ Many 501(c)(3) organizations have an associated 501(c)(4) organization to take advantage of these differences, i.e. Sierra Club

Hot Topics in Board Governance for Nonprofits

- ▶ Role of Executive Committee
- ▶ Size of board
- ▶ Term limits
- ▶ Board/CEO relationship
- ▶ Use of the Executive Session at a board meeting
- ▶ Removal of board members for poor attendance at meetings
- ▶ Using prior board members' expertise in creative ways
- ▶ What best practices have you seen?



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