

## Nonprofits and the Law

# What's On Your Attorney General's Radar?

**N**onprofit leaders are certainly aware that the IRS casts a watchful eye over the nonprofit sector. But closer to home, it may be your State Attorney General who actually has more day-to-day impact on your organization. After all, it is typically this office that fields complaints from disgruntled donors, board members and consumers.

### Who's in Charge?

All 50 states have laws on the books governing the behavior of charitable organizations. They consider nonprofit oversight to be an important matter of consumer protection.

Reports of mismanagement typically come to the attention of attorneys general through the media, from donors, from "whistleblowers" within the organization, or from former officers, directors or employees.

Problems that AGs frequently investigate include:

- Illegal use of charitable funds.
- Diversion of charitable trust funds from their intended purpose.
- Violations of telemarketing and other fundraising rules.
- Excessive amounts paid for salaries, benefits, travel and entertainment.
- Self-dealing transactions between a director and/or trustees and the nonprofit organization.

Attorneys general do not usually investigate these matters:

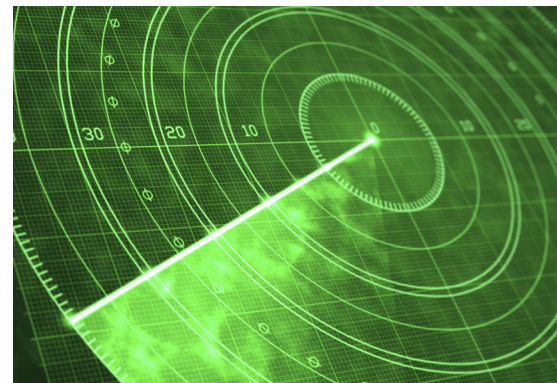
- Homeowners associations and other nonprofit membership benefit corporations.
- Disagreements between directors and/or members over policies and procedures.
- Matters involving internal labor disputes and contested elections.

### How to Stay Off the Radar

Attorneys general aggressively pursue fraud within charitable solicitations — both in their role as guardian of charitable assets and through state consumer protection laws. But there are plenty of other practices that are practically guaranteed to set an AG's radar off, including these:

- **Mismanagement of charitable trusts/gifts** — In many states, attorneys general are involved in the oversight of charitable trusts and gifts. In Tennessee, for example, the state's Uniform Trust Code empowers the AG to act as a qualified beneficiary, requiring him or her to be a party in any judicial or non-judicial proceeding involving a charitable trust. In similar fashion, AGs protect endowment funds under the Uniform Prudent Management of Institutional Funds Act (UPMIFA) or similar state statutes.

*Action:* Review the handling of all trusts and gifts to be sure they



are in compliance with state and federal laws.

- **Lack of transparency** — The public is watching and they expect information and full disclosure. If they don't get it, they will complain. In fact, lack of transparency is at the core of the majority of complaints to state attorneys general.

*Action:* Make your tax returns and tax exemption information available to the public in accordance with IRS public disclosure requirements. Above and beyond that, consider creating a simple annual report or an "at-a-glance" summary of finances on your website. Solicit input from your independent auditor to ensure the financial accuracy of such data.

- **Failure to register fundraising activities** — Organizations that fail to

*Continued on page 3*

## 5 Things Your Nonprofit Should Know

**“Promises are like crying babies in a theater, they should be carried out at once.”**

— Norman Vincent Peale

Ah, if it was only so easy. In the world of nonprofit fundraising, much-needed support often comes in the form of a promise: for example, a signed pledge card, an e-mail acknowledgement or a letter of intent.

And while your nonprofit certainly shouldn't look a gift horse in the mouth, such pledges do require action on your part. Specifically, you need to properly account for and disclose promised gifts in your financials. Here's how:

**1. Treat promises to give as an asset.** In general, promises to give are treated as an asset and shown on the books when the promise is made. To record the revenue, simply make a debit to “contributions receivable” and a credit to “contribution revenue.”

**2. Make the distinction between a promise and an intention.** There is a big difference between someone making a pledge and someone simply indicating their intention to give. A mere statement of an intention to give should not be recorded as revenue. Factors that distinguish between promises and intentions include:

*Promise:* Words such as “promise,” “agree” or “binding” are used in the agreement.

*Intention:* The donor does not put the promise in writing. If there is a written communication, it uses words such as “intend,” “plan” or “may.”

*Promise:* The amount of the promise is determinable.

*Intention:* The gift amount is not clear or readily computable.

*Promise:* The promise contains a fixed payment schedule.

*Intention:* No formal method or schedule of payment is proposed.

*Promise:* The donor has the financial ability to fulfill the promise.

*Intention:* Payments were due, but no payments have been made.

### 3. Determine the conditions.

Here, it is important to understand that “conditions” take place before the funds are received, while “restrictions” govern the use of the contribution after it is received.

An *unconditional* promise to give is a promised gift on which the donor has placed no conditions — or has made the gift conditional only on the passage of time or a demand for performance. For example, a passage-of-time condition is created when a donor makes a pledge to support your organization next year (i.e., promise is made now, but the gift can't be used until next year).

Similarly, a performance demand would be created when a donor promises your nonprofit a specific amount of money to purchase new computers. Here, the gift must be used to perform a specific action, like purchase computer equipment. In both examples, the donor is making an unconditional promise to give and is placing restrictions only on your organization's use of the gift.

From an accounting standpoint,

record unconditional promises to give as revenue immediately, even if the donor has placed a time or performance restriction on the gift and the restriction will not be met until some future time.

By contrast, a *conditional* promise to give makes the gift contingent on some future event occurring before the donor is bound to make the contribution. For example, a donor may promise to make a \$10,000 matching donation on the condition that \$10,000 in other donations is raised first.

From an accounting standpoint, do not record a conditional promise until the conditions of the promise are substantially met and the conditional promise becomes unconditional. Note that in some cases, the donor's conditions may be met in stages. As your organization receives qualifying contributions in a dollar-for-dollar match, for example, a corresponding equal amount should also be recognized from the matching gift. Here, the donor's condition on the matching gift is being met as qualifying contributions come in.

**4. Record it properly.** Intentions are disclosed in notes to the financial statements, while promises are recorded as receivables and revenue.

**5. Plan for it.** Consider establishing a formal policy for revenue recognition regarding promises to give. This includes what documentation must be obtained or maintained in order to substantiate the amount and timing of revenue recognition.

A promise to give is a good thing. It means someone has promised to deliver funds, services or property to your organization sometime in the future. Take the next step by ensuring that promised gifts are properly accounted for. ■

*For more information on proper revenue recognition procedures, contact our office.*



# What's On Your AG's Radar?

Continued from page 1

properly register with the appropriate state, county and municipal authorities can be subject to fines and civil suits — they can even have their right to solicit contributions revoked. Two hot button issues: telemarketing activities and fundraising that crosses state lines.

*Action:* Consider using the Unified Registration Statement, a standardized registration form that allows you to register with 36 cooperating states and the District of Columbia. Visit <http://www.multistatefiling.org> to use the form. For detailed guidance on best practices for solicitations using the Internet, consult the Charleston Principles established by the National Association of State Charity Officials (NASCO) at <http://www.nasconet.org>.

**Deceptive financial reporting** — Overstating program expenses and/or misrepresenting program accomplishments can lead to big trouble. Likewise, understating fundraising and administrative expenses can invite unwelcome scrutiny. AGs are often skeptical of an organization that raises thousands of dollars while reporting zero fundraising expenses.

*Action:* Use IRS Form 990 to explain your finances in detail. For example, take time to demonstrate that your fundraising expenses are reasonable in light of various factors, including your organization's size, funding sources and the "popularity" of its cause.

**Mergers and conversions** — Nonprofits considering a formal merger with another charitable organization are usually required to notify the attorney general of the planned merger. Likewise, prior approval from the attorney general is usually required before converting an organization or its assets to for-profit status. Ditto for a planned dissolution of a nonprofit organization.

*Action:* Understand your state's notification requirements and keep the AG in the loop.

**Excessive political activity** — While they can advocate for causes and even perform a limited amount of lobbying, nonprofits are completely prohibited from "electioneering." This includes anything that you do to improve or damage the chances of someone winning an election for public office. On the lobbying side, the general rule is that "no substantial part" of an organization's expenditures can go to lobbying. Nonprofits crossing the line may see their nonprofit status quickly revoked.

*Action:* Obviously, avoid any electioneering. Beyond that, understand the IRS-imposed limitations on lobbying activities. Your nonprofit may make a so-called "501(h) election" by filing IRS Form 5768. You will then know upfront the specific dollar limits, calculated as a percentage of total exempt purpose expenditures, that you may spend to influence legislation.

**Poor governance** — Increasingly, attorneys general are keeping a close eye on proper governance of charitable corporations. Many states have adopted the Revised Model Nonprofit Corporation Act, which gives AGs the power to remove directors, prevent conflicts of interest, appoint receivers, and even dissolve a nonprofit when it is not being properly governed.

*Action:* Ensure that your directors and officers are fulfilling their fiduciary obligations of duty, care and obedience. A thorough orientation for new board members — and ongoing training for everyone — can go a long way in encouraging good governance. If you haven't already, adopt some of the policies that the IRS considers to be governance best practices, such as conflict of interest, whistleblower, document retention and destruction, etc.

**Excessive compensation** — Paying excessive compensation to direc-

tors and key employees can be grounds for revocation of your organization's tax-exempt status. The same goes for inappropriate loans to officers and directors.

*Action:* In general, executive compensation is presumed to be reasonable if comparable salary data is used in making the compensation decision, the decision is made by "disinterested persons," and the compensation decision is properly documented.

## Play by the Rules

State attorneys general are key players in our country's system of charity oversight. Under their watch, oversight and enforcement actions have been stepped up in recent years, especially as nonprofit fundraising increasingly crosses state lines. Savvy charities keep AGs at bay by knowing and playing by the rules. ■

*Contact our office for guidance on managing your nonprofit's risk exposure.*

## 4 Legal Best Practices for Nonprofits

Nonprofits can typically stay on the straight and narrow by following some general best practices:

1. Operate programs that are within the authorized purposes of the organization.
2. Make board decisions in a manner consistent with the organization's bylaws.
3. Comply with established standards for fundraising.
4. File annual financial reports with the IRS or applicable state regulators.

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## Public Charity or Private Foundation?

**I**n the nonprofit world, you're either a horse or a zebra ... a public charity or a private foundation. It's important that nonprofit leaders clearly understand the distinction — because a nonprofit that doesn't act like a true public charity risks losing its charitable status.

The IRS sees it this way: A 501(c)(3) organization is considered to be a private foundation unless it proves otherwise. In fact, the IRS will not say that an organization is a public charity — only that it is *not* a private foundation.

In general, a public charity is an organization that:

- Engages in activities to promote general welfare,
- Does not exist to make a profit,
- Obtains its funding from the general public or the government, and

- Provides services that support its tax-exempt purposes.

By contrast, private foundations are typically funded by a single source — usually a family or corporation. Most private foundations do not provide charitable services. Instead, they provide funding to other organizations to do so.

One way to look at it is that public charities are involved in charitable work, while private foundations are involved in supporting the work of those public charities.

In the end, the story you tell on your annual *IRS Form 990* makes or breaks the case. Use Schedule A, *Public Charity Status and Public Support*, to show that your organization fits within an organization category that



is not considered to be a private foundation. Then use Schedule A, Part III-A, to show the percentage of support you receive from the public and investment income.

Just as important, leverage your organization's *Form 990* as a marketing tool to clearly and compellingly convey program accomplishments. Ultimately, it is critical that the IRS — and the public — know the color of your spots (or stripes). ■



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