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Top 5 Nonprofit Legal Issues of the Past Year

The IRS scandal, diverting assets, ethics and more – the annual list of issues that affected associations and nonprofits in the past year.

1. Nonprofit corporation law changes

New York and the District of Columbia both revised the laws governing nonprofit corporations in recent years. As a result, associations incorporated in those states have broader leeway to use electronic communications as part of their governance. The new statutes, however, also bring about new burdens for associations as well, particularly with New York's new law.

In New York, there has been some streamlining and modernization, doing away with the old Type A, B, C and D categories and allowing emails to be used for notices and in ballots. There are also a number of new burdens that nonprofits incorporated in New York will now face, including a prohibition on an employee serving as chair of the board and a mandatory requirement that each nonprofit corporation adopt conflicts of interest policies.

DC's law has been in place and effective for a couple of years, though recently "technical corrections" were enacted to clean up a few errors from the initial statute. DC's law makes clear that member balloting can occur electronically and also provides for greater flexibility on a number of other matters that membership organizations face. The recordkeeping requirements in the new law are somewhat more burdensome than before, and the changes in the new law have made it more difficult for older corporations to continue to be covered under a pre-1962 corporate law.

2. IRS scandal and fallout for associations

The Exempt Organizations function of the Internal Revenue Service was the source of national news in May when it was reported that the IRS engaged in inappropriate flagging of conservative political groups when evaluating whether such entities qualified for tax-exempt status. While the focus of the scandal was largely on "tea party" and similar groups that would not traditionally be described as associations, the impact of the scandal has been broad, as numerous key IRS Exempt Organizations personnel have been replaced, and Congress has been scrutinizing closely all operations.

One potential positive result of all this scrutiny could be a focus on the immense backlog of exemption applications that the IRS currently has. In response to the issues that arose, the IRS has implemented a number of changes designed to streamline consideration of applications.

3. Association slapped over code of ethics provision

The Federal Trade Commission and the Music Teachers National Association entered a consent order after the FTC took issue with a code of ethics provision of MTNA. That provision (which MTNA maintained had not been enforced for a number of years) restricted members from soliciting clients from other music teachers. Under the consent order, the association was required to change its code of ethics, maintain an antitrust compliance program, and stop affiliating with any other group that MTNA knows to be restricting solicitation, advertising or price-related competition.

4. Tax reform plan takes aim at exempt organizations

U.S. House of Representatives Ways and Means Committee chairman Dave Camp recently released "The Tax Reform Act of 2014," a 979-page sweeping federal tax reform package that, among many other things, addresses a number of rules and laws applicable to tax-exempt organizations, and could impose significant new tax liabilities on nonprofits. While not expected to be voted on this year, many of the proposals could well find their way into law as part of any future federal tax legislation and many of the exempt organization-related proposals would fundamentally change the tax obligations of nonprofits.

The legislation proposes changes that impact both tax-exempt organizations and contributors to

exempt organizations. The act would amend which activities and organizations are subject to unrelated business income tax, and would impose new excise taxes and modifications of current excise taxes on certain nonprofit organizations and activities.

Key aspects of the proposed legislation:

Royalty: Fees from the licensing of an organization's name or logo would be treated as expressly subject to UBIT.

Sponsorship: The act proposes to limit the ability of a tax-exempt organization to treat sponsorship payments as not subject to UBIT.

UBIT deductions: Requires tax-exempt organizations to compute UBIT separately for each unique activity that is subject to the tax. Thus, a tax-exempt organization would no longer be able to apply losses from one unrelated activity to offset gains from other such activities.

Changes to intermediate sanctions: Currently, if there are excessive benefits paid to certain insiders of section 501(c)(3) and 501(c)(4) organizations, an excise tax may be imposed on those individuals who so benefit as well as on those organization managers who approved those benefits. These provisions are often referred to as "intermediate sanctions." The act proposes sweeping new changes to the intermediate sanctions regime, including:

- Expanding the coverage of the provisions to apply also to 501(c)(5) and 501(c)(6) organizations;
- Adding a new excessive benefits excise tax, equal to 10 percent of the excess benefit, on the organization if certain minimum standards of due diligence or other procedures were not followed; and
- Doing away with the current law "rebuttable presumption of reasonableness," which gives a presumption that a transaction is not excessive if certain steps are followed.

Compensation tax: The legislation would impose an excise tax of 25 percent on executive compensation (including any parachute payments) over \$1 million, to be paid by the organization. This excise tax would apply to any of the five-highest compensated employees of any tax-exempt organization.

5. Attention on diversion of assets

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

While the numbers are shocking, this trend will not surprise those in the nonprofit world, who have long known that nonprofits are highly susceptible to fraud and embezzlement. Nonprofits are generally established for beneficial purposes and assume that their employees, especially senior management, share the organization's philanthropic mission. As such, nonprofits tend to be more trusting of their employees and have less stringent financial controls than their for-profit counterparts. Thus, they fall prey to embezzlement and other forms of employee fraud at an alarming rate. The IRS scandal, diverting assets, ethics and more – the annual list of issues that affected associations and nonprofits in the past year. We start with changes to the nonprofit corporation law in New York and Washington.

For a detailed discussion on protecting against fraud and embezzlement in associations, [click here](#).

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