NONPROFIT TRENDS

THE APPROPRIATE APPROACH TO MISAPPROPRIATION: RESPONDING TO FRAUD IN NON-PROFIT ORGANIZATIONS

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Fraud can be one of the most devastating discoveries within an organization. Reports of fraud are rising with news about defrauded organizations suffering significant losses due to employee corruption.

Unfortunately, non-profit organizations are not immune to this trend, and these entities can even have a higher level of potential fraud risk, as limited staff, tight operating budgets, and an altruistic nature all combine to make them attractive targets for fraudulent activities.

According to a 2013 report published in the Washington Post, between 2008 and 2012 more than 1,000 non-profits disclosed hundreds of millions of dollars in losses from theft, fraud, embezzlement, and other unauthorized uses of organizational funds and assets. Of course fraud anywhere is bad, and for charitable organizations such as non-profits, it is particularly troubling as it directly removes dollars that would otherwise have been used to help those in need!

Although the best offense is a good defense, and non-profits should be exceedingly proactive in taking steps to prevent fraud, it's equally important to be prepared for the aftermath of fraud, as many regulatory reporting requirements must be addressed when charitable assets are stolen. Having an understanding of these implications can help an organization to efficiently respond and recover from fraud.

Reporting Fraud

One of the biggest challenges in dealing with fraud specific to non-profits is the issue of disclosure. An incident of fraud, particularly if involving top leadership, can irreparably damage a non-profit's most valuable asset: its reputation.

The organization should have a plan in place to communicate to its key stakeholders and assure them of its plans to recover the assets stolen and the steps it will take to prevent such a crime from recurring. However, any public disclosure should be carefully constructed, as a public accusation connecting a specific individual to the incident, if false, could lead to a defamation lawsuit.

Even if litigation or public media disclosure of the incident is unlikely, the organization must still evaluate the possible impact of publicly-available reports of the incident to regulators.

As of 2008, the Internal Revenue Service implemented regulations which provide that tax-exempt organizations with gross receipts greater than or equal to $200,000, or whose assets are greater than or equal to $500,000, must report "any unauthorized conversion or use of the organization's assets other than for the organization's authorized purposes, including but not limited to embezzlement or theft." As a result, these organizations are now required to publicly disclose any embezzlement or theft that is a "significant" diversion of assets, defined as "if the gross value of all diversions (not counting restitution, insurance, or similar recoveries) exceeds $250,000, 5% of the organization's gross receipts, or 5% of its total assets."

Asset diversions (in any amount) by an insider, such as a charity's founders, members of its governing body, officers, senior employees, persons with financial oversight responsibilities or anyone in a position to exert significant influence on the charity must also be reported. These "excess benefit transactions," occur whenever such insiders ("disqualified persons") receive economic benefit from the non-profit. Under IRC § 53.4958-6, "in no event shall an economic benefit that a disqualified person obtains by theft or fraud be treated as consideration for the performance of services." Thus, embezzlement by a disqualified person is an automatic excess benefit transaction, and must be reported.

Federal Reporting

All 501(c)(3) organizations must annually file one of the series 990 information return with the Internal Revenue Service.

- Organizations with annual gross receipts normally of $50,000 or less are eligible to file a 990-N (e-Postcard), which contains only basic biographical information.
- Organizations that normally have less than $200,000 of gross receipts and less than $500,000 of total assets can file a simplified return, the 990-EZ.
- Organizations that exceed these thresholds must file the longer and more complex Form 990 return.

The type of Form 990 a non-profit files will determine whether it must publicly report a significant asset diversion or excess benefit transaction.

- *Form 990*: The return asks in Part VI, Section A, Line 5 whether the organization has become aware of a material diversion of its assets. If this is marked "Yes," Form 990 requires the organization to include on Schedule O the nature of the diversion, dollar amounts of cash and property involved, corrective actions taken to address the matter and pertinent circumstances of the diversion. The organization should not identify the person or persons who diverted the assets by name.

  If the diversion constituted private inurement or an excess benefit transaction, this must be disclosed in the relevant sections of the form as well (and can trigger an excess benefit transaction reportable on Schedule L).

- *990-EZ:* A 990-EZ filer is only required to report an excess benefit transaction, but not a significant diversion of assets.
- *990-N (e-Postcard):* Filers are not required to report either excess benefit transactions or charitable asset diversions.

However, any non-profit organization can voluntarily report embezzlement to the IRS on Form 3949-A. This form is used for reporting suspected tax fraud, and an organization filing this form discloses the contact information and details of the embezzler.

In addition, organizations should consider what the appropriate categorization for embezzlement is from an Income Statement/Balance Sheet perspective, which can differ based on the particular scenario.

In some cases the organization may not expect to recover any of the diverted funds, and can immediately show this as a loss/expense, which would be reflected on Form 990, Part IX (Statement of Functional Expenses). Other times, such as when a recovery of funds is expected, it may be more appropriate to treat as a balance sheet item, which would only affect Form 990, Part X (Balance Sheet).

While these are just some examples, the case-specific facts and circumstances should be examined to determine what treatment best reflects the financial position of the organization.

Excess Benefit Transactions

As mentioned above, when the suspected embezzler is also a “disqualified person,” there are additional regulations that must be considered.

Under section 4958 of the Internal Revenue Code, if a 501(c)(3) organization provides an excess benefit, the insider who received it is subject to excise taxes in the amount of 25% of the excess benefit, as are any managers (including officers and directors) who approved the transaction.

With an automatic excess benefit transaction like embezzlement, where there was obviously no actual approval of the action, directors are not likely to be personally subjected to the excise tax.

In all cases, the excess benefit must be corrected by the disqualified person by making a payment in cash or cash equivalents equal to the correction amount. The correction amount is the sum of the excess benefit, plus interest on the excess benefit at a rate that equals or exceeds the applicable Federal rate, compounded annually. If the correction is not made to the organization by the due date in the IRS notice, an additional tax of 200% of the excess benefit will be imposed on the disqualified person.

In the case of 501(c)(3) private foundations, a diversion by a disqualified person is also a self-dealing transaction subject to penalties and reportable on Form 990-PF.

There is no tax or penalty imposed on a non-profit that was the victim of an excess benefit transaction. However, a tax equal to 10% (up to $20,000 per transaction) of the excess benefit may also be imposed on each manager who participated in the transaction, knowing it was an excess benefit transaction, unless the participation is not willful and is due to reasonable cause. The $20,000 is an aggregate figure; all managers participating in the transaction are jointly and individually liable.

While the Form 990 or 990-EZ report can alert the IRS and the public that an excess benefit transaction has occurred, these are not the only filings used to report such transactions. Form 4720 is a separate annual filing that must be made by disqualified persons or managers who owe the taxes described above.

State Reporting Requirements

Beyond the federal requirements, non-profits are regulated by the states in which they operate, generally under the auspices of the state’s attorney general. Each state has different requirements for when and how fraud is reported by non-profits, however many states specifically ask for this information on their annual charitable organization filings. In California, for example, any theft, embezzlement, diversion or misuse of a non-profit’s charitable property or funds, regardless of the amount of the loss, must be reported on Form RRF-1, the annual filing with the California Attorney General.

As each state has its own regulations, it’s critical for an organization to have an in-depth understanding of the reporting requirements for all states in which it has nexus.

Prior Years

Neither the Internal Revenue Code nor the underlying Treasury Regulations require a taxpayer to amend returns after an error or omission is discovered in a previously filed tax return. As such, organizations should seek advice from qualified professionals to determine the best course of action. Ultimately, if a non-profit decides it does want to amend its previously filed tax return to reflect the fraud, it has three years from the original filing date.

Also, though amending a Form 990 does not restart the clock on the statute of limitations (generally three years from the later of original due date or actual filing date), if a non-profit’s amended return shows an increase in tax due and is filed near the end of the three-year period, the IRS has 60 days after it receives the amended return to decide whether to extend the statute of limitations to six years (a six-year statute of limitations applies if the taxpayer omits more than 25% of the income that is reported).

Conclusion

Charitable asset diversion in any amount, regardless of whether reportable on Form 990, is serious and can damage donor trust and agency reputation, thereby undermining a non-profit’s good work. In extreme cases, it can lead to the revocation of tax-exempt status and even personal liability for directors. Ultimately when it comes to combating fraud, it’s vital for non-profits to apply both the adages of “the best offense is a good defense” and focus on fraud prevention, and “always be prepared” in order to effectively move forward from any fraud scenario.

At Mazars USA LLP we provide a professional full service approach with experts in forensics and non-profit organizations to assist clients through this challenging process. Please reach out to our professionals should you have any questions.

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