# Intro to Non-Profit Law

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# Today's Agenda

- Non-Profit Basics
- Philosophy of Non-Profit Practice
- Tools of the Trade
- Non-Profits: Mitigating Risk
- Private Inurement
- Non-Profits and Business
- Non-Profits and Religion
- Non-Profits and Politics
- Questions?

# Non-Profit Basics Cont.

- NPOs with exempt status don’t pay tax from income, (generally).
- Only 501(c)(3) exempt organizations can provide a tax deduction to their donors, as a “charitable deduction”.
- Internationally, NPOs are called “Non-Governmental Organizations”, or NGOs.

# Forming a U.S. Non-Profit in 5 Steps

- Step 1: File Articles of Incorporation with the applicable state's secretary of state's office and apply for a Federal Employer Identification Number (FEIN) and a state tax id number (if applicable)
- Step 2: Have the Initial Board Meeting for the NPO – Elect initial board of directors, adopt by-laws, and adopt a conflict of interest policy (if applicable)
- Step 3: Apply for Federal Tax Exempt Status.
  - Form 1023
  - Form 1023-EZ
  - Form 1024
- Step 4: Once you receive Federal Tax Exempt Status, apply for State/Municipal tax exempt status
- Step 5: Register the non-profit with the State Attorney General's Office (if applicable)

# Basics: What is a Non-Profit Organization?

- Definition of Non-Profit: A corporation, which is organized for a purpose other than the generation of profits to be distributed to equity holders.
- Non-Profit Organizations, or NPOs, are "non-stock corporations"; they have no equity and no ownership. This does not preclude an NPO from owning equity in another entity.
- NPOs are not automatically tax exempt on the federal or state level - they must apply for that status.

# Philosophy of Non-Profit Law

- NPOs are corporations, they just don't have equity units. Therefore, they should be treated by attorneys exactly like they treat their for-profit clients (with some additional considerations).
- Tax exemption and donation deductions take money from Uncle Sam's pocket, in furtherance of a non-profit purpose for the public good.
- NPO attorneys don't have to personally agree with the Non-Profit's purpose, but they still need to use their best judgment!
- Some additional considerations:
  - Tax-exempt status must be managed concurrently on the Federal and State levels.
  - Non-Profit clients need to be disabused of the idea that non-profit activities don't come with risk.
  - The "exempt" purpose of an NPO is a fiduciary duty, to which officers and directors are held (i.e., duties of care & loyalty).

# Tools of the Trade: Fiscal Sponsorships

- A fiscal sponsorship is a contractual arrangement, in which a 501(c)(3) organization effectively extends their tax exempt status to an organization which also has a non-profit purpose, but *doesn't* have tax exempt status.
- Fiscal sponsors take in the donations directly, provide 501(c)(3) compliant receipts to donors, and distribute funds to the sponsored org.
- The sponsored organization does not need to be incorporated separately, but that is helpful for liability protection purposes.
- Fiscal sponsors have a fiduciary duty to ensure that the funds they take in and distribute are used for non-profit purposes.
- Fiscal sponsors generally take a percentage of the funds received as a service fee. The percentage taken varies wildly, and there are NPOs that do only this professionally.
- If you are representing a fiscal sponsor, make sure you have a strong claw back provision and auditing capabilities.

# Tools of the Trade: Friends of Organizations

- NGOs cannot simply "waive in" to tax exempt status in the United States.
- Friends-of Organizations ("FoOs") are separately incorporated NPOs that exist as a fundraising conduit for a specific NGO (or group thereof) outside the United States.
- FoOs must have a separation of management between themselves and the NGO to which their funds are distributed.
- In its 501(c)(3) application, a FoO must provide details as to the NGO which will receive their funds, that NGO's management, and the forms of control they will have on the use of tax exempt funds.
- A FoO is ultimately responsible for how its NGO handles the donated funds. Thus, a strong grant agreement with financial oversight and claw back provisions is essential.
- If a FoO is handling large amounts of money, they may want to have signatory access to the NGO's operations account, as additional security.
- Friends-of African organizations generally undergo heightened scrutiny with the IRS.

# Tools of the Trade: Professional Fundraisers

- Professional Fundraisers ("PFs") can be a useful tool for larger Non-Profits to obtain sponsors for events, and to obtain other forms of donations.
- Professional Fundraisers and Professional Grant Writers may overlap in skill-sets, but they are NOT the same thing.
- PFs must be registered with the Charities Bureau of the states in which they work.
- Each Charities' Bureau has different standards for PF services contracts in their state.
- If your client is using a PF's services, their contract must be registered with the local CB.
- PFs generally work on contingency, taking a percentage of the gross revenue attributable to their services.
- BEWARE THE EXPENSES TRAP

# Mitigating Risk: Issues With Grants

- When you're representing the Granting Organization:
  - The grant application must filter out undesirable applicants, using a balance of "business considerations" and "tax considerations".
  - For international grants, having a 3rd party administrator or trustee may be prudent.
  - Auditing and Claw-Back provisions are key to grant agreements. Warranties by the grantee as to use of funds should be taken directly from IRC § 501.
  - Make sure to obtain enough information about the grantees for Donor Reports.
- When you're representing a Grant Recipient:
  - Ensure that your client is using the funds within the scope of their grant.
  - Operational grants and project grants MUST be treated differently.
  - Ensure your client keeps meticulous financial records.
  - Grant money should NEVER go towards UBIT transactions.

# Mitigating Risk: Insurance Related Issues

- Types of actions NPOs often deal with which require insurance:
  - Employment Practices Related liability
  - Personal Injury Liability
  - State Attorney General Actions
  - Cyber Liability (if applicable)
  - Property Damage Liability
  - Director and Officer Coverage
  - Automobile Insurance
  - Event Liability
- Brief your client on the claim reporting provisions in their insurance policies, as that can make or break a coverage dispute.
- For fundraising events, make sure to have your client name themselves as an additional insured on vendor policies.

# Mitigating Risk: Volunteer Liability

- The legal principle of *Respondeat Superior* applies to an NPO’s volunteers, as well as an NPO’s employees.
- NPOs are also subject to liability for volunteers who are injured during their volunteer activities. NPO clients tend to think that they are exempt from liability in this vein by virtue of being non-profit.
- Mitigation Actions:
    - Personal Injury and Image Consent waivers.
    - Volunteer training manuals.
    - In-Person training of new volunteers.
    - Always check for volunteer exclusions in insurance policies.
    - Give employees tasks that need judgment, give volunteers tasks with minimal discretion.

# Mitigating Risk: Conflict of Interest Policies

- NY Rules have changed recently.
- The IRS requires COI policies for all 501(c)(3) orgs
- Some states, like NY, have their own COI policy requirements, which should be heeded.
- COI policies are also helpful for non-501(c)(3) orgs, because adherence to such policies shields those NPOs from allegations of commingling or private inurement.
- Annual conflict disclosure forms are required for directors and officers of NPOs, all of which should be renewed annually, with records carefully maintained.

# Private Inurement Problems

- Excess Benefit Transactions (*far and above* Fair Market Value)
- Excessive Compensation to Employees
  - "Reasonable compensation" standard
  - Rebuttable presumption of reasonability (26 CFR 53.4958.3)
- Flow of exempt funds to privately owned businesses

# Private Inurement Consequences

- Excise tax levied upon the disqualified person or entity
- If pervasive, there may be a potential loss of exempt status.

# IRS Notice 2012-52

- Single member LLCs wholly owned by a 501(c)(3) organization are disregarded for tax purposes – but NOT for liability purposes.
- This rule allows non-profit organizations to open special purpose entities for exempt purposes, without cumbersome regulatory issues.
- Funds placed into a single member LLC owned by a 501(c)(3) organization are deductible as if the funds were donated to the 501(c)(3) organization directly.
- The rules on unrelated trade or business income are applied to such a single member LLC.
- This rule is a useful tool in hybrid partnerships in creating SPEs.
- https://www.irs.gov/pub/irs-drop/n-12-52.pdf

# NPOs and Business: Beware UBIT!

- The Unrelated Business Income Tax ("UBIT") is a tax levied on 501(c)(3) Organizations for money they collect from ventures which are unrelated to their charitable exempt purpose.
- UBIT is taxed at the Corporate Rate.
- Deductions such as expenses, depreciation, etc. count in UBIT calculation.
- Guided by "Majority of Activities" threshold.

# NPOs and Business: Common UBIT Situations

- Sale of Advertising (except for QSPs)
- Gaming (*e.g.*, Bingo games and raffles)
- Sale of Merchandise and Publications
- Rental Income
- Parking Lots
- Pro Tip: Remember the Substantial Relationship Test!

# NPOs and Business: UBIT Considerations

- If a venture serves the charitable purpose of your 501(c)(3) organization, then flaunt it whenever possible.
- If the venture does NOT serve the charitable purpose, make sure that the venture does not actively hinder the organization's mission.
- Proper accounting of the expenses and revenue to your non-profit organization is crucial for compliance.
- Whether or not UBIT applies, disclose the income and expenses on the 990 and state equivalent submission.
- UBIT withholding is a useful tool to ensure compliance. It can also be off-set by additional expenses.

# NPOs and Religion: Separation of Churches and State

- Influencing Elections or Legislation is banned
- "Substantial activities" test
- "Expenditure" test - Only available to Religious Organizations
- Issue: Advocacy vs. Election Intervention
- Accepted Voter Education Activities
- Non-Accepted Voter Education Activities
- Election "Meet the Candidates" Events

# What is a 501(c)(4) Organization?

- Social Welfare Organizations, formed exclusively to promote social welfare.
- Like their 501(c)(3) counterparts, 501(c)(4)s are prohibited from "private inurement" and excess benefit transactions are subject to excise taxes.
- 501(c)(4) organizations are not required to disclose their donors' identities.
- An organization that has lost its section 501(c)(3) status due to substantial attempts to influence legislation may not thereafter qualify as a section 501(c)(4) organization.
- Donations to 501(c)(4) organizations are not tax deductible as charitable donations.
- As of 2018, the IRS requires a new form for 501(c)(4) applications, form 1024-A.

# What is a 501(c)(6) Organization?

- Section 501(c)(6) gives federal tax exemption to:
  - Business Leagues
  - Chambers of Commerce
  - Real Estate Boards
  - Boards of Trade
- Private inurement is prohibited for 501(c)(6) organizations
- Donations to 501(c)(6) organizations are not tax deductible as charitable donations but may be deductible for other purposes.

# Compliance Tips

- Annual federal returns (f990)
- Automatic revocation of exemption for 3 years of non-compliance
- Annual state filings (NY NP Revitalization Act)
- Conflict of Interest – Board annual disclosures
- Keep strong financial records
- Keep good corporate records
  - All board meetings should have minutes (show compliance with CoI policy)
  - All board resolutions must be memorialized

# Resources for NPO Practitioners

- Guidestar
- 990 Forms (link)
- http://multistatefiling.org/
- IRS Bulletins https://apps.irs.gov/app/picklist/list/internalRevenueBulletins.html
- IRS Guide Wire- https://www.irs.gov/newsroom/subscribe-to-irs-guidewire
- IRS Guide to IRC Section 501 https://www.irs.gov/pub/irs-pdf/p501.pdf

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