230 West Street
Suite 700
Columbus, OH 43215

tel 614.221.1120
fax 614.227.6999

www.gbq.com

GBQ Partners

Significant Diversion of Assets

Recent reports regarding the significant diversion of assets by nonprofit organizations has caused federal and state officials to launch investigations as to what this actually means. The revised Form 990 Part VI, Section A (Governing Body and Management) line 5 asks: Did the organization become aware during the year of a significant diversion of the organization's assets? The instructions to Form 990 expound upon how the question should be answered. As you may be aware, the Governing Body and Management section was very controversial when added to the Form 990 during its revision. Segments of the public argued that only questions authorized by the statute should be reported on the form. The Internal Revenue Service (IRS) responded saying that a well-governed organization was more likely to be tax-compliant and, therefore, in order to insure that taxes are properly collected, they had the authority to ask the questions. Many in the nonprofit sector agreed that the transparency provided by the new form allowed the public to gain information that was necessary, especially in the case of a donor who was considering making a gift to a charity.

In April 2012 the IRS announced the results of a study it had done to see if a well-governed organization was more likely to be tax-compliant and stated they had found that the greatest correlation between "good governance" practices and tax compliance was where the board of directors was significantly involved in setting compensation and also where organizations had procedures in place for the proper use of charitable assets. At the same meeting, the IRS announced a new audit program whereby the IRS would audit organizations that had indicated there had been a significant diversion of assets. The IRS looked at:

- The tax filings and publicly available information on the 285 organizations that reported a significant diversion of assets in 2009 and that initial research found "roughly $170 million in significant diversions was identified" and 82 cases resulted in civil or criminal charges against the responsible party. These are charges that were brought by the organizations involved, or by local authorities, who were outraged by the activity. They are not IRS charges. Forty-seven individuals were incarcerated or served probation for the diversion of the assets. Again, this did not arise from IRS actions. In nine cases restitution was paid in full; in 11 cases there was partial restitution.

See http://www.irs.gov/pub/irs-tege/georgetown_04192011.pdf for more details.

Here are the details of what is supposed to be reported. "Significant" means the gross value of all diversions (not taking into account restitution, insurance or similar recoveries) discovered during the organization's tax year to the extent they exceed the lesser of:

1. 5 percent of the organization's gross receipts for its tax year,
2. 5 percent of the organization's total assets as of the end of its tax year, or
3. $250,000.

If the organization became aware of the diversion during the tax year, even though the diversion occurred in another year, the diversion is supposed to be reported. The organization is supposed to report on Schedule O the nature of the diversion, the amounts of property involved, corrective actions taken to address the matter and other pertinent circumstances.

A diversion of assets includes theft, embezzlement or any unauthorized use of the organization's assets and can involve any person, whether or not an officer, director, key employee or independent contractor. So it could also include a grantee diverting grant funds or an investment advisor. Diversions of assets do not include transactions at fair market value. For example, if an exempt organization sets up a taxable subsidiary and takes back the stock or enters into a partnership agreement where the exempt organization gets a quid pro quo interest, these are not a diversion of assets to be reported.

The IRS instructions to Form 990 note that, "A diversion of assets can in some cases be inurement of the organization's net earnings. In the case of section 501(c)(3), 501(c)(4), and 501(c)(29) organizations, it also can be an excess benefit transaction taxable under section 4958 and reportable on Schedule L (Form 990 or 990-EZ)." So this means that if it is found that a Disqualified Person, i.e., someone who can substantially influence the organization, diverts assets for his/her own behalf, in addition to any other adverse actions that could result, that person could be subject to a 25 percent tax on the excess amount and a 200 percent tax if the transaction is not corrected by returning it with interest.

This article originally appeared in BDO USA, LLP's "Nonprofit Standard" newsletter (Winter 2013). Written by Laura Kalick, JD, LLC, National Director, BDO Nonprofit Tax Consulting.

For more information please contact:

Jennifer Osburn, CPA
Director
Community Action Practice
josburn@gbq.com
614.947.5277