Time for a Legal Tune-Up: Compliance Issues for Nonprofit and Tax-Exempt Organizations

presented by
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Disclaimer

This material is provided for informational purposes only and does not constitute legal advice.
Topics

- State and federal regulatory agencies
- Nonprofit vs. tax-exempt
- Nonprofit corporations in California
- California compliance issues
- Federal compliance issues
State and Federal Regulatory Agencies

- Secretary of State
- California Attorney General
- Franchise Tax Board
- State Board of Equalization
- Internal Revenue Service
Nonprofit vs. Tax-Exempt

True or False:
Nonprofit and tax-exempt mean the same thing

FALSE
Nonprofit vs. Tax-Exempt

- *Nonprofit* means no private inurement
- *Tax-exempt* means excused from paying income tax
Nonprofit vs. Tax-Exempt

True or False:
Tax-exempt and “501(c)(3)” mean the same thing

FALSE
Nonprofit vs. Tax-Exempt

• There are 75 categories of tax-exempt organizations under the Internal Revenue Code
  • This includes 29 subsections under IRC Section 501(c)
• Only a subset of these are eligible to receive deductible gifts
• Most likely to encounter:
  • Charitable/educational organizations under IRC Section 501(c)(3)
  • Trade/professional organizations under IRC Section 501(c)(6)
  • Social clubs under IRC Section 501(c)(7)
Nonprofit vs. Tax-Exempt

- Tax-exempt charitable organizations (IRC § 501(c)(3))
- Tax-exempt organizations
- Nonprofit organizations
Nonprofit Corporations in CA

- Nonprofit public benefit corporations
- Nonprofit mutual benefit corporations
- Nonprofit religious corporations
Nonprofit Corporations in CA

Nonprofit public benefit corporations

• Formed for public/charitable purposes
• Subject to the most governmental regulation
• Assets irrevocably dedicated to public/charitable purposes
• Typical category of federal tax exemption: IRC § 501(c)(3)
Nonprofit Corporations in CA

Nonprofit mutual benefit corporations

- Formed for any lawful purpose
- Less stringent governmental regulation than public benefit corps
- May distribute assets to members on dissolution (but not before)
- Typical categories of federal tax exemption: IRC § 501(c)(6) [trade associations/business leagues], § 501(c)(7) [social club]
Nonprofit Corporations in CA

Statutory Members

- Nonprofits corps are not required to have statutory members
- Nonprofit mutual benefit corps usually have statutory members; nonprofit public benefit corps typically do not
- Can refer to donors as “members” – this doesn’t mean they are statutory members
California Compliance Issues

- Secretary of State
- Corporate recordkeeping
- California Attorney General
  - Role of the AG
  - Registration and reporting requirements
  - Regulation over governance/finance, fundraising, and raffles/charitable gaming
  - Oversight of certain transactions
  - Restricted funds
California Compliance Issues: Secretary of State

True or False:
Your nonprofit corporation has ongoing reporting responsibilities to the Secretary of State

TRUE
California Compliance Issues:
Secretary of State

- Biennial report to Secretary of State
California Compliance Issues:  
*Corporate Recordkeeping*

- Keep copies of Articles of Incorporation (as amended) and current Bylaws at principal office
- Keep adequate and correct books of account
- Keep minutes of the proceedings of the board and committees of the board
California Compliance Issues: Corporate Recordkeeping

Who has a right to inspect board minutes?

• Members of the board?  
  YES

• The Attorney General?  
  YES (for orgs holding charitable funds)

• The general public?  
  NO
California Compliance Issues: **Attorney General**

Role of the California Attorney General

- Attorney General is the representative for the public beneficiaries of charitable organizations
- Attorney General’s power extends to areas involving regulation, supervision, and enforcement
California Compliance Issues: Attorney General

Role of the California Attorney General

- Investigates diversion of charitable assets or gross mismanagement resulting in significant financial loss

- Does not investigate
  - Non-charities
  - Internal governance matters or disagreements (contested elections, etc.)
  - Legal actions between charities and third parties regarding contracts or torts
California Compliance Issues: Attorney General

Registration & Reporting Requirements

• Orgs holding funds for charitable purposes must register with the Attorney General’s Registry of Charitable Trusts w/in 30 days of initially receiving charitable assets
  • Unless an exemption applies

• File Form RRF-1 (and IRS Form 990, 990-EZ, or 990-PF, if required) with the Registry of Charitable Trusts on annual basis
California Compliance Issues: Attorney General

Regulation of Governance/Finance

• All charities must review/approve executive compensation
  • Executive compensation (including benefits) of President/CEO and Treasurer/CFO must be reviewed and approved by the board upon initial hiring, renewal or extension of the employment contract term, and modification of compensation
  • Charity must comply with both the California law and the IRS excess benefit transaction rules
California Compliance Issues: Attorney General

Regulation of Governance/Finance

- Charities of certain size must obtain an audit and, if a corporation, establish and maintain an Audit Committee
- Audits must be made available for inspection by the AG and the general public
California Compliance Issues: Attorney General

Regulation of Fundraising

- Charity must exercise control and avoid misrepresentation
- Ensure registration of recipient charity
- Contracts with a commercial fundraiser or fundraising counsel must be in writing
- Ensure registration of commercial fundraisers and fundraising counsel
California Compliance Issues: Attorney General

Regulation of Raffles & Charitable Gaming

- Raffles
  - Regulated by AG’s Charitable Trusts Section
  - See [http://oag.ca.gov/charities/faq#raffles](http://oag.ca.gov/charities/faq#raffles)

- Charitable gaming
  - Regulated by AG’s Bureau of Gambling Control
  - See [http://oag.ca.gov/gambling/charitable](http://oag.ca.gov/gambling/charitable)
California Compliance Issues: Attorney General

Oversight of Certain Transactions

- AG notice and/or consent requirements
  - Dissolution
  - Merger
  - Sale or disposition of substantially all assets
  - Self-dealing transactions and loans to insiders
California Compliance Issues: Attorney General

Restricted Funds

• Funds set aside for a specific use/purpose
• Lessons from AG investigations re: restricted funds
  • Review solicitation language
  • If funds are restricted to a specific purpose, only use them for that purpose
Federal Compliance Issues

- Obtaining tax-exempt status
- Jeopardizing tax-exempt status under IRC § 501(c)(3)
- IRS excess benefit transaction rules – focus on payment of excessive compensation
- IRS Form 990 (in brief)
Federal Compliance Issues: Obtaining Tax-Exempt Status

- Most orgs must submit an application in order to obtain recognition of federal tax-exempt status
  - If exempt status is granted, the application becomes a public document
- Recognition of federal tax-exempt status exempts the org from federal income tax only
  - California FTB requires separate filing
Federal Compliance Issues: *Jeopardizing 501(c)(3) Status*

- Straying from exempt purpose(s)
- Private inurement
- Excessive lobbying
- Political campaign activity
- Excessive unrelated business activity
Federal Compliance Issues: *Excess Benefit Transaction Rules*

- IRC § 4958 and accompanying regulations
- Allow IRS to impose excise taxes for violation of prohibition on private inurement
- aka “intermediate sanctions”
- These rules only apply to IRC § 501(c)(3) public charities and IRC § 501(c)(4) organizations
Federal Compliance Issues: Excess Benefit Transaction Rules

- Excess benefit transaction: transaction between a disqualified person and a tax-exempt organization in which the organization confers an economic benefit on the person that exceeds the value of what the organization has received in return.

- Disqualified person: any person who exerts substantial influence over the affairs of the organization.
  - e.g., director, officer, key employee, major donor (+ family members)
Federal Compliance Issues: Excess Benefit Transaction Rules

• Excessive compensation to disqualified persons is one of the most common types of excess benefit transaction

• **Reasonable compensation**: the amount that would ordinarily be paid for like services by like enterprises under like circumstances

• **Compensation**: *all* economic benefits provided by the organization in exchange for the performance of services
Federal Compliance Issues
Excess Benefit Transaction Rules

- Rebuttable presumption of reasonableness (see Treas. Reg. § 53.4958-6)
  - Transaction is approved in advance by board or committee composed entirely of disinterested persons
  - Board or committee obtains and relies on appropriate comparability data
  - Board or committee adequately and timely documents the basis for its decision concurrently with making the decision
Federal Compliance Issues

*Excess Benefit Transaction Rules*

- Appropriate comparability data
  - Compensation paid to persons in comparable positions at comparable organizations
  - Salary surveys (CAVEAT)
  - Actual written offers from comparable organizations
Federal Compliance Issues

Excess Benefit Transaction Rules

• What documentation is needed to satisfy the rebuttable presumption?
  • Names/votes of those present, plus summary of discussion
  • Information and comparability data obtained and relied upon
  • Terms of arrangement being approved, plus date of approval
  • Any actions taken by interested persons with respect to consideration of the compensation arrangement
  • Documentation of the basis for the determination
Federal Compliance Issues

*IRS Form 990*

- Initially a financial report
  - Now much more than a financial report
  - But also a good opportunity to showcase the org’s programs and operations
- Increased focus on governance/policies
- Public document
Federal Compliance Issues

**Internal Revenue Service**

Current Filing Thresholds

<table>
<thead>
<tr>
<th>Status</th>
<th>Form to File</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross receipts normally ≤ $50,000</td>
<td>990-N</td>
</tr>
<tr>
<td>Note: Organizations <strong>eligible</strong> to file the e-Postcard may choose to file a full return</td>
<td></td>
</tr>
<tr>
<td>Gross receipts &lt; $200,000, and Total assets &lt; $500,000</td>
<td>990-EZ or 990</td>
</tr>
<tr>
<td>Gross receipts ≥ $200,000, or Total assets ≥ $500,000</td>
<td>990</td>
</tr>
<tr>
<td>Private foundation - regardless of financial status</td>
<td>990-PF</td>
</tr>
</tbody>
</table>
And don’t forget the FTB!

Current Filing Thresholds

<table>
<thead>
<tr>
<th>Exempt under all R&amp;TC 23701 Sections except R&amp;TC Section 23701r</th>
<th>Form 199</th>
<th>FTB 199N</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax year 2012 and future</td>
<td>Gross receipts normally equal to or less than $50,000</td>
<td>No</td>
</tr>
<tr>
<td>Gross receipts greater than $50,000</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>
Helpful Resources

- California Attorney General
  - FAQs [http://oag.ca.gov/charities/faq#charities](http://oag.ca.gov/charities/faq#charities)

- IRS

- California Tax Service Center
  - Overview of taxes applicable to California nonprofit organizations [http://www.taxes.ca.gov/exemptbus.shtml](http://www.taxes.ca.gov/exemptbus.shtml)
Questions?

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