IN COMPLYING WITH THE NEW NON-PROFIT LAW,

DON'T FORGET THE TAX RULES

BY JOSHUA GEWOLB, ESQ.

The Non-Profit Revitalization Act took effect in New York State on July 1, 2014.

The Act establishes significant new reporting and compliance obligations for New York non-profits.

While these are rules of state law, they interact with the federal tax law in a number of important ways. In complying with the new New York rules, it is important for non-profits to take IRS rules into account.

The changes under the new non-profit law can be divided into two general categories: changes that streamline the operation, administration and governance of non-profit entities and changes designed to safeguard against abuses.

It is the second category of changes that overlaps with IRS rules, particularly the extensive new rules relating to transactions between non-profits and related parties such as their directors, trustees, officers, and certain employees.

Historically, the New York Attorney General has had plenary authority to act on behalf of the people to ensure that the assets of non-profits are used to further their mission. However, New York law has not had any specific procedural requirements with respect to how non-profits interact with related parties. If a New York charity were, for example, to buy a headquarters building from a trustee, the old New York law required that the transaction be fair, but didn't have much to say about the process used to approve the deal.

The new act adds such rules to New York law for the first time. Federal tax law, however, has long contained detailed rules regarding related party transactions. Unfortunately, the new New York State rules differ from the tax rules in a number of important respects, presenting significant traps for the unwary. It is important that non-profits not lose sight of the federal tax law in complying with the new state rules.

There are two important requirements under federal tax law to note.

The first are the so-called "excess benefit" rules, which apply to transactions between charities and related persons, such as trustees. Under these rules all such transactions must be at fair market value.

While this may sound simple, the IRS rules apply to a different set of transactions than the new New York law. Careful legal analysis is required to determine whether one or both regimes apply. As a matter of best practice, it makes sense to assume that both sets of rules apply to all transactions.

In addition, the two sets of rules contain different requirements about how related party transactions need to be approved.

The IRS rules contain a safe harbor which presumes that a transaction is fair if it was properly approved by disinterested board members after considering data about similar deals. In the example involving the trustee selling a building to the non-profit, the non-profit would need to obtain an appraisal with comparables and the trustee could not participate in consideration of the purchase.

New York does not contain a safe harbor and a transaction can be questioned even if all of the applicable requirements are followed.

In addition, under New York law, following the federal safe harbor procedures is not enough. To comply with New York law, no trustee that has any business relationship with the corporation can participate in consideration of the sale. This includes any trustees that are employees of the corporation, who are employed by companies that do significant business with the corporation, or have relatives that fall in these categories.

Another key area of overlap is the "self-dealing" rules applicable to grant-making foundations.

These rules contain many specific and often counterintuitive prohibitions on transactions between the foundation and related persons, including transactions that would benefit the foundation.

For example, these rules would prohibit the organization in our example from buying the building from the trustee, even at, or below, fair market value, regardless of the procedures that are followed. (The trustee would be allowed to donate the building.) Just because a transaction is allowed under New York law doesn't mean that the tax rules allow it.

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The revised New York law requires that non-profits have a policy about transactions with interested persons complying with the above rules. The IRS doesn't require a policy of this kind, but it has promulgated a model policy that many non-profits adopt but which contains rules that are different from the New York requirements.

While protecting against abuses in transactions with related parties may seem like a matter of common sense, there are many very specific rules both under federal tax rules and under the new New York law. Unfortunately, these requirements are not always consistent with each other, presenting many opportunities for inadvertent missteps. Non-profits should establish policies that comply with both sets of rules and be sure to abide by these policies in any transactions with their directors, officers, trustees, or key employees. ■

Joshua E. Gewolb, Esq. is a tax attorney at Harter Secrest & Emery LLP. He can be contacted at: jgewolb@hselaw.com