NOW & NEXT

Nonprofit Organizations Alert

JANUARY 5, 2023

Nonprofit compliance strategies in the current regulatory environment

By Travis Hill and Michael J. Cooney

Now is the time for nonprofits, charities, and civic organizations to review and revise their policies and compliance plans.

What's the Impact?

- Nonprofit executives and boards must be aware of the unique regulatory and enforcement environment in which they operate
- Tax compliance and donor privacy are the subjects of numerous recent enforcement actions
- Nonprofits should regularly engage with outside counsel to ensure successful operations and minimize regulatory scrutiny

According to the National Center for Charitable Statistics, there are more than 1.54 million nonprofit organizations registered in the U.S., with the sector contributing an estimated $1.047 trillion to the U.S. economy. In recent years, private giving to nonprofits from individuals, foundations, and businesses totaled $427.71 billion, and 25% of U.S. adults volunteered with a nonprofit.

Simply put, nonprofits are big business, with the largest organizations overseeing multi-million and, in some cases, billion-dollar budgets, martialing widespread community impact, political

influence, and social change. Some nonprofits, such as trade associations, exist for the benefit of their members, but the majority of nonprofits are charitable entities, guided not by pecuniary profit but by the benefit conveyed to the community served. They must be organized and operated exclusively for exempt purposes, such as charitable, religious, educational, or scientific purposes, as set forth in Internal Revenue Code Section 501(c)(3), and none of its earnings may inure to any private shareholder or individual. Nonprofit executives and boards must be aware of the unique regulatory and enforcement environment in which they operate.

Federal regulations and enforcement

Nonprofits are subject to numerous federal regulations due to their special status under the Internal Revenue Code. The fundamental enforcement powers and remedies of the IRS are, not surprisingly, the ability to revoke tax-exempt status and impose income, employment, penalty excise, and other taxes, in some cases, on both the exempt organization and those governing or employed by it. Common issues raised in IRS audits are employee/independent contractor classification, executive compensation, and unrelated business income tax.

The IRS has the authority to audit an organization to ensure it continues to qualify as exempt under Section 501(c)(3). An ancillary issue is whether the organization is properly classified as a public charity or a private foundation under Section 509(a). Private foundations and their managers are subject to an array of penalty excise taxes set forth in Article 42 of the Code.

Perhaps the most impactful of penalty excise taxes in the public charity taxing regime is Section 4958, which imposes penalty excise taxes on any organization manager (i.e., officer, director, or trustee) who knowingly approves or otherwise participates in an excess benefit transaction. The effect of the excess benefit transaction excise tax can be substantial. In *Caracci v. Comm'r*,[1] members of one family were assessed over $41 million in excise taxes under Section 4958.

Federal law also regulates the political activities of nonprofits and for charities, prohibits it altogether. Under the "Johnson amendment" of 1954, Congress prohibited 501(c)(3) organizations from certain political activities. The law defines a charity as one "which does not participate in or intervene in (including the publishing or distributing of statements) any political campaign on behalf of (or in opposition to) any candidate for public office." Congress strengthened the ban with the passage of the "Bork amendment" in 1987, clarifying that the prohibition also applies to statements opposing candidates.

However, civic organizations recognized as tax-exempt under Section 501(c)(4), unlike charities, can engage in an unlimited amount of lobbying related to their exempt purposes, as well as some electioneering. An organization may conduct lawful lobbying activities and remain exempt under Section 501(c)(4) as long as it is primarily engaged in activities that promote social welfare and are not primarily political.

---

[1] [1] *Caracci v. Comm'r*, 118 T.C. 379 (T.C. 2002).

State regulations and enforcement

Most states regulate charitable organizations through the state attorney general's office and/or secretary of state. There is a growing sophistication and cooperation of state nonprofit regulators. An example of an advanced state regulator in this area is the Charities Bureau of the New York State Attorney General's (AG's) Office.

In many ways, the reach of the Charities Bureau is more extensive than the IRS, and its available remedies broader. The powers of the Bureau arise out of three statutes, along with judge-made common law:

- The Not-for-Profit Corporation Law (N-PCL)
- Estates, Powers, and Trusts Law (EPTL) §§ 8-1.1 & 8-1.4
- Article 7-A of the Executive Law

Additionally, the NY AG has any number of other remedies, ranging from those against garden-variety fraud[2] to the broadly defined *parens patriae* power of the state.[3]

While, perhaps, not technically in the category of enforcement actions and remedies, the NY AG's broad authority under the N-PCL to regulate fundamental not-for-profit corporate changes positions the Bureau to be involved in matters other states typically avoid, such as amendments to certificates of incorporation; approval of the sale, lease, exchange, or other disposition of all or substantially all of an organization's assets; dissolutions; and mergers and consolidations.

Most states, including New York, have disclosure regimes for charitable solicitations, roughly fashioned as consumer protection laws. Approximately 40 states have charitable solicitation laws, and 23 specifically define and regulate third-party providers that facilitate fundraising (such as professional fundraisers, fundraising counsel, and commercial co-ventures). In New York, these requirements are found in Article 7-A of the Executive Law, though general consumer fraud statutes apply as well.

The NY AG can initiate court action seeking the removal of directors who authorize or acquiesce in inappropriate payments or other benefits to fellow directors. Additionally, the AG may bring an action to remove directors and officers of a not-for-profit corporation for cause.

The NY AG can also surcharge individual trustees who have arguably squandered or wasted charitable assets, requesting a court to order one or more trustees to pay restitution to the charitable organization and thereby make it whole. N-PCL Section 715(f) provides the AG broad powers to bring an action to enjoin, void, or rescind any related party transaction or proposed related party transaction, even requiring a fiduciary to pay (in the case of willful and intentional conduct) an amount up to double the amount of any benefit improperly obtained.

---

[2] See *Madigan v. Telemarketing Assocs*, 538 U.S. 600 (2003).

[3] See, e.g., *People v. Grasso*, 11 N.Y.3d 64 (N.Y. 2008), followed by *People v. Grasso*, 54 A.D.3d 180 (N.Y. App. 2008).

A few high-profile Charities Bureau enforcement matters demonstrating the breadth of the NY AG's authority include the 2019 settlement with the Donald J. Trump Foundation, shuttering the organization and requiring a payment of $2 million in damages and the pending lawsuit seeking to dissolve the National Rifle Association (NRA) for the diversion of millions of dollars away from its charitable mission. The NRA has vigorously challenged the validity of the NY AG's lawsuit and was successful in having the AG's claims for dissolution dismissed. The court held that the Complaint failed to allege "the type of public harm that is the legal linchpin for imposing the corporate death penalty" and "dissolving the NRA could impinge . . . on the free speech and assembly rights of its millions of members." The remaining claims against the NRA and its individual officers for violating the N-PCL, the EPTL, and the Executive Law were upheld. The case is currently progressing through discovery with a special master.[4]

Protecting donor information

Donor confidentiality is not new to the nonprofit world. But the proper solicitation, substantiation, maintenance, and exploitation of donor information does not always receive the attention it deserves.

At the federal level, public charities have long been required to file a Schedule B donor disclosure with their IRS Form 990. Congress, however, prohibited the IRS from making public the name or address of any contributor to that reporting charity—a protection not afforded to private foundations or political organizations. Further, public charities themselves are not required to disclose donor information and so may withhold disclosure of their Schedule B to the public.

A handful of attorneys general argued all the way to the Supreme Court that they were not subject to the federal non-disclosure regime. In 2021, the Court held in *Americans for Prosperity Foundation v. Bonta*[5] that a California law requiring charities to submit an unredacted copy of Form 990, Schedule B was unconstitutional. In response, the NY AG suspended its requirement for Schedule B donor disclosures in state reporting on CHAR 500. The instructions for the New York form reassure filers that Form 990 Schedule B is exempt from disclosure to the public, as the complete filing package is otherwise made available online. Further, New York adopted changes to Section 172 of the Executive Law, prohibiting the NY AG from releasing nonprofit donor lists and exempting those lists from public records requests.

Since 2006, this general deference to donor confidentiality recognized a specific statutory regime for reporting from the IRS to state officials, permitting donor disclosure to a state officer if the Service determines that such "return information may constitute evidence of noncompliance under the laws within the jurisdiction of the appropriate State officer." In other words, some evidence of probable cause is a prerequisite to IRS disclosure.

---

[4] *State of New York v. The National Rifle Association of America, Inc., et al.*, Sup. Ct. NY Cnty, Index No. 451625/2020, NYSCEF Doc. No. 609.

[5] *Americans for Prosperity Foundation v. Bonta*, 141 S.Ct. 2373, 2389 (2021).

Nonprofits registering and reporting under state charitable solicitation laws should pay close attention to the information required and how it can be used. A state official may well have the power to compel a private charitable organization, even without any allegations of fraud or other violations of law, to disclose donor information. Donors, for their part, may change their behavior by giving anonymously, through intermediaries, or not at all.

Compliance strategies and best practices

The best compliance strategies encompass regulatory and compliance expertise, complex investigations know-how, litigation strategy, media savvy, and overall crisis management. Nonprofits should regularly engage with outside counsel to ensure successful operations, avoid regulatory scrutiny to the extent possible, and successfully weather any regulatory storms that may arise.

- Create your own narrative and consistently hew by it in as many expressions as possible (e.g., the purposes clause in your Certificate of Incorporation, your Form 990 narrative, your charitable solicitations, other regulatory filings, etc.)
- Develop appropriate internal policies and compliance programs that are achievable and verifiable
- Foster a culture of ethics and compliance, accounting for the role of the governing board and its various committees to provide oversight but not management
- Continually update policies and procedures to comply with current statutes and regulations, as well as industry best practices
- Thoroughly investigate all credible allegations of wrongdoing in a timely manner and in accordance with internal policies and external requirements (such as whistleblower claims)
- Engage with regulatory agencies, as appropriate
- Develop a media strategy that powerfully supports your mission and practices and contemplates responses to public inquiry and criticism

The key to avoiding regulatory scrutiny, government enforcement actions, and extensive litigation is being proactive and implementing proper controls. To successfully navigate such incidents when they occur, you need the right tools and the best team to respond efficiently and effectively. Nixon Peabody has the expertise to guide your organization through all manner of regulatory and enforcement actions, as well as complex investigations and litigation. More importantly, we have the experience necessary to partner with you to ensure that the right internal policies and compliance programs are in place to minimize future regulatory scrutiny to the greatest extent possible.

For more information on the content of this alert, please contact your Nixon Peabody attorney or:

Travis Hill
212.940.3131
thill@nixonpeabody.com

Michael J. Cooney
202.585.8188
mcooney@nixonpeabody.com