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“Spring Cleaning for Your Nonprofit”

Presented by GKH Corporate Practice Group
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DISCUSSION TOPICS

1. FUNDAMENTAL CHANGE TRANSACTIONS
2. COMPENSATION
3. DISSOLUTION

NONPROFIT VS. 501(C)(3) ORGANIZATIONS

- Nonprofit Corporation – Recognized under Pennsylvania Law, subject to the PA NonProfit Corporation Law of 1988
- 501(c)(3) Organization – Extra step taken by a Nonprofit Corporation to receive tax-exempt status from the IRS.
 - Typically obtained so that contributions from your donors will be tax deductible.

FUNDAMENTAL CHANGE TRANSACTIONS

1. Name and Address Changes
2. Purpose Modifications
3. Transfer of Charitable Assets

FUNDAMENTAL CHANGE TRANSACTIONS

NON-PROFIT CORPORATION – (Governed by PA law only.)

1. PA Corporation Bureau – Articles of Amendment (name or purpose modification)

- Statement of Change of Registered Office for address change.

2. IRS - EIN Division for Name Change

FUNDAMENTAL CHANGE TRANSACTIONS

501(C)(3) ORGANIZATIONS – *Additional Requirements*

1. PA Corporation Bureau – Articles of Amendment (name or purpose modification)
 - Statement of Change of Registered Office for address change.
2. IRS - EIN Division for Name Change
3. IRS – **Exempt Organizations Division*

FUNDAMENTAL CHANGE TRANSACTIONS

IRS Exempt Organizations Division

Name or Address Change – *Notification Only*

- Mail letter to IRS for notification
- Include copy of Articles of Amendment (or Stmt. of Change of Reg. Office)

Purpose modification – Most likely requires *approval* from IRS or may lose 501c3 tax exempt status.

- REMEMBER: You cannot provide charitable deduction receipts for donations for the *new* purpose or tell donors you are a tax-exempt organization until approval is granted by the IRS for the new purpose.

FUNDAMENTAL CHANGE TRANSACTIONS

IRS Exempt Organizations Division (cont.)

- If approval for a *purpose modification* is not required, notify IRS by completion of Schedule O of the organization's Form 990.
 - Example: An organization that filed their 1023 Application with two separate and distinct charitable purposes (i.e., providing food to the homeless and bible teachings for children) which now intends to only engage in one of the two charitable purposes.
- Questions: Call IRS toll-free at 1-877-829-5500, then option 2.
 - ***BEST PRACTICE** - For a Name Change or Purpose Change request new Determination Letter from IRS. (3-4 month timeframe)

FUNDAMENTAL CHANGE TRANSACTIONS

Approval of Pennsylvania Attorney General & Orphans' Court

- The Transfer of *all or substantially all* of an organizations charitable assets requires *Attorney General and Lancaster County Orphans' Court* approval.
- Attorney General must review proposed transfer to ensure that public interest is protected.

FUNDAMENTAL CHANGE TRANSACTIONS

Pennsylvania Attorney General & Orphans' Court

The process for seeking the PA Attorney General's approval can be reviewed at:

<http://www.attorneygeneral.gov/consumers.aspx?id=229>

FUNDAMENTAL CHANGE TRANSACTIONS

FRIENDLY REMINDER:

- When making decisions about the organization, just remember that if it involves a fundamental change affecting the name, address, purpose or assets of the organization, notification and prior approval may be required.

COMPENSATION

“REASONABLE” STANDARD

Compensation for services provided to organization is permitted so long as the amount is “reasonable.”

- Hours worked
- Need for the position
- Total budget of organization

***BEST PRACTICE:** Compare to what other “similarly situated” organizations are paying for similar services.

COMPENSATION

BOARD APPROVAL REQUIRED - Salary amount to be voted on and approved by the board.

QUESTION: Can the board member to be compensated attend the meeting where the vote will be taken?

- Pennsylvania law permits interested parties to vote under certain conditions, but the IRS recommended Conflict of Interest policy does not. Under IRS guidelines, the interested party is to leave the meeting for discussion of and vote on the matter.

***BEST PRACTICE** - Do not vote on matters pertaining to own compensation – appearance of conflict of interest.

COMPENSATION

DISCLOSURE REMINDERS - PUBLIC RELATIONS ISSUE

- Salaries in excess of \$50,000 must be disclosed on 501(c)(3) Application.
- Also disclosed on organization's annual form 990.

DISSOLUTION

Legal Process for winding up and closing down the operations of the organization.

- Average Timeframe for dissolution process: 12 – 18 months.
- Costly Process: Filing fees, Publication Fees, Accounting Fees and Legal Fees.

DISSOLUTION

STATUTORY REQUIREMENTS: *Applicable to both nonprofit corporations and 501(c)(3) organizations*

1. Tax Clearance Certificates (Dept of Revenue/Dept Labor & Industry)
2. Plan of Dissolution
3. Notice to Creditors and Taxing Authorities
 - Different priority for different types of creditors (secured creditors; guaranteed debts; etc...)
4. Legal Advertising
5. Articles of Dissolution (PA Dept. of State)
6. *Orphan's Court Approval – Orphan's Court must review the dissolution and approve the distribution of assets.

DISSOLUTION

DISTRIBUTION OF ASSETS: NONPROFIT CORPORATION VS. 501(c)(3) ORGANIZATION

- While content of Articles of Dissolution are the same (even same state form), there is a difference in the required distribution of remaining assets once liabilities have been discharged.
 - 501(c)(3) organizations must distribute to other 501(c)(3) organizations.

DISSOLUTION

WHEN TO FILE FOR DISSOLUTION

KEY QUESTION : Is there any risk of creditor claims?

***BEST PRACTICE** – If there is a risk of creditor claims, file for dissolution.

REASON: Filing date of Articles of Dissolution start 2 year clock on creditor claims. After 2 year date, claims are barred.

NEW FORMATION VS. “ASSUMPTION” OF ANOTHER 501(c)(3) ENTITY

USE CAUTION!

DO YOUR DUE DILIGENCE:

1. Corporate Documentation: Articles of Incorporation, bylaws, and minutes – What is the ***purpose*** of the organization?
2. Tax Returns (even if Informational Only Return – 990)
3. Financial Information: Income statements, balance sheet, bank accounts, and loan information and balances
4. Legal Matters: Pending claims or major disputes
5. Employee Benefits: Retirement plans, any employees under COBRA?
6. Real Estate: Leases, mortgages, environmental concerns
7. 501c3 Tax Exempt Status: Is it still active?

REMEMBER: If organizations do not file with IRS for 3 years, tax exempt status is revoked.



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NEW FORMATION VS. “ASSUMPTION” OF ANOTHER 501(c)(3) ENTITY

MERGER PROCESS

If you are already an existing non-profit organization, just looking to gain the 501(c)(3) tax exempt status, you will need to go through the “merger” process first:

- Articles of Merger, Plan of Merger, Resolutions
- Requires Attorney General Approval - Merger = Transfer of Assets

***BEST PRACTICE** – Start fresh with a new entity and apply for own tax exemption. Likely more cost effective, and eliminates the concern over assuming the debts and liabilities of an existing organization.

DIRECTORS and OFFICERS

DIRECTORS

- Directors oversee the business and affairs of Nonprofit
- Often self-perpetuating
- Natural persons at least 18 years old

OFFICERS

- Officers operate the Nonprofit
- President, Secretary and Treasurer
- President and Secretary- Natural persons at least 18 years old
- Treasurer may be a corporation

DIRECTORS and OFFICERS

General Responsibilities

- Attendance at meetings
- Compliance oversight
- Approval oversight
- Hire, supervise and remove Executive Director
- Elect and remove Directors
- Adopt, amend and repeal Bylaws
- Fiduciary Duties

DIRECTORS and OFFICERS General Rights

- Receive all information
- Special meetings
- Initiate court proceedings
- Establish committees
- Others

DIRECTORS and OFFICERS Fiduciary Duties

- A Director shall stand in a fiduciary relation to the Nonprofit
- Duty of Care and Duty of Loyalty
- Generally- Defined by Statute

DIRECTORS and OFFICERS

Fiduciary Duties

WHO may enforce:

- 1) Nonprofit itself
- 2) Others on behalf of Nonprofit
- 3) The members
- 4) Attorney General
- 5) IRS

DIRECTORS and OFFICERS

Duty of Care

- Must use reasonable inquiry, skills and diligence in the performance of duties as a person of ordinary prudence would use under similar circumstances
- Entitled to rely in good faith on “information, opinions, reports or statements” by officers and other employees “whom the director reasonably believes to be reliable and competent” and by counsel, public accountants and others on matters “which the director reasonably believes to be within the professional or expert competence of such person.”
- Good faith is absent if Board has knowledge concerning the matter in question that would cause reliance to be unwarranted
- Generally the same test is applicable to Officers

DIRECTORS and OFFICERS

Duty of Loyalty

- Board must perform duties in good faith, in a manner reasonably believed to be in the best interests of the Nonprofit
- Generally the same test is applicable to Officers
- Presumption: Absent breach of fiduciary duty, lack of good faith or self-dealing, any act of the Board, a Committee of the Board or a Director shall be presumed to be in the best interests of the Nonprofit

DIRECTORS and OFFICERS

Duty of Loyalty

- Corporate Opportunity Example: President of golf club was approached with an opportunity to purchase 3 parcels of property located among the fairways of the club's golf course. President agreed to purchase the property in the President's own name and did not disclose plans to purchase the property to the Board. Later, President was approached with the opportunity to purchase another property, which was surrounded on 3 sides by the golf course. President purchased the property. President informed the Board both times after the purchases and the Board took no formal action. Board became dissatisfied with development. Land could have been developed by club and sufficiently related to club's business.

DIRECTORS and OFFICERS

WHO & WHAT may be considered in a “best interests of Nonprofit” evaluation?

- Members, employees, suppliers, customers, creditors and communities in which officers or other establishments of the Nonprofit are located
- Short and long term interest of Nonprofit
- The resources, intent and conduct of any person seeking to acquire control of Nonprofit
- All other pertinent factors

DIRECTORS and OFFICERS Conflict of Interest

- Potential
- Apparent
- No Contract between a Nonprofit and any of its Directors or Officers shall be:
 - Void solely for this reason OR
 - Because the interested Director or Officer is present at or participates in the Board meeting authorizing the Contract OR
 - Because the vote of the interested Director or Officer is counted
 - PROVIDED:
 - Material facts as to interest are disclosed and Board, in good faith, authorizes the Contract OR
 - Contract is fair as to the Nonprofit when ratified

DIRECTORS and OFFICERS Conflict of Interest

- Bylaw provision
- Conflict of interest policy
- Best Practice: REFRAIN

DIRECTORS and OFFICERS

Private Inurement and Self-Dealing

- Private Inurement- *It is not permitted* when individuals unilaterally allocate Nonprofit assets to themselves or others
- Personal liability may result
- Act of self-dealing = breach of duty of loyalty
- Loyalty lies with Nonprofit and not with the Director's or Officer's personal interests

DIRECTORS and OFFICERS Self-Dealing

- Since its inception, the tax code has contained restrictions on dealing between Nonprofit and related persons
- 501(c)(3) organizations are either public charities or private foundations
 - Presumption is private foundation
- The IRS prohibits private foundations from self-dealing with a disqualified person

DIRECTORS and OFFICERS Self-Dealing – Disqualified Person

Disqualified Person includes:

- A substantial contributor to the foundation
- A foundation manager that is any officer, director, or trustee, or a person having responsibility similar to such individuals
- An owner of more than 20% of a corporation, partnership, trust or unincorporated enterprise which is a substantial contributor to the foundation
- A member of the family of anyone listed above
- A corporation, partnership, trust, or estate in which persons listed above own more than 35% of the total combined voting power



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DIRECTORS and OFFICERS

Self-Dealing – Specific Acts Prohibited

- Sale, exchange, or leasing of property
- Lending of money or other extension of credit
- Furnishing of goods, services, or facilities
- Payment of compensation/Reimbursement of expenses
- Transfer to, or use by or for the benefit of, a disqualified person of the private foundation's income or assets
- Agreement to make any payment of money or other property to a government official, other than an agreement to employ such individual for any period after the termination of his government service if such individual is terminating his government service within a 90 day period

DIRECTORS and OFFICERS

Self Dealing – Consequences/Penalties

- Any disqualified person who engages in an act of self-dealing is assessed a penalty
- In addition, a private foundation manager who willingly participates in the act, knowing it is prohibited, is subject to penalty
- If the transaction is not timely corrected, the disqualified person and/or foundation manager is subject to an additional (second tier) penalty
- Self-dealing policy
- Best Practice: REFRAIN

DIRECTORS and OFFICERS

Personal Liability and Indemnification

PERSONAL LIABILITY

- Protection of Directors against personal liability for monetary damages
- Exception: Directors cannot be protected against personal liability arising from a breach (or failure to perform) statutory duties and self-dealing, willful misconduct or recklessness
- Also, protection does not apply to the responsibility/liability of Directors under any criminal statute or for the payment of taxes under Federal, State or local law

PERMISSIVE INDEMNIFICATION

- Nonprofit may indemnify Directors and Officers against their expenses and liabilities in connection with civil, criminal and other legal proceedings arising out of their service to the Nonprofit unless Bylaws of Nonprofit state otherwise



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DIRECTORS and OFFICERS Personal Liability and Indemnification

PERMISSIVE INDEMNIFICATION, CONT.

- BUT, Directors and Officers must have acted in good faith and in a manner reasonably believed to be in (or not opposed to) the best interests of the Nonprofit
- This provides protection for Directors and Officers and assists in making a decision whether or not to serve as a Director or Officer of a Nonprofit
- Assumption: An act of the Board or individuals in best interest of Nonprofit

MANDATORY INDEMNIFICATION

- Nonprofit MUST indemnify Directors and Officers who are successful on the merits in 3rd party, derivative and Nonprofit action for actual & reasonably incurred expenses, including attorney fees



- A Nonprofit may purchase insurance to cover Directors and Officers (D&O Liability Insurance)

BENEFIT CORPORATIONS

Dispelling the Myths

- It is NOT a Nonprofit BUT a For-Profit with 3 distinctions
- The law's prime sponsor was Rep. Gordon Denlinger along with representatives of the Sustainable Business Network
- The Commonwealth began to accept these registrations on January 22, 2013
- S-Corps and Professional Corporations can be Benefit Corps.
- Annual Benefit Report

NONPROFIT BANKRUPTCY

- Odd concept because a nonprofit is not a business entity for profit
- However, a large nonprofit may have significant assets and contractual obligations requiring bankruptcy to assure equitable treatment of creditors

END GAME FOR MOST NONPROFITS

- Just close up shop and walk away
- Bank left with liquidating secured assets
- There are no unencumbered assets to dispose of

END GAME FOR 501(c)(3)s

- There is the issue of disposing of assets to an eligible 501(c)(3)
 - Bureau of Corporations and Charitable Organizations
 - Need to approve disposition of assets
 - Usually simple letter sufficient
 - For example, a congregation disbands and sells its church to another congregation
 - Any proceeds must go to qualified exempt organization
- Endowed funds
 - Principal untouchable by creditors
 - Income included in debtor assets unless a separate trustee controls the endowment
 - *Cy pres* to direct the endowment to a different charity in event of a chapter 7 bankruptcy

ADVANTAGES OF BANKRUPTCY

- Avoidance powers – preference claims
- Executory contracts
- Discharge of certain indebtedness

INVOLUNTARY DISSOLUTION

- Under Title 15 of Nonprofit Corporation Law
 - For instance if there is misconduct by board member or officers
 - A creditor may petition – this state law option is available where in federal bankruptcy, you can't file involuntary petition
 - Court will order dissolution and winding up and appoint a liquidating receiver

BOARD OF DIRECTORS AND OFFICERS DUTIES AND LIABILITIES

- Vulnerability
 - Use of restricted assets to fund operations
 - Personal guaranties of board members
- Protection
 - Bylaw provisions requiring advancement as well as indemnity
 - D&O Insurance

PREFERENCE CLAIMS

- What if you do business with someone that files bankruptcy?
- Preference claims
- Charitable contributions: What if you receive a gift from a donor that files bankruptcy?
 - Trustee might be able to claw it back
 - Rule – absent a fraudulent conveyance claim, the donation is safe if not more than 15% of donor's gross annual income and consistent with donor's prior history of charitable contributions.

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