



Modernizing North Carolina Nonprofit Laws Could Cut Red Tape and Improve Accountability

The North Carolina Center for Nonprofits, which works with nonprofits serving all 100 counties of North Carolina, is asking state legislators to make several changes to the Nonprofit Corporation Act). These changes would allow nonprofits to operate more efficiently and to use more of their time and money for their mission-related programs, services, and activities.

Specifically, the Center is recommending that legislators make four important changes to the NC Nonprofit Corporation Act:

Nonprofit annual reports. Unlike most states, nonprofits incorporated in North Carolina do not file basic annual reports with the state. This means that many defunct nonprofits continue to exist as legal entities in North Carolina. Currently, more than 140,000 nonprofits are incorporated in North Carolina, but only about 36,000 tax-exempt organizations file some variation of the Form 990 with the IRS. This large and growing number of defunct (but still existing) nonprofits makes oversight of the state's nonprofits more challenging and creates an opportunity for potential fraud and abuse.

- **Legislators can address this issue by creating a simple, online, no-fee annual reporting requirement for North Carolina nonprofit corporations. This proposal was included as Part III of S.362 in the 2019 session, which the Senate unanimously approved.**

Number of nonprofit directors. Currently, North Carolina law allows nonprofit corporations to operate with only one board member. A single-member board can make it impossible for a nonprofit to take action on matters if the board member has a conflict of interest. It is also inconsistent with nonprofit best practices guidelines (e.g. the Center's *Principles & Practices: Best Practices for North Carolina Nonprofits* recommends that nonprofits have at least five board members) and with the Model Nonprofit Corporation Act (adopted by many other states), which requires nonprofit corporations to have at least three board members.

There are two situations where it may be reasonable for nonprofits to have a single board member:

1. A foundation that was established by a single individual or family may be able to operate effectively with only one board member; and
 2. In some circumstances when nonprofits are going out of business, board members resign while the nonprofit is winding up business and it is difficult to recruit new board members for the dissolving nonprofit.
- **Legislators can address this issue by requiring North Carolina nonprofits to have at least three board members with limited exceptions for private foundations and for nonprofits with vacancies in board positions.**

Mergers and dissolutions of nonprofits. During the COVID-19 pandemic and the current period of high inflation, a growing number of nonprofits are having difficulty maintaining the financial resources necessary to sustain their operations. As a result, there has been an increase in mergers between nonprofits and in dissolutions of nonprofits. In many situations, the merger or dissolution of a nonprofit is the most efficient way to ensure that another organization can use the nonprofit's remaining charitable assets for the best possible purposes to support communities. The current nonprofit corporation law has two limitations that can create unnecessary barriers to effective mergers and dissolutions:

1. The statute does not expressly permit mergers between unincorporated nonprofit associations (which are governed by Chapter 59B of the General Statutes) and nonprofit corporations or between nonprofits and limited liability companies (LLCs) that are treated as 501(c)(3) charitable organizations for federal tax purposes.
 2. The statute generally requires nonprofits to seek review by the Attorney General of any significant transfers of assets. When a 501(c)(3) nonprofit dissolves, its board of directors has a duty to develop a plan of dissolution to protect its charitable assets by transferring them to another nonprofit. The additional review by the Attorney General often requires a dissolving nonprofit to use a significant portion of its remaining assets for legal fees rather than for charitable purposes.
- **Legislators can address these issues by: (a) expressly allowing for mergers of nonprofit corporations with unincorporated nonprofit associations and with LLCs that are treated as 501(c)(3) tax-exempt entities for federal tax purposes; and (b) exempting transfers of assets of a dissolving nonprofit – if the dissolution is properly approved by the nonprofit's governing board – from review by the Attorney General. These changes were included in H.B. 732 in the 2019 session, which the House unanimously approved.**

Domestication of nonprofits. In 2014, the Internal Revenue Service issued guidance explaining that tax-exempt nonprofits can change their state of incorporation without having to re-apply for tax-exempt status by following state laws for domestication of foreign nonprofits. Currently, the NC Nonprofit Corporation Act does not allow for domestication of foreign nonprofits, so nonprofits that are changing to their state of incorporation to or from another state must create a new legal entity and then merge or transfer assets from the previous entity to the new entity, and then re-apply for tax-exempt status. This process creates unnecessary costs and administrative burdens for these nonprofits.

- **Legislators can address this issue by adopting a form of the domestication provision in the Model Nonprofit Corporation Act.**

Nonprofit conversions. The NC Nonprofit Corporation Act does not currently provide for a process for for-profit corporations seeking to nonprofit corporations. Likewise, the statute does not provide for a process for nonprofit corporations to convert to limited liability corporations. This means that entities that would like to change their corporate form must now dissolve and create a separate legal entity, which creates additional and unnecessary legal and operational expenses (e.g., having to establish new contracts and bank accounts under the name of the new legal entity).

- **Legislators can address this issue by adding a conversion provision to the NC Nonprofit Corporation Act that is similar to language in the NC Business Corporation Act and the Model Nonprofit Corporation Act.**

The NC House of Representatives unanimously approved most of these changes in 2021 as part of H.B. 695. These changes are also included in H.B. 741 and S.529.

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