

OVERVIEW OF A MARYLAND EXEMPT ORGANIZATION

BASIC CONCEPTS AND CONCERNS

MILES & STOCKBRIDGE P.C.



Steven M. Gevarter, Esquire
Miles & Stockbridge
(410) 312-6709

sgevarter@milesstockbridge.com

September 25, 2007

General Overview

- Some key issues:

What is a tax exempt organization?

What laws govern a tax-exempt organization?

What does it mean to be director—a member of the “governing body” of an exempt organization?

What is good corporate practice, as shaped by the needs of the particular organization and the practical limitations of a director’s service?

- These organization are generally “formed” under state law but their tax-exempt status and classifications are generally determined under federal law—i.e., the Internal Revenue Code.

- There are separate provisions of the Corporations & Associations Article of the Annotated Code of Maryland that apply to non-stock corporations. See C&A §§ 5-201 *et seq.*
- However, the provisions of the Maryland General Corporation Law apply to the extent not inconsistent with those specific provisions relating to nonstock corporations.

Tax- Exempt Organizations

28 Categories of exempt organizations under Section 501 of the Internal Revenue Code

- **Charities - §501(c)(3)**
- **Civic Associations – §501(c)(4)**
- **Trade Associations – §501(c)(6)**
- **Social Clubs – §501(c)(7)**

Less commonly known:

Cemetery companies not operated for profit - §501(c)(13)

Credit unions - §501(c)(14)

Fraternal organizations operating under the lodge system - §501(c)(8)

Section 501(c)(3)

“Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and 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.”

Types of Charitable Organizations

- Public Charity
- Supporting Organization
- Private Foundation
- Private Operating Foundation

All Section 501(c)(3) organizations are subdivided into two categories: (i) so-called “public charities” and (ii) “private foundations.”

Presumption of private foundation status unless the organization falls within one of the four statutory exceptions.

Public Charities

- 1. Organizations such as churches, schools or colleges, hospitals, governmental units and “publicly support organizations” (i.e., at least 1/3 of the organization’s “support” comes from contributions made from governmental units and/or the general public.**
- 2. Organizations which normally receive a substantial amount of public support in the form of contributions and income from activities directly related to the organization’s exempt function.**
- 3. Organizations which support public charities (“supporting organizations”)**
- 4. Organizations which engage exclusively in testing for public safety.**

Two substantial differences between the two:

- Contributions to a private foundation are not as favorable for the donor when compared to contributions to a public charity.
- Private foundations are subject to certain operational restrictions in the form of excise taxes that are not imposed on public charities.

Supporting Organizations. The Hybrid.

Excluded from private foundation classification by reason of its close relationship to those public charities classified as Section 509(a)(1) or Section 509(a)(2) organizations.

Based upon theory that the public charity's control or involvement with the supporting organization will render unlikely the potential for manipulation for private objectives present in private foundations.

Supporting Organizations

To qualify as a “supporting organization,” the organization must be:

- (i) Organized, and at all time thereafter operated, exclusively for the benefit of, to perform the functions of, or to carry out the purposes of, one or more publicly supported organizations;
- (ii) Operated, supervised, or controlled by or in connection with one or more publicly supported organizations; and
- (iii) Not controlled directly or indirectly by one or more “disqualified persons” (generally a substantial contributor as defined in Section 4946 of the Code).

The Downside of PF Status: Excise Taxes

- Investment income - § 4940
- Self-dealing transactions - § 4941
- Failure to distribute income - § 4942
- Excess business holdings - § 4943
- Jeopardizing investments - § 4944
- Taxable expenditures - § 4945

Intermediate Sanctions - § 4958

- An alternative to revocation of tax-exempt status
- Aimed at excess benefit transactions
- Imposes an initial penalty of 25% of the excess benefit on the recipient/disqualified person
- Increases to 200% if not timely corrected
- Imposes a 10% penalty on managers knowing that it was an excess benefit transaction

Unrelated Trade or Business Income

- Income derived from activities or investments not substantially related to organization's exempt purposes.
- Taxed at the top corporate rate - 35%
- If more than an insignificant amount, it can jeopardize the tax-exempt status of the organization.
- UBIT is really aimed at unfair competition.

Requirements for unrelated trade or business income:

- Income from a trade or business;
- Such trade or business is regularly carried on by the organization;
- Not substantially related to its exempt function.

Exemption for sales if:

- If substantially all the work is performed without compensation (volunteers);
- Primarily for the convenience of its members, students, patients, officers or employees;
- Selling donated merchandise.

Exemption for passive income, including –

- Dividend and interest
- Annuities
- Royalties
- Rents from real property and personal property leased as part of real property and incidental in amount

Exception to the exception: § 514 Unrelated Debt Financed Property

But, an exception to the exception to the exception: If the property is substantially related to the organization's tax-exempt purpose(s)

Donor Notification Requirements

A donor who makes a charitable contribution of \$250 or more will not be allowed a federal income tax deduction unless the donor obtains a contemporaneous written “acknowledgment” from the donee organization.

Cannot simply rely solely on a canceled check.

An “acknowledgment” is considered to be “contemporaneous” if it is obtained by the earlier of the date on which the donor files a tax return for the tax year in which the contribution was made, or the due date, including extensions for filing that return.

The acknowledgment must state:

- The amount of cash contributed.
- Description of any property other than cash contributed to the donee.
- Statement of whether or not the donee provided any goods or services in consideration, in whole or in part, for any of the cash or other property transferred to the donee.
- Description of any property contributed, other than cash.
- The value, estimated in good faith by the donee, of any goods or services the donee gave in return for the contribution.

Disclosure Requirements

Most exempt organizations must file an annual informational return (Form 990 or Form 990-PF) with the IRS

The information returns, together with any Form 990-T (filed for taxable unrelated business income) must be made available to the general public for 3 years after their filing or due date.

The organization's exempt status application materials must also be made available for public inspection.

As an alternative to producing and copying this information, the organization may make this information widely available (i.e., on the internet).

Maryland Corporation Law

§2-401. Function of directors

Management. – The business and affairs of a corporation shall be managed under the direction of a board of directors.

Power of Board. – All powers of the corporation may be exercised by or under authority of the board of directors except as conferred on or reserved to the stockholders by law or by the charter or bylaws of the corporation.

Maryland Corporation Law

§2-403. Qualifications of Directors

In general. – Each director of a corporation shall have the qualifications required by the charter or bylaws of the corporation.

Director need not own stock. – Unless required by its charter or bylaws, a director need not be a stockholder in the corporation.

Who Selects the Directors?

- Election by members or others
- Self-perpetuating boards
- Election by status (e.g., *ex officio*)

The Corporation's Purpose and How it Affects a Director

- All directors must know the corporation's purpose and the persons or interests it serves
- The corporate documents should state the corporation's purpose and its constituencies
- Actual corporate activities should be consistent with such statements

What Does It Mean To Be a Director of a Nonprofit Corporation?

- A director directs, but does not perform, the corporation's activities.
- Delegation of authority
- The directors act on behalf of one or more constituencies

What Does a Director Do?

- **Oversight of management varies from corporation to corporation.**
- **Typically, a director's duties include:**
 - **Setting and reviewing major corporate strategies and goals**
 - **Reviewing and evaluating the performance of senior management**
 - **Reviewing major financial and accounting matters**
 - **Performing any duties imposed by law or the entity's charter**

Director's Rights

- Management Access
- Books and Records
- Notice of Meetings
- Right to Dissent and Have Dissent Recorded

Accountability

- The accountability of directors of public benefit and religious corporations—
- Direct beneficiaries generally have no legal oversight power over nonprofit corporation directors
- A state attorney general is generally deemed to speak for the beneficiaries of any entity, such as a public benefit corporation, which has assets that are considered to be held in a charitable trust
- Despite their importance, donors are not considered part of the nonprofit's legal constituencies

Accountability to Members Responsible for Appointing a Director

- A public benefit corporation may have a membership to whom a director may be accountable, to the extent the membership has the power to remove or fail to re-elect the director or to sue directors on the corporation's benefit.
- Even if elected by a member in order to represent the viewpoint of such member, the director's obligation, as a director, is to make decisions and take actions in accordance with the corporation's best interest—irrespective of any individual member interest.

Maryland Corporation Law

§2-405.1. Standard of care required of directors

In general. – A director shall perform his duties as a director, including his duties as a member of a committee of the board on which he serves:

- (1) In good faith;
- (2) In a manner he reasonably believes to be in the best interest of the corporation; and
- (3) With the care that an ordinarily prudent person in a like position

Duties and Rights of Nonprofit Corporation Directors

Directors are subject to two primary duties:

- The Duty of Care
- The Duty of Loyalty

Duty of Care

- The duty of care calls upon a director to act in a reasonable and informed manner when participating in the board's decisions and its oversight of the corporation's management.
- The duty of care requires a director to be informed and discharge his duties in good faith, with the care that an ordinarily prudent person in a like position would reasonably believe appropriate under similar circumstances.

Elements of the Duty of Care

- Regular attendance at meetings, including committee meetings
- Exercising independent judgment
- Having adequate information

Delegation

- The board of directors is not expected to operate the corporation on a day-to-day basis
- Adoption of appropriate monitoring and control procedures
- Evidencing specific delegation of authority to officers
- Delegation of board management authority to an executive committee

Discharging the Duty of Care: Some Practical Suggestions

- **Regular schedule of meetings**
- **Meeting agenda and committee reports**
- **Action by written consent**
- **Regular schedule of information**
- **Schedule of reports to be provided to the board**
- **Distribution of information in advance of board meetings**
- **Practical limitations on staff time to prepare required reports and other information**
- **Rules of procedure and minutes**

Maryland Corporation Law

Some general comments to Section 2-405.1

Good faith is synonymous with what other states refer to as the duty of loyalty.

To be “reasonable,” the decision must be based on adequate information.

What is in the best interest of the corporation is an elusive concept. For a for-profit corporation, viewed as the interest of the stockholders. But what about a nonprofit?

Maryland Corporation Law

Reliance on information from others. –

(1) In performing his duties, a director is entitled to rely on any information, opinion, report, or statement, including any financial statement or other financial data, prepared or presented by:

(i) An officer or employee of the corporation whom the director reasonably believes to be reliable and competent in the matters presented;

(ii) A lawyer, certified public accountant, or other person, as to a matter which the director reasonably believes to be within the person's professional or expert competence; or

(iii) A committee of the board on which the director does not serve, as to a matter within its designated authority, if the director reasonably believes the committee to merit confidence.

The Business Judgment Rule

A director exercising good-faith judgment will usually be protected from liability to the corporation or its membership under the Business Judgment Rule—which provides that a court, in an action brought by the corporation or its internal constituency, will not re-examine the actions of a director in authorizing or permitting corporate action if such director's action was undertaken in good faith, in a manner reasonably believed to be in the best interests of the corporation and based on the director's independent informed judgment.

Duty of Loyalty

- The duty of loyalty requires directors to exercise their power in good faith and in the best interests of the corporation, rather than in their own interests or the interests of another entity or person.
- The director shall not use a corporate position for individual personal advantage.

Duty of Loyalty Primarily Relates The To--

- Conflicts of Interest
- Corporate Opportunity
- Confidentiality

Conflicts of Interest

- Not inherently illegal
- A conflict of interest is present whenever a director has a material personal interest in a proposed contract or transaction to which the corporation may be a party.
- This interest can occur either directly or indirectly

Dealing With Conflicts

Generally, a director's conflict will not result in a deemed breach of the director's duty of loyalty or render the transaction void if—

1. The transaction was approved by a disinterested majority of the board or after full disclosure by the affected director of the material facts regarding the transaction and the director's interest; and/or
2. The transaction was fair to the corporation at the time it was entered into.

Conflict of interest policies and disclosure statements

- Good corporate practice to adopt and adhere to a written conflicts of interest policy
- Corporate minutes or other records should document the nature of the disclosure, as well as the board's proceedings to evaluate the relevant transaction in light of the conflict
- Disclosure may be required in the corporation's audited financial statements and in its annual tax filing to the IRS

Corporate Opportunity

- Involves a prospective transaction which the director reasonably should know may be of interest to the corporation
- Need to consider what plausibly might fall within the corporation's present and future activities
- The “opportunity” should first be presented to the corporation

Confidentiality

- A director should not, in the regular course of business, disclose information about the corporation's legitimate activities unless they are already known by the public or are of public record
- In the normal course of business, a director should treat as confidential all matters involving the corporation until there has been general public disclosure or unless the information is a matter of public record or common knowledge

Maryland Corporation Law

Liability limited. – A person who performs his duties in accordance with the standard provided in this section shall have the immunity from liability described under §5-417 of the Courts and Judicial Proceedings Article.

Presumption of satisfaction. – An act of a director of a corporation is presumed to satisfy the standards of subsection (a) of this section.

Section 5-406 of Courts & Judicial Proceeding Article

- Limits the personal liability of agents of certain organizations, including charitable organizations
- Agent includes a director, officer, trustees, employee or volunteer
- No personal liability for an agent's acts or omissions if the organization maintains insurance
- The insurance has a coverage of (1) not less than \$200,000 per individual claim and \$500,000 per total claims arising from the same occurrence; or (2) \$750,000 per policy year and \$500,00 per total claims arising from the same occurrence

Section 5-407 of Courts & Judicial Proceeding Article

- Limits the personal liability of “volunteers” of certain organizations, including charitable organizations
- Volunteer includes a director, officer, trustees or other person performing duties without compensation
- Not liable for damages beyond the limits of any personal insurance the volunteer may have for acts or omissions unless it constitutes gross negligence, reckless, willful or wanton misconduct or intentionally tortious conduct

Special Duty: Knowledge of Illegal Activities

- If the chief executive or board chair fails to respond, the issue should go to the full board
- A director may not ignore what he or she believes to be illegal activities. Instead, the issue should be drawn to the attention of the chief executive or board chair with a demand for action or investigation

Special Duty: Knowledge of Illegal Activities

- If after a board discussion the matter is not repudiated, the director may want to consult his or her counsel to determine if further disclosure outside of the corporation is required or if she or he should resign

ADDED RESPONSIBILITY

Although the law does not consider a director of a nonprofit corporation to be a trustee in most situations, in some circumstances, directors may be held to the generally higher trustee standards; for example, responsible for carrying out the terms of a gift or bequest or with respect to endowment funds held for specific purposes.