

Second Annual Nonprofit Executive Summit:

Bringing Nonprofit Leaders Together
to Discuss Legal, Finance, Tax, and
Operational Issues Impacting the Sector

October 2, 2014
Venable LLP



Agenda



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Tax, and Operational Issues Impacting the Sector**

**October 2, 2014
Venable LLP
Washington, DC**

Networking Breakfast **8:00 AM - 8:45 AM**

Welcome Remarks **8:45 AM - 9:00 AM**

John P. Langan, CPA
Managing Principal, Public Sector Group, CliftonLarsonAllen

Jeffrey S. Tenenbaum, Esq.
Partner and Chair of the Nonprofit Organizations Practice, Venable LLP

Session 1. **9:00 AM - 10:15 AM**

***Fraud and Embezzlement:
The Executive Team's Role in Detecting, Reporting, and Preventing Fraud***

Since the overhaul of the IRS Form 990 in 2008, over 100,000 nonprofits have reported a “significant diversion of assets,” costing these organizations and their supporters over \$100M in losses and a blow to their collective reputations. The *Washington Post* investigation and exposé on these frauds has raised serious questions concerning the sector’s willingness to provide financial transparency as well as the ability of its executives and boards to protect donors from future losses. This panel will discuss the increased concerns and provide practical solutions to nonprofit leaders.

Moderator

Jeffrey S. Tenenbaum, Esq.
Partner and Chair of the Nonprofit Organizations Practice, Venable LLP

Speakers

Mary Pat Flaherty, Investigative Reporter, *The Washington Post*

William H. Devaney, Esq.
Partner and Co-Chair of the FCPA and Anti-Corruption Group, Venable LLP

Marion A. Hecht, CPA/CFF, CIRA
Principal, Fraud & Forensic Investigations, CliftonLarsonAllen

Networking/Cell Phone Break

10:15 AM - 10:30 AM

Session 2.

10:30 AM - 11:45 AM

***Executive Employment Contracts:
Getting Compliant and Creative***

Nonprofits and their executives attempting to negotiate, document, and benchmark successful employment relationships should not do so in a vacuum. This panel will provide an understanding of the legal, accounting, and regulatory requirements—along with creative best practices—in designing and funding incentive benefit plans. This is essential to establishing and maintaining productive and accountable executive relationships.

Moderator

Kelly Davis, ERPA
Manager, Employee Benefits Plans Practice, CliftonLarsonAllen

Speakers

Lawrence D. Sloan, CAE
President and CEO, Society of Chemical Manufacturers and Affiliates

David R. Warner, Esq.
Partner, Venable LLP

Break/Lunch

11:45 AM - 12:20 PM

Keynote Introduction

12:20 PM - 12:30 PM

James L. Shea, Esq.
Chairman, Venable LLP

Keynote Presentation

12:30 PM - 1:00 PM

Domenico Montanaro
Political Editor and Senior Producer for Politics and Law
PBS *NewsHour*

Nonprofit Tax Issues:***Where the IRS Is Today, and Where Congress Is Headed***

Over the past several months, Congress and newspaper headlines have focused on the IRS' treatment (or mistreatment) of nonprofits seeking tax-exempt status. This session will review the impact of heightened scrutiny on the IRS, along with current IRS enforcement priorities. We will also discuss areas of possible tax reform, with implications for nonprofits and the availability of the charitable deduction.

Moderator

Robert L. Waldman, Esq.
Co-Managing Partner, Venable LLP

Speakers

David J. Trimner, CPA
Principal, Northeast Tax Leader, CliftonLarsonAllen

Matthew T. Journy, Esq.
Associate, Venable LLP

Best Practices for Enhancing the Nonprofit Governance Model

Ensuring a nonprofit's governance structure and related policies are properly aligned, communicated and adhered to is a necessary and often thankless job for a nonprofit's leadership team. This session, including case studies, will focus on the key governance policies and practices that drive organizational success and the role of the executive team in ensuring successful synergies.

Moderator

John P. Langan, CPA
Managing Principal, Public Sector Group, CliftonLarsonAllen

Speakers

Michael F. Curtin, Jr.
Chief Executive Officer, DC Central Kitchen

George E. Constantine, Esq.
Partner and Co-Chair of the Regulatory Practice Group, Venable LLP

Sarah Curfman
Managing Consultant, Public Sector Group, CliftonLarsonAllen

Presentations



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Thursday, October 2, 2014
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Washington, DC





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Nonprofit Executive Summit Agenda

Panel 1. Fraud and Embezzlement: The Executive Team's Role in Detecting, Reporting, and Preventing Fraud

Panel 2. Executive Employment Contracts: Getting Compliant and Creative

Keynote. Midterm Landscape 2014

Panel 3. Nonprofit Tax Issues: Where the IRS Is Today, and Where Congress Is Headed

Panel 4. Best Practices for Enhancing the Nonprofit Governance Model

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PANEL 1

**Fraud and Embezzlement:
The Executive Team's Role in Detecting,
Reporting, and Preventing Fraud**

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Moderator



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Recent Examples of Nonprofit Fraud and Embezzlement



Self, Inc.

- SELF, Inc. is a Philadelphia-based nonprofit organization that operates nine homeless shelters in the city.
- In August 2014, two former SELF executives were charged with theft stemming from allegations that they charged over \$350,000 to the organization's credit cards, spending the money on luxury items such as shoes and electronics, hotel stays and dining at the Four Seasons, and frequent trips to the Caribbean.
- Both former executives claim they reimbursed SELF, but prosecutors estimate they returned a pittance of what they spent (if they returned anything at all).
- The alleged embezzlement scheme began in 2005 and continued until 2010, just after both executives were fired.



American Legacy Foundation

- In 2013, Sen. Charles Grassley (R-Iowa) opened an investigation into the American Legacy Foundation, a nonprofit dedicated to educating the public about the dangers of smoking.
- The investigation was spurred by a *Washington Post* report that the foundation had suffered an estimated \$3.4 million loss as a result of alleged embezzlement by a former IT specialist.
 - According to the *Washington Post*, the IT specialist generated 255 invoices for computer equipment sold to the foundation from 1999 to 2007, 75 percent of which were fraudulent.
 - When a whistleblower came forward (after his concerns were ignored years earlier), the foundation hired forensic examiners and notified the board of directors.
 - The U.S. Attorney's Office told the *Post* that its investigation had been closed in February 2012...***because the foundation had taken more than three years to report the missing equipment and lacked reliable records.***

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Vassar Brothers Medical Center

In late October 2013, the *Washington Post* reported that Vassar Brothers Medical Center in Poughkeepsie, New York, reported a 2011 loss of \$8.6 million through the "theft" of certain medical devices.

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American Red Cross (NY Chapter)

- On February 27, 2013, the former financial director for a New York chapter of the American Red Cross was sentenced to two to seven years in prison for grand larceny.
- As signatory to the chapter's operating account, the former director obtained an ATM debit card in her name and linked to the chapter's account to make cash withdrawals, sometimes as often as every few days.
- The former director used the money to pay for clothing, her children's tuition, and other personal expenses, embezzling over \$274,000 between 2005 and 2009.
- The missing funds were uncovered by an audit.



H.O.W Foundation

- On November 8, 2012, the former executive director of the H.O.W. Foundation, a nonprofit alcohol and drug treatment center in Tulsa, was sentenced to 15 months' imprisonment and ordered to pay over \$1.5 million in restitution for defrauding H.O.W. over the course of eight years.
- The former executive director wrote himself 213 unauthorized checks totaling over \$1.35 million. He also embezzled more than \$200,000 from a thrift store operated by the nonprofit.



Global Fund to Fight AIDS, Tuberculosis and Malaria

- In 2012, the Global Fund to Fight Aids, Tuberculosis and Malaria, (based in Geneva) reported to the federal government a misuse of funds or unsubstantiated spending of \$43 million by grant recipients in several countries.
- In a 2013 report, The Global Fund determined that 1.9 percent of Global Fund grants were misspent, fraudulently misappropriated, or inadequately accounted for.



Why Does Employee Fraud Occur?



Why Does Employee Fraud Occur?



Why Does Employee Fraud Occur?

Motivation

Economic factors such as personal financial distress, substance abuse, gambling, overspending, or other similar addictive behaviors may provide motivation.

Rationalization

The employee finds a way to rationalize the fraud...perceived injustice in compensation compared to for-profit enterprises, unhappiness over promotions, the idea that they are simply "borrowing" and fully intend to return the assets at a future date, or a belief that the organization doesn't really need the assets and won't even realize they are missing.

Opportunity

The employee has sufficient access to assets and information to believe the fraud can be committed and successfully concealed.

Why Are Nonprofits Frequently the Victims of Embezzlement?

Management and board members are often more trusting

Fewer stringent financial controls for nonprofits

A belief that audits will catch any fraud



Controls to Reduce Risk of Fraud



Set the Tone at the Top

Management,
including directors
and officers, need to
“set the tone at the top”

Management
must set a good example
for fair and honest business practices



Role of the Board

- Boards of directors have a fiduciary duty to ensure
 - Financial decisions are made soundly and legally
 - Individual directors and management always put the organization’s financial and business interests ahead of personal financial and business interests
 - The board prudently manages the organization’s assets in furtherance of the organization’s stated purpose

- Business Judgment Rule protects actions taken by board members. However, those actions must be taken in good faith, with the degree of diligence, care, and skill that ordinary prudent people would exercise under similar circumstances.



Role of the Board

- Satisfying these obligations requires hands-on oversight of management
 - Review financial and other business records
 - Question management
 - Ensure the organization's policies, procedures, and mission are followed
- At least one board member should have relevant financial experience
- At least some board members should not be current or former associates of management. Consider a seasoned lawyer as a board member, as well as members with nonprofit and sector expertise.



Fraud Risk Assessments

- The purpose of a fraud risk assessment is to identify where fraud may occur within an organization and how it may be perpetrated.
- The assessment process:
 - Define fraud as it pertains to the organization's industry, culture, and tolerance for risk;
 - In collaboration with management and other appropriate employees, identify relevant fraud risks and scenarios
 - Organize fraud brainstorming sessions for selected processes and/or departments
 - Map fraud risks with their mitigating controls and identify control gaps;
 - Measure each fraud risk; and
 - Prioritize fraud risks
- Conduct such assessments on a recurring basis. Risk level/tolerance may change.



Segregation of Duties

- One individual should not be responsible for an entire financial transaction
 - Record
 - Reconcile
 - Custody of assets
 - Authorization
- Money Coming In: No single individual should be responsible for receiving, depositing, recording, and reconciling the receipt of funds.
- Money Going Out: No single individual should be responsible for authorizing payments, disbursing funds, and reconciling bank statements.
- Not enough staff to segregate these duties? Utilize compensating controls.



Double Signatures and Authorizations

- Multiple layers of approval make it far more difficult for embezzlers to steal from your organization.
- For expenditures over a pre-determined amount, require two signatures on every check and two authorizations on every cash disbursement.
- Consider having an officer or director be the second signatory or provide authorization for smaller organizations.
- For credit cards, require prior written approval for costs estimated to exceed a certain amount.
- The person using the credit card cannot be the same person approving its use.
- Have a board member or officer review the credit card statements and expense reports of the Executive Director, CFO, CEO, etc.



Require Backup Documentation

- All check and cash disbursements must be accompanied by an invoice showing that the payment is justified.
- If possible, the invoices or disbursement requests should be authorized by a manager who will not be signing the check.
- Only pay from original invoices.



Never Pre-Sign Checks

- Many nonprofits do this if the executive director is going on vacation.
- Keep blank checks and signature stamps locked up.



Purchasing and Fixed Asset Controls

- Fair Bidding Process
 - All contracts over a pre-determined financial threshold should be subject to at least three bids, and approved by a manager uninvolved in the transaction.
 - Large contracts should be reviewed and voted on by the board.
 - Extensive review of related party transactions

- Fixed Asset Inventories
 - Conduct a fixed asset inventory review at least once per year to ensure that no equipment (computers, printers, etc.) is missing
 - Record the serial numbers of the equipment and consider engraving an identifying mark on each item in case of theft



Automated Controls

- Use system-generated reports to detect fraud when it occurs.
- Provide ongoing monitoring and feedback mechanisms (e.g., system-generated e-mails notifying management of exceptions)
- Physical access codes
- System passwords
- Use notification and alert services to alert the organization of possible debits to accounts.
 - Positive pay exceptions notifications
 - Wire notifications (incoming/outgoing)
 - ACH Fraud Filter notifications
 - Balance threshold notifications



Conduct Background Checks

- Background checks on new employees and volunteers are important. Many organizations skip this basic step.
- The Association of Certified Fraud Examiners reports that 7% of embezzlers have been convicted of a previous crime.
- Background checks can reveal undisclosed criminal records and prior instances of fraud, allowing you to avoid a bad hire in the first place.
- They are also fairly inexpensive and should be made a part of your hiring process.



Mechanisms for Reporting and Investigating Fraud

- Explain what to do if employees/constituents perceive a fraud threat.
 - Whom to contact
 - How to contact
 - Anonymity
 - Evaluations of reports received
 - Incident responses
- Provide a means of anonymous communication.
- Employees must have the means to contact a board member if something needs to be reported and they do not feel comfortable reporting to management.
- Board members must be prepared to take these reports seriously, keep the reporting employee protected, and contact legal counsel.



Effective Compliance Programs

- The best way to prevent embezzlement and to protect an organization is a comprehensive and vigorous compliance program that is more than a mere “paper program.”
- Any effective compliance program will:
 1. Be tailored to the specific organization, so that the controls mitigate the risks inherent in that organization’s business and address any applicable government regulations and industry standards
 2. Include a written corporate code of ethics. The organization’s commitment to ethical behavior should be clearly and concisely communicated to the board, management, and employees. This commitment to the code should be affirmed by all employees on a periodic and ongoing basis.
 3. Be owned by senior management. Management must be proactive. The board must have ultimate oversight and control of the program.
 4. Provide for regular education and training for directors, management, employees, volunteers and staff



Effective Compliance Programs

- Any effective compliance program will (cont’d):
 5. Be regularly monitored and audited to ensure that it is working
 6. Contain effective means to report violations and concerns, such as whistleblower hotlines or other anonymous reporting mechanisms
 7. Provide meaningful discipline for violation of the policy. A reputation for aggressively investigating fraud can have a strong deterrent effect, while a reputation for ignoring possible fraud is an invitation to commit fraud.
 8. Require that appropriate steps are taken if a crime occurs
 9. Address any control weaknesses uncovered



What to Do if an Issue Is Discovered

- Selection of investigative team
- Evidence preservation
- Evidence gathering
- Background checks in an investigation
- Interviews
- Reporting
- Remediation



Nonprofit Fraud... Exposed

FORM 990, PART VI, SECTION A, LINE 5: REGRETTABLY IN LATE APRIL
WAS DISCOVERED THAT A CSAVR EMPLOYEE HAD ENGAGED IN SIGNIFICA
OF EMBEZZLEMENT AND EMPLOYEE THEFT FROM 2003 UNTIL APRIL 201
DETERMINED THAT THE SAID EMPLOYEE ALLEGEDLY STOLE OVER \$82
CSAVR.





Reputational Risk – Best Practices



Things to Think About

- Professional skepticism
 - It is ok to ask questions to determine responses that do not make sense.
 - Follow up and seek documentation and/or other supporting information.
 - Rule of Two – Always a good idea to run questionable events or transactions by someone.
 - Independent consultation is valuable.
- Ostrich attitude
 - Head in the sand – Can hurt the organization’s reputation, sustainability, and economic stability.
 - Instead – Four “I”s: Interview, Intervene, Interpret, Inspect...
- Pressures
 - Environment, Economic, Financial, Personal, Organization
 - (Fraud Triangle – Rationalization, Pressure, Opportunity)

Things to Think About

- Do you know where your assets are? What about liabilities?
- Big check?
 - Slow down and look beyond the numbers on the check to the issuer.
 - Gifts for no consideration can be “clawed back”.
 - Seek financial information on the donor, look at the footnotes to financial statements.
 - Ask questions.
 - Examples of damages to nonprofits
 - Ponzi schemer gifts that a Receiver will claw back.
 - Bankruptcy Code provides for preference actions against recipients of gifts based on facts and circumstances.
- Entity level controls
 - Employee handbook and code of conduct, regularly reviewed by all employees with signature/date.
 - Anti-fraud controls.



Preventive Measures and Quick Tips

- Look at checks (front and back)
 - [Checks endorsed to subsequent payee]
- Bank statements should be sent to CEO, accounts reconciled on regular basis
 - [Payees altered and ATM withdrawals not authorized at strange times in the late evening]



Preventive Measures and Quick Tips

■ Credit card abuse

- Look at the transactions and the purpose of the charges, and determine who has authorization to use the credit cards.
- Personal expenses NEVER should be charged on a corporate credit card.
- Document authority.
- Reimbursement from an employee – why not add --the requested reimbursement is pursuant to our firm policy and is true and complete.
- Seek advice from HR and potentially counsel before changing firm forms.
- [Senior executive used company credit card for personal use, travel for relatives, payments to consultants with less than arm's length relationship, additional credit cards paid by firm, among others.]
- [Look at contracts with board.]



Internal Controls

■ Vendors

- Phantom or real? Or, related parties?
- Do employees have second jobs?
- Document and look at the possibility of organization funds used for purposes other than the allowed business purpose.
- [Classic examples include staff as well as management feeling they can rationalize the theft of firm assets for their off duty jobs, among other reasons.]

■ Process controls

- Over recording transactions, segregation of duties, approval limits, continuous monitoring, etc.



Reminder – The Fraud Triangle

- Incentives and pressures
 - What are the incentives and pressures that drive financial performance?
- Opportunities
 - How strong are internal controls, internal audit department, and anonymous reporting programs?
- Rationalization/concealment
 - Character, ethical values, integrity, and how management may justify their actions

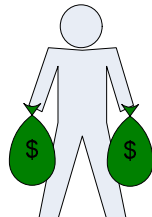


Reminder - Fraud is defined as:

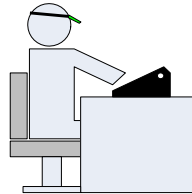
“...any intentional act or omission designed to deceive others and resulting in the victim suffering a loss and/or the perpetrator achieving a gain.”



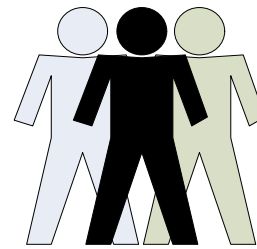
Reminder – Three Fraud Categories



Asset Misappropriation



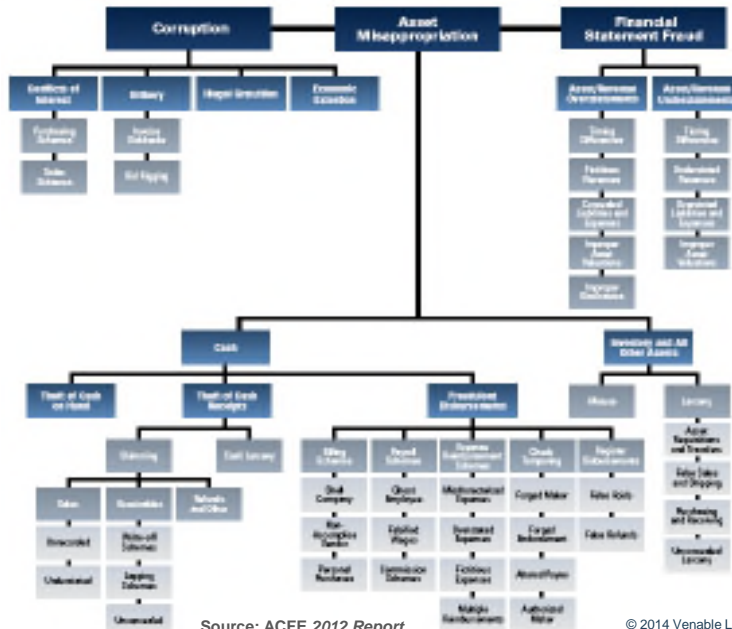
Financial Statement Fraud



Corruption



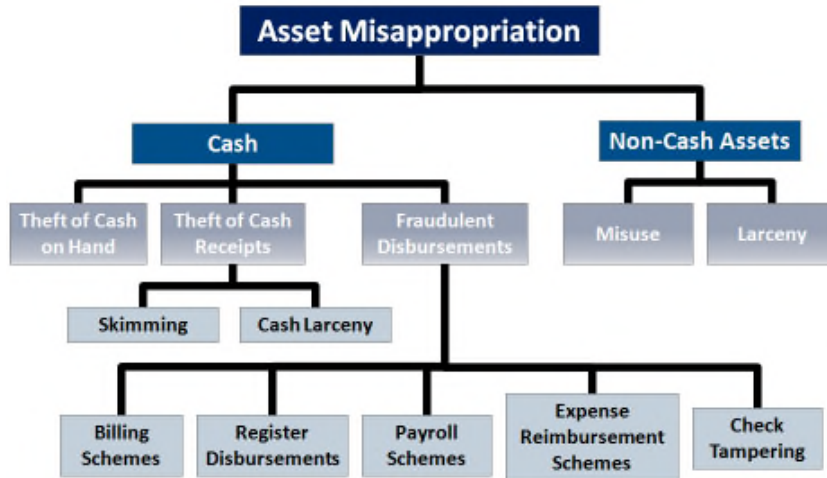
Uniform Occupational Fraud Classification System



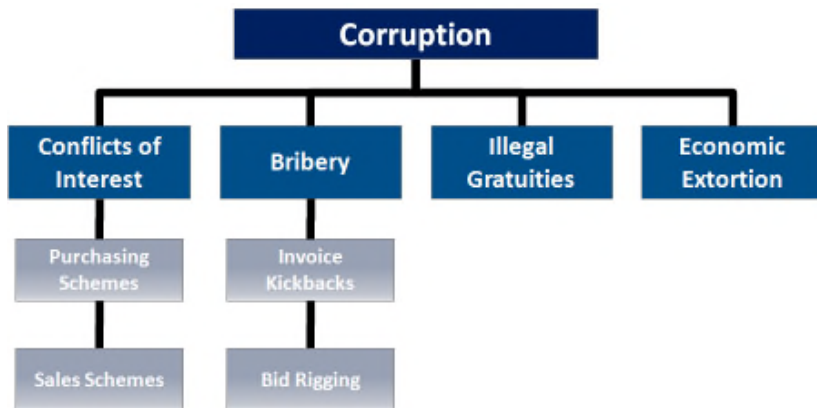
Source: ACFE 2012 Report to the Nations



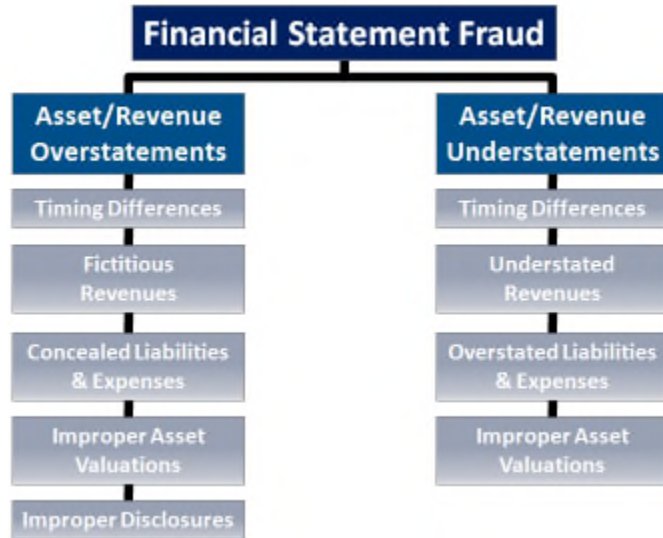
Asset Misappropriation



Corruption



Financial Statement Fraud



Categories of Fraud

Frequency of Fraud by Type



How Fraud Affects Our Clients

- According to the ACFE's 2012 *Report to the Nations on Occupational Fraud and Abuse*:



The typical organization loses an estimated 5% of its annual revenues to occupational fraud.

- Median loss: \$140,000
- Median duration: 18 mo.

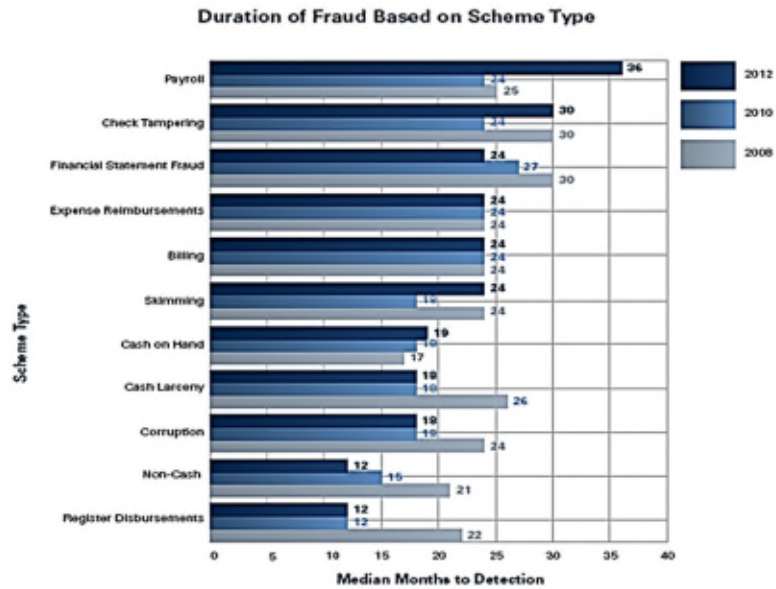


Victim Organizations

Prevalence by Size of Victim Organization



Gestation Period for Fraud Detection



Source: ACFE 2012 Report to the Nations

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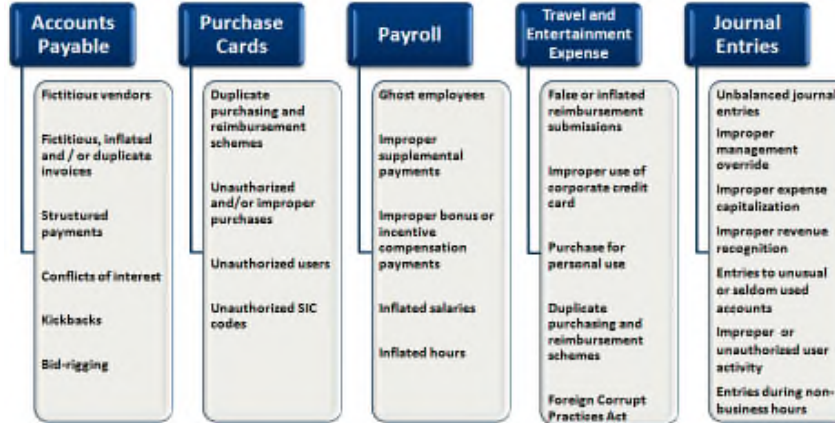
Forensic Data Analysis

- **Forensic Data Analysis** is the process of gathering, summarizing, comparing, and aggregating existing disparate sets of data that organizations routinely collect in the normal course of business with the goal of detecting anomalies that are traditionally indicative of fraud or other misconduct.
- Can be used in the **prevention, detection, or response** of fraud or other misconduct
- Provides additional comfort to C-Level executives, audit committees, internal audit departments, and management

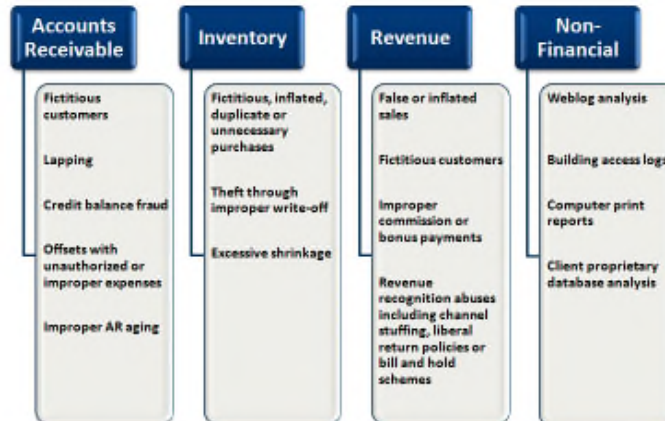


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Types of Fraud and Areas of Analysis



Types of Fraud and Areas of Analysis





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PANEL 2

**Executive Employment Contracts:
Getting Compliant and Creative**

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Moderator



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Offer Letter vs. Formal Contract



Offer Letter vs. Formal Contract

- Formal contracts provide security to both the executive and the organization.
- Trend: Formal contracts are becoming increasingly common for CEOs. Typical length is 3 to 5 years for both the initial term and contract extension.
- Tip: Be careful with “evergreen” provisions.



Key Compensation Elements



Key Compensation Elements

- Whether in an offer letter or formal agreement, the following compensation elements should be addressed in detail:
 - Base salary
 - Incentive compensation/bonus
 - Deferred compensation
 - Perks



Base Salary

- Not just salary for the initial year but also how salary adjustments will be addressed in future years
 - Automatic increases (cost of living, etc.)
 - Market based (public surveys, compensation consultant, etc.)
- Trend: Common for boards to state that salary will be reviewed annually and adjusted based on performance (organizational and individual) and market movement
- Tip: Review compensation information and salary for prior incumbent (Form 990s) over several years to get a sense of salary levels and annual adjustments.



Bonus

- Your agreement should detail both the “target” and “maximum” bonus opportunity.
 - Critical for setting expectations
 - With board turnover, it is also important for the understanding to be memorialized/documented for consistency.
- Trend: With CEO compensation levels rising, association boards want to tie compensation directly to performance.
- Tip: Make sure there is an established performance evaluation process, and that you are involved in setting goals and metrics.



Deferred Compensation

- Ensuring you have adequate savings to offset retirement costs is critical.
 - Start now rather than waiting until you have a short employment horizon (difficult to accrue ample savings in the last few years)
 - Try to keep the arrangement simple.
- Trend: 457(b) and 457(f) arrangements (detailed on the following slides) are the most common vehicles.
- Tip: Focus the board on the annual dollar amount you desire in deferred comp rather than getting them to commit to a specific income replacement ratio.



“Nonqualified” Deferred Compensation

- Section 457(b) Plan or Agreement
 - Employee contributions limited to \$17,500 per year (indexed for inflation)
 - Can be fully vested
 - Minimum distribution rules apply beginning at age 70 ½
 - Taxed only when actually distributed
 - No rollover to IRA or qualified plan
 - Can be transferred to §457(b) plan of subsequent, tax-exempt employer



“Nonqualified” Deferred Compensation

- Section 457(f) Plan or Agreement
 - Contributions—no limit
 - Contributions and earnings must be subject to “substantial risk of forfeiture” for at least two years from date of agreement
 - “Substantial risk of forfeiture” usually means a requirement to perform substantial services until the “substantial risk” lapses (*i.e.*, the vesting date)
 - Vesting date is usually end of contract or anticipated retirement date
 - “Substantial risk” rule not violated if employment terminates before vesting date other than by voluntary resignation (*e.g.*, death, disability, termination by employer)
 - Taxed when vested
 - Can’t extend vesting date
 - Usually distributed when taxed
 - No rollover or transfer to further defer tax
 - May be subject to §409a, if distribution deferred beyond vesting

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Excess Benefit Transactions

- Transaction in which an economic benefit is provided, directly or indirectly, by a 501(c)(3) or 501(c)(4) tax-exempt organization, to or for the use of a disqualified person, where the value of the benefit provided exceeds the value of the consideration received by the organization
- Disqualified person is one in a position to exercise substantial influence over the organization’s affairs (includes directors, officers, and key employees)
- Compensation arrangements to disqualified persons must be presumed reasonable and not providing excess benefits

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Excess Benefit Transactions

- Reasonableness of compensation for purposes of determining excess benefits - all compensation provided by a 501(c)(3) or 501(c)(4) organization to a disqualified person in exchange for the performance of services is taken into account:
 - Salary, bonuses, severance, deferred compensation, insurance premium payments, fringe benefits, all non-cash compensation
- Excess benefit transactions may result in:
 - Severe sanctions imposed by IRS
 - Revocation of an organization's tax-exempt status
 - Excise taxes (IRC section 4958)



Excess Benefit Transactions

- Presumption of reasonableness of compensation:
 - Compensation arrangement must be approved in advance by an authorized body of the tax-exempt organization, composed of individuals who do not have a conflict of interest concerning the transaction
 - Prior to making its decision, the authorized body obtained and relied upon appropriate data as to comparability, and
 - The authorized body adequately and timely documented the basis for its determination concurrently with making that determination
- IRS can always refute.
- Recommend organization retain all supporting documentation, including transaction terms, approval date, authorized body members present during debate and approval, the comparability data relied upon, and basis for determination



Perks

- Common perks and benefits for CEOs:
 - Supplemental insurance
 - Memberships in professional organizations
 - Annual physical exams

- Trend: With increased scrutiny, the prevalence of CEO perks have been declining (e.g., housing, car leases, sabbaticals, social clubs).

- Tip: Focus only on perks that are important to you (i.e., long-term care or business class travel) – otherwise it might be better to negotiate a higher salary.



Other Key Contractual Elements



Severance

- Discuss severance provision up front while the relationship is strong; understand relationship with “cause” terminations

- Trend: Typically 6 to 12 months of salary

- Tip: Ensure that the severance length is at least as long as any non-compete period. Clarify whether severance is based on base salary or base plus target/pro-rated bonus.



Restrictive Covenants

- Confidentiality

- Non-solicitation
 - Employees
 - Members, customers

- “Do Not Compete”

- Limits on outside activities



Executive Authority and Reporting

- “Full time and attention”
- Description of responsibilities
(*a.k.a. The Job Description*)
- Authority over staff
- Report to board or committee
- Annual reviews



Term and Termination

- Term, renewal
- Rights to terminate, “cause”
 - Right of executive to terminate for “good reason”
- Payments upon termination
 - Accrued obligations
 - Severance
 - Liability release as a pre-condition
- Return of records and association property
- Dispute resolution – arbitration vs. courts



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KEYNOTE PRESENTATION

Midterm Landscape 2014

Domenico Montanaro
Political Editor PBS *NewsHour*

Keynote Speaker



Domenico Montanaro
Political Editor
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PANEL 3

**Nonprofit Tax Issues:
Where the IRS Is Today,
and Where Congress Is Headed**

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Moderator



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IRS Developments



Lois Lerner

- How it began:
 - The IRS failed to rule on exemption applications filed by organizations that were potentially going to engage in political activities
 - The IRS identified such entities by looking for certain words in the organization's name
- What is the result:
 - IRS officials: Individuals were fired, individually named in lawsuits, and Lois Lerner has been called to testify (or not testify) before Congress on numerous occasions
 - New leadership with far less EO specific experience
 - EO Division: Has been attacked for bias, has been attacked for losing and/or destroying emails, and has been portrayed as incompetent and/or corrupt



Lois Lerner

- Problems:
 - A less knowledgeable EO leadership team
 - A more timid EO leadership team
 - A focus on clearing the decks, not reaching the correct results

- Opportunities:
 - Less enforcement
 - Lack of follow through on prior enforcement initiatives
 - Focus on clearing the decks



Religious Organizations

- How it began:
 - The IRS was sued several times in the last few years by organizations seeking for the IRS to engage in greater enforcement initiatives against religious organizations.

- What is the result:
 - The IRS and DOJ have announced an increase in enforcement efforts against religious organizations.



Automatic Revocation

- How it began:
 - As of 2010, organizations that failed to file a Form 990 or Form 990-N for three consecutive years were automatically revoked.
 - The IRS revoked many, many entities that should not have been revoked.
 - The IRS failed to adequately prepare for the impact of applications for reinstatement recognition of exempt status by automatically revoked organizations or establish procedures for correcting erroneous revocations.

- What is the result:
 - Significant delays
 - Less thorough reviews of exemption applications
 - Creation of Form 1023-EZ



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Impact on Exempt Organizations



Impact of IRS Developments

- A lack of published IRS guidance
- Fewer enforcement initiatives
- Less focus on applications for recognition of tax-exempt status
- Enforcement focus on religious organizations



What Does This Mean for You?

- The IRS is less focused on enforcement now.
 - When looking at potential risks of activities and tax positions, one consideration must be the lack of IRS enforcement.
 - The lack of industrywide programs may mean less lead time prior to an examination.
- The IRS review of applications is less involved now.
 - Now is the time to file a Form 1023 or Form 1024.
- The IRS has not gone away.
 - Pay attention to public reports about your organization or industry.



Current Focus of IRS Enforcement



Areas of IRS Focus

- Church audits
- Executive compensation
- Political activities
- Unrelated business income
 - Income and expenses allocation
 - NOLs



Factors Affecting Tax Reform



Factors Affecting Tax Reform

- FOR
 - Complexity causes errors
 - Complexity impedes collection
 - Complexity is expensive

- AGAINST
 - Elections
 - Political will
 - Lowering rates, broadening the base, maintaining revenue neutrality



Principles of Good Tax Policy

1. **Equity and Fairness.** Similarly situated taxpayers should be taxed similarly.
2. **Certainty.** The tax rules should clearly specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined.
3. **Convenience of Payment.** A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.
4. **Economy in Collection.** The costs to collect a tax should be kept to a minimum for both the government and taxpayers.
5. **Simplicity.** The tax law should be simple so that taxpayers understand the rules and can comply with them correctly and in a cost-efficient manner.
6. **Neutrality.** The effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum.
7. **Economic Growth and Efficiency.** The tax system should not impede or reduce the productive capacity of the economy.
8. **Transparency and Visibility.** Taxpayers should know that a tax exists and how and when it is imposed upon them and others.
9. **Minimum Tax Gap.** A tax should be structured to minimize noncompliance.
10. **Appropriate Government Revenues.** The tax system should enable the government to determine how much tax revenue will likely be collected and when.






Charitable Donation Deduction

- Charitable donations are an itemized deduction
- Generally the fair market value of the gift
 - Deduction Rate = Marginal Tax Rate
 - Applies to most gifts of appreciated property
- Limitations
 - Cash contributions up to 50% of AGI
 - Capital gain property up to 30% of AGI
 - Pease Limitation



The Problem

- 3 people donate \$100 to the Save the Whales Foundation
 - Mrs. Bellevue earns \$20,000,000 and owns a mansion. Her donation costs her \$60 after taxes.
- 
- Mr. Maplewood earns \$100,000 and owns a condominium. His donation costs him \$72 after taxes.
- 
- Mrs. Fishtown earns \$20,000 and lives in an apartment. Her donation costs her \$100 after taxes.
- 



Nonprofit Reform Proposals



Previous Proposals

- Reduce the tax benefit for the wealthy
 - Lower the AGI limit
 - Cap the value of the benefit (28%)
 - Hard Dollar Cap (\$25,000)
 - Create a floor
- Increase the tax benefit for the non-wealthy
 - Permit deductions for non-itemizers
 - Permit charitable donations to be withheld/reported on W-2
- Equalize and limit the tax benefit to all
 - Eliminate entirely
 - 12 percent tax credit



Current Proposals

Raise the standard deduction

Thresholds	Single	Household
Current Law	\$6,200	\$12,400
Proposed Law	\$11,000	\$22,000

- Only 5% of taxpayers expected to itemize (currently 30%)
- Presumed charitable deduction “baked in”
- Elimination of charitable deduction for many



Illustration #1

- Household AGI: \$200,000 (28% bracket)
- Rent
- Charitable gifts: \$20,000

Under current law:

Itemize deductions: Pay \$50,400 in tax

Standard deduction: Pay \$52,528 in tax

Under proposed law:

Tax is \$49,840 using the standard deduction

- Will the donor give \$20,560?
- Or \$0?



Current Proposals

2% Floor

- Deduction can only be claimed on contributions that exceed 2% of AGI
- Does not affect giving at margin
- Interacts with new standard deduction



Illustration #2

- Household AGI: \$400,000 (33% bracket)
- Charitable gifts: \$15,000
- Mortgage interest: \$13,000

Under current law:

Itemized deductions

Proposed law:

Standard deduction of \$22,000

(2% floor is \$8,000, so itemized deductions would only be \$20,000)



Other Proposals

- Reduce AGI limits on charitable deductions
 - Current law: Cash donations up to 50% of AGI
Capital gain property donations up to 30% of AGI
 - Proposed law: Cash donations up to 40% of AGI
Capital gain property donations up to 25% of AGI
- Many noncash gifts would be valued at the donor's basis instead of FMV
- Gifts of real estate would be limited to basis
- Deny any deduction that includes athletic tickets



Timing of Gifts

Current law: Gifts must be made within the tax year.

Proposed law: Gifts must be made prior to the due date (April 15) for the individual's income tax return for the tax year.



Executive Compensation

Current law: Organizations may follow the “rebuttable presumption of reasonableness”

Proposed law: 25% excise tax on compensation in excess of \$1 million paid to 5 highest paid employees



Endowments

Current law: No excise tax on endowments

Proposed law: 1% excise tax on the net investment income of private colleges and universities with endowments greater than \$100,000 per full-time student



Royalties

Current law: Income derived from the sale or licensing of a tax exempt organization's name or logo is excluded from unrelated business taxable income.

Proposed law: Name and logo royalties would be subject to UBIT



Sponsorships

Current law: A qualified sponsorship payment (QSP) is not UBI.

Proposed law: A QSP may not acknowledge the sponsors' products. A QSP greater than \$25,000 may not receive greater benefits than the majority of other sponsors.



Other Provisions

- Double the late filing penalty for nonprofit information returns.
- Eliminate exemption for Type II and Type III supporting organizations.
- Require that donor-advised funds be distributed within five years.



UBI Provisions

- Research income is UBI unless the results are made freely available to the public.
- Advertising expenses amortized over 10 years
- Losses from one UBI trade or business may not offset gains from another.
- 5% accuracy-related penalty on managers for substantial understatement of UBIT



UBI Provisions

- Raises the specific deduction from \$1,000 to \$10,000
- Reduces the top tax rate from 35 percent to 25 percent by 2019
- Allows net operating losses to offset only 90 percent of taxable income
- Repeals the alternative minimum tax



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PANEL 4

**Best Practices for Enhancing
the Nonprofit Governance Model**

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Legal and Practical Considerations



Legal and Practical Considerations

- Governance basics
 - Nonprofit vs. tax-exempt
 - Corporate protection
- Nonprofit corporate hierarchy of authority
 - Nonprofit corporate law (statute and common law)
 - Articles of incorporation
 - Bylaws
 - Policies



Governance Legal Issues

- Board is generally only permitted to act in a meeting (but UWC, telephone meetings)
- State of incorporation governs, regardless of location of headquarters (but note foreign corp. filings)



Governance Hierarchy

- Board of directors
- Executive committee
- Other committees of the board
- Advisory committees, task forces, etc.
- What about staff?
- What about officers?
- What about individual directors?



Governance Legal Duties

- Duty of Care
- Duty of Loyalty
- Duty of Obedience



Duty of Care

- Duty of care standard is that of “ordinary and reasonable care,” or, what would an ordinarily prudent person do in the same or similar circumstances?
 - Very subjective
 - Tied to reasonableness
- Business judgment rule—bad decisions are more easily defended than ignorance



Compliance with Duty of Care

1. Review all materials provided in advance of meetings.
2. Ask questions.
3. Avoid actions/discussions outside the formal meeting setting.
4. Be familiar with organizational documents (policies, bylaws, articles).
5. Maintain confidentiality.



Compliance with Duty of Care (cont'd)

6. Directors may rely on experts when appropriate (but must understand such reliance cannot be absolute).
7. Directors should ascertain that all minutes (particularly recorded votes and attendance) are accurate.
8. Encourage directors to attend meetings regularly, read publications, and be involved.
9. Work with chief elected officer to encourage best practices/compliance with duty of care.



Compliance with Duty of Loyalty

- Keep in mind that the organization's interests come first.
- Adhere to conflict of interest policy.
 - Disclose actual, apparent, and potential conflicts of interest through regular disclosure statements (and at each meeting as appropriate).
 - Deliberate as a board or through a committee to determine whether conflict exists.



Duty of Obedience

- Obedience to nonprofit mission
- Follow terms of articles of incorporation, bylaws, policies, and procedures
- Applicable laws and regulations must be followed



Policies to Consider and Implement

- Form 990
 - Conflict of interest policy and annual disclosure
 - Record retention
 - Whistleblower
 - Joint ventures
 - Compensation review
 - Form 990 review
 - Auditor selection and review

- Others
 - Board member roles and responsibilities
 - Director agreement

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Case Studies and Examples



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Discussion and Examples

- Considering the legal framework just discussed, panelists will offer examples of strategies that have been successful in enhancing board governance.





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October 21, 2014 – [Fundraising 201: An Update on Managing the Legal Risks of Nonprofit Fundraising](#)

November 19, 2014 – [Enhancing the Nonprofit Governance Model: Legal Pitfalls and Best Practices](#)

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Jeffrey Tenenbaum chairs Venable's Nonprofit Organizations Practice Group. He is one of the nation's leading nonprofit attorneys, and also is an accomplished author, lecturer, and commentator on nonprofit legal matters. Based in the firm's Washington, DC office, Mr. Tenenbaum counsels his clients on the broad array of legal issues affecting charities, foundations, trade and professional associations, think tanks, advocacy groups, and other nonprofit organizations, and regularly represents clients before Congress, federal and state regulatory agencies, and in connection with governmental investigations, enforcement actions, litigation, and in dealing with the media. He also has served as an expert witness in several court cases on nonprofit legal issues.

Mr. Tenenbaum was the 2006 recipient of the American Bar Association's Outstanding Nonprofit Lawyer of the Year Award, and was an inaugural (2004) recipient of the *Washington Business Journal's* Top Washington Lawyers Award. He was one of only seven "Leading Lawyers" in the Not-for-Profit category in the prestigious 2012 *Legal 500* rankings, one of only eight in the 2013 rankings, and one of only nine in the 2014 rankings. Mr. Tenenbaum was recognized in 2013 as a Top Rated Lawyer in Tax Law by *The American Lawyer* and *Corporate Counsel*. He was the 2004 recipient of The Center for Association Leadership's Chairman's Award, and the 1997 recipient of the Greater Washington Society of Association Executives' Chairman's Award. Mr. Tenenbaum was listed in the 2012-15 editions of *The Best Lawyers in America* for Non-Profit/Charities Law, and was selected for inclusion in the 2014 edition of *Washington DC Super Lawyers* in the Nonprofit Organizations category. In 2011, he was named as one of Washington, DC's "Legal Elite" by *SmartCEO Magazine*. He was a 2008-09 Fellow of the Bar Association of the District of Columbia and is AV Peer-Review Rated by *Martindale-Hubbell*. Mr. Tenenbaum started his career in the nonprofit community by serving as Legal Section manager at the American Society of Association Executives, following several years working on Capitol Hill as a legislative assistant.

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Graduate Management Admission Council
Habitat for Humanity International
Homeownership Preservation Foundation
Human Rights Campaign
Independent Insurance Agents and Brokers of America
Institute of International Education
International Association of Fire Chiefs
International Sleep Products Association
Jazz at Lincoln Center
LeadingAge
Lincoln Center for the Performing Arts
Lions Club International
March of Dimes
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Money Management International
National Association for the Education of Young Children
National Association of Chain Drug Stores
National Association of College and University Attorneys
National Association of Manufacturers
National Association of Music Merchants
National Athletic Trainers' Association
National Board of Medical Examiners
National Coalition for Cancer Survivorship
National Council of Architectural Registration Boards
National Defense Industrial Association
National Fallen Firefighters Foundation
National Fish and Wildlife Foundation
National Propane Gas Association
National Quality Forum
National Retail Federation
National Student Clearinghouse
The Nature Conservancy
NeighborWorks America
Peterson Institute for International Economics
Professional Liability Underwriting Society
Project Management Institute
Public Health Accreditation Board
Public Relations Society of America
Recording Industry Association of America
Romance Writers of America
Telecommunications Industry Association

Trust for Architectural Easements
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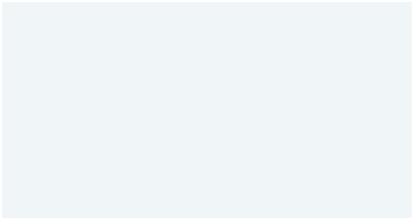
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Mr. Langan established Langan Associates in 1988 after several years with the international accounting firm of Arthur Andersen. He has nearly 30 years experience serving not-for-profit organizations and has a national reputation as an expert, author and presenter on financial, tax and technology topics facing not-for-profit organizations. He has served major not-for-profit organizations including the American Public Transportation Association, Biotechnology Industry Organization, National Telecommunications Cooperative Associations, Cotton Council International, United Way Worldwide among many others.

Mr. Langan is a member of the American Institute of CPA's, Greater Washington Society of CPA's and Virginia Society of CPA's. He Chairs the audit committee at Lynn University, is Treasurer for the Pentagon Memorial Fund, is a board member for Boys & Girls Clubs of Greater Washington (Alexandria Branch) and serves on the CLA Board of Directors.

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Mary Pat Flaherty joined the Washington Post as an investigative editor heading a team of reporters and works now as an investigative reporter. Her series have included pieces about overseas testing by US pharmaceutical companies of unproven medicines; counterfeiting rings in the US for medicines; a troubled and costly Pentagon program to build a new hybrid airplane/helicopter; and reliability problems with Pepco and Verizon's 911 service. She has been involved in breaking news coverage as well.

Her recent work includes a [series of articles](#) with Joe Stephens about significant diversions at nonprofits and the reporting—or not—of losses.

Flaherty's work has received numerous national awards, including the Pulitzer Prize. A native of Pittsburgh—where she worked for The Pittsburgh Press—Flaherty lives in Washington, DC.



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Mr. Devaney has significant jury trial and appellate experience, as well as significant experience leading investigations.

Mr. Devaney was an Assistant United States Attorney in the District of New Jersey, where he was most recently a member of the Securities Fraud Unit. As a federal prosecutor, Mr. Devaney investigated and prosecuted numerous cases involving securities fraud, bank fraud, mail and wire fraud, tax evasion, money laundering, terrorism, government program fraud, computer trespass, and export violations. Prior to joining the Department of Justice, Mr. Devaney practiced white-collar criminal defense and complex civil litigation, representing clients in federal and state criminal investigations, SEC and CFTC investigations, as well as attorney disciplinary proceedings.

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Mr. Devaney's recent matters have included the defense of corporations and individuals in areas such as the FCPA, export control and economic sanctions, antitrust, tax evasion, insider trading, accounting fraud, Medicare/Medicaid fraud, visa fraud, and mail and wire fraud, civil RICO, securities litigation and consumer fraud actions by state attorneys general. Mr. Devaney has also recently conducted several national and multi-national internal investigations for companies in the insurance, chemical, software, retail, and logistics industries.

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JUDICIAL CLERKSHIPS

Honorable Oliver Gasch, U.S. District Court for the District of Columbia

of the City of New York, (where he sits on the Criminal Advocacy Committee and previously sat on the Council for Criminal Justice), the Federal Bar Council and the National Association of Criminal Defense Lawyers. Mr. Devaney is also a member of the Criminal Justice Act panel for the U.S. District Court for the Southern District of New York.

RECENT PUBLICATIONS

Mr. Devaney has been the author of publications involving such topics as the FCPA and corporate compliance programs. Mr. Devaney also appears often in the print media commenting on current criminal matters.

- May 2014, The Eleventh Circuit Defines "Instrumentality" of a Foreign Government under the Foreign Corrupt Practices Act, FCPA and Anti-Corruption News E-lert
- April 2, 2014, FCPA Year in Review 2013, Part 3, *Corporate Compliance Insights*
- March 26, 2014, FCPA Year in Review 2013, Part 2, *Corporate Compliance Insights*
- March 19, 2014, FCPA Year in Review 2013, Part 1, *Corporate Compliance Insights*
- March 2014, FCPA Snapshot – 2013, FCPA and Anti-Corruption News E-lert
- February 11, 2014, Safeguarding Your Nonprofit against Fraud and Embezzlement: Best Practices, Common Pitfalls, and Practical Strategies
- January 15, 2014, How to Safeguard Your Nonprofit against Fraud and Embezzlement: Best Practices, Common Pitfalls, and Practical Strategies

RECENT SPEAKING ENGAGEMENTS

Mr. Devaney has recently lectured on reverse mergers, trends in SEC and Department of Justice enforcement and responding to attorney general civil investigations.

While with the Department of Justice, Mr. Devaney lectured extensively on the Patriot Act. He has also lectured on corporate criminal liability and served as a faculty member at the National Advocacy Center.

- October 2, 2014, Second Annual Nonprofit Executive Summit: Bringing Nonprofit Leaders Together to Discuss Legal, Finance, Tax, and Operational Issues Impacting the Sector
- July 15, 2014 - July 16, 2014, Life Sciences Forum on Distributor Audits: "Monitor Internal Processes to Increase Visibility of Distributor Activities, Identify and Assess Risk and Accomplish Operational Integrity"
- April 10, 2014, Government Contracts Symposium
- February 27, 2014, 2014 Brand IP Seminar Series, New York
- February 11, 2014, Legal Quick Hit: "Safeguarding Your Nonprofit against Fraud and Embezzlement: Best Practices, Common Pitfalls, and Practical Strategies" for the Association of Corporate Counsel's Nonprofit Organizations Committee
- February 7, 2014, What Every Business Lawyer Needs to Know about the Foreign Corrupt Practices Act (FCPA)
- January 15, 2014, How to Safeguard Your Nonprofit against Fraud and Embezzlement: Best Practices, Common Pitfalls, and Practical Strategies



*Marion A. Hecht, CPA, CFF, CFE, CIRA, MBA
Principal, Fraud & Forensic Investigations
CliftonLarsonAllen LLP
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Marion.Hecht@CLAconnect.com*

Marion has extensive experience tracing the flow of payments through multi-tiered entities, including identifying shell companies and other entities to document potential misuse of funds and “Piercing the Corporate Veil”. Her forensic examinations total over 300 and include hundreds of interviews. Marion has over 25 years’ experience working with attorneys in all phases of litigation.

Marion often works with the FBI, the IRS Criminal Investigation Division, and Inspector Generals and US Attorneys’ offices on parallel criminal investigations. She has significant experience in bankruptcy and receivership litigation cases that involve fraud investigations; asset management and liquidation; mortgage company and title company frauds; clawback and constructive trust actions; and dispute resolution and diplomacy. Marion currently serves as a U.S.D.C.-appointed Receiver in three SEC enforcement matters. She also investigates allegations of fraud and other improprieties for audit committees, private companies, and NGOs, domestically and internationally.

She formerly served as Principal Agent for SBA, as Receiver of Small Business Investment Companies, managing 18 receiverships. Marion is the former CFO of an international environmental venture capital corporation, managed a Latin American subsidiary, is on the Board of Directors for the National Association of Federal Equity Receivers, and is Co-Chair for the Commercial Fraud Committee of the American Bankruptcy Institute.



*Kelly Davis, ERPA
Manager, Employee Benefits Plans Practice
CliftonLarsonAllen LLP
602.604.3526
Kelly.Davis@CLAconnect.com*

Kelly Davis is a manager in the Employee Benefit Plans Practice at CliftonLarsonAllen. Ms. Davis specializes in consulting nationally with employers of various size and industry on employee benefit plan tax and ERISA compliance and reporting matters—including qualified and nonqualified employee benefit plans, executive compensation, tax-favored health plans, fringe benefits, and healthcare reform.

Ms. Davis is a member of the American Institute of Certified Public Accountants (AICPA) and is the incoming vice chair of the AICPA Employee Benefits Tax Technical Resource Panel for 2014/15. She is a member of the AICPA Healthcare Reform Tax Task Force and the Western Pension and Benefits Conference. Ms. Davis is a national speaker and author on a variety of employee benefit plan topics and healthcare reform, and is an Enrolled Retirement Plan Agent (ERPA) with the IRS.



*Lawrence D. Sloan, CAE
President and CEO
Society of Chemical Manufacturers and Affiliates
202.721.4123
sloanl@SOCMA.com*

Larry Sloan is president and CEO of the Society of Chemical Manufacturers and Affiliates (SOCMA), the leading trade association serving small and mid-sized batch, custom, and specialty chemical manufacturers. In this capacity, he focuses SOCMA's efforts on increasing public confidence in the industry, championing the passage of rational laws and regulations, and maximizing business opportunities for all SOCMA member companies.

Prior to joining SOCMA, Mr. Sloan served as president of the Adhesive and Sealant Council from 2005 to 2010. During his tenure, he spearheaded initiatives designed to help grow the adhesives industry. Notable projects include the creation of a new adhesive CAD symbol to facilitate the use of adhesives in engineering drawings, as well as the development and launch of a new website to educate product designers, engineers, architects, and college engineering students about the benefits of using adhesives and sealants in modern design and assembly.

Mr. Sloan currently serves on the board of the Chemical Educational Foundation. In addition, he is a former board member of the National Association of Manufacturers' Council of Manufacturing Associations, where he served as chairman in 2012.



David R. Warner

Partner

Tysons Corner, VA Office

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AREAS OF PRACTICE

Labor and Employment
 Financial Services Wage Compliance
 Regulatory
 Insurance
 Insurance Coverage and Disputes

INDUSTRIES

Government Contractors
 Nonprofit Organizations and Associations

BAR ADMISSIONS

Virginia
 District of Columbia
 Maryland

COURT ADMISSIONS

U.S. District Court for the District of Maryland
 U.S. District Court for the District of Columbia
 U.S. Court of Appeals for the Fourth Circuit
 U.S. District Court for the Northern District of Florida

David Warner's practice focuses on the resolution and litigation of complex labor, employment, and business disputes. He represents and counsels both private and public sector clients, with a particular emphasis on the government contractor and nonprofit industries.

Business Litigation: Mr. Warner routinely represents companies in commercial litigation matters, often concerning the enforcement of management rights in regard to restrictive covenants, trade secrets, business conspiracy and procurement integrity laws. Representative engagements include:

- Lead counsel in \$21 million breach of service contract action
- Lead counsel in \$8 million breach of teaming agreement action
- Lead counsel for government contractor in breach of contract, Unfair Trade Practices Act, and fraud claims against prime contractor; matter resolved before filing of complaint with full recovery to client
- Lead counsel in prosecution of breach of duty of loyalty and trade secret claims against medical supply sales representative in Maryland
- Representation of telecommunications contractor in prosecution of business conspiracy, copyright, breach of duty of loyalty, and trade secrets claims against former employee and competitor; matter resolved prior to trial with more than \$4 million paid to client

Government Contractor Compliance and Audits: Mr. Warner has extensive experience advising government contractors in compliance matters, audits, and litigation with the federal government regarding E.O. 11246, the Davis-Bacon Act and Service Contract Act. Representative engagements include:

- Lead attorney in negotiation of 75% reduction of multi-million dollar back pay demand (levied prior to client's engagement of Venable) on behalf of one of the fifty largest private employers in the United States; directed compliance efforts resulting in successful conclusion of multi-year conciliation agreement
- Lead attorney in successful resolution of defense contractor audit, which included significant issues concerning pay equity in salaried ranks
- Lead attorney in training of executives and senior leadership regarding affirmative action, diversity, and talent management best practices at Fortune 100 company
- Represented multi-billion dollar services company in successful resolution of OFCCP glass ceiling audit
- Represented national financial services company in defense of claims of systemic hiring discrimination brought by OFCCP
- Represented multi-billion dollar food manufacturing company in successful resolution of OFCCP glass ceiling audit

EDUCATION

J.D., *cum laude*, Georgetown University Law Center, 1996

Editor, Articles and Notes, *American Criminal Law Review*

B.A., *cum laude*, Georgetown University, 1993

MEMBERSHIPS

American Bar Association

Maryland Bar Association

Virginia Bar Association

District of Columbia Bar Association

Maryland Defense Counsel, Inc.

Employment Counseling: Mr. Warner's practice includes counseling employers on labor and employment related matters in order to minimize potential litigation risk. In addition to day-to-day counseling on employment actions, Mr. Warner provides guidance regarding the design and implementation of effective and defensible application, hiring, promotion, and compensation practices, including conducting comprehensive audits of personnel practices to proactively identify and remediate issues that could give rise to class claims. Mr. Warner also advises companies in cross-border employment matters, including the design and implementation of expatriate employment agreements, application of U.S. laws to foreign-based employees, and related issues. Representative engagements include:

- Design and implementation of ex-pat employment agreements for employees located in Iraq, Afghanistan, Africa, Central and South America, and the Caribbean
- Investigation and resolution of harassment allegations of foreign employees in Africa
- Negotiation of 70% reduction of back-pay and benefits demanded by United Mine Workers of America under the federal Worker Adjustment and Retraining Notification ("WARN") Act following shutdown of mining facility
- Design and implementation of strategic corporate diversity initiatives for company with 100,000+ employees
- Design and implementation of application and selection processes for 5,000+ management positions at Fortune 100 company
- Training of executives and senior leadership regarding talent management best practices at Fortune 100 company
- Comprehensive equity analysis of management pay at Fortune 500 company, including implementation of remedial adjustments to employee compensation

Employment Litigation: Mr. Warner routinely represents employers in litigation concerning alleged violations of the FLSA and state wage and hour laws, Title VII, the ADA, ADEA, and other federal and state laws prohibiting discrimination and retaliation. Mr. Warner's litigation experience includes complex class action litigation, brought by both private claimants and government agencies, involving extensive electronic discovery and statistical analyses. Representative engagements include:

- Serving as lead defense counsel in nationwide promotions class action pending before the Equal Employment Opportunity Commission (EEOC)
- Lead defense counsel in successful opposition to class certification in five putative class actions before the EEOC
- Lead defense counsel in hostile work environment and retaliatory discharge matter
- Member of defense trial team for what would have been the largest employment discrimination class action ever tried to a jury had the matter not resolved – following a significant defense victory on motions *in limine* – on the eve of trial
- Lead defense counsel for successful defense of several discrimination and wrongful termination claims filed in the District of Columbia against national hotel chain under private ADR agreement

HONORS

Recognized in *Chambers USA*, Labor & Employment, Virginia, 2013 and 2014

Recognized in *Legal 500*, Not-For-Profit, 2014

RECENT PUBLICATIONS

- June 18, 2014, Performance Management and Discipline in Nonprofits: Common Pitfalls, Unique Challenges, Effective Solutions
- May 13, 2014, Performance Management and Discipline in Nonprofits: Common Pitfalls, Effective Solutions?
- April 30, 2014, Focus on Nonprofit Employee Misclassification: Are Your Workers "Employees," "Volunteers" or "Contractors?"
- February 19, 2014, Implementing a Bring-Your-Own-Device Policy

RECENT SPEAKING ENGAGEMENTS

Mr. Warner is a frequent lecturer on topics including compliance with the McNamara-O'Hara Service Contract Act, the Davis-Bacon Act, the Family and Medical Leave Act, the Fair Labor Standards Act, reasonable accommodation under the Americans with Disabilities Act, OFCCP compliance, hiring, firing, discipline and other aspects of the employer/employee relationship touched upon by state and federal law.

- October 2, 2014, Second Annual Nonprofit Executive Summit: Bringing Nonprofit Leaders Together to Discuss Legal, Finance, Tax, and Operational Issues Impacting the Sector
- June 18, 2014, Performance Management and Discipline in Nonprofits: Common Pitfalls, Unique Challenges, Effective Solutions
- May 13, 2014, Legal Quick Hit: "Performance Management and Discipline in Nonprofits: Common Pitfalls, Effective Solutions?" for the Association of Corporate Counsel's Nonprofit Organizations Committee
- April 30, 2014, *Association TRENDS* Webinar: "Focus on Nonprofit Employee Misclassification: Are Your Workers 'Employees,' 'Volunteers' or 'Contractors?'"
- February 19, 2014, Implementing a Bring-Your-Own-Device Policy: What Your Nonprofit Needs to Know



James L. Shea

Chair

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Washington, DC Office*

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AREAS OF PRACTICE

Commercial Litigation
Product Liability and Mass Torts
Appellate Litigation
Healthcare
Securities Class Action Defense
Technology Transactions and Outsourcing
Communications

INDUSTRIES

Financial Services
Hospitality and Lodging

CLIENT FOCUS

Retail
Insurance
Telecommunications

GOVERNMENT EXPERIENCE

Assistant Attorney General, Office of the Maryland Attorney General

BAR ADMISSIONS

District of Columbia
Maryland

REPRESENTATIVE CLIENTS

Mr. Shea's clients include:

- Marriott International, Inc.
- M&T Bank
- CareFirst BlueCross BlueShield
- Verizon
- Pepco
- Johns Hopkins University

He has also represented financial institutions, sports franchises, professional service firms and pharmaceutical companies in various commercial matters.

SIGNIFICANT MATTERS

Mr. Shea has both prosecuted and defended major corporations in securities class actions, contract, breach of fiduciary duty, and products liability cases. Particular matters have involved the ownership of professional sports franchises, software disputes, fiduciary duties, executive compensation, contract claims and alleged personal injury, and a number have required emergency injunctive relief.

HONORS

Fellow, American College of Trial Lawyers

Power 50: The Men and Women Who Rule, *Baltimore Magazine*, 2007, 2003

Leadership in Law Award, *The Daily Record*

Listed for more than eleven years in *The Best Lawyers in America* for Bet-the-Company and Commercial Litigation (Woodward and White)

Listed as one of the leading Commercial Litigation lawyers in the United States in multiple editions of *Chambers USA: America's Leading Lawyers for Business*

Recognized in *Super Lawyers Business Edition*, Business Litigation, Baltimore, 2013

EDUCATION

J.D., University of Virginia School of Law, 1977

Order of the Coif

A.B., *cum laude*, Princeton University, 1974

JUDICIAL CLERKSHIPS

Honorable Joseph H. Young, U.S. District Court for the District of Maryland, 1977 - 1978

MEMBERSHIPS

Defense Research Institute

Maryland Association of Defense Trial Counsel

Selected for inclusion in *Maryland Super Lawyers*, 2008 – 2014

Selected for inclusion in *Washington DC Super Lawyers*, 2014

Selected for inclusion in *Benchmark Litigation* “Local Litigation Stars” for Maryland, 2013

AV® Peer-Review Rated by Martindale-Hubbell

ACTIVITIES

Active in the community, Mr. Shea is the Chair of the Board of Regents of the University System of Maryland and the Central Maryland Transportation Alliance. He is a member of the Boards of the Greater Baltimore Committee and the Equal Justice Council. He is a recent past member of the Boards of Mercantile Bankshares and Mercantile Bank and Trust, and past Chairman of the Boards of Downtown Partnership of Baltimore, and the Empower Baltimore Management Corporation, and past Trustee of the Hippodrome Foundation and the Calvert School. He is a current fellow of the American College of Trial Lawyers, and is a member of the Defense Research Institute, and the Maryland Association of Defense Trial Counsel.



Domenico Montanaro
Political Editor and Senior Producer, Politics and Law
PBS NewsHour
dmontanaro@newshour.org

Domenico Montanaro is the Political Editor and Senior Producer for Politics and Law for the PBS *NewsHour*. In addition to guiding the broadcast's domestic political and legal coverage, he also appears on air and provides political analysis in his political morning note, *The Morning Line*. Before moving to the *NewsHour*, Mr. Montanaro worked for seven years in the Political Unit at NBC News under Chuck Todd, serving as deputy political editor.

He previously worked in the Election & Survey Unit at CBS News, was a newspaper reporter at the Asbury Park Press in New Jersey, was a high-school English teacher, and worked for a private investigations firm in New York. Mr. Montanaro is a graduate of the University of Delaware and the Columbia University Graduate School of Journalism.



Robert L. Waldman

Co-Managing Partner

Baltimore, MD Office

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rlwaldman@Venable.com

AREAS OF PRACTICE

Tax and Wealth Planning
 Tax-Exempt Organizations
 Healthcare
 Business Transactions Tax
 Tax Controversies and Litigation
 Tax Policy
 Anti-Money Laundering

INDUSTRIES

Nonprofit Organizations and Associations
 Education

BAR ADMISSIONS

Maryland
 Pennsylvania

EDUCATION

J.D., Stanford Law School, 1981
 B.A., Haverford College, 1978

MEMBERSHIPS

American Bar Association
 Maryland State Bar Association

Bob Waldman, Venable's Co-Managing Partner, also leads the firm's national representation of tax-exempt organizations. Mr. Waldman's practice includes general representation of numerous foundations, hospitals, educational institutions, trade associations and other charitable entities. Mr. Waldman also practices extensively in the areas of philanthropic and estate planning, employee benefits and taxation. Mr. Waldman is included in *The Best Lawyers in America* in the fields of Employee Benefits Law, Non-Profit/Charities Law and Tax Law.

The Daily Record, the newspaper serving Baltimore's business and legal communities, honored Mr. Waldman with its "Leadership in Law" award. The award recognizes those individuals whose leadership, both in the legal profession and in the community, has made a positive impact on Maryland, and who have demonstrated outstanding achievement in the practice of law; involvement in the profession, and support of the community. Mr. Waldman was also recognized in the 2012 edition of *Legal 500* and was selected for inclusion in *Maryland Super Lawyers*, 2010 - 2013 editions. Mr. Waldman is an Elected Fellow of the Baltimore City Bar Foundation.

HONORS

Named "Lawyer of the Year" for Baltimore Non-Profit/Charities Law in *The Best Lawyers in America*, 2014

Listed in *The Best Lawyers in America* for Employee Benefits Law, Non-Profit/Charities Law, and Tax Law (Woodward/White, Inc.)

Recognized in *Legal 500*, Not-For-Profit, 2012 - 2014

Selected for inclusion in *Maryland Super Lawyers*, 2010 - 2013

AV® Peer-Review Rated by *Martindale-Hubbell*, selected as a 2013 Top Rated Lawyer in Healthcare

Recipient, Spirit of Partnership Award, Sodexo Foundation

The Daily Record, the newspaper serving Baltimore's business and legal communities, honored Mr. Waldman with its "Leadership in Law" award. The award recognizes those individuals whose leadership, both in the legal profession and in the community, has made a positive impact on Maryland, and who have demonstrated outstanding achievement in the practice of law; involvement in the profession, and support of the community.

Elected Fellow of the Baltimore City Bar Foundation

ACTIVITIES

Mr. Waldman is a member of the Board of the Association of Baltimore Area Grantmakers (past Chairman) and serves on the Boards of the Enoch Pratt Free Library and the Downtown Partnership of Baltimore. He has also served on the Board

of the Maryland Association of Nonprofit Organizations and is a member of the Best Lawyers Advisory Board.

Mr. Waldman is a member of the American Bar Association Committee on Tax-Exempt Organizations and former chair of the Employee Benefits Subcommittee of the Maryland State Bar Association.

RECENT PUBLICATIONS

- The IRS Clarification of Parking Income is a Roadblock for Tax-Exempts
- November 14, 2013, Managing Donated Funds: Donor Intent, Restricted Funds, and Gift Acceptance Policies
- October 8, 2013, Complying (or Deviating) from Donor Intent: Recent Developments for Nonprofits
- May 29, 2013, Legal Issues in International Philanthropy
- March 2013, Tax Considerations of International Grantmaking in Today's World
- March 2013, The FCPA and Anti-Corruption Enforcement: What Does It Mean for Charitable Contributions?
- March 12, 2013, Charity Boards – Ethical Considerations under the Microscope
- February 5, 2013, Tax Considerations of Grantmaking in Today's World

RECENT SPEAKING ENGAGEMENTS

- October 2, 2014, Second Annual Nonprofit Executive Summit: Bringing Nonprofit Leaders Together to Discuss Legal, Finance, Tax, and Operational Issues Impacting the Sector
- November 14, 2013, Managing Donated Funds: Donor Intent, Restricted Funds, and Gift Acceptance Policies
- October 8, 2013, Legal Quick Hit: "Complying (or Deviating) from Donor Intent: Recent Developments for Nonprofits" for the Association of Corporate Counsel's Nonprofit Organizations Committee
- May 29, 2013, Association of Corporate Counsel Webcast: "Legal Issues in International Philanthropy"
- March 12, 2013, "Charity Boards – Ethical Considerations Under the Microscope" at the Bank of America Merrill Lynch Strategic Governance and Leadership Summit
- March 11, 2013, "The FCPA and Anti-Corruption Enforcement: What Does It Mean for Charitable Contributions?" at the Annual Conference of the Association of Corporate Contributions Professionals
- February 5, 2013, "Tax Considerations of Grantmaking in Today's World" at the CliftonLarsonAllen National Foundation Conference



*David J. Trimner, CPA
Principal, Northeast Tax Leader
CliftonLarsonAllen LLP
571.227.9676
David.Trimner@CLAconnect.com*

David Trimner has provided specialized tax consulting and compliance services to several hundred tax-exempt clients over his 16 year career, focusing primarily on public charities, private foundations, trade associations, healthcare organizations, and higher education institutions. Mr. Trimner devotes himself to the rules and regulations critical to charitable and tax-exempt entities, as well as the preparation of tax filings designed to enhance an organization's image with contributors, the media, and the general public. He also assists clients on a variety of other issues, including unrelated business income, intermediate sanctions, obtaining and maintaining exempt status, IRS examinations, executive compensation and benefits disclosures, and state solicitation requirements.

Prior to joining CLA, Mr. Trimner was a tax partner with BDO USA and a tax manager with PricewaterhouseCoopers. He is a member of the American Institute of Certified Public Accountants and a member of Greater Washington Society of Certified Public Accountants (Not-for-Profit Committee chair, 2012-2013).



Matthew T. Journy

Associate

Washington, DC Office

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mtjourny@Venable.com

AREAS OF PRACTICE

Tax-Exempt Organizations
Tax and Wealth Planning
Political Law
Regulatory
Tax Controversies and Litigation

INDUSTRIES

Nonprofit Organizations and Associations
Credit Counseling and Debt Services

GOVERNMENT EXPERIENCE

Attorney, Internal Revenue Service

BAR ADMISSIONS

Massachusetts
District of Columbia

EDUCATION

LL.M., Georgetown University Law Center, 2006
J.D., Northeastern University School of Law, 2003
B.A., Marquette University, 1999

Matt Journy is an associate in Venable's Washington, DC office, where he practices in the Nonprofit Organizations and Associations Practice Group. In his practice, Mr. Journy counsels trade and professional associations, public charities, private foundations, and other nonprofits on a variety of tax, governance, and general corporate matters, including tax exemption applications, audits, tax planning, joint ventures, unrelated business income tax issues, lobbying, and charitable solicitation, among other issues.

Mr. Journy also represents nonprofit clients in tax disputes with the IRS. Mr. Journy has represented clients before the IRS during each stage of the IRS examination process, including: the examination stage and administrative appeals process. If the tax controversy is not resolved administratively, Mr. Journy represents the client in court litigation, typically in U.S. Tax Court.

SIGNIFICANT TAX CONTROVERSY LITIGATION MATTERS

- Successful representation in U.S. Tax Court of taxpayer accused by IRS of having entered into an "excess benefit" transaction under IRC § 4958. After developing a thorough factual record and expert testimony demonstrating that the transaction between the taxpayer and the tax-exempt organization provided a substantial benefit to the nonprofit entity and thus, did not constitute an "excess benefit" transaction, the IRS conceded the case, acknowledging that taxpayer owed no additional tax.
- Litigated multiple Declaratory Judgment matters contesting the authority of the IRS to issue a final adverse determination letter to organizations recognized as exempt under IRC § 501(c)(3). Settling each case by entering into a closing agreement under which the IRS continued to recognize the organization's tax-exempt status.
- Litigated and negotiated favorable settlement of deficiency cases resulting from the revocation of a nonprofit organization's tax-exempt status.

Mr. Journy has appeared frequently before the IRS National Office, representing clients in requests for private letter rulings or technical advice memoranda.

Having worked both as a regulator and tax consultant in the nonprofit community, Mr. Journy draws upon his prior experience to provide clients with reliable and thorough advice on the wide array of legal issues faced by nonprofits. Before joining Venable, Mr. Journy worked at Ernst & Young, LLP in the National Tax Practice, where he provided nonprofit clients with tax advice relating to corporate reorganizations, expenditure responsibility for international grants, fundraising activities, commercial co-ventures, unrelated business income, and post-issuance compliance for private activity bonds. In addition to providing tax advice, Mr. Journy provided tax compliance services, including the technical review of various federal and state tax and information returns. Prior to joining Ernst & Young, Mr. Journy worked in the Tax-Exempt/Government Entities Division of the IRS Office of Chief Counsel, where he

prepared legal and technical advice for field agents and composed legal memoranda on a variety of issues affecting tax-exempt organizations.

HONORS

Named American Bar Association "Outstanding Nonprofit Lawyer of the Year Award," Young Attorney category, 2014

Recognized in *Legal 500*, Not-For-Profit, 2013 and 2014

RECENT PUBLICATIONS

- May/June 2014, Mitigating the Income Tax Expense of a Retroactive Revocation for EOs, *Taxation of Exempts*
- November/December 2013, Tools for Bypassing IRS Delays in EO Applications
- October 25, 2013, "The IRS Final Report on Nonprofit Colleges and Universities: Lessons for All Tax-Exempt Organizations" at the NGO General Counsel Forum Fall Meeting
- October 24, 2013, The IRS Final Report on Nonprofit Colleges and Universities: Lessons for All Tax-Exempt Organizations
- September 26, 2013, Nonprofit Executive Summit: Bringing Nonprofit Leaders Together to Discuss Legal, Finance, Tax, and Operational Issues Impacting the Sector
- July 2013, Lessons from the IRS Nonprofit College and University Compliance Project: Final Report Offers a Wealth of Information for All Tax-Exempt Organizations (article – long version)
- July 9, 2013, A Look at the IRS Final Report on the Nonprofit Colleges and Universities Compliance Project: UBIT and Executive Compensation Lessons for All Tax-Exempt Organizations (presentation)
- May 2013, IRS Releases Final Report on Nonprofit Colleges and Universities Compliance Project: UBIT and Executive Compensation Lessons for All Tax-Exempt Organizations (article – short version)
- April 18, 2013, An Unfair Fight: IRS Enforcement of Intermediate Sanctions and the Lessons Learned from Recent Tax Controversies
- March 12, 2013, Protecting Your Nonprofit Housing Counseling Agency's 501(c)(3) Status
- March 2013, IRS Denials of Tax-Exempt Status to Mortgage Foreclosure Assistance Providers Offer Lessons for Housing Counseling Agencies
- March/April 2013, Using Section 7428 to Resolve Exempt Status Controversies, *Taxation of Exempts*, Volume 24, Number 5
- February 5, 2013, IRS Releases Exempt Organizations 2012 Annual Report and 2013 Workplan
- February 4, 2013, IRS Examinations of Nonprofit Housing Counseling Agencies
- January 28, 2013, Protecting Tax-Exempt Status: The Importance of Intangible Asset Valuation

RECENT SPEAKING ENGAGEMENTS

- October 2, 2014, Second Annual Nonprofit Executive Summit: Bringing Nonprofit Leaders Together to Discuss Legal, Finance, Tax, and Operational Issues Impacting the Sector
- March 21, 2014, "How to Handle Tax Controversies and State AG Investigations" at the 2014 Washington Nonprofit Legal & Tax Conference
- December 4, 2013, "How to Protect Your Tax-Exempt Status – Beyond the Basics" at the NYSSCPA and FAE Exempt Organizations Conference
- October 25, 2013, "The IRS Final Report on Nonprofit Colleges and Universities: Lessons for All Tax-Exempt Organizations" at the NGO General Counsel Forum Fall Meeting

- October 24, 2013, The IRS Final Report on Nonprofit Colleges and Universities: Lessons for All Tax-Exempt Organizations
- September 26, 2013, Nonprofit Executive Summit: Bringing Nonprofit Leaders Together to Discuss Legal, Finance, Tax, and Operational Issues Impacting the Sector
- July 25, 2013, "The IRS College and University Compliance Project Final Report: UBIT & Executive Compensation Lessons for All Tax-Exempt Organizations" for Non-Profit Cooperation Circle
- July 9, 2013, Legal Quick Hit: "A Look at the IRS Final Report on the Nonprofit Colleges and Universities Compliance Project: UBIT and Executive Compensation Lessons for All Tax-Exempt Organizations" for the Association of Corporate Counsel's Nonprofit Organizations Committee
- April 18, 2013, "An Unfair Fight: IRS Enforcement of Intermediate Sanctions and the Lessons Learned from Recent Tax Controversies" at the 1st Annual Institute on Not-for-Profit Law
- March 12, 2013, Protecting Your Nonprofit Housing Counseling Agency's 501(c)(3) Status



*Michael F. Curtin, Jr.
Chief Executive Officer
DC Central Kitchen
202.334.0707
mcurtin@DCcentralkitchen.com*

Mike Curtin is CEO of DC Central Kitchen, a nationally recognized "community kitchen" that recycles food from around Washington, DC and uses it as a tool to train unemployed adults to develop work skills—while providing thousands of meals for local services agencies in the process. Drawing on his experiences as an entrepreneur in the restaurant business, Mr. Curtin has spent significant time expanding the Kitchen's revenue-generating social enterprise initiatives. Under his leadership, DC Central Kitchen's Fresh Start Catering has expanded from traditional catering opportunities to include contracts to provide locally-sourced, scratch-cooked meals to schools in DC. Since 2010, DC Central Kitchen has generated over \$20 million from these businesses, and social enterprise now accounts for roughly 65% of the Kitchen's total operating budget. Because of these and many other innovative social service programs, the Kitchen now employs over 130 people, approximately 40% of whom are graduates of the Kitchen's nationally recognized Culinary Job Training Program.

In order to secure sustainable, healthy food for the Kitchen, Mr. Curtin has developed strategic partnerships to purchase unclassified produce from local farms. This initiative has saved money and employed more graduates of the Kitchen's Culinary Job Training Program. The Kitchen's new focus on procuring local produce garnered a Mayor's Environmental Excellence Award and the Washington Business Journal's Green Business Award for Innovation.

Mr. Curtin is a Chair Emeritus of the Restaurant Association Metropolitan Washington and a board member for The Common Market in Philadelphia. He also is on the Advisory Board of DC Greens and Catalyst Kitchens, the Leadership Council of DC Hunger Solutions, and an Advisory Board member for the Center for Health and the Global Environment at Harvard Medical School.



George E. Constantine

Partner

Washington, DC Office

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AREAS OF PRACTICE

Political Law
Tax-Exempt Organizations
Tax Controversies and Litigation
Tax and Wealth Planning
Regulatory

INDUSTRIES

Nonprofit Organizations and Associations
Credit Counseling and Debt Services

BAR ADMISSIONS

Maryland
District of Columbia

EDUCATION

J.D., University of Maryland School of Law, 1998

Recipient, Order of the Coif law school honors society

Recipient, Judge R. Dorsey Watkins Award for excellence in torts

B.A., Loyola College In Maryland, 1989

George Constantine concentrates his practice exclusively on providing legal counseling to and advocacy for nonprofit organizations, including trade associations, professional societies, advocacy groups, charities, and other entities. He has extensive experience with many of the major legal issues affecting nonprofit organizations, including contracts, tax, antitrust, governance, and political activity matters.

Mr. Constantine has represented Internal Revenue Code § 501(c)(3), 501(c)(4) and 501(c)(6) clients on a number of critical tax-exemption matters, including representing clients that are undergoing Internal Revenue Service examinations challenging their exempt status; he has assisted associations and other nonprofit organizations going through mergers, consolidations, joint ventures, and dissolutions; and he has provided ongoing counseling on numerous transactional and governance matters that are unique to nonprofit organizations.

Mr. Constantine serves on the Legal Section Council of the American Society of Association Executives. In addition, Mr. Constantine is the former Staff Counsel of the American Society of Association Executives (ASAE), the 25,000-member national society for trade and professional association executives. As ASAE's sole staff attorney, he gained in-depth experience with the many legal issues facing associations. He also represented ASAE's interests before Congress and federal agencies. Mr. Constantine co-chairs Venable's Regulatory Practice Group.

HONORS

Recognized in *Legal 500*, Not-For-Profit, 2012 - 2014

RECENT PUBLICATIONS

Mr. Constantine is the author of numerous articles regarding legal issues affecting associations and other nonprofit organizations published by ASAE, the Greater Washington Society of Association Executives, the American Chamber of Commerce Executives, the New York Society of Association Executives, and the Texas Society of Association Executives.

- June 24, 2014, Multi-Entity Organizations
- March 27, 2014, Top Five Nonprofit Legal Issues of the Past Year
- February 2014, Key House Committee Chairman Releases Long-Awaited Tax Reform Overhaul: Major Changes Proposed for Nonprofits
- February 2014, Informing Regulators When You Alter Your Mission
- January 2014, Is Your Nonprofit Selling Goods Online? U.S. Supreme Court Provides Reminder of Potential Sales Tax Liability

RECENT SPEAKING ENGAGEMENTS

Mr. Constantine is a frequent lecturer on association and tax-exemption organization legal topics, including corporate and tax issues.

- November 19, 2014, Enhancing the Nonprofit Governance Model: Legal Pitfalls and Best Practices
- October 2, 2014, Second Annual Nonprofit Executive Summit: Bringing Nonprofit Leaders Together to Discuss Legal, Finance, Tax, and Operational Issues Impacting the Sector
- August 11, 2014, "Association Law Review for Aspiring CAEs" at the 2014 ASAE Annual Meeting & Exposition
- August 10, 2014, "Comparing Compensation: Effective Approaches to Benchmarking Pay and Perks" at the 2014 ASAE Annual Meeting & Exposition
- June 24, 2014, "Multi-Entity Organizations" for the Greater Washington Society of CPAs (GWSCPA)
- June 3, 2014, "The Impossible NO (A Panel on Getting Funders to YES)" at the 2014 Nonprofit Empowerment Summit hosted by Raffa, PC
- April 25, 2014, "Trade Association Update" for Georgetown Law's Representing and Managing Tax-Exempt Organizations CLE
- April 15, 2014, "Certified Association Executive (CAE) Prep Course Webinar," American Society of Association Executives



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Sarah Curfman is a managing consultant with CliftonLarsonAllen's Public Sector Group, specializing in the areas of financial and operational consulting. Ms. Curfman works with a range of foundation and nonprofit clients in the areas of business and strategic planning; philanthropic due diligence and program management; organizational assessment; board governance; group facilitation; and fact-based research analysis.

Ms. Curfman has over 15 years of consulting, project management, and sales experience in both corporate and nonprofit settings. She provides direct consulting and training services on financial and strategic management issues to nonprofit managers, executives, and board members.

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2012 2008 2004
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July 2014

A COLLECTION OF VENABLE'S NONPROFIT LEGAL ARTICLES, PRESENTATIONS, AND RECORDINGS FROM THE SECOND QUARTER OF 2014

Venable's Nonprofit Organizations Practice Group is pleased to share below these articles, presentations, and recorded webinars by our attorneys. These quarterly digests are a collection of our most interesting and useful materials to help your organization as you tackle the always-challenging array of legal issues facing nonprofits. In case you missed it, please [click here](#) for the Collection of Venable's Nonprofit Legal Articles, Presentations, and Recordings from the First Quarter of 2014.

To read or listen to any of these articles, presentations, or recordings, please click on the title.

Federal Grant & Contract News for Nonprofits - June 2014 (Article)

Your Nonprofit's Next Big Event: Spotting and Solving the Most Common Meeting Contract Pitfalls (Presentation) (Recording Available)

Multi-Entity Organizations (Presentation)

Performance Management and Discipline in Nonprofits: Common Pitfalls, Unique Challenges, Effective Solutions (Presentation) (Recording Available)

Canada's New Anti-Spam Legislation: What Does It Mean for U.S. Nonprofits? (Article)

Developing Your Government Investigations Playbook: What Your Nonprofit Should Be Doing Now to Prepare for the Future (Presentation)

Federal Grant & Contract News for Nonprofits - May 2014 (Article)

The New York Non-Profit Revitalization Act (Presentation)

Surviving a Governmental Investigation without a Black Eye: Key Legal, Communications and Crisis Response Considerations for Nonprofits (Presentation) (Recording Available)

When Is It Appropriate to Divert Designated Funds for General Fund Uses? (Article)

Nonprofits and Celebrity Endorsements: Common Legal Pitfalls and Practical Tips (Article)

Federal Grant & Contract News for Nonprofits - April 2014 (Article)

Focus on Nonprofit Employee Misclassification: Are Your Workers "Employees," "Volunteers" or "Contractors?" (Presentation)

Election-Year Advocacy: Maintaining Your Nonprofit's Clear Message in Cloudy Legal Seas (Presentation) (Recording Available)

Two Recent FTC Cases Demonstrate the Antitrust Risk of Association Codes of Ethics (Article)

Considerations for Nonprofits when Using Getty's New "Free" Images (Article)

The Case for Effective "Policing" of Nonprofit Funds (Article)

Everything You Wanted to Know about Nonprofit Tax Law (Presentation) (Recording Available)

Prohibited Discrimination in Hiring: Disparate Treatment and Disparate Impact – Considerations for Nonprofits (Article)

IRS Proposed Rules for Political Activity of 501(c)(4) Organizations (Presentation) (Recording Available)

Election-Year Activities for Your Nonprofit: Avoiding the Legal Pitfalls and Understanding the

Evolving Landscape (Presentation)

BYOD for 501(c)s: Pros and Perils of "Bring Your Own Device" (Presentation)

Upcoming Events

July 8, 2014: **Legal Quick Hit: "Key Trademark and Copyright Rules for Nonprofits to Follow – and Break!"** for the Association of Corporate Counsel's Nonprofit Organizations Committee

July 17, 2014: **Key Trademark and Copyright Rules for Nonprofits to Follow – and Break!**

August 10, 2014: **"Comparing Compensation: Effective Approaches to Benchmarking Pay and Perks"** at the 2014 ASAE Annual Meeting & Exposition

August 11, 2014: **"Association Law Review for Aspiring CAEs"** at the 2014 ASAE Annual Meeting & Exposition

August 11, 2014: **"Get the Most out of Your Trusted Advisors"** at the 2014 ASAE Annual Meeting & Exposition

August 12, 2014: **Legal Quick Hit: "Drafting and Revising Bylaws: Common Pitfalls, Best Practices, and Maximizing the Effective Governance of Your Nonprofit"** for the Association of Corporate Counsel's Nonprofit Organizations Committee

August 13, 2014: **Privacy and Data Security for Your Nonprofit: Understanding Your Legal Obligations and Insuring against Risk**

August 15, 2014: **"Drafting and Revising Nonprofit Bylaws: Common Pitfalls and Best Practices"** for the National Business Institute

September 16, 2014: **What's Ahead for 2015: Preparing Your Nonprofit's Group Health Plan for the Employer Mandate**

December 18, 2014: **"Perfecting the Charitable Promotion: Legal, Financial and Practical Considerations for Commercial Co-Ventures"** at the 26th Annual Greater Washington Society of CPAs Non Profit Finance & Accounting Symposium

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2011 2007

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April 2014

A COLLECTION OF VENABLE'S NONPROFIT LEGAL ARTICLES, PRESENTATIONS, AND RECORDINGS FROM THE FIRST QUARTER OF 2014

Venable's Nonprofit Organizations Practice Group is pleased to share below the best articles, presentations, and recordings of our monthly in-house nonprofit luncheon programs/webinars by our **attorneys**. These quarterly digests are a collection of our most interesting and useful materials to help your organization as you tackle the always-challenging array of legal issues facing nonprofits. In case you missed it, please **click here** for the Collection of Venable's Nonprofit Legal Articles, Presentations, and Recordings from the Fourth Quarter of 2013.

To read any of these articles, alerts, or presentations, please click on the title.

Federal Grant & Contract News for Nonprofits - March 2014 (Article)

Association TRENDS 2014 Legal Review (Article)

Top Five Nonprofit Legal Issues of the Past Year (Article)

Preventing and Investigating Fraud, Embezzlement, and Charitable Asset Diversion: What's a Nonprofit Board to Do? (Article)

The OMB Super Circular: What the New Rules Mean for Nonprofit Recipients of Federal Awards (Presentation) (Recording Available)

The Affordable Care Act and Nonprofit Organizations: An Overview (Article)

Nonprofit Insurance Coverage: You Need More Than a Directors and Officers Policy (Article)

Federal Grant & Contract News for Nonprofits - February 2014 (Article)

Key House Committee Chairman Releases Long-Awaited Tax Reform Overhaul: Major Changes Proposed for Nonprofits (Article)

The Impact of IRS Recognition of All Legal Same-Sex Marriages on Nonprofit Organizations' Employee Benefit Plans (Presentation)

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Conducting Operations Overseas: What Every Nonprofit Should Know (Presentation)

Implementing a Bring-Your-Own-Device Policy: What Your Nonprofit Needs to Know (Presentation) (Recording Available)

Nonprofits and HIPAA Violations: An Overview (Article)

Bring-Your-Own-Device Programs: Steps to Minimize Nonprofits' Legal Risks (Article)

Federal Grant & Contract News for Nonprofits - January 2014 (Article)

Is Your Nonprofit Selling Goods Online? U.S. Supreme Court Provides Reminder of Potential Sales Tax Liability (Article)

How to Safeguard Your Nonprofit against Fraud and Embezzlement: Best Practices, Common Pitfalls, and Practical Strategies (Presentation) (Recording Available)

Nonprofit Interns: IRS Regulations and Liability (Article)

Employment Law Litigation Trends: How Your Nonprofit Can Avoid Common Family-Oriented Lawsuits (Presentation)

Upcoming Events

April 8, 2014: **Legal Quick Hit: "Election-Year Activities for Your Nonprofit: Avoiding the Legal Pitfalls and Understanding the Evolving Landscape"** for the Association of Corporate Counsel's Nonprofit Organizations Committee

April 17, 2014: **GuideStar Webinar: "Everything You Wanted to Know about Nonprofit Tax Law"**

April 29, 2014: **Election-Year Advocacy: Maintaining Your Nonprofit's Clear Message in Cloudy Legal Seas**

April 30, 2014: **Association TRENDS Webinar: "Focus on Nonprofit Employee Misclassification: Are Your Workers 'Employees,' 'Volunteers' or 'Contractors?'"**

May 20, 2014: **Surviving a Governmental Investigation without a Black Eye: Key Legal, Communications and Crisis Response Considerations for Nonprofits** (details coming soon)

June 18, 2014: **"Does Your Social Media Policy Pass the 'Sniff Test'?" at the American Society of Association Executives' (ASAE) 2014 Marketing, Membership & Communications Conference**

June 18, 2014: **Performance Management and Discipline in Nonprofits: Common Pitfalls, Effective Solutions** (details coming soon)

July 17, 2014: **Key Trademark and Copyright Rules for Nonprofits to Follow – and Break** (details coming soon)

August 10, 2014: **"Comparing Compensation: Effective Approaches to Benchmarking Pay and Perks" at the 2014 ASAE Annual Meeting & Exposition**

August 11, 2014: **"Association Law Review for Aspiring CAEs" at the 2014 ASAE Annual Meeting & Exposition**

August 11, 2014: **"Get the Most out of Your Trusted Advisors" at the 2014 ASAE Annual Meeting & Exposition**

August 15, 2014: **"Drafting and Revising Nonprofit Bylaws: Common Pitfalls and Best Practices" for the National Business Institute**

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A COLLECTION OF VENABLE'S NONPROFIT LEGAL ARTICLES, PRESENTATIONS, AND RECORDINGS FROM THE FOURTH QUARTER OF 2013

Venable's Nonprofit Organizations Practice Group is pleased to share below the best articles, presentations, and recordings of our monthly in-house nonprofit luncheon programs/webinars by our **attorneys**. These quarterly digests are a collection of our most interesting and useful materials to help your organization as you tackle the always-challenging array of legal issues facing nonprofits. In case you missed it, please **click here** for the Collection of Venable's Nonprofit Legal Articles, Presentations, and Recordings from the Third Quarter of 2013.

Happy holidays and best wishes for the new year,

Venable's Nonprofit Organizations Practice Group

New York Nonprofit Revitalization Act Signed into Law (Article)

Antitrust Risks of Association-Sponsored Market Research: Avoiding Compliance Pitfalls of Information Exchanges and Surveys (Presentation)

Your Nonprofit Has Gone Global: Now What Are Your U.S. and Foreign Tax Compliance and Reporting Obligations? (Presentation)

Work & Family: What Nonprofit Employers Should Know about Family-Oriented Employment Laws (Presentation) (Recording Available)

Federal Grant & Contract News for Nonprofits - November 2013 (Article)

Drafting and Revising Nonprofit Bylaws: Common Pitfalls and Best Practices (Presentation)

Managing Donated Funds: Donor Intent, Restricted Funds, and Gift Acceptance Policies (Presentation) (Recording Available)

Employee Benefits for Same-Sex Couples: What Your Nonprofit Needs to Know (Presentation)

Preventing Fraud and Embezzlement in Your Nonprofit Organization (Article)

Guidelines for Nonprofits when Negotiating Online Advertising Arrangements (Article)

Tools for Bypassing IRS Delays in EO Applications (Article)

Federal Grant & Contract News for Nonprofits - October 2013 (Article)

The New Nonprofit Revitalization Act (Presentation)

The IRS Final Report on Nonprofit Colleges and Universities: Lessons for All Tax-Exempt Organizations (Presentation) (Recording Available)

The Evolving Schedule K to IRS Form 990: Supplemental Information on Tax-Exempt Bonds (Article)

New York Legislature Passes Nonprofit Revitalization Act: Comprehensive, Significant Changes to New York Nonprofit Corporation Law on Horizon (Presentation)

Combinations and Alliances among Nonprofit Organizations (Article)

The 15 Most Common Nonprofit Bylaw Pitfalls: How to Avoid the Traps (Article)

"Donor Intent and Contributions with Strings" for Nonprofit Spark Radio (Recording)

Removing Requirements for Commercial Co-Ventures: Maine Repeals Registration

Requirements for Promotions with Charitable Appeal (Article)

Complying (or Deviating) from Donor Intent: Recent Developments for Nonprofits (Presentation)

Association-Sponsored Market Research Programs: Common Pitfalls, Antitrust Risks, and Opportunities (Presentation) (Recording Available)

Upcoming Events

January 15, 2014: **How to Safeguard Your Nonprofit against Fraud and Embezzlement: Best Practices, Common Pitfalls, and Practical Strategies**

January 16, 2014: **Government Affairs Compliance Tune-Up**

February 19, 2014: **Implementing a Bring-Your-Own-Device Policy: What Your Nonprofit Needs to Know**

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2013 2009 2005
2012 2008 2004
2011 2007

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October 2013

A COLLECTION OF VENABLE'S NONPROFIT LEGAL ARTICLES, PRESENTATIONS, AND RECORDINGS FROM THE THIRD QUARTER OF 2013

Venable's Nonprofit Organizations Practice Group is pleased to share below the best articles, presentations, and recordings of our monthly in-house nonprofit luncheon programs/webinars by our **attorneys**. These quarterly digests are a collection of our most interesting and useful materials to help your organization as you tackle the always-challenging array of legal issues facing nonprofits. In case you missed it, please **click here** for the Collection of Venable's Nonprofit Legal Articles, Presentations, and Recordings from the Second Quarter of 2013.

Best wishes,

Venable's Nonprofit Organizations Practice Group

Federal Grant & Contract News for Nonprofits - September 2013 (Article)

Allowing User-Generated Content on Social Media: Steps for Minimizing Nonprofits' Legal Risks (Article)

New Developments on Federal Tax Matters Impacting Associations (Presentation)

Building and Protecting Your Association's Brand in Social Media: Managing the Legal Pitfalls (Presentation)

Nonprofit Executive Summit: Bringing Nonprofit Leaders Together to Discuss Legal, Finance, Tax, and Operational Issues Impacting the Sector (Presentations)

Keeping Up with Technology and the Law: What Your Nonprofit Should Know about Apps, the Cloud, Information Security, and Electronic Contracting (Presentation) (Recording Available)

The Impact of IRS Recognition of All Legal Same-Sex Marriages on Nonprofit Organizations' Employee Benefit Plans (Article)

Connecting the Dots for Nonprofits on Healthcare Reform: The Exchanges, the Premium Subsidies, and the Employer Mandate (Presentation) (Recording Available)

Employee Leaves of Absence and Other Accommodations under the Law: What Every Nonprofit Needs to Know (Presentation)

Tools for Bypassing IRS Delays in EO Applications (Article)

Federal Grant & Contract News for Nonprofits - August 2013 (Article)

Association Membership and Program Restrictions and the Antitrust Laws: Don't Stumble Out of the Gate (Article)

Expanding Your Advocacy and Political Reach: Adding a 501(c)(4) to Your Nonprofit's Org Chart (Presentation)

The Road Map to HIPAA Compliance: What Your Nonprofit Needs to Know (Presentation) (Recording Available)

Federal Grant & Contract News for Nonprofits - July 2013 (Article)

Lessons from the IRS Nonprofit College and University Compliance Project: Final Report Offers a Wealth of Information for All Tax-Exempt Organizations (Article)

New York Legislature Passes Nonprofit Revitalization Act: Comprehensive, Significant

Changes to New York Nonprofit Corporation Law on Horizon (Article)

Raise Money, Not Risk: Legal Considerations in Fundraising (Presentation)

Evaluating Your Nonprofit's Options under the *Affordable Care Act*: The Pros and Cons of Health Insurance Alternatives for Your Employees (Presentation) (Recording Available)

Focus on Misclassification: Are Your Association's Workers "Employees," "Volunteers," or "Contractors?" (Presentation)

U.S. Senate Finance Committee Report Highlights Potential Tax Reforms for Tax-Exempt Organizations (Article)

A Look at the IRS Final Report on the Nonprofit Colleges and Universities Compliance Project: UBIT and Executive Compensation Lessons for All Tax-Exempt Organizations (Presentation)

What Your Nonprofit Needs to Do about HIPAA – Now (Article)

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November 2013

PREVENTING FRAUD AND EMBEZZLEMENT IN YOUR NONPROFIT ORGANIZATION

An abbreviated version of this article was published in Nonprofit Quarterly on December 4, 2013.

AUTHORS

William H. Devaney
Doreen S. Martin
Nicholas M. Buell
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2014 2010 2006
2013 2009 2005
2012 2008 2004
2011 2007

On October 26, 2013, the *Washington Post* reported that from 2008 to 2012, more than 1,000 nonprofit organizations disclosed hundreds of millions in losses attributed to theft, fraud, embezzlement, and other unauthorized uses of funds and organizational assets. According to a study cited by the *Post*, nonprofits and religious organizations suffer one-sixth of all major embezzlements, second only to the financial services industry.

While the numbers are shocking, this trend will not surprise those in the nonprofit world, who have long known that nonprofits are highly susceptible to fraud and embezzlement. Nonprofits are generally established for beneficial purposes and assume that their employees, especially senior management, share the organization's philanthropic mission. As such, nonprofits tend to be more trusting of their employees and have less stringent financial controls than their for-profit counterparts. Thus, they fall prey to embezzlement and other forms of employee fraud at an alarming rate. By way of recent example, as reported by the *Washington Post*:

- From 1999 to 2007, the American Legacy Foundation, a nonprofit dedicated to educating the public about the dangers of smoking, suffered an estimated \$3.4 million loss as a result of alleged embezzlement by a former employee.
- In 2012, the Global Fund to Fight Aids, Tuberculosis and Malaria reported to the federal government a misuse of funds or unsubstantiated spending of \$43 million.
- In 2011, the Vassar Brothers Medical Center in Poughkeepsie, New York reported a loss of \$8.6 million through the "theft" of certain medical devices.

In addition to those incidents reported by the *Washington Post*, a few other recent examples include:

- On February 27, 2013, a former financial director for a New York chapter of the American Red Cross was sentenced to two to seven years in prison for grand larceny. The former director embezzled over \$274,000 between 2005 and 2009, using the money to pay for clothing, her children's tuition, and other personal expenses.
- On November 8, 2012, the former executive director of the H.O.W. Foundation, a nonprofit alcohol and drug treatment center in Tulsa, Oklahoma, was sentenced to 15 months' imprisonment and ordered to pay over \$1.5 million in restitution for defrauding H.O.W. over the course of eight years. The former executive director wrote himself 213 unauthorized checks for a total of more than \$1.35 million and embezzled more than \$200,000 from a thrift store operated by the nonprofit.
- On October 12, 2013, the former CFO of Project Genesis, a Connecticut nonprofit organization that serves adults and children with disabilities, was sentenced to 33 months' imprisonment after embezzling more than \$348,000 from the organization over a three-year period. The former CFO stole the organization's funds by keeping terminated employees on the payroll and then transferring their salaries to his personal bank account.

While external audits are necessary and helpful in ensuring that financial controls and fraud prevention measures are being followed and are effective, the standard audit is not designed and should not be relied upon to detect fraud. The Association of Certified Fraud Examiners reports that less than 4% of frauds are discovered as a result of an audit of external financial statements by an independent accounting firm.

Many nonprofits had previously elected to handle instances of fraud or embezzlement quietly in order to avoid unwanted attention and embarrassment. That is no longer an option. In 2008, the Internal Revenue Service implemented additional regulations designed to enable the public to more easily evaluate how

effectively larger nonprofits manage their money. Tax-exempt organizations whose gross receipts are greater than or equal to \$200,000, or whose assets are greater than or equal to \$500,000, are subject to additional disclosure requirements on their IRS Form 990 concerning embezzlement or theft. Specifically, these organizations are now required to publicly disclose any embezzlement or theft that exceeds \$250,000, 5% of the organization's gross receipts, or 5% of its total assets.

Additionally, in light of the disturbing numbers reported by the *Washington Post*, both Congress and numerous state attorneys general have pledged to launch investigations. This will inevitably lead to even greater scrutiny.

This newly found focus on fraud and embezzlement strikes at the heart of an organization's ability to raise funds and affect its mission. As one nonprofit official quoted by the *Washington Post* explained, "[p]eople give their money and expect integrity. And when the integrity goes out the window, it just hurts everybody. It hurts the community, it hurts the organization, everything. It's just tragic."

Nonprofits are not defenseless, however, and there are several proactive steps organizations can and should take immediately (if they are not doing so already) to prevent and detect employee fraud and embezzlement:

Double Signatures, Authorizations and Back-up Documentation

Multiple layers of approval will make it far more difficult for embezzlers to steal from the organization. For expenditures over a predetermined amount, require two signatories on every check and two different signatories on every authorization or payment. Where the professional staff of a nonprofit is too small to effectively implement a double signatory/authorization policy, consider having a (volunteer) officer or director be the second signatory. Similarly, all check requests and requests for cash disbursements should be accompanied by an invoice or other document showing that the payment or disbursement is appropriate. Never pre-sign checks. With credit cards, require prior written approval, again from two individuals, for costs estimated to exceed a certain amount. Require back-up documentation demonstrating the *bona fides* of the expense. And again, the person using the card should not be the same person authorizing its use.

Segregation of Duties

Hand-in-hand with multiple authorizations goes the segregation of duties. At a minimum, different employees should be responsible for authorizing payments, disbursing funds, and reconciling bank statements and reviewing credit card statements. If the nonprofit does not have enough professional staff to effectively segregate duties, a (volunteer) officer or director should be tasked with reconciling the bank statements and reviewing credit card statements. Because embezzlement also can occur when funds are coming into an organization, no single individual should be responsible for receiving, depositing, recording, and reconciling the receipt of funds. By the same token, all contracts should be approved by a manager uninvolved and personally uninterested in the transaction and, wherever possible, larger contracts should be the product of competitive and transparent bidding.

Fixed Asset Inventories

At least annually, the organization should perform a fixed asset inventory to ensure that no equipment or other goods are missing.

Automated Controls

Use electronic notifications to alert more than one senior member of the organization of bank account activity, balance thresholds, positive pay exceptions, and wire notifications.

Background Checks

Background checks on new employees and volunteer leaders can unearth things such as undisclosed criminal records, prior instances of fraud, and heavy debt loads that can make it more likely that an employee or volunteer leader might succumb to fraud. The Association of Certified Fraud Examiners reports that 6% of embezzlers have been convicted of a previous fraud-related offense.

Audits and Board-Level Oversight

The control measures discussed above only work if someone is checking. In addition to management, who should be ensuring that the measures discussed above are followed, nonprofits also should undertake regular external audits to ensure that these measures are effective. Organizations should establish audit committees on their boards of directors, containing at least one person familiar with finance and accounting, who would serve as the primary monitor of these anti-fraud measures. In lieu of an audit committee, smaller nonprofit organizations should consider putting a CPA or other financially knowledgeable person on the board of directors to serve a similar function.

Encourage Whistleblowers

While nonprofits should encourage the reporting of suspected wrongdoing to management or a designated board member, employees must have a means of anonymous communication if they do not feel comfortable reporting to their supervisor or management. Employees may not report theft or mismanagement if they believe that their job is in jeopardy. The board of directors must ensure that these reports are taken seriously, that the reporting employee is protected, and that outside legal counsel is brought in as appropriate.

Strong Compliance Program

The best way to prevent fraud and embezzlement and to protect nonprofits is a comprehensive and vigorous compliance program that must be more than a "mere paper program." An effective compliance program must be tailored to the specific organization, include a written code of ethics, be effectively implemented through periodic training, have real consequences for violations of the policy, have an effective reporting mechanism, and be periodically audited to ensure its effectiveness.

Self-Audits

Bringing in outside expertise – such as CPAs experienced in conducting fraud audits (different from the standard annual financial statement audit) and attorneys experienced in evaluating and enhancing internal controls as well as training staff on best practices – can be a critical tool in both identifying fraud and embezzlement that may be occurring and in shoring up weak controls and other process deficiencies that may make the organization more susceptible to theft.

While there will always be instances where a determined thief manages to beat an organization's controls, the steps suggested above will go a long way toward deterring and preventing embezzlement and other types of fraud at nonprofit organizations.

* * * * *

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This article is not intended to provide legal advice or opinion and should not be relied on as such. Legal advice can only be provided in response to a specific fact situation.

are you exposed to corruption risk?

FREQUENTLY ASKED QUESTIONS & ANSWERS ABOUT THE FOREIGN CORRUPT PRACTICES ACT

Q 1. WHAT IS THE FOREIGN CORRUPT PRACTICES ACT (“FCPA”)?

Congress enacted the FCPA in 1977 to bring a halt to the rampant bribery of foreign government officials. The FCPA has two main areas of focus:

- **Anti-Bribery Provisions:** Prohibits the offering or paying of a bribe or anything else of value to a foreign government official or political party official in order to obtain or retain business or secure any improper advantage.
- **Books and Records Provisions:** Requires companies that trade on U.S. exchanges to make and keep accurate books, records, and accounts of all payments, and to devise and maintain reasonable internal accounting controls for preventing and detecting FCPA violations.

Q 2. DOES THE FCPA APPLY TO ME?

The FCPA applies to U.S. companies conducting business abroad, most foreign subsidiaries of U.S. companies, and U.S. subsidiaries of foreign companies. Even non-U.S. companies with securities that trade on U.S. exchanges are subject to the FCPA. The FCPA also applies to all U.S. citizens and any resident aliens. Even if none of the above applies, most any U.S. nexus to a corrupt payment, such as an e-mail or phone call to the U.S., or even a dollar-denominated banking transaction, may be enough to confer jurisdiction.

The scope of the anti-bribery provisions of the FCPA is broad. What many would consider normal business entertainment or accommodations may run afoul of the statute. Furthermore, the acts of independent sales representatives, consultants, other agents, joint venture partners and the like that violate the FCPA will likely be attributed to any company that falls under the statute’s jurisdiction. And, companies acquiring another company, even minority positions, are expected to perform specific FCPA due diligence or face potential liability. In a very real sense, you can buy another company’s FCPA problem.

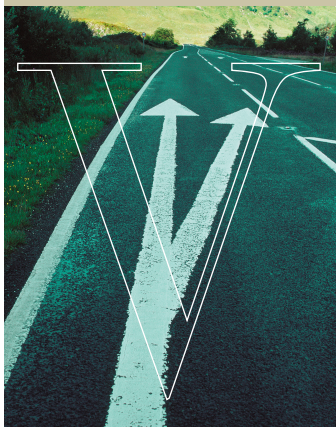
Q 3. WHY SHOULD I BE CONCERNED?

Over the last several years, there has been a dramatic increase in FCPA enforcement activity. Since 2005, the U.S. Department of Justice (“DOJ”) and the Securities and Exchange Commission (“SEC”) have brought more than 250 enforcement actions against corporations and individuals—more than the total number of enforcement actions brought between the FCPA’s enactment in 1977 and 2004. In 2010 and 2011, DOJ and the SEC reached record-high enforcement numbers. In a prolific 2010, DOJ brought 38 new actions and the SEC brought 26. Total monetary penalties collected in 2010 exceeded \$1.7 billion, a record high. While the number of new enforcement actions was lower in 2011, it was still the second highest year on record. In 2012, enforcement activity lagged somewhat, with DOJ bringing only 13 enforcement actions, and the SEC bringing only 12. Total monetary penalties in 2012 were over \$260 million. Despite these decreases, however, there is no reason to think that DOJ and the SEC are losing their zeal for enforcement. Rather, it is likely that DOJ and the SEC are juggling the approximately 150 open investigations and were distracted by the drafting of their comprehensive FCPA Resource Guide, which was released in November 2012, as well as several trials.

The number of individuals being criminally charged has steadily increased since 2005. Ten were charged in 2010, and eight were charged in 2011. Significant prison sentences have been imposed in many cases. In 2011, the longest prison term in FCPA history—15 years—was handed down. In 2012, the average prison sentence was just over 23 months.

There has also been an intentional increase in the number of enforcement actions against non-U.S. corporations, which amounted to roughly half of the corporate actions settled in both 2010 and 2011.

DOJ and the SEC have recently increased the number of attorneys and investigators dedicated to FCPA enforcement, with their targets set on industries such as defense, logistics, engineering and construction, technology/telecommunications, tobacco, and health care and “life sciences.” Further, the whistleblower provisions of the 2010 Dodd-Frank Act provide large monetary incentives for individuals to report suspected FCPA violations by public companies. And, internationally, the United Kingdom, with its Bribery Act going into effect in July 2011, and several other countries have jumped firmly into the arena of international anti-corruption enforcement.



FOR MORE INFORMATION ABOUT THE FCPA, CONTACT US TODAY.

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Q 4. WHAT SHOULD I BE LOOKING FOR?

The issues below do not automatically mean there is an FCPA problem, but they do indicate areas of heightened concern that need to be examined closely.

- The transaction is in, or involves, a country known for corrupt payments, such as China, India, Russia, Iraq, Afghanistan, and Nigeria;
- Government officials or their relatives are being entertained;
- Unusual contract terms or payment arrangements, such as requests for payment in cash, bearer instruments, or “upfront payments”;
- The use of shell or holding companies;
- Your sales representative or agent is requesting an unusually high commission or fee;
- The customer’s insistence on the use of a particular agent; and/or
- When the role or function of an agent, consultant, or middleman is not clear.

Q 5. WHAT CAN I DO TO PROTECT MY ORGANIZATION?

Implement a comprehensive and vigorous compliance program. Corporations can be found criminally or civilly liable through the acts of an employee or agent, even if that person is acting against company policy. Because any corporation may find itself with a rogue employee or agent, the most effective way for a corporation to avoid or mitigate liability is through a comprehensive and vigorous compliance program, a fact demonstrated by DOJ’s and the SEC’s very public declination of prosecution/enforcement against Morgan Stanley in 2012. Accordingly, any corporation that conducts business abroad, or with non-U.S. governmental entities, should input an FCPA-specific compliance module into its compliance program for both its U.S. and non-U.S. operations.

An effective compliance program is far more than policies in a binder. Effective controls must be designed and maintained. The organization must track, vet, and appropriately monitor such things as promotional accounts, charitable giving, entertainment expenses, and the use of and payments to middlemen, consultants, agents, and distributors. All relevant managers, employees, and agents, such as independent sales representatives, must receive regular training. Contracts and other agreements, where appropriate, should contain FCPA clauses and certifications. Periodic FCPA audits must be conducted, and any violations of the policy or the law should be dealt with appropriately. Finally, a senior manager should have direct responsibility over the program.

Q 6. WHAT SHOULD I DO IF A POTENTIAL FCPA VIOLATION SURFACES?

An organization’s response must be swift. Retain counsel, stop the conduct in question, preserve all electronic data, ensure that no hard copies of documents are destroyed, and conduct a thorough inquiry. If you discover the potential violation before the government does, you must consider the benefits of voluntary disclosure. While the FCPA does not mandate disclosure of violations, voluntary disclosures frequently enable the corporation to either avoid prosecution or obtain significant mitigation of civil and criminal penalties. Before a corporation self-reports, however, it is crucial that you seek advice of counsel expert in the FCPA.

Venable’s FCPA, SEC/White-Collar Defense and International Trade practices combine our knowledge in white collar crime and high-stakes litigation with an in-depth understanding of, and experience with, the regulatory and business issues facing corporations engaged in international trade. We provide clients with an aggressive, coordinated approach focused on preventing regulatory inquiries from becoming criminal matters, avoiding prosecution and reaching as quick a resolution as practicable. For matters of foreign law that might impact our international investigations, Venable maintains long-established relationships with attorneys throughout the world to assist us.



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Preventing and Investigating Fraud, Embezzlement, and Charitable Asset Diversion: What's a Nonprofit Board to Do?



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Preventing and Investigating Fraud, Embezzlement, and Charitable Asset Diversion: What's a Nonprofit Board to Do?

D) **Increasing Scrutiny of Fraud, Embezzlement, and Charitable Asset Diversion in the Nonprofit Sector**

A) The *Washington Post's* Investigation, "Inside the Hidden World of Thefts, Scams and Phantom Purchases at the Nation's Nonprofits"

On October 26, 2013, the *Washington Post* reported that from 2008 through 2012, over 1,000 nonprofit organizations disclosed hundreds of millions of dollars in losses attributed to theft, fraud, embezzlement, and other unauthorized uses of funds and organizational assets. According to a study cited by the *Post*, nonprofits and religious organizations suffer one-sixth of all major embezzlements, second only to the financial services industry.

While the numbers are shocking, the reasons nonprofits can be susceptible to fraud and embezzlement are easy to surmise. Many begin as under-resourced volunteer-run organizations with a focus on mission rather than strong administrative practices. As agencies established for public benefit, nonprofits assume that the people who work for them, especially senior management, share their philanthropic goals. Nonprofits often are more trusting of employees, and frequently have less stringent financial controls than their for-profit counterparts.

Unfortunately, nonprofit employees are as vulnerable as anyone else to economic distress, including personal financial difficulties, overspending, and even gambling and other addictive behaviors. Nonprofit employees who engage in fraud often rationalize their unlawful conduct. Such rationalizations can include perceived injustices in compensation or treatment compared to their peers at for-profit enterprises; unhappiness over denied promotions, requested raises, or the absence of similar benefits; and that the employees are "borrowing" from the organization with the plan to fully return the money to the organization at a later date. In addition, high-level employees at nonprofit organizations and their close associates have significant access to the organization's funds and financial records, causing them to believe not only that they can commit the fraud and embezzlement but also that they can successfully conceal their conduct from outside scrutiny.

Examples are easy to find. Only last week, a former executive director of a nonprofit symphony was arraigned in Northern California on charges of embezzlement, grand theft, forgery, identity theft and tax evasion following the discovery of a loss of \$500,000 – an amount comprising nearly all of the

organization's operating funds and endowment. The executive director was accused of siphoning off money from the nonprofit's accounts beginning shortly after he was hired in 2010. He allegedly wrote numerous checks to himself, including duplicate payroll checks, using some of the money to pay his credit card debts. He also was suspected of taking out an unauthorized \$25,000 loan on behalf of the symphony and forging the signature of two board members on several of the checks. At the time, the board didn't have controls in place to monitor the accounts. "We very much trusted him," the board chair is reported to have said.¹

Many nonprofits try to handle instances of fraud or embezzlement quietly to avoid unwanted attention and embarrassment. That is no longer an option for 501(c)(3) organizations that file Form 990 information returns. In 2008, the Internal Revenue Service implemented additional regulations designed to enable the public to more easily evaluate how effectively larger nonprofits manage their money. Tax-exempt organizations with gross receipts greater than or equal to \$200,000, or whose assets are greater than or equal to \$500,000, must report "any unauthorized conversion or use of the organization's assets other than for the organization's authorized purposes, including but not limited to embezzlement or theft." Specifically, these organizations are now required to publicly disclose any embezzlement or theft that exceeds \$250,000, 5% of the organization's gross receipts, or 5% of its total assets.²

Charitable asset diversion in any amount, regardless of whether reportable on Form 990, is serious. Embezzlement in particular can damage donor trust and agency reputation, undermining a nonprofit's good work. In extreme cases, it can lead to the revocation of tax exempt status and even personal liability for directors.

B) The Regulatory Backdrop

In California, oversight of nonprofit activities falls under the jurisdiction of the California Attorney General, who is authorized to protect charitable assets for their intended use and ensure that the charitable donations are not misapplied and squandered through fraud or other means. Under the authority to protect charitable assets, the California Attorney General requires all registered charities to annually report whether they have experienced theft, embezzlement, diversion or misuse of the organization's charitable property or funds in any amount in the past year. State prosecutors may elect to bring charges under California Penal Code Section 503-515, which defines embezzlement as "the fraudulent appropriation of property by a person to whom it has been entrusted."

Most California nonprofits that receive charitable assets must register with the Attorney General through the Registry of Charitable Trusts. The IRS and Franchise Tax Board have co-extensive jurisdiction over California nonprofit organizations that have been granted tax exempt status under federal and California law, respectively, and can levy penalties or excise taxes, or revoke tax exempt status altogether where a significant diversion of assets is involved.

If the nonprofit receives federal funding, it may face scrutiny by the granting agency's Office of Inspector General (OIG). Besides performing traditional audit work, the OIGs—and sometimes, the FBI—work hand-in-hand with federal prosecutors at the Department of Justice in Washington, DC, and the U.S. Attorneys' Offices across the country, to investigate fraud and embezzlement at nonprofit organizations. Federal prosecutors may elect to bring charges under, among other applicable federal statutes, 18 U.S.C. § 641, which makes it a crime to steal money from the United States or any department or agency thereof, and 18 U.S.C. § 1341, which makes it a crime to devise a scheme to defraud another of property or money with the use of interstate wire communications.

C) The Role of the Board of Directors

Instances of fraud and embezzlement strike at the heart of an organization's ability to raise funds and affect its mission. As one nonprofit official quoted by the *Washington Post* explained, "[p]eople give their money and expect integrity. And when the integrity goes out the window, it just hurts everybody. It hurts the community, it hurts the organization, everything. It's just tragic." Directors of nonprofit corporations are charged with the important responsibilities of conducting and overseeing the management of the corporation's affairs. While the day-to-day

[1] "Former Peninsula Symphony director jailed on embezzlement charges," San Jose Mercury News, March 4, 2014.

[2] In addition, asset diversions (in any amount) by a charity's insider—including, but not limited to, a charity's founders, members of its governing body, officers, senior employees, persons with financial oversight responsibilities or anyone in a position to exert significant influence on the charity—must also be reported. Called "excess benefit transactions," these sorts of charitable asset diversions occur whenever such insiders (or, as referred to by the IRS, "disqualified persons") receive some kind of economic benefit from the nonprofit organization that exceeds the value of the benefit they provide to the organization. The Internal Revenue Code Regulations state in Section 53.4968-4(c) that "in no event shall an economic benefit that a disqualified person obtains by theft or fraud be treated as consideration for the performance of services." Thus, embezzlement by a disqualified person is an automatic excess benefit transaction—and as such, it must be reported.

operations of a nonprofit can be and often are delegated to staff, the directors maintain the ultimate authority over all corporate activities.

State law and judicial decisions impose upon directors the fiduciary duties of care and loyalty regarding the corporations they serve. In California, these duties are detailed in Section 5231(a) of the Corporations Code:

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.

A nonprofit director who observes the duties of care and loyalty is generally insulated from personal liability. However, the board's actions must be taken in good faith with that diligence, care and skill which an ordinary prudent person would exercise under similar circumstances.

II) Prophylactic Measures to Prevent and Detect Employee Fraud and Embezzlement

Nonprofits are not defenseless against charitable asset diversion. There are several proactive steps organizations can and should take to prevent and detect fraud and embezzlement, and the board should develop a policy of internal controls appropriate for the organization. Below are common internal control practices that can be modified for nonprofit organizations of various complexities and sizes. Most can apply to nonprofit volunteers as well as employees.

Double Signatures, Authorizations and Back-Up Documentation

Multiple layers of approval will make it far more difficult for embezzlers to steal from the organization. For expenditures over a predetermined amount, require two signatories on every check and two different signatories on every authorization or payment. Where the professional staff of a nonprofit is too small to implement a double signatory/authorization policy, consider having a volunteer officer or director be the second signatory. Similarly, all check requests and requests for cash disbursements should be accompanied by an invoice or other document showing that the payment or disbursement is appropriate. Never pre-sign checks. Where possible, it would be preferable for an administrative assistant to bring the checks to the two signatories for signing, so there is an intermediary employee serving as a buffer between the signatories. With credit cards, require prior written approval, again from two individuals, for costs estimated to exceed a certain amount. Require back-up documentation demonstrating the bona fides of the expense. And again, the person using the card should not be the same person authorizing its use.

Segregation of Duties

Hand-in-hand with multiple authorizations goes the segregation of duties. At a minimum, different employees should prepare payment records, authorizing payments, disbursing funds, and reconciling bank statements and reviewing credit card statements. If the nonprofit does not have enough paid staff to segregate duties, a volunteer officer or director should be tasked with reconciling the bank statements and reviewing credit card statements. Because embezzlement also can occur when funds are coming into an organization, no single individual should receive, deposit, record, and reconcile the receipt of funds. By the same token, all contracts should be approved by a manager uninvolved and personally uninterested in the transaction and, wherever possible, larger contracts should be the product of competitive and transparent bidding.

Fixed Asset Inventories

At least annually, the organization should perform a fixed asset inventory to ensure that no equipment or other goods are missing.

Automated Controls

Use electronic notifications to alert more than one senior member of the organization of bank account activity, balance thresholds, positive pay exceptions, and wire notifications.

Background and Credit Checks

Background checks on new employees and volunteer leaders can unearth things such as undisclosed criminal records, prior instances of fraud, and heavy debt loads that can make it more likely that an employee or volunteer leader might succumb to fraud. Note, however, that California law prohibits employers and prospective employers from using consumer credit reports to screen applicants or to make other employment decisions, unless the employee or prospective employee falls within an excepted position. Excepted positions include managerial positions exempt from overtime, positions in which the person is or would be a named signatory on the employer's bank account, or authorized to enter into financial contracts on the employer's behalf and positions that involve regular access to sensitive information or large amounts of cash.

Audits and Board-Level Oversight

The control measures discussed above only work if someone is checking. Besides management, who should ensure that the measures discussed above are followed, nonprofits also should undertake regular external audits to ensure these measures are effective. Organizations should establish audit committees on their boards of directors, containing at least one person familiar with finance and accounting who would serve as the primary monitor of these anti-fraud measures. In lieu of an audit committee, smaller nonprofit organizations should put a CPA or other financially knowledgeable person on the board of directors to serve a similar function.

Encourage Whistleblowers

While nonprofits should encourage the reporting of suspected wrongdoing to management or a designated board member, employees (and volunteers) must have a means of anonymous communication if they do not feel comfortable reporting to their supervisor or management. Employees may not report theft or mismanagement if they believe that their job is in jeopardy. The board of directors must ensure these reports are taken seriously, that the reporting party is protected, and that outside legal counsel is brought in as appropriate. By adopting and implementing a whistleblower protocol, the board of directors can set a “tone at the top” to inspire confidence and ensure that employees and volunteers follow proper internal controls and protocols, including reporting troubling activities among the organization’s personnel. Public Counsel has prepared an annotated whistleblower policy that can be adapted for your organization’s use. It is accessible through a link in the Resources section at the end of this publication.

Strong Compliance Program

The best way to prevent fraud and embezzlement and to protect nonprofits is a comprehensive and vigorous compliance program that must be more than a “mere paper program.” An effective compliance program must be tailored to the organization, include a written code of ethics, be implemented through periodic training, have real consequences for violations of the policy, have an effective reporting mechanism, and be periodically audited to ensure its effectiveness. The organization’s commitment to ethical behavior should be clearly and concisely communicated to the board, management, and employees. This commitment to the code should be affirmed by all employees on a periodic and ongoing basis.

Communication with Donors

Being in conversation with donors regularly can also serve as an early warning system against embezzlement. Donors can tell an organization of any issues with donations that may not be obvious to management, such as checks being cashed but no record of them at the organization, or contributions from the donor not being appropriately acknowledged. In the case of an organization that receives federal or state grant funds, the board should review all correspondence between the nonprofit corporations and the funding agencies so the board is kept up-to-date on any of the grant agency’s concerns.

Self-Audits

Bringing in outside expertise—such as CPAs experienced in conducting fraud audits (different from the standard annual financial statement audit) and attorneys experienced in evaluating and enhancing internal controls and training staff on best practices—can be a critical tool in both identifying fraud and embezzlement that may occur and in shoring up weak controls and other process deficiencies that may make the organization more susceptible to theft.

Insurance Coverage

Various types of insurance can help to ensure that any stolen property or money can be replaced or repaid. Fidelity or “employee dishonesty” insurance protects a nonprofit from theft by “covered individuals” of property owned by it. Generally “covered individuals” will cover all of the insured’s employees, but not necessarily all of its volunteers. A separate endorsement may be required to protect against that risk. Depositor’s forgery coverage can also be a useful form of risk management. This insurance product covers theft of blank checks and credit cards and instances where checks are altered. In addition, some insurance policies may cover the cost of hiring outside counsel to investigate alleged fraud or embezzlement. A good insurance broker can help a nonprofit to navigate the choices.

While there will always be instances where a determined thief beats an organization’s internal controls, the steps suggested above will go a long way toward deterring and preventing embezzlement and other types of fraud at nonprofit organizations.

III. Guidance for Investigating and Reporting Employee Fraud and Embezzlement

A comprehensive plan of action to handle cases of suspected fraud or embezzlement is a tool that all nonprofit boards should have in place before it is ever (hopefully never) needed. Many regulatory reporting requirements must be addressed when charitable assets are stolen. To enable your organization to think through the issues that may arise in conducting an internal investigation and notifying regulators and stakeholders, consider the following case study involving a hypothetical California public benefit corporation:

SoLA Teens (SLT) is a California nonprofit public benefit corporation that is tax exempt under Section 501(c)(3) of the Internal Revenue Code and Section 23701(d) of the California Revenue and Taxation Code. SLT serves at-risk high school girls by providing tutoring and enrichment activities focused on a science, technology and mathematics curriculum. By leveraging the skills and enthusiasm of local college volunteers, the small paid staff of SLT has run a highly successful one-on-one after school program for 100 girls on an annual budget of \$75,000. Through relationships that the charismatic Program Director has cultivated with technology companies, SLT receives enough donated laptops so every participant who enters college will have a free new computer to take with her to school.

The Board Chair of SLT greatly admires the personal leadership and management abilities of the Program Director. She was shocked to receive a telephone call from an SLT administrative assistant who, in line with the organization’s whistleblower policy, wanted to express a confidential concern. He told the Board Chair that for some time he has been instructed by the Program Director to send donor thank you letters for many more gifts of computers and other equipment than SLT has ever received.

Not believing the Program Director could possibly be involved in wrong-doing, but recognizing the importance of honoring the whistleblower policy, the Board Chair called the Board into executive session to discuss how to proceed. The six other SLT directors were also skeptical that the Program Director could have been involved in any fraud. However, they realized that once they were alerted to this possibility, both the duty of care and the nonprofit’s whistleblower policy required them to investigate further.

The directors agreed that the investigation needed to be prompt, but also highly confidential. They were very concerned about how to maintain the good reputation of SLT, no matter what the outcome. They did not want to falsely accuse the Program Director if the administrative assistant was mistaken. They also needed to make sure that the administrative assistant not be retaliated against for having reported his concern.

The Board authorized the Board Chair to conduct a very preliminary investigation to try and corroborate the administrative assistant’s story before launching a more extensive inquiry. She quickly concluded that the laptops and other equipment referenced in the gift receipt acknowledgements provided to her by the administrative assistant had never been included in the monthly financial report of gifts-in-kind received by the Board, and were more expensive models than she had ever seen being used by SLT participants. She also confirmed these particular computers were not in the storage facility used by SLT to warehouse spare computer equipment. Now concerned that there might be merit to the administrative assistant’s concerns, the Board Chair decided that she needed to take steps to preserve evidence before confronting the Program Director. She also contacted a friend who is an employment attorney for advice.

The Board Chair, accompanied by a second Board member to corroborate the substance of the interview, confronted the Program Director with the suspicious gift receipts. The Program Director immediately

confessed, tearfully explaining that she has a gambling addiction, and that she stole the new laptops to pay off prior gambling debts. She swore that she was in a recovery program, that she would do nothing to hurt SLT or take resources away from the SLT participants; she simply solicited from a technology company that could afford to make the gift of more laptops than were needed. The Board Chair suspended the Program Director so that a full investigation could commence. She reconvened the Board to determine what to do next.

Preliminary Considerations

If a nonprofit board suspects embezzlement or other charitable asset diversion, investigate quickly and carefully. A thoughtful investigation is the first step the board should take to discharge its fiduciary responsibility to protect charitable assets, and to help insulate its members from any claim of personal liability for the loss.³

The primary standards of conduct upon which the investigation should be built are the duties of care and loyalty. To satisfy these duties in conducting an investigation, a director should: (i) exercise independent and informed judgment; (ii) judge what is in the corporation's best interest, irrespective of other entities with which the director is affiliated or sympathetic, or to which the director owes his board appointment; and (iii) have adequate information and assure the adequacy and clarity of information.

For the sake of confidentiality, the board may initially choose a small sub-committee or an individual to conduct the inquiry. Depending on the sensitive nature of the investigation, the board may elect to retain the services of an attorney or auditor with experience handling such investigations. The duty of care permits a director to rely on information, opinions, reports or statements, including financial statements, prepared or presented by others whom the director believes to be reliable and competent in the matters presented.

In determining whether to retain outside counsel, the board should evaluate the following considerations at the outset of the investigation to ensure that the matter is handled fairly, impartially, and consistent with personnel policies:

- whether anyone on the board has sufficient investigative skill and experience to lead the inquiry;
- the likelihood that employees with first-hand knowledge of the alleged fraud or embezzlement will be honest and forthright with board members;
- the relative scale of the suspected misconduct, and the management level of the person(s) implicated;
- the board members' relationship and personal history with the subject and whistleblower (the investigator should never be the subject's supervisor);
- whether the nonprofit's insurance policy will cover the costs of the internal investigation;⁴
- whether it may be important to rely on the attorney-client privilege to protect from subsequent disclosure to private third parties or the government in the event of a future investigation or litigation; and
- if insurance coverage is not available, the availability of other nonprofit resources to pay for outside investigative expertise.

If the embezzlement scheme has been sophisticated or longstanding, the nonprofit may require a forensic accountant or certified fraud examiner to determine how much has been stolen.

[3] Given the facts of the case study, where the possible wrong-doer is the senior-most member of management, the board (as opposed to management) by necessity needs to take the lead in directing the investigation. Under different facts, senior nonprofit management may be the first to discover possible financial fraud perpetrated by a lower level employee. In that situation, the nonprofit's executive director or senior HR manager may be the initiator of the investigation, as would be the case in other matters of employee misconduct. Nevertheless, the board should be kept fully informed so that it can appropriately discharge its fiduciary responsibilities.

[4] If the nonprofit's insurance policy provides coverage, prompt notice to the insurer may be needed. It is possible that the insurer will provide advice about preparing for, or elect to participate in, the investigation. The insurance company may require the organization to file a police report in connection with an insurance claim.

Employment Law Considerations

If the preliminary investigation establishes credible evidence of embezzlement involving a current employee, then the nonprofit should consider consulting with employment counsel. While the facts as then known may seem to constitute grounds for immediate termination of employment, the most prudent employer response could depend on the particular offense, state employment law, the nonprofit's employment policies and any relevant employment agreement. Under California law, employment-related investigations must be prompt, thorough, and fair to those being investigated. An employee being accused of misconduct should always be confronted with the allegations and given a fair opportunity to present his or her side of the story.

Secure Relevant Records and Files

After determining that the allegations merit a full internal investigation, the board should try to preserve evidence and maintain relevant records including emails, handwritten notes, files, calendar entries, checks, financial statements, and related documents. The board should circulate a "litigation hold" notice requesting persons with access to relevant documents and information maintain such materials and provide copies to the board. The board should consider restricting the employee's access to the organization's computer network and other books and records. Other security measures may also be necessary, including, but not limited to, changing passcodes, locks, and bank account signatories. The organization should exercise caution to ensure these steps are taken in accordance with the organization's policies and bylaws.

Interviewing the Suspect and "Witnesses"

After discussing the initial allegations, gathering relevant information that is immediately available, and reviewing the board's preliminary findings, a senior member of the organization or retained outside counsel should take the lead on interviewing the suspect. **As part of the interview process, the interviewer should not promise confidentiality or make any such assurances to the subject.** A second person should accompany the lead investigator to the interview. This person should take notes during the interview if such activity would not be disruptive. It is imperative that the interviewers memorialize the suspect's statement in a formal memorandum or legible notes. Such notes and/or memorandum should record both inculpatory and exculpatory statements. A similar level of care should be taken when interviewing employees who have first-hand knowledge of the unlawful conduct. Notes and/or memos of the interviews will become critical sources of information in subsequent litigation and/or a government investigation. The board should consider placing the suspected embezzler on a leave of absence immediately after the interview.

Recovery of Funds or Assets

A nonprofit board has a fiduciary obligation to attempt to recover embezzled assets and will be expected to explain the efforts it took to do so in the reports it must make to the Attorney General and the IRS, described below. As discussed, some nonprofit organizations anticipate the risk of insider theft and obtain fidelity or crime insurance. If no insurance is available to compensate the nonprofit for what was stolen, the organization must weigh the benefits and drawbacks of litigation to collect the debt from a possibly judgment-proof (i.e., financially insolvent) defendant. Private resignation/restitution arrangements can be negotiated, but this should be undertaken with the assistance of an attorney and fully documented under a settlement agreement and payment plan. **Nonprofits should never threaten criminal prosecution as a negotiation tactic. Such threats could be construed as a type of extortion, which in and of itself is a crime.** The nonprofit should consult with employment counsel before attempting to recover any funds from the embezzler's final paycheck, vacation time, etc.

Referral to Law Enforcement Authorities

In the case of embezzlement, the California Attorney General has taken the position that the duties of care and loyalty require nonprofit directors to take reasonable steps to recover stolen assets and to refer the matter to the local District Attorney for possible criminal prosecution. Many nonprofit agencies struggle with this expectation. They fear bad publicity. They feel sorry for the embezzler. They will accept restitution and keep the fraud quiet hoping they will not lose funders. While such a choice may seem to be in the best interest of the charity, it must be acknowledged that failure to prosecute allows the perpetrator an opportunity to be re-employed and steal from other organizations. If the nonprofit corporation receives funding from state and/or federal agencies, the organization must present their findings to the grant agency's OIG and try to ensure that the incident does not disrupt the organization's current funding or plans for grant renewal. A prompt and thorough investigation and disclosure concerning employee misconduct will inspire confidence in the grant agency and minimize potential funding problems for the organization.

Public and Internal Disclosure

One of the most challenging aspects of dealing with embezzlement (or any other crisis) is determining how much to disclose and to whom. A nonprofit organization depends on the public perception that it is a good steward of charitable donations. An incident like embezzlement, particularly if involving top leadership, calls its reputation and the reputation of its management and board into question.

The organization must identify its spokesperson and develop a communication plan to assure its key stakeholders of its plans to recover the assets stolen and the steps it will take to prevent such a crime from recurring again. The specific contents of any public disclosure must be carefully considered, however, because a public accusation linking a specific employee to the theft, if proven false, could lead to a defamation action. To quash the inevitable water-cooler rumors, affected staff must be notified early on, although only with “need to know” details until the investigation is concluded. If there is to be a dismissal or litigation, the nonprofit should consider informing major funders privately before the news is made public.

Even if litigation or public media disclosure of the incident is unlikely, the organization must still evaluate the possible impact of publicly available reports of the incident to regulators. A well-prepared nonprofit should have a general crisis communication plan prepared in advance to deal with any number of unexpected events.

Federal Reporting Requirements

Every 501(c)(3) tax exempt organization must file annually a series 990 information return with the IRS. Small organizations with annual gross receipts normally of \$50,000 or less are eligible to file a 990-N e-Postcard, which reports only basic contact and operational status information. Organizations that normally have less than \$200,000 of gross receipts and less than \$500,000 of total assets can file a simplified return, the 990-EZ. Larger organizations must file the longer and more complex Form 990 return.

The type of Form 990 return a nonprofit organization files determines whether it must publicly report a significant asset diversion or excess benefit transaction (discussed above). A nonprofit filing the Form 990 return is asked in Part VI, Section A.1.a whether it has become aware during the year of a material diversion of its assets, regardless of whether the loss actually occurred during the tax year. If so, the nonprofit must explain the nature of the diversion, the amounts or property involved, the corrective actions taken to address the matter and any other pertinent circumstances. If the diversion constituted private inurement or an excess benefit transaction, this must be disclosed in the relevant schedule of the form.

An organization that files a 990-EZ is only required to report an excess benefit transaction, but not a significant diversion of assets. An organization that files a 990-N e-Postcard is not required to report either excess benefit transactions or charitable asset diversions on that form. However, any nonprofit organization can independently report embezzlement to the IRS on Form 3949-A. This form is used for reporting suspected tax fraud, and an organization filing this form provides the contact information and details of the embezzler. This reporting is voluntary.

Avoiding Federal Penalties

As discussed above, when the suspected embezzler is also a “disqualified person,” the risk to the organization and its directors of IRS intervention and penalties increases. Under section 4958 of the Internal Revenue Code, if a 501(c)(3) tax-exempt organization provides an excess benefit, **the insider who receives the excess benefit is subject to excise taxes, as are any organization managers—including officers and directors—who approved the excess benefit.** With an automatic excess benefit transaction like embezzlement, where there was no literal approval of the action, directors are not likely to be personally subject to the excise tax (unless, of course, one or more were knowing participants in the scheme). Nevertheless, the board must still be vigilant in their plans to explain and rectify the fraud.

The cost of receiving an excess benefit is severe. In all cases, the excess benefit must be corrected by the disqualified person by making a payment in cash or cash equivalents, excluding payment by a promissory note, equal to the correction amount. The correction amount is the sum of the excess benefit, plus interest on the excess benefit at a rate that equals or exceeds the applicable Federal rate, compounded annually.

In addition, the disqualified person will be taxed 25% of the excess benefit. The IRS will deliver a notice of deficiency, outlining the penalties imposed. If the correction is not made to the organization by the due date in the notice, an additional tax of 200% of the excess benefit will be imposed on the disqualified person.

There is no tax or penalty imposed on a nonprofit that was the victim of an excess benefit transaction. However, a tax equal to 10% (up to \$20,000 per transaction) of the excess benefit may also be imposed on each organization manager who participated in the transaction, knowing it was an excess benefit transaction, unless the participation is not willful and is due to reasonable cause. The \$20,000 is an aggregate figure; all organization managers participating in the transaction are jointly and severally liable.

While the Form 990 or 990-EZ report can alert the IRS and the public that an excess benefit transaction has occurred, these are not the only filings that are used to report such transactions. Form 4720 is a separate annual filing that must be made by disqualified persons or managers who owe the taxes described above. Though Form 4720 is not a filing required of the victim organization, some tax practitioners have suggested that it could be used by nonprofits, including very small agencies that file 990-N e-postcards, to try to trigger an IRS collection action against a fraud perpetrator who has not tried to repay embezzled funds.

California Reporting Requirements

In California, any theft, embezzlement, diversion or misuse of a nonprofit organization's charitable property or funds, regardless of the amount of the loss, must be reported on Form RRF-1, the annual filing with the California Attorney General. If any of these incidents have occurred, the organization must report the nature, date, and amount of the loss; a description of steps taken to recover the loss and a copy of any police or insurance report; and a description of steps implemented to prevent such a loss from recurring.

ADDITIONAL RESOURCES

California Attorney General – *Guide for Charities* (includes a discussion about financial management, internal controls and how to respond to embezzlement)

http://oag.ca.gov/sites/all/files/agweb/pdfs/charities/publications/guide_for_charities.pdf

Public Counsel - *Risk Management and Insurance Guide for Nonprofits*

www.publiccounsel.org/publications?id=0190

Public Counsel – *Annotated Form of Whistleblower Policy*

www.publiccounsel.org/publications?id=0063

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Piercing the Corporate Veil

by Marion A. Hecht, CIRA, CP AICFF, CFE, MBA



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Piercing the Corporate Veil

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Incorporation is the bedrock of the modern business enterprise – and one way of structuring an organization so that owners and executives could be appropriately protected from the business risks associated with its operation. The corporate structure could protect the business owners and senior executive team from the risk of losing personal assets that may result as a consequence of actions by the business corporation. It allows the business to obtain financing for expansion or operations on the strength of its own balance sheet without encumbering the personal finances of the owners or the executives. And, under normal circumstances, it protects them as well from personal exposure in the event a tort or other claim results in a judgment of liability against the business enterprise.

In some instances, however, aggressive litigators may be able to reach beyond the four corners of the corporation - “piercing the corporate veil” as it is commonly known - as a means of attempting to impose liability in an underlying cause of action, such as a tort or breach of contract, directly on the personal assets of the shareholders, directors, senior executives, or dominant controlling persons. When a litigator can, to the satisfaction of the court, demonstrate that in some way the operations of the business and those of the owner or senior executives are so inextricably intertwined that they cannot be separated, then that corporate protection may dissolve, subjecting the personal assets of the shareholders or executives to exposure.

RISKS TO THE CORPORATE VEIL

It should be no surprise that during turbulent economic times, there may be increased attempts to pierce the corporate veil. This claim, if proved, could permit a court to set aside the corporate separate identity and hold an individual or corporate shareholder responsible. Research conducted in 2010 suggests that, among US corporate litigated matters, whether to pierce the corporate veil is among the most frequent issues¹. Questions about the legitimacy of the corporate veil arise in several broad contexts. If the corporation has piled up a significant backlog of unpaid bills with little hope of relief in sight, creditors’ advocates may seek to recover their losses by attempting to hold shareholders or executives personally responsible for at least some of the debt. Similarly, federal or state tax collectors, faced with a significant unpaid corporate tax liability, may consider whether there is evidence to hold those same individuals responsible for covering what is owed. In either case, the attempt to pierce the veil can occur whether or not the corporation has sought to restructure its debt in bankruptcy court.

1 McPherson, Richmond & Raja, Nader (2010), “Corporate Justice: An Empirical Study of Piercing Rates and Factors Courts Consider When Piercing the Corporate Veil”, *Wake Forest Law Review* 45: 931-969.

McPherson & Raja quote, and follow up on the research reported in what they identify as “the foundational empirical study” on the subject of corporate-veil piercing. That study is:

Thompson, Robert B. (1991), “Piercing the Corporate Veil: An Empirical Study”, *Cornell Law Review* 76: 1036-1074

Inadequate capitalization by itself might not prompt a ruling for piercing the veil², but may give rise to such if it is accompanied by other circumstances, such as failure to properly protect the company for well-known risks. This is especially so when the failure to capitalize the entity points to an underlying question of bad faith on the part of the business executives. A 2005 Illinois decision is instructive. A couple who hired a contracting firm for close to \$1.5 million to build their home sued the company after numerous alleged defects that culminated in failure to complete the project; the uninhabitable home was later razed. They also sued the firm’s president. On paper, the president’s wife was the sole shareholder of the company. However, the lower court found, and an appellate court affirmed in 2005, that the company had never been capitalized at all. The lower court judge ruled that the president of the business was “the dominant force behind this corporation, that the corporation is little more than a shell which was established to shield him from liability.”³ The president was held personally liable for the judgment.⁴

A significant tort judgment against a company - for instance from a claim of defective product manufacture or professional errors, omissions or malpractice in the case of a professional service firm - may also lead to an attempt to pierce the veil, if the circumstances lead a plaintiff’s attorney to suspect that the company has wrongly sequestered assets into private hands to avoid paying just compensation. And finally and most seriously, an allegation of fraud on the part of the company, with the attendant demand for restitution, fines or both upon judicial determination, provides a strong motivation for parties to reach beyond the corporate structure and seek judicial assignment of liability directly to the individuals who own and/or operate the business.

None of these circumstances - massive debt to creditors or taxing institutions, tort liability, or fraud - by themselves may result in a judicial determination of dissolution of the protections that incorporation provides. All of them, however, have the potential of bringing the corporate veil into question, risking a judgment that owners or executives may be essentially “alter egos” of the corporation and subject to personal liability.

PRESERVING THE VEIL

Long before such a risk even presents itself, the well-managed corporation should take affirmative steps to protect its shareholders and executives from such a judgment by putting into place the necessary safeguards to ensure the appropriate separation between the organization and the individuals who own

2 McPherson, Richmond & Raja, Nader (2010), “Corporate Justice: An Empirical Study of Piercing Rates and Factors Courts Consider When Piercing the Corporate Veil”, *Wake Forest Law Review* 45: 931-969. p. 963

3 Fontana v. TLD Builders, No. 01-MR-745, (Circuit Court of Du Page County, Ill., 2001), aff’d., 2-05-0045 (Ill2d App.2005).
<http://www.state.il.us/court/opinions/appellatecourt/2005/2nddistrict/december/htm112050045.htm>

4 Fontana v. TLD Builders, No. 01-MR-745, (Circuit Court of Du Page County, Ill., 2001), aff’d., 2-05-0045 (Ill 2d App. 2005).
<http://www.state.il.us/court/opinions/appellatecourt/2005/2nddistrict/december/htm112050045.htm>

and operate it. Those safeguards include structural, financial, and operational measures. Corporations seeking to maintain that distinction should seek legal and accounting advice to set up systems and controls to establish and document the following:

Follow corporate formalities—Even the smallest corporation must adhere to the responsibilities imposed by the state laws where the firm is incorporated. Legal expertise should be consulted to ensure that the business is abiding by those strictures. The requirements may vary from state to state, but in general, they include:

- Maintaining an active board of directors;
- Documenting and maintaining the board of directors minutes with corporate resolutions properly authorized and noted;
- Ensuring active, functioning, and responsible officers;
- Consistently filing all required state paperwork associated with being incorporated, such as the original registration, subsequent renewals, and any amendments to the Articles of Incorporation;
- Issuing stock that is duly authorized, and keeping track of stock issuances;
- Producing an annual report and holding an annual meeting, complete with accurate minutes and documented votes.

Maintain separate finances and appropriate financial controls—First, a functioning corporation, whether it is a longstanding organization that has passed through several generations of leadership or a brand-new startup launched by an ambitious entrepreneur, must be adequately capitalized with an appropriate initial investment, reasonable reserves to ensure on-time payment to creditors, and resources to cover its basic needs, from insurance to raw materials to human capital.

Second, the financial structure of the corporation must be independent from the finances of the owner. Separate cash, bank and credit accounts in the name of the corporation must be maintained. Personal funds and corporate funds must not be commingled. Payments from the corporation to the owner should be made in accordance with a formal structure, in the form of wages, salary or dividends, and should be governed by a formal employment agreement between the corporation and the individual acting as an executive, duly authorized by the board of directors or its designee. Financing arrangements and covenants should be documented and reviewed periodically for compliance with lenders' requirements.

Unauthorized payouts to shareholders or other stakeholders whether reported in the accounting records or not, would give rise to attempts by disgruntled parties to attempt to pierce the corporate veil. So would paying personal expenses from corporate accounts or moving money back and forth between the personal and corporate accounts. Corporate accounts must not take on the appearance of being simply a personal piggy bank on which a stakeholder could draw. Accordingly, the establishment of, and compliance with, formalized corporate expense and reimbursement policies is crucial.

Accompanying a true separate financial structure for the business should be the full complement of financial controls and procedures governing how corporate funds are invested, saved, and disbursed, as well as how and when the corporation goes into debt in the course of its operation. These controls include procedures to ensure that financial decisions are subject to thorough internal scrutiny and properly authorized supported by relevant documentation. In addition, regular audits along with appropriate internal control procedures governing purchasing of supplies and capital equipment, the hiring and termination of employees, as well as the selection of vendors and professional consultants to the business, are all part of that strong financial control regime.

Maintain an ethical workplace—This means don't merely avoid fraud, but put in place ethical principles to which all must subscribe as a condition of employment and follow through on their terms and conditions. A detailed ethics policy should address risks of misconduct specific to the organization and establish a positive and ethical "tone at the top" that encourages flows of communication from all levels. Institution of a "hot line" for confidential reporting of allegations of wrongdoing is a must. Organizations should establish a code of conduct for all employees and regularly seek employees' certification that they have reviewed the document. Documentation of the reviews should be maintained. The organization would be wise to create an atmosphere of intolerance of unethical behavior. Corporate funds should never be used to engage in illegal, fraudulent or reckless acts.

CONCLUSION

The limited liability afforded by business incorporation is a valuable asset to both the business itself and the principals who own and operate it. However, that limited liability protection is not certain. It can best be sustained by structuring and operating the business so that it remains a truly separate entity at arm's length from those individuals running it, in fact as well as on paper.

While there is no guarantee of protection from a veil-piercing action, taking the steps outlined above can help ensure that the organization as well as its principals will remain reasonably safe from such a successful action. ■

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LEAN Manufacturing Paying Off for Specialty Chemical Makers

By Lawrence D. Sloan, SOCMA President & CEO

Implementing LEAN manufacturing practices at chemical facilities should be simple, and it's the "smart thing to do," says Bill Seaton, Vice President of U.S. Operations for Sigma-Aldrich, who spoke to more than 100 chemical manufacturers at a conference in Pittsburgh. But despite the success stories, he said implementing LEAN fails more than 75 percent of the time. Why?

LEAN manufacturing will only be as successful up to the level it's supported. The effort not only needs the backing of management and employees, but there has to be willingness to change wasteful cultures and get rid of the "we've always done it this way" attitude, which isn't as easy as it seems. But the end result is well worth the effort.

And what company doesn't want to remove waste? From improving visual job management with proper labeling of parts and equipment, to establishing planning and scheduling in quality control and maintenance that optimizes equipment use and process flow – from redesigning a work cell for improved work flow, to value stream mapping (where you walk the path a product takes through your facility to expose wasteful steps) – these are all great examples of improvements that can be made through the LEAN process.

By incorporating LEAN, chemical companies can become more efficient and save millions of dollars, greatly improving their bottom lines. Seaton shared example after example of ways implementing these efforts saved one company \$1.2 million per month. But, again, it all comes down to buying into the idea and streamlining processes to make facilities more efficient.

With 45 to 95 percent of the work we do considered waste, according to Seaton, it's essential that changes are made in every area of an organization, from the manufacturing floor to the R&D lab to the sales process and beyond...all in the interest of improving productivity. And it's not just limited to operations; it also goes to recruitment and retention of employees.

Based on feedback from our members, Emerald Performance Materials wholeheartedly agrees with Seaton's assessment that it takes support from the top and employee engagement to make a LEAN program work. "Having the right leadership in place and embedding this into the culture of the organization are all critical for the program to be successful," said Doug Jackson, Manufacturing Director for Emerald Specialties Group, which embarked on a structured process to accelerate continuous improvement and incorporate LEAN manufacturing processes in its operations in 2012.

While Emerald's program is relatively new, Jackson says the initial results have been positive, and they expect improved performance and increase operational efficiencies to support the company's overall sustainability goal to reduce energy consumption and waste.

According to Jackson, Emerald demonstrated its commitment to LEAN by adding key resources and hiring an operations manager with a well-documented and successful background in continuous improvement practices and implementations to lead the endeavor. Continuous improvement

coordinators were provided for each process area, and supervisory personnel received training in coaching, mentoring and professional leadership to support a strong continuous improvement effort. Emerald's initial path included training sessions that introduced LEAN, the 5S process – sort, straighten, shine, standardize and sustain – and Kaizen, activities that continually improve all functions and involves all employees. Jackson said the Emerald staff began to build confidence with the tools, which was followed by more complex challenges using cross-functional teams that employed a range of problem-solving tools.

Communication of results and reward and recognition programs helped Emerald highlight the process and reinforce desired behaviors, Jackson said. Emerald has several rewards in place, including the "Waste Warrior," which rewards employees who put forth effort within their normal positions to reduce waste and provide an opportunity to infuse some fun and competition in the workplace.

SOCMA member Cambrex Corporation is utilizing a different LEAN tool, Lean Six Sigma, in its manufacturing and development processes to enhance and continuously improve quality, design, productivity, safety and project management. Lean Six Sigma is a managerial concept combining LEAN and Six Sigma that results in the elimination of seven kinds of wastes: transportation, inventory, motion, waiting, overproduction, over-processing and defects.

Since 2004, Cambrex has employed several Six Sigma coordinators, called "Black Belts," who implement improvements through the LEAN manufacturing program. This allows the company to deliver efficient, high-quality, cost-competitive products with less time to market for their clients. But more importantly, Cambrex recognizes the benefits of a team approach to improvements.

By using Lean Six Sigma, the Cambrex Chemical Development team has made significant progress in reducing inconsistent and long cycle times, while improving the quality and yield of the final product on an in-house chemical manufacturing process. And in the past 9 years, the company has improved more than 50 processes using Lean Six Sigma at all their facilities globally.

It's exciting to hear success stories from our members regarding their efforts to eliminate waste and enhance their manufacturing processes. These LEAN practices can and will make a difference for specialty chemical makers and all manufacturers facing increased competition. And I believe it can greatly enhance a company's chances to survive and thrive in our global economy.

Free Speech for Targeted Nonprofits Should Be Defended By All

by David Trimner



Free speech does not need protection when the views being expressed are looked upon with favor by the government and the majority of the public. It is the expression of unpopular views that requires vigilant protection. Nonprofit organizations should vigorously defend the rights of all nonprofits, even when the goals and mission of those groups may not align with their own.

In response to the ongoing controversy regarding the IRS's alleged targeting of certain applicants for tax-exempt status, conservative nonprofit groups have become increasingly convinced that their due process and equal protection rights are at risk. Emails have surfaced from Lois Lerner, former director of the IRS Exempt Organizations Division, that appear to confirm a political bias against such groups.

Public disclosure of donor names

Some conservative organizations are considering whether to continue to provide the names and addresses of their donors on Form 990 Schedule B. Although not open to *public* disclosure, nonprofits are required to provide this information to the IRS. However, the Campaign for Liberty, a 501(c)(4) organization, and others have refused to turn over their donor lists. Citing privacy and freedom of association considerations, these organizations claim that through such disclosure their donors become targets of an IRS that is openly hostile to their political and social missions.

Tax-exempt organizations also fear that their donor lists will be leaked to the media or to their political opponents. In 2008, the IRS provided a copy of the National Organization for Marriage's (NOM) Form 990 Schedule B (including the names and addresses of donors who contributed more than \$5,000 to the group working against same-sex marriage), to the lesbian, gay, bisexual, and transgender civil rights group, Human Rights Campaign (HRC). In 2012, HRC posted those names and addresses on its website, and then forwarded the list to the *Huffington Post* and other news sites. Although it is a felony to disclose confidential tax information, the list was used by the president's campaign to criticize Mitt Romney's supporters. In June 2014, the IRS agreed to pay \$50,000 in damages to NOM.

Congress has attempted to address the issue, but has been hampered by its own deep political divisions. On July 16, the House Financial Services Subcommittee voted to fund the IRS at a level that is \$1.4 billion below the amount requested by President Obama for fiscal year 2015. Chairman Andre Crenshaw (R-Fla.) stated, "This committee remains troubled by their activities, including the inappropriate singling out of certain tax-exempt groups based on their political beliefs, wasteful spending on conferences and videos, and providing bonuses to staff without evaluating their conduct or tax compliance." The provision appears to have almost no chance of passing the Senate.

However, the media attention around the issue may have caused the IRS to relax its scrutiny of politically active nonprofits — even if an investigation is warranted.

A recent investigation conducted by the Center for Public Integrity concluded that the IRS has “all but quit regulating politically active nonprofits in any consistent, demonstrable way.” Noting that the Exempt Organizations Division has lost 14 percent of its staff while seeing a 40 percent increase in nonprofit organizations over the last 20 years, the investigation concludes that IRS employees are now afraid to deny or revoke the exempt status of social welfare organizations even when there is evidence of excessive political activity. Applications were historically denied at a rate of about 4 percent; by 2013 that rate had fallen to less than 0.25 percent.

Attempts to streamline the application process

On July 30, a bill was introduced to the Joint Economic Committee to allow 501(c)(4) social welfare applicants that have not had their exemption application processed within nine months to ask the U.S. Tax Court for approval through declaratory judgment. 501(c)(3) charitable organizations already have this right. Currently, a 501(c)(4) applicant must wait to have its application denied and begin paying federal income tax before taking the IRS to court.

“This legislation will provide a much-needed avenue of relief for nonprofits whose applications for tax-exempt status are languishing at the IRS,” said Senator Dan Coats (R-Ind.). “With the IRS approval times of up to three years or more ... this bill would give groups the same tools as charities while applying for tax-exempt status.”

Advice for moving forward

Nonprofit organizations should monitor these developments closely. If the IRS becomes powerless to deny or revoke the exempt status of truly bad actors, then the reputation of the entire nonprofit sector will suffer. However, nonprofit organizations should stand together against politically motivated abuses regardless of whether they agree with the political and social goals of the abused. They should also support responsible efforts to regulate and oversee the sector in a balanced, nonpolitical way.

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Tax Reform Proposal Would Impact Nonprofits and Donors

The U.S. House of Representatives Ways and Means Committee has released a massive reform plan to dramatically overhaul the nation's tax code. Several provisions may interest tax-exempt organizations, including some regarding unrelated business income (UBI). The proposed changes also would significantly impact the charitable deductions that donors currently receive.

Chances of the package becoming law as-is in 2014 are virtually nonexistent, but it does provide a starting point for more modest reforms that may find their way into passable legislation.

"CLA considers passage of this tax reform proposal to be extremely remote," says David Trimner, a principal in CLA's nonprofit tax group. "The president and both houses of Congress do not seem to be making this a high priority. Nevertheless, certain features may be transferred to other pieces of legislation, so we advise all tax-exempt organizations — particularly charities and those with unrelated business income — to make themselves aware of the relevant elements of the proposal."

Nonprofit organizations

- Imposes a 25 percent excise tax on certain executive compensation of tax-exempt organizations greater than \$1 million
- Eliminates the rebuttable presumption of reasonableness for compensation
- Doubles the late filing penalty for nonprofit information returns
- Imposes 1 percent excise tax on the net investment income of private colleges and universities with endowments greater than \$100,000 per full-time student
- Eliminates exemption for Type II and Type III supporting organizations
- Requires that donor-advised funds be distributed within five years

Donors

- Repeals the "Pease Limitation" for high-income earners as an integral part of other reform provisions
- Limits deductible charitable contributions to those exceeding 2 percent of adjusted gross income
- Reduces the 50 percent and 30 percent ceilings on charitable deductions to 40 percent and 25 percent, respectively
- Limits the deduction for contributions of appreciated property (other than public securities, inventory, conservation contributions, scientific property, and mission-related tangible personal property) to the donor's basis

Unrelated business income

- Includes royalty payments for the licensing of a nonprofit's name or logo as UBI
- Prevents qualified sponsorships from acknowledging the sponsors' products
- Prevents qualified sponsorship payments greater than \$25,000 from receiving greater benefits than the majority of other sponsors
- Includes research income as UBI unless the results are made freely available to the public



In the current political climate, it may be years before any of these nonprofit tax reforms become reality, while others seem dead on arrival. Either way, there is reason to believe that significant changes may be somewhere down the road.

- Requires that advertising expenses be amortized over 10 years
- Requires the separate calculation of UBI from each trade or business; losses from one may not offset gains from another
- Raises the specific deduction from \$1,000 to \$10,000
- Reduces the top tax rate from 35 percent to 25 percent by 2019
- Allows net operating losses to offset only 90 percent of taxable income
- Repeals the alternative minimum tax

Trimner says that in the current political climate, it may be years before any of these reforms become reality, while others seem dead on arrival. Either way, there is reason to believe that significant changes may be somewhere down the road.

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Free Speech or Tax Exemption: Nonprofits Can't Have It Both Ways

by David Trimner

The First Amendment to the U.S. Constitution prohibits any law abridging freedom of speech. The 16th Amendment gives Congress the power to collect taxes on income. Increasingly, nonprofit organizations are finding themselves giving up some of their rights under the First Amendment in order to obtain or retain exemption from the 16th.

Is it a fair trade-off? The U.S. Treasury Department thinks so and has proposed new regulations that would place limits on political speech by some nonprofit groups. The issue gained increased attention following the recent IRS targeting controversy and the unprecedented amount of money flowing from politically active nonprofits in the 2012 national election. We expect that political spending by nonprofits will remain in the news through the upcoming mid-term elections.

Free speech and tax exemption

Of all the entities operating under Internal Revenue Code Section 501(c), public charities and private foundations (Section 501(c)(3)) give away the most free speech rights. In exchange for exemption from federal income tax and a charitable deduction for their donors, these organizations are absolutely prohibited from supporting or opposing the election of any candidate for public office.

Lobbying activities, defined differently than political activities, are limited for public charities and prohibited for private foundations. 501(c)(3)s must provide the names and addresses of their major donors when filing their annual tax returns, although the IRS does not require that the list be publicly disclosed.

Social welfare organizations (Section 501(c)(4)) are not considered charitable, but they must be primarily engaged in activities that promote civic betterment and community improvement. In exchange for exemption from federal income tax with no charitable deduction permitted for their donors, they do not have to provide the names of donors, and they may engage in limited lobbying and political activity as long as it does not become their "primary" activity.

The IRS examines the "facts and circumstances" to determine how much lobbying and political activity is too much, including the resources, funds, time, space, and equipment devoted to the activity. Many organizations assume they can spend up to 49.9 percent of their resources on politics without it being considered their primary activity.

The U.S. Supreme Court's 2010 decision in *Citizens United v. Federal Election Commission* broadly expanded, on First Amendment grounds, the ability of corporations to spend money in federal election campaigns. The Center for Responsive Politics estimates that election-related spending by 501(c)(4), (5), and (6) organizations rose from \$5.2 million in 2006 to more than \$300 million in 2012.



Nonprofits involved in lobbying and political activity on behalf of their supporters must carefully consider how many rights they should be expected to waive, or are willing to waive, in exchange for tax-exempt status.

Already alarmed by this increased activity, the IRS found more and more conservative and progressive activist groups applying for tax exempt status as 501(c)(4) social welfare organizations in the months leading up to the 2012 election. Understaffed, overwhelmed, and concerned that these were political groups masquerading as social welfare organizations in order to avoid donor limits and disclosure requirements, the IRS began filtering applications that contained such terms as “Tea Party,” “freedom,” and “patriot,” setting them aside for more intensive examination and intrusive questioning. Evidence indicates that a disproportionate number of these “fact-intensive inquiries” may have affected groups opposed to the re-election of the president. The controversy that erupted during the summer of 2013 led to the resignations of several high-ranking IRS officials.

Attempts to define political activity

In response, new regulations have been proposed by the Treasury Department that it contends would provide clarity to the definition of political activity. In reality, by excluding “candidate-related political activities” from the definition of social welfare, the free speech rights of these groups would be significantly curtailed. Examples of candidate-related political activities include:

- Communications that advocate a clearly identifiable candidate or party
- Voter registration drives
- “Get-out-the vote” drives
- Distribution of materials prepared on behalf of a candidate
- Voter guides that refer to candidates or parties
- Candidate appearances within 60 days of a general election or 30 days of a primary election
- Grants to Section 527 political organizations and other tax-exempt organizations that may conduct political activities

In addition, the Treasury Department is considering whether there should be specific, measurable limits on activities that do not promote social welfare. Similar regulations are under consideration for Section 501(c)(5) labor organizations, Section 501(c)(6) trade associations, and Section 527 political organizations.

The proposed regulations raise several questions:

- Would nonprofits be prohibited from hosting candidate debates within 60 days of an election?
- Are nonpartisan voter registration efforts really a political activity?
- Will organizations have to “scrub” their websites 60 days before an election, including blog posts, newsletters, and announcements that favorably mention a candidate by name?
- If Congress is debating a budget in October of an election year, will grass roots lobbying activities, such as encouraging members to contact Congressional representatives, be limited?
- Will 501(c)(4) organizations that provide grants to other 501(c)(4)s have to get written representations promising that the funds will not be used for political purposes?

The debate continues

Faced with an increasingly polarized electorate, the IRS has the almost impossible task of enforcing vague standards, navigating the distinction between political activism and social welfare, and measuring political activity relative to total activities without a clearly defined objective measure.

The IRS is caught between those such as Jeffrey Toobin, who argues in a May 14,

2013, *New Yorker* blog post that the “real scandal is that 501(c)(4) groups have been engaged in political activity in such a sustained and open way,” and those like James Taranto, who wrote in the May 17, 2013, *Wall Street Journal* that “the demagoguery ... was sufficient to prompt the IRS agents to cast aside their professional obligations and embark on a campaign of political abuse whose effect was to ease [President] Obama's re-election.”

Nevertheless, it appears that the Treasury Department's response to accusations of unfairly limiting the free speech rights of nonprofit organizations is to institutionalize limits on the free speech rights of nonprofit organizations. Replacing the ambiguous “facts and circumstances” test with more objective criteria, while beneficial, still offers no definition for the allowable proportion of total activities that nonprofits can safely devote to politics.

In addition, the proposed regulations restrict educational and voter registration efforts even when those efforts stop short of promoting or endorsing a particular candidate or party. The result may be to drive political activity out of 501(c)(4)s and into Section 527 political action committees. Some commentators have suggested that this is the real purpose of the proposed regulations, and that the executive branch appears to be attempting to achieve a result that would stand almost no chance of being approved by the legislative branch.

Donors to politically active social welfare organizations are rightly concerned because Section 527 political action committees must disclose donor names, opening the way for potential retaliation, intimidation, harassment, vandalism, and boycotts.

Should free speech be taxable?

Partisans can agree that free speech is a cornerstone of American identity, and an essential ingredient to public debate and dissent. The Supreme Court confirmed this in *Citizens United v. Federal Election Commission*, ruling that it is unconstitutional to restrict the political speech of corporations. With these newly proposed regulations, the executive branch, through the Treasury Department, is telling nonprofits that they can say whatever they want, they just can't do it tax-free.

The debate will no doubt continue, and nonprofits involved in lobbying and political activity on behalf of their supporters must carefully consider how many rights they should be expected to waive, or are willing to waive, in exchange for tax-exempt status.

We encourage you to have further conversations on the impact of this debate and evolving laws on the future of your programs, structure, and exempt-status.

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Checkpoint Contents

Tax News

Journal Preview (WG&L)

Taxation of Exempts (WG&L)

LESSONS OF THE COLLEGES AND UNIVERSITIES COMPLIANCE PROJECT, Taxation of Exempts (WG&L)

COMPLIANCE PROJECT LESSONS

LESSONS OF THE COLLEGES AND UNIVERSITIES COMPLIANCE PROJECT

The Final Report presents a wealth of information for tax-exempt organizations of every category.

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In October 2008, the IRS began work on the nonprofit Colleges and Universities Compliance Project ("the Project"), distributing an initial compliance questionnaire to over 400 tax-exempt colleges and universities. Based on the information obtained from the compliance questionnaires, the IRS then selected 34 colleges and universities for further examination.

The schools selected for examination included both public and private colleges and universities, with about two-thirds of those examined considered large schools (i.e., over 15,000 students). The IRS has now completed 90% of those examinations, and, on 4/25/13, the IRS released its final report on the Project (the "Final Report"). ¹ The Final Report summarizes the findings from the completed examinations and represents the culmination of almost five years of research and analysis of the tax-exempt higher education community.

Although the Project focused on colleges and universities only, the Final Report nevertheless contains critical information that can be used by all tax-exempt organizations. Specifically, the Report can help organizations identify and understand issues that will be the likely focus of future examinations, such as

unrelated business income and executive compensation. The IRS is likely to remain particularly vigilant in reviewing and overseeing compliance with the rules applicable to these two areas in future examinations of all organizations recognized as exempt under Section 501(c)(3).

The role and nature of IRS compliance projects

The use of compliance check projects is an emerging trend at the IRS, and all exempt organizations should be aware of the steps and processes involved in such initiatives. Over the last decade, the IRS has conducted three detailed compliance projects, including reviews of tax-exempt hospitals and tax-exempt credit counseling organizations. It is currently engaged in two more: one project is focused on the exempt housing counseling and foreclosure prevention industry and the other on organizations that use the self-certification process. In the past, the IRS relied primarily on individual examinations to identify areas of misreporting or noncompliance. Now, the development of compliance check projects allows the IRS to gain information about a broader portion of an industry and develop more focused examinations accordingly.

In a compliance project, the IRS broadly reviews an entire industry at one time, comparing organizations within the industry to gain an understanding of common practices, such as reporting of income and classification of common activities. By taking a snapshot of an entire industry, the IRS can identify anomalies that may indicate broader trends within the industry. These compliance projects then help the IRS identify common areas of potential abuse and noncompliance on which agents can focus in future examinations.

Each compliance project typically follows the same order of events, beginning with the creation and distribution of a compliance check questionnaire and ultimately leading to on-site examinations by IRS agents. There are several phases to each project. After identifying an industry, the IRS prepares and sends out a compliance check questionnaire to a significant portion of that chosen industry. The compliance check questionnaire is the phase that touches the broadest segment of the identified industry. The colleges and universities that received the Project's initial questionnaire represent about 16% of the entire tax-exempt higher education field.

The questionnaires are typically designed to collect a substantial amount of information about the practices of organizations in the sector. In the Project, the questionnaire developed by the IRS was over 30 pages long and asked for substantial information about the institution's income, compensation of various employees including athletic coaches and faculty, related exempt organizations, the types of unrelated business activities in which the institution engaged, accounting methods, endowment funds, and governance policies, among other categories. [2](#)

The IRS uses the responses to the questionnaires, coupled with data from the Forms 990 and 990-T filed by the organizations that received the questionnaire, to learn about the operations of these institutions. The initial analysis of the Project data identified unrelated business income and executive compensation

as areas of common noncompliance. The IRS then selected the 34 schools for examination based specifically on those two categories of potential noncompliance.

The next phase, on-site examinations, affects a much smaller segment of an industry but is the most burdensome, time-consuming, and potentially problematic for an organization. Unlike the review of a compliance check questionnaire, an examination can result in the assessment of additional tax or even revocation of an organization's tax-exempt status. The number of examinations the IRS typically opens during a compliance project depends on the information that the IRS obtains from its review of the questionnaires. In the Project, about 8.5% of the total number of colleges and universities that originally received the questionnaire were ultimately selected for examination. By way of comparison, during the hospital compliance project that began in 2006, the IRS opened up examinations at 20 tax-exempt hospitals. During the credit counseling compliance project that took place between 2004 and 2012, the IRS conducted examinations of more than 80% of the industry, as measured by revenue.

Final Report findings

As noted above, in the Final Report, the IRS identified certain trends and potential areas of widespread noncompliance with respect to reporting unrelated business taxable income and the payment of compensation, both to officers and to other highly compensated employees.

Unrelated business income.

Tax-exempt organizations generally are not required to pay federal income taxes on income derived from activities that are substantially related to their exempt purposes. A tax-exempt organization may, however, be subject to the federal corporate income tax on income derived from unrelated trade or business activities. This tax is known as the unrelated business income tax (UBIT).

Unrelated business income (UBI) arises when a tax-exempt organization regularly carries on a trade or business that is not substantially related to the tax-exempt purposes of the organization. The Code imposes UBIT at the regular corporate rates on an organization's UBI, reduced by the organization's related losses and deductions. The regulations explain the rationale for the UBIT regime with the following background: "The primary objective of adoption of the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete." [3](#)

An "unrelated trade or business" is any activity that meets each of the following three conditions:

- The activity must be a trade or business.
- The trade or business must be regularly carried on.
- The trade or business must not be substantially related to the purposes for which the organization was recognized as exempt from income tax. [4](#)

To be a "trade or business" the activity must be carried on for the production of income from the sale of goods or the performance of services. **5** It is important to recognize that activities do not lose their identity as a trade or business simply because they might be conducted as part of similar activities related to the organization's exempt purpose. For example, in the colleges and universities context, operating a golf course that is used to provide educational benefits to students does not mean that income from the use of the golf course by non-student members of the general public for recreation also does not constitute a trade or business.

In determining whether an activity is "regularly carried on," the IRS will look at whether the activity is conducted often and continuously and how it is pursued. The IRS will compare the activity with the same or similar activities conducted by non-exempt organizations. Finally, for the activity to be "substantially related" to an organization's exempt purposes, it must contribute significantly to the accomplishment of one or more of the organization's exempt purposes. Merely generating money for use in pursuit of an organization's exempt purposes, however, is not itself enough to characterize an activity as "substantially related." **6**

Misunderstanding UBI and unrelated business activities can have severe consequences for an organization. Outside of paying tax on income generated from the activity, a tax-exempt organization can jeopardize its exempt status if an unrelated business activity is substantial in relation to an organization's total exempt functions. This is why organizations that engage in one or more unrelated business activities in a more than insubstantial manner often create taxable for-profit subsidiaries to house and carry out such activities.

Among the colleges and universities examined, the IRS found that adjustments to UBIT liability often arose in connection with certain activities that were regularly carried on and were not substantially related to the exempt purposes of the institutions. These activities included advertising, arena use, facility rentals, and the operation of fitness and recreation centers, sports camps, and golf courses. Nearly half of the colleges and universities examined incurred changes to their UBIT liability in connection with their advertising and facility rentals. Similarly, the operation of fitness, recreation, sports, and golf programs resulted in UBIT adjustments for approximately one-third of the organizations examined. **7**

The Final Report also contains important findings about reporting of UBI. When an organization generates at least \$1,000 of gross UBI, it must file a Form 990-T, "Exempt Organization Business Income Tax Return," to report the income and pay any taxes due on that income. The Form 990-T must be filed in conjunction with the organization's annual Form 990. When computing and reporting UBI, an organization can take a number of tax deductions. The Code permits deductions for net operating losses (NOLs), **8** and organizations may also take deductions for expenses that are "directly connected" with the carrying on of the unrelated trade or business. **9** Thus, for an organization to utilize losses to reduce its UBIT liability, those losses must relate to the activity or activities giving rise to UBI. Conversely, if the losses do not arise from the conduct of an unrelated trade or business, they may not be used to offset UBI.

The Final Report notes that 90% of the schools examined had misreported UBI on their Forms 990 and

990-T during the years under examination. The scope of these reporting discrepancies includes over \$170 million in disallowed claims of losses and NOLs against the UBIT liability of these institutions. The resulting changes in the reporting of losses and NOLs could result in over \$60 million in assessed taxes. On 60% of the Forms 990-T that it examined, the IRS determined that losses used to offset UBI were not sufficiently connected to unrelated business activities. The Final Report also notes that the IRS disallowed more than \$150 million in NOLs during the course of its Project-related examinations, because the examining agents found that the institutions failed to demonstrate the requisite connection between the trades or business and the activities generating losses. [10](#)

In particular, if an activity consistently resulted in losses over the course of several years, the IRS concluded that such activities lacked the necessary "profit motive" that characterizes a trade or business. [11](#) As such, the IRS did not allow those losses to reduce an organization's UBIT exposure. The IRS identified numerous instances in which examined colleges and universities had reported net losses on activities "for which expenses had consistently exceeded UBI for many years." The IRS determined that these activities were not carried on with a profit motive and, as such, disallowed the NOLs that flowed from those activities. [12](#)

Other common findings among the examined colleges and universities included errors in computation of NOLs and the substantiation of such amounts and misclassification of activities as related to the institution's tax-exempt purposes. About 40% of the institutions examined had misclassified activities as exempt and not reportable, leading to the reclassification of nearly \$4 million as UBI, subject to tax. In conducting the examinations, the IRS found that activities classified as exempt were not in fact substantially related to the organization's exempt purposes. [13](#)

The IRS found that only 20% of the institutions examined sought outside advice about potentially unrelated business activities and UBI reporting. [14](#) With the complexity of UBI and reporting issues, outside advice is critically important. In the event of an examination, the IRS may not ultimately agree with decisions about characterization of an activity or how income was reported, as was the case in several of the Project-related examinations, but obtaining legal and accounting advice and documenting the organization's decisions can help the organization defend its position during an IRS examination.

Executive compensation.

Organizations exempt under Section 501(c)(3) must be organized and operated for the benefit of the public, rather than for private interests. [15](#) To the extent an organization confers a substantial benefit on any private individual or entity, the IRS can find that the organization is not operating exclusively for exempt purposes. However, "[o]ccasional economic benefits flowing to persons as an incidental consequence of an organization pursuing exempt charitable purposes will not generally constitute prohibited private benefits." [16](#) Thus, the IRS and courts have recognized that private persons will necessarily benefit, under some circumstances, when an exempt organization carries out its mission.

Determining whether such benefits constitute impermissible private benefits to individuals focuses on whether the benefits are incidental, qualitatively and quantitatively, to the public benefits the organization furnishes. For the qualitative aspect of the test, the IRS focuses on whether the benefit to the public of the organization's activities cannot be achieved without a benefit to certain private individuals, and ensuring that the private benefit is no larger than necessary to carry out the public benefit. **17** On the quantitative side, a benefit will be considered quantitatively insignificant if it is insubstantial when compared with the public benefit the organization confers. The amount of private benefit, therefore, varies with the public benefit in this comparative test. **18**

As part of this prohibition on private benefit, charitable organizations are also prohibited from allowing any part of their net earnings to inure to the benefit of any private individual or shareholder. A "private individual or shareholder" refers to a person having a personal and private interest in the activities of the organization. **19** This concept, known as "private inurement," is commonly viewed as a part of the private benefit analysis. Private inurement is more limited, however, in that the prohibition focuses on the beneficiaries' relationship to the organization and the types of benefits being received. As such, "all inurement is private benefit, but not all private benefit is inurement." **20** The private inurement doctrine applies only to transactions between a tax-exempt organization and an "insider" (i.e., someone with a close relationship with or ability to exert influence over the organization). It is important to note that this doctrine does not prohibit dealings between a charity and its insiders; it requires that dealings between a charitable organization and its insiders be reasonable, at arm's length, and in good faith. For example, paying reasonable compensation to a founder for services rendered is not considered private inurement. **21**

In lieu of, or in addition to, the possibility of revocation if an organization's net earnings inure to the benefit of an insider, Section 4958 allows the IRS to impose excise taxes on "disqualified persons" who receive "excess benefits" from a transaction with an exempt organization. Taxes assessed on excess benefit transactions under Section 4958 are known as "intermediate sanctions." These penalty taxes apply only if an organization pays an amount in excess of what would reasonably be paid by a similarly situated organization for comparable services. If a Section 501(c)(3) organization pays reasonable compensation to its officers, directors, trustees, and key employees (ODTKEs), no excess benefit transaction occurs.

Through the intermediate sanctions provisions of the Code, the IRS may require an individual who is deemed to have received unreasonable compensation to return the excessive portion of the compensation to the organization. It may also impose an excise tax of up to 200% (of the excess benefit amount) on the individual who received the excessive benefit. Additionally, the IRS may impose an excise tax of 10% on every ODTKE that approved the transaction. Finally, as conferring an excess benefit will likely cause an organization's assets to inure to the benefit of an insider, the IRS may revoke an organization's exempt status if it finds the organization is no longer operating as a charitable organization due to excessive private inurement. **22**

Section 4958 and the accompanying regulations provide a "safe harbor" that results in a rebuttable presumption that amounts paid by the organization to its ODTKEs are reasonable. To establish the

rebuttable presumption of reasonable compensation:

- The organization must appoint an "independent body" to review and determine the amount of compensation.
- The independent body must rely on appropriate comparability data to set the compensation amount.
- The independent body must contemporaneously document its decisions in setting compensation.

To overcome this presumption, if established, the IRS must develop sufficient contrary evidence to rebut the value of the comparability data on which the organization relied. [23](#)

Colleges and universities exempt under Section 501(c)(3) are subject to these rules on private benefit and private inurement. In the Final Report, the IRS found that the compensation for 94% of ODTKEs at the colleges and universities examined was set following procedures intended to satisfy the requirements for the rebuttable presumption. However, the IRS concluded that 20% of the institutions examined did not satisfy the standards established by the regulations. One significant shortcoming was the use of comparability data that derived, at least in part, from organizations that were not "similarly situated" to the institution in question. The Report states that factors such as location, endowment size, revenues, total net assets, number of students, selectivity in admissions, and age of the institution led agents to conclude that schools included in the comparability data were not in fact similar institutions. In addition, several colleges and universities relied on compensation studies that (1) did not adequately document how and/or why certain data was used or (2) did not specify whether the amounts reported included salary only or also reflected other types of taxable and non-taxable compensation. [24](#)

Organizations commonly rely on compensation consultants to provide this comparability data and to assist in setting compensation. Indeed, the IRS found that 50% of the schools examined used outside compensation consultants. [25](#) Use of a consultant did not necessarily result in the use of accurate comparability data, however. As discussed, 20% of the schools examined would not have successfully met the rebuttable presumption of reasonable executive compensation. Thus, reliance on a compensation consultant-and the comparability data provided by that consultant-is not enough by itself to fully protect an organization from the possibility of intermediate sanctions under the private inurement rules.

While the Final Report reaches certain conclusions about the scale of compensation paid by colleges and universities to various ODTKEs, it does not specify the number of institutions under examination actually found to have engaged in an excess benefit transaction subject to tax. Still, the Report's focus on executive compensation is consistent with other recent examinations of organizations outside the field of higher education. Revenue agents have imposed intermediate sanctions based on unreasonable compensation far more often in recent years than in the past. In informal discussions, IRS officials have indicated that compensation is a focus at all levels within the IRS, from the Examinations Division to the Office of Chief Counsel, and all tax-exempt organizations should therefore take heed of the executive compensation pitfalls identified in the Report.

Non-ODTKE compensation and employment tax issues.

The Final Report also contains the findings of the IRS examinations with respect to compensation of non-ODTKEs at colleges and universities. The highest paid non-ODTKEs at these institutions were typically investment managers and sports coaches. In addition, the IRS found that department heads, faculty, and administrative and managerial employees were among other highly compensated non-ODTKEs at the schools examined. [26](#) Non-ODTKEs generally do not fall within the categories of individuals that are *per se* treated as "disqualified persons" for purposes of the intermediate sanctions rules in Section 4958, and as such they may not rise to the level of insider who would be subject to the private inurement and excess benefit rules. Whether other employees can be considered insiders depends on the circumstances surrounding their employment. The regulations list various "facts and circumstances" that may indicate an individual's exercising substantial influence over the affairs of an organization. Depending on the interplay of such facts and circumstances, an individual may ultimately be deemed a "disqualified person" for purposes of Section 4958 and thus subject to intermediate sanctions.

[27](#)

In addition, employees who are not ODTKEs still may be determined to have received a prohibited private benefit. As discussed, Section 501(c)(3) tax-exempt organizations are still subject to the broader prohibition on private benefit, which prohibits payment of excessive compensation for services rendered by an employee. As such, the IRS may determine that an organization is conferring a private benefit on an employee based on the amount and structure of an individual's compensation package. Thus, the payment of excessive compensation to non-ODTKEs can still jeopardize an organization's tax-exempt status.

The inclusion of this additional data by the IRS in the Final Report provides important and useful information for colleges and universities when considering the appropriate salary structures for all highly compensated employees. Beyond the higher education industry, other exempt organizations should also take note of the Service's interest in non-ODTKE compensation. While not all organizations employ individuals like sports coaches, many organizations employ investment managers or other highly compensated non-officers that possess varying levels of control within the organization.

As part of the Project, the IRS also opened employment tax examinations at 11 of the 34 colleges and universities and retirement plan examinations at eight schools. Each of these examinations resulted in upward adjustments to wages and the assessment of additional taxes in excess of \$7 million, with more than \$160,000 in associated penalties. The reasons for these wage adjustments included common problems for all exempt organizations, such as failure to properly account for the value of personal use of automobiles, housing, and travel in the wage calculation, as well as failures to properly classify individuals as employees or independent contractors. [28](#)

Since the Final Report

On 5/8/13, the House Ways and Means Subcommittee on Oversight held a hearing to discuss the findings set forth in the Final Report. At that hearing, Rep. Charles Boustany (R-LA) called the information in the Final Report "troubling" and indicative of "almost universal noncompliance" with the Code's provisions on UBI and executive compensation by colleges and universities. He noted that the House Ways and Means Committee is considering revisions to the Code that may affect these provisions.

In her testimony before the Committee, then-Director of the IRS Exempt Organizations Division, Lois Lerner, assured members of the Committee that the IRS has already begun a second UBIT compliance project, focusing on exempt organizations that report UBI on their Forms 990 but do not then file Form 990-T. She stated that the IRS is currently planning a more expansive project, to begin next year, which will investigate whether issues identified in the Final Report are present across a greater portion of the tax-exempt sector. Ms. Lerner explained that the IRS views its projects and publications like the Final Report as a critical way to educate the exempt organizations community and thereby to increase and improve compliance.

Conclusion

The Final Report contains valuable lessons for colleges and universities as well as many other types of tax-exempt organizations. It is a guide for organizations subject to future compliance projects, a highlight reel of issues of interest in current IRS examinations, and a preview of issues on which the IRS will focus in future examinations. The Final Report and the entire Project are part of a broader pattern in IRS enforcement that has emerged over the last ten years. From the hospital and credit counseling compliance projects to the ongoing projects on foreclosure and mortgage services organizations and self-certified organizations, the IRS has consistently been using the compliance project format to conduct examinations and identify what it sees as likely widespread issues for all tax-exempt organizations. The Final Report for the Project thus provides a critically important blueprint to what the IRS will consider to be optimal compliance when conducting an examination.

Some of the lessons that all tax-exempt organizations should take from the Project include:

- If an organization receives a compliance check questionnaire as part of an IRS initiative, the organization should complete it and file it with the IRS. In the Project, 13 colleges and universities received, but did not complete, the questionnaire. The IRS opened examinations of all 13 schools. While the IRS states that completing a questionnaire is voluntary, it appears as though the failure to do so will automatically result in additional IRS scrutiny.
- When completing Forms 990 and 990-T and in determining an organization's UBIT liability, organizations should allow adequate time to consult with their tax counsel, to ensure that expenses are accurately allocated and that losses and NOLs bear the requisite relationship to the activity giving rise to UBI. If an organization takes the position that an activity is substantially related to its tax-exempt purposes, it should document the basis for its determination.
- An organization should consider using for-profit subsidiaries to house and conduct unrelated

business activities that may be substantial. If a tax-exempt organization is contemplating substantial engagement in an unrelated business activity, a taxable, wholly owned subsidiary may be a helpful option to house the activity and protect the organization's tax-exempt status. Importantly, a taxable, for-profit subsidiary can pay some or all of its after-tax profits to the parent exempt organization in the form of dividends, all of which are tax-free to the parent. Additionally, if properly maintained, a for-profit subsidiary can isolate liabilities that may arise from the conduct of an activity, protecting the parent from legal risks associated with the activity. A variety of options exist for capturing unrelated business activities in new taxable entities, and these are options exempt organizations should review when considering a new endeavor that may be unrelated to the organization's exempt purposes.

- Organizations exempt under Section 501(c)(3) or (c)(4) should closely review their methods for setting executive compensation and their use of comparability data. The payment of unreasonable executive compensation can lead to the imposition of intermediate sanctions involving significant penalty taxes or even the revocation of exempt status. Executives at all tax-exempt organizations should be aware of the compensation approval process.
- Organizations should adopt and follow formal compensation policies to set executive compensation. The Final Report states that nearly two-thirds of the schools examined used compensation policies that applied to at least one of their ODTKEs during the tax years included in the exams. Having a formal compensation policy can assist an organization in establishing the rebuttable presumption of reasonable compensation.
- Organizations should seek outside advice and engage with the consultants, accountants, and lawyers that the organization hires. Even though the IRS may not agree with the conclusions reached by outside advisors with respect to UBI or compensation, going to the process of obtaining, analyzing, and utilizing outside opinions indicates a level of care and diligence exercised by the organization in deciding how to handle particular matters. When using an outside consultant for compensation data, organizations should ask questions about the origins of the data and ascertain whether the data reflects the practices of organizations that are truly similarly situated.
- Organizations that do not use compensation consultants should review their own procedures for selecting comparability data to ensure that such data reflects the practices of similarly situated entities. In its examinations, the IRS found that schools that did not use compensation consultants commonly relied on current surveys as their primary form of comparability data. If an organization does not use a compensation consultant, it should carefully examine the types of surveys used in setting compensation and consider the types of organizations reflected in those surveys.
- Smaller organizations that may not be able to hire outside experts to assist with UBI and executive compensation issues can still take steps to ensure compliance. Smaller institutions can receive substantial benefits from membership in a trade association of similar entities that can pool their resources and, collectively, hire appropriate experts to provide general information and develop guidelines for compensation and annual tax reporting.

Expect UBI and executive compensation issues to continue to garner attention from the IRS in the coming years. During the course of the Project, the IRS went to great lengths to educate its revenue agents about these issues and their consequences. Top IRS officials have already indicated that the agency will be conducting a more wide-ranging compliance project focusing on these areas in the future. Therefore, regardless of whether an examination is commenced through a compliance project or not, these are issues that will be at the forefront of an agent's focus during all future examinations.

1

"Colleges and Universities Compliance Project Final Report," available at www.irs.gov/pub/irs-tege/CUCP_FinalRpt_042513.pdf.

2

The original questionnaire may be viewed at: www.irs.gov/pub/irstege/sample_cucp_questionnaire.pdf.

3

Reg. 1.513-1(b).

4

Section 512(a)(1) (defining unrelated business taxable income to mean "the gross income derived by any organization from any unrelated trade or business ... regularly carried on by it").

5

Reg. 1.513-1(b).

6

Regs. 1.513-1(c)(1), (d).

7

Final Report, *supra* note 1 at 11-12 (2013).

8

NOLs are losses that are reported in one year and used to offset gains in past or future years. Colleges and universities, as well as other exempt organizations, often report NOLs resulting from unrelated business activities and use such amounts to mitigate their overall UBIT liability.

9

IRM 7.27.6.2(1), IRM 7.27.6.2(2).

10

Final Report, *supra* note 1 at 11-14.

11

See, e.g., Rev. Ruling 81-69, 1981-1 CB 361 (where a service is offered at a price insufficient to recover costs, the activity is not conducted with a profit motive, and losses from the activity may not be used to

offset gains from other, profitable unrelated business activities).

12

Final Report, *supra* note 1 at 3.

13

Id. at 13.

14

Id. at 14.

15

Reg. 1.503(c)(3)-1(d)(1)(ii).

16

American Campaign Academy, 92 TC 1053 , 1066 (1989).

17

Ltr. Rul. 9615030.

18

See Rev. Rul. 70-186, 1970-1 CB 128.

19

Reg. 1.501(a)-1(c).

20

IRM 7.76.3.11.1(1).

21

IRM 4.76.3.11.2(3).

22

H. Rep't No. 104-506, 104th Cong., 2d Sess. 56, fn. 15 (1996).

23

Regs. 53.4958-6(a), (b).

24

Final Report, *supra* note 1 at 4, 22-23.

25

Id. at 22.

26

Id. at 17-18.

27

Reg. 53.4958-3(e)(2). These facts and circumstances include, but are not limited to, whether the person (1) founded the organization; (2) is a substantial contributor to the organization; (3) is compensated based primarily on revenues derived from activities of the organization, or of a particular department or function of the organization that the person controls; (4) has or shares authority to control or determine a substantial portion of the organization's capital expenditures, operating budget, or compensation for employees; (5) manages a discrete segment or activity of the organization that represents a substantial portion of the activities, assets, income, or expenses of the organization, as compared to the organization as a whole; (6) owns a controlling interest (measured by either vote or value) in a corporation, partnership, or trust that is a disqualified person; or (7) is a non-stock organization controlled, directly or indirectly, by one or more disqualified persons.

28

Final Report, *supra* note 1 at 19-21.

**DC Central Kitchen**

We Are the Job Creators

Posted: 02/05/2013 2:52 pm EST Updated: 04/07/2013 5:12 am EDT

By Michael F. Curtin, Jr., CEO, DC Central Kitchen

Lots of smart, good, hard-working people give their time, money, and energy to DC Central Kitchen because they think we're a great charity. We are thrilled that people support us because they feel we are doing the right thing or the good thing, but we really hope people understand that what we are doing is the smart thing.

For too long those of us in the nonprofit sector have been happy to fit ourselves into the charity model - give us your pennies and we'll solve your dollar problems - but we have to be honest and say that that simply isn't getting us to the place we need to be. We may have the heart of a nonprofit, but our brain is all business. In fact, today, we are an \$11 million per year business - and our leading product is empowerment. The difference between us and a "regular" business, however, is that business is in it to make money; we're in it to make change.

At DCCK, our social enterprises, which include the production of nearly 5,000 healthy, scratch-cooked school meals each day and a gourmet catering company that generated \$1.3 million in revenue last year, are not separate from our social service programs. Instead, they are extensions of our mission. We operate two busy commercial kitchens here in the District of Columbia, staffed almost entirely with graduates of our Culinary Job Training program. The men and women we train come to us after extended stays in prison cells, at drug rehabilitation programs, or on the welfare rolls. First, we help them get their heads right. Next, we give them tangible skills for work in the culinary industry. Finally, we help them find jobs. Many find those jobs at DC Central Kitchen.

Today, 68 graduates of our program work for us. Every new hire starts at a living wage - in DC, that's \$12.50 an hour, with 100% paid health benefits, life insurance, paid sick leave and a company matched retirement plan. We didn't start offering these packages because we had lots of money to spare. We did it to model to other employers, nonprofit and for-profit,

that they can pay people well, provide great products and services, and still show a profit at the end of the day.

Now, after three years of rapid growth in our social enterprise activities, we have lots of that proof. Our Healthy School Food program is earning month-to-month profits, exceeding student participation targets, and providing schools in low-income DC neighborhoods with higher quality food service than they have ever had. Our catering company saw significant revenue growth in 2012, thanks to our expansion into a new kitchen facility. We've even begun delivering fresh produce and nutritious, handmade snacks to 29 corner stores in Washington's 'food deserts.' In just the fourth quarter of last year, those participating retailers topped \$10,000 in sales, showing that the residents of these communities will make healthy choices - they just need the opportunity, knowledge, and means to do so.

At DC Central Kitchen, we spend hundreds of thousands of dollars on local farm products each year, pay living wages, and train men and women that others have written off as helpless, or even hopeless, for real careers. We don't do these things because they make us feel good. We don't do them because donors tell us to. We do these things because they are the smartest things we can do in service of our community and our common future.

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