

FOSTER LAW GROUP

A PROFESSIONAL LIMITED LIABILITY COMPANY

MEMORANDUM

TO: Client

FROM: Dorothy K. Foster

DATE:

RE: Nonprofit Governance Update

Best practices suggest that the board of a charitable organization consult with legal counsel regarding its governing practices, contracts and policies every three years. Such regular reviews can prevent minor compliance problems from escalating into serious matters.

A non-exclusive, representative sampling of issues to be considered in the review are as follows:

1. Amending Organizational Documents. Legal counsel should be consulted regarding any proposed amendment to the organization's Articles of Incorporation, Bylaws, or Charitable Trust Agreement. Depending upon the nature of the amendment, the Washington State Attorney General and the Internal Revenue Service ("IRS") may need to be notified. Sometimes such governmental entities must actually provide permission before any such amendment may be made.
2. Changes to Legal Structure. Any organization making material changes to its legal structure by means of a reorganization or merger, "conversion" from corporate/trust form, or change in tax-exempt status should contact its counsel. All such changes are governed under Washington and federal law and must be properly documented. Depending upon the significance of proposed changes, a prior ruling may need to be obtained from the IRS.
3. Changes to "Mission". A charitable organization's mission must not differ significantly from the charitable purposes expressed in its Articles of Incorporation or trust agreement. Any changes to an organization's "mission statement" may constitute a change in charitable purpose. Any contemplated change to an organization's charitable purpose will require notification to the Washington State Attorney General's office and to the Internal Revenue Service. Significant changes may require a private letter ruling or re-determination of tax-exempt status.
4. Change in Tax Exempt Status. A charitable organization that has received status as a 501(c)(3) organization is further categorized, under IRC § 509, as a private foundation, a

supporting organization, or one of two kinds of public charities. Both state and federal legal requirements vary depending upon the §509 classification. The Board should ensure that it and the Executive Director are aware of the organization's § 509 status and understand the basic legal implications.

To be exempt from federal income taxation, most organizations must file applications for recognition of exemption with the IRS. The law provides exceptions from filing to Churches, their integrated auxiliaries, and convention or associations of churches. Failure to have obtained such status may hamper the organization in obtaining charitable donations. Application may be made at a later date.

Affiliated organizations may be granted “group exemption.” That is, a parent organization that has already obtained tax-exempt status may petition the IRS to extend such status to new affiliated organizations—whether existing or prospective. An organization with constituents in other jurisdictions should consider this group exemption process.

5. Hiring of Executive Director. While the Board often has the necessary skills and resources to make hiring decisions, when it comes to the initial hiring of an Executive Director, a Board often fails clearly to delegate authority to that position. The resulting conflict of expectations and ambiguity regarding spheres of authority cause great stress within the organization. Legal counsel can assist the charitable organization with proper delegation of authority and other employment matters.

6. Charitable Trust Registration and Annual Filings. An organization administering or holding income-producing assets in excess of \$250,000 for charitable purposes must register with the Washington Secretary of State by filing a Form CHT-1 (Application for Registration as a Charitable Trust) within two months of receiving the minimum assets. This requirement applies to nonprofit corporations as well as charitable trusts. Various exemptions apply, including an exemption for certain religious organizations and educational institutions. Legal counsel can advise an organization on the availability of these exemptions.

7. Solicitation and Fundraising. When undertaking new fundraising events such as benefit dinners and membership drives, a charitable organization should contact its legal counsel regarding the rules and appropriate documentation. All oral or written requests for charitable contributions made within Washington are regulated by the Charitable Solicitations Act. Solicitation in another U.S. state and some municipalities (and counties—for example, unincorporated King County) requires registration in that jurisdiction under the applicable local law. Under Washington law, a violation of the charitable solicitation laws is deemed to be a violation of the Consumer Protection Act, and directors or officers who participate in or approve of such violations may be held personally liable.

Once an organization has received a charitable contribution, federal law imposes extensive documentation and reporting requirements upon both the donor and the charitable organization.

8. Political Campaign Intervention. While a charitable organization is absolutely prohibited from engaging in any political campaign, it may undertake voter education

activities and voter registration drives if carried out in a non-partisan manner. In addition, members of the Board and the Executive Director may speak out on political matters if speaking for themselves, as individuals. A charitable organization, or its leaders, considering political activities of any nature should contact legal counsel.

9. Legislative Activities. A charitable organization that has received status as a “public charity” or supporting organization may attempt to influence legislation (lobby), but may do so only if such activities are “insubstantial.” A private foundation is prohibited from lobbying. The IRS considers a number of facts and circumstances to determine substantial involvement including the time devoted by the charity’s personnel and volunteers as well as total expenditures. A charitable organization considering lobbying of any nature should contact legal counsel to determine whether or not its proposed lobbying activities rise to the level of “substantial.”

10. Distributions to Individuals. A charitable organization that makes grants to individuals must keep records and individual case histories to demonstrate the charitable nature of the grants. Distributions to individuals for travel, study, or similar purposes must be awarded on an objective and nondiscriminatory basis pursuant to a program approved in advance by the Internal Revenue Service. Legal counsel should be consulted before an organization undertakes any charitable program benefitting individuals.

11. Subsidiaries. A successful nonprofit organization often generates constituents in other jurisdictions with an interest in carrying out the organization’s charitable purposes in that jurisdiction. These “subsidiaries” or “sister organizations” must be properly organized as legal entities under local law and their relationship with the “parent” organization must be properly documented. Governance, licensing and intellectual property issues arise. Sometimes, the parent organization, itself, must be licensed to do business in that new jurisdiction. Sometimes, a group exemption application should be made. International activities require understanding of and compliance with the laws governing “charities” in other countries. All of these issues require legal advice.

12. Profit-making Activities and “Partnerships”. Charitable organizations are allowed to engage in for-profit enterprises. If such an enterprise is outside of the organization’s charitable purposes, however, the organization will be required to pay “unrelated business income tax” on the enterprise’s earnings. Charitable organizations may also participate in strategic charitable alliances and partnerships with other charitable organizations and, sometimes, with for-profit organizations. The rules regarding such joint ventures are complex. A charitable organization contemplating a business-type activity or joint venture should contact legal counsel.

13. Arrangements with Conflicted Parties. With the exception of loans made to an officer or director, neither Washington nor federal law prohibit contractual arrangements or other business dealings between a public charity and its officers, directors or managers. With respect to transactions between private foundations or supporting organizations and their organizational insiders, the opposite obtains: many (indeed, most) transactions between a charitable organization and such individuals are prohibited under federal law. For all charitable organizations, conflicts of interest must be disclosed on an annual basis.

14. Contracts and Leases. Not all contracts and leases must be reviewed by legal counsel. Generally, a contract concerning an obligation exceeding a dollar amount set in advance by the organization's Board should be reviewed by legal counsel. Similarly, a lease exceeding a certain term of years should receive such review. Most charitable organizations also benefit by obtaining from legal counsel a template for any particular contract that the organization expects to replicate frequently.

15. Threats of Litigation. The Board and Executive Director of many charitable organizations, by virtue of their reliance upon volunteers rather than professional staff, are subject to errors of judgment. Such errors of judgment may garner discontent among the organization's constituents and, sometimes, threats of litigation. At the first intimation of litigation, counsel and the organization's liability insurance carrier should be contacted immediately. "Intimation" means any concern expressed by any individual within the organization, whether or not an actual lawsuit materializes.

16. Endowment and Gift Acceptance Policies. Good fiscal management suggests that a charitable organization's Board should adopt policies regarding monies in the organization's control. The "institutional memory loss" inherent to nonprofit organizations and their funders' donative purposes can be obviated with clearly articulated policies regarding fund management. New Washington state legislation governs the management of endowment funds and should be incorporated into these policies. Legal counsel can assist with their drafting.

17. Termination of Organization. A nonprofit organization that ends its operations either through shutting down, transfer of assets or merging with another tax-exempt organization must follow specific guidelines. Both Washington and federal law dictate procedures to be followed. The Internal Revenue Code may impose a termination tax which may be avoided with proper advice from counsel. Further, the Pension Protection Act of 2006 directed the IRS to revoke the tax-exempt status of any tax-exempt organization that had not filed its annual information return (generally, Form 990) for three consecutive years. That requirement has been in effect since 2007.

18. Audits of Exempt Organizations. The IRS has recently undertaken the audit of tax-exempt organizations. Issues in an audit may include an organization's tax-exempt status and private foundation classification, whether it paid employment taxes, whether it paid tax on unrelated business income when required, and whether it filed required returns and reports. Procedures for examinations are explained in greater detail in [Publication 892](#), *Exempt Organization Appeal Procedures*. Always, at the first notification of an audit, legal counsel should be consulted.
