

Hot Topics for Public Charities

Presentation Outline of
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Hot Topics for Public Charities

1. Politics!

a. Political Campaign Activities:

- (i) A 501(c)(3) entity may not engage in any activities in support of or opposition to a candidate for public office. (In contrast, a 501(c)(6) business league may engage in some political activities of this type, so long as that is not its primary activity; a 527 organization may support or oppose political candidates.)

- (1) The IRS' primary enforcement remedy for violation of this rule is to strip a charity of its exempt status – a very severe remedy!



(2) Section 527(f) imposes a tax on “exempt function” expenditures of 501(c) organizations. Basically, these are expenditures to support or oppose a federal or state political candidate. The tax is imposed at the highest corporate rate on the lesser of: (a) the organization’s annual net investment income (income from interest, dividends, rents, and royalties, and the gains from sale or exchange of

assets minus the losses for such assets and investment management expenses); or (b) the aggregate amount expended on political activities during that year. Paying this tax does not avoid the risk to a 501(c)(3) of losing its exemption altogether for engaging in prohibited political activities.

- (3) Note that IRS Form 990 requires a 501(c) organization to report certain information about its political expenditures.

- (ii) Issues advocacy vs. involvement in political campaigning: According to the IRS, factors that tend to show an expenditure for an issue advocacy communication is for an “exempt function” include:

- (1) the communication identifies a candidate for public office,
- (2) the communication identifies the candidate’s position on the subject of the communication,
- (3) the candidate’s position has been raised (either by the communication or in other public communications) to distinguish him or her from other candidates,
- (4) the communication is timed to coincide with an electoral campaign,
- (5) the communication is targeted at voters in a particular election, and
- (6) the communication is not part of an ongoing series of substantially similar advocacy communications by the organization on the same issue.

(IRS Rev. Rul. 2004-6.)

- (iii) Factors that tend to show the expenditure is not for an “exempt function” include:

- (1) the absence of one or more of the above factors,
- (2) the communication identifies specific legislation or an event outside the organization's control that the organization hopes to influence,
- (3) the communication's timing coincides with a specific event outside the organization's control that it hopes to influence,
- (4) the candidate is identified solely as a government official who is in a position to act on the issue in connection with a specific event (e.g., will vote on the legislation), and
- (5) the candidate is identified solely in a list of the legislation's key sponsors.

<u>PROHIBITED:</u>	<u>PERMITTED:</u>
<p>Endorsements of a candidate.</p> <p>Publication or distribution of statements in favor of or in opposition to a candidate.</p> <p>Direct financial contributions or other support to a candidate, political party, or PAC (other than a ballot measure committee).</p> <p>In-kind contributions to a candidate, political party, or PAC (other than a ballot measure PAC) including, but not limited to:</p> <ul style="list-style-type: none">• mailing, membership, or donor lists or other resources for fundraising;• provision of facilities or office space;• staff time;• polling results;• organizing volunteers for the campaign;• opposition research; comparative ratings of candidates;• publicizing names of political candidates who support or oppose the organization's position on public issues;• membership communications expressly advocating the election or defeat of a candidate; and• payment of the administrative and fundraising costs of a political organization.	<p>Voter education and engagement activity, including candidate questionnaires and debates.</p> <p>Issue education projects.</p> <p>Get-out-the-vote programs.</p> <p>Voter registration.</p> <p>Note: These activities must be conducted in a nonpartisan manner—that is, if they do not support or oppose candidates or political parties.</p> <p>Note: There may be federal or state campaign finance rules that govern these activities.</p>

For your further reading: IRS Rev. Rul. 2007-1 (which includes hypothetical scenarios).

- b. A charity that is a 501(c)(3) organization may not devote a “substantial” part of its resources to **legislative lobbying**.
- (i) The 501(h) election provides a safe-harbor calculation for permitted expenditures.
- (ii) Certain educational activities are not considered “lobbying.”
- (1) In general, you are **lobbying** when you state your position on specific legislation to legislators or other government employees who participate in the formulation of legislation, or urge your members to do so (**direct lobbying**). In addition, you are lobbying when you state your position on legislation to the general public and ask the general public to contact legislators or other government employees who participate in the formulation of legislation (**grassroots lobbying**).
- (2) Activities that are not “lobbying” include:
- Examination and discussion of broad social problems.
 - Technical advice to legislators.
 - Member communications (that do not request members to lobby).
 - Self-defense communications.
 - The portion of mixed-purpose member or public communications that does not represent lobbying.
- (iii) Where a 501(c)(3) entity has a related 501(c)(4) lobbying entity, it raises issues regarding whether the resources of the IRC 501(c)(3) organization are used to subsidize lobbying activities of the IRC 501(c)(4) organization, particularly in situations where the two organizations share staff, facilities or other expenses or in which the two organizations conduct joint activities requiring an allocation of income and expenses. Any allocation of income or expenses between the two organizations must be carefully reviewed to ensure that the allocation method is appropriate and that an arms’ length standard is utilized. The determination of whether the method used is appropriate is based upon all the facts and circumstances.
- c. Unlike IRC 501(c)(3) organizations, **other organizations described in IRC 501(c)** may engage in an unlimited amount of lobbying, provided that such lobbying is related to the organization’s exempt purpose.

d. 501(h) lobbying expenditures limit:

<u>ANNUAL EXPENDITURES</u>	<u>OVERALL LOBBYING LIMIT</u>
\$500,000 or less	20%
\$500,000 to \$1 million	\$100,000 + 15% of expenditures over \$500,000
\$1 million to \$1.5 million	\$175,000 + 10% of expenditures over \$1 million
\$1.5 million to \$17 million	\$225,000 + 5% of expenditures over \$1.5 million
Over \$17 million	\$1 million

Note: The sub-limit on “grassroots” lobbying expenditures is 25% of the above limit.

- e. Detailed IRS regulations provide guidance regarding how to calculate the 501(h) dollar limits on lobbying expenses. Furthermore, there are exclusions for “examination and discussion of broad social problems,” “technical advice,” “member communications” and “self defense.” For more information, go to the IRS website. For a spreadsheet that calculates the 501(h) dollar limits on lobbying expenditures: <http://www.bolderadvocacy.org/501h-lobbying-calculator>.

2. Private Inurement and Conflicts of Interest

a. Excise Taxes on “Excess Benefit Transactions”

- (i) “Intermediate Sanctions” – penalties for insider transactions called “excess benefit transactions” -- under IRC § 4958 apply to **501(c)(3) and 501(c)(4), but not 501(c)(6)** entities.
- (ii) Prior to these rules, the IRS’ main remedy for “private inurement” transactions was to revoke tax-exempt status. Intermediate sanctions are generally viewed as a less terrifying remedy.
- (iii) Section 4958 imposes a tax on transactions between a public charity and certain insiders (such as officers, directors and substantial contributors and their family members and related interests, called “disqualified persons”) where the disqualified person receives an excess economic benefit. Apart from and in addition to these excise taxes, the disqualified person receiving the “excess benefit” must repay the entire excess benefit.
 - (1) “Excess benefit” generally means more than the disqualified person is entitled to, based upon what he/she/it provided to the organization.
 - (2) The issue arises in compensation and benefits situations, but also in transactions (leases, contracts, purchases) involving executives, directors and substantial contributors or their related parties.
 - (3) The sanction is an “excise tax” imposed directly on the disqualified person(s) who received an excess benefit from the transaction if the person is, or within the past 5 years has been, in a position to substantially influence the organization.

(4) The excise tax is also imposed on anyone who participates in the benefit transaction even if he/she received nothing, knowing that it was such a transaction, unless it was not willful and was due to a reasonable cause.

(5) The excise tax is generally:

- 25% of the Excess Benefit
- If 25% is not paid timely, then 200% penalty.
- If anyone approved the transaction (e.g., organization manager), a penalty of 10% of the benefit up to \$20,000 per transaction.

b. State Attorney General Actions

(i) State Attorneys General usually have jurisdiction to enforce state laws protecting the public interest in charitable funds. In California, the Attorney General registers all California charities and has the power to enforce the terms of charitable trusts and to prosecute self-dealing transactions and other violations of state laws.

(ii) Charitable trusts duties and liabilities arise from the Probate Code, from trust law, and from UPMIFA, among others.

(iii) The California Corporations Code addresses conflicts of interest, called "self-dealing transactions." Section 5233(a) of the California Corporations Code defines a self-dealing transaction as "a transaction to which the corporation is a party and in which one or more of its directors has a material financial interest and which does not meet the requirements of paragraph (1), (2), or (3) of subdivision (d)" (below).

(1) The Section 5233(d)(1) exception requires the Attorney General or a court to approve the transaction before or after it was consummated.

(2) The Section 5233(d)(2) exception requires that all of the following facts be established:

- The corporation entered into the transaction for its own benefit.
- The transaction was fair and reasonable as to the corporation at the time it entered into the transaction.
- Prior to consummating the transaction or any part thereof the board authorized or approved the transaction in good faith by a majority of the directors then in office without counting the vote of the interested director or directors, and with knowledge of the material facts concerning the transaction and the director's interest in the transaction.
- Prior to authorizing or approving the transaction the board considered and in good faith determined after reasonable investigation under the circumstances that the corporation could not have obtained a more advantageous arrangement with reasonable effort under the circumstances or the corporation in fact could not have obtained a more

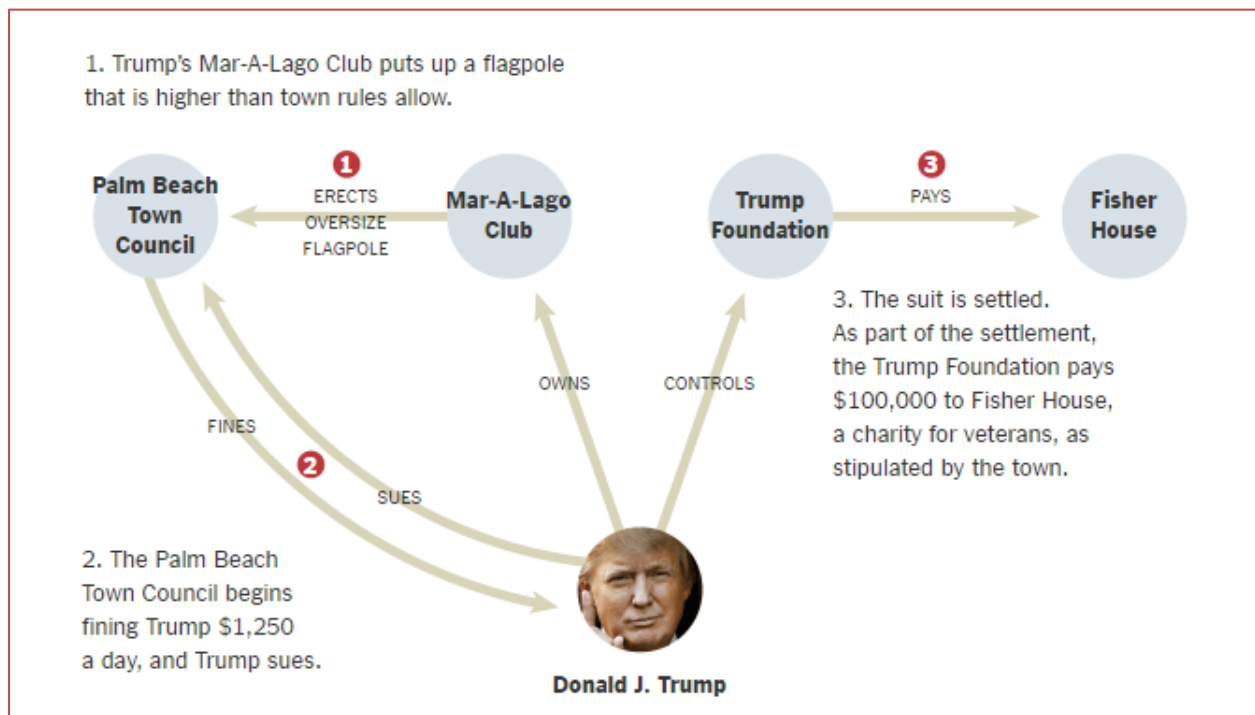
advantageous arrangement with reasonable effort under the circumstances.

(3) The Section 5233(d)(3) exception requires that all of the following facts be established:

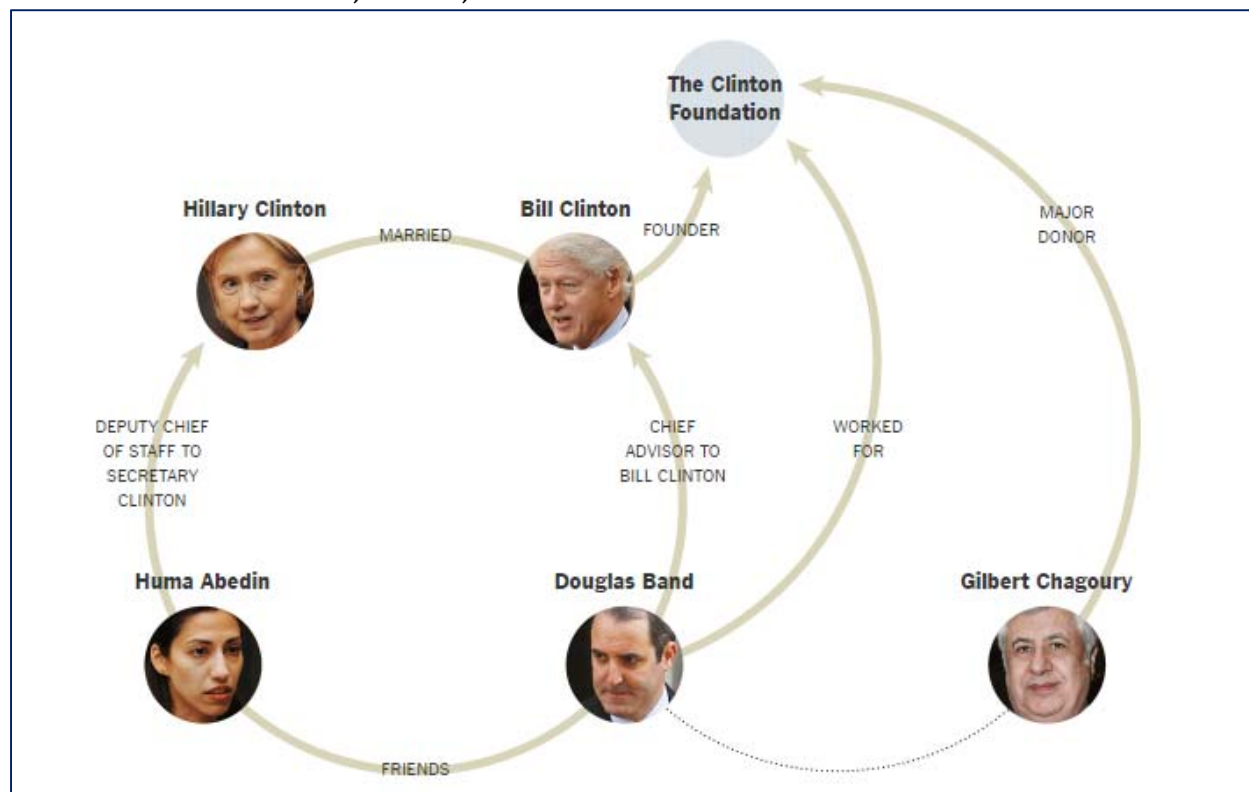
- A committee or person authorized by the board approved the transaction in a manner consistent with the standards set forth in Section 5233(d)(2).
- It was not reasonably practicable to obtain approval of the board prior to entering into the transaction.
- The board, after determining in good faith that the two conditions set forth above were satisfied, ratified the transaction at its next meeting by a vote of the majority of the directors then in office without counting the vote of the interested director or directors.

(iv) Corporations Code § 5236 absolutely prohibits a corporate loan or guarantee for the benefit of a director or officer, unless it is approved in advance by the Attorney General. The one statutory exception is a home loan designed to induce an officer to work or continue working for the nonprofit. Directors who approve a prohibited loan are jointly and severally liable to the corporation for doing so (Corp. Code § 5237).

Two Variations on “Private Inurement” in the Recent Press



Source: New York Times, Oct. 22, 2016



Comment: The alleged use of Trump Foundation resources to settle a business debt could be a prohibited self-dealing transaction and excess benefit transaction. The alleged use of Clinton Foundation donations to buy influence in government decisions does not appear to run afoul of these rules, but might violate government ethics rules.

3. Liability for Unpaid “Trust Fund” Payroll Taxes

- a. Organizations of all sizes, business and nonprofit, must be vigilant against embezzlement, especially during times of economic recession. One of the most common types of embezzlement is the taking of payroll taxes due to the IRS or state authorities. Also, executives of financially strapped organizations sometimes forego scheduled payroll tax payments, hoping to make them up later.
- b. Section 6672 of the Internal Revenue Code imposes a 100% penalty on any “responsible person” for so-called trust fund taxes, that is, employment taxes (social security payments and withholding, etc.) required to be collected from an employee's wages.
- c. Federal law immunizes from this liability volunteer directors who:
 - (i) serve solely in an “honorary” (?) capacity;
 - (ii) do not participate in daily or financial operations of the employer; and
 - (iii) have no actual knowledge of the failure to pay trust fund amounts.

--Unless no one else in the organization is a “responsible person.”

4. County Assessor as Charity Regulator

- a. The Board of Equalization and the County Assessors have no statutory authority to regulate the operation of public charities in California.
- b. However, the BOE and County Assessors have the ability to grant or deny the Welfare, Church and Religious Exemptions for property taxes.
- c. The California Supreme Court has said that the Welfare Exemption is to be “broadly construed” (*Stockton Civic Theatre v. Board of Supervisors*, 66 Cal. 2d 13, 18 (Cal. 1967)) and the Assessors’ Handbook similarly states that it “is to be broadly interpreted rather than narrowly construed in favor of taxability.” (Section 267, Part I, at 2.)
- d. As a practical matter, an Assessor reviewing the availability of the Welfare Exemption has substantial leverage to require changes in the way a charity operates, if the charity is dependent on the property tax exemption.

5. The IRS’ Corporate Governance Expectations

- a. Traditionally, corporate governance policies have been the province of **state laws**, which dictate:
 - (i) Corporate management and control
 - (ii) The structure and independence of nonprofit boards
 - (iii) Standards for addressing conflicts of interest
 - (iv) Compensation practices
 - (v) Insider transaction rules.
- b. The IRS has adopted the role of enforcer of good corporate governance, on the theory that good governance is essential to compliance for “tax-subsidized” entities.¹ New Form 990 (phased in 2008-2014) *implies* that nonprofits should have the policies set forth in the following pages.
- c. How should an organization respond?
 - (i) The IRS does not “require” these policies. But there is a fear that “NO” answers on the 990 may trigger a future audit. Furthermore, the IRS’ identification of these policies may be cited as evidence of a new baseline for “prudent practices” in litigation. So, for all practical purposes, the IRS is creating a new compliance obligation.

¹ See *Remarks of Sarah Hill Ingram, Commissioner for Tax Exempt and Government Entities*, June 23, 2009, available at http://www.irs.gov/pub/irs-tege/ingram_gtown_governance_062309.pdf.

(ii) We recommend:

- (1) Consider which policy topics apply to your organization. Some policies may not be applicable to a particular organization.
- (2) Do not adopt “canned” model policies verbatim. Use good models as a starting point, and tailor them to your organization’s needs.
- (3) These policies can appropriately be placed in an organization’s bylaws. (Before doing so, consider whether your members must vote on bylaw amendments and whether the bylaws approach is desirable, given that these policies may change frequently.)
- (4) Alternatively, if your organization has a good system for adopting, publishing and maintaining policies of this type (e.g., a readily accessible and frequently used policy handbook or electronic folder), consider this method for recording and publishing these important corporate policies.

<u>Policy</u>	<u>Comments</u>
#1. Mission statement (Part III, line 1).	Most nonprofits have a mission statement. They are often revisited and revised at board retreats. Note: Be sure the mission statement is consistent with the legal statement of purpose in the articles of incorporation.
#2. Local branches, chapters, and affiliates (Part VI, Question 10b)	If an organization had local chapters, branches or similar affiliates during the year, the Form 990 asks if there are written policies and procedures governing their activities to ensure consistency with the activities of the organization. If the answer to this question is No, an explanation is required in Schedule O as to how the organization ensures that the local unit’s activities are consistent with its own.
#3. Review of Form 990 (Part VI, Question 11)	Organizations must describe in Schedule O the process, if any, the organization uses to review the Form 990. While no process to review the Form 990 is required, a simple procedure may be appropriate to indicate if and when the board receives the Form 990 and the process for handling questions/comments from the board. Consider, that it might also be prudent to address the use of a questionnaire for all insiders in the course of <i>preparing</i> the 990.

#4. Conflict of interest policy (Part VI, Question 12 a-c)	Organizations are asked if they have a written conflict of interest policy, if certain individuals are required to disclose annually interests that could give rise to conflicts (a questionnaire might accomplish this disclosure), and how the organization regularly and consistently monitors and enforces compliance with the policy. An explanation is required on Schedule O of how this is done.
#5. Whistleblower policy (Part VI, Question 13)	Organizations are asked if they have a written whistleblower policy.
#6. Document retention and destruction policy (Part VI, Question 14)	Organizations are asked if they have a written document retention and destruction policy.
#7. Compensation approval of top management officials and key employees (Part VI, Question 15 a-b)	Organizations are asked to describe on Schedule O the process for determining compensation, including a review and approval by independent persons, comparability data, and contemporaneous substantiation of the deliberation and decision relating to the organization's CEO, Executive Director, or top management official plus other officers or key employees.
#8. Joint venture policy (Part VI, Question 16 a-b)	Organizations are asked if they invest in, contribute assets to, or participate in a joint venture or similar arrangement with a taxable entity. If Yes, the organization is asked if it has adopted a written policy or procedure requiring the organization to evaluate its participation in joint venture arrangements under applicable Federal tax law, and taken steps to safeguard the organization's exempt status with respect to such arrangement.
#9. Public inspection of Form 1023, 990, and 990-T (Part VI, Question 18)	Organizations are asked how they make these forms available for public inspection. This question suggests an organization should have a procedure.

<p>#10. Disclosure of governing documents, conflict of interest policy, and financial statements (Part VI, Question 19)</p>	<p>Organizations are asked if they make governing documents, conflicts of interest policy, and financial statements available to the public. This question suggests an organization should have a procedure. However, <i>such disclosures are generally not required by law.</i></p>
<p>#11. Policy for the payment of a housing allowance, first class or charter travel, spousal travel, gross-up payments, discretionary spending, health or social club dues, etc. (Schedule J, Question 1b)</p>	<p>This is a subject for which there are no “bright line” rules.</p>
<p>#12. Gift acceptance policy for non-standard gifts (Schedule M, Question 31)</p>	<p>Organizations that meet the \$25,000 gifts-in-kind threshold for filing this schedule are asked if they have a gift acceptance policy that requires the review of any non-standard contributions.</p>
<p>#13. Soliciting, processing, or sale of non-cash contributions (Schedule M, Question 32 a-b)</p>	<p>Organizations that meet the \$25,000 gifts-in-kind threshold for filing this schedule are asked if they hire or use third parties or related organizations to solicit, process, or sell non-cash contributions. If Yes, a description is required in Part II of Schedule M.</p>
<p>#14. Policy on acceptance of conservation easements (Sch. D, Part II, line 5)</p>	<p>This applies to a very limited set of environmental and land-trust organizations.</p>
<p>#15. Board independence policy (Part I, line 4; Part VI, line 15)</p>	<p>Note that California law requires a majority of the board to be “independent” outsiders.</p>

#16. Policy on endowments (Sch. D, Part V, line 4)	Any organization that accepts endowment gifts should have a policy with acceptance criteria, spending policy, and related matters.
#17. Committee review and oversight of audit and selection of independent accountant (Part XI, line 2)	Note that California law requires an audit for any year in which revenues exceed \$2 million (including an extraordinary bequest).

6. Public Disclosures Requirements

- a. There are many documents that are covered under IRS disclosure rules, including IRS Forms 990, 990-EZ, 990-PF, and 1023 and an organization's IRS determination letter.
 - (i) Form 990 or 990-EZ. With the exception of most faith-based organizations, tax-exempt nonprofits must file this return annually with the IRS. The three most recent returns must be made available along with any filed attachments, although the names and addresses of contributors must be masked on copies made available to the public. Amounts of contributions and bequests must be disclosed, unless they would identify contributors.
 - (ii) Form 990-PF. A private foundation must follow the disclosure rules that apply to Forms 990 and 990-EZ.
 - (iii) Form 1023 or 1024. A charitable organization's application for exemption (Form 1023 or 1024), any attachments to the application, and any materials the IRS requests in connection with the application must also be disclosed.
 - (iv) Letter of determination. An organization must make its letter of determination available to the public.
- b. If this information is requested in person at a nonprofit's principal office, generally the organization must provide the information that day. If the information is requested in writing, the organization usually has 30 days to comply.
- c. Keep in mind that organizations do have the right to charge the requester "reasonable copying costs" for the document in question. The allowable charge is the same amount charged by the IRS for providing copies, currently 20¢ per page.
- d. What happens if the information is not supplied? The penalty for not disclosing an annual return is \$20 per day for as long as the failure to comply continues, up to a maximum of \$10,000 maximum fee per return not disclosed. There is no maximum fee for failure to provide the application for exemption. However, the requester must first write to the IRS, who will then give the charity a chance to comply before assessing penalties.

- e. Organizations that do not wish to provide hard copies of these document(s) do have another option: they can post a copy on their Web site. If the documents are available *for free* at another website, the charity can direct the requester there. The California Attorney General's charities site has copies of filed documents, but this usually does not include the most recent 990.
- f. Apart from the IRS' public disclosure rules, California's Nonprofit Integrity Act of 2004 requires that audited financial statements produced in accordance with the law (gross revenues > \$2 million) be publicly disclosed.
- g. Directors and management of public charities commonly believe that their bylaws and board minutes are public documents, and that board meetings are subject to the open meeting requirements of California's Brown Act. This is generally not true, although there are a few types of nonprofits that are subject to these rules.