

CALIFORNIA NONPROFIT ORGANIZATIONS –

HOT CURRENT ISSUES

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This outline should be viewed only as a summary of the law and not as a substitute for legal or tax consultation in a particular case. Your comments would be appreciated and are invited.

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1. NONPROFIT REGULATION TIMELINE

- 1916 – Deduction for charitable contributions allowed in first income tax law.
- 1959 – Uniform Supervision of Trustees for Charitable Purposes Act adopted in California (now “Supervision of Trustees and Fundraisers for Charitable Purposes Act”)
- 1969 – Comprehensive revision of federal tax law for tax-exempt organizations, including penalty taxes on “prohibited transactions” for private foundations
- 1976 – Comprehensive revision of California corporate law
- 1978 – Comprehensive revision of California nonprofit corporation law
- 1990 – Uniform Management of Institutional Funds Act (“UMIFA”) adopted in California
- 1996 – Federal “intermediate sanctions” enacted
- 1997 – Federal Volunteer Protection Act
- 2001 – Enron declares bankruptcy
- 2002 – Arthur Anderson firm convicted of obstructing justice in Enron proceeding (overturned in 2005)
 - Federal Sarbanes-Oxley Act (“Public Company Accounting Reform and Investor Protection Act”)
- 2003 – Boston Globe and San Jose Mercury News publish articles documenting abuses of exempt status by a few foundations

2003 – Eliot Spitzer, then Attorney General of New York, proposes a NY “Sarbanes-Oxley Act for nonprofits” with annual revenue over \$250,000 (never enacted)

2004 – California Nonprofit Integrity Act (a “Sarbanes-Oxley Act for nonprofits”)

2004 – IRS announces “listed transactions” that shift income to tax-exempt organizations (IRS shifts to “no more Mr. Nice Guy” about charities)

2004 and 2005 – Senator Grassley’s Senate Finance Committee (Federal) hold hearings about “Nonprofit Accountability”

2006 – (Federal) Pension Protection Act restricts tax-exempt organizations, grant-making and charitable giving

2009 – New IRS Form 990 required for largest charities (for 2008 years)

2010 – New IRS Form 990, 990EZ and 990N required for more organizations

2. **FUNDAMENTALS**

2.1. **Nonprofit organization**

- ◆ Corporation, association or trust
- ◆ Not necessarily tax-exempt

2.2. **Types of Nonprofit Corporations**

- ◆ California public benefit (typical charity; Attorney General has a major role)
 - ⇒ Need not have members
- ◆ California mutual benefit (trade association or country club; Attorney General has a small role)
 - ⇒ Must have members
- ◆ California religious (church)

- ⇒ Very limited role for Attorney General
- ⇒ Family of a slain officer
- ⇒ Least structure imposed by law
- ◆ Delaware nonstock corp
 - ⇒ Need not have members
 - ⇒ If operating in California, can be subject to supervision by California Attorney General

2.3. **Members**

- ◆ Analogous to shareholders in a for-profit corporation
- ◆ Not necessary or even advisable to have members of a California public benefit or religious corporation or a Delaware nonstock corporation
 - ⇒ Alternatives:
 - staggered board of directors – each year 1/3 of the board seats are elected. Directors serve for three-year terms.
 - A person, officer or organization designates the directors

2.4. **Role of the California Attorney General**

- ◆ Charitable Trust Section - 7 attorneys, 15 auditors
- ◆ No one has gone to jail for many years (except for tax fraud), but civil enforcement and computer testing are active
- ◆ 2004 Act civil penalties - \$1,000 first offense, \$2,000 if not promptly corrected
- ◆ Suspension for not filing RRF-1 => \$800 minimum tax applies, even if otherwise exempt from California income tax

2.5. **Types of Section 501(c)(3) organizations:**

- ◆ Private foundations (the default)
- ◆ Organizations exempt from private foundation status:
 - ⇒ Publicly-supported charities
 - ⇒ Self-supported charities
 - ⇒ Supporting organizations
 - ⇒ Other bases of exemption from private foundation status (educational institution, medical research organization, etc.)

2.6. **California Property and Sales Taxes**

- ◆ Welfare exemption from property tax
- ◆ Museum exemption from sales and use tax

3. **OPERATING ISSUES**

3.1. **Fundraising**

- ◆ Registering to solicit funds
- ◆ Registered commercial fund-raisers
- ◆ Contracts with commercial fund-raisers
- ◆ Fundraising counsel

3.2. **Gambling and raffles**

- ◆ Poker tournaments and casino nights must comply with the Attorney General's rules

<http://ag.ca.gov/gambling/content/fundraisers.php>

- ◆ Raffles must comply with the Attorney General's rules

<http://caag.state.ca.us/charities/raffles.htm>

3.3. Business investments

- ◆ Unrelated business taxable income
 - ⇒ Theory: unfair competition with businesses subject to income tax
 - ⇒ Threat to the exemption: more than “incidental” business activity
 - ⇒ Overlap with “private activity” prohibition for tax exempt financing
 - ⇒ UBTI tax returns must be disclosed (unlike returns of other businesses)
 - ⇒ Tip: Use a corporate for-profit subsidiary (not an LLC or S corp) to conduct the unrelated business
- ◆ Debt-financed property
- ◆ Holding securities
 - ⇒ Street name (and SIPC) vs. custodial accounts
- ◆ Holding real estate for investment
 - ⇒ Acting as general partner of a general or limited partnership
 - ⇒ The LLC alternative
 - To hold real estate
 - To isolate related but risky investments
 - “Series” LLCs (usually bad) and single-member LLCs (often good)

- ◆ Avoiding Ponzi schemes (or minimizing the risk) through asset allocation and portfolio diversification
- ◆ Joint ventures with for-profit businesses:
 - ⇒ The nonprofit must control the tax-exempt activity
 - ⇒ Each venture requires specific tax advice to protect the tax exemption
- ◆ FIN 48 disclosure rules apply to nonprofits
 - ⇒ Regarding uncertain tax positions and issues
 - ⇒ Disclose serious concerns about tax exempt status, unrelated business taxable income, unreported or unpaid sales tax

3.4. **Tax-exempt bonds or certificates of participation**

- ◆ Complying with the trust indenture to avoid acceleration
- ◆ Complying with the “**private activity**” rules to preserve the tax-exempt status of the interest payments

3.5. **Endowments**

- ◆ Gift acceptance letters
 - ⇒ Have a policy
 - ⇒ Be clear about purpose and ability to change purpose
 - ⇒ Keep them forever and ever
- ◆ Spending policies (depend on gift acceptance letters)
- ◆ Restricted funds and “borrowing” from them (Don’t!)
- ◆ Uniform Prudent Management of Institutional Funds Act – “UPMIFA” (Cal. Probate Code §§ 18500-18509) – Revised effective 1-1-09 – would allow directors to spend original principal, but ...

- ⇒ FASB Staff Position (FSP) 117-a limits discretion to spend original principal and requires additional disclosure.
- ⇒ GASB alternative?
- ⇒ NY still as UMIFA, with “historical cost” rule

3.6. Pledges

◆ Making pledges

- ⇒ The pledge should be made by the entity that is going to write the check
- ⇒ Problem: Mr. Donor makes the pledge, which is satisfied by the Donor Family Foundation. Is the Foundation paying a debt of Mr. Donor? If so, it would be a “prohibited transaction” and both the IRS and the Attorney General would have problems with it.
 - Similar problems arise if Mr. Donor makes the pledge, which is satisfied by the Donor Fund at the Local Community Foundation or at the Brokerage House Foundation.

◆ Enforcing pledges

- ⇒ Requires action by charity to make pledge enforceable
- ⇒ Will the board enforce the pledge, even if it is made enforceable?
 - If the pledge is enforceable but the board does not enforce it, do the board members breach their duty? What if the Pledgor is a director or officer?
 - If so, is it worthwhile to make the pledge enforceable?

3.7. **Supporting organizations**

- ◆ After 2006, grant-seeking organizations will want to be exempt from private foundation status on some basis other than being a “supporting organization.”
- ◆ If when the organization obtained its tax exemption, the organization told the IRS that it would be a “supporting organization,” then the IRS probably still lists it that way, even if on its Form 990 the organization reports a different basis for exemption from private foundation status.
- ◆ If grant-making foundations see that a grant-seeking organization is listed by the IRS as a supporting organization, the grant maker will ask for an IRS letter stating that the grant-seeker is a “good” supporting organization to which the grant maker can make grants with no problem. In 2006 the IRS required grant makers to check whether a donee was a supporting organization and, if to, to be sure that it was the right kind of supporting organization.
- ◆ The bottom line: Grant-seeking organizations that are listed by the IRS as “supporting organizations” should apply to the IRS either (1) to change their classification from “supporting organization” to another exemption from private foundation status or (2) to get a letter from the IRS stating that the organization is the “good” type of supporting organization.

4. **DUTIES OF DIRECTORS**

4.1. **Rights and duties:**

- ◆ Duty of care (prudent person standard)
- ◆ Right to information and duty to obtain it
- ◆ Reliance on outsiders
 - ⇒ Get the management letter from the auditor
- ◆ All activities subject to directors’ supervision

- ◆ Right to resign
- ◆ Investment standard (for California nonprofit public benefit corporations): preserve principal
 - ⇒ Different than the standard for trustees under California trust law (which is modern portfolio theory: diversification, asset allocation)
 - ⇒ Delaware nonstock corporation: prudent person standard.
 - ⇒ Usually specific investment instructions in a gift instrument trump the general duties of directors

4.2. **Conflicts of interest:**

- ◆ Directors and officers doing business with the organization
- ◆ Common directors
- ◆ Loans, leases, guarantees
- ◆ Enforcement by Attorney General
 - ⇒ Some transactions require *prior* notice to the Attorney General
- ◆ Prohibited transaction rules for private foundations
- ◆ Excess benefit rules (“intermediate sanctions”) for public charities
 - ⇒ Compensation or “transaction” committees to vet conflict situations
 - ⇒ Formal conflict of interest policies
 - ⇒ Liability of directors, officers, trustees (and, possibly executive directors) who knowingly approve excess benefit transactions: up to \$20,000 excise tax and...

- A possible requirement by the Attorney General to replace the lost dollars to the organization.

4.3. **Indemnification and insurance**

- ◆ Liability protections
 - ⇒ Requirement to obtain (or try to obtain) d&o insurance
 - Tip: Get EPL insurance, too. It is often offered with D&O.
 - ⇒ Volunteer Protection Act of 1997, 42 U.S.C. §§ 14501-04
- ◆ Bylaws issue: Optional vs. mandatory indemnification

4.4. **Political activities**

- ◆ Candidates vs. causes

5. **AUDITS AND THE AUDIT COMMITTEE**

5.1. **Audits**

- ◆ California law requires audited financial statements for certain charitable organizations.
- ◆ If a charitable organization receives or accrues in any fiscal year gross revenue of \$2 million or more, it must have an audit.
 - ⇒ Grants from government entities are excluded if the government entity requires an accounting of the funds received.
 - ⇒ Receipts from contracts with government entities also are excluded if the government entity requires an accounting of the funds received.

- ◆ The auditor must be independent and must use generally accepted accounting principles.
 - ⇒ Government Auditing Standards apply to determine independence, but the Attorney General can issue regulations applying other standards.
- ◆ For an organization with that controls other organization, a consolidated audited financial statement can satisfy the audit requirement.
- ◆ The audited financial statements (including the footnotes, but not including the management letter) must be submitted to the Attorney General and made available for public inspection.
 - ⇒ The due date is nine months after the fiscal year end.
 - ⇒ The public disclosure rules for Forms 990 apply.
- ◆ If an organization has an audit performed that is not required by these rules, the audited financial statements must be submitted to the Attorney General and made available for public inspection.
 - ⇒ This would apply to organizations with receipts of less than \$2 million but which are required by grant, contract or other laws to have audited financials.

5.2. **Audit Committee**

- ◆ A charitable corporation that must have an audit because it passes the \$2 million threshold (discussed above) must have an audit committee appointed by its board of directors.
 - ⇒ This applies to corporations organized outside of California but required to file with the California Attorney General's office.
- ◆ Subject to the supervision of the board of directors, the audit committee is responsible for recommending to the board of

directors the retention and termination of the independent auditor.

⇒ It may negotiate the independent auditor's compensation, on behalf of the board of directors.

◆ The audit committee:

⇒ Confers with the auditor to satisfy the committee members that the financial affairs of the corporation are in order;

⇒ Reviews the audit and decides whether to accept it;

⇒ Assures that any non-audit services performed by the auditing firm conform with standards for auditor independence; and

⇒ Approves the performance of any non-audit services by the auditing firm.

◆ The audit committee may include persons who are not members of the board of directors, but the member or members of the audit committee shall not include any members of the staff, including the *president* or *chief executive officer* and the *treasurer* or *chief financial officer*.

⇒ For a California nonprofit corporation or a Delaware nonstock corporation, a committee that exercises powers of the Board cannot have members who are not directors. The audit committee would often be this type of committee.

- An advisory committee that advises the Board but *cannot* exercise any Board powers *can* have members who are not directors.

◆ If the corporation has a *finance committee*, it must be separate from the audit committee.

⇒ Members of the finance committee may serve on the audit committee.

- ⇒ The chairperson of the audit committee may not be a member of the finance committee and members of the finance committee must constitute less than one-half of the membership of the audit committee.
- ◆ Members of the audit committee may not receive any compensation from the corporation in excess of the compensation, if any, received by members of the board of directors for service on the board.
- ◆ Members of the audit committee may not have a material financial interest in any entity doing business with the corporation.
- ◆ If the corporation is controlled by another corporation, the audit committee may be part of the board of directors of the controlling corporation.

6. COMPENSATION ISSUES

6.1. Overlapping laws

- ◆ California corporate law –
 - ⇒ No better deal available;
 - ⇒ No payment for past service unless there was contract in place before the services were rendered
- ◆ Federal tax law –
 - ⇒ No excess benefit to others,
 - ⇒ Safe harbor if independent comp committee, objective evidence, written reasoning and conclusions
 - ⇒ Payment for past service allowed by tax law if prove undercompensated (but *not* allowed by the California Attorney General *unless* there was a deferred compensation agreement in place *before* the services were performed)

- ◆ Nonprofit Integrity Act – “just and reasonable”

6.2. **Deferred compensation for founders and other key personnel**

- ◆ The IRS allows compensation for past services if it is reasonable in view of the value of the services rendered and the compensation paid
- ◆ The California Attorney General treats compensation for past services as a diversion of the organization’s funds for private purposes, unless the payments are made pursuant to a deferred compensation agreement that was enforceable at the time the services were rendered.
- ◆ Consider having a friendly organization (possibly for-profit) hire the retiree as a consultant or community relations officer.

6.3. **IRS inquiry letters**

- ◆ The IRS periodically sends letters to organizations asking about compensation issues.
- ◆ This is partly to build a database.
- ◆ Also to search for noncompliance. Most issues are resolved by correspondence. but a few have resulted in audits

6.4. **Compensation Committees**

- ◆ Nonprofits that must file Form RRF-1 must also have a compensation committee to review the compensation of their President and CFO.
- ◆ They must determine if the comp packages are “just and reasonable.”
- ◆ The review must be made at hiring and whenever the comp package changes.
- ◆ The board of directors can undertake this review, but a comp committee of independent directors is usually more efficient

(and also is required for the safe harbor to avoid the federal “intermediate sanctions”).

7. ASSET TRANSFERS AND MERGERS

7.1. Prior notice to the Attorney General

- ◆ Before closing a transfer of substantially all of the entity’s assets, including sales or transfers incident to dissolving the entity.
- ◆ Applies at *dissolution* – even if the corporation has no assets to distribute.
- ◆ The Attorney General assures that the funds are used for the primary purpose that the organization or as required by the gift instrument.
- ◆ The Attorney General can request additional information
 - ⇒ Including appraisals and sale documents in the case of a sale

7.2. Mergers

- ◆ A nonprofit corporation can merger with another entity, including a for-profit corporation or another nonprofit corporation.
 - ⇒ An alternative is to have the board of the “taken over” organization resign and directors of the “acquiring” organization become directors of the “taken over” organization.
- ◆ A for-profit corporation can convert to a nonprofit, but the conversion is treated as a taxable liquidation for federal income tax purposes.
 - ⇒ A merger of a nonprofit into a for-profit is rarely possible.

- ◆ Mergers allow organizations to combine and become stronger
 - ⇒ Will the surviving organization be able to receive more grant money than the merged organizations received before the merger? Less?
 - ⇒ Before the merger, try to get buy-in from the board of directors, the staff, constituents and grantmakers.

8. **EXPANDING**

When a nonprofit expands to other geographic area, it needs to consider several additional issues:

- ◆ Trademark protection and licensing
 - ⇒ Often the right to use the nationally-known name is the glue that keeps the whole organization together.
- ◆ Group tax exemptions
- ◆ Clauses in the articles and bylaws of local chapters
- ◆ Degree of control that the parent organization retains.

9. **CHANGING PURPOSES**

9.1. An organization can change its purpose

- ◆ It must advise the IRS of the change
- ◆ Donors might want a confirming letter from the IRS that the exemption is still good
- ◆ It might need to get a new determination letter if the change is drastic

9.2. The California Attorney General wants the pre-change funds to be used for the old purposes.

- ◆ Funds raised *after* the change is effective can be used for the *new* purposes
- ◆ This applies to all funds, not just to “restricted funds”

10. **ACTIVITIES OUTSIDE THE UNITED STATES**

10.1. Increased role of the federal government after 9-11-01

10.2. Protecting the charitable contribution deduction

10.3. Expenditure responsibility

10.4. Protecting the trade name and trademarks

[End of outline.]

ADDITIONAL INFORMATION

To receive more information about these issues, please check the box(es) below, provide your address (or business card) and return this page to Bill Staley -- or FAX it to Susan Rognlie at (818) 936-2990.

1. **“Limited Liability Companies: An Introduction.”***
2. **“New California Rules for Nonprofit Organizations”** (SB 1262, aka “The Nonprofit Integrity Act of 2004”)*
3. **“Penalty Taxes on Managers and Insiders of Organizations Exempt from Tax under Sections 501(c)(3) or (c)(4): Intermediate Sanctions for Excess Benefits”**
4. **“Tax Planning for Large Charitable Contributions: Private Foundations and Community Foundations.”** A discussion of the alternatives and a list of local community foundations.

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