

Nuances in Nonprofit Compliance

Six common concerns for nonprofit organizations

By **Tamar Rosenberg / Sheppard Mullin Richter & Hampton LLP**

Whether your organization is a nonprofit or you're on the board of a nonprofit, the following are six common compliance concerns we see among clients – large and small – and a summary of the key issues involved.¹

1 Political Campaign Activity/Donations by Section 501(c)(3) Organizations

Law: Section 501(c)(3) organizations are prohibited from participating, directly or indirectly, in any political campaign on behalf of, or in opposition to, any candidate for elective public office. This is an absolute prohibition – there is no acceptable minimal amount. The prohibition applies to campaigns at the federal, state and local levels. Section 501(c)(3) organizations may take positions on public policy issues but generally are required to avoid issue advocacy that constitutes political campaign intervention.

The IRS determines whether an organization has violated the prohibition against political campaign activity based on all relevant facts and circumstances. Prohibited political campaign activity is not limited to making a donation to a candidate's campaign. It can also include any activity that favors or opposes a candidate for public office, such as

- distributing written statements for or against a candidate, such as posts on the

- organization's website, social media accounts or blogs
- making verbal statements for or against a candidate, such as statements made when a political candidate attends an organization's fundraising event
- making a statement regarding public issues that does not expressly say to vote for or against a specific candidate, if the content nonetheless favors or opposes a candidate
- activity conducted by an organization's leaders or employees when it appears that they are acting in their capacity as representatives of the organization, such as when the organization's president or CEO is quoted in the newspaper as supporting or opposing a candidate
- allowing a candidate to use the organization's assets or facilities free of charge

Issue: Section 501(c)(3) organizations sometimes lose sight of the political campaign prohibition in the midst of election season or do not realize how they may inadvertently trip over the rules. Employees who do not regularly deal with these rules may not be aware of them.

Suggestion: Consider adopting a policy to safeguard against violations, such as prohibiting the organization's employees from posting statements supporting or opposing candidates on the organization's website, blogs, or Facebook, Twitter or other social media accounts or from using their work e-mail accounts to do so. It is helpful to remind employees of the policy during election season.

Suggestion: If the organization's leaders speak publicly or publish in their personal capacity, consider requiring that they expressly state that their comments are personal and do not represent the views of the organization.

Suggestion: Resources from the IRS on this topic are available at www.irs.gov.

2 Failing to Comply with Charitable Solicitation Registration Requirements

Law: Approximately 40 of the 50 states require registration prior to soliciting charitable contributions or grants in their state. The rules vary from state to state, can be nuanced and are sometimes unclear in the context of fundraising on social media. Even after the initial registration, many states require filing an annual renewal report and paying an annual fee. Penalties can be imposed for noncompliance, including monetary penalties

(which are often imposed for late filings) and barring fundraising in their state.

Issue: Organizations are sometimes not aware

- of the registration requirements altogether;
- that the registration requirement is triggered by the act of soliciting, even if no contribution or grant is received;
- that the registration requirements can be triggered by soliciting even a small

Conflict of interest transactions are generally not prohibited, provided that appropriate steps are taken to manage the conflict and to ensure that the transaction is in the organization's best interests.



Tamar Rosenberg
Associate in the New York
office of Sheppard Mullin
Richter & Hampton LLP
trosenberg@sheppardmullin.com

number of potential donors, rather than the public at large;

- that the requirements can apply even if the organization solicited only grants from private foundations and not donations from the general public;
- that even if an exemption applies, some states require affirmatively applying for exemption from the registration requirements; or
- that engaging in a charitable sales promotion with a for-profit partner, such as a promotion in which a business promises to contribute a portion of the proceeds from the sale of certain goods or services to a specific charity (often referred to as a “charitable co-venturer” arrangement) – can trigger registration, reporting, contracting and other requirements.

A common slipup is when an initial fundraising effort does not trigger the registration requirements, but the donor is added to the organization’s mailing list and subsequent solicitations trigger the requirements.

Suggestion: Review the states in which your organization solicits grants or contributions and assess the applicable requirements.

Suggestion: Evaluate your organization’s process for adding donors to its mailing lists after they make an initial contribution and institute a procedure for ensuring registration in advance of soliciting.

Suggestion: Evaluate the application of the charitable co-venturer rules for charitable sales promotions with for-profit businesses or similar activities.

3 Having Nondirectors Serve on Board Committees

Law: The nonprofit corporate laws of some states, such as New York, prohibit individuals other than board members from serving as voting members of any committee of the board – meaning any committee that has the authority to take action on behalf of the board that is legally binding on the organization. The general concept underlying this rule is that any individual who has the authority to act on behalf of the board should be subject to, and held responsible for, the fiduciary duties of board members.

Issue: This requirement is sometimes overlooked, as nonprofit organizations seek to involve individuals – such as prospective donors,

potential future board members and outside advisors – in the organization’s governance.

To the extent that it is desired to have nondirectors participate in board committees, the nondirectors may potentially participate only in an advisory capacity. Nondirectors may also serve on committees that are not delegated the authority to make decisions that bind the board but instead make only recommendations to the board or its leadership. These committees are often referred to as committees of the corporation or advisory committees, rather than committees of the board.

Suggestion: Review your organization’s bylaws and board committee authority and composition to ensure compliance with applicable state law.

4 Failing to File IRS Form 990 for a New Organization Before the IRS Approves Its Tax Exemption Application

Law: We have seen that many organizations do not realize that they may be required to file an IRS Form 990 annual return even *before* their application for tax exemption is approved by the IRS.² The first filing deadline is four and a half months after the end of the organization’s first year – i.e., the year in which it is incorporated. Failure to file IRS Form 990 for three consecutive years causes an organization’s tax-exempt status to be revoked *automatically*.

Issue: We often remind newly formed nonprofits of the Form 990 requirement because we have seen the filing requirement overlooked in an organization’s initial years, particularly at times when there is a long wait for the IRS to approve a tax exemption application. We had one client whose tax-exempt status was revoked almost immediately after it was granted, given the time taken by the organization to prepare and file its application for tax-exempt status following its incorporation and the length of time taken by the IRS to review and approve the application.

Suggestion: When you form a new organization that is intended to obtain tax exemption, ensure that the organization complies with applicable Form 990 filing requirements beginning with its first year following its incorporation.

Suggestion: Information on the Form 990 filing requirements is available at www.irs.gov.

5 Failing to Properly Address Conflicts of Interest Among Directors or Officers

Law: Many state nonprofit corporate laws impose specific rules with respect to transactions involving a conflict of interest, and directors and officers have fiduciary duties under state law to act in the best interest of the nonprofit corporation, rather than for private gain. Some states, like New York, require certain nonprofit organizations to adopt a conflict of interest policy that meets basic requirements.

In addition, Section 501(c)(3) and Section 501(c)(4) tax-exempt organizations are subject to the “excess benefit transaction” rules for certain transactions with the organization’s directors or officers, their relatives, or entities they control and in which the tax-exempt organization receives less than fair market value. In the case of an excess benefit transaction, disgorgement can be required and financial penalties can be imposed on the director or officer involved in the transaction and potentially on board members who knowingly approved the transaction.

Certain related party transactions are required to be disclosed on the organization’s annual IRS Form 990 return, and Form 990 also requires disclosure of whether the organization’s board has adopted, and implemented, a conflict of interest policy. Form 990s are widely available to the public, donors and the press online.

Issue: Conflicts of interest involving an organization’s directors or officers are not unusual, such as when the organization seeks to do business with an enterprise owned by a director or his or her family members, or to hire a relative of a director or officer as an employee or independent contractor. Conflict of interest transactions are generally not prohibited, provided that the conflict is managed in accordance with applicable law and the organization’s conflict of interest policy, which typically would require approval by independent board members, recusal of the interested director or officer from the board’s deliberation and vote, and taking appropriate steps to ensure that the organization receives fair market value.

Suggestion: The organization’s board should adopt an appropriate conflict of interest policy if it has not done so. Directors and officers should be required to complete and annually submit a conflict disclosure form and to report potential conflicts that arise during the year.

Suggestion: If a potential conflict is disclosed, the organization must carefully follow its conflict of interest policy, review and comply with applicable law, and document as much (e.g., in the board minutes).

6 Failing to Adhere to the Organization's Bylaws

Law: An organization's bylaws set forth the operating rules for the organization's governance, such as for the election and removal of directors and officers and determining the number of board members. The bylaws should also reflect state law requirements regarding governance. It is important to follow the bylaws to ensure compliance with applicable law and for the election of directors and officers and other corporate actions to be legally valid and recognized.

Issue: Some nonprofit organizations, particular smaller organizations, tend to either not strictly follow their bylaws or to modify their bylaws in ways that are not consistent with applicable law (such as to permit those not on the board to serve on a board committee – see number three above). Bylaws can be confusing and frustrating to those who do not regularly deal with them because they're often written in legalese. However, the technical language included in bylaws is often critical because it is drafted to have a precise legal meaning designed to comply with applicable law and to be commonly understood by attorneys.

Taking action (e.g., approving an agreement or transaction) without strictly following the organization's bylaws and board resolutions and customary corporate formalities – such as not having a quorum at a

board meeting or not giving required notice to board members – can make the action susceptible to being challenged and cause significant difficulties for the organization.

Suggestion: The organization's bylaws should be reviewed periodically by the board or a board committee and should be amended as needed to reflect changes to the organization and to applicable law over time.

Suggestion: When amending your organization's bylaws, applicable state law should be reviewed for any requirements or restrictions.

Suggestion: If in doubt, consult a qualified attorney. Oftentimes, a little legal advice from a qualified attorney can prevent issues from becoming a bigger problem down the road.

To review the footnotes to this article, visit <http://www.metrocorp.counsel.com>