

[◀ Previous Edition \(#/archive/Whats-the-business-case-for-giving-back\)](#)

What are the Big Issues Facing the

Economy in 2011? (#/!)

[Back to homepage \(#/!\)](#)

QUESTIONS WITH...

Michael Schley: Keeping Non-Profits Out Of Legal Trouble

Michael Schley (#) Partner, Schley Look Guthrie & Locker LLP | *December 28, 2010*

Share: (#)

Before they can save the world, charities need to make sure everything's on the up-and-up.

What's the biggest tax challenge for a newly incorporated non-profit?

The biggest tax challenge is getting exemptions from the IRS. Every new nonprofit has to get their tax-exempt status approved, and that process has become more difficult in recent years. The IRS is watching like a hawk for any signs of self-dealing, so there are lots of questions in the application about relationships between the non-profit and major donors, directors and officers. Those can lead to questions from the examining IRS agent and a more difficult road to tax exemption.

They are also being a little tougher about approving a charity's exempt purpose. I've worked with charities that, for example, that want to take a macroeconomic approach to an environmental issue, such as creating a marketplace for sustainably caught seafood. The IRS examiners reviewing these matters have had difficulty understanding the difference between for-profit and macroeconomic solutions.

What about those that have been around for longer, say a decades-old family foundation?

I'd say number one is the restrictions on insider self-dealing. They can be a trap, especially for private foundations, where almost all transactions with insiders are prohibited. But the rules can be very difficult to comply with, even for a public charity. The second issue is political involvement. A lot of people don't realize that a 501(c)(3) charity is absolutely prohibited from endorsing candidates for public office, and when it comes to legislative lobbying, there are significant restrictions on what they can do. It's easy for charities to run afoul of those rules.

There's an interesting issue here. One of the major challenges in the non-profit sector is to become more professionally managed. That requires paying for talent. But the only IRS rules that touch on the issue penalize non-profits if they pay too much. Those rules are a knee-jerk reaction to the United Way situation many years ago, when management were criticized for having excessive compensation and benefits. Congress passed a law that penalizes non-profits that do that. The effect was to make it more difficult for the sector as a whole to attract good talent.

What would be the penalty for that?

The IRS rules talk about an excess benefit transaction. If a charity pays too much to an insider or a related party then the overpayment is an excess benefit, and the rule is the excess benefit has to be returned. The recipient is taxed 20% of the excess benefit. If the excess benefit is not promptly returned, the recipient is taxed 200%.

What are they on the lookout for, in self-dealing?

Self-dealing would be any transaction between a charity and a member of its

board, one of its officers, a large donor, or anyone else who is in a position to influence the management of the charity. The general rule is that any of those



Getty Images

The IRS examiners reviewing these matters have had difficulty understanding the difference between for-profit and macroeconomic solutions.

board, one of its officers, a large donor, or anyone else who is in a position to influence the management of the charity. The general rule is that any of those

[Editions \(#/archive/\)](#)[Contact Us \(mailto:theshoshinproject@glgroup.com\)](mailto:theshoshinproject@glgroup.com)[Privacy Policy \(#/content/PrivacyPolicy\)](#)[Terms of Use \(#/content/TermsOfUse\)](#)[Shoshin \(#/content/AboutUs\)](#)

transactions have to be on arms-length terms. Now even small charities have to have comparability study information to justify what they pay their CEO or executive director. It's quite a burden.

What are some of the other big legal challenges that non-profits might overlook?

There are very precise rules about documenting and acknowledging gifts so that those gifts are tax-deductible. There are fairly complex rules about maintaining public charity status. Every 501 (c)(3) charity is either public or private. A private foundation is usually funded by one source, like a wealthy family, and a public charity is funded by the public. That seems like a pretty simple concept, but IRS rules are pretty detailed about what can be counted as a public gift and how much of your funding must come from those kinds of gifts to qualify as a public charity. If you're not classified as a public charity, then you are subject to very complicated regulations that govern private foundations, as well as some taxes private foundations all pay.

Should non-profits be concerned about threats to tax credits for donors?

They should, because the president has proposed limiting the deductibility of charitable contributions to 28%, when the top tax rate is 35%. The impact would be fewer charitable contributions. There was quite a bit of dialogue when the president first proposed it, and I think industry observers who are honest about the answer acknowledge that charitable gifts would decline if the tax incentives change.

Could you speak a bit to the need for corporate governance for non-profits? What's involved in getting that set up?

Corporate governance has always been an important issue for the sector, just as it is for the for-profit sector. It's been on my mind lately because the IRS has made it an important issue. The IRS believes non-profits are poorly managed and they don't deserve their tax exemption, so the agency recently amended its tax return for non-profits to ask almost two dozen pointed questions about corporate governance policies. The obvious implication is that if you answer those questions incorrectly, you might be audited. The sector is scrambling to make sure they have written policies and procedures that address those issues, so that they don't come under close IRS scrutiny. But the fact is, corporate governance is important. The right decision process will help ensure that the right decisions are made. For a typical non-profit, that means a good agenda, a good information process supporting your decisions, good corporate records, reflecting what decisions were made and how they were made.

Is there something you think is particularly important to note that isn't getting enough attention?

I think the laws and regulations are way behind the curve when it comes to social enterprise. There's almost no legal framework for those kinds of solutions and for non-profit/for-profit alliances and joint ventures to deal with social issues. Again, one of the biggest needs in the sector is to attract good management, and the only legal framework for that is to punish non-profits that pay too much, which is a disincentive to attracting good management. And federal and state regulation of the non-profit sector is still one-size-fits-all, so the largest multinational companies are subject to the same regulations as the tiniest all-volunteer grassroots charities. There ought to be some calibration of the complexity of regulation depending on the size of the organization.