



# **Nonprofit Reporting Requirements and Legal Issues**

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# Outline

- Unincorporated Nonprofit Associations
- Starting a Tax-Exempt Nonprofit Corporation
- 501(c)(3)
- Reporting Requirements
- Governance
- Fiscal Sponsorship



# Tax-Exempt Organizations: choice of legal entity

- Unincorporated nonprofit association
- Nonprofit corporation
- Trust
- Limited liability company (LLC)



# Definitions – CA Corp. Law

- **"Unincorporated association"** means an unincorporated group of two or more persons joined by mutual consent for a common lawful purpose, whether organized for profit or not.
- **"Nonprofit association"** means an unincorporated association with a primary common purpose other than to operate a business for profit.



# Unincorporated Nonprofit Association

## Common Legal Issues:

- Nonprofit doesn't mean tax-exempt
- Liability exposure of directors and members
- Fictitious business name
- Registration – Registry of Charitable Trusts
- Reporting



# Nonprofit vs. Tax-Exempt

## **Nonprofit** - State *corporate law* concept

- Corporate purpose is not primarily to earn a profit
- No owners / no distribution to “owners”

## **Tax-Exempt** – Federal and State *tax law* concept

- Exempt from paying corporate income taxes on income generated from activities substantially related to the entity’s exempt purpose



# Liability: Corporation > Unincorporated Assn.

- liability protection statutes in Nonprofit Public Benefit Corporation (“NPBC”) Law (offer limited protection, but better than none)
- mandatory indemnification under certain circumstances (you can also add such protections to the bylaws of the unincorporated association, but they would be subject to change at any time by the board)
- greater body of case law (there are more precedents for protecting directors and officers of corporations from personal liability than there are for directors and officers of unincorporated associations)
- greater understanding by all parties of limited liability shield (this may serve to dissuade some potential plaintiffs from suing individual directors and officers)
- unincorporated association under common law and certain jurisdictions may not be respected as a separate legal entity, exposing its members to liability for debts and obligations of the association



# Fictitious Business Name

- File fictitious business name statement with county clerk (optional)
  - Evidence of unincorporated nonprofit association to protect members from personal liability
- BUT
- Better to file Form LP/UNA 128 with Secretary of State





# Initial Filings

- Secretary of State – Form LP/UNA 128
- Registrar of Charitable Trusts – Form CT-1
- Employment-related filings
- Local licenses and permits



# Ongoing Reporting

- Secretary of State – Form UA-100
- AG Registry of Charitable Trusts – Form RRF-1
- Franchise Tax Board
  - Tax Return (Form 100); or
  - Information Return (Form 199)
- Internal Revenue Service
  - Tax Return (Form 1120); or
  - Information Return (Form 990)



# Nonprofit Corporations

## **Public benefit corporations (Corp. Code §5110-6910)**

- Organized primarily for charitable purposes
- Organized to act as a civic league or social welfare organization

## **Mutual benefit corporations (Corp. Code §7110-8910)**

- Organized for other than religious, charitable, civic league or social welfare purposes

## **Religious corporations (Corp. Code §9110-9690)**

- Organized to operate a church or to be otherwise structured for primarily religious purposes



# Corporation > Unincorporated Association

- Stronger protection against personal liability
- Recruitment of directors and officers
- Default provisions in the Code fill in the gaps
- Organizational perpetuity – outlives managers/directors
- Greater flexibility with employee benefits



# Potential Disadvantages with Incorporating

- Start-up formalities and costs
  - Incorporation, bylaws, etc.
  - Application for tax-exemption
- Transfer of assets and liabilities – timing
  - Assignment and assumption
  - Existing contracts – notice requirements, adverse consequences
- New licenses and permits (may not transfer)



# Nonprofit Corporation Law (Corporations Code)

- Organization & Bylaws
- Directors & Management
- Members, Meetings, & Voting
- Corporate Changes (e.g., merger, dissolution)
- Records & Reports
- Crimes & Penalties



# Forming a Nonprofit Corporation

- Decide where to incorporate
- Draft Articles of Incorporation
  - Purpose statement – broader = more flexibility
  - Tax exemption language
    - 501(c)(3)
    - Property taxes (CA Board of Equalization)
- File Articles of Incorporation with Secretary of State



# Other Start-Up Formalities

- Appoint a board of directors
- Hold and document the first board meeting
  - Elect officers
  - Adopt bylaws and conflict of interest policy
- Get Employer Identification Number (IRS Form SS-4)
- File AG Form CT-1 (Initial Registration)
- File IRS Form 1023 (Exemption Application)
- File FTB Form 3500 or 3500A





# Exempt Organizations – 501(c)(3)

**501(c)(3)** - Entity organized and operated exclusively for one or more of the following purposes:

- Religious
- Charitable
- Scientific
- Testing for public safety
- Literary
- Educational
- Foster national or international sports competition
- Prevention of cruelty to children or animals



# 501(c)(3) – Organizational & Operational Tests

## Organizational Test:

- organized exclusively for exempt purposes set forth in its governing documents.

## Operational Test:

- ORG must be operated *primarily* for one or more exempt purposes
- Only "insubstantial part" of ORG's activities may be devoted to non-exempt purposes
  - E.g., operating an unrelated business.



## 501(c)(3) – No Private Inurement

No part of the ORG's net earnings may inure to the benefit of any private shareholder or individual.

- an insider such as a director, officer or other person in a position to influence the ORG's decisions

Sanction: **REVOCATION**



## 501(c)(3) – No Private Benefit

- ORG must serve a public rather than a private interest.
- ORG must not be operated for the benefit of private interests.
- ORG may confer benefits to individuals so long as they are incidental, quantitatively and qualitatively, to the furthering of ORG's exempt purposes.



# 501(c)(3): Private Foundation vs. Public Charity

Default rule: All 501(c)(3) organizations are private foundations

Exceptions: Section 509(a)(1), (2), (3) or (4) organizations (aka “public charities”), including:

- *Per se* public charities: churches, schools, hospitals, college endowments, governmental entities
- 170(b)(1)(a)(vi) publicly supported orgs: 1/3 Support Test or Facts & Circumstances Test
- 509(a)(2) publicly supported orgs: 1/3 Support Test and Not-More-Than 1/3 Support Test
- 509(a)(3) supporting organizations



# Private Foundations – subject to more regs

- No self-dealing - IRC 4941
- Minimum distributions – IRC 4942
- No “excess business holdings” – IRC 4943
- No “jeopardizing investments” – IRC 4944
  - Exception: Program Related Investments (PRIs)
- Prohibition against certain expenditures (incl. lobbying and grants to orgs other than certain public charities) – IRC 4945
  - Exception: Expenditure Responsibility (due diligence)
- Taxed on net investment income – IRC 4940



# Private Foundations – less attractive to donors

- Lower potential deduction
- Expenditure Responsibility Rule (applicable to private foundations) – IRC 4945



# Public Charities – No Excess Benefit Transactions

Excessive economic benefit provided by a public charity to a disqualified person (current or former director, CEO, CFO, relatives, 35% entities)

- Penalties

- 25%, 200% (disqualified person)
- 10% (up to \$10,000) (board, if knowing and willing participation)

- Presumption of Reasonableness

- Approval in advance by disinterested board (or committee)
- Appropriate comparability data
- Concurrent documentation





# Public Charities – No Substantial Lobbying

## Lobbying

- Communication
- Principal purpose is to influence legislation
- Reflects a view on specific legislation

## What's *substantial*?

- Substantial Part Test
- 501(h) Expenditure Test



# Lobbying – Substantial Part Test

Vague standard: based on facts and circumstances

- 5% insubstantial safe harbor?
- Revocation if violation in any one year



# Lobbying – 501(h) Expenditure Test

Defined standard: measuring only lobbying expenditures

TOTAL:

- 20% of first \$500,000 of EPE
- 15% of next \$500,000 of EPE
- 10% of next \$500,000 of EPE
- 5% of remaining EPE (up to \$1 million)
  - EPE = Exempt Purpose Expenditures

GRASSROOTS:

- 25% of Total Lobbying Expenditure Limits

Specific exclusions from lobbying

Revocation based on 4-year period



# Two Types of Lobbying – 501(h)

## ■ Direct

- Communication to member of legislative body
- Principal purpose is to influence legislation
- Reflects a view on specific legislation

## ■ Grassroots

- Communication to general public
- Reflects a view on specific legislation
- With a call to action (e.g., to contact legislator)



# Exceptions to Lobbying – 501(h)

- Nonpartisan analysis, study or research
- Examinations of broad social, economic and similar problems
- Technical advice or assistance to governmental body upon written request
- Self-defense communications



# 501(c)(3) – No Electioneering

Absolute prohibition

Electioneering =

- Directly or indirectly participating in, or intervening in, any political campaign
- On behalf of, or in opposition to, any candidate for elective public office



# 501(c)(3) Electioneering Prohibitions

- Contribute to political campaign fund
- Make public statement of position on behalf of organization in favor of, or in opposition to, any candidate for public office (e.g., endorsement)
- Allowing one candidate to use organization's resources without giving equal opportunity to other candidates



# 501(c)(3) Permissible Political Activities

- Voter education activities/expenditures
  - Public forums
  - Voter education guides
- Voter registration/get-out-the-vote drives





# Reporting Requirements

- Secretary of State: Statement of Information (biennial)
- Attorney General: Registration Renewal (Form RRF-1)
- Franchise Tax Board: Form 199 (>\$25K)
- Internal Revenue Service: Form 990, 990-EZ, 990-N, or 990-PF
- Local licenses
- Employment-related returns



# Nonprofit Governance – Legal Duties

A director shall perform the duties of a director, including duties as a member of any committee of the board upon which the director may serve, **in good faith**, in a manner such director believes to be **in the best interests of the corporation** and **with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.**

– Cal Corp Code §5231(a)



# Duty of Care

- Ordinary prudent person standard
  - Reasonable inquiry (investigation)
  - Independent judgment
- Issues:
  - Reliance
  - Delegation



# Duty of Loyalty

- In good faith
- In the best interests of the corporation
- Issues:
  - Conflict of interest
  - Corporate opportunity
  - Confidentiality



# Duty of Obedience

- Carry out the corporation's purpose
- Comply with the law
- Refrain from *ultra vires*\* activities

\* beyond the corporation's powers



# Areas of Potential Director Liability

- Breach of fiduciary duties
- Actions outside scope of authority
- Employment claims
- Discrimination claims
- Other claims (e.g., torts, contracts, IP)
- Failure to pay payroll taxes
- Failure to observe corporate formalities



# Executive Compensation

- Nonprofit Integrity Act of 2004 (CA)
  - CEO & CFO compensation must be “just and reasonable”
- Board or Board Committee must approve compensation:
  - When hired
  - When term of employment is renewed or extended
  - When compensation is modified\*
- Comparables for Rebuttable Presumption of Reasonableness
  - Compensation surveys
  - Form 990 of comparable organizations



# Fundraising

- Nonprofit Integrity Act of 2004 (CA)
  - Registration with the Attorney General's Registry of Charitable Trusts
  - No misrepresentation of charity's purpose or nature or purpose or beneficiary of a solicitation
  - Charity must "establish and exercise control" over its fundraising activities conducted for its benefit
  - Charity shall not enter into any agreement with, or employ, any unregistered Commercial Fundraiser or Fundraising Counsel
  - Charity shall not enter into any agreement with, or raise any funds for, any charity required to be registered but not yet registered (unless they agree to register prior to any solicitation)





# NIA's 12 Prohibitions (condensed)

- Don't lie
- Don't cheat
- Don't steal



# Charitable Trust Doctrine

- Restricted gifts – terms of restriction
- Unrestricted gifts – declared purpose
- Non-gifted assets – declared purpose
- Change in purposes – *cy pres* doctrine



# Receipts (Substantiation & Disclosure)

- Donor cannot claim deduction for contribution unless donor maintains a record of contribution
- Donor requires *written acknowledgment* from charity for \$250+ gift
  - To claim charitable deduction
- Charity must provide *written disclosure* to donor if:
  - Payment exceeds \$75
  - Part-gift, part-exchange for goods or services\*  
(*quid pro quo*)



# Unrelated Business Income Tax (UBIT)

General Rule: An activity is an unrelated business (and subject to UBIT) if:

- It is a trade or business
- Regularly carried on
- Not substantially related to the org's exempt purpose



# UBIT: Trade or Business

- Any activity carried on for the production of income from selling goods or performing services.
- Even if carried on within a larger framework of other activities that may, or may not, be related to the organization's exempt purposes.



# UBIT: Regularly Carried On

- Activities that show a frequency and continuity, and are pursued in a manner similar to, comparable commercial activities of nonexempt organizations.



# UBIT: Not Substantially Related

- *Substantially related* when the conduct of the business activities has a substantial causal relationship to achieving exempt purposes (other than through the production of income)
- The activities that generate the income must contribute importantly to accomplishing the organization's exempt purposes to be substantially related



# Exclusions from “Unrelated Trade or Business”

- Where substantially all of the work is performed by volunteers
- Where carried on primarily for the convenience of its members, students, patients, officers, employees
- Where sale of donated merchandise
- Passive income – interest, dividends, annuities, royalties, certain rents, gains from sale/exchange/transfer of capital asset
  - Exception: Debt-financed property, not substantially related to ORG’s exercise/performance of its exempt functions
  - Exception: Income from a more than 50% controlled corporation





# Fiscal Sponsorship – Common Model (A)

- Existing 501(c)(3) public charity sponsors “Project”
- Project has no separate legal existence
- Sponsor’s board has ultimate control and discretion
- Management of Project delegated to Project committee
- Donors donate to Sponsor
  - Sponsor retains administrative fee
  - Sponsor makes remaining funds available to Project



# Fiscal Sponsorship – Keys

- Reputable, knowledgeable Sponsor
- Committed Project committee
- Well-drafted fiscal sponsorship agreement
  - Services and benefits provided by Sponsor
  - Administrative Fee
  - Exit provisions



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