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Charity Issues of Concern to CA Attorney General

10.24.17 | Linda J. Rosenthal, JD

Around the nation, state attorneys general have the key oversight responsibility for charitable organizations and property held in charitable trust in their jurisdictions. Historically, the most high-profile ones are from the biggest states. California's Javier Becerra and New York's Eric Schneiderman are carrying on this tradition of aggressive investigation and enforcement.

This, of course, is in addition to federal tax-exempt oversight authority of the Internal Revenue Service.

Charity Probe Focus

The attorneys and auditors of the Charitable Trusts Section of the California Attorney General's Office "investigate and bring legal actions against charities and fundraising professionals that misuse charitable assets or engage in fraudulent fundraising practices."

At a July conference in Northern California, nonprofit leaders and professional advisers listened as Elizabeth Kim, the Supervising Deputy Attorney General, described the key areas of concern that are currently on the radar of officials. She highlighted two specific enforcement issues of interest to watch: (1) Gifts in Kind (misleading donors in ways including over-valuing gifts, or acting only as a pass-through); and (2) Joint Cost Allocation (misleading donors by artificially reducing or mischaracterizing fundraising expenses).

What's The Issue About Gifts-In-Kind?

While most charities request and receive cash donations, others "hold events to raise donations of food, property, clothing, equipment, home goods, supplies" and other "gifts-in-kind."

These organizations may distribute these products directly to recipients or give the items over to other charities for redistribution through – for example – thrift stores or relief organizations.

Sometimes, a "soliciting organization acts as an intermediary between a business having property to donate and … 501(c)(3) organizations whose charitable programs involve assisting needy individuals."

While most groups involved in these activities are legitimate and follow all rules, some organizations "take advantage of donors' good intentions and tax provisions designed to provide an incentive for in-kind donations."

Specifically, Internal Revenue Code section 170(e)(3) was enacted as an incentive for donation of gifts-in-kind to help people in need. "When used as intended gifts-in-kind can benefit everyone. The charity's purpose gets fulfilled, donors may be able to get a tax deduction, and items that may have otherwise been discarded can be used to satisfy the needs of others in unfortunate situations."

Of course, in the hands of unscrupulous individuals and groups, this incentive can be abused "for fraudulent purposes." Problems arise in "two areas: the valuation of donated goods, and the actual use of the donated goods in programs that serve the needy."

On Form 990, the 501(c)(3) organization must report "how money was spent, and what its assets and liabilities are." A charity's spending is divided into three categories: program service expenses, management and general expenses, and fundraising expenses. A charity can report the fair value of a gifts-in-kind received as donated revenue, and the value of the gifts-in-kind it distributes as a program service expense if certain IRS set criteria is met.

If an organization incorrectly reports these donations, it can be made to "look more successful than it really is, and can also serve to hide any wasting of useful resources. Reporting false numbers can also inflate a charity's donation and program expense numbers to make them more attractive to donors, grantors, and other public support. Inflating program expenses can serve to minimize excessive fundraising and administrative costs, making them appear to be a smaller percentage of expenses than they really are.

This might inflate a charity's rating on a watchdog site like GuideStar or CharityWatch. There are a few different ways in which false reporting can occur. For instance, a charity can: mark up the value of goods; assign some value to goods that are worthless (a machine that has missing parts); or take credit for the value of a gift-in-kind that was simply redistributed to another organization. In that third scenario, the charity would essentially be claiming ownership of the gifts when – instead – it was merely posing as a middleman.

Conclusion

In a later post, we'll discuss the second areas of interest: joint cost allocation.

— Linda J. Rosenthal, J.D., FPLG Information & Research Director