

# Henderson Caverly & Purn LLP

**NONPROFIT ORGANIZATIONS NEWSLETTER**  
*February 2018*

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## **UNRELATED BUSINESS INCOME TAX - CHANGES UNDER THE 2017 TAX REFORM ACT**



The 2017 Tax Cuts and Jobs Act (the “Act”) has amended the Internal Revenue Code by adding a special rule for organizations with more than one unrelated trade or business. Unrelated business taxable income (UBTI) will now be computed separately with respect to each such trade or business, so that deductions or losses no longer shelter income across businesses.

Under Section 512(a) of the Internal Revenue Code, nonprofits are subject to tax on gross income, minus directly connected expenses, for activities that constitute an “unrelated trade or business.” The Code offers a three-pronged test for determining whether a particular activity is an “unrelated trade or business.” The activity must be (1) a trade or business that is (2) regularly carried on, and (3) isn’t substantially related to the organization’s exempt purpose. There are many exceptions to what activities qualify as “unrelated trade or business,” including exceptions for volunteer services. For additional information on the exceptions and exclusions, see our August 2017 [article](#) on UBTI.

Specific changes under the Act include:

- Section 512(a)(c) requires tax-exempt organizations to treat each trade or business activity separately for UBTI purposes\*; and
- Subjects certain employer-provided fringe benefits (such as transportation and on-premises gyms and athletic facilities) to unrelated business income tax—which tax-exempt entities are required to pay. New Section 512(a)(7) reads as follows: "Unrelated business taxable income of an organization shall be increased by any amount for which a deduction is not allowable under this chapter by reason of section 274 and which is paid or incurred by such organization for any qualified transportation fringe (as defined in section 132(f)), any parking facility used in connection with qualified parking (as defined in section 132(f)(5)(C)), or any on-premises athletic facility (as defined in section 132(j)(4)(B)). The preceding sentence shall not apply to the extent the amount paid or incurred is directly connected with an unrelated trade or business which is regularly carried on by the organization. The Secretary shall issue such regulations or other guidance as may be necessary or appropriate to carry out the purposes of this paragraph, including regulations or other guidance providing for the appropriate allocation of depreciation and other costs with respect to facilities used for parking or for on-premises athletic facilities."

\* Whereas under previous law, separate trade and business activities could be used to offset UBTI liability (by offsetting losses with income), under current law, there are fewer opportunities to do so—with the only offsets allowed being between different tax years for the same trade or business activity.

If you have questions regarding unrelated business income tax and your nonprofit organization, please call

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## NONPROFIT CORPORATIONS: BOARD AUTHORITY AND FIDUCIARY DUTIES

Persons serving on boards of directors of California nonprofit corporations are often unaware of the authority held by the board and the duties each director owes to the organization they serve.

Pursuant to the California Corporations Code (the “Code”), the board of directors exercises, or directs the exercise of, all corporate powers, subject to member approval where required. (Code §§[5210](#), [7210](#), [9210](#))



The authority of the board is tempered by the fact that all decisions are made collectively by all members of the board. In addition, all decisions of the members of the board are made in light of four primary fiduciary duties owed by all directors to the organizations they serve. Those duties are as follows: (1) the duty of care; (2) the duty of inquiry; (3) the duty of loyalty; and (4) the duty to follow investment standards.

### 1. The Duty of Care.

The standard of conduct for directors of nonprofit public benefit corporations is set forth in Code §[5231\(a\)](#), which provides as follows: “A director shall perform the duties of a director, including duties as a member of any committee of the board upon which the director may serve, in good faith, in a manner such director believes to be in the best interests of the corporation, and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.”

### 2. Duty of Inquiry.

The director’s obligation to make reasonable inquiry is derived from Code §[5231](#). This duty provides that directors cannot close their eyes to the activities of the organization and, if they are put on notice by the presence of suspicious circumstances, they may be required to make such reasonable inquiry as an ordinarily prudent person would make under similar circumstances. In fulfilling their duty of inquiry, directors may obtain the services of and rely upon opinions, reports or other information prepared or presented by any of the following:

- One or more officers or employees of the corporation whom the directors believe to be reliable and competent in the matters presented;
- Counsel, independent accountants, or other persons on matters which the director believes to be within such person’s professional or expert competence; and
- A committee of the board upon which the director does not serve, as to matters within the committee’s designated authority, which committee the director believes to merit confidence. If a director has a reason to doubt information that he/she is being supplied, the director owes a fiduciary duty to inquire further into those matters. Such duty may be exercised by the board through the retention of experts to assist the directors in verifying the information supplied, obtaining additional information, and analyzing the matters to which the information pertains.

### 3. Duty of Loyalty.

Directors must act in a manner that they believe to be in the best interest of the corporation. (Code §§[5231](#), [7231](#), [9241](#)) Where the organization does not have a membership that is served by the organization, the directors must strive to advance the organization’s charitable purposes. The duty of loyalty includes a duty to avoid conflicts of interest between the directors individually and the corporation.

#### 4. Duty to Follow Investment Standards.

This fiduciary duty applies to investment assets held by public benefit corporations, the assets of which are held in charitable trust. Code §5240 sets forth the following applicable standards:

- Avoid speculation, looking instead to the permanent disposition of the funds, considering the probable income, as well as the probable safety of the corporation's capital;
- Comply with additional standards, if any, imposed by the corporation's articles, bylaws, or the express terms of an instrument or agreement pursuant to which the assets were contributed to the corporation; and
- In carrying out their investment duties, a director must comply with the duties of due care and reasonable inquiry, may rely upon others, and may delegate its investment powers as permitted by Code §5210.

In addition to the duties mentioned above, directors of applicable organizations are obligated to use funds and assets, including but not limited to endowment funds, in accordance with the provisions of the Uniform Prudent Management of Institutional Funds Act ("UPMIFA"). (California Probate Code §§ 18501-18510)

Directors of nonprofit and religious organizations are encouraged to learn more about the duties under which they operate and the standards to which they are held.

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### IRS - UPDATE TO IRS FORM 1023-EZ



The IRS recently revised IRS Form 1023-EZ, Streamlined Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code. The Instructions for IRS Form 1023-EZ were also updated to assist charities in applying for tax exempt status.

A summary of the revisions to the Form 1023-EZ are as follows:

- A text box was added to Part III requesting a brief description of the organization's mission or most significant activities. This change is designed to provide a better understanding of the most significant activities that an organization engages in to further its exempt purposes.
- Questions about annual gross receipts, total assets and public charity classification were added to the Form 1023-EZ. These questions are also on the Form 1023-EZ Eligibility Worksheet in the Instructions for Form 1023-EZ that organizations must certify they have completed.
- Question 29 on the Form 1023-EZ Eligibility Worksheet now requires that an automatically revoked organization applying for reinstatement must seek the same foundation classification they had at the time of automatic revocation to be eligible to use the Form 1023-EZ. If you are applying for retroactive reinstatement under section 4 of Rev. Proc. 2014-11, after being automatically revoked and seek a foundation classification that is different from the classification you had at the time of revocation, you must submit Form 1023.

Choosing the correct foundation classification on Form 1023-EZ is important. Different operational rules apply to public charities and private foundations. Most organizations described in Section 501(c)(3) are classified as public charities rather than private foundations. In choosing your foundation classification, carefully review the instructions for Part IV to ensure that you are correctly identifying your status based on your expected sources of funding. The IRS will process your Form 1023-EZ application with the foundation classification you choose.

If you require assistance in preparing and submitting an IRS Form 1023-EZ or a Form 1023 application for your organization, please call our office or email [Jon Grissom, Esq.](mailto:Jon.Grissom@hcesq.com)

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