

# Mosherlaw Nonprofit Update

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### *Mission Statement*

*The legal professionals of Mosher & Associates are dedicated to serving the legal needs of both small and large charitable, religious, educational, and human service organizations and the larger philanthropic community.*

## IRS Redesigns Form 990

The IRS recently released a revised IRS Form 990, the first complete redesign of the annual information return since 1979. The Service's goals in the redesign are to provide a more realistic picture of an organization and its operations, improve comparative analysis with similar organizations, promote compliance, and minimize the burden on filing organizations. While it is clear the first three goals will be met, the philanthropic community is significantly concerned with the administrative energy and costs that will need to be expended to annually prepare the new return. In particular, the revised 990 goes well beyond a simple accounting requiring a full organizational and operational analysis. A copy of the draft form may be obtained from [www.irs.gov](http://www.irs.gov), and is expected to be required for the 2008 fiscal year.

## Sound Fiscal Management Begins with Well-Drafted Corporate Documents

Many charitable organizations continually struggle with financial accountability and management. Without proper safeguards, organizations risk misuse of funds, a corresponding loss of reputation, severe IRS and other governmental penalties, and even loss of tax exemption.

Financial accountability should be established clearly through an organization's corporate documents. An organization's articles of incorporation and bylaws establish the foundational framework for its legal operations, providing authoritative guidance for how the leaders are to govern in accordance with their responsibilities under state and federal law. Some examples of bylaw provisions pertaining to financial accountability include the following: annual meetings for budget approval, board compensation; financial authority and responsibilities of officers; indemnification and insurance for directors and officers; and procedures for handling conflicts of interest.

In light of the IRS's recent scrutiny of perceived and actual financial conflicts of interest, it is prudent for every charitable organization to adopt a written conflict of interest policy. Many organizations wisely require directors and officers to annually complete conflict of interest disclosure statements to continually disclose any potential conflicts. Please feel free to contact our office for further assistance with conflict of interest provisions and policies.



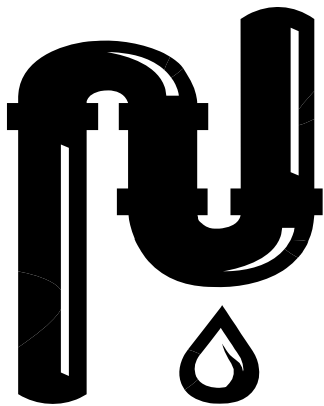
## Pitfalls and Penalties of Compensation

The IRS has recently heightened its scrutiny of tax exempt organizations and executive compensation, in response to perceived abuses within the nonprofit sector. It is thus extremely important to understand the legal implications of payments to and on behalf of nonprofit employees. When a person receives a private benefit from a nonprofit organization, certain liability may result if the private benefit is inconsistent with the organization's exempt purposes and therefore improper. If the organization -- through its Directors -- allows such improper private benefit to an insider, this constitutes "inurement" that is absolutely prohibited under federal tax law, puts the organization at risk of losing its tax exempt status, and violates state charitable trust laws. In addition, under federal tax law, liability may be imposed on both the person who receives the improper private benefit for such "excess benefits" and the governing Directors responsible for allowing or approving them.

As a general rule, tax exempt organizations such as a church may pay only reasonable and proper compensation to its employees. Whether paid as wages, fringe benefits, or other payments, compensation in excess of what is generally considered to be reasonable -- for similar organizations in

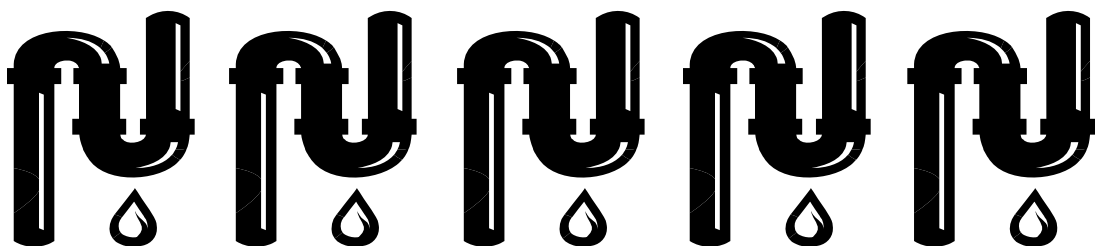
similar locations with similarly trained and skilled employees, and otherwise depending on the applicable law -- is considered to violate charitable trust principles regarding the proper uses of funds in furtherance of the organization's tax exempt purposes. This is known as "excess benefits" under federal law.

Under federal tax law, a "disqualified person" (someone in a position to exercise substantial influence over the tax exempt organization) who receives such "excess benefits" must return the excess benefits to the organization. In addition, the disqualified person to whom the excess benefits are paid, may be subject to harsh IRS sanctions, including 25% penalties for the amount of the unlawful excess benefit. If repayment is not effectively made, the IRS may assess an additional 200% penalty. The Managers who permit the excess benefit may be subject to a 10% penalty. See Internal Revenue Code § 4958. Such payments are treated as *automatic* excess benefits subject to these IRS sanctions, unless they are prospectively approved by the Board as compensation, reported as compensation on applicable tax forms, and supported by comparable compensation data.



## Water Exemption Reminder

Most Chicago nonprofits are eligible for entire exemptions from water bills and partial \$500 annual exemptions from sewer bills. Pursuant to sections 11-12-540(a) and 3-12-020(a) of the Chicago Municipal Code, nonprofit organizations that own and use Chicago property exclusively to provide educational, religious, or charitable services may obtain both the water and sewer exemptions. For more information, please contact our office.

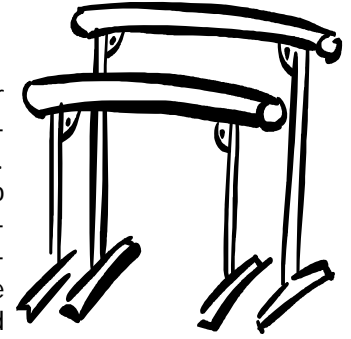


## Do You Have a Parallel Corporation Condition?

For the past several years, our office has worked with numerous congregations that have what we commonly call the "parallel corporation condition." This condition only affects religious organizations (churches, synagogues, temples, and their affiliated organizations) that were initially incorporated under the Illinois Religious Corporation Act ("RCA").

The RCA was enacted in 1872 when the legal environment in Illinois was much simpler and very different from today. The RCA contains minimal guidelines for governance. Among other problems, the RCA does not provide any means for religious corporations to dissolve or merge. It is also significant that few attorneys and people working with real estate concerns are familiar with the RCA.

The parallel corporation problem may occur years later when the organization is purchasing property or refinancing existing assets. Lenders or interested parties may want to see evidence of corporate status. The Secretary of State has no record of religious corporations. Legal counsel may assume the corporation was administratively dissolved and quickly reincorporate under the Not-for-Profit Corporation Act of 1986 in order to proceed with the financial transaction. The organization now has two separate corporations and may soon experience a variety of legal issues affecting property and operations. If you think your church or synagogue has parallel corporations, please contact our office as soon as possible.



## Receipt Please!



To claim federal income tax deductions for charitable contributions to qualified donee organizations, donors must have proper written acknowledgments from the recipients of such contributions. Accordingly, a qualified organization should provide written acknowledgments of all charitable contributions to donors, with the following information: (1) the donee organization's name; (2) the donee organization's federal employer identification number (FEIN); (3) the amount contributed; (4) the date of the contribution; (5) whether the Foundation provided the donor with

any goods or services as a result of their contribution (other than token items); and (6) a description and good faith estimate of the value of any goods or services described in (3) above.

We recommend using the following language, depending on the circumstances. On organization letterhead, state:

(A) "Thank you for your tax-deductible gift of \$\_\_\_\_\_ to \_\_\_\_\_ [the organization]\_\_\_\_\_, which is a tax exempt charitable organization under section 501(c)(3) of the Internal Revenue Code (\_\_\_\_ FEIN \_\_\_\_). No goods or services were provided to you as a result of your contribution."

**OR**

(B) "Thank you for your contribution of \$\_\_\_\_\_ to \_\_\_\_\_ [the organization]\_\_\_\_\_, which is a tax exempt charitable organization under section 501(c)(3) of the Internal Revenue Code (\_\_\_\_ FEIN \_\_\_\_). The following goods or services were provided to you as a result of your contribution, with a good faith estimated value of \$\_\_\_\_\_: [describe what was received by the Foundation]. The remaining amount of \$\_\_\_\_\_, for which no goods or services were provided to you as a result of your contribution, is a tax-deductible charitable contribution."

For contributions of tangible property, such as real property, vehicles, and art, additional IRS substantiation rules apply. Please contact us for further information.

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## Keep Reimbursable Expenses Nontaxable

To the extent that an employee incurs expenses that are properly reimbursable as business expenses, the nonprofit organization may pay him or her without such payments constituting taxable compensation. If, however, the proper procedures are not followed, then such payments may be taxable compensation. This is an important area for tax law compliance.

To be excluded from taxable compensation, any payments paid by the nonprofit employer to the employee for business expenses must qualify under an "accountable reimbursement" plan. However, to be treated as accountable business expenses, the employee must account to the employer for business expenses within a reasonable period of time, and specifically not more than 60 days after an expense was incurred. In particular, he or she must substantiate such expenses with documentation showing the business nature and the amount of all expenses, broken down into categories such as transportation, meals and lodging while away from home overnight, and entertainment expenses. In addition, the employee must incur these expenses while performing services as an employee of the organization. See IRC Regulations 1.162-17, 1.274-5T(f).

If no accountable plan exists or there is failure to comply with the expense reporting requirements, the employee's business expenses will be considered by the IRS as nonaccountable reimbursed expenses. Furthermore, if the employee is a "disqualified person" for purposes of excess benefits, any such payments not reported as taxable compensation may constitute "automatic excess benefits" subject to excise taxes and other penalties on him or her, the other directors individually, and the organization, *regardless of whether the payments are unreasonable or excessive in amount.*

For further information on organization business and travel policies for Board approval, as well as business expense reimbursement forms, please feel free to contact our office.

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## Charge! Charge? Charge!



An organization's credit card should only be used for specific categories of legitimate business expenses that have been approved in advance by the Corporation. The nonprofit should have a Board-approved written credit card policy restricting its usage. This is also a practical risk management measure to reduce the risk of theft or fraud.

The credit card should *never* be used for anyone's personal expenses. Such use, without reimbursement by the employee, is an obvious, documented example of taxable compensation and, if not reported as compensation, unlawful excess benefits. Please contact our office if you would like further legal counsel regarding such a policy or the distinctions between personal versus business expenses under the Internal Revenue Code.

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## About Mosher & Associates

The law firm of Mosher & Associates has developed over the past thirty years in the context of the charitable and philanthropic community. We have helped to successfully establish more than fifteen hundred tax-exempt organizations, many of which we still work with today. Our legal services also encompass a wide range of corporate, tax, employment and real estate issues affecting our tax-exempt clients.

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