January 21, 2015

Day Pitney Nonprofit News - Winter 2015

UPDATE: Form 1023-EZ -- Simplification of the Application Process for Smaller Charities?

Article by Jennifer M. Pagnillo

On July 1, 2014, the IRS released a final version of the Form 1023-EZ, a simplified application for tax-exempt status that may be used by smaller organizations. This three-page form drastically reduces the burden on smaller charities by permitting them to attest that they meet the organizational and operational tests for tax-exempt status.

The Form 1023-EZ must be filed electronically on the website www.Pay.gov, and carries with it a reduced user fee of $400 (which also must be paid electronically on that website). Unlike with the Form 1023, an organization is not required to provide any of its organizational documents to the IRS. Also, the Form 1023-EZ does not require a narrative description of an organization's activities, nor does it require budgetary information as part of the application. There is a streamlined approval process for an organization that files a Form 1023-EZ, which means that organization may receive its determination letter within a few weeks.

In order to use the Form 1023-EZ, an organization must be "eligible" -- meaning it must qualify after completing the eligibility worksheet. An organization that does not qualify on the eligibility worksheet must file a full Form 1023 in order to apply for tax-exempt status. Even if an organization is eligible to file the simplified form, it may decide to file the full Form 1023 in any event, in order to provide additional information to the IRS for consideration in making a determination of tax-exempt status, such as detailed budgetary information or a description of potential future activities.

The IRS has promised to shift its attention to the "back end" for entities that have opted to file the Form 1023-EZ, and has suggested it will engage in more audits of such entities once the entities are operational. It is yet to be seen, however, whether the IRS will be able to divert the resources that will be necessary, especially with the likely large increase in applications for tax-exempt status now that the Form 1023-EZ is available.

New Nonprofit Law Audit Committee Requirements Apply to More Than Just New York-Based Nonprofit Organizations

Article by Warren J. Casey

At the end of 2013, the state of New York enacted substantial revisions to the New York not-for-profit statute, resulting in a major overhaul of New York laws applicable to nonprofit organizations.

One particular section of the new New York nonprofit statute, relating to audit committees and required functions of audit committees, has broader coverage than simply regulating nonprofit organizations "incorporated" or "based" in New York. Under the new law, which is now in effect, out-of-state nonprofit organizations that are required to file independent accountant's audit reports with the New York attorney general -- which includes out-of-state nonprofit organizations that (i) are registered in New York to engage in charitable solicitations and (ii) have annual gross revenues in excess of specified "threshold" amounts -- are required to meet significant new audit oversight requirements.

For example, those out-of-state nonprofit organizations which are covered by the new New York statute must meet the following new audit committee requirements:

- Either the full board of trustees (acting solely through "independent" trustees on the board) or an appointed "audit committee" comprised entirely of independent trustees is required to oversee the audit and financial reporting function of the nonprofit organization.
- The required independent audit committee (or independent board trustees performing these functions) also is responsible for reviewing with the outside auditor the plan and scope of the audit before audit commencement, reviewing with the outside auditor any material risks or weaknesses in internal control which have been identified by the outside auditor, reviewing any restrictions on the scope of the outside auditor's work as well as any significant disagreements between management and the outside auditor, and annually reviewing the performance and independence of the outside auditor.
- The term "independent" trustee is defined in the statute and includes, among other requirements, that such person not be an employee of or have a substantial financial interest in, and not have a relative who is an officer of or has a substantial financial interest in, an entity that has made payments to or received payments from the nonprofit organization or an affiliate in an amount that, in any of the past three fiscal years, exceeds the lesser of $25,000 or 2 percent of such other entity's consolidated gross revenues.

The definition of "independent" trustee can be problematic for many nonprofit organizations, particularly those that provide opportunities for companies with which their trustees are associated to host events at the nonprofit's facilities or that otherwise provide similar business opportunities, for fees and other payments, to take advantage of the services, facilities or products of that nonprofit organization. Although it would appear that normal charitable contributions are not intended to be included within the calculation of the $25,000/2 percent of gross revenues standard, many nonprofits provide business opportunities to outside entities with which trustees are officers or are otherwise employed (or have a family member in an officer position). Ensuring that the required audit functions outlined in the New York statute are performed only by trustees meeting the independent standards may require planning, such as the use of subcommittees for particular audit committee functions.

Further, it will be important for nonprofit organizations which are based or incorporated outside of New York to determine whether they are subject to this new statute. If an organization is subject to this new New York law, the organization should undertake immediately to satisfy its audit and audit governance requirements. It can be expected that New York state, one way or the other, will ensure that out-of-state organizations soliciting charitable contributions within New York State are in full compliance with these requirements.

IRS Rules On Corporate Domestication

Article by Edward Bion Piepmeier

In many states, corporations are permitted to change the law that governs them through a process called "domestication." Through this process, a corporation is "transferred" to another state's jurisdiction without any break or interruption in that corporation's existence. The corporation would continue to own the same assets and bear the same liabilities and is usually not considered a brand-new entity. The corporation, for all purposes, remains the same, with the exception of its governing law. Depending upon the law of the states in question, most corporations can effect a domestication by filing a simple form with the applicable Secretary of State's office.

The IRS recently issued a letter ruling holding that a tax-exempt corporation may, through domestication, change its governing law to a different state without having to reapply for tax-exempt status. In PLR 201446025 (August 20, 2014), the IRS held that a corporation's domestication to a new state didn't require the filing of a new exemption application. In reaching its decision, the IRS noted the corporation was keeping its "organizational form," was maintaining its "original incorporation date" and continued to be the same corporation after it consummated the domestication. The domestication did "not amount to the creation of a new organization" and was not considered a "substantial change" in the corporation's "character, purposes or methods." Accordingly, the corporation could continue to rely on its existing determination of tax-exempt status issued by the IRS. The IRS noted the corporation should still report the change in governing law on its Form 990.

With this recent IRS letter, tax-exempt corporations changing the jurisdictions of their governing law may be able to proceed without having to reapply for tax-exempt status. However, before undertaking such action, the corporation will need to analyze the applicable law of both its domicile state and the state where it desires to transfer, to ensure there is no break or change in the corporation's existence.

Deal to Rename Avery Fisher Hall Raises Issues of Donor Expectation and Enforcement

Article by Sam C. Shulman

In 1973, Avery Fisher donated $10.5 million to Lincoln Center in New York to be put toward the renovation of the New York Philharmonic's concert hall, which was renamed Avery Fisher Hall. On November 13, 2014, Lincoln Center reached an agreement with the Fisher family under which the arts venue will pay $15 million for the family's consent to the auctioning of the rights to rename the building. The deal raises many legal and practical issues, including the following:

- **Do "naming rights" have value, and are they enforceable?** The only IRS or Treasury Department guidance, which is decades old, suggests naming rights have no monetary value; and it is general practice to take a deduction for the full value of a charitable gift entitling the donor to a naming right. If that were proper, then the donor would not be able to

enforce the portion of the pledge agreement creating the naming right for lack of consideration. On the other hand, if the naming right were enforceable, then a portion of the donation would be in return for something of value (at the least, the legally enforceable naming right, in addition to the more nebulous public recognition or reputational boon). And if that were correct, then the original full-value deduction would have been improper. Absent new guidance from the government, therefore, the enforceability of a donor's expectation of a perpetual, "valueless" naming right is questionable.

- **What is a donor's expectation regarding naming rights, and who should enforce that expectation?** It is the state attorney general's obligation to ensure exempt organizations are acting properly and adhering to the terms of donations. If an organization desires to use funds in a manner arguably adverse to a donor's expectations -- but one otherwise charitable and proper and in the public's interest, and to which the donor consents -- how aggressively should the attorney general scrutinize the use? Donors' expectations seem to be more personal than public issues.
- **Should donor expectations regarding naming rights be respected if a contradictory use provides the organization with a substantial net gain of charitable assets?** Here, Lincoln Center is paying $15 million to obtain well over $100 million in expected new donations at a time when arts organizations nationwide are in dire need of funding. All this funding will be used to renovate the Philharmonic's theater. This was the exact purpose of Fisher's original 1973 gift. If this result requires removal of Fisher's name from the building, is that consistent or inconsistent with Fisher's donative expectation?

An interesting twist to the Fisher deal is that "Avery Fisher Hall" was not Fisher's desire. Fisher apparently quipped -- perhaps witty only to New Yorkers -- "Who's Major Deegan?" In fact, Lincoln Center had to convince Fisher to permit the use of his name on the building. It was a right "in perpetuity" that Fisher granted Lincoln Center under his pledge, not an obligation demanded by Fisher of Lincoln Center. Fisher's original donation, therefore, is not a good test of naming rights' value or enforceability. Lincoln Center's current solicitation, however, might better probe the issue.

Annual Performance Reviews

Article by Daniel L. Schwartz and Basil C. Sitaras

With the calendar year drawing to a close, many organizations find themselves in the process of preparing and delivering annual performance reviews of their employees. These performance reviews are an important means of communicating with employees about their strengths, weaknesses and suggested areas for improvement. In light of the importance of these documents, we recommend that you keep in mind the following guidelines:

Do:

1. Put performance reviews in writing.
2. Be accurate and clear, especially when documenting performance deficiencies that might eventually be used as grounds for termination of employment.
3. List and describe areas where improvement is expected.
4. Have supervisors meet in person with employees to discuss their performance reviews.

5. Have employees sign their performance reviews to acknowledge receipt of them.
6. Where required by law, such as in Connecticut, notify employees in writing that they have the right to submit a written rebuttal to a performance review.
7. Maintain performance reviews in employees' personnel files.

Do Not:

1. Base any performance evaluation or any other employment decision (e.g., raises, bonuses) on Equal Employment Opportunity (EEO)-protected characteristics, such as race, color, religion, gender, national origin, sexual orientation, age, disability, marital status or any other category protected by law.
2. Exaggerate an employee's strengths or provide higher scores than deserved.
3. Use solely numerical scores; written narratives are much more informative.
4. Retaliate against an employee for having engaged in activity that is legally protected, such as complaining about wages, overtime, working conditions, harassment, etc.
5. Criticize or penalize an employee for having taken a protected leave of absence, including but not limited to leaves taken pursuant to the Family and Medical Leave Act (FMLA) or the Uniformed Services Employment and Reemployment Rights?Act (USERRA).
6. Criticize or penalize an employee for seeking or receiving a reasonable accommodation for a disability.
7. Fail to complete and deliver performance reviews just because they are time-consuming or difficult; as noted above, such reviews are critical both for evaluating annual performance and for establishing and communicating future expectations.