

ADVISING NONPROFITS: AN OVERVIEW OF LEGAL ISSUES

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September 16, 2005

The focus of this overview is to provide nonprofit managers with enough information about the laws governing nonprofits to know when to consult an attorney, and to give attorneys without extensive knowledge in this area the ability to spot potential legal issues when they arise. This outline discusses some of the more frequently implicated legal requirements applicable to nonprofits.¹

I. Formation and start-up

A. Incorporation

Most nonprofits are formed as corporations, primarily in order to attain limited liability of its directors and members.

1. Determining in which state to incorporate.

It is relatively difficult to dissolve or amend the certificate of incorporation of a nonprofit formed under the New York Not-for-Profit Corporation Law (the “N-PCL”). See, e.g., N-PCL §§ 804 (certain amendments must be approved by a court, on notice to the Attorney General), 1002 and 1003 (certain dissolutions must be approved by a court in two steps, each on notice to the Attorney General). Therefore, many nonprofits choose to incorporate in Delaware instead, then obtain authority to do business in New York.

Despite the cumbersome processes prescribed by the N-PCL, some nonprofits choose to incorporate in New York because they believe doing so will help obtain certain state and local government approvals or funding, or will be beneficial for public perception or public relations purposes.

2. Incorporation in New York

In New York, nonprofits formed for certain purposes are incorporated under statutory provisions other than the N-PCL. For example, religious corporations are formed under the Religious Corporations Law, and schools and museums are chartered by the Board of Regents under the Education Law.

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a. Consent or waiver from various state departments

An organization that would properly be formed under the N-PCL, but which has a purpose that may appear to require formation under a different statutory provision, must obtain the appropriate department’s consent (or waiver of consent) to incorporate under the N-PCL. Such waiver or consent must be obtained before filing the certificate of incorporation with the Department of State.

b. Type A-D

Not-for-profit corporations formed under the N-PCL are designated as any one of Types A through D. Organizations seeking tax-exempt status under section 501(c)(3) of the Internal Revenue Code will generally be Type B or C.

3. Incorporation in Delaware

Nonprofits may incorporate as nonstock corporations under the Delaware General Corporation Law. As noted above, dissolutions and amendments of certificates of incorporation are more easily achieved by a Delaware corporation than by a New York not-for-profit corporation. Before engaging in activities in New York, such “foreign” corporations must file for authority to do business within the state, which requires the consent or waiver and involves assignment as to Type discussed above.

4. Certificate of incorporation

The purposes and powers enumerated in a nonprofit’s certificate of incorporation should be drafted broadly enough to permit the organization to conduct all activities it may wish to conduct in the future.

In order for a nonprofit to qualify as tax exempt under section 501(c)(3) of the Internal Revenue Code, its certificate of incorporation may include only charitable purposes. It must also provide that, upon the corporation’s dissolution, its assets will be distributed to another 501(c)(3) organization or to the federal government, or a state or local government, for a public purpose.

One important decision that should be made upon formation is whether the corporation will have voting members, which have rights akin to those of shareholders of a for-profit corporation.

B. Bylaws and organizational meeting

Once a nonprofit has been incorporated, which generally occurs upon the Department of State’s filing the certificate of incorporation, its board of directors (and members, if any) should hold an initial meeting to adopt bylaws, elect and empower officers, and adopt other resolutions to facilitate the corporation’s commencement of activities. In lieu of such meeting, the board of directors may adopt the bylaws and other resolutions by unanimous written consent.

As with for-profit corporations, the bylaws of a nonprofit govern the oversight and management of the corporation. The bylaws include technical requirements for notice of meetings, quorum, committees, elections and voting.

In addition, the board of directors should adopt a conflict of interest policy, either in the bylaws or as a separate document. The application for IRS recognition of a nonprofit's 501(c)(3) status, Form 1023, provides a sample conflict of interest policy and asks whether a similar policy has been adopted by the organization's board.

C. Federal tax exemption under IRC section 501(c)(3)

1. IRS recognition

Generally, a nonprofit organization will seek to be recognized by the Internal Revenue Service as tax exempt. For organizations exempt under section 501(c)(3), IRS recognition is obtained by filing Form 1023 (revised in 2004), which provides information about the corporation's organization, activities, finances, and corporate governance safeguards.

For newly formed organizations, a favorable outcome is the receipt of a "determination letter," wherein the IRS acknowledges the organization's status under the appropriate paragraph of subsection 501(c). The determination letter also states whether the IRS expects the organization to be a public charity or private foundation, discussed below. Provided the organization is organized and operated as described in its Form 1023, the organization and its donors may rely on the conclusions expressed in the IRS's determination letter during the "advance ruling period," discussed below. At the end of this period, the organization must provide the IRS with information to enable a determination as to whether the organization is a public charity or private foundation.

2. Status as public charity vs. private foundation

Section 501(c)(3) organizations are divided into two types: public charities and private foundations. Both types are generally referred to as "charities". Private foundations are treated less favorably under the Code. For example, limits on the deductibility of contributions to private foundations are generally lower for gifts to private foundations. In addition, private foundations are generally subject to the rather onerous provisions of Chapter 42 of the Code, including a tax on net investment income (IRC § 4940), a minimum distribution requirement (IRC § 4942), severe taxation of certain expenditures (IRC § 4945), which effectively prohibit lobbying by private foundations, and prohibition on "self-dealing," discussed below. Thus, where feasible, nonprofit organizations will seek status as a public charity.

a. Private foundations

The Code defines "private foundation" as a 501(c)(3) organization *other than* certain specified organizations. Those specified organizations constitute public charities and are described below.

b. Public charities

The following are public charities:

(1) "Traditional" charities (schools, hospitals, etc.)

"Traditional" charities, such as churches, schools and colleges, hospitals, as well as governmental units. IRC §§ 509(a)(1) and 170(b)(1)(A)(i)-(v).

(2) "Publicly supported" organizations

- (a) Organizations which normally receive a substantial part of their support (exclusive of income received in pursuit of their charitable purpose) from a governmental unit or from contributions from the general public, IRC §§ 509(a)(1) and 170(b)(1)(A)(vi), and
- (b) Organizations which normally receive
 - (i) not more than 1/3 of their support from certain investments and from business activities unrelated to their charitable purposes, and
 - (ii) more than 1/3 of their support from any combination of
 - (A) gifts, grants, contributions or membership fees, and
 - (B) gross receipts from activities related to their charitable purposes (up to the greater of \$5,000 or 1% of the organization's total support per person or governmental agency),not counting amounts received from "disqualified persons," (generally, those in a position to exercise "substantial influence" over the organization), IRC § 509(a)(2).

(3) Supporting organizations

Organizations which are organized and operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more traditional charities or publicly supported organizations described immediately above. Supporting organizations must be operated, supervised, or controlled by or in connection with the supported organizations, and may not be controlled by certain "disqualified persons." IRC § 509(a)(3).

D. Federal tax exemption other than under IRC section 501(c)(3)

There are many types of nonprofits that are exempt from corporate tax under provisions other than section 501(c)(3), including trade associations and business leagues, labor organizations, social clubs and fraternities, political organizations, and title holding companies. These organizations receive reduced benefits under the Code and, often, under state tax law. Most notably, donors' contributions are not tax deductible.

E. State tax exemptions

Most nonprofits also seek exemption from state and local taxes, including corporate, sales, and real property taxes. Such exemptions are generally easier to obtain after the organization has received its determination letter from the IRS.

II. Activities and operations

A. Governance

Attorneys advising nonprofits and their boards of directors must be aware of the legal norms governing their conduct. In addition, since nonprofits generally rely on contributions and grants, nonprofits' advisors must be cognizant of the operative public perceptions concerning nonprofits and their boards.

1. The Legal Duties of Not-for-Profit Officers and Directors

Officers and directors are considered fiduciaries of the not-for-profit organizations they manage. Scheuer Family Foundation, Inc. v. 61 Associates, 179 A.D.2d 65, 582 N.Y.S.2d 662 (1st Dept. 1992); Billings v. Shaw, 209 N.Y. 265, 282, 103 N.E. 142, 148 (1913). Their fiduciary duties of care and loyalty, derived from common law, are articulated in the New York Not-for-Profit Corporation Law (“N-PCL”).

a. The Duty of Care

Nonprofit directors and officers owe the organization on whose boards they serve a duty of care, articulated in Section 717 of the N-PCL as follows:

Directors and officers shall discharge the duties of their respective positions in good faith and with that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions.

1. This provision requires the board to pay attention to fiscal affairs of the corporation, conscientiously decide the matters that come before it, create and enforce “internal information systems” and “serve as a check or veto on management.” Fishman, “Standards of Conduct for Directors of Nonprofit Corporations,” 7 Pace L. Rev. 389, 393 (1987).
2. This standard allows directors considerable leeway and discretion in the discharge of their responsibilities. Note, “The Fiduciary Duties of Loyalty and Care Associated with the Directors and Trustees of Charitable Organizations,” 64 Va. L. Rev. 449, 453-454 (1978). On its face, the statutory language articulating the duty of care suggests that directors will be found to have breached the duty upon a finding of negligence. Furthermore, it appears that the “business judgment rule” would apply to decisions of not-for-profit directors. Consumers Union of U.S. v. New York, No. 83, 2005 N.Y. Lexis 1433 (N.Y. Ct. App. June 20, 2005). That rule “bars judicial inquiry into actions of corporate directors taken in good faith and in the exercise of honest judgment in the lawful and legitimate furtherance of corporate purposes.” Auerbach v. Bennett, 47 N.Y.2d 619, 629, 419 N.Y.S.2d 920, 925 (1979).

b. The Duty of Loyalty

The duty of loyalty requires a director to pursue the interests and mission of the not-for-profit with undivided allegiance. Beyond N-PCL § 717(a)’s reference to discharge of directorial duties “in good faith,” there is no statutory formulation of this duty. One must look to case law for an articulation of the standard under New York law.

1. To satisfy the duty of loyalty, directors must “subordinate their individual and private interests to their duty to the corporation.” Nechis v. Gramatan, 231 N.Y.S.2d 383, 35 Misc.2d 949 (Sup. Ct. Westchester County 1962), quoting Winter v. Anderson, 242 A.D. 430, 275 N.Y.S. 373 (4th Dept. 1934).
2. They also are prohibited from utilizing their fiduciary position to usurp a business opportunity or advantage available to the corporation. This “corporate opportunity doctrine” has been described as follows:

[I]f there is presented to a corporate officer or director a business opportunity . . . in which the corporation has an interest or a reasonable expectancy, and, by embracing the opportunity, the self-interest of the officer or director will be brought into conflict with that of [the] corporation, the law will not permit [the officer or director personally] to seize the opportunity. . . .

Robinson v. R & R Publ'g, Inc., 943 F.Supp. 18 (D.D.C. 1996), quoting Guth v. Loft, 23 Del. Ch. 255, 5 A.2d 503, 511 (Del. 1939). See also American Baptist Churches of Metro. N.Y. v. Galloway, 271 A.D.2d 92, 710 N.Y.S.2d 12 (1st Dept. 2000); Bolton v. Stillwagon, 410 Pa. 618, 190 A.2d 105 (1963); Fishman, "Standards of Conduct for Directors of Nonprofit Corporations," 7 Pace L. Rev. 389, 431-432 (1987).

3. One particular type of self-dealing conduct – loans from the not-for-profit to an officer or director – is explicitly prohibited by N-PCL § 716.
4. The duty of loyalty does not bar all transactions between a director and the not-for-profit. Section 715 of the N-PCL allows these "interested party transactions" under certain specified circumstances.
 - a. The directors' or officers' interest in the transaction must be fully disclosed to the board or be known by them and the transaction must be authorized by a vote of "disinterested" board members, i.e., a majority of the board that does not include the vote of the interested director. N-PCL § 715(a)(1).
 - b. In a membership organization, the transaction may be authorized by a vote of the members, if the material facts of the interest are disclosed to the members or known to them. N-PCL § 715(a)(2).
 - c. Interested officers and directors can be present at a meeting at which approval of the transaction in which they have an interest is considered, and they can be counted in determining the presence of a quorum at such meeting. N-PCL § 715(c).
 - d. The interested party transaction may still be binding on the corporation even in the absence of the required disclosure and in the absence of a vote of disinterested board members, as where the interested director's vote was necessary for the authorization of the transaction. Under those circumstances, the parties to the transaction must "establish affirmatively that the contract or transaction was fair and reasonable as to the corporation...." N-PCL § 715(b).

2. Internal Revenue Code Rules Relating to Conduct of Fiduciaries

The Internal Revenue Code ("IRC") also prohibits acts of self-inurement and self-dealing for tax-exempt organizations. IRC § 501(c)(3) requires that every 501(c)(3) organization be operated exclusively for tax-exempt purposes and that "no part of [its] net earnings ... inures to the benefit of any private shareholder or individual...." While this prohibition affects individuals other than directors and officers, in practice, these rules have the most direct bearing on those charged with the governance of not-for-profit organizations.

a. Rules for Public Charities

IRC § 4958 proscribes “excess benefit transactions” between certain charitable organizations and “disqualified persons” (generally, those in a position to exercise “substantial influence” over the organization). This section gives the Internal Revenue Service the authority to impose penalty taxes (known as “intermediate sanctions,” in contrast to the ultimate sanction, revocation of exempt status) when a transaction is found to bestow an excess benefit on a disqualified person.

a. Definition of Excess Benefit. An excess benefit transaction is one in which the economic benefit provided to the disqualified person is greater than the return benefit to the applicable tax-exempt organization. IRC § 4958(c)(1)(A). In short, the deal is lopsided in favor of the disqualified person. Such transactions include unreasonable compensation paid to a disqualified person, including reimbursement for expenses, and sales of property to disqualified persons for less than the fair market value of such property. See P.L.R. 200247055 (Nov. 22, 2002) (no excess benefit found where benefit to physicians who were disqualified persons from hospital’s free bus service does not exceed benefits to public generally); P.L.R. 200421010 (Feb. 20, 2004) (sharing of expenses for employees, office space, and equipment not an excess benefit transaction where based on detailed allocation records as to the various expenses); P.L.R. 200335037 (June 2, 2003) (nonprofits’ grants which raise a bank’s rating under the Community Reinvestment Act of 1977 did not confer an economic benefit on the bank and thus did not constitute excess benefit transactions).

- 1) The excess benefit rules will not apply to fixed payments made pursuant to an initial contract. Thus, for example, the initial contract of an organization’s CEO will not be subject to the excess benefit transaction rules. This is sometimes referred to as the “first bite” exception. Treas. Reg. § 53.4958-4(a)(3).
- 2) Both direct and indirect economic benefits, e.g, benefits provided to a disqualified person through a controlled entity or an intermediary, may be considered excess benefit transactions. Treas. Reg. § 53.4958-4(a)(2).

b. Definition of Disqualified Person. A “disqualified person” is one who, at any time during a five-year “lookback” period prior to the transaction, was in a position to exercise substantial influence over the organization. Voting members of the governing body, presidents, chief executive officers, chief operating officers, and chief financial officers are presumed to have substantial influence. Treas. Reg. § 53.4958-3.

- 1) In addition, the following family members of those in positions of substantial influence are also considered to be disqualified persons: spouse, ancestors, children, grandchildren, great-grandchildren, spouses of children, grandchildren and great-grandchildren, brothers and sisters and their spouses. IRC § 4958(f)(4). (Note that for private foundations, the list of family members deemed to be disqualified persons by virtue of their relationship excludes the siblings, and their spouses, of the disqualified person.)

- 2) Entities as well as individuals can be disqualified persons. An entity where 35% of the control is held by a disqualified person is itself a disqualified person. Treas. Reg. § 53.4958-3(a)(2).
 - 3) The determination of whether a person (including an entity) is in a position to exercise substantial influence over the organization is measured by the person's actual powers and duties and not by title alone. The IRS evaluates all the relevant facts and circumstances in determining whether an individual has substantial power or influence. Treas. Reg. § 53.4958-3(e).
 - 4) Non-profit organizations exempt under IRC § 501(c)(3) are deemed not to be disqualified persons, and organizations exempt under IRC § 501(c)(4) are deemed not to be disqualified persons with respect to other IRC § 501(c)(4) organizations. Treas. Reg. § 53.4958-3(d).
- c. Excise Taxes. The penalty for engaging in an excess benefit transaction is a tax on the disqualified person, not on the organization.
- 1) The initial tax is equal to 25% of the excess benefit. If the excess benefit is not corrected within a reasonable time, an additional tax equal to 200% of the excess benefit will also be imposed. IRC § 4958(a)(1), (b).
 - 2) Organization managers may also be subject to penalty taxes in cases where a tax is imposed on a disqualified person and the manager(s) knowingly participated in the transaction, and such participation was willful and not due to reasonable cause (such as reliance upon a written opinion of counsel). IRC § 4958(a)(2). The tax on organization managers is 10% of the excess benefit, up to a maximum total of \$10,000 per transaction. IRC § 4958(d)(2).
- d. Safe Harbor Procedures. The regulations contain a set of procedures that, if followed when approving a transaction between a disqualified person and the organization, will afford the disqualified person the benefit of a rebuttable presumption that the transaction was reasonable. If the transaction is a compensation arrangement, a rebuttable presumption will be created that the compensation is reasonable, and if the transaction is a transfer of property, a rebuttable presumption will be created that the transfer is at fair market value. This presumption shifts the burden of proving that the transaction was unreasonable (and thus subject to intermediate sanctions) to the IRS. Treas. Reg. § 53.4958-6. It is highly recommended that all non-profit organizations take advantage of the protection the safe harbor provisions offer. The procedures are as follows:
- 1) The decision about the transaction must be made in advance by the board (or an authorized committee thereof), composed entirely of individuals who do not have a conflict of interest with respect to the transaction and, thus, are truly "disinterested." Treas. Reg. § 53.4958-6(a)(1).

- 2) The Board or committee must have obtained and relied upon appropriate comparability data in making its decision. Appropriate data as to comparability may include appraisals, other offers or, in the case of compensation decisions, this data can include documented compensation levels of persons working in similar positions in similar organizations. (Similarities of size and geographic location are among the factors considered.) The Board can also look to reliable surveys of compensation levels and expert studies. Treas. Reg. § 53.4958-6(a)(2). See P.L.R. 200244028 (June 21, 2002) (no rebuttable presumption created where minutes of meeting approving compensation failed to substantiate board reliance on compensation study and where compensation study was done after meeting). Organizations with less than \$1 million a year in gross receipts need only rely on comparability data from three other organizations. Treas. Reg. § 53.4958-6(c)(2).
- 3) The disqualified persons, or those for whom the transaction presents a conflict of interest, may meet with other members to answer questions, but may not be present during debate and voting on the transaction. Treas. Reg. § 53.4958-6(c)(1)(ii).
- 4) The board or committee must document the basis for its decision within 60 days of the action taken, or before their next meeting. The documentation must include: a) the terms of the transaction and the date approved; b) the members of the board, or committee, who participated in the discussion and who voted on it; c) the comparability data relied upon and how it was compiled; and 4) the actions of any member of the board or committee having a conflict of interest with respect to the transaction. Treas. Reg. § 53.4958-6(a)(3), (c)(3).

Consistent with the intensified interest in conflicts of interest, the Internal Revenue Service has revised the Form 1023 in order to “streamline the application process for the organizations and [to] help the IRS spot potential abusive charities.” See <http://www.irs.gov/pub/irs-pdf/f1023.pdf> Part V of the new Form 1023 requests information about compensation to directors, officers, trustees, as well as compensated employees and independent contractors. In addition, the Form 1023 asks for a description of the organization’s conflicts of interest policies and whether transactions with officers, employees and contractors are negotiated at arm’s length.

b. Rules for Private Foundations

Organizations which are classified as private foundations by the Internal Revenue Service (generally, organizations which derive their support from one or more related individuals) are subject to special, stringent rules concerning transactions between them and the disqualified persons. With limited exceptions, these rules prohibit these so-called “self-dealing” transactions between disqualified persons and the private foundation, regardless of the benefit (or lack thereof) to either party, and impose excise taxes for violations of these rules. IRC § 4941.

- a. Definition of Disqualified Person. Although the term “disqualified person” is also used in connection with excess benefit transactions, it is defined somewhat differently in the private foundation context.

- 1) For purposes of the self-dealing rules, disqualified persons are defined as follows: a) substantial contributors to the foundation (typically the founder and other major donors); b) foundation managers (typically directors and officers); c) an owner of more than 20% of the voting power, profits interest or beneficial interest of a corporation, partnership or trust, respectively, that is a substantial contributor to the foundation; d) the spouse, ancestors, children, grandchildren, great-grandchildren and the spouses of children, grandchildren and great-grandchildren of a person described in a), b) or c), above; and e) entities in which disqualified persons own more than 35% of the equity, voting power, or beneficial interests. IRC § 4946(a).
 - 2) Note that the siblings (and their spouses) of disqualified persons are not considered disqualified persons in the self-dealing context, whereas they are for purposes of the excess benefit transaction rules.
 - 3) Only those individuals or entities meeting the technical definition are considered disqualified persons, in contrast to the excess benefit transaction context, where any individual or entity that is in a position to exercise substantial influence will be considered a disqualified person.
- b. Definition of Self-Dealing Transaction. The following transactions (whether direct or indirect) between a private foundation and a disqualified person are acts of self-dealing and are strictly prohibited, with certain very limited exceptions. IRC § 4941(d)(1).
- 1) The sale, exchange or leasing of property between a private foundation and a disqualified person. Treas. Reg. § 53.4941(d)-2(a), (b).
 - 2) A loan or other extension of credit between a private foundation and a disqualified person. Treas. Reg. § 53.4941(d)-2(c).
 - 3) The furnishing of goods, services or facilities between a private foundation and a disqualified person. Treas. Reg. § 53.4941(d)-2(d).
 - 4) The payment of compensation, including reimbursement of expenses, by a private foundation to a disqualified person. Treas. Reg. § 53.4941(d)-2(e).
 - 5) The transfer of a private foundation's income or assets to or for the benefit of a disqualified person, including the use of such assets by the disqualified person. Treas. Reg. § 53.4941(d)-2(f).
 - 6) The agreement by a private foundation to make payments of money or other assets to a government official. Treas. Reg. § 53.4941(d)-2(g).
- c. Exceptions to the Self-Dealing Rules: Although the rules cited above are per se prohibitions, the exceptions limit their negative impact to some extent, as they encompass some of the most benign transactions between disqualified persons and the private foundation:

- 1) The leasing of property by a disqualified person to a private foundation without charge does not constitute self-dealing, even when the private foundation pays for the basic maintenance costs it incurs in relation to its use of the property (as long as the payment is not made directly or indirectly to the disqualified person). Treas. Reg. § 53.4941(d)-2(b)(2).
- 2) The lending of money, or extension of credit, to a private foundation by a disqualified person is not an act of self-dealing as long as no interest or other charge is involved. Treas. Reg. § 53.4941(d)-2(c)(2).
- 3) It is not an act of self-dealing for a disqualified person to furnish goods, services or facilities to a private foundation without charge. For purposes of this exception, the private foundation can pay for transportation, insurance and maintenance costs associated with its use of the property or services, as long as the payment is not made directly or indirectly to the disqualified person. Treas. Reg. § 53.4941(d)-2(d)(3).
- 4) It is not an act of self-dealing for a private foundation to furnish goods, services or facilities to a disqualified person so long as they are made available to the general public on as least as favorable terms. Treas. Reg. § 53.4941(d)-3(b)(1).
- 5) It is not an act of self-dealing for a private foundation to pay compensation to a disqualified person for personal services rendered that are reasonable and necessary to carry out the exempt purposes of the foundation, as long as the compensation is not excessive. This exception does not apply to government officials. Treas. Reg. §§ 53.4941(d)-2(e), 53.4941(d)-3(c)(1).
- 6) A disqualified person can receive incidental benefits from a private foundation's use of its income or assets without running afoul of the self-dealing rules. For example, if a private foundation gives public recognition to a disqualified person who has been a substantial contributor to the foundation, this benefit is viewed as incidental and, thus, is not an act of self-dealing. Treas. Reg. § 53.4941(d)-2(f)(2).
- 7) The "First-Bite" Exception. Self-dealing does not include a transaction between a private foundation and a disqualified person where the disqualified person status arises as a result of the transaction. For example, if a person sells property to a foundation at a bargain price and, as a result of this transaction becomes a substantial contributor (and, thus, a disqualified person) as a result of the transaction, this "first-bite" transaction will not be considered an act of self-dealing. Treas. Reg. § 53.4941(d)-1(a). However, the person who became a substantial contributor by virtue of this transaction will be treated as a disqualified person going forward.
- 8) Transactions During Estate Administration. Fair market value sales and exchanges that occur as part of the administration of an estate of which the private foundation is a beneficiary are not acts of self-dealing but are subject to court approval. Treas. Reg. § 53.4941(d)-1(b)(3).

d. Excise Taxes. The penalty for engaging in an self-dealing is a tax on the self-dealer and foundation managers, not on the organization.

- 1) Tax on the Self-Dealer. An initial tax equal to 5% of the amount involved in the act of self-dealing is imposed on any disqualified person (other than a foundation manager acting only in that capacity) who participated in the act. Except in the case of government officials, the tax will be imposed even when the disqualified person had no knowledge at the time of that act that it constituted self-dealing. IRC § 4941(a)(1). A disqualified person is considered to have “participated” in an act of self-dealing even in instances where he directed another person to engage in the transaction. Treas. Reg. § 53.4941(a)-1(a)(3). If the act of self-dealing is not “corrected” (generally, undoing the transaction or returning the private foundation to at least the financial position it would have been in absent the transaction) in a timely fashion, an additional tax of 200% of the amount involved is imposed upon the disqualified person. IRC § 4941(b)(1).
- 2) Tax on Foundation Managers. An initial tax equal to 2.5% of the amount involved in the act of self-dealing is imposed on foundation managers who participate in an act of self-dealing. Participation in this case means that the foundation manager knows that the transaction is an act of self-dealing, his participation is willful and is not due to reasonable cause (such as exercising ordinary business prudence or relying on a written opinion of counsel). IRC § 4941(a)(2). If the foundation managers refuse to agree to all or part of the correction, an additional tax equal to 50% of the amount involved will be imposed. IRC § 4941(b)(2). Section 4941 taxes on managers are capped at \$10,000 per transaction, regardless of how many foundation managers participated. IRC § 4941(c)(2).

3. Practical Measures for Assuring Proper Board Behavior and Avoiding Liability

While the discharge of fiduciary responsibility is ultimately up to each individual, certain types of governance structure, particular patterns of conduct, and habits of deliberation will foster the careful and scrupulous performance of the board’s responsibilities. See, generally, Fishman, “Improving Charitable Accountability,” 62 Md. L. Rev. 218 (2003). These are discussed in the balance of this outline, with explanations, where relevant, drawn from these cases. Below are a few concrete ways in which nonprofit organizations can facilitate appropriate conduct by their officers and directors.

a. Facilitating the duty of care

In concrete terms, the duty of care requires the director to be attentive to the affairs of the organization and to actively oversee the way in which its assets are managed. Particular structural mechanisms and procedures will aid organizations in carrying out their functions and reaching decisions in a careful and responsive manner.

1. To facilitate the directors’ careful attention to corporate affairs, it is advisable to have structural features which maximize the likelihood that directors will have access to

appropriate information and will carry out their responsibilities in the most efficient and conducive environment, including the following:

- a. Formation of standing committees with responsibility for important functions, such as audit, compensation and budget, and personnel.
 - b. Requiring regular meetings of the board, with a minimum number of meetings per year specified in the bylaws.
 - c. Requiring written agendas, minutes, and meaningful written materials to be distributed to the board in advance of the meetings. This will give the board sufficient notice of the matters to be discussed and allow time for necessary pre-meeting preparation by the board members.
 - d. Board size sufficiently large to allow diverse views and interests, but not so large as to be unwieldy. Specifying minimum and maximum number of directors in the bylaws is a good way of accomplishing this.
 - e. Board composition is a key structural factor toward assuring that responsibilities are discharged carefully. Boards should include people with substantive familiarity with the work of the organization, management and financial background, and people who can exercise judgment independent of the CEO and/or the controlling faction of the board.
 - f. Sufficient board turnover to guard against burn-out and excessive clubbiness, both of which tend to stifle lively debate and careful attention. Term limits should also be considered.
 - g. Limitation of the number of staff members that can serve on the board and/or delineation of the issues which must be discussed without board members from the staff in attendance. This is a partial brake on the tendency toward staff control and domination of the board.
2. In addition, the duty of care requires that directors be in a position to exercise meaningful oversight, by behaving in certain ways, including:
- a. Becoming familiar with important corporate documents, such as the certificate of incorporation and by-laws.
 - b. Regular monitoring of organization's finances, either directly or through the appropriate standing committees.
 - c. Access to, and direct review of, corporate books and records.

- d. Regular attendance at board and committee meetings. Many practitioners recommend an attendance policy, which, of course, will be meaningful only to the extent it is taken seriously and enforced.
- e. Careful review of any written materials disseminated in advance of meetings or during the course of meetings.
- f. Delegation to qualified professionals of tasks requiring specialized expertise, especially if no one on the board has such expertise, and the regular opportunity to question such experts about issues facing the board. See N-PCL § 717(b) (allowing delegation to committees or experts and good faith reliance on information supplied by delegees).
- g. Insistence upon access to sufficient information, opportunity, and time to allow for informed and prudent decisions concerning issues facing the corporation.

b. Assuring the duty of loyalty

1. Common Trouble Spots. The duty of the board to give undivided loyalty to the not-for-profit is a key factor in advice as to the appropriate governance structure for a newly created organization or the proper procedures or policies by which the board of an established organization should conduct business. The procedures and policies must be adequate to allow the not-for-profit to avoid common dual loyalty situations such as:
 - a. Setting compensation for board members who are also employees of the organization or providing services to the organization. Compensation for the CEO who sits on the board is an especially tricky issue.
 - b. Contracts for goods or services between the organization and a firm owned or controlled by a board member, e.g., a bank, software vendor, or architectural firm.
 - c. Investment of organizational funds in companies or other investment vehicles where board members are also investors or otherwise have an interest in the investment.
 - d. Boards comprised of individuals in the same substantive field as the organization or affiliated with entities that seek funding from the same sources as the organization.
2. Procedures for Avoiding Conflicting Loyalties. In order to avoid situations where a board member's interest may improperly conflict (or appear to conflict) with the organization's interests, the not-for-profit should create an organizational structure where the best interests of the organization can be vigorously analyzed and pursued, through such mechanisms as:
 - a. A board that is made up of individuals of diverse backgrounds and interests and is large enough so that no single faction controls. As discussed above, this will also facilitate the careful performance of the board's oversight.

- b. Similarly, a board that turns over at regular intervals and has term limits will facilitate a fresh look at whether the organization's contracts and business arrangement serve the organization's best interests, as opposed to private interests of board members on staff, while helping the board perform its responsibilities carefully.
 - c. Lines of authority and committee structure within the board which encourage a sharing of power among people with diverse perspectives and economic interests will tend to safeguard against conflict situations.
- 3. Conflict of Interest Policies. The not-for-profit should also institute policies which address potential or actual conflicts of interest and set standards for permissible and impermissible conduct. These will generally include:
 - a. A written statement articulating the criteria governing the board's consideration of transactions involving actual or potential conflicts of interest between the organization and the board member and reaffirming the board's duty of undivided loyalty to the not-for-profit, and
 - b. A form to be completed by each board member annually, indicating that they are in compliance with the conflict of interest policy and stating any interest they may have in any transaction where consideration by the board is pending.
- 4. Conflict of Interest Procedures. The not-for-profit should be counseled to institute procedures for dealing with conflicts of interest which arise between board members and the organization. Since the "safe harbor" procedures outlined above are designed to avoid the conflicts of interest represented by excess benefit transactions, and, at the same time provide the organization with the benefit of the rebuttable presumption of reasonableness, these should be incorporated into the organization's bylaws, including:
 - a. Detailed written procedures to be followed when interested party transactions are proposed. The procedures should include disclosure of any director's interest, some mechanism for independently assessing whether the proposed transaction is advantageous to the organization (such as studies of charges for similar transactions or competitive bids) and should address whether the interested director can be present during deliberations or voting, as well as whether the interested director can be counted for purposes of determining the existence of a quorum.
 - b. Detailed written procedures to be followed when setting salaries or other compensation for any board members who are also employees or consultants. The procedures should require the compilation of comparative data concerning salary/compensation and should prohibit the board member from being counted in the quorum or being present during deliberations or voting.
 - c. Procedures for detailed documentation of board approval of interested party transactions or other arrangements having even the appearance of conflicting interests between the organization and a board member, including minutes reflecting

disclosures by board members, consideration of comparative costs or market value information, and articulating any other factors considered by the board in approving the transaction.

B. Reporting requirements

Tax-exempt organizations having annual gross receipts averaging more than \$25,000 must file an annual information return with the IRS. Public charities file Form 990; private foundations file Form 990-PF. In addition, New York requires annual reports from nonprofits required to register with the Attorney General's Charities Bureau under the EPTL and/or Art. 7-A of the Executive Law (regarding solicitation of charitable contributions). Other states have similar annual reporting requirements.

C. Fundraising issues

1. State registration and disclosure requirements

38 states require that a nonprofit register with the state before soliciting charitable contributions within the state, which is defined quite broadly. In addition, many states have laws requiring certain disclosures in the course of raising funds from the public.

2. Contracts with fundraising professionals

Any arrangement between a nonprofit and a fundraising professional must be in writing. Most states requiring registration require a copy of such contract, and several states have specific terms that must be included in such contract. Fundraising professionals must also register, file closing statements and periodic statements, and, in many states, post a bond.

3. Disclosure regarding deductibility of charitable contributions

Generally, nonprofits are not charged with policing the tax deductions for charitable contributions that their donors claim. However, nonprofits must provide certain information about donations to donors and, in some cases, to the IRS. There are three basic substantiation and disclosure requirements regarding federal income tax reporting of contributions:

- 1) A donor is responsible for obtaining a written acknowledgment from the charity for any contribution of \$250 or more before the donor can claim a charitable contribution on his or her income tax return. The acknowledgment must describe any goods or services that the organization provides in exchange for the contribution, or state that no goods or services were provided. However, certain low cost articles, insubstantial services, and benefits from membership in the organization are exempted from this requirement.

Although a charity that does not provide a written acknowledgment for contributions of \$250 or more will not itself be penalized, its donors' ability to claim a charitable deduction will be jeopardized. Thus, it is sound policy for a charity to provide its donors with a timely, written acknowledgment. (A contributor of less than \$250 in cash, check, or credit card only need to retain a canceled check, receipt, or some other reliable record.)

- 2) With respect to noncash contributions, regardless of amount, donors must obtain a receipt from the charity showing a description of the property "in detail reasonably sufficient under

the circumstances.” For contributions of under \$5,000, this detail may, but need not, include the fair market value of the item(s) contributed. For non-cash contributions of more than \$5,000, a charity should require an appraisal from the donor.

3) A charity is required to provide a written disclosure to a donor who receives substantial goods or services in exchange for a single payment in excess of \$75 (a “*quid pro quo* contribution”). The required disclosure statement must include a good faith estimate of the fair market value of the goods or services and indicate the portion of the contribution that is deductible for federal income tax purposes. The deductible amount is the money or value of property contributed by the donor that exceeds the value of the goods or services provided by the organization. The disclosure statement must be furnished, in writing and such that it will likely come to the attention of the donor, in connection with either the solicitation or the receipt of the *quid pro quo* contribution.

A written disclosure is not required where the provided goods or services meet the token exception described above or where there is no donative element involved in a particular transaction, such as in the purchase of tickets to attend a symphony concert produced by a nonprofit symphony orchestra.

There is one special rule worth mentioning: Money paid for a raffle ticket or other game of chance is not a deductible charitable contribution, regardless of the donor’s donative intent. In addition, there are numerous state and local regulations related to games of chance, and these rules vary from jurisdiction to jurisdiction.

D. Grantmaking issues

Private foundations that make grants to organizations other than public charities (and certain operating foundations) must exercise “expenditure responsibility” with respect to those grants to ensure that they are used for their intended purpose. IRC § 4945(d)(4). In addition, before a private foundation can make a grant to individuals, it must generally obtain IRS approval.

E. Fundamental 501(c)(3) restrictions and intermediate sanctions

In addition to the restrictions on inurement and private benefit discussed above, 501(c)(3) imposes strict restrictions on a charity’s lobbying and political activity.

1. Political campaign activity (electioneering)

Section 501(c)(3) organizations are not permitted to “participate in, or intervene in . . . , any political campaign on behalf of (or in opposition to) any candidate for public office.” IRC § 501(c)(3). This prohibition is absolute; no amount of such political activity is permissible. A 501(c)(3) organization that is found to have engaged in such activity risks the revocation of its exempt status.

2. Lobbying limitation

Public charities. Section 501(c)(3) provides that “no substantial part” of a charity’s activities may consist of “carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)).” A violation of that requirement results in a failure to qualify as tax exempt under § 501(c)(3). Section 501(h) provides a safe harbor that allows an

electing public charity to make expenditures for lobbying within calculable dollar limits without risking its tax-exempt status. Generally, it is recommended that an organization planning to lobby make an election under § 501(h). The organization must continue to be operated “exclusively” for charitable purposes, § 501(c)(3), so any lobbying conducted by the organization must be in furtherance of the organization’s charitable purposes.

Private foundations. Section 4945 imposes taxes on a private foundation’s “taxable expenditures,” which include amounts paid or incurred in attempting to influence legislation. These taxes are imposed on both the foundation and its managers and can exceed 100% of the expenditure. Thus, § 4945 has the practical effect of an outright prohibition on taxable expenditures.

501(c)(4) affiliate. Because many charitable purposes can be furthered by influencing legislation, many 501(c)(3) organizations affiliate themselves with a 501(c)(4) organization, which may engage in such lobbying. When operating under this structure, care must be taken to maintain the appropriate separation between the two entities.

F. New York restrictions and requirements

1. Asset management

a. Restricted assets

Annual financial reports filed by nonprofits with the New York Attorney General’s Charities Bureau must comply with Generally Accepted Accounting Principles (“GAAP”). 13 NYCRR § 94.2(a)(1). The Financial Accounting Standards Board (“FASB”) requires that each nonprofit’s assets be divided into three categories: unrestricted, temporarily restricted, and permanently restricted. Statement of Financial Accounting Standards (“SFAS”) No. 116 ¶ 14 and No. 117 ¶ 21. These restrictions reflect a *donor-imposed* restriction. Donors can restrict, for example, the purposes to which their gift may be expended, the time period during which the gift may be expended, the organization’s authority to spend the funds (as in a principal-restricted endowment fund), or some combination of the foregoing.

The GAAP rules provide that, “A restriction on an organization’s use of the assets contributed results either from a donor’s explicit stipulation or *from circumstances surrounding the receipt of the contribution that make clear the donor’s implicit restriction on use.*” SFAS No. 116 ¶ 14 (emphasis added). Thus, assets may be restricted, for example, where donors contribute in response to solicitation materials that describe the funds being raised as for an “endowment fund” or for a particular purpose.

Assets that are restricted by the board rather than donors (sometimes referred to as “quasi-endowment” funds) are properly classified as unrestricted. SFAS No. 117, Appendix D (definition of “Endowment Fund”).

b. Investment responsibility: Prudent Investor Act

Charities in New York are subject to the “prudent investor act,” which sets forth the standards for investing and managing charitable assets. Estates, Powers and Trusts Law § 11-2.3. See also

EPTL § 11-2.2 (regarding power to invest) and Article 5 of the N-PCL, particularly N-PCL §§ 512-514, 522.

2. Transfer of substantially all assets

New York law requires court approval, on notice to the Attorney General, before a Type B or C corporation (i.e., all 501(c)(3) organizations) may sell, lease, exchange or otherwise dispose of all or “substantially all” its assets. N-PCL §§ 510 and 511. The Attorney General has interpreted the “substantially all” requirement to be more than 50% of an organization’s assets or an asset that significantly changes the organization’s activities.

3. Transfer of an interest in real property

A corporation organized under the New York religious corporation may not sell, mortgage or lease for a term exceeding 5 years any of its real property without court approval, on notice to the Attorney General. Religious Corporations Law § 12(1).

G. Unrelated Business Income Tax

In general, an exempt organization is subject to the unrelated business income tax (“UBIT”) when three conditions are met: (1) the income is derived from a trade or business; (2) such trade or business is regularly carried on by the exempt organization; and (3) such trade or business is not substantially related to the organization’s exempt purpose. IRC §§ 512(a)(1), 513(a). In addition to subjecting the organization to UBIT, an organization that derives excessive amounts of income from an unrelated business can jeopardize its tax-exempt status.

Certain debt-financed income is subject to UBIT. IRC § 514. There are numerous exemptions from the UBIT. See, e.g., IRC § 512(b).

Under the Code, a trade or business includes any activity that is carried on for the production of income from the sale of goods or the performance of services. Whether the activity is motivated by a desire to make a monetary profit is also considered in determining whether an activity is trade or business for the purposes of UBIT. The making of a substantial profit over a period of time is considered strong evidence of a profit motive. U.S. v. American Bar Endowment, 477 U.S. 105, 111 (1986). Another factor that indicates a profit motive is whether the activity is normally engaged in by commercial companies.

The Service will consider the frequency and continuity with which activities are conducted and the manner in which an activity is conducted when establishing if the “regularly carried on” requirement is met. Treas. Reg. § 1.513-1(c)(1). In general, a business activity is regularly carried on if the activity is carried on with a similar frequency and in a similar manner to comparable nonexempt organizations. *Id.*

When examining whether a business activity is “substantially related” or not, the Service will consider whether there is a substantial causal relationship between the achievement of an organization’s exempt purposes and its business activity. The production or distribution of goods or the performance of services must contribute importantly to the accomplishment of the organization’s exempt purposes. In determining whether a trade or business contributes importantly to an organization’s exempt purposes, one factor to consider is the size and extent of

the business activity in relation to the nature and extent of the exempt function that the activity purports to serve. Treas. Reg. § 1.513-1(d)(3).

III. Fundamental corporate changes

A. Fundamental change in activities

Before a nonprofit commences a new activity, it should verify that the activity furthers the exempt purposes set forth in its certificate of incorporation. In addition, the nonprofit should verify that the proposed new activity is consistent with its tax-exempt status and consistent with the activities described in its Form 1023.

B. Change in corporate purposes

If a proposed new activity would not further the exempt purposes set forth in the nonprofit's certificate of incorporation, the certificate should be amended to authorize the new activity. This is generally accomplished by filing an amended certificate. However, in New York, a certificate amendment that changes the corporation's purposes must be approved by a court, on notice to the Attorney General. In addition, assets held by the nonprofit at the time of a change in corporate purposes may only be used toward the old corporate purposes. Alco Gravure, Inc. v. The Knapp Foundation, 64 N.Y.2d 458; 490 N.Y.S.2d 116 (1985).

C. Dissolution

The dissolution of a nonprofit corporation is generally accomplished by filing a certificate of dissolution with the state of incorporation. Dissolution of a New York not-for-profit corporation requires approval of a court, on notice to the Attorney General. Under legislation passed recently, however, dissolution of corporations with no assets will not require court approval. As noted above, section 501(c)(3) requires that any remaining assets be distributed to another organization exempt under section 501(c)(3) or to the federal government, or a state or local government, for a public purpose.