Framework for Nonprofit Legal Stewardship

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Today's Discussion

Overview of Nonprofit Legal & Tax Issues

- Organization & Governance
  - Corporate Status
  - Governing Documents
  - Board of Directors' Legal Duties
- Tax Exemption
  - Sources of Tax Exempt Status
  - 501(c)(3) and 501(c)(6) Status
  - Unrelated Business Income Tax
  - Lobbying and Political Activity Restrictions
- Contracts
  - Key Terms
  - Meeting Contract Provisions

Organization and Governance

What is a Nonprofit Organization?

Legal Form of Organization

- Most common legal structures:
  - Corporation
  - Unincorporated Association
- Governed by state law (statutes and common law)
  - Nonprofit Corporation Laws
  - Unincorporated Association Laws
- Non-distribution constraint is fundamental characteristic
  - Profits are used to further mission, not distributed to shareholders
- Nonprofit status is not synonymous with tax-exempt status

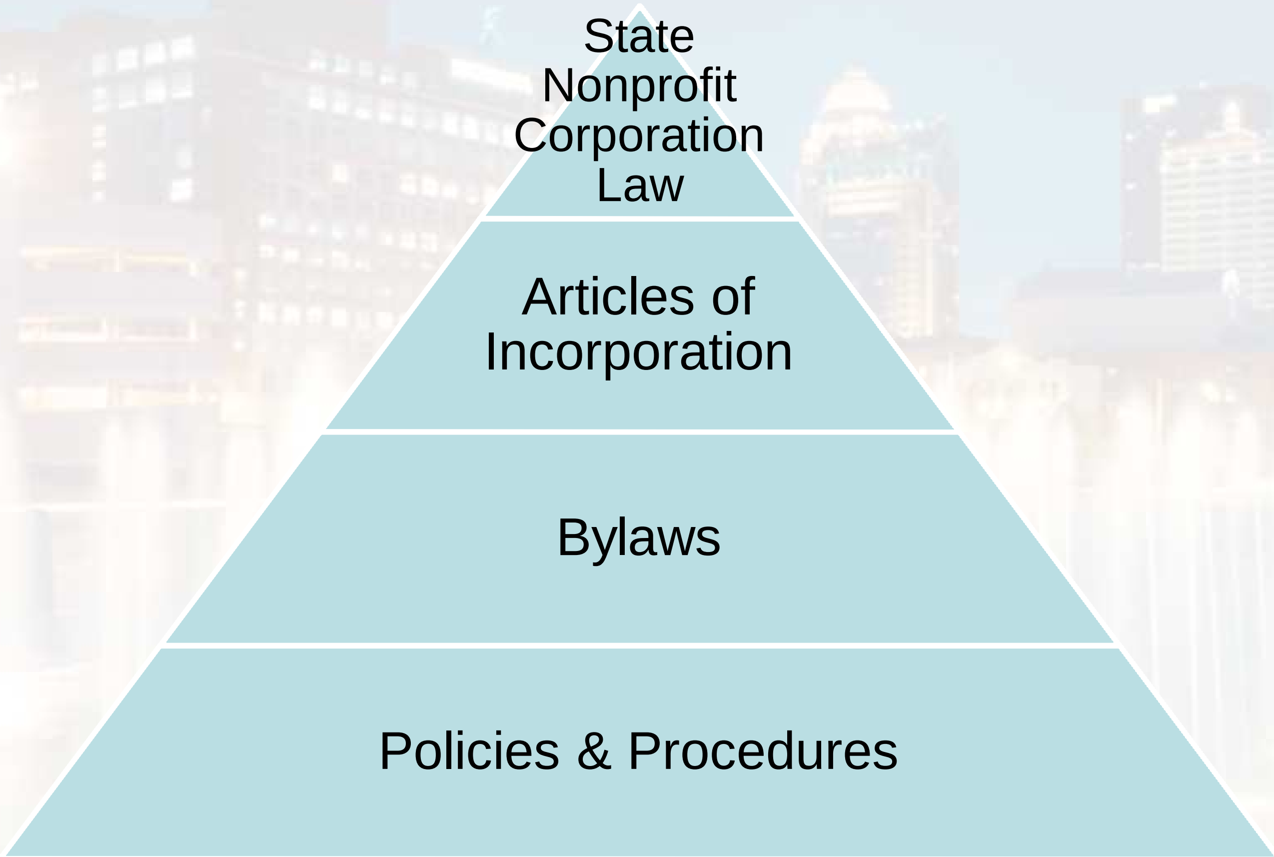
What is a Nonprofit Organization?

Legal Form of Organization—Corporations

- Limited Liability Protection
  - Incorporation grants organization "corporate shield" so long as operations are consistent with state corporate requirements
- Corporate Status Requirements:
  - File and maintain articles of incorporation with the state
  - Comply with state nonprofit corporation law governing organization and decision-making (i.e., elections, meetings, voting, etc.)
  - File annual report with the state to remain in good-standing

Governance

Hierarchy of Governing Documents



Governance

Role of the Board of Directors

- Board of directors is the ultimate decision-making body
  - Delegation to officers, committees, or staff is permissible, but oversight is required
- Boards generally are only allowed to act in a meeting or by unanimous written consent
- Authority to govern the corporation comes with duties—state statutory and common law requires that corporate board members fulfill:
  - Fiduciary duty of care
  - Fiduciary duty of loyalty
  - Fiduciary duty of obedience

Governance
Duty of Care

- Standard is that of "ordinary and reasonable care," or what would an ordinarily prudent director do in the same or similar circumstances?
- Business judgment rule—bad decisions are more easily defended than ignorance; it is the due diligence process that matters most
- Can rely on reports and consultants, if reliable
- Compliance with fiduciary duty of care:
  - Review all materials
  - Ask questions
  - Actively participate in meetings

Governance

Duty of Loyalty

- Duty of undivided allegiance
- Duty to avoid conflicts of interest (actual, potential, and apparent)
  - Examples
    - Business dealings with association
    - Business dealings with competitors
    - Corporate opportunities doctrine
  - Remedies
    - Disclosure; recusal or resignation
- Confidentiality

Governance
Duty of Obedience

- Articles of incorporation, bylaws, other governing documents must be followed
- Applicable laws and regulations must be followed

Governance
Board Role Summary

- Meet and deliberate
- Act in best interests of the organization
- Document compliance through minutes

Governance
Apparent Authority

- As long as a board member, officer, or employee reasonably appears to be acting with the organization's approval, the organization may be liable for that individual's actions
- Often it is no defense to say that the board member, officer, or employee was not acting within the scope of his/her actual authority

Governance
Risk Management

- Insurance
  - Directors & Officers
  - General Liability
  - Errors & Omissions
  - Meeting Cancellation
- Volunteer Protection Acts (state and federal)
- Indemnification
- Informed consent/waiver

Governance

IRS Form 990

- Questions Regarding Board and Management
  - Are minutes taken at board and board committee meetings?
  - Does the board receive a copy of Form 990 before filed?
- Questions Regarding Governance Policies
  - Maintain a written conflict of interest policy
  - Maintain a compensation review policy—follow the procedures for the "rebuttable presumption"
  - Maintain a written whistleblower policy
  - Maintain a written document retention and destruction policy
  - Maintain a joint venture policy to govern transactions with taxable entities

Tax Exemption

Tax Exemption

Topic Overview

- Sources of Tax Exemption
- 501(c)(3) and 501(c)(6) Status Fundamentals
- Unrelated Business Income Tax
- Lobbying and Political Activities

Tax Exemption

Sources of Tax Exemption

- Federal Tax Exemption
  - Internal Revenue Code provides exemption from federal income tax to qualified nonprofit organizations
  - Recognition by IRS obtained through application or group exemption
- State Tax Exemption
  - State statutes may provide exemption from state income or franchise tax, as well as state property, sales, and use taxes
  - May be conditioned upon recognition of federal tax exempt status but *not* always tied together or automatically granted—application to state revenue agency may be required

Tax Exemption

Section 501(c)(3) Tax Exempt Status

- Tax-exempt purpose—educational, scientific or charitable
- Contributions tax-deductible by donors as charitable contributions (minus value of benefits received in return)
- No "private inurement" or impermissible "private benefit"
- No "substantial" lobbying
- No political campaign activities
- Taxation of unrelated business income ("UBIT")

Tax Exemption
Section 501(c)(6) Tax Exempt Status

- Tax-exempt purpose—improvement of business conditions of industry or profession
- No "private inurement"
- No "particular services" for members
- Unlimited lobbying
  - Lobbying portion of dues not tax-deductible by members as a business expense
- Some political campaign activities permissible
- Taxation of unrelated business income ("UBIT")

Tax Exemption
Understanding UBIT

- Unrelated Business Income Tax (UBIT)—income is taxable if derived from :
  - a trade or business,
  - that is regularly carried on, and
  - that is not substantially related to furthering the exempt purpose of the organization

Tax Exemption
Understanding UBIT

- Unrelated business activities permitted, but must be less than substantial portion of overall activities (otherwise tax-exempt status jeopardized)
- Revenue-generating activity itself must be related to exempt purposes; using the proceeds for good works is not enough to avoid UBIT

Tax Exemption
Understanding UBIT

- Examples of "related" income-generating activities:
  - Conference or program registration fees
  - Exhibit booth rentals
- Examples of activities that can generate UBI:
  - Sale of advertising
  - Sale of consumer products where selling product does not further mission
  - Performance of services unrelated to mission
  - Certification or job board activities by 501(c)(3) organizations (can do to limited extent but note UBIT consequences)

Tax Exemption

Understanding UBIT—Key Exceptions

- Qualified Sponsorship Payments
- Qualified Convention and Trade Show Activities
- Royalties

Tax Exemption

Understanding UBIT—Qualified Sponsorship Exception

- Qualified sponsorship payments are excepted from the definition of UBI—sponsor neither gets nor expects any return benefit other than:
  - Goods, services or other benefits, the total value of which does not exceed two percent of the sponsorship payment (includes event registrations, etc.); or
  - Recognition, i.e., use or acknowledgement of the sponsor's name, logo, or product lines in connection with the nonprofit's activities

Tax Exemption

Understanding UBIT—Qualified Sponsorship Exception

- Recognition, NOT advertising:
  - If the substantial return benefit is a form of advertising, the sponsorship payment is subject to UBIT
  - Advertising is defined as any message that promotes or markets any trade or business, or any services, facility, or product
  - Messages containing qualitative or comparative language, price information or other indications of savings or value, an endorsement, or an inducement to purchase, sell, or use the products or services are advertising

Tax Exemption

Understanding UBIT—Qualified Sponsorship Exception

- Permissible forms of recognition:
  - Use or acknowledgment of the name or logo (or product lines) of the sponsor's business, as long as the use is not qualitative or comparative
  - List of sponsor's location, telephone number, and/or Internet address, including a hyperlink from the exempt organization's website to the sponsor's website
  - Designating a sponsor as an "exclusive sponsor"
  - Product samples okay

Tax Exemption

Understanding UBIT—Qualified Convention &Tradeshow Exception

- Income from activities traditionally carried on at convention and trade shows is not subject to UBIT
  - Exhibit booth rentals
  - Registration fees
  - Watch out for “virtual” trade show income

Tax Exemption
Understanding UBIT—Royalties Exception

- Revenue from licensing of property rights
  - Name, mark and mailing list
  - Affinity programs
- No active promotion (or quantify value and pay tax)
  - Announcement letter okay
  - Quality control measures okay

Tax Exemption
Lobbying and Political Activities

- 501(c)(3)
  - Lobbying permitted, provided it is not a "substantial part" of the organization's total activities.
  - NO political campaign activities permitted.

- 501(c)(6)
  - Unlimited lobbying permitted.
    - Lobbying portion of dues not tax-deductible by members as a business expense.
  - Political campaign activities permitted, provided they are not the organization's primary activity.
    - Be aware of federal and state campaign finance laws, particularly with regard to restrictions on political activities of corporations.

Tax Exemption

Lobbying and Political Activities—501(c)(3) Compliance Options

- What is Lobbying?
  - Basic general concept—attempts to influence *legislation* at the federal, state, or local levels through direct or grassroots communications
- Two options for measuring compliance with (c)(3) limitation on lobbying activities:
  - No substantial part test
  - 501(h) expenditure test

Tax Exemption

Lobbying and Political Activities—501(c)(3) Compliance Options

- No substantial part test:
  - Vague, facts and circumstances test
  - Strict sanctions
    - revocation of exempt status
    - excise tax on organization and its managers (5% of lobbying expenditures)
- 501(h) expenditure test:
  - Lobbying activity measured solely by the amount of money spent on lobbying
  - Lobbying will not be considered "substantial" provided organization does not exceed expenditure cap
  - Clear definitions of lobbying and exclusions for specific activities
  - Must affirmatively elect to use by filing IRS Form 5768
  - Flexible sanctions
    - 25% tax on amount spent over the cap
    - No tax penalties imposed on organization managers for exceeding the limits
    - Revocation of exempt status results only if the organization exceeds 150 percent of the cap over a 4-year consecutive averaging period

Tax Exemption

Lobbying and Political Activities—501(h) Spending Caps

Exempt Purpose Expenditures	Percentage Allowed for Lobbying	Total Maximum Lobbying Amount
$0 to $500,000	20%	Up to $100,000
$500,001 to $1,000,000	15%	$100,000 plus 15% of excess over $500,000
$1,000,001 to $1,500,000	10%	$175,000 plus 10% of excess over $1,000,000
Over $1,500,000	5%	$225,000 plus 5% over $1,500,000, up to a maximum of $1,000,000

- Grassroots lobbying expenditures limited to no more than 25% of the total amount permitted for lobbying in a year.

Tax Exemption

Lobbying and Political Activities—Tax Reporting

- Tax-exempt organizations report lobbying and political activities on Form 990, Schedule C

- Effective compliance requires careful tracking of time and money spent on lobbying
  - Include allocable staff time and compensation, overhead, and administrative costs
  - Time and money spent on research, planning, drafting, reviewing, publishing, and mailing in support of lobbying is included

Tax Exemption

Lobbying and Political Activities—Other Applicable Laws

- Lobbying registration and reporting laws (federal, state, and local)
  - Be aware of reporting obligations under federal, state, or local lobbying laws—different definitions of lobbying may apply (e.g., lobbying may include attempts to influence not just legislation but also executive branch activities)
- Campaign finance laws (federal, state, and local)
- Restrictions on use of federal funds

Tax Exemption

Protect Your Tax Exempt Status

- Form 990 Annual Filing Requirements:
  - All tax-exempt entities must file the 990, 990EZ, or 990N (e-postcard)
- Failure to file for 3 years results in automatic loss of tax-exempt status

Gross receipts ≦ $50,000	Form 990N (e-postcard) or Form 990
Gross receipts < $200,000 and assets < $500,000	Form 990EZ or Form 990
Gross receipts ≧ $200,000 and assets ≧ $500,000	Form 990

Tax Exemption

Protect Your Tax Exempt Status

- Be aware of Internet presence
  - Particularly appearances of advertising or lobbying
  - Easy for IRS to review

- Also be aware of state filings, including
  - State tax returns
  - Charitable solicitation requirements

Contracts

Contracts
Key Terms

- Scope
- Payment
- Ownership
- Responsibility
- Term and Termination

Contracts
Scope

- "Four corners rule"—everything should be in the contract
  - Almost all litigation arises over lack of clarity
  - Don't rely on oral promises—get it in writing
- Carefully define what the organization is obligated to do or what you are paying for
- Particularly important in "soft" contracts (i.e., research, writing)
- Timelines and deliverables are crucial
- BUT, beware of too much control—can lead to "employee" status

Contracts
Payment

- Tie payment to satisfactory delivery of deliverables according to the timeline
- Withhold final payment until all items are delivered—always need an incentive to perform
- Consider audit rights, if needed

Contracts
Ownership

- Absolutely crucial, and often overlooked
- Copyright vests in the creator, even if you contracted for the services
- Get a perpetual, unlimited license or assignment of all rights
- Applies to committees, volunteers too – particularly important in the development of "intellectual capital," such as certification standards
  - Very important for meetings, speakers

Contracts

Responsibility (Indemnification)

Make it mutual?

- Generally desirable for each party to agree to indemnify the other for its own negligence
- Promises may but need not be identical—should reflect each party's activities and accompanying risk

Actions of persons outside your control

- Avoid agreeing to be responsible for third-party negligence or risks not within your control (e.g., don't agree to be responsible for actions of *all* meeting attendees or other parties not within the organization's control)
- Officers, directors, employees, and agents are generally within the organization's control

Limit Scope to Available Insurance?

- Can protect your organization against unexpected obligation to pay liabilities of others
- But consider risk that insurance coverage of the other party may not be sufficient to make your organization whole in the event of claims arising out of that party's actions

Defense Costs

- Be sure to clarify whether the parties agree to pay the cost of defending against claims as those costs are incurred—litigation is expensive

Contracts
Term and Termination

- Match term to your interests.
  - Particularly for "unknown" partners.

- Beware of "Evergreen Provisions."
  - Note when notice of non-renewal is due.
  - Generally, no more than 90 days advance.

Contracts

Meeting Contract Provisions

- Force Majeure
  - Make reciprocal
  - Include events which affect/limit participation
- Attrition & Cancellation
  - Have allowable “slippage”—usually 20%
  - If necessary, guarantee percentage of anticipated profits, not anticipated revenues
  - Require hotel to resell rooms
  - Don’t pay penalty until AFTER meeting event
  - Have right to audit

Questions and Discussion

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