



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

---



## AUTHOR

Edward J. Loya, Jr.  
Associate  
ejloya@Venable.com  
310.229.9923

## 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.<sup>1</sup>

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.<sup>2</sup>

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.<sup>3</sup>

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;<sup>4</sup>
- 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](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](http://www.publiccounsel.org/publications?id=0190)

**Public Counsel – *Annotated Form of Whistleblower Policy***

[www.publiccounsel.org/publications?id=0063](http://www.publiccounsel.org/publications?id=0063)

This publication was written as a collaboration among attorneys of the Community Development Project of Public Counsel and a number of private corporate, litigation, tax and employment law practitioners who volunteered their legal expertise *pro bono*. In particular, Public Counsel acknowledges the contribution of **Edward J. Loya, Jr.**, a trial attorney in the Century City office of **Venable LLP** and former federal prosecutor in the Public Integrity Section of the Criminal Division of the U.S. Department of Justice. Mr. Loya successfully prosecuted a former acting executive director, grant administrator, and nonprofit legal assistant for stealing more than \$150,000 in federal funds from the U'una'i Legal Services Corporation, a now-defunct nonprofit organization in American Samoa that provided free legal services to the poor. He would like to thank Venable partners **William H. Devaney**, **Doreen S. Martin**, and **Jeffrey S. Tenenbaum**, on whose written work he relied in preparing portions of this publication.

© 2014 Venable LLP. This alert is published by the law firm Venable LLP. It is not intended to provide legal advice or opinion. Such advice may only be given when related to specific fact situations that Venable has accepted an engagement as counsel to address.  
ATTORNEY ADVERTISING.