REID AND RIEGE, P.C.

NONPROFIT ORGANIZATION REPORT – SUMMER 2012

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<u>IS TRANSPARENCY THE BEST MEDICINE?</u> For several years the IRS has prescribed transparency as an elixir for good governance. While we acknowledge the truism that "sunlight is the best disinfectant," we also see wisdom in the maxim "too much of a good thing." In other words, while a dollop of transparency enhances the governance recipe, when taken in excess it can encumber the ability of management and board members to have the frank deliberations necessary for good governance. Moreover, too often we have seen people use transparency as a rhetorical tool to advance a personal agenda that has nothing to do with governance. In this article we will try to bring some transparency to the topic of transparency by framing the issue with some cases from our workbench, articulating some general principles to guide your judgment if the issue presents itself, and concluding with the argument that privacy is necessary for good governance and that translucence is really the best medicine.[1]

Here are some recent examples of transparency matters that we have encountered. We were asked if the public had a right to attend a board meeting of a social service provider at which a vote was being taken on a proposed merger. An executive director asked us to respond to a board member's request that minutes be placed on the Website. A landlord in hostile negotiations with a nonprofit client invoked the state Freedom of Information Act in a letter stating "[t]his is a request for records under the Freedom of Information Act … to include, but not limited to, a list of all meetings or discussions, names of persons involved, voicemail, email, faxes, videotape, audiotape, computer records, handwritten notes, typed notes, memorandums(sic), calendars (office & personal), pictures, photocopies, phone logs, phone messages and PDAs."

The general transparency/privacy principles we recommend are as follows:

1. Board meetings are not open to the public. The only people who have a right to attend are board members and those persons who are "invited." The invitation is typically an informal practice such as having senior staff attend to answer questions. The invitation can be more formal, such as a request that an outside consultant attend to speak to an issue (see point 4 below).

2. Records, minutes, contracts, reports, notes, files, etc. are not subject to public inspection. Additionally, under state and federal law certain information must be kept confidential – such as personnel files and protected health information.

3. Under federal law the annual tax return (Form 990) and the application for tax exempt status (Form 1023) must be made available to the public; and under state charitable solicitation and corporate law the names and addresses of officers and directors, paid fundraisers, audits and other data is typically open for public review.

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[1] Nonprofit Organizations Practice Area Chairman Jack Horak participated in a panel discussion on nonprofit transparency in Washington sponsored by the Philanthropy Roundtable and the Aspen Institute in May of this year. The panel offered different opinions on the topic and can be viewed at http://www.youtube.com/embed/ZNFh31RtTlU.

4. The items discussed in points 1 and 2 are subject to disclosure if a subpoena is issued by a private litigant (if you are sued) or by a governmental agency with subpoena power. The only way to prevent disclosure in this context is by use of the attorney-client privilege – namely, having the lawyer who represents the organization present at the meeting or a party to written communications – with the attorney invoking the privilege at the meeting or in the communications.[2]

5. FOIA legislation is designed to give the public access to records and proceedings of governmental entities, but in some states the reach of the legislation has been extended to include organizations which are "functional equivalents" of governmental organizations. The functional equivalent standard is vague, and interpreted aggressively could force nonprofits dependent on government revenue (especially social service providers) to open their windows and closets to anyone who asks. The above case of the disgruntled landlord speaks volumes about the operational consequences of FOIA. We typically advise clients to deny requests based on FOIA to avoid opening a can of worms that will create ongoing problems.

Our defense of privacy is based on the fiduciary obligations of boards and management to act solely in the *interests* of the organization *as a whole* and not in their personal interests, nor in the interest of vendors, donors, state agencies, employees, creditors or anyone else whose interests are "adverse" to that of the organization. The term "adverse" does not mean being in a dispute, but simply that the outside interests (a landlord, for example) want to "sell high" while the other wants to "buy low." This simple principle and dynamic (as old as civilization and commerce) is encumbered when one of the parties has the ability to access the inside thoughts, reasoning, and strategy of the other. How could our nonprofit client have effectively protected its interests against an unhappy landlord if the landlord had access to the client's inner thought processes?

In conclusion, we believe translucence is the best medicine. There are outside parties with a legitimate interest in knowing that your organization is well managed and financially sound (regulators, funders, and consumers), and it is important to let in sufficient light to obtain its sanitizing benefits and to maintain goodwill and a positive reputation. Nevertheless, nonprofits should not lose sight of the fact that they are private associations with both a fiduciary duty and a right to keep many things private. The right balance can be struck by complying with all mandatory disclosure requirements (item 3 above), making voluntary disclosures, publishing an annual report, maintaining a robust Website (with copies of conflict of interest and compliance policies), getting ahead of problems, and being a good citizen in your community.

IS THERE A DISREGARDED ENTITY IN YOUR FUTURE! Many nonprofits are complex enterprises (with real estate, employee benefit plans, debt, operational risk, vehicle fleets, volunteers, audits, licenses, and the like). In this milieu it is a prudent practice to create a governance structure in which discrete activities or assets are conducted or held by separate subsidiary legal entities under the control of a nonprofit "parent." Traditionally, these structures were assembled by creating subsidiary stock corporations (to conduct an unrelated business) and subsidiary nonstock corporations with a separate IRS tax exemption ruling (to conduct an exempt function). However, over the past decade "disregarded entity" limited liability companies (LLCs) have emerged as a common alternative, and a recent IRS pronouncement expands the usefulness of LLCs dramatically enough to suggest a sea change will occur in the

[2] The fact that a board member happens to be an attorney will not be sufficient to invoke the privilege.

assembly of multi-entity structures.[3] We have often thought that the reputation of disregarded entity LLCs suffers unnecessarily from an aura of complexity ("disregarded entity" does sound like an oxymoron), and we will try to demystify the applicable concepts and explain why a disregarded entity is likely a part of your future.

First, as a preliminary matter it is necessary to remember that entities are created under and governed by state law, but that tax treatment is generally a matter of federal law. An entity can be treated differently under each body of law.

Second, historically, lawyers tasked with forming a *for-profit* entity were limited to stock corporations or partnerships.[4] Corporations have the state law advantage of *limited liability* (stockholders are not responsible for corporate obligations), but the federal law disadvantage of *double taxation* (income is taxed to the corporation and again when distributed to shareholders). Partnerships have the state law disadvantage of *personal liability* (partners are responsible for partnership obligations), but the federal law advantage of *single taxation* (profits are taxed only to the partners). In the 1990s state and federal law evolved to authorize LLCs as an alternative offering the best both worlds. Under state law the owners of a LLC (called members) are not responsible for the LLC's liabilities (as with a corporation); and under federal law the LLC's income passes through and is taxed to the owners (as with a partnership). The term "disregarded entity" is used to describe LLCs because they are "*disregarded*" for tax purposes, but they remain fully "*regarded*" as a liability shield under state law.

Third, when a LLC is 100% owned by a nonprofit, the situation is much the same as described in the previous paragraph. State law protects the nonprofit from the liabilities of the LLC, but as the IRS declared in 1999, the *income and expenses of the LLC are treated for tax purposes as income and expenses of the nonprofit* and must be reported on the nonprofit's tax return (Form 990). For example, as a matter of federal tax law, if a nonprofit-owned LLC conducts a trade or business not related to the nonprofit's exempt purposes, the LLC's income is reported on the nonprofit's Form 990 as Unrelated Business Taxable Income.

Fourth, the IRS advanced the ball further in 2002 when it analyzed the neighborhood development activities of a LLC owned 100% by a nonprofit college, and concluded that the LLC's activities were of a type qualified under Section 501(c)(3) and should be reported on the College's Form 990 as exempt function activity. This ruling was significant because (a) the IRS did not require the LLC to file a Form 1023 to obtain a separate Section 501(c)(3) determination letter (which would have been the case if the college used a nonstock corporation instead of the LLC), and (b) the IRS was not concerned by the fact that state LLC statutes are designed for for-

[3] The focus of this piece is those nonprofits which are exempt under Section 501(c)(3) of the Internal Revenue Code, to which deductible donations may be made. Nonprofits exempt under other sections of the Code (Such as Section 501(c)(4) social welfare/lobbying organizations) are not eligible for charitable donations but the above discussion otherwise applies to them.

[4] There are variations on these general choices (such as a limited partnership, Subchapter S corporations, and the like) which are beyond the scope of this newsletter.

profit businesses – presumably because the neighborhood development activities in question were exempt in nature and the LLC's existence was disregarded for tax purposes.

Finally, on July 31st of this year the IRS issued a statement concluding that a donor could take a charitable deduction for a contribution to an LLC of the type described in the previous paragraph – treating the contribution as if it was made directly to the Section 501(c)(3) owner of the LLC. While this announcement by the IRS (which has been expected for many years) still leaves some questions open,[5] it will make it much easier and less expensive for nonprofits to assemble (and to disassemble) affiliated groups for planning and strategic purposes, as follows.

LLCs with a single owner are easier and cheaper to create and to govern than stock or nonstock corporations. In most cases a single person/manager can be appointed to take on most of the responsibility. LLC documents (Articles of Organization and Operating Agreement) are simpler than corporate Certificates of Incorporation and By-laws. It generally takes about an hour of legal work to create a single member LLC. The same LLC documents can be used regardless of the nature of the activities the LLC will undertake – whether an unrelated business, a charitable program, or simply holding title to real estate or investment assets. If an LLC is created to perform a charitable activity it will not be necessary to undertake the costly and time-consuming process of applying for a determination letter (Form 1023) for the LLC, and that same LLC can accept tax deductible contributions from funders. While there are still some questions and details to be answered and worked out, these developments are nothing but good news for nonprofits. We urge readers to email us at nonprofit@rrlawpc.com with any questions or comments.

The Reid and Riege Nonprofit Organization Report is a quarterly publication of Reid and Riege, P.C. It is designed to provide nonprofit clients and others with a summary of state and federal legal developments which may be of interest or helpful to them.

This issue of the Nonprofit Organization Report was written by John M. (Jack) Horak, Chair of the Nonprofit Organizations Practice Area at Reid and Riege, P.C., which handles tax, corporate, fiduciary, financial, employment and regulatory issues for nonprofit organizations. While this report provides readers with information on recent developments which may affect them, they are urged not to act on this report without consultation with their counsel.

For information or additional copies of this newsletter, or to be placed on our mailing list, please contact Carrie L. Samperi at (860) 240-1008 or info@rrlawpc.com, or members of Reid and Riege, P.C., One Financial Plaza, Hartford, CT 06103. For other information regarding Reid and Riege, P.C., please visit our website at www.rrlawpc.com.

[5] This development dovetails with a 2010 announcement by the IRS that a donation from a private foundation to a disregarded entity LLC owned by a public charity was treated as a donation directly to the public charity. Some of the questions we see as unresolved are these: Would the IRS allow a deduction for a contribution to a 100% nonprofit owned LLC if the LLC conducts an unrelated trade or business, or if the LLC operating agreement contains language inconsistent with Section 501(c)(3)? If a 100% owned LLC conducts a trade or business that becomes larger in size and budget than that of the nonprofit owner, would the nonprofit's exemption be at risk? If an LLC merely holds title to real estate for the benefit of a nonprofit, would the real estate remain qualified for property tax exemptions designed for nonprofits? Finally, even though the IRS treats LLC's as pass through entities, the LLC will need a separate Employer Identification Number and will be subject to employment related excise taxes if it has its own payroll.