Solo, Small Firm and General Practice Division

AMERICAN BAR ASSOCIATION

2014 ABA Annual Meeting

Nonprofit Boards of Directors 101: What You Must Know!

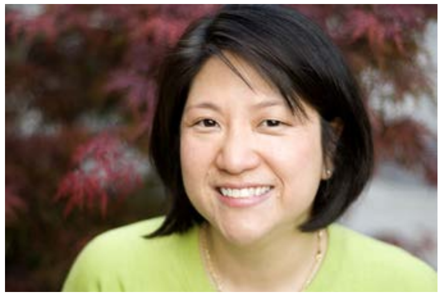
Saturday, August 9, 2014

2:00 p.m. – 3:30 p.m.

Primary Sponsor:
Solo, Small Firm and General Practice Division

Co-Sponsors:
Business Law Section
  Nonprofit Organizations Committee
Judicial Division
Law Practice Division
Senior Lawyers Division
Tort Trial & Insurance Practice Section
Young Lawyers Division

Amy Lin Meyerson, Moderator

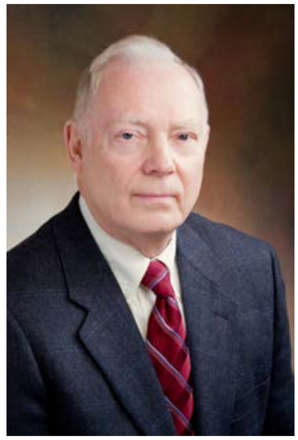


Amy Lin Meyerson is Chair-Elect of the ABA Solo, Small Firm and General Practice Division and a Fellow of the American Bar Foundation. She is a Past President of the National Asian Pacific American Bar Association. Amy founded the Connecticut Asian Pacific American Bar Association in 2000, and the CAPABA Educational Foundation in 2006. She served as a Commissioner on the Asian Pacific American Affairs Commission of Connecticut and on the ABA Standing Committee for Professional Discipline. Amy practices business and general corporate law in Weston, Connecticut as a sole practitioner.

Amy received a 2012 NAPABA Women's Leadership Award, was named a Top Lawyer in Fairfield County in 2010 to 2013, selected as one of NAPABA's Best Lawyers Under 40 in 2003, and received a New Leaders In the Law Award from the Connecticut Law Tribune in 2002. She received the 2006 Edwin Archer Randolph Diversity Award from the Lawyers Collaborative for Diversity along with a Proclamation from then Connecticut Governor M. Jodi Rell proclaiming April 26, 2006 as Amy Lin Meyerson Day in Connecticut.

She earned her J.D. from the University of Connecticut School of Law, and received her A.B. with distinction from Duke University. Amy is admitted to the bars of Connecticut, Georgia and the District of Columbia, the D.C. Circuit and the U.S. Supreme Court.

Donald W. Kramer, Speaker



Donald W. Kramer is chair of the Nonprofit Law Group at the Philadelphia law firm of Montgomery, McCracken, Walker & Rhoads, LLP. Mr. Kramer has more than 40 years of experience dealing with the concerns of nonprofit organizations, not only as a lawyer, but also as a teacher, writer, publisher, and board member. Mr. Kramer is editor and publisher of *Don Kramer's Nonprofit Issues®,* a national electronic newsletter of "Nonprofit Law You Need to Know" (www.nonprofitissues.com.), which he started at Montgomery, McCracken in 1989. He writes and lectures frequently on nonprofit legal issues, and has taught courses on nonprofit organization law at the University of Pennsylvania Law School, the School of Social Policy and Practice at the University of Pennsylvania, and Eastern University. He has worked with nonprofit organizations of all types and sizes, helping structure start-up situations and restructure multi-organizational social service, health and educational systems. He counsels on a wide range of corporate, governance, tax, real estate, charitable giving and other nonprofit issues. Mr. Kramer also serves on the Boards of the Pennsylvania Association of Nonprofit Organizations, the Philadelphia Council for Community Advancement and the Philadelphia Fire Department Historical Corporation. He served as Deputy Development Coordinator and Assistant to the Mayor of Philadelphia before joining Montgomery, McCracken in 1972. A graduate of Princeton University, he earned an LL.B. degree from Harvard Law School.

REPRINTED FROM *NONPROFIT ISSUES*® VOL. XVI NO. 13 Revised February 2013

READY REFERENCE PAGE

NO. 92
FOR YOUR FILE

What Do We Mean When We Say "Nonprofit"?

Terminology obscures distinctions that are critical to understanding the rules that apply to organizations

We often start our lectures by quizzing the participants on their understanding of "nonprofits."

By show of hands, how many think the following organizations are nonprofits?

The Bill Gates Foundation; your church, synagogue, or mosque; the local United Way; the local community foundation; a major local university such as Harvard; a local social service organization; the Sierra Club; the local private golf club; the National Football league; the New York Stock Exchange.

A whole lot of people do not raise their hands very often. The hands particularly start to drop after the United Way or the community foundation. Yet all of these organizations are nonprofits except the New York Stock Exchange. And even the New York Stock Exchange was a nonprofit until 2006.

We all think we know what we mean when we say "nonprofit." But the key to understanding nonprofits is to understand that there are many different types of nonprofits. Different rules apply, depending upon the type of organization. An understanding of the difference is critical to understanding the world of nonprofit organizations.

Nonprofit

"Nonprofit is a concept of state law, which means that an organization may not pay dividends or otherwise pass any surplus revenue, or "profits," from the enterprise on to shareholders, members, or other individuals. Although a nonprofit may pay reasonable compensation for services actually rendered to it, in general, any surplus generated by the organization must stay within the organization and be used for its stated purposes.

(New York Attorney General Eliot Spitzer's suit against Richard Grasso, former President of the New York Stock Exchange, was based on the provision of the New York Not-for-Profit Corporation Law which, like most nonprofit corporation laws, permits payment of reasonable compensation only. There is no corresponding limitation in the business corporation law. (See Ready Reference Page: "Spitzer Challenges Grasso Salary as 'Objectively Unreasonable'.")

A nonprofit corporation is not "owned" by anyone. It may be controlled by individuals or other entities, but those who control the nonprofit do not have an ownership interest in the organization. (See Ready Reference Page: "The Key Question: Whose Organization Is It?")

Tax Exempt

When we say "nonprofit" we are usually thinking of an organization that is exempt from taxation. Most, but not all, nonprofit organizations are exempt from paying *federal* income tax on their earnings.

Section 501(c) of the Tax Code now spells out 29 separate categories of exempt organizations. These categories include:

Section 501(c)(2) title holding companies (See Ready Reference Page: "Title Holding Companies Have Limited Uses."); Section 501(c)(4) social welfare and advocacy organizations like the Sierra Club; Section 501(c)(5) agricultural or labor organizations; Section 501(c)(6) business leagues, professional and trade associations, like the National Football League; Section 501(c)(7) social clubs; Section 501(c)(8) and (10) fraternal organizations; cemetery organizations ((c)(13)); veterans organizations ((c)(19)) and so on down to (c)(29).

Charities

The largest category, and the one most people usually think of when they think of "nonprofit" or "tax exempt," is Section 501(c)(3) "charitable" organizations. Virtually all charities are nonprofits; but not all nonprofits are charities.

Under the Tax Code definition, a Section 501(c)(3) charitable organization is one which is "organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals."

In addition, no part of the net earnings may inure to the benefit of any private shareholder or individual, no substantial part of the activities may consist of carrying on propaganda, or otherwise attempting, to influence legislation, ("lobbying"), and the organization may not participate in any political campaign for or against any candidate for public office ("electioneering"). (See Ready Reference Pages on Requirements for Federal Tax Exemption, and on Lobbying and Electioneering.)

When the U.S. Supreme Court decided in the *Citizens United* case in 2010 that corporations could spend unlimited amounts on "uncoordinated" political campaign advertising, many existing and newly created 501(c)(4) advocacy groups and 501(c)(6) trade associations significantly increased their electioneering activity, as they are permitted to do under the law. Unfortunately, in much of the media discussion of the expenditures, the media referred to spending by "nonprofits," without distinguishing between those allowed to participate in elections and charities that are not so permitted. While the media was not wrong in calling these organizations nonprofits, the use of the term was hugely confusing because many people equate nonprofit" with "charitable" and charities cannot participate in election campaigns.

The other critical distinguishing feature of charities, as opposed to almost all other types of federally exempt organizations, is that individuals and corporations may make charitable contributions to charitable organizations and claim a charitable contribution deduction on their own federal income tax returns.

Public charities and private foundations

Section 501(c)(3) charities are further subdivided under Section 509(a) of the Tax code between "public charities" which receive broad public support and "private foundations" which receive the great

bulk of their income from a very limited number of contributors and investment income. All charities are deemed to be private foundations unless they show the Internal Revenue Service that they qualify as public charities. (See Ready Reference Page: "Calculating Public Support.")

Section 509(a)(1) describes publicly supported organizations such as churches, hospitals, and schools, which are considered publicly supported by virtue of what they do, and also organizations that receive a specified percentage of their revenue from a broad range of contributions such as the United Way, or a community foundation.

Section 509(a)(2) describes those that are deemed publicly supported because they receive a broad range of public support from contributions and fees for service, such as many social service organizations or a nursing home.

Section 509(a)(3) describes those organizations that are deemed publicly supported because they are "operated, supervised, or controlled by or in connection with" a publicly supported charity or governmental unit. (See Ready Reference Page: "Supporting Organizations Are Public Charities.")

Charities that don't meet the criteria of Section 509(a) are considered private foundations. Like the Gates Foundation, essentially all of their income has come form a single or limited number of individuals, families, or corporations and income on their investments. Private foundations are subject to more stringent regulation. (See Ready Reference Pages on Private Foundations.)

Nonexempt nonprofits

Although rare, there are nonprofit organizations that are not tax-exempt, like the New York Stock Exchange immediately before it converted to a for-profit so that it could sell stock to provide an ownership interest to investors. A "nonprofit" organization partakes of some of the "halo effect" of the term, even though most people do not understand that the term is not completely descriptive.

Some state nonprofit corporation laws make distinctions between charitable, mutual benefit, religious and other types of nonprofit corporations, and apply different rules for each, but many nonprofit corporation laws have only a single classification that includes all nonprofits.

State tax exemption

State tax exemption in most states is an entirely separate matter. Although most are likely to be exempt from state corporate income taxes, if any, many states have separate criteria, often more stringent than the federal 501(c)(3) criteria, for real estate or state sales tax exemption.

If you can't identify the category in which a nonprofit fits, you can't know the rules by which it is regulated.

REPRINTED FROM *NONPROFIT ISSUES®* VOL. XIX NO. 18 November 1-30, 2009

READY REFERENCE PAGE

NO. 110
FOR YOUR FILE

Top Ten Policies and Practices for Nonprofit Organizations

Increased emphasis on transparency and accountability requires more formal attention to governance and administration

The emphasis since the enactment of Sarbanes-Oxley on governance practices of all nonprofits organizations, and the specific questions on the revised Form 990 about conflict of interest, whistle blower, document retention and compensation setting policies and procedures of 501(c)(3) public charities have spurred renewed interest in written policies. The following are policies and practices that 501(c)(3)s and other nonprofits may want to consider.

Conflict of interest policy. Most nonprofits have a conflict of interest policy that helps to enforce nonprofit directors' duty of loyalty under state law. The revised Form 990 asks (a) whether the organization has a written policy, (b) whether officers, directors and key employees are required to disclose annually interests that could give rise to conflicts, and (c) for a description of how the organization regularly and consistently monitors and enforces the policy. Most organizations have adopted policies that enable them to give "good" answers to the Form 990 questions. The essence of most conflict policies is a disclosure procedure, where the director, officer or employee of the organization reports as to whether he or she, or any related individual or entity, has a financial interest in any vendor of goods or services to, or recipient of goods or services from, the organization. If such an interest exists, the interested party does not participate in the decision to purchase or provide the goods or services, and might be asked to leave the room during the discussion and decision. (See Ready Reference Page: "Conflict of Interest Policies Help Avoid Problems")

The revised Form 990, in addition to asking about the organization's conflicts policy, asks direct questions about financial transactions between the organization and directors, officers or key employees or related individuals and entities, but it is much more detailed in its inquiries than are most conflict of interest policies. The form also asks about personal and financial relationships between directors, officer and key employees of the organization. Most organizations distribute a separate questionnaire in order to answer the direct Form 990 questions.

Code of ethics/whistleblower policies. One of the two narrow provisions of Sarbanes-Oxley that applies directly to nonprofits creates penalties for retaliating against whistleblowers during a federal investigation. The revised Form 990 asks if the organization has a whistleblower policy, and this question has spurred nonprofits to adopt a written policy. Some organizations do this by adopting a code of ethical conduct that encourages directors, officers and employees to report unethical or illegal conduct of any type, and provides that there will be no retaliation for reporting pursuant to the policy.

Document retention. Sarbanes-Oxley prohibits the destruction of documents that may be material to a federal investigation. This provision applies to nonprofit as well as for-profit organizations. The revised Form 990 asks whether the organization has a document retention policy, and most organizations that did not previously have a written policy are adopting them. Some statutes require certain types of records to be kept for a stated period. For the most part, however, the periods for which documents are to be retained are based on the statute of limitations for a lawsuit. For example, because the IRS has six years after the filing of a return to bring a claim for taxes if there has been an underreporting of income

by 25% or more, most policies require retention of tax returns for 7 years. For records dealing with minors, it may be necessary to retain them until the statute of limitations would run after they reach the age of majority. And, of course, the policies state that no documents may be destroyed or altered where there is pending, threatened or reasonably foreseeable governmental investigation.

Compensation setting procedure. The revised Form 990 asks whether the organization is using a procedure for setting compensation in which an independent portion of the board is using comparables and making a determination based on those comparables that compensation for officers and key employees is reasonable. It also asks whether the determination that compensation is reasonable is put in writing contemporaneously. These three steps are taken from the regulations that provide 501(c)(3) public charities and 501(c)(4) organizations with a rebuttable presumption that compensation paid to an insider is reasonable or that amounts paid to purchase property from an insider do not exceed market value, but the Form 990 asks the question about the procedure of every organization filing the Form 990. (Of course, 501(c)(3) private foundations essentially cannot make purchases from insiders, other than purchases of services necessary for the foundation's operations.)

The regulations that contain the rebuttable presumption procedure are part of the excess benefit rules that apply to insiders of 501(c)(3) public charities and 501(c)(4) organizations. (See Ready Reference Page: "Charities Must Avoid Excess Benefit Transactions") Under these rules, if the organization overpays an insider, the insider must repay the overpayment to the organization and pay an excise tax to the IRS equal to 25% of the overpayment. A manager of the organization who participates in the overpayment knowing that it is an excess benefit is subject to a tax equal to 10% of the excess up to a maximum of $20,000. The severity of the overpayment taxes makes the rebuttable presumption very useful. Economic benefits provided to an insider but not treated as compensation (think spousal travel) are automatic excess benefits to the insider of a 501(c)(3) public charity or a 501(c)(4) organization.

The revised Form 990 asks questions about spousal travel, first class travel, social club dues, and other benefits that could contain a compensation element, of any filing organization that paid compensation greater than $150,000 to any employee. Of course, such benefits provided to the insider of a 501(c)(3) private foundation but not treated as compensation are private inurement, and could cause the foundation to loose its exempt status.

Nonprofit organizations need to pay attention to all elements of compensation, be sure to treat them as compensation and be sure that the total compensation paid does not exceed what is reasonable. The procedures outlined in the rebuttable presumption regulations are very helpful, even for nonprofits not subject to the excess benefits rules of which the regulations are a part.

Charity care/debt collection. For several years Senator Charles Grassley (R-IA) and others have been questioning whether nonprofit hospitals provide sufficient charity care to justify their tax exemptions. News reports of nonprofit hospitals using commercial collections procedures have also generated questions. Perhaps as a result of the inquiries, the revised Form 990 and its Schedule H, which will be completed by 501(c)(3) hospitals beginning 2010, asks hospitals to quantify the amount of charity care they provide. Senator Grassley, mostly prior to the recent decline in the value of endowments, has also questioned whether the educational institutions with the largest endowments are providing sufficient charity care.

Many states have begun to look at the value of real estate and sales tax exemptions and some have made a specific level of charity care a requirement for state and local tax exemption. These discussions have prompted many nonprofit organizations that charge fees to think about the level of charity care they pro-

vide and to begin to document it. Even if the organization is not required to provide a stated level of charity care and does not wish to have a policy of providing a stated level of care, the board should know how it measures against norms being used by or applied to other organizations. A discussion at the board level about how collections will be handled is also appropriate.

Spending policy. Related to the issue of charity care, for organizations with permanently restricted investment assets, is the organization's spending policy. Private foundations are required to spend annually for charitable purposes an amount equal to 5% of the value of their net investment assets. They may choose to spend more, for example, in times when the value of their assets have fallen. Changes in the state laws governing true endowments (funds restricted by the donor to the expenditure of income only), permit flexibility in the amount that may be spent. (See Ready Reference Page: "New UPMIFA Sets Rules for Management of Charitable Funds") This leaves the organization's governing board with choices to make about what the level of spending from the endowment will be. Even if the organization's funds are not donor restricted, the board needs to balance the current needs of the organization with anticipated future needs, and setting a spending policy gives the board an opportunity to consider those competing needs.

Investment policy. Every organization with investment assets should have an investment policy. The existence of the policy and procedures for its review provide the board or investment committee the opportunity for addressing how assets are invested and for thinking about what allocations should serve the organization best.

Gift acceptance. Even a simple gift acceptance policy can provide guidance for a development officer or board member when a prospective donor offers to gift an interest in real estate, a partnership or a limited liability company. The policy can be as simple as a statement that gifts other than cash and publicly traded stock are subject to an acceptance procedure. A policy may help the organization avoid offending potential donors by making it clear that the extra level of review is something that is a general practice and not directed at the specific situation.

Restricted gifts. A charitable organization is required to use restricted gifts for the purposes for which they are given. This requires the organization to be thoughtful in its solicitations, and once it has accepted a restricted gift, to be diligent in documenting its use of the gift. An accounting system that classifies restricted investment assets on their receipt and records expenditures attributed to those assets is necessary. Because of the administrative burden, the organization may only want to accept permanently restricted investments assets in excess of a stated level.

Joint ventures. The revised Form 990 asks any charity that has participated in a joint venture with a for profit entity during the year whether it has a written policy governing participation in such ventures. If an organization is entering into an arrangement which could be viewed as a sharing of profits with a for profit entity, it should become familiar with the IRS's views on joint ventures, and it may wish to adopt a policy about participation in such ventures. (See Ready Reference Page: "IRS Says Charities Must Control Joint Ventures")

--Virginia P. Sikes
Montgomery, McCracken, Walker & Rhoads, LLP

REPRINTED FROM *NONPROFIT ISSUES®* VOL. XXII, NO. 7 July 1-15, 2012

READY REFERENCE PAGE

NO. 121
FOR YOUR FILE

Mergers and Acquisitions Can Take Many Forms

Since boards fear taking on known and unknown liabilities, most "mergers" are really changes in control rather than statutory mergers

Nonprofits are regularly urged to consider merging or acquiring organizations that will complement their mission and make them stronger, particularly in economically turbulent times such as those of the Great Recession. Foundations fund major projects promoting collaboration, affiliation, and outright mergers.

Unlike the business world where generally all it takes is money (and/or stock) for one for-profit company to buy another, money is often in short supply in the nonprofit world. Boards psychologically invested in their own organization are often not particularly interested in joining with, or being taken over by, another. Directors legitimately fear taking on known or unknown liabilities. Negotiating a merger or acquisition demands a lot of effort to reach consensus on all sides.

Traditionally, most "mergers" in the nonprofit field have been a form of take-over of a weak or failing organization by a larger and stronger one. A true merger of equals has not been the general rule. For groups considering a merger or acquisition option, it is useful to consider several different ways in which it might be accomplished. Each method has benefits and detriments that affect its suitability for the transaction.

Purchase of Assets

One common approach is for one organization to acquire some or all of the assets (including programs and people) of another, with the intent of continuing the activities within the program of the acquiring organization. Such an acquisition usually, although not always, requires a cash payment to the seller, or at least an assumption of certain liabilities.

If the selling entity is a charity that will not continue to do business, its net remaining assets must be given to another charity or used for another charitable purpose upon dissolution. As an alternative, the selling entity may continue as a grantmaking foundation. Several hundred charitable hospitals have been sold to for-profit organizations in the last 20 years, and most have become, or created, "conversion foundations" to make grants for health-related purposes in the community. (See Ready Reference Page: "Conversion Foundations Face Key Issues Early")

If the selling charity will be going out of business and dissolving, it may be appropriate to try to obtain a court order that the income from any charitable trusts designated for the charity, or bequests or charitable remainders not yet available, will go to the purchasing organization. If there is no trust income and has been no serious planned giving program, it may be less of an issue.

Where the seller is saddled with debt, it may be possible to purchase assets out of a bankruptcy proceeding without accepting all the liabilities. However, if the creditors are not friendly, they may push for an increased purchase price or even force the sale to an unfriendly higher bidder in order to collect more on their unpaid debt. Since a charity cannot be put involuntarily into federal bankruptcy proceedings (although it may be possible to force an involuntary state receivership), an insolvent organization has substantial negotiating leverage with its creditors before filing. State bankruptcy proceedings,

which are seldom used and few people know the rules, may offer a more flexible approach than federal bankruptcy proceedings.

A purchase of assets requires real money, however, and in the nonprofit world where real money is often in short supply, a merger or acquisition may take another form.

Dissolution and Transfer of Assets

Where there isn't any money to purchase the assets and the parties are not ready for a full merger because of potential liabilities, it may be possible for the "selling" organization simply to dissolve and transfer its remaining net assets to the acquiring entity. Although claims may be made against the organization going out of business during its dissolution proceedings, dissolution will eventually cut off claims in a way that a true merger will not.

Acquisition of Stock

A few nonprofit organizations are formed on a stock basis so that control is vested in those who hold the stock of the corporation. In such a case, an acquisition can be made by acquiring the stock of the entity from the present shareholders, with or without payment, if state law allows such a transfer.

Substitution of Members

Where a nonprofit corporation is formed as a membership corporation, members function essentially the same as shareholders of a business corporation and are responsible for major corporate decisions, including, in most cases, selection of members of the board of directors.

A change of control can be accomplished by having the current members appoint representatives of the acquiring corporation as members of the acquired organization, and then having the old members resign. Such a transition gives the acquiring entity control over the old corporation without payment (although payment may be made if permitted by state law). The new members can then appoint appropriate directors of the corporation.

It will probably be appropriate to amend the bylaws of the acquired corporation to assure that the acquiring organization retains control through its appointment process and a veto power on changes in structure.

Substitution of Directors

A similar result can be accomplished in a nonmembership corporation (controlled by a self-perpetuating board of directors) by having the existing board members (or at least a majority of them) arrange resignations and appointments so that all, or a majority, of the board is selected by the acquiring corporation. Again, an amendment to the bylaws will probably be appropriate to assure the continued control of the acquiring entity.

Controlling the acquired organization through change of control such as those discussed above gives the acquiring organization a level of protection from the liabilities of the acquired corporation. If the acquired entity is operated as a separate entity, and not legally merged into the acquirer, it should be difficult for a claimant to "pierce the corporate veil" and impose liability on the controlling entity for obligations of the controlled entity.

If uncertainties exist about potential liabilities, it may be appropriate to acquire control and operate the organization for a period of time before effectuating an actual merger or consolidation.

Merger or Consolidation

At some point, it may make sense to legally merge the organizations. Under some state nonprofit corporation laws there is a distinction between a merger, in which two or more entities merge but one of

them continues as the "surviving" entity, and a consolidation, in which two or more entities come together and create a new consolidated entity. In each case, the continuing entity succeeds to all the rights, privileges, assets, obligations and liabilities of the former organizations.

A consolidation may be psychologically more attractive to the participants than a merger, especially to the "acquired" entity. In a merger, one entity "survives" while the other does not. In a consolidation, a new entity supersedes all the participants, usually with a new name different from all of the former corporations. Those from the acquired organization who continue to serve may feel less like second class citizens on the board of a "new" organization than on the board of a "surviving" organization.

A consolidation requires a new recognition of exemption from the IRS, however, since it creates a new entity. The IRS ought to be notified of any fundamental change such as this, but a new exemption will not be required for a "surviving" entity. These methods are obviously creatures of state nonprofit corporation law, which must be reviewed to be sure that the proposed transaction is permitted. In some states, for example, a nonprofit may merge with an out-of-state nonprofit only if the in-state nonprofit is the surviving entity.

The state attorney general undoubtedly has jurisdiction to review a fundamental change of a charity, and may have either statutory or administrative rights to review the transaction before it is consummated. In some cases, court approval may be required, especially if any assets committed to a charitable purpose will be diverted from the purpose to which they were originally committed.

A New "Parent" Organization

If the boards of the two (or more) organizations considering the merger or affiliation cannot agree on which entity ought to be the surviving one, or if there are legitimate legal reasons why they should not cease to function separately, it may be possible to create a new "parent" organization, composed of representatives of each of the continuing operating entities, to control the operating entities and provide strategic planning for a new "system" of organizations.

Representations and Warranties

The acquiring organization ought to do a thorough "due diligence" review of the organization being acquired (See Ready Reference Page: "Mergers and Affiliations Require 'Due Diligence'") and the acquired organization ought to be asked to make a series of representations and warranties. The warranties should particularly cover financial issues, contingent liabilities, and pending or potential litigation.

In the business world, where people pay for acquiring an organization, such reps and warranties provide a means of recourse to recover part of the purchase price for damages if the warranties turn out to be incorrect. But if the take-over is a no-cash deal, as is more usually the case with a nonprofit, the warranties have essentially no financial value. The acquiring organization already has all of the assets which might be used to pay for the losses, and it is unlikely that it would seek to impose personal liability on individual members of the old board.

An acquiring organization may want to retain an "exit strategy" in the acquisition agreement, perhaps allowing it to give the stock or membership interests back to the old group. Or it may just dissolve the acquired entity if things do not work out as anticipated.

As with most of the nonprofit world, there is no one-size-fits-all method for acquisitions, mergers or affiliations. Understanding the various possible options can help decision makers make better decisions.

Charities Must Set Value on 'Quid Pro Quo' Gifts

Donors may deduct only the amount of the payment in excess of the value of the goods or services received

When somebody gives your charity a generous contribution, or pays far more than it is worth to attend the annual fundraising dinner, you want to be sure that you comply with the law and that your donors are able to claim an appropriate charitable contribution deduction.

In the early 1990's, Congress spelled our new rules for deductions. Donors must receive a written substantiation letter from a charity for any gift of $250 or more. Charities must determine the amount deductible if the donor makes a payment of more than $75 in return for goods or services.

The substantiation rules apply to donors, who may not claim a charitable contribution deduction without having received the written receipt. (See Ready Reference Page: "IRS Requires Substantiation of Contributions") The charity will not suffer a direct penalty for failing to give the receipt, although it may create a lot of unhappy donors.

The "quid pro quo" rules apply directly to charities, which can be fined $10 by the IRS for each contribution for which they fail to make the proper disclosure, not to exceed $5000 for any one fundraising event or mailing. (Tax Code Sec. 6714.)

The issue is one of public relations as well as law. The requirement was enacted in 1993 because Congress got fed up with the failure of charities to notify their donors of the amount which could be deducted. Therefore, it especially behooves charities to pay attention to the rules.

A quid pro quo contribution is a payment made partly as a contribution and partly in consideration for goods and services furnished to the donor. The annual fundraising dinner, where tickets are priced at various levels depending on the amount of support by the donor, is a typical example. The public radio or television on-air fundraiser, where they give a recording or a video of the show for higher level gifts, is another.

If an organization receives a quid pro quo contribution in excess of $75, it must provide the donor a written statement of the amount deductible for federal income tax purposes. Only the amount in excess of the value of the goods or services received in return for the gift is deductible. The organization must make a "good faith estimate" of the value of such goods or services. (Tax Code Sec. 6115.)

The disclosure may be made either in connection with the solicitation or with the receipt of the contribution. It generally makes sense to give the information with both the solicitation and the receipt, when possible, and even where the payment is less than $75.

The quid pro quo rules apply to donations of less than $75. A donor who receives a $20 lunch for a payment of $50 may deduct only $30. The charity has no legal obligation to tell the donor, but it is considered best practice to do so.

The statute specifically excludes payments to religious organizations where the donor receives “solely an intangible religious benefit that generally is not sold in a commercial transaction.” This would include “pew fees” or charges for admission to certain religious ceremonies.

The valuation question can be tricky. It is not difficult to value the commercially available recording or video. It may be more difficult to value the formal dinner dance, or a tennis lesson, or a garden tour.

The Regulations make clear, however, that it is the value of the goods or services received by the donor, and not the *cost* to the charity, that is the measure for reducing the deduction. Even if the entire dinner and all of the services of the catering facility are donated to the charity for its dinner dance, the charity must estimate the value of the event and advise the donor how much is not deductible.

By the same token, it is not the cost to the charity which is necessarily the measure of the value to the donor. If the charity is able to buy the recording for $5, but the regular sale price in the stores is $12, the reduction in the contribution would be $12.

The only way the donor can avoid reducing the contribution deduction is by refusing to accept the quid pro quo benefits in advance. It is not sufficient merely to fail to attend the event. The donor must affirmatively decline to accept the ticket or otherwise advise the charity that he or she does not intend to appear.

The Regulations provide that a charity “may use any reasonable methodology in making a good faith estimate, provided it applies the methodology in good faith.” If the estimate is not in good faith, however, the IRS can impose penalties.

The IRS has issued some regulations which help eliminate some types of benefits from the calculation.

Perhaps the most significant are those goods or services which have “insubstantial value” or fall within the “low cost items” exception. For 2013 an item is considered to be of insubstantial value if it is worth less than $102 or 2% of the gift, whichever is less. (The $102 figure is based on a statutory amount of $50 as indexed for inflation and is $102 for 2013.)

“Low cost items” typically include souvenir items including the organization’s logo, like pens, key holders, coffee mugs, or calendars. For 2013, they can be disregarded if the gift is more than $51 and the cost of all the items given to the donor is less that $10.20. (These figures are also indexed for inflation based upon statutory amounts of $25 and $5.) The low cost items provision is one of the very few situations where the cost to the charity (rather than the value to the donor) is the measuring figure.

Also excluded are certain “membership” benefits, such as free or discounted admissions to the organization’s facilities or events, free or discounted parking, preferred access to goods or services, and discounts on the purchase of goods or services, so long as such benefits can be exercised freely during the membership period. Also excluded are events open only to members when the cost to the charity is less than the “insubstantial” amounts mentioned earlier. The Tax Code says these benefits are disregarded where the membership dues are $75 or less but an example in the IRS Regulations disregards such benefits upon the payment of higher dues as well. The charity is not required to value such benefits for members paying higher dues.

Where a celebrity is present at an event, the Regulations say to disregard the value of the celebrity's presence and value the event as if the celebrity were not there.

Newsletters which feature the President's message and pictures of donors but have no "commercial value" need not be considered. If they are separately sold, carry advertising, or pay writers other than staff, they probably have commercial value which should be determined in figuring the amount by which the gift should be reduced.

Charity auctions are another area in which the charity is required to make a good faith estimate of the value of the goods or services on which the participants bid. To the extent that the bidders pay more than the fair market value of the items, they may take a deduction for the difference. To the extent that they pay only the fair value or less, they are merely purchasing the items and have no deduction.

Charities normally do not place a value of gifts of property given to them by donors but they are required to estimate the fair market value of the donated items to be sold at the auction.

Since charities regularly say thanks to their major donors, they frequently ask whether a recognition from the charity is "in consideration for" the gift and thereby forces the donor to reduce the contribution deduction. The Regulations provide that goods or services will be deemed in consideration of payment "if, at the time the taxpayer make the payment…, the taxpayer receives or expects to receive the goods or services in exchange for that payment," even where the payment is in a year other than the year of the gift.

Therefore, if you always invite your $1000 donors to the President's tea after the Homecoming football game, the value of the tea would be deducted from the contribution. But if you surprise the $1000 donors with various recognitions in some years but not others, the gift will not be reduced.

REPRINTED FROM *NONPROFIT ISSUES*® VOL. XI NO. 11 **Revised February 2013**

READY REFERENCE PAGE NO. 51 FOR YOUR FILE

The Key Question: Whose Organization Is It?

Nonprofits come in many different shapes and sizes; they will be more effective if their governing instruments reflect the constituencies which must be represented to make them work

Nonprofit consultants and "best practices" commentators often seem to assume that there is an ideal structure for nonprofit organizations that is embodied in a standardized set of bylaws taken off the shelf.

Usually they envision a self-perpetuating Board of Directors drawn from the community to serve a limited number of terms and then rotate off the Board. They reflect an assumption that the directors represent "the public" and run the organization in the public interest.

But nonprofits are not all alike. They are formed for many purposes, representing many constituencies, with many subtle issues of control.

Consider the vast differences between the new nonprofit founded by the social entrepreneur to make the world a better place; the youth sports league where the parents care passionately for the years their kids are eligible to play and could not care less thereafter; the state association of nonprofit organizations, formed to help the members make their own organizations more effective and represent them in the halls of power; the social service provider working with professionals and client representatives to help individuals dealing with certain problems; the city art museum formed to protect and display community treasures forever; and the subsidiary of the church formed to carry out part of the church's social mission.

The differences in these organizations should be reflected in the structure established in their bylaws. Unlike a business corporation, where, in ultra-simplistic terms, whoever owns the most stock has the power, the power relationships of a nonprofit are spelled out in the articles (or certificate) of incorporation and the bylaws. To work well for the organization, they should reflect the answer to the question: Whose organization is it?

This isn't a literal question of who owns it. No one "owns" a nonprofit. But somebody controls it. Who is the driving force? Who cares whether the organization is effective? Who must be represented to make it work? The answer to these questions may change over time but they ought to be reflected in the structure of the organization.

One of the first questions is whether the organization should be a membership organization, in which individual or organizational members hold ultimate powers with regard to its purpose and structure, select directors and have other important legal rights similar to those of shareholders in a business.

Some organizations function best as membership organizations. The state association, a fraternity, sorority or social club, a civic association, and some denominations of churches often function best in this form. The members care about the organization, are invested in its outcomes, and are willing to pay at least some attention to its success or failure. They usually carry out their responsibilities by

paying dues, participating in activities, and selecting the Board to represent them in getting things done.

But not every organization structured with members should be. A classic example involved a community hospital in Alaska, whose bylaws provided that anyone who paid $5 and showed up at the annual meeting could be a "member" and participate in the election of the Board. In 1992, a "larger than usual" turnout organized quietly by opponents of abortion showed up at the annual meeting. They voted out the incumbent Board and replaced it with selections of their own. A few months later, the new Board voted to stop performing abortions at the hospital. (See Nonprofit Issues®, February 1998.) That does not seem to be the way issues of public importance should be decided.

Many organizations, like public radio or television stations, or the local zoo, orchestra or art museum, have contributing "members," but those "members" do not have legal rights to control the organization. Where the "members" are merely users or supporters from among the general public, but have no continuing vested interest in assuring its success, there is probably no need for legal membership. A self-perpetuating Board of Directors with fiduciary duties to the organization would be better suited to the situation.

A membership structure can be vital, however, for the social entrepreneur who wants to assure that he or she can pursue his or her vision for making the world better without being fired by the Board. We have seen many situations in which an individual starts an organization intending to make it a life's work and creating a Board-only structure. Although the entrepreneur tries to populate that Board with friends, they ultimately decide to go in a different direction and fire the founder.

A founder can avoid that possibility by remaining the sole member of the corporation and retaining the power to select and remove the directors. Not everyone will be willing to serve on the Board in such situations, but the entrepreneur knows that arbitrary behavior in firing Board members will make it a lot harder to attract good people to help with the mission.

Assuming that membership is not appropriate, the question still arises about how the Board is selected. Is it solely a self-perpetuating Board where all members are selected in the same fashion, or are there different categories? Is there a requirement for representation of certain constituencies? Does the youth sports league need parents representing specific age groups? Does the social service provider require representation of clients? Are there ex-officio representatives from governmental agencies or other directly involved organizations? Is there representation from, or are there reserve powers for, another organization for which this is a local chapter or affiliate? Should the bylaws require diversity so that more divergent views are represented?

If these representations are built into the bylaws, should the bylaws provide that they can't be changed without the approval of the representatives involved?

An important issue is whether to have term limits forcing directors off the Board after a certain number of years. This goes to the heart of the question: whose organization is it?

If the organization is a subsidiary of the church, should the Bishop be thrown off the Board because of term limits. If it is a membership organization, should the members be prohibited from electing the people they want to lead them? If it is an advocacy organization, should the Board be required to lose the most visible and effective proponent of its position because of term limits? If it is a family founda-

tion, should the family be required to throw momma (or poppa) off the Board?

The primary rationale for term limits is that they force the Board to get rid of “dead wood” directors who don’t contribute to the organization. It is a rule designed to protect the Board from having to make hard decisions and tell an unproductive Board member it is time to move on. There are much better ways to eliminate dead wood and assure an active, committed board. (See Ready Reference Page: “Boards Should Assess Their Own Performance”)

Term limits guarantee that the Board will lose its most productive and helpful members at some arbitrarily fixed point in time. Even if they are allowed to return later, the organization loses some of their contribution.

Term limits also cause a subtle shift in the answer to the question: whose organization is it? Especially if the time on the Board is short, term limits inhibit the growth of strong Board leadership and shift the power toward the executive director, who can become the one with the most knowledge and institutional memory to understand how the organization works.

The size of the Board can also effect the answer to the question. If the Board is too large, the average member is likely to be less invested in the organization than if it is smaller. It will tend to become the organization of the Executive Committee or of the staff, not the full Board.

Structuring a nonprofit organization is more of an art than a science. But to do it well requires thought and understanding the answer to the question: whose organization is it? There is no single form on the shelf. There is no one size that fits all.

REPRINTED FROM *NONPROFIT ISSUES*® VOL. XVIII NO. 2 February 1-29, 2008

READY REFERENCE PAGE

NO. 103-A
FOR YOUR FILE

Compliance Assessments Protect Charities – Part I

Proactive review can reduce the risks of waking up to adverse publicity and loss of trust

Hardly a day goes by without numerous newspaper articles and other media stories about real or perceived abuses in the nonprofit sector. In addition to this steady stream of media coverage, both the Senate Finance Committee and the House Oversight and Government Reform Committee have recently conducted high visibility hearings and inquiries into actual and perceived sector abuses.

What's especially tragic about the vast majority of this negative media and Congressional scrutiny is that much of it could have been avoided had the organizations' boards, officers, employees, and/or volunteers simply fulfilled their fiduciary responsibilities. In fact, virtually every case prosecuted by state and federal regulators can ultimately be traced back to the organization's board, officers, employees, and/or volunteers failing to fulfill their basic fiduciary responsibilities. Had the individuals in question been more vigilant, the wrongdoing could have been detected, addressed, and, in most instances, the subsequent negative media and Congressional scrutiny avoided, or at least minimized.

Therefore, it's crucial that every board institute appropriate procedural safeguards and that every board member pay attention to his or her fiduciary responsibilities so they don't wake up one morning and find their organization featured in a negative light on the local paper's front page— or, worse still, find that their organization is now under investigation by the IRS or one or more state regulators.

A comprehensive compliance assessment can help an organization discover actual or potential problems that, if not addressed in an appropriate and timely manner, could lead to damaging media stories and/or state or federal prosecutions that could seriously impair the organization's integrity and credibility and, therefore, its overall effectiveness and viability.

What follows are brief descriptions of just a few of the many items to review during such an assessment.

First, verify that your organization is in compliance with all applicable state charitable solicitation statutes.

Thirty-nine states and the District of Columbia have statutes governing the solicitation of charitable contributions. Verify that your organization is properly registered in all states where it solicits that have registration requirements. Experience has shown that sometimes organizations that handle this time-consuming, confusing, and costly process in-house are not always in complete compliance like they thought they were. Very often the person tasked with this responsibility has many other job responsibilities that keep him or her from devoting the requisite amount of time to making sure that the organization is in compliance with these important legal requirements. A charity that solicits in a state that has a registration requirement without being properly registered risks having significant fines imposed against it if caught and many an organization has been shocked to discover that the person tasked with this important responsibility has either intentionally or unintentionally "dropped the ball." When this happens and is discovered by the media and/or one or more state regulators, the organization can be the recipient of not just negative publicity, but significant fines and penalties as well.

Second, verify that all your organization's professional fundraisers are properly registered and have filed copies of their contracts with any appropriate state oversight agencies as required.

Not only do charities that aren't specifically exempt or excluded have to register where required before they solicit contributions, any private, for-profit profes-

sional fundraisers the charities hire (either those who help develop and manage campaigns as fundraising counsel or those who directly ask for funds, such as telephone solicitors) most likely also have to register and file copies of their contracts too. Failure to do so can again result in the unregistered entities being subjected to significant fines and penalties as well as other legal sanctions.

Third, verify that all your organization's solicitation materials are truthful and free of material false statements, misrepresentations, and/or omissions.

For example, one state oversight agency recently settled a case with a prominent regional charity that regularly represented to the public that it had given significantly more to a medical research center than it actually had. Some years the charity's founder would even hold a press conference where he would present one of those big, oversized checks to a representative of the research facility. The only trouble was that there wasn't always a real little check that actually transferred the entire sums in question to the research facility. As part of the Settlement Agreement, the charity was required to live up to the representations it had made over the years and, among other things, actually transfer $4 million to the research facility.

The subsequent negative media publicity about the organization damaged the organization's credibility with actual and potential donors as well. More recently, during the House Oversight and Government Reform Committee hearing held in January, the head of a national veteran's charity admitted that his organization sometimes overstated how much it spent on program services in its various solicitation materials because, he claimed, if the organization didn't, donors would not give anything to the organization. This particular charity official will very likely be hearing from one or more state regulators concerning this admitted misrepresentation.

Fourth, verify that all your organization's solicitation materials contain all statutorily-required disclosure statements.

There are about thirteen states that currently have disclosure statement requirements. For example, Section 9(k) of Pennsylvania's solicitation law requires that every solicitation, written confirmation, receipt, and reminder of a contribution clearly and conspicuously state that the official registration and financial information concerning the soliciting charity is available by calling [Pennsylvania's] toll-free number and that registration does not imply endorsement.

Failure to include this statutorily-required disclosure statement is a fairly common violation and each solicitation, written confirmation, receipt, and reminder of a contribution made without the required disclosure statement could result in up to a $1,000 fine being imposed for each violation in certain states.

Fifth, verify that your organization is keeping true and accurate fiscal records.

This is a fairly uniform and commonsense requirement and, yet, unfortunately, it's also a very common violation for charities of all sizes— whether they're run completely by volunteers or by full-time paid professional staff. All charities soliciting contributions have to be able to clearly show exactly how much money they've collected and how they've spent it— even, in most cases, if they're exempt from the annual registration requirements. Therefore, a charity needs to make sure it can clearly account for every dollar collected and show it spent every dollar for purposes consistent with its charitable purposes and the solicitation request. In fact, the failure to keep "true and accurate" fiscal records is itself a violation in many states. In addition, experience has shown that an organization's failure to keep "true and accurate" records greatly facilitates the ability of individuals within the organization to defraud the organization itself.

This list of the top 10 areas of review will be continued in the next edition of Nonprofit Issues®.

--Karl E. Emerson

Mr. Emerson, formerly Director of the Pennsylvania Bureau of Charitable Organizations, is now an attorney with Montgomery, McCracken, Walker & Rhoads, LLP in Philadelphia.

Lobbying Rules Create Opportunity for Charities

There are many ways to advocate for public policy goals without going beyond the limitations of the Tax Code

Public charities can usually advocate on public policy issues a lot more than they think they can.

For years, they were conditioned to fear losing their exemption if they got involved in advocacy of any type. They knew that one of the conditions of Section 501(c)(3) status is that "no substantial part" of an organization's activities can include attempting to influence legislation or "lobbying."

Since there was no clear line to determine what is "substantial," and since they did not always understand what was meant by "attempting to influence legislation," many tended to shy away from any involvement in public policy debate.

In 1976, Congress attempted to relieve the fears by enacting Code Section 501(h), allowing most public charities to elect to measure their lobbying activity solely by the amount of money spent. The final regulations, which were promulgated 14 years later in 1990, eliminate many of the definitional problems. Public charities, and the private foundations which want to fund their advocacy efforts, should be a lot more confident about their ability to jump into the public policy fray.

Although technically the definitions apply only to those groups which have made the 501(h) election, they seem to embody the IRS thinking that would be applied even for non-electing organizations.

The first important point is that not all advocacy is limited. The limitation applies only to attempting to influence "legislation."

"Legislation" includes action by a legislative body at any level of government, such as Congress, a state legislature or city council. It also includes action by the public on a referendum, ballot initiative, constitutional amendment or similar procedure.

Legislation does not include promulgating administrative regulations or taking executive actions which do not require changes in the law. It does not include action by administrative bodies, such as school boards, zoning boards, housing authorities or other agencies which do not pass laws. And it does not include litigation.

An arts organization seeking an additional appropriation in this year's budget for the National Endowment for the Arts is lobbying. The same organization working with the NEA on its definition of decency for purposes of making grants is not lobbying, since an administrative regulation is not legislation.

Understanding this distinction opens a whole lot of territory for advocacy, without having to worry whether it is a substantial portion of your activity. When dealing with legislation, the regulations define two types of lobbying: direct lobbying and grass roots lobbying.

Direct lobbying is any attempt to influence legislation through communication with 1) a member or employee of a legislative body or 2) any government official or employee who may help formulate legislation, when the communication a) refers to specific legislation and b) reflects a view on that legislation.

Grass roots lobbying is a communication with the general public that a) refers to specific legislation, b) reflects a view on the legislation and c) encourages the recipient to take action.

It will be considered a call to action if it a) encourages the recipient to contact a legislator or employee of a legislative body; b) states the address or phone number of a legislator or employee of a legislative body; c) provides a tear-off postcard to mail to the legislator or employee; or d) specifically identifies that a legislator scheduled to vote on the legislation is opposed or undecided on the views expressed in the communication or is the recipient's representative, or identifies the legislator as a member of the committee that will consider the legislation.

A group may purchase a full page newspaper ad stating that a proposed bill is the most enlightened proposal possible on the subject. It is not grass roots lobbying unless it contains the call to action.

Certain activities are specifically excluded from the definition of lobbying. One of the more important exceptions is "nonpartisan analysis, study or research." Such analysis may even advocate a particular viewpoint "so long as there is a sufficiently full and fair exposition of the pertinent facts to enable the public or an individual to form an independent opinion or conclusion" on the issue.

Even where the research is later used for the purposes of lobbying, the costs of the research will not be considered lobbying expenses where "the primary purpose" of the research was not for use in lobbying. The regulations provide a "safe harbor" which says that the primary purpose will not be for use in lobbying if, prior to or contemporaneously with the use of the materials in lobbying, the organization makes a substantial non-lobbying distribution, i.e. without a call to action.

The regulations exempt provision of technical advice in response to a written request by a governmental body. A charity may testify before a legislative committee without limitation if the testimony is pursuant to a written request. Assistance to an individual legislator or to a single political party does not qualify for this exemption.

The regulations also exempt "self defense" communications where a legislative body is considering action that may affect the continued existence of the charity, its powers or duties, its exempt status or the deductibility of contributions to it. Charitable activity opposing the Istook Amendment several years ago was widely believed to be self defense lobbying because the Amendment would have significantly reduced a charity's right to participate in public policy questions.

The rules for distributions to bona fide members of an organization are slightly more lenient and allow a broader range of activity without having it go against the limits.

Private foundations are also helped significantly by the final regulations. Private foundations, with very few limited exemptions, such as the "self defense" exemption, must pay an excise tax on any lobbying expenditures and traditionally were even more reluctant to engage in or support advocacy efforts.

The new rules, however, establish clear safe harbor provisions by which foundations may support ad-

vocacy projects without serious worry about their own status.

A grant for general support, unless earmarked for lobbying activities, will be deemed not to be a lobbying expense. A grant for a specific project will not be deemed to be a lobbying expense if the total of the foundation's grant to the project for the year does not exceed the amount budgeted for non-lobbying activities.

If a $100,000 project budget contains $20,000 for lobbying, the foundation may fund up to $80,000 without concern. The foundation is able to rely on the grantee's budget unless it has reason to know that the budget is wrong. The grantee charity may also get the other $20,000 from a private foundation without either foundation having a problem. Each of the two grants, although together they will provide funds for lobbying, is deemed to go to the non-lobbying activity.

Armed with a clear understanding of the rules, a charity interested in public policy advocacy should be able to mount significant efforts, and should be able to obtain foundation funding to support its work.

YOU NEED TO KNOW

A charity that does not spend at least a portion of its time in advocacy work is probably not doing its job as well as it should.

Therefore, charities must understand the tax law definitions of "lobbying" and "legislation." There is a vast amount of advocacy that can be carried on without approaching tax limitations. Private foundations can support most of it, and preparing an application with foundation rules in mind can make it easier to get funded.

Tax law is not the only issue, however. Beware of federal and state lobbying registration requirements, with different definitions and different reporting.

READY REFERENCE PAGE

NO. 2 Rev. Dec. 2013
FOR YOUR FILE

IRS Requires Substantiation of Contributions

Donors must obtain acknowledgment from charity for gifts worth $250 or more, must file Form 8283 for gifts of property over $500, with appraisal over $5,000

It isn't as easy as it once was to claim a charitable contribution deduction for a gift to charity.

Because of perceived abuses by taxpayers claiming inflated deductions without adequate justification, Congress and the Internal Revenue Service have tightened the rules over the last several decades.

The rules apply to the taxpayers seeking the deduction. In most cases, they do not directly apply to the charities receiving the gifts and do not impose penalties on charities, but charities that want to assist their donors and receive additional gifts will want to be sure that the donors are in position to claim their deductions properly.

Cash contributions. For "cash" contributions of less than $250 made by currency, check, electronic funds transfer, credit card, debit card, or payroll deduction, the donor may not claim the deduction unless the donor has a cancelled check, bank record or credit card statement, an acknowledgment from the recipient charity, or a payroll record. The rule was changed by the Pension Protection Act of 2006 to require the written acknowledgment from the charity for gifts of currency, even for a gift of only $1.

For cash contributions of $250 or more, the donor must obtain a "contemporaneous" written acknowledgment from the recipient charity. The acknowledgement must include a statement of the amount of the gift, whether or not the donor received any goods or services in return, and if so, a description and good faith estimate of the value of such goods or services. Generally, a donor who receives goods or services in return, except for certain items of nominal value, is entitled to deduct only the amount of the payment that exceeds the value of the goods or services received. (See Ready Reference Page: "Charities Must Set Value on 'Quid Pro Quo' Gifts")

If the only benefit received is an "intangible religious benefit," such as that received by those who "rent" pews in church or pay extra dues to attend High Holy Day services in a synagogue, the organization does not have to place an economic value on the benefits.

The acknowledgment is considered contemporaneous if received by the earlier of the time the taxpayer files the tax return claiming the deduction or the date the return is due, including extensions.

In determining whether cash contributions are $250 or more, the IRS says a donor need not combine all of the contributions during the year. If a donor contributes $25 a week to a church, the payments need not be combined to require the written acknowledgement from the church (unless, of course, they are made in currency). The donor can utilize the bank or credit card statements as substantiation.

Noncash Contributions. For noncash contributions, Congress and the IRS have come up with what is essentially a three-tier system for donors to substantiate their claims for deductions. The valuation

breakpoints are generally gifts worth $500 or less, gifts between $500 and $5000, and gifts for which a deduction is claimed for more than $5000. There are also special rules for gifts of certain types of property for which it is widely perceived that inflated contribution deductions have been claimed in the past.

The basic rule for noncash gifts of less than $250 is that the donor must obtain a written receipt from the charity containing the name of the charity, the date and location of the gift, and a "reasonably detailed description" of the property. The IRS says the donor doesn't have to obtain the receipt if it isn't practical to do so, such as for a gift left in a collection box in a shopping center. The receipt need not be as elaborate as the acknowledgment and need not contain a statement of whether or not goods or services were received in return for the gift.

In addition, however, the donor must maintain reliable written records for each item given, including the cost basis of the property, the estimated value, a statement of the method used to determine the value, and a statement of any conditions that may have been applied to the gift. For securities, the donor must also have the name of the issuer, the type of security, and whether it is regularly traded on an exchange or over the counter market.

For gifts with a value of at least $250 but not more than $500, the donor needs the records previously required and must obtain the contemporaneous written acknowledgement from the charity describing the property and stating whether any goods or services were received in return. Note that the acknowledgment need not put a value on the noncash gifts and a charity will not normally set the value of such gifts. Valuation is normally left to the donor and an appraiser where necessary. (The charity may use the donor's value for the charity's bookkeeping and reporting if the charity deems the value reasonable, but it has no obligation to do so.)

In determining the value of gifts, all items of similar property given to charity must be aggregated to determine the reporting requirements. A donor who gives a lot of books, for example, that have an aggregate value of more than $250 will be required to report based on the aggregate value of all the books given away, even though none of the individual items is worth $250, and even though the gifts are split among multiple organizations.

For gifts of property valued over $500 but not more than $5000 (including all publicly traded securities even if valued at more than $5000), the donor must file a Form 8283 with the tax return claiming the deduction. The Form must describe the property given, but does not require an acknowledgment of receipt by the charity. In addition, the donor must have records showing how the property was acquired (by purchase, gift, inheritance, etc.), the approximate date of acquisition, and the cost basis of the property.

For gifts of property worth more than $5000 (except for publicly traded securities and privately traded stock worth $10,000 or less), the Form 8283 must contain a summary of a "qualified appraisal" and an acknowledgment by the charity that it has received the items. The acknowledgment does not represent an agreement by the charity with the valuation claimed by the donor. The actual appraisal report must normally be attached to a claim of more than $500,000.

C corporations, other than personal service corporations and closely held corporations, are required to file Form 8283 only if claiming deductions of more than $5000. S corporations and partnerships must file the Form 8283 with their own S corporation or partnership returns if they claim more than $500 in deductions.

The IRS has the authority to deny *any* deduction, even up to $500, if a donor fails to file an accurate Form 8283 when claiming a deduction for which the Form is required. The IRS has been inconsistent on administering the rule, but the Courts have upheld the total denial in many cases.

Qualified Appraisals. Congress also tightened the rules for qualified appraisals and appraisers in the Pension Protection Act and increased the penalties for knowingly participating in a claim for an excessive deduction. (See Ready Reference Page: "Congress Passes Charitable Reforms")

A qualified appraisal must be made and signed by a qualified appraiser and must be made in accordance with generally accepted appraisal standards not more than 60 days before the date of the contribution. It must include a description of the property, its physical condition if tangible personal property, its estimated value, and a statement of the basis for the determination.

A qualified appraiser is a person who has earned an appraisal designation from a recognized society, regularly performs such appraisals for compensation, can demonstrate verifiable education and experience in the type of property being appraised, has not been prohibited from practicing before the IRS within the last three years, and is not excluded by Treasury regulations. The appraiser cannot be the donor or taxpayer claiming the deduction, the donee, a party to the transaction in which the donor acquired the property, an employee of any of these, or an appraiser who regularly performs appraisals for any of these persons and does not do a majority of his or her work for others.

Generally no part of the fee arrangement can be based on the amount of the appraised value or the amount of the deduction ultimately allowed by the IRS.

The "Squeal Rule". Normally a donor may claim a deduction only for the lower of cost basis or fair market value for a gift of tangible personal property to a charity, and may not claim an appreciated fair market value deduction for property held more than a year unless the property is actually used by the charity within its charitable purpose. Therefore, if the organization sells, exchanges, or otherwise disposes of property (other than publicly traded securities) valued on a Form 8283 at more than $5000 within three years of receipt of the gift, the organization is required to file a Form 8282 with the IRS (and give a copy to the donor) disclosing the disposition. The time period was increased by a year under the Pension Protection Act. For tangible personal property for which the donor claimed an appreciated fair market value deduction, the property will be considered not used in the charitable operation. The donor will have to reverse the claim and include the difference between the cost basis of the property and claimed deduction as income in the tax return for the year of the disposition. (See Ready Reference Page: "Congress Passes Charitable Reforms") For other types of property, the report will give the IRS an opportunity to see whether the claimed deduction seems reasonable.

Special Rules for Certain Types of Gifts.

Cars, boats and planes. In 2004, Congress changed the rules for deductions for gifts of automobiles, boats and airplanes. Because Congress was convinced that many donors deducted inflated amounts for such gifts, it provided that a donor may deduct only an amount equal to the gross proceeds of the sale of such property when the charity disposed of it after acquisition, usually for cars at auction. (The normal deduction rules apply if the charity uses the vehicle in its program or substantially repairs the vehicle.) The donor must file a Form 1098-C with the return claiming the deduction. The charity should supply the Form with a statement of the gross proceeds of sale. Generally the form must be

dated within 30 days after the sale. (See *Nonprofit Issues*®, Tax Matters, 10/16/04.)

Clothing and household items. In the Pension Protection Act of 2006, Congress substantially tightened the rules for deducting gifts of clothing and household items. A donor may not deduct anything for the value of clothing or household items unless they are in "good used condition or better," and, if the donor claims a deduction, the donor must have all of the records required for noncash gifts for the level of deduction. The Secretary of Treasury has been authorized to deny, by regulation, deductions for contributions of "minimal value" but has not yet done so.

A donor may deduct for gifts of lesser quality, but only if the donor claims a deduction of more than $500 for a single item and includes a qualified appraisal of such item with the return. (See Ready Reference Page: "Congress Passes Charitable Reforms")

Household items include furniture and furnishings, electronics, appliances, linens and similar items. They do not include food, paintings, antiques and other artistic items, jewelry and collections.

Out-of-pocket expenses for volunteer services. No deduction is available for the value of services contributed to a charity, but volunteers may deduct their out-of-pocket expenses incurred in rendering volunteer services. To claim a deduction for out-of-pocket costs, a volunteer must have adequate records to substantiate the expenses, and for expenses of $250 or more, must obtain a written acknowledgment from the charity.

For more detailed information, see IRS Publication 526 on Charitable Contributions, and IRS Publication 561, Determining Value of Donated Property.

REPRINTED FROM *NONPROFIT ISSUES*® VOL. XV NO. 11 June 16-30, 2005

READY REFERENCE PAGE

NO. 82
FOR YOUR FILE

Term Limits Are For Cowards

Arbitrary end of service assures that organizations lose some of their best talent

We received a call not too long ago from the CEO of a nonprofit client asking how the Board could retain the services of its chairman during a particularly challenging year of transition for the organization. The chairman was coming to the end of his third three-year term and everyone thought he would have to go off the Board because of the term limit in the bylaws.

Fortunately for the organization, the term limit was 10 years, not three terms, and the Chair could be reelected to a fourth term. Although he would have to leave at the end of the next year, he would be able to lead the group during the transition.

It was just another instance in which arbitrary limits on Board service could have hurt an organization. It was typical of the type of question we get on a regular basis, when Boards ask for help to avoid losing some of their best people because of term limits. It is one of the reasons we don't put term limits in the form of bylaws we suggest for clients creating new organizations.

Most of the "good governance" commentators believe that term limits are necessary for all nonprofits. Term limits are required, they say, to keep the Board fresh, to keep new blood and new interest in the organization, and to avoid the "dead wood" that piles up when people stay too long.

We take a distinctly opposite minority position. We think the primary reason most people like term limits is so that they don't have to ask the "dead wood" directors to leave the Board. It gives a convenient way to let them go without risking confrontation.

Term limits necessarily cost organizations some of their best people. Even when the bylaws allow them to come back on the Board after a year or so, many move on to other endeavors and are never heard from again. It is certainly not clear that the organization is better off for the loss.

But term limits have other significant, if less visible, repercussions.

One of the most significant questions about a nonprofit organization, in our view, is the question "Whose organization is it?" (See Ready Reference Page: "The Key Question: Whose Organization Is It?") We think that those with a significant stake in the outcomes of the organization ought to be represented on the Board, probably with representatives of their own choice. Term limits can upset that balance.

Should the founder be required to rotate off the Board because eight years have passed since the organization was created? Should the organization's best advocate be forced off the Board after nine years? Should the Archbishop of the Diocese be forced off the Board because he has held office more than six years? Should the members of a membership association be required to elect new representatives even when they want to continue those who have served well for several terms?

One of the critical factors that affects the success of a nonprofit organization is the balance between the executive director and the Board. If there is too much Board turnover too quickly, the organization may effectively become the executive director's organization.

We were once asked to review the situation of a federally funded inner city health care organization after the executive director had run off with much of the money. In reviewing the bylaws, we saw that members of the Board were to serve for one three-year term, and only in exceptional circumstances remain for an additional three years. Who could possibly figure out federal funding for health care in enough time to act as a check or balance against the executive director?

The rapid turnover on term-limited Boards causes the organization to lose its institutional memory. The "old timers" may have been around only six or seven years. They may have no recollection of why something is done the way it is. The Executive Director may have served longer than any of them and have the only institutional memory for the discussion.

If there are term limits, the Board is forced to recruit and orient a relatively large number of new members to the history and mission of the organization. It may be difficult to continually find groups of committed new members, especially if the cause is not popular.

It takes time to develop the knowledge and experience to provide appropriate leadership for Boards of nonprofits. It may take longer if the Board does not meet very often (like a college), or if the organization is complex (like a health care system). By the time a director is ready to serve as chair of the Board, his or her term may be about to expire.

In part because of required turnover, Board chairs of most nonprofits change extraordinarily frequently. Many change every year. That turnover means the chief executive has to learn a new way of doing business every time there is a new Board chair. The continuity of program is sacrificed as each new leader tries to put his or her stamp on the activities of the organization.

Nonprofits are always being told to act more like businesses. While there are many reasons not to take that admonition too seriously (See Ready Reference Page: "A Corporate Mentality in the Board Room."), there is at least one reason to pay some attention. Most businesses do not have term limits on their boards. Virtually no business experiences the type of regular change and disruption that is a constant feature of nonprofit governance.

Since there are significant negatives from imposing term limits, nonprofits need to find other ways to deal with the perceived risks of not having limits.

Natural attrition from relocations, retirements, or change in interests will make many seats available. Maintaining appropriate diversity on the Board will help assure that different experience and perspectives are brought to bear on issues facing the organization. (See Ready Reference Page: Boards Should Build Diversity for Maximum Performance.") Developing advisory committees, doing performance evaluations, or surveying for client satisfaction can all help bring in new ideas and improve performance—without having anything to do with term limits.

But nonprofits can also avoid the "dead wood" issue, and keep their best people, if they engage in regular Board self-assessment. (See Ready Reference Page: "Boards Should Assess Their Own Performance.") The very act of looking at Board service will cause some to drop off if they are not able to participate adequately.

Ironically, having term limits may actually make it easier to avoid looking carefully at participation. If a director will have to go off the Board in a couple of years anyway, it may be easier just to let that director slide.

It may be difficult to ask a director to leave. But if a Board can't face that issue, how well will it do if it has to consider firing the executive director? A highly functioning Board may be required to make tough decisions.

We urge Boards to interview every candidate for a Board seat, including those who may want to continue. Ask those up for re-election what they think the major issues facing the organization will be during their next term. Ask them how they will help work on those issues.

If the answers are not satisfactory, say thanks for your service and look elsewhere. If the person has been contributing significantly and can help in the future, say thanks, please serve another term. If someone promises to do things and doesn't follow through, talk to that person during the new term.

We recognize that it is hard work to follow this process, and that it may be difficult to say thank you and good by. But if a major reason to have term limits is to avoid this work and these occasional awkward moments, those term limits are for cowards.

READY REFERENCE PAGE

NO. 88
FOR YOUR FILE

IRS Issues New Guidance on Electioneering

Service has promoted educational efforts
to avoid uncertainty for charities during election cycles

The Internal Revenue Service has issued a formal Revenue Ruling (Rev. Rul. 2007-41) to provide guidance to charities on conduct that it will interpret as participation in a political campaign. Based in part on situations examined after the 2004 election and first issued as a Fact Sheet in 2006, the document is intended to help charities understand what they can and cannot do during an election campaign.

Section 501(c)(3) of the Tax Code prohibits a charity from participating in a political campaign. (See Ready Reference Page: "Charities May Not Participate in Elections.") But the IRS said it found many charities, including churches, confused about the limits during its investigation of the 2004 election cycle. (See "IRS Revokes 3 Exemptions for Electioneering; Will Continue Monitoring During '06 Elections.")

"Political campaign intervention includes any and all activities that favor or oppose one or more candidates for public office" at any level, the IRS said. "The prohibition extends beyond candidate endorsements. Contributions to political campaign funds or public statements of position (verbal or written) made by or on behalf of an organization in favor of or in opposition to any candidate for public office clearly violate the prohibition on political campaign intervention."

Distribution of statements prepared by others that favor or oppose a candidate are also prohibited. Allowing a candidate to use an organization's assets or facilities will also violate the limit if other candidates are not given an equivalent opportunity. Voter registration and get-out-the-vote activities are permissible so long as they don't favor or oppose a candidate. Many determinations will be made on a "facts and circumstances" review of the entire situation, it said.

The IRS illustrated its principles with many examples.

Individual Activity by Charity Leaders

The statute "is not intended to restrict free expression on political matters by leaders of organizations speaking for themselves, as individuals," the IRS said. "Nor are leaders prohibited from speaking about important issues of public policy. However, for their organizations to remain tax-exempt under section 501(c)(3), leaders cannot make partisan comments in official organization publications or at official functions of the organization." In addition, the Service says leaders "are encouraged to clearly indicate that their comments are personal and not intended to represent the view of the organization."

Where a charity CEO personally endorses a candidate as one of five prominent leaders in a full-page ad in the local newspaper which states that "titles and affiliations of each individual are provided for identification purposes only," the charity did not contribute to the cost of the ad, and it was not in an official publication of the charity, the ad does not constitute participation.

Where a university president endorses a candidate in a regular "My Views" column in a monthly alumni newsletter, the endorsement in an official publication constitutes intervention even when the president paid for the cost of the publication personally.

A minister endorsing a candidate at a press conference at a candidate's headquarters is not engaged in improper participation where there is no indication that the church endorses the candidate. But where the chair of the Board of a conservation organization urges members to vote for a candidate at a regular

meeting of the organization, the organization is considered to have intervened since the personal endorsement was made at an "official" meeting of the organization.

Candidate Appearances

Candidate appearances may demand more analysis under the "facts and circumstances" test. The IRS warns charities not to blindly accept the reassurance of a candidate that an activity is appropriate. The candidate "may not be familiar with the organization's tax-exempt status," the IRS says charitably, and "may be focused on compliance with the election laws that apply to the candidate's campaign rather than the federal tax law that applies to the organization."

When a candidate is invited to speak at an organization event as a political candidate, the Service says the organization should ensure that it provides equal opportunity to other candidates for the same office, it does not indicate support for or opposition to any of the candidate, and no political fundraising occurs.

A charity will not be likely to be deemed to have offered equal opportunity if one candidate is invited to speak at the organization's "well attended annual banquet" and the other at a "sparsely attended general meeting."

Even with public forums with multiple candidates, the IRS would inquire whether questions are prepared by an independent nonpartisan panel, whether the forum covers a broad range of topics and not only the field of interest to the organization, and whether the candidates are asked whether they agree or disagree with positions taken by the organization.

In its examples, the IRS says inviting candidates to address the group separately in regular meetings for three consecutive weeks is okay when they are all publicly announced and there is no indication at any meeting of support or opposition for particular candidates. If there are four candidates and one turns down the opportunity to speak, an event can continue with the other three and a statement that the fourth declined.

If a minister allows a candidate to speak the Sunday before election without inviting the opponent and the candidate urges the congregation to "go the extra mile" to get a big turnout, the activities are considered intervention by the church because it is an official activity.

Candidates may appear in a non-candidate capacity and it will not be deemed to be an intervention if the individual is chosen to speak solely for reasons other than the candidacy, the individual speaks only in a non-candidate capacity, neither the individual nor any representative of the organization mentions the election, no campaign activity occurs, and the organization maintains a non-partisan atmosphere at the event.

The IRS gives some examples of the application of this rule. Where the president of the organization traditionally recognizes any public officials in the audience, recognition of a public official, without mention of the candidacy, is permissible. A hospital may ask the local member of Congress to participate in a groundbreaking for a new facility so long as nothing is said about the election. A university alumni magazine may include a statement that alum X of the class of 'xx is running for mayor of Metropolis in a class notes column without being deemed to participate in the election so long as there is no campaign material other than the simple statement of fact.

But if the Mayor attends a symphony concert and the chair of the Board tells the audience that "we will need his help if we want these concerts to continue next year so please support the Mayor in November as he has supported us," the organization has crossed the line.

Issue Advocacy vs. Intervention

The IRS also takes the position that certain issue advocacy can result in intervention in a political cam-

paign if there is any message favoring or opposing a candidate, even if it does not expressly tell an audience to vote for or against the candidate. This area is even more problematic and subject to “facts and circumstances” analysis. The Service has previously issued guidance on activities that cause a nonprofit to engage in political activity under Section 527. (See Ready Reference page: “IRS Gives Guidance on Advertisements That Constitute Section 527 Political Activity.”)

Factors include whether a communication identifies one or more candidates, expresses approval or disapproval of a candidate’s position, is delivered close to an election, makes reference to voting, addresses an issue distinguishing the candidates, is made as part of a continuing series of communications unrelated to election cycles, or is related to a non-electoral event such as a scheduled vote on specific legislation.

A university’s advertisement urging voters to call or write an incumbent who has opposed funding for education is okay, even shortly before the election, if the ad does not call attention to the election, the issues are not distinguishing in the campaign, and the ad is directly related to a scheduled vote. But a radio ad urging an increase in state funding for public education shortly before an election in which the governor is a candidate for re-election, asking voters to tell the Governor what they think about underfunded schools, is not part of an ongoing series, and is not related to any non-election event is considered participation.

Voter Guides and Business Activity

In the 2006 Fact Sheet the Service said voter guides may violate the prohibition if they focus “on a single issue or narrow range of issues, or if the questions are structured to reflect bias.” This is the position taken in Rev. Ruls. 78-248 and 80-282 which apparently have never been tested in the courts. (See Ready Reference Page: “Charities May Not Participate in Elections.”) This material was not carried forward to the final Revenue Ruling but is probably still the position of the IRS.

The IRS notes that if a charity distributes a voters guide prepared by another entity, the distributing charity is responsible for the distribution and will be deemed to have participated in a campaign if the guide is biased.

A charity can also get into trouble making goods or services, particularly facilities or mailing lists, available to candidates unless they are equally available to all at customary and usual rates and not available only for a particular candidate.

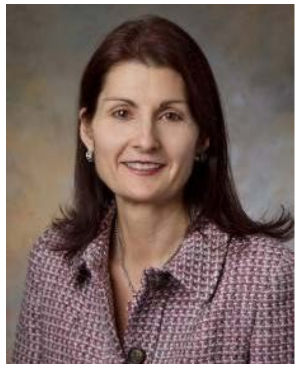
Renting a hall generally available to the public at the standard rate is not political intervention, but renting a mailing list at prevailing rates to one candidate while denying it to others would be participation. (The IRS does not say anything about renting to one candidate when the other never asks.)

Internet websites also come under scrutiny, not only for what is on the organization’s own site but also for what is on a site linked from the charity.

Links to all candidates’ websites are permitted if presented “in a neutral unbiased manner.” Links to a newspaper article praising the work of the charity is not a political intervention even though the newspaper’s site may contain editorials endorsing candidates in pending elections. A statement on a church website urging members to “lend your support” to “your fellow parishioner” is clearly intervention on an official site.

Finally, the Service warns that even though the examples are described separately, “where there is a combination of activities, the interaction among them may affect whether or not the organization is engaged in political campaign intervention.” In other words, the whole may be greater than the sum of the parts.

Jeannie C. Frey, Speaker



Jeannie C. Frey is Chief Legal Officer and General Counsel of Presence Health, an Illinois-based nonprofit healthcare system, including 12 hospitals, over 25 nursing and senior care facilities, physician practices and other healthcare providers. Ms. Frey was previously General Counsel of Resurrection Health Care, a predecessor system of Presence Health. Ms. Frey was formerly a partner in the Chicago office of McDermott, Will & Emery, where she specialized in health care law, nonprofit mergers and acquisitions, and corporate governance. Ms. Frey has written and spoken widely on topics relating to health care and nonprofit organizations. She served as co-editor of the 2nd and 3rd editions of the *Guidebook for Directors of Nonprofit Corporations* (ABA 2002, 2012), the primary author of *Guide to Nonprofit Corporate Governance in the Wake of Sarbanes-Oxley* (ABA 2005), and Executive Editor of the *Nonprofit Management and Governance (3rd Ed.)* (ABA 2011). Ms. Frey has a B.A. degree from the University of Colorado, Boulder, and a Juris Doctorate degree from Yale Law School.

be provided to the board regarding both current operating results and future challenges and opportunities.

The Practical Advice Section of this Chapter has specific suggestions for how board and management leaders might work together on governance issues and also lists a number of matters to keep in mind in attempting to make governance changes. See pages 23–27.

Board Basics

Role of the Board in General

Decision-Making, Oversight and Advice, Leadership. Every corporation has a board of directors with the primary functions of major decision-making, overseeing and advising, and providing leadership to management and the organization. It is by the exercise of these functions that the nonprofit board helps assure that the entity achieves its mission and fulfills its obligations under the law to its donors, its staff and volunteers, its clients, and the public.

Decision-making functions of nonprofit boards most often include:

- Shaping, and if necessary, revising the nonprofit's mission;
- Setting strategy and goals for the organization;
- Determining and approving major organizational policies;
- Hiring, evaluating, and, if necessary, terminating the Executive Officer;
- Delegating authority to board committees for specific governance oversight and decisions in certain areas (such as finance, executive compensation, or compliance);
- Delegating appropriate levels of operational and decisional authority to management;
- Approving budgets, major expenditures, and the acquisition or disposition of major assets; and
- Setting policies and procedures for enhancing and evaluating the board's own performance.

Oversight and advice functions of nonprofit boards typically include:

- Evaluating how well the nonprofit's operations fulfill its mission;
- Monitoring financial performance and projections and use of assets;
- Evaluating the adequacy of internal controls and financial reporting;
- Overseeing and reviewing management performance;

- Reviewing performance measures for the organization's programs and goals;
- Overseeing functions that support compliance with legal obligations and organizational policies;
- Evaluating risks to the organization and its mission;
- Evaluating trends that may affect the organization's ability to fulfill its mission and serve its intended class of beneficiaries;
- Making suggestions and providing advice based on experience; and
- Serving as a sounding board for management ideas.

Leadership functions of nonprofit boards include:

- Serving as an advocate for the organization and its mission;
- Bringing creativity, experience, personal good judgment, common sense, and integrity to board deliberations and other work as directors;
- Supporting and advising the Executive Officer and other senior staff without micromanaging; and
- For nonprofits that are tax-exempt charitable organizations, personal participation in fund-raising and personal donations to the organization at a leadership level.

Operating or Governing Boards. Boards are sometimes categorized as either "operating boards" or "governing boards." These terms can be misleading. All boards govern; that is their role. However, especially with smaller nonprofit organizations having minimal professional staff and resources, individual board members or other members of the organization may also assume certain managerial roles. In such cases, the governing and management roles of board members may become blurred, and members of a so-called operating board may essentially function as an executive management committee of the nonprofit, handling day-to-day decisions. Even in organizations in which the nonprofit board does function more as a governance-oriented body, a crisis may induce or require the board to become involved in operational decisions that normally would be delegated to management. In effect, board members of operating boards are playing two roles: that of management and that of board member, and it can be difficult for board members to keep separate their board/governance role and their management/operational role.

More typically, directors are not engaged in actual delivery of services, and directors do not function as members of management. Most nonprofit boards function primarily as oversight or governing boards which engage in decision-making, oversight, and leadership, but delegate implementation of board decisions, as well as day-to-day operational decision-making and management, to the nonprofit's Executive Officer and staff. The board is thereby able to focus on overseeing the nonprofit's ability to deliver its mission and sustain itself over time. While governing boards do affect the day-to-day operations of the organization, they do so by such activities as periodic review of the mission,

setting strategy, approving budgets, monitoring risk, fund-raising, and hiring, evaluating, and, if necessary, removing the Executive Officer.

Importance of Understanding the Board's Role. The role distinctions between governing and operating boards are not always easy to make. Management concerns about micromanagement by the board and board perceptions of management's desire to control the organization without "interference" or guidance from board members tend to stem from misunderstandings about the appropriate role of the board and management. Frequent and candid communication between the board—in particular the Board Chair—and the Executive Officer can help reduce such misunderstanding, defuse potentially explosive situations, and strengthen the supportive functions of the board for management and of management for the board.

Member Organizations. A nonprofit may have a member or members who have various voting rights. Members may have the right to elect the directors or the right to vote on or to approve certain matters set forth under state law or in the articles of incorporation or bylaws of the nonprofit. These rights often are referred to as "reserved powers." These members may be individuals, as is common in trade associations, or other nonprofits, as is common with membership organizations formed by hospital systems and colleges and universities. With respect to nonprofits with a single nonprofit member, the nonprofit's bylaws often specify who has the authority to act on behalf of the sole member (board, committee, Executive Officer), and the mechanism for the member to take such action.

The Practical Advice Section of this Chapter suggests a number of issues for Board Chairs and Executive Officers to discuss on the topic of governance. ***See pages 24–26.***

Collective vs. Individual Action of Directors

Collective Action. A board acts as a collective body. If a quorum is present, typically a majority vote will decide an issue, absent a state law or bylaw requirement of a greater than majority vote. A director may dissent or vote "no," but once the majority has made a decision, the organization and all its directors, staff, and other agents are bound by the decision of the majority.

Collegiality and Dissent. Collegiality and shared values can be important factors in effective governance, but collegiality does not preclude discussion and dissent. In many nonprofit organizations, there is a strong but sometimes unstated bias against decisions that are not supported at least apparently by all or substantially all board members.

One key function of the Board Chair is to make sure that all directors are comfortable articulating dissenting views and to encourage board members to consider all perspectives, even if some perspectives appear to be held by only a small percentage of voting directors. However, significant dissent, or continued actions in opposition by board members unable to support a majority decision once it has occurred, may indicate a serious problem that needs to be addressed.

Board retreats, strategic planning sessions, use of outside advisors, board self-evaluations, and individual director evaluations are all tools that can be employed to help create a more cohesive board. Nonetheless, from time to time, board and management leaders may need to consider if one or more board members are in such conflict with the other directors that the board's overall effectiveness is undermined. Addressing such situations requires courage, sensitivity, and diplomacy, especially from Board Chairs and Executive Officers. Failing to address clear or growing problems of internal board dissent may result in adverse, and occasionally devastating, effects on the organization's ability to fulfill its mission.

Apparent Authority. An individual director is not legally empowered, as a director, to sign contracts, enter into agreements, or take other individual action that is binding on the organization, unless that action has been authorized as required by law and the appropriate procedures of the nonprofit. However, there may be circumstances in which an individual board member takes action or agrees to do something on behalf of the nonprofit which the other party to the transaction believes the director has authority to undertake. In such event, the other party is said to be relying on the apparent authority of the board member holding himself or herself out as authorized to speak or act for the organization, and the nonprofit may find itself obligated to the other party even if the director's action was not appropriately authorized.

Avoiding instances of apparent authority may best be accomplished by periodically reminding board members that their governance role does not permit them to hold themselves out as representing the board or the organization unless the board has specifically delegated such authority to them. Operating boards in which directors exercise both governance and managerial authority may especially need to clarify the extent of a board member's authority when acting in a managerial capacity. Apparent authority issues often arise with a founder or "heart of gold" board member who so identifies with the organization that outside parties assume that the director has authority to speak for or bind the organization.

Basic Legal Duties of Directors

Fiduciary Duties. Directors, whether of for-profit or nonprofit organizations, are considered fiduciaries who owe two core duties to the organization: the

Practical Advice on Governance Basics

Practical Realities

There are a number of practical considerations to take into account in shaping the governance practices of a nonprofit:

- Governance practices of an entity reflect its origins and traditions, as well as decisions and philosophy about the allocation of responsibility and influence for decisions affecting the organization and its operations.
- Any significant change in an organization's governance structure can be difficult and may cause internal disruption.
- Changes to governance structures and practices may have political or social implications, since such changes (such as imposition of term limits, changes in delegated authority, revisions to committee structures, or modifications to board meetings or materials) may affect individual board members or members of management who may view such changes as a personal affront or as a negative statement on past practices.
- Good governance is not something static that can be achieved through bylaw provisions and policies that are put in place and then forgotten. Achieving and maintaining good governance requires continued attention and refinement.
- Good governance does not necessarily require immediate major changes to board operations or adoption of totally different policies and procedures. While sometimes a nonprofit will determine that significant changes in governance structures are required within a short period, more often good governance structures and practices evolve over time through regular reviews of board effectiveness. Such reviews typically result in incremental changes and, as important, help build openness and support among board and staff for a regular, transparent process for adoption of revised or new practices.
- One size does not fit all. Certain governance structures and practices may be quite effective in some organizations and less so in others, but despite this fact, some choices may be viewed more favorably than others by various constituents of an organization or by certain governance experts.

State nonprofit laws typically require that nonprofit corporations have a board with overall responsibility for the organization and have certain specified officer positions (the titles of which may vary), although neither board nor officer duties are typically specified in other than the broadest terms. Also,

for nonprofits with members, state nonprofit laws typically reserve certain powers to the members of the nonprofit.

Recently, some states have mandated specific governance practices. California, for example, requires nonprofits with income over $2 million to have an audit committee and requires board or committee approval of certain management salaries. However, relatively few governance practices are mandated by law, which leaves boards, Board Chairs, and Executive Officers with a great deal of flexibility to suggest structures and shape practices that are likely to work most effectively for the organization. The following points may be useful to keep in mind when reviewing an organization's governance structure and practices:

- There is no universally agreed upon set of "best practices" for board governance, but there are many governance trends and suggestions that are useful to consider, many of which are widely recommended by commentators and regulators and have been adopted by numerous for-profit and nonprofit boards as well.

- Organizations that ignore governance trends may be viewed, fairly or unfairly, as less effective, out-of-step, and as taking legal and operational risks, making it harder to attract needed board members, management, donors, or other funders. Additionally, these organizations may attract unwanted and distracting scrutiny from regulators or the press which may draw unflattering parallels with nonprofit organizations that have experienced high-profile scandals.

- Some governance practices and trends have, particularly recently, been included in various state and federal laws or inserted in regulatory applications for nonprofit status or highlighted for discussion in annual report or informational returns such as the IRS Form 990.

- A list of governance issues that many organizations and commentators consider important to consider is contained in Chapter 3. In addition to the suggestions contained in this text, there are a number of other sources of information that can be helpful to boards, Executive Officers, and Board Chairs seeking to improve the governance of their organization.

Appendix 3 has a partial list of additional sources of information about evolving governance practices and standards for nonprofits.

Beginning Discussions About Governance

There are many ways to start a review of an organization's governance structures and practices: the Executive Officer and Board Chair might review and discuss governance issues together; a committee of the board might be charged with comparing the organization's practices to governance trends; the board might conduct a self-evaluation, or use a consultant to conduct a board effectiveness review.

Perhaps the easiest way to begin discussions about governance issues and how well a particular nonprofit is governed is for the Executive Officer and the Board Chair to consider and discuss the types of questions and issues listed below. The critical points of such conversations are to raise the issues, identify and discuss any differences of opinion between how the Board Chair and the Executive Officer may view governance matters, and determine whether changes in governance are needed or may be helpful. The Board Chair and the Executive Officer can then discuss how best to bring about any such changes, including how and when to engage board members or a board committee in the process. However, because of the fundamental importance of governance matters to board performance, it is important for the board or a board committee to become involved as soon as practical.

There are a variety of topics and questions to consider in getting started.

- Do the amount of time and effort spent on board, and in particular governance, matters by the Chair and the Executive Officer move the mission of the nonprofit forward?
- How much of the board's time is devoted to strategic matters and major decision-making, oversight/advising, and leadership? Is the relative amount of time spent on each of these activities appropriate to the organization's needs and do these efforts move the organization's mission forward?
- What role does the board play in the nonprofit organization: Boss? Active/Passive Consultant? Cheerleader and Fund-raiser? Partner? Leader? A combination of all of the above? Might changing the mix or the emphasis on these different roles make the board more valuable to the nonprofit and assist in achieving the organization's mission?
- In a nonprofit with members, what role do the members play? How do members view the actions of the board or other policy-making body (such as a house of delegates)? How do the members interface with the board? With the Executive Officer? With the rest of the staff?
- Are the amount of time and degree of effort spent by board members and by staff on board matters, including work in committees, sufficient to provide effective oversight and direction? Do they provide value and aid in achieving the mission?
- Does the board understand and appreciate the nonprofit's mission and accomplishments?

- Does the staff understand and value the board's oversight and governance?
- How would other board and staff members respond to the above questions?
- Is there a difference between how the board currently operates and how boards of other similarly situated nonprofit organizations appear to operate, or between how the board operates and the societal/constituent expectations of how the board should operate?
- Have board members, or members of the nonprofit if there are members, suggested that the governance process and procedures are lacking in some significant way or recommended other than minor changes?
- Does the board have appropriate and effective committees?
- Does the board have a committee charged with oversight of the board's governance practices, and if so, is it functioning effectively? If such a committee does not exist, would one be helpful to the organization? If there is such a committee, but it isn't functioning well, what changes in its function or membership might help make it more effective?
- Do board members understand their legal responsibilities and liabilities as well as current governance trends for nonprofits? Is there an effective initial and continuing education program for board members in governance matters?

Basic Practices That Can Help Directors Understand and Meet Their Duties of Care and Loyalty and Help Provide Protection of the Business Judgment Rule

The Executive Officer and Board Chair can help directors satisfy their legal responsibilities, reduce the possibility of challenge to board decisions, and improve the board's defense of its decision-making process, if challenged, by actions such as the following:

- Actively encouraging all directors to attend board meetings and meetings of the committees on which they serve;
- Providing presentations that help educate the board on the scope of operations and the issues and challenges that the organization faces;
- Scheduling mission-critical matters for discussion at board or committee meetings or at board retreats;
- Providing the board and its committees with information that is relevant, accurate, succinct, clear, easy to understand, and free of technical jargon;
- Providing the board and its committees on a regular basis with information and background material well in advance of meetings to allow time for review;

- Prioritizing agenda items so there is sufficient time for major issues to be adequately discussed;
- Allowing adequate time at board and committee meetings for members to ask questions and discuss issues;
- Allowing time for executive sessions of the board on a regular basis;
- Creating an atmosphere at board meetings that welcomes questions and does not shrink from challenges, without encouraging irrelevant digressions;
- Enforcing a board-adopted conflict of interest policy, including requiring board members to leave the room during discussions of matters in which they have a conflict;
- Providing formal written resolutions as well as less formal descriptions of actions to be approved to help ensure that board and committee members fully understand the action they are being asked to take;
- Ensuring that accurate minutes of all meetings are maintained and taking the time to read each set of minutes before they are sent out to board members;
- Distributing minutes promptly to board and committee members, including those not present at the meeting;
- Distributing committee minutes, or a summary of committee actions, to the full board as soon as practicable;
- Ensuring that minutes are filed and accessible for future reference and in the event of litigation or a regulatory investigation;
- Creating a document describing general expectations for board members (such as regular attendance at board meetings, adequate preparation for meetings, constructive participation in board discussions, disclosure of conflicts of interest, etc.) which is approved by the board, and periodically redistributed to each board member and discussed at board meetings;
- Including discussion of board member duties and rights and the potential for liability in board member orientation meetings and materials, and reviewing such matters periodically at board and committee meetings or retreats or special educational sessions;
- Making board members aware of some of the publications, many of them free, that cover such matters as board member liability and other issues to help board members understand their roles; and
- Encouraging board member attendance at director training programs offered by outside groups.

Indemnification and Insurance to Protect Directors

Make It Easy to Understand. Once directors understand that there is the potential for personal liability for their actions or failure to act, they typically want assurance that indemnification and insurance are available to help protect them.

- Orientation meetings and materials can be used to inform board members of the protection offered by the organization's indemnification and insurance arrangements.
- Brief, plain English summaries of indemnification, insurance coverage, and legal protections against liability can be helpful to board members, as these issues can be difficult to understand as presented in organizational, legal, or insurance documents. Legal counsel and insurance agents are often willing to assist in reviewing such summaries for accuracy.

Particular Issues. In providing information on indemnification and insurance, it may be helpful to highlight the following issues:

- Under what circumstances is the nonprofit required to indemnify a director, officer, employee, volunteer, or member?
- Under what circumstances may the nonprofit choose whether or not to indemnify a director, officer, employee, volunteer, or member?
- Under what circumstances is the nonprofit required to advance certain litigation expenses to a director or to others?
- Under what circumstances may the nonprofit choose to advance certain litigation expenses to a director or to others?
- What findings and actions are required for the board to indemnify or advance expenses?
- Under what circumstances might a board member or another person be required to reimburse the nonprofit for expenses advanced by the nonprofit?
- Which laws and legal documents specify the organization's indemnification obligations: state nonprofit corporation act, the organization's own articles/charter, its bylaws, individual contracts, or a combination of these?
- How frequently does legal counsel review the nonprofit's indemnification arrangements?
- What is the process for assuring that indemnification provisions remain current?
- Has the organization purchased insurance to cover matters that are or cannot be covered by indemnification?
- Does the insurance coverage also extend to spouses or others who might be sued, including the estate of the board member?
- Are employment practices covered? Are there specific processes that need to be followed to obtain this coverage?
- Is service on affiliated boards covered?

- Has the board or a board committee reviewed the organization's D&O coverage limits, deductibles, co-insurance requirements, and premiums and determined that the insurance coverage obtained covers necessary risks and was and remains at a cost that is competitive and that the nonprofit can afford?
- Is the insurer well-rated and is the rating reviewed periodically? (From time to time, especially in times of national or global economic distress, solvency of insurers can become a significant issue.)
- What information is available on the insurer's record of payment under similar policies and have similar nonprofit organizations been satisfied with the insurer's handling of claims made? (Often insurance brokers and litigation attorneys who have defended nonprofit organizations are good sources of information on an insurer's reputation and the experience of similar organizations when a claim was made.)
- Has the organization requested bids from other insurers to evaluate whether the current carrier's coverage is the best option?
- If the organization does not have D&O liability insurance, does the organization have sufficient financial resources to satisfy potential indemnification claims or obligations?

Role of the Board Chair

Leadership Considerations. Leadership by the Board Chair is critical to effective governance. It is important for the board and the person holding, or being considered for, the position of Chair to weigh carefully both the current needs of the organization and the skills of the Chair to make sure they are compatible. The Board Chair also needs to understand and be responsive to the views and expectations of other board members and to work with them to enhance their effectiveness. The following points may be helpful to consider in selecting a Board Chair:

- Not everyone is suited to be a Board Chair and even someone with strong leadership and interpersonal skills may not be the right person for the job at a particular time.
- Weaknesses in certain skills of the Board Chair can be compensated for, at least in part, by appointing other officers with a mix of the requisite skills.
- Creating a job description for the Board Chair can be helpful in assuring compatibility between organizational needs and individual skills, although this task is not easy and typically requires a careful review of how the board is currently functioning as well as a review of organizational leadership priorities.
- Although a board committee charged with governance matters or the nominating committee might be a logical place for initial development of

a written job description for the Chair, input from the Executive Officer and former Chairs is also valuable.

- Because organizational and board leadership needs may change, a written job description for the Board Chair requires regular review to determine if modifications or changes in emphasis are needed.

Appendix 4 has two sample Board Chair job descriptions.

Factors for Board Chairs and Prospective Board Chairs to Consider. Because the role of Board Chair varies greatly among organizations, it is particularly important that the Chair or someone considering a Chair position consider a number of factors before agreeing to become or to continue as Chair. Here are some practical questions that may be helpful to consider, regardless of the size or type of organization:

- ***Importance.*** Is your leadership of this organization something personally or professionally important to you, and if so, why? Are your reasons for considering the position consistent with the organization's aims and mission?

- ***Time.*** How much time are you willing and realistically able to devote to the organization during the anticipated term? Is the time you have available consistent with the organization's expectations and needs?

- ***Skills Needed.*** What skills does the organization need from its Board Chair?
  - Does it need a public face/advocate in the community, a fund-raiser, a governance expert, someone to reinvent the board, a financial expert, or a turn-around expert?
  - Are your skills and what you want to accomplish as Board Chair a good match for the organization's current needs?

- ***Scope of Job.*** Is it feasible for the various duties of the Chair to be divided between a Chair and another officer, or might some duties be formally delegated to one or more Vice Chairs or Vice Presidents? Is delegation or division of labor consistent with your leadership style and with the nature and tradition of the organization?

- ***Financial Commitment.*** If the organization raises funds, are you prepared to make a personal financial donation at a leadership level, and will the level of your donation be considered adequate by the organization for its Board Chair?

- ***Type of Board.*** Is the board functioning as an operating board or a governance board, and is its form of operation consistent with your view of the governance leadership role needed by the organization and with your own governance views?

- ***Needs of the Organization.*** What does the organization need most from its board and its board leadership at this time?
  - Is the board structured to provide for the organization's current needs?
  - If you believe there is a gap between what the organization needs and what it has, are you willing to assume the responsibility of leading a restructuring of the board, its membership, or its operations?
- ***Board Composition.*** What is the composition of the board?
  - Are the board members independent of management?
  - Is the board as a whole and are individual board members functioning effectively?
  - If there are weaknesses in board composition, are you willing to ask people to resign? Will your influence be helpful in attracting new board members?
- ***Support from Board Members.*** Are there individuals on the board on whom you can rely to support your leadership efforts or, conversely, are there individuals on the board who might undermine or resist your leadership?
- ***Support from Members of the Nonprofit.*** If the nonprofit has members, are there individual members, or groups of members, on whom you can rely to support your leadership efforts or, conversely, are there individual members or groups of members who might undermine or resist your leadership?
- ***Relationship with the Executive Officer.*** Are you comfortable with the Executive Officer's leadership? Do you have a good working relationship with the Executive Officer or do you perceive that there may be impediments to your being able to work together well and develop trust?
- ***Relationship with Affiliates.*** Do you understand the relationship between the nonprofit and any affiliated or fund-raising organizations that support your programs or operations? Are you comfortable with the leadership of such affiliated organizations or are there impediments to your being able to work together with their leadership?
- ***Understanding Operations.*** Do you understand the nonprofit's operations and financial status sufficiently to be able to assume a board leadership role with respect to operations and governance?
- ***Tolerance for Criticism.*** Do you feel you are able to take constructive criticism from fellow board members and the Executive Officer? Are you willing to modify your leadership to address criticisms?
- ***Administrative Support.*** Do you feel that you will require administrative support from the organization and, if so, is it available? If you are required to provide your own administrative support, do you have the resources to do so?

Role of the Executive Officer

Helping to Shape Board Governance. Many Executive Officers mistakenly view board governance matters as something of concern only to the board. Whether or not the Executive Officer is a board member, effective board functioning is a matter that can affect the Executive Officer's ability to manage the organization. The Executive Officer, as the senior organizational executive, is well-positioned to identify strengths and weaknesses in board operations. There are a number of ways in which the Executive Officer can assist in shaping and improving board governance:

- ***Discussions with the Board Leadership.*** One important way in which the Executive Officer can help shape board governance is simply by being frank with board leadership if he or she believes that the current board:
  - Does not appear to add value or provide adequate leadership;
  - Does not seem to understand the organization or its mission;
  - Is not uniformly interested in or supportive of the work of the organization;
  - Micromanages or requires an inordinate amount of staff time to respond to board requests for information or assistance; or
  - Spends too much time on minutiae and too little time on strategic matters.

These types of issues all indicate a need for a review of board effectiveness and usually signal that the board is not as effective as it might be or that the relationship between the board and the Executive Officer has deteriorated or needs attention. Whether in reality or just perception, if there appears to be disagreement between the Executive Officer and the board on these sorts of issues, it is important to have the differences brought out so that steps can be taken to work out any problems and better align perceptions and reality.

Sometimes the conduct of individual board members affects the functioning of the board negatively, or creates significant problems for management. The Executive Officer can also help shape board governance by pointing out such problems and working with board leadership to address them.

- ***Staying in Touch with Industry Trends.*** Since the Executive Officer is frequently a member of one or more associations of similar organizations, he or she can provide information to the Chair and other board leadership on how similar organizations are addressing governance issues and can report on recommendations on governance from associations to which the organization belongs.

- ***Working with a Corporate Secretary or Board Liaison.*** Another way in which an Executive Officer may affect board governance is by working with the Corporate Ssecretary or a board assistant or liaison who assumes these functions. A competent Corporate Secretary or board assistant can

be very helpful to the effective functioning of the board. He or she is often the main point of contact between the organization and its board members.

A Corporate Secretary or board assistant typically performs a number of important clerical and administrative duties, including:

- Maintaining and updating important and useful personal information about directors (e.g., contact information, date elected to the board, date term ends, number of terms on the board, past and present committee memberships, expertise, current employment, personal attributes related to board service criteria or needs, biographical information, and similar information);
- Helping to schedule meetings;
- Drafting meeting notices, sending them when approved, and tracking responses and actual attendance;
- Creating first drafts of agendas and finalizing them based on input from the Chair and Executive Officer;
- Collecting materials to be sent to directors in advance of meetings;
- Distributing meeting packages;
- Making arrangements for meeting locations and rooms and seeing that the arrangements are carried out;
- Collecting materials following the meeting to assure appropriate disposal;
- Taking minutes at meetings and creating a first draft for the Board Chair and others such as the Executive Officer, and perhaps other key directors or officers, to review;
- Maintaining the minute book, meeting files, and other board records;
- Providing other administrative assistance to the Board Chair; and
- Handling routine inquiries and requests from board members.

Diplomacy, attention to detail, good organizational and follow-up skills, and the ability to keep confidences are among the most important attributes of any individual assigned to this role.

In many nonprofits, the board assistant or liaison is the administrative assistant to the Executive Officer. Larger nonprofits may have a more senior person serving as the functional equivalent of a Corporate Secretary in the for-profit arena. Such an individual would typically occupy a senior position in management and would:

- Oversee the administrative tasks listed above;
- Serve as the principal focal point for communication between and among board members and senior management and many of the organization's other constituencies;
- Advise the Executive Officer and the board on governance trends;
- Assist the Executive Officer and Board Chair in developing substantive agendas;

- Help develop and review materials to be sent to the board;
- Assist the Executive Officer and Board Chair in the administration of critical matters related to governance, the board, and, in some cases, senior management; and
- Serve as a sounding board and confidant to the Executive Officer and Board Chair on governance and other matters related to the effective functioning of the board.

- ***Interacting with the Board and Relationship Building.*** Another way in which the Executive Officer assists with governance matters is through his or her interaction with board members. These interactions provide the Executive Officer an opportunity to understand individual board members' points of view, backgrounds, values, and concerns, and give board members an opportunity to understand the Executive Officer's vision and aspirations for the organization, his or her management style, and the problems or issues the Executive Officer faces in day-to-day management. This knowledge not only helps build the level of understanding between the board and the Executive Officer but may also create a level of trust which can be critical to board effectiveness.

  Relationship building between the Executive Officer and board members usually involves personal outreach on the part of the Executive Officer, finding opportunities for one-on-one or small group interaction with board members outside of regularly scheduled meetings. A level of comfort in these relationships does not happen overnight or only through board or committee meetings but takes continuous effort. The value of the effort is likely to be most evident when organizations face difficult decisions or problems. When individuals have spent the time on building relationships, important discussions are likely to be more productive.

  The Executive Officer can also work with the Board Chair and other management or board leadership to promote relationship building among board members. This may occur through formal and informal opportunities for groups of board members to spend time together, such as lunches, post-board meeting receptions or meals, board retreats, and board and management holiday gatherings.

Relationship Building Between the Board Chair and the Executive Officer

Building solid relationships between the Executive Officer and Board Chair often takes serious effort. Here are a few suggestions that may help:

Understand the Importance of Past History. Expectations are shaped by past history and traditions. When a new Board Chair or Executive Officer takes office, each will have expectations based on how each sees his or her

role and the role of the other, how such roles have been conducted in the past, and how each perceives such roles might need to change. Often such expectations are left unstated and their basis unexplored, particularly if the organization's founder is still involved in leadership. Acknowledging the potential importance of past history in creating expectations may help avoid misunderstandings and discomfort in building the Executive Officer-Board Chair relationship.

Build Mutual Understanding and Agree on the Roles. Establishing sound relationships can be greatly facilitated by mutual understanding and agreement as to the role the Board Chair and the Executive Officer are each to play in the organization and by agreement on the form and frequency of regular communication each expects from the other.

- ***Job Descriptions.*** Creating written job descriptions for both the Board Chair and the Executive Officer, if not already established, may be a good starting point.
- ***Diary.*** Maintaining a list of activities actually handled by the Board Chair may provide a useful picture of the actual Board Chair role, clarifying not only where the Board Chair is actually spending time, but also suggesting areas for which greater or lesser attention is needed.
  - Such a list can be maintained by either the Board Chair, the Executive Officer, or both. The Executive Officer might provide a log for the Board Chair which lists categories of typical activities, such as planning for board meetings, attendance at meetings, fund-raising, consultation with the Executive Officer, consultation with other board members, and review of information, and provides space for time expended.
  - Such a list can be given to subsequent Chairs and Executive Officers to help them understand past practices, or to help the board develop a written job description for the Chair, if none exists. The board or the Board Chair might also use such a list to consider reallocation of time spent in specific activities.
- ***Goals and Priorities.*** Creating a list of goals or priorities for both the Executive Officer and the Board Chair for the upcoming board year can also be helpful.
  - Priorities can be developed independently and then agreed upon after mutual discussion, or developed jointly by the Executive Officer and the Board Chair.
  - Recognizing and agreeing on areas of mutual interest or responsibility in which both the Board Chair and the Executive Officer would like to have input or some discussion before a decision is made can be helpful. While such agreement can be made in advance, often issues will surface that were not envisioned. Nonetheless, understanding each other's interests and priorities may help minimize problems in these situations.

- ***Form of Communication.*** Establishing agreement on frequency and preferred forms of communication (monthly, weekly, daily, in person, by e-mail, or by phone) can also be important to creating a sound working relationship between the Board Chair and the Executive Officer. Those who rely on e-mail may be surprised to find that others rarely use it. Those who dislike long voice mail messages may not listen to a long message.

Be Colleagues, Not Necessarily Friends. The Executive Officer and Board Chair need not be close friends, but their relationship will be more effective for the organization if they seek opportunities to build camaraderie and understanding.

- Too close a relationship between the Board Chair and the Executive Officer might, at some point, interfere with the ability of each to act in the best interests of the organization.
- Events and other opportunities outside of board-related events, such as social lunches or dinners, attendance at social events, traveling together to out-of-town meetings, and the like can assist in developing understanding and building trust that might otherwise take longer to create.

Give Constructive Feedback. Providing constructive feedback is critically important to building relationships of trust. Both Executive Officers and Board Chairs can profit by reviewing recommendations from human resources experts and others on how best to provide feedback. Such experts generally recommend a feedback process that:

- Provides recognition and praise for accomplishments;
- Gives specific information about what has worked well;
- Clearly indicates when the conversation is moving from discussing accomplishments to areas in which performance was different than expected, rather than switching the conversation abruptly or moving back and forth between discussions of strengths and weaknesses;
- Provides specific suggestions for improvement;
- Focuses on current and relevant issues, not old grievances;
- Is respectful to the individual being evaluated, even when there is disappointment in performance, and avoids personal attacks (for example, consider "I was disappointed" rather than "You disappointed me" or, "It's important for the organization that you do X…." rather than "You can't do Y");
- Takes word choices seriously and recognizes that neutral words can often be used in place of words with a more negative connotation yet achieve the same result (for example, consider "areas for focus" rather than "areas for improvement");
- Focuses on issues that are capable of improvement and avoids matters over which the individual has no control;

- Allows participants to engage in a conversation, rather than separate monologues, and encourages participants to listen to what the other individual has to say;
- Allows for comments and suggestions to be revised if it becomes clear that certain facts or assumptions were incorrect or misunderstood;
- Encourages the evaluator to take responsibility for assisting with needed changes, asking, for example, "What can I do to help you accomplish X"; and
- Ends by focusing again on accomplishments and strengths, as well as on next steps for addressing areas that need attention.

Alternative Methods of Surfacing Issues

Some Executive Officers and Board Chairs may find it personally difficult to criticize or confront issues with each other despite efforts to create an open atmosphere or to build trust. In such cases, board effectiveness studies and board member evaluations, which are discussed later in this publication, may provide ways to raise issues that might otherwise be left unstated and negatively affect the ability of the Board Chair and Executive Officer to work together effectively.

Anita Lichtblau, Speaker

Anita Lichtblau is a partner in the Nonprofit Organizations Law practice of Casner & Edwards, a Boston law firm which provides comprehensive legal advice to tax exempt organizations and businesses and individuals involved in nonprofit matters. Her areas of legal expertise include nonprofit formation and affiliations, governance, fundraising, lobbying and political activity, employment, and government and foundation grants and contracts.

Before joining Casner & Edwards, Anita served for fifteen years as both the General Counsel for Action for Boston Community Development (ABCD), a large nonprofit human services organization and Community Action Agency (CAA) that provides Head Start and other services to low-income people, and Executive Director of Community Action Program Legal Services (CAPLAW), a nonprofit providing legal training and technical assistance to the approximately 1000 CAAs across the country. In those positions, she advised, provided training, and wrote numerous articles and publications on many issues. She presented hundreds of in-person workshops and webinars across the national Community Action network.

Prior to holding those positions, Anita was a senior trial attorney with the United States Department of Justice handling white collar criminal cases in federal courts in New England and practiced with the Boston firm Hill & Barlow and the Washington D.C. firm Steptoe & Johnson. Anita is a graduate of Harvard Law School and Cornell University.

TAX-EXEMPT NONPROFITS: LOBBYING FROM THE FEDERAL LAW PERSPECTIVE

Robert E. Cowden III
Anita S. Lichtblau
Susan M. (Sandy) Tarrant
Casner & Edwards, LLP
303 Congress Street
Boston, MA 02201
617-426-5900
Lichtblau@casneredwards.com

January 2014

I. Tax Law

A. <u>§501(c)(3) charitable, educational, scientific, religious organizations</u>

1. income generally exempt from federal income tax
2. contributions generally deductible by donor, including contributions to 501(c)(3) organizations that lobby
3. however, under Reg. §1.170A-1(j)(6), contributions earmarked for lobbying are not deductible
4. scope of permissible lobbying activity

    a. "no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h))" [IRC §501(c)(3)]
        i. applies to activity with respect to federal, state and local legislative bodies
        ii. includes ballot initiatives and referenda, appropriations bills, constitutional amendments
        iii. "substantial part test": substantiality (other than §501(h)) is determined by examining the particular "facts and circumstances" of the matter, not by bright line or percentage tests
            a. focus is "activity," not necessarily expenditures
            b. some commentators suggest that 5% of organization's total expenditures is a safe threshold
            c. however, IRS does not use a financial percentage test, rather focusing on the number and extent of attempts to influence legislation
            d. possible factors:
                i. extent of lobbying expenditures
                ii. time devoted by staff, board members, and volunteers
                iii. number and extent of attempts to influence legislation

iv. the continuous or intermittent nature of the organization's attention to the activity
v. the amount of publicity that the organization assigns to the activity – website prominence

iv. if organization will do too much lobbying for 501(c)(3) status, it may qualify as a 501(c)(4)

b. expenditure test: under §501(h), §4911, and Reg. §56-4911-0 through 4911-10, organization that is a public charity under §509(a) may elect to be subject to specific definitions and lobbying expenditure limits rather than the vague "no substantial lobbying" test
   i. NOTE: §501(h) not available to:
      a. churches, affiliated groups of churches, etc.
      b. private foundations
   ii. to do 501(h) election, file Form 5768, Line 1 prior to the end of the organization's tax year to which the 501(h) election is effective
      a. to revoke 501(h) election
         i. file Form 5768, Line 2
         ii. revocation effective for the next tax year after filing
   iii. 501(h) test looks at expenditures, not amount of activity
   iv. under §4911, excise tax on lobbying expenditures that exceed the limits
   v. 501(c)(3) organization can lose exemption if it "normally' spends more than 150% of the permissible amount
      a. "normally" means exceeds this 150% amount over a running four-year period
   vi. total lobbying expenditures limit is a percentage of the organization's exempt purpose expenditures (up to a total cap of $1 million):
      a. 20% of the first $500,000, plus
      b. 15% of the next $500,000, plus
      c. 10% of the next $500,000, plus
      d. 5% of the remaining exempt purpose expenditures
   vii. grass roots lobbying expenditure limit: 25% of charity's total lobbying expenditures limit, above

c. Private Foundations
   i. expenditures for lobbying activities are taxable expenditures under §4945 and Reg. §53.4945-2
   ii. may make grants to support nonpartisan research, analysis and study
   iii. may make a general support grant, not earmarked for lobbying, to a 501(c)(3)/509(a) public charity that lobbies
   iv. may make a grant, not earmarked for lobbying, to a 501(c)(3)/509(a) public charity for a project that includes lobbying,

if the foundation's grants for the project in the year do not exceed the project's non-lobbying costs.

v. See IRS letter 50-09822 December 9, 2004, which explains these and other aspects of the private foundation lobbying limitation

d. What is "lobbying" (i.e., what is "attempting to influence legislation") under substantial part test?
   i. see Reg. § 1.501(c)(3)-1(c)(3)(ii).
   ii. contacting, or urging public to contact, members of legislative body for purpose of proposing, supporting, or opposing legislation; OR
   iii. advocating adoption or rejection of legislation
   iv. does not include testifying at legislative hearing in response to invitation or nonpartisan analysis, study, and research if no advocacy for or against legislation
   v. does not include lobbying by individual employees or board members on their own time and without use of organization's resources if they don't identify themselves with organization

e. What is "lobbying" (*i.e.*, what is "attempting to influence legislation") under Section 501(h) expenditure test?
   i. see Reg. §56-4911-0 through 4911-10
   ii. for Private Foundations, see IRC §4945(e) and Reg. §53.4945-2
   iii. "lobbying" is a <u>communication</u> to members of a legislative body, or to the public, that is an attempt to influence the content of legislation or the adoption or rejection of legislation
   iv. the following is not lobbying:
      a. nonpartisan analysis, study, research (and making the results thereof known to the public)
         i. excluded from 501(h) lobbying even if it expresses or advocates the organization's position on the legislation: (a) if the advocacy is a full and fair exposition of the facts that enables the audience to form an independent opinion; (b) if the organization does not make material available only to persons favoring only one side of the issue; and (c) if grassroots communication material does not include a direct call to contact legislators
      b. examination and discussion of broad social, economic and societal issues if no specific legislation is addressed
      c. communications with members that do not encourage members to lobby
      d. advice or technical assistance requested in writing by a governmental body or committee or other subdivision thereof

e. communications to legislative body with respect to possible decision of such body which might affect the existence of the organization, its powers and duties, tax-exempt status, or the deduction of contributions to the organization.

f. lobbying by organization's employees on their own time, outside of office, and without use of organization's resources does not count toward organization's lobbying expenditures

5. Reporting to IRS

   a. Form 990/990-EZ/990-PF
      i. Form 990
         a. Part IV, line 4 and Schedule C (lobbying activities and 501(h) election)
         b. Part IV, line 34 and Schedule R (relationship to any tax-exempt or taxable entity)
         c. Part IV, line 36 and Schedule R (transfer to or financial transaction or arrangement with related exempt non-charitable organization)
         d. Part IX, line 11d (lobbying expenditures)
      ii. Form 990-EZ
         a. Part VI, line 47 and Schedule C (lobbying activities)
         b. Part VI, line 49 (transfer to exempt non-charitable related organization)
      iii. Form 990-PF
         a. Part VII-A, line 1a (lobbying activities)
         b. Part XVII, line 1 (transfer to or financial transaction or arrangement with exempt non-charitable organization, including §527 organization)
         c. Part XVII, line 2 (relationship with any exempt non-charitable organization, including §527 organization)

   b. Schedule C (lobbying activities)
      i. Part II-A
         a. if 501(h) election filed
      ii. Part II-B
         a. if 501(h) election not filed

   c. Schedule R (related organizations)

   d. Form 4720 (excise taxes)
      i. Schedule E

a. Private Foundation excise tax on Taxable Expenditures under §4945

ii. Schedule G

a. excise tax on Excess Lobbying Expenditures of 501(c)(3) that filed 501(h) election

iii. Schedule H

a. excise tax on Disqualifying Lobbying Expenditures of 501(c)(3) that lost exemption due to excessive lobbying

6. Affiliation with lobbying organizations from tax law perspective

a. §501(c)(3) organization may have affiliated §501(c)(4), (c)(5), or (c)(6) organizations that lobby

i. the organizations may not be agents of each other

ii. the §501(c)(3) and the §501(c)(4)/(c)(5)/(c)(6) must maintain separate structure, finances, activities

iii. §501(c)(3) organization may not earmark any of its funding for legislative advocacy activity

b. Practice notes:

i. inter-organizational purchase of services is permissible if fair value is paid

ii. under the 501(h)/4911 regulations, a 501(c)(3) grant to a non-501(c)(3) that lobbies is a lobbying expenditure unless the grant limits the grantee's use to a specific non-lobbying project in furtherance of the 501(c)(3)'s exempt purposes, with documentation of such use. Reg. §56/4911-3(c)(3) & §53.4911-4(f)(3).

7. Result of violation

a. revocation of §501(c)(3) exemption

b. loss of deduction to donors [Reg. 1.170A-1(j)(5)]

c. §4911 excise tax on excess lobbying expenditures of 501(c)(3) that is subject to a 501(h) election

d. §4912 excise tax

i. on 501(c)(3) whose exemption is revoked for excessive lobbying

a. if organization was eligible to make but had not made 501(h) election

ii. on managers for knowing violation

e. §4945 penalties on private foundation and managers

f. if organization loses §501(c)(3) status because of excessive lobbying, then ineligible for §501(c)(4) exemption. [IRC §504.]

8. IRS guidance

    a. Reg. §56-4911-0 through 4911-10 and Reg. §53.4945-2
    b. Continuing Professional Education (CPE) text, "Lobbying Issues" (1997)
    c. CPE text, "Political Campaign and Lobbying Activities of IRC 501(c)(4, (c)(5), and (c)(6) Organizations" (2003)
    d. CPE Text, "Affiliations Among Political, Lobbying and Educational Organizations" (2000)
    e. IRS web site summary, "Lobbying": www.irs.gov
    f. Publication 557, "Tax-Exempt Status for Your Organization" at page 44
    g. IRS letter 50-09822 December 9, 2004 (explains the private foundation lobbying limitation)

9. Other guidance

    a. Alliance for Justice publications on lobbying and political activities of tax-exempt organizations: http://bolderadvocacy.org/navigate-the-rules.
    b. Community Action Program Legal Services (CAPLAW) website: Q & A on Lobbying and other materials (Click on Tools and Resources, then By Topic)

B. <u>§501(c)(4) social welfare organization; civic league; §501(c)(5) labor organization; §501(c)(6) trade association; business league; chamber of commerce</u>

1. income generally exempt from federal income tax
2. contributions generally not deductible, except as business expense
3. legislative lobbying support is not a deductible business expense

4. Scope of permissible lobbying activity

    a. 501(c)(4) social welfare organizations, 501(c)(5) labor organizations, and 501(c)(6) professional or trade associations are not limited as to legislative activity if the activity is in furtherance of the organization's exempt purposes

5. Reporting to IRS

    a. Form 990/990-EZ/990-PF
        i. Form 990
            a. Part IV, line 34 and Schedule R (relationship to any tax-exempt or taxable entity)
            b. Part IX, line 11d (lobbying expenditures)
        ii. Form 990-EZ
            a. no questions regarding lobbying
            b. Schedule C (lobbying activities)
        iii. Part II-A

a. if 501(h) election filed

iv. Part II-B

a. if 501(h) election not filed

b. Schedule R (related organizations)

6. Affiliation with 501(c)(3) organizations

   a. §501(c)(4), (c)(5), or (c)(6) organization may have affiliated §501(c)(3) organization
      i. the organizations may not be agents of each other, due to lobbying limitations applicable to the §501(c)(3) organization
      ii. the §501(c)(3) and the §501(c)(4)/(c)(5)/(c)(6) must maintain separate structure, finances, activities
      iii. §501(c)(3) organization may not earmark any of its funding for legislative lobbying activity

   b. Practice notes:
      i. inter-organizational purchase of services is permissible if fair value is paid
      ii. under the 501(h)/4911 regulations, a 501(c)(3) grant to a non-501(c)(3) that lobbies is a lobbying expenditure unless the grant limits the grantee's use to a specific non-lobbying project in furtherance of the 501(c)(3)'s exempt purposes, with documentation of such use. Reg. §56/4911-3(c)(3) & §53.4911-4(f)(3).

7. Result of violation by §501(c)(4)/(c)(5)/(c)(6) organization
   a. Exemption revocation

8. IRS guidance
   a. CPE text, "Political Campaign and Lobbying Activities of IRC 501(c)(4, (c)(5), and (c)(6) Organizations" (2003)
   b. CPE Text, "Affiliations Among Political, Lobbying and Educational Organizations" (2000)

9. Other Resources
   a. Alliance for Justice publications on lobbying and political activities of tax-exempt organizations: http://bolderadvocacy.org/navigate-the-rules.

II. Government Funding

1. Federal grant funds generally may not be used for lobbying
   a. Annual appropriation acts
   b. Anti-Lobbying Act, 18 U.S.C. 1913
   c. Cost Principles, 2 C.F.R. 230 Appendix B. paragraph 25 (aka OMB Circular A-122)

2. 501(c)(4)s that engage in legislative lobbying may not receive federal grant funds: Simpson-Craig Amendment, 2 USC 1611
3. State funds provided to contractors under human and social services contracts may not be used to compensate staff, consultants, or outside lobbyists or pay for any associated lobbying costs for legislative or executive lobbying at state level where lobbying is part of the individual's regular and usual employment and not just incidental to it. 808 CMR 1.05(18). In addition, if state-funded program receives federal financial assistance, lobbying restrictions of OMB Circular A-122 apply to state funds as well.

III. Federal Lobbying Disclosure Act

A. See 2 U.S.C. 1601, *et seq.*
B. Applies to lobbying covered legislative branch and executive branch officials in connection with: federal legislation, regulations, policy, and executive orders; administration of a federal program; awarding of a federal grant or contract; and nomination or confirmation of a person for position subject to Senate confirmation
C. "Lobbyists" must register with and report quarterly on lobbying activities to the Secretary of the Senate or the Clerk of the House of Representatives
D. A "lobbyist" is an individual who has more than one lobbying contact and whose lobbying activities constitute 20% or more of his or her time on behalf of that client during any three-month period
E. A lobbying contact is any oral, written, or electronic communication to a covered official
F. Covered Executive Branch officials are: the President; Vice President; officers and employees of the Executive Office of the President; officials serving in Executive Level I through V positions (cabinet level and some below); certain military officers (serving at grade O-7 or above); and Schedule C political appointees
G. Covered Legislative Branch officials means members of Congress and their staff
H. Organizations that employ in-house lobbyists must register if total lobbying expenses exceed or are expected to exceed $12,500 during a quarterly period
I. Organizations that don't employ a lobbyist, but instead hire an outside lobbyist, don't need to register or report; the lobbyist does
J. Lobbying includes preparation and planning activities and research

Janet Rickershauser, Speaker

Janet Rickershauser, a senior attorney in Goodwin Procter's Trusts & Estate Planning Practice, specializes in estate planning, charitable giving and tax-exempt organizations. Ms. Rickershauser advises individuals and families on both estate and charitable planning strategies, including transfers of interests in business entities and the creation of charitable foundations, charitable remainder trusts and charitable lead trusts. She also works with large and small charitable organizations on tax and governance issues and with banks and trust companies on trust-related federal tax and state law issues.

WORK FOR CLIENTS

Ms. Rickershauser's work with tax-exempt organizations ranges from guiding new organizations through the process of obtaining 501(c)(3) status to advising established charities on the unrelated business income tax ("UBIT"), intermediate sanctions and private foundation excise tax issues, and operating as a scientific research or medical research organization. She has also provided guidance on joint ventures with for-profit business entities, scholarship and disaster relief programs, and international grantmaking and other international charitable activities.

In her estate planning work, Ms. Rickershauser advises clients on the complex tax issues involved in transferring interests in partnerships, limited liability companies and S corporations. She also assists clients with income and transfer tax issues related to life insurance and retirement benefits, and with complex gift and estate tax planning involving trusts and family partnerships. In addition, Ms. Rickershauser works with banks and trust companies on compliance with trust- and IRA-related state and federal regulatory requirements as well as on fiduciary income tax issues.

PROFESSIONAL ACTIVITIES

Ms. Rickershauser has lectured at the Boston Bar Association on charitable lead trusts and on state and federal requirements for terminating private foundations. Since 2007, in conjunction with Lawyers' Clearinghouse and Volunteer Lawyers for the Arts, she has taught seminars on creating and operating 501(c)(3) nonprofit corporations in Massachusetts.

PROFESSIONAL EXPERIENCE

Before joining Goodwin Procter in 2007, Ms. Rickershauser was an associate at Patterson, Belknap, Webb & Tyler in New York and at Cummings & Lockwood in Stamford, Connecticut.

BAR AND COURT ADMISSIONS

Ms. Rickershauser is admitted to practice in Massachusetts, New York and Connecticut.

Intermediate Sanctions

Goodwin Procter LLP

The intermediate sanction rules (section 4958 of the Internal Revenue Code and the regulations thereunder, also referred to as the excess benefit rules) were enacted to allow the IRS to impose penalty taxes on persons who engage in impermissible self-dealing-type transactions with public charities. Prior to the enactment of the intermediate sanction rules, the IRS's only remedy in such a case was to revoke the organization's tax-exempt status. Now, the Service may instead impose substantial financial penalties on persons who improperly benefit from transactions with public charities and on certain organization managers. The intermediate sanction rules apply to 501(c)(3) organizations which are classified as public charities and to 501(c)(4) organizations. 501(c)(3) organizations which are classified as private foundations are not subject to the intermediate sanction rules but are subject to a different, more stringent set of self-dealing rules.

A. Definitions: Excess Benefit Transactions and Disqualified Persons

Disqualified persons are:

- Any person who was, at any time during the five-year period ending on the date of the transaction involved, in a position to exercise substantial influence over the affairs of the organization;
- A member of the family (as defined in Internal Revenue Code sections 4958(f)(4) and 4946(d)) of such a person; and;
- Any entity in which individuals in the preceding two categories have more than a 35% interest (voting power, profits interest, or beneficial interest in a trust or estate).

Certain persons, such as voting members of an organization's governing body, the president, the chief executive officer, the chief financial officer and the chief operating officer, are deemed to have substantial influence over the affairs of an organization. An organization's founder or a substantial contributor will generally also be considered to have substantial influence. Independent contractors (e.g., lawyers, accountants and investment advisors) and non-highly compensated employees will generally be considered not to have substantial influence over the affairs of an organization in the absence of other factors showing substantial influence. Other factors tending to show substantial influence or the lack thereof are listed in the regulations under section 4958 as well.

An <u>excess benefit transaction</u> is defined as any transaction between an organization and a disqualified person where the economic benefit received by the disqualified person exceeds the value of the consideration (including the performance of services) provided to the organization by the disqualified person. The difference between the economic benefit received by the disqualified person and the value of the consideration provided is the <u>excess benefit</u>. One of the biggest areas of IRS concern in the excess benefit transaction context is compensation paid to disqualified persons.

B. Penalties on Excess Benefit Transactions

If an excess benefit transaction is found to have occurred, a penalty tax will be imposed on the disqualified person in the amount of twenty-five percent of the excess benefit. A tax of ten percent of the excess benefit may also be imposed on an organization manager who participated in the transaction knowing that it was an excess benefit transaction, unless the manager's participation was not willful and was due to reasonable cause. In general, if a manager relied on a reasonable written opinion of counsel or a certified public accountant, the

manager will not be subject to the tax. The tax on the manager may not exceed $20,000 per transaction. If more than one person is liable for any penalty tax, all such persons are jointly and severally liable.

Punitive second-tier penalty taxes are imposed on the disqualified person if the excess benefit transaction is not corrected within a specified "taxable period." The second-tier tax is equal to two hundred percent of the excess benefit. The taxable period begins on the date on which the transaction occurred and ends on the earliest to occur of (1) the mailing of a notice of deficiency as to the initial tax and (2) the date on which the initial tax is assessed. Further, under Internal Revenue Code sections 4961 and 4963, if the excess benefit transaction is corrected within the "correction period," then the second-tier tax will not be assessed or, if assessed, the assessment will be abated. If the tax has been collected, it will be credited or refunded as an overpayment. The correction period ends ninety days after the mailing of a notice of deficiency with respect to the second-tier tax, extended by any period during which a deficiency cannot be assessed under section 6213(a) (i.e., during a period in which the taxpayer is challenging the deficiency notice in Tax Court) and by any other period which the Secretary determines is reasonable and necessary to bring about correction.

Correction of the excess benefit transaction involves undoing the excess benefit transaction to the extent possible, and taking any additional measures necessary to place the organization in a position that is no worse than the position it would have been in if the disqualified person had been acting under the highest fiduciary standards. In general, this means that the disqualified person must repay to the organization the excess benefit he or she received, with interest.

C. Supporting Organizations and Donor-Advised Funds

The Pension Protection Act of 2006 expanded the intermediate sanction rules to apply the penalty taxes to the full amount (not just the excess benefit) of any grant, loan, payment or compensation or similar payment (1) from a supporting organization (a type of public charity) to a substantial contributor to the organization, a family member of a substantial contributor, or an entity which is at least 35% controlled by a substantial contributor, or (2) from a donor-advised fund to a donor or an advisor appointed by the donor, an investment advisor compensated by the sponsor of the donor-advised fund (other than an employee of the sponsor), a family member of any such person, or an entity which is at least 35% controlled by such a person.

D. Rebuttable Presumption of Reasonableness

The regulations under section 4958 provide a safe harbor for organizations entering into transactions with disqualified persons. If the organization complies with the safe harbor requirements, the organization will not be guaranteed to avoid the intermediate sanctions penalties, but it will be entitled to a "rebuttable presumption of reasonableness" – that is, it will be presumed that the transaction is not an excess benefit transaction and the burden of proving otherwise will shift to the IRS.

There are three requirements that must be met for an organization to be entitled to the rebuttable presumption of reasonableness:

1. The arrangement must be approved by the organization's governing body or a committee thereof, in either case composed entirely of individuals who do not have a conflict of interest with respect to the transfer. The interested party may meet with the authorized body only to answer questions and otherwise must recuse himself or herself from the meeting. The interested party may not be present during the debate and voting on the transaction. The

definition of “conflict of interest” with respect to a particular transaction is set out in Treasury Regulation §53.4958-6(c)(1)(iii).

2. The authorized body approving the transaction must obtain and rely on appropriate data as to comparability. In the case of compensation, relevant information includes:

- compensation paid by similarly situated organizations, both tax-exempt and taxable, for functionally comparable positions;
- the availability of similar services in the geographic area;
- current independent compensation surveys; and
- actual written offers from similar organizations competing for the person’s services.

For organizations with less than $1 million of annual gross receipts, the organization will be considered to have examined appropriate data as to comparability if it has data on compensation paid by three comparable organizations in the same or similar communities for similar services.

3. The authorized body must adequately document the basis for its determination concurrently with the making of the determination. The records (generally the minutes of the authorized body) must note:

- the terms of the transaction and the date it was approved;
- the members of the authorized body who were present during the debate on the transaction and those who voted on it;
- the comparability data obtained and relied upon and how it was obtained (and, if the payment decided upon is outside the range of comparability data, the basis for that decision); and

- any actions taken with respect to consideration of the transaction by anyone who is a member of the authorized body who had a conflict of interest.

For a decision to be documented concurrently, the records must be prepared before the later of the next meeting of the authorized body or 60 days after the final action is taken. The records must be reviewed and approved by the authorized body as reasonable, accurate and complete within a reasonable time thereafter.

<u>Unrelated Business Income Tax</u>

Goodwin Procter LLP

<u>Unrelated Business Income Tax Provisions</u>

(A) <u>Nature of Tax</u>. An exempt organization is taxed on its unrelated business taxable income ("UBTI"). Section 511 of the Internal Revenue Code of 1986, as amended (the "Code").

(B) <u>Definition of UBTI</u>. UBTI means gross income from any unrelated trade or business regularly carried on by the exempt organization, less allowable deductions directly connected with the carrying on of such trade or business. Code §512(a)(1).

> (1) <u>Partnership Income</u>. UBTI includes an organization's share of gross income (and deductions directly connected with such income) derived from any unrelated trade or business carried on by a partnership of which the organization is a member. Code §512(c).

(C) <u>Unrelated Trade or Business</u>. "Unrelated trade or business" means any trade or business the conduct of which is not substantially related (aside from the exempt organization's need for and use of the income or profits of such trade or business) to the exercise or performance of the exempt organization's purpose or function constituting the basis for its exemption from taxation. Code §513(a).

(D) <u>Exclusions from UBTI</u>. UBTI does not include income from dividends, interest, payments with respect to securities loans, annuities, income from notional principal contracts, other substantially similar income from ordinary and routine investments to the extent determined by the Commissioner, loan commitment fees, royalties, certain rents, and gains and losses from the disposition of certain property. Code §512(b)(1)-(3), (5); Treas. Reg. §1.512(b)-1(a)(1).

> (1) <u>Rents</u>. Rents from real property are generally excluded. Rents from personal property are not excluded from UBTI except in the case of personal property leased with real property if the rents attributable to the personal property are an incidental amount (not more than 10%) of the total rents under the lease. Rents from real property are not excluded from UBTI if more than 50 percent of the rent under the lease is attributable to personal property. Rents from real property are not excluded from UBTI if the amount of rents depends in whole or in part on the amount of income or profits derived from the property leased (other than a fixed percentage of receipts or sales). Code §512(b)(3); Treas. Reg. §1.512(b)-1(c)(2).

> (2) <u>Gains or Losses on the Disposition of Property</u>. UBTI does not include gains or losses from the disposition of property (except stock in trade, inventory, property held primarily for sale to customers in the ordinary course of business other than certain real property and mortgages acquired from financial institutions in conservatorship or receivership, and certain cuttings of timber), the lapse or termination of options to buy or

sell securities or real property, or the forfeiture of good faith deposits for the purchase, sale, or lease of real property. Code §512(b)(5), (16).

(3) Deductions. Items of deduction directly connected with items of income excluded from UBTI are also excluded from UBTI. Code §512(b); Treas. Reg. §1.512(b)-1.

(E) Limitations on Exclusions from UBTI.

(1) Debt-Financed Income. The exclusions from UBTI of dividends, interest, payments with respect to securities loans, annuities, income from notional principal contracts, other substantially similar income from ordinary and routine investments, loan commitment fees, royalties, real property rents, and gains or losses from the disposition of certain property do not apply to unrelated debt-financed income. Code §§512(b)(4), 514; Treas. Reg. §1.512(b)-1(a)(2).

(2) Controlled Entities. Interest, annuities, royalties or rent received from controlled organizations with respect to the tax-exempt organization will be recharacterized as UBTI to the extent that the controlled entity's income consists of UBTI. Control generally means ownership of more than 50% by vote or value, determined with reference to constructive ownership rules.

GOODWIN | PROCTER

Nonprofit Boards of Directors 101: What You Must Know!

- Excess Benefit Transactions and Intermediate Sanctions
- Unrelated Business Income Tax

Janet M. Rickershauser
Senior Attorney
Tax-Exempt Organizations
Goodwin Procter LLP

August 9, 2014

Excess Benefit Transactions and Intermediate Sanctions

- “Excess Benefit” Transactions
  - Insider transactions involving unreasonable financial benefits to private interests
    - a An excess benefit arises if an organization directly or indirectly confers an economic benefit on a disqualified person that exceeds the fair market value of what the organization receives in return
  - Areas of concern:
    - Compensation
    - Business transactions such as sales of property

Excess Benefit Transactions and Intermediate Sanctions

- Insider or “Disqualified Person”
  - Any person or entity in a position to exercise substantial influence over the affairs of the organization at any time during the five years preceding the excess benefit transaction
    - Whether a person exercises substantial influence depends on facts and circumstances
    - 5-year look-back period
  - Family members of a disqualified person are disqualified persons
  - Entities controlled by a disqualified person are disqualified persons
    - Control is > 35% voting power, profits interest, or beneficial interest

Excess Benefit Transactions and Intermediate Sanctions

- Excess Benefit Transactions Are Subject to Intermediate Sanctions
  - Penalties imposed on public charities in lieu of loss of 501(c)(3) status
  - Private foundations are subject instead to self-dealing prohibitions and penalties

Excess Benefit Transactions and Intermediate Sanctions

- Penalties
  - Disqualified person:
    - 25% penalty tax on the excess benefit
    - Additional 200% penalty if excess benefit is not corrected
      - Must be corrected ***within taxable period***
  - Manager who knowingly participated:
    - 10% of excess benefit
    - $20,000 cap per transaction
    - Exception if participating was due to reasonable cause

Excess Benefit Transactions and Intermediate Sanctions

- Special Rules for Donor-Advised Funds
  - The amount of any grant, loan, compensation, or other similar payment to a donor-advisor is an excess benefit

- Special Rules for Support Organizations
  - The amount of any grant, loan, compensation, or other similar payment is an excess benefit if paid to:
    - A substantial contributor
    - A family member of a substantial contributor
    - A 35%-controlled entity of a substantial contributor

Excess Benefit Transactions and Intermediate Sanctions

- Safe Harbor
  - Advance approval by disinterested members of governing board or committee
  - Reliance on comparability data
  - Documentation

- Initial Contract Exception
  - Fixed payments
  - Does not apply to performance-based compensation or bonuses

Unrelated Business Income Tax

- Unrelated business income tax (UBIT)
  - Unrelated business taxable income (UBTI) will be subject to income tax despite the organization's tax-exempt status
  - UBTI will arise if the organization:
    - a has gross income from a trade or business activity
      - that is regularly carried on and
      - is not causally related to the organization’s charitable mission
  - The test is whether the activity <u>itself</u> furthers the exempt purpose, not whether the organization uses the funds that it raises from the activity for an exempt purpose

Unrelated Business Income Tax

- UBIT Exceptions
  - There are several exceptions to UBTI, including including income raised from activities where volunteers perform substantially all of the work, most investment income, royalties and rental income not arising from debt-financed property.

- Take away
  - If the organization is engaged in any commercial-type activity, such as the sale of goods or services, or has income from debt-financed property, it may have UBTI