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NONPROFIT PLANNING

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NEW CALIFORNIA RULES FOR NONPROFIT ORGANIZATIONS

California has a new law that has been called “the Sarbanes-Oxley Act for nonprofits.” Also known as the “Nonprofit Integrity Act of 2004” or just “SB 1262,” it makes major changes for the nonprofit organizations that it affects. These are mostly those with annual receipts over \$2 million, those that use professional fundraisers, and unincorporated associations.

Registering with the California Attorney General’s Office. Associations that are not charities but hold assets in charitable trust are now specifically required to register and report to the California Registrar of Charitable Trusts in the Attorney General’s office. The California Attorney General says “That included all charities that solicit donations and conduct sales solicitations in California, no matter where those organizations are domiciled.” They are also subject to the new rules regarding nonprofits.

A new nonprofit organization must register with the Attorney General’s office (by filing Form CT-1) within 30 days after it is organized. Under the prior law, 6 months was allowed. In many cases, new organizations will need to file their Form CT-1 before they file their exemption applications with the IRS and the California Fran-

chise Tax Board. A charitable trust files within 30 days after it receives property. If the trust initially has a future interest, the trust must file within 30 days after the charitable interest becomes a present interest.

Excluded Organizations. The new rules for reporting, audits, audit committees and compensation review do not apply to the following:

- Governments, government agencies and subdivisions;
- Religious corporations and organizations that hold property for religious purposes;
- Cemetery corporations;
- Organizations that are organized and operated primarily as a religious organization, educational

institution, hospital or licensed health care service plan.

Audits. For the first time, California law requires audited financial statements for certain charitable organizations. If a charitable organization receives or accrues in any fiscal year gross revenue of \$2 million or more, it must have an audit. For purposes of the \$2 million threshold, grants from government entities are excluded if the government entity requires an accounting of the funds received. Receipts from contracts with government entities also are excluded if the government entity requires an accounting of the funds received.

The auditor must be independent and must use generally accepted accounting principles. Government auditing Standards apply to determine independence, but the Attorney General can issue regulations applying other standards.

For an organization with that controls other organization, a consolidated audited financial statement can satisfy the audit requirement.

The audited financial statements (including the footnotes, but not including the management letter) must

be submitted to the Attorney General and made available for public inspection. The due date is nine months after the fiscal year end. The public disclosure rules for Forms 990 apply.

If an organization has an audit performed that is not required by these rules, the audited financial statements must be submitted to the Attorney General and made available for public inspection. This would apply to organizations with receipts of less than \$2 million but which are required by grant, contract or other laws to have audited financials.

Audit Committee. Certain charitable organizations must now have audit committees. These rules and the compensation review rules (discussed below) are the parts of the new law that are most clearly derived from the Sarbanes-Oxley rules that now apply to publicly-traded for-profit companies.

A charitable corporation that must have an audit because it passes the \$2 million threshold (discussed above) must have an audit committee appointed by its board of directors. This would apply to corporations organized outside of California but required to file a Form CT-1 with the California Attorney General's office.

Subject to the supervision of the board of directors, the audit committee is responsible for recommending to the board of directors the retention and termination of the independent auditor. It may negotiate the independent auditor's compensation, on behalf of the board of directors.

The audit committee:

- Confers with the auditor to satisfy the committee's members that the financial affairs of the corporation are in order;
- Reviews the audit and determines whether to accept it;
- Assures that any non-audit services performed by the auditing firm conform with standards for auditor independence; and
- Approves the performance of any non-audit services by the auditing firm.

The audit committee may include persons who are not members of the board of directors, but the member or members of the audit committee shall not include any members of the staff, including the president or chief executive officer and the treasurer or chief financial officer.

If the corporation has a finance committee, it must be separate from

the audit committee. Members of the finance committee may serve on the audit committee; however, the chairperson of the audit committee may not be a member of the finance committee and members of the finance committee must constitute less than one-half of the membership of the audit committee.

Members of the audit committee may not receive any compensation from the corporation in excess of the compensation, if any, received by members of the board of directors for service on the board. Members of the audit committee may not have a material financial interest in any entity doing business with the corporation.

If the corporation is controlled by another corporation, the audit committee may be part of the board of directors of the controlling corporation.

Compensation Review. For all charitable organizations required to register with the California Attorney General, the board of directors or trustees must review the compensation of the President or CEO and the Treasurer or CFO. They must determine that the compensation, including benefits, is "just and reasonable." This review must be made when the officer is hired and whenever the compensation package is changed, unless the change

is the same for substantially all of the employees.

A compensation committee can perform this review for the board. This is typically how this review is handled under the corresponding provisions of the “intermediate sanctions” or “excess benefit” rules under the Internal Revenue Code.

If one entity of several related entities handles personnel decisions for all of them, the board of that entity can review the compensation of the officers of the other entities.

Commercial Fundraisers for Charitable Purposes and Fundraising Counsel. Commercial fundraisers and fundraising counsel must register with the California Attorney General’s office within ten days before soliciting funds for a nonprofit.

There must be a written contract with the charity. It must cover specific points and must be made available to the California Attorney General’s office.

The charity has a specific period of time to back out of the contract - enough time to have an attorney look it over. The charity can always back out if the commercial fundraiser or fundraising counsel is required to register with the California Attorney General’s office but has not done so.

Commercial fundraisers must keep specified records for ten years.

Significant other new rules apply to commercial fundraisers and fundraising counsel. Many bad practices are now illegal.

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I would be pleased to discuss how these new rules apply to your organization or activities.

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