STAYING THE COURSE:  
GOOD GOVERNANCE IN TURBULENT TIMES

AUTHOR/SPEAKER:

SHANNON G. GUTHRIE  
Benenati Law Firm  
2816 Bedford Road  
Bedford, Texas 76021  
(817) 267-4529  
(817) 684-9000 fax  
sguthrie@benenatilaw.com  
www.benenatilaw.com

SPEAKER:

TYREE COLLIER  
Thompson & Knight LLP  
1722 Routh Street, Suite 1500  
Dallas, Texas 75201  
(214) 969-1409  
(214) 999-1655 fax  
Tyree.Collier@tklaw.com  
www.tklaw.com

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I. INTRODUCTION

The purpose of this paper is to provide guidance to nonprofit organizations and their advisors in educating directors as to their duties and responsibilities to the organization on whose board they serve. This paper is not intended to provide instruction on how to create a nonprofit organization from a structural standpoint. However, because there are some aspects of advising directors that relate to organizational matters and documents, some discussion of organizational documents and issues is involved in this paper. It is intended that this paper may serve as a resource to nonprofit organizations to give to directors to assist them in understanding their role in the organization.

II. BACKGROUND: UNDERSTANDING THE ORGANIZATIONAL MAKEUP

The purposes of nonprofit organizations vary. Some are charitable, others educational or religious. Others, such as trade associations and social organizations are more fraternal in nature. Most states allow nonprofit entities to be formed for any lawful purpose. As a result, not all nonprofit entities qualify for exemption from federal income taxation. Organizationally, depending on state law, nonprofits may be organized as trusts, corporations, LLCs or associations. It is important for directors to understand the type of organizational structure so that he or she understands the law applicable to his or her position. Under Texas law, a nonprofit that is a trust will be governed by the Texas Trust Code while a nonprofit that is created as a corporation will be governed by the Texas Business Organizations Code and specifically Chapters 20 and 22 of Title 1, which are referred to as Texas Non-profit Corporation Law. Texas law also includes a nonprofit association and defines it to be an unincorporated organization, other than one created by a trust, but consisting of three or more members joined by mutual consent for a common, nonprofit purpose. BOC § 252.001. Unincorporated associations are governed generally under Section 252 of the Texas Business Organizations Code. Most references in this paper will presume that an entity is established as a nonprofit corporation and thus, most references will be to the Texas Business Organizations Code and to directors; however, most rules and provisions, except where differentiated, are applicable to both directors and trustees. Directors and trustees should understand the difference between what the organization’s governing documents provide and what state law provides due to the circumstances where state law will fill-in provisions oftentimes where the organizational documents are silent.

Board Structure. Nonprofits are either membership or non-membership organizations. BOC § 22.151. In membership organizations, the members usually elect the directors, for example, in churches or the local bar association. In non-membership nonprofit organizations, the board is generally self-perpetuating. Where the nonprofit organization is part of a system of affiliated nonprofit entities, generally directors are elected by the board of a parent organization. Charities that are supporting organizations fall into a separate category and the directors may have the same as those of the supported organization, they may be elected by the board of the supported organization, or may be a combination of insider and outsider directors, meaning that some directors are perhaps within a certain class of individuals and others may be elected by the organizations supported by the entity. Texas requires that a non-profit corporation have a minimum of three directors.

Trustees. Trustees of a charitable trust are selected in accordance with the terms of the trust agreement. One primary reason for using a charitable trust as the organizational structure of an entity is due to its lack of requiring three directors as is required of a nonprofit corporation. Another reason is due to the privacy of the governing document. Consider that the Certificate of Formation of a nonprofit corporation is on file with the Secretary of State.

Terms. In most nonprofit organizations, especially public charities, directors or trustees generally serve one to three year terms. Most often, terms are staggered so that a portion of the board or slate of trustees is elected each year. This allows the nonprofit to have some continuity in its governing body. Additionally, best practices now involve the staggering of terms for public charities or rotation of the directors.

Operating Through Officers and Committees. Regardless of how the governing body is elected or whether they are referred to as “directors” or “trustees,” the directors are charged by law with overseeing the affairs of the nonprofit entity. Generally, that authority is exercised, in part, through officers elected by the directors or committees appointed by the board of directors or staff persons hired by the nonprofit entity. Because the directors act for the benefit of others, they owe certain fiduciary duties to the corporation they serve, often referred to
as the “duty of care” and the “duty of loyalty,” discussed below.

Executive Committees. Many nonprofit entities choose to establish an executive committee, usually composed of officers of the corporation and sometimes including one or more directors, which is empowered to make specified decisions, such as those decisions necessary between board meetings. Other committees generally make only recommendations for consideration by the board of directors.

Officers. Officers generally include a president, one or more vice presidents, a secretary and a treasurer. The bylaws (or trust agreement) together with the state’s nonprofit law specify the powers of each of the officers. Again, best practices for charitable organizations would provide for some separate of powers within the organization in order to lessen the risk of inappropriate use of organizational assets and resources for private purposes.

Incorporation. Nonprofit corporations are incorporated in one of the states or the District of Columbia (or another country), typically by filing in a public office a document called Articles of Incorporation, Certificate of Incorporation or, in Texas, a Certificate of Formation. The formation document is called a charter. It establishes the corporation, states its purposes, contains any specific language required by the state’s incorporation laws and may contain language appropriate to obtain the desired tax-exempt status, such as for charitable organizations.

Bylaws. Nonprofit corporations also have bylaws or regulations that provide guidance for questions regarding various issues, such as eligibility for and rights of membership; the process for nominating and electing directors and officers; standards and process for removing members, directors and officers; notice and quorum requirements for meetings of directors and members; the establishment and powers of committees; and the indemnification and limitation of liability of officers and directors.

Charitable Trust. Charitable trusts are established by a trust agreement. The trust agreement may provide a structure akin to that of a nonprofit corporation, although with entities, such as family foundations, the structure of the governing body is simplified due to the control being in a small number of individuals who are often related.

Mission Statement. Nonprofit organizations usually have a mission statement (generally summarized in the Articles of Incorporation and bylaws) defining the mission of the organization and the persons whom it intends to serve. In charitable organizations, this is sometimes referred to as the charitable class or beneficiaries.

Governmental Oversight. In most states, the attorney general has broad power to oversee the operation of nonprofit organizations, particularly those that are charitable in nature. In Texas, oversight is provided by the Charitable Trust Division of the office of the Attorney General. This is in addition to oversight that is tax related through the State taxing authority (in Texas, the State Comptroller) and the Internal Revenue Service.

III. DUTIES OF DIRECTORS

A. Duty of Care.

The Texas Trust Code provides that a trustee shall administer the trust in good faith according to its terms and the Trust Code and in absence of contrary terms in the trust agreement or the Trust Code, shall perform all of the duties imposed on trustees by the common law. For other non-profit entities, the duty of care requires a director to be informed regarding the affairs of the organization, to discharge his or her duties in good faith, to exercise the care that a prudent person in his or her position would exercise, and to do so in a manner that the director reasonably believes to be in the best interest of the corporation.

To fulfill the duty of care, at a minimum, a director should:

1. Regularly attend meetings of the board of directors;
2. Be informed about the affairs and finances of the corporation; and
3. Exercise independent judgment with respect to issues under consideration.

Directors should make certain that board meetings are held regularly. Typically, board meetings are held on a monthly or quarterly basis, especially for significant charitable organizations. Directors should review the organization’s governing documents to determine when and where meetings are to be held in order to make certain that the organization is operating within its governing documents. Meetings held only as the need arises are rarely adequate.

Reliance Upon Information Provided by Staff. Directors frequently rely upon staff members to provide information regarding the affairs and finances of the corporation. In general, a director may rely upon information supplied by staff members, the corporation’s legal counsel, public accountants or board committees, unless the director is aware that
such information is not accurate or has other reason to believe that the information may not be reliable. If, however, sufficient information is not supplied, it is the director’s duty to request additional information. The director should read written information that is provided.

Although a director may rely upon information provided by staff, he or she should exercise independent judgment and should not hesitate to take a position differing from that of the staff should he or she believe that to be appropriate.

State laws vary as to the factors a director may consider when evaluating a proposed course of action. For example, in considering whether a proposed course of action is in the best interest of a nonprofit corporation, in some states, a director may, but is not required to, consider the effects of the proposed action on employees and contractors with the corporation, as well as the community in which the corporation is located.

Compensation: Because compensation has become more closely scrutinized by the public and the IRS, it is more thoroughly discussed in Section XI below.

B. Duty of Loyalty.

The duty of loyalty requires a director to exercise duties in a manner that furthers the interest of the organization rather than his or her personal interest or the interest of another person or organization. Matters related to this duty include:

1. Conflicts of interest;
2. Corporate opportunity; and
3. Confidentiality.

Conflicts of Interest. A director should reveal to the board any conflicts of interest that he or she may have when those conflicts or potential conflicts may be relevant. For example, if the corporation will be doing business with a company owned by the director or a family member, the board should be informed of that relationship. Similarly, if the director also serves as a director, committee member or employee of a competitor of the corporation, the board should be so informed.

Vote Where Conflicts Are Involved. If the board will be making decisions that present a conflict or potential conflict of interest, the affected director should answer any questions that board members have about the conflict and should abstain from voting on the matter. It is usually appropriate that the affected director leave the room while the matter is being discussed or considered so that other directors will feel comfortable in addressing the matter fully and frankly.

Comparable Information. It is often advisable to obtain comparable information so the board has evidence that the transaction is fair to the corporation. The minutes should describe the disclosure of the conflict, any recusals and any comparable information on which the board relied.

Conflict of Interest Policy. A nonprofit should have a written conflict of interest policy approved by its board. The policy should require each director to complete and deliver an annual disclosure statement indentifying potential conflicts of interest, such as the director’s employer, significant investments and other board positions. (Usually, similar information is also required for the director’s family members.) The policy should also define a conflict of interest, indentify all classes of individuals covered by the policy, and set procedures for (a) determining whether potential conflicts are actual conflicts and (b) approving transactions that are subject to a conflict. Typically, the president (or other presiding officer) of the corporation reviews the disclosure statements so that he or she will be generally aware of potential conflicts of interest. In order to be in compliance with “Best Practices,” charitable organizations should have an adopted policy regarding conflicts of interest and should require directors to annually submit such disclosure and acknowledgment regarding conflicts of interest. The IRS has a form Conflict of Interest Policy attached to its instructions for Form 1023; however, the any board should carefully consider whether this policy is sufficient to protect the organization from all conflicts of interest that may affect the organization.

Business Opportunities. A director is obligated to refer to the corporation business opportunities appropriate for the corporation prior to using them for his or her personal benefit.

Confidentiality. The director must not disclose to others confidential matters of the corporation. Any question should be addressed to counsel for the corporation.

C. Duty of Obedience.

Directors must adhere to the governing documents of the organizations and adhere to its mission and follow restrictions on granted funds. They must not act outside of the scope of their authority.
IV. TYPICAL RESPONSIBILITIES OF DIRECTORS

The board of directors is charged with defining and overseeing the implementation of the organization’s mission. The board is responsible for:

i) developing and overseeing the implementation of a strategic plan;
ii) protecting the organization’s long-term values and mission against sacrifice for short-term gains;
iii) assuring that the programs operated by the organization are consistent with its mission; and
iv) preserving the organization’s assets against waste or abandonment.

The board also:

A. Selects the president, chief executive officer or executive director.
B. Approves the organization’s annual budget (capital and operating) as well as modifications to the budget throughout the year.
C. Selects auditors, attorneys and other professionals engaged by the organization.
D. Oversees the management and investment of the organization’s endowment and investments so as to assure the long-term viability of the organization and the availability of its resources, when needed. It assures that donations are invested and used in the manner required by donors or law. In some organizations, the board assists in fundraising. Board members should be familiar with the rules related to management of organizational funds, such as state law rules. In Texas, the Uniform Prudent Management of Institutional Funds Act (“UPMIFA”) governs the investments and endowments of such organizations.

V. RIGHTS OF DIRECTORS

Most state nonprofit corporation statutes grant directors specific rights, typically including access to the books and records of the corporation, such as the financial records. The directors should also have access to key management staff.

Directors are entitled to notices of meetings and the minutes of meetings of the board and committees. State laws or the bylaws often give the director standing to challenge corporation actions with which he or she disagrees.

VI. ETHICAL ISSUES

In recent years, nonprofit organizations have been subject to greater scrutiny due to scandals in the for profit world and nonprofit world and also because of Sarbanes Oxley. With the exception of its provisions relating to document destruction and retaliation against whistleblowers, most of SARBOX’s requirements do not apply to nonprofit organizations. In order to protect the organization and the board in its oversight, boards should consider the following actions:

A. Establishing an audit committee separate from the finance committee. The audit committee is generally comprised of persons who are not employed by the nonprofit but who are knowledgeable about financial matters and they make recommendations regarding the selection of auditors, oversee auditors and establish processes for addressing complaints regarding accounting and internal control issues.
B. Establishing a nominating/governance committee composed of directors who are not employees.
C. Establishing a policy regarding the retention and destruction of documents.
D. Establishing a whistleblower policy.
E. Establishing a conflict of interest policy.
F. Establishing an investment policy.
G. For charities, establishing a gift acceptable policy.

Nonprofits should also consider whether first class travel, resort accommodations and similar practices should be allowed or continued. Charitable organizations should not pay for first class travel or accommodations so that they do not violate and prohibited transactions rules. (See discussion below regarding private inurement and intermediate sanctions.)

VII. TAX EXEMPTION

Directors and trustees should have a general understanding of the tax status of the organization. In most instances, the organization must apply to the IRS for its exempt status. Many, but not all, nonprofit organizations qualify for exemption from federal income tax because they are described in one or more provisions of Section 501(c)(3) of the Internal Revenue Code. Approval as a Section 501(c)(3) organization affords both exemption from federal income tax and deductibility of charitable contributions to the organization. Qualification under other sections of 501(c) affords exemption from federal income tax, but not deductibility of contributions.

When recognizing 501(c)(3) status, the IRS also looks to whether the organization is a public charity or private foundation. The preferable status is that of a public charity due to the more liberal operations and transaction ability of the organization as well as the more favorable tax deductions available to donors.
Political Activity. Public charities are not permitted to engage in any political campaign activity in support of or in opposition to any candidate for public office.

Lobbying. A public charity may engage in lobbying only if the amount of the lobbying is not substantial. Some organizations are eligible to elect to be governed by a financial formula set forth in 501(h) instead of the substantial part test.

Inurement: A public charity is expected to operate for the benefit of the public and the charitable class served by the organization, rather than the benefit of private persons. For example: the organization cannot pay excessive compensation. (See discussion of Intermediate Sanctions/Excess Benefit Transactions.)

Intermediate Sanctions/Excess Benefit Transactions: Disqualified persons who engage in excess benefit transactions with a 501(c)(3) organization that is a public charity or with a 501(c)(4) organization are subject to an excise tax (somewhat akin to self-dealing in the private foundation world). Disqualified persons are those with substantial influence over the exempt organization. They include officers and directors and persons in positions of authority with the public charity during the previous five years, as well as their family members and companies owned by them. A transaction may be presumed not to involve any excess benefit, if 1) it is approved by a committee or board comprised entirely of disinterested directors; 2) the board uses comparable information as a guide; and 3) the directors properly documented their decision-making process. Specific questions pertaining to situations involving potential excess benefit transactions should be directed to legal counsel or tax counsel for the organization as penalties may apply, not only to the organization, but to the directors.

Private Foundations: Restrictions on political campaign activity and private inurement also apply to private foundations and they cannot engage in lobbying. Additionally, they are subject to significant restrictions on operations and relationships with directors, their family members and entities they and their family members control (i.e., insiders). They are subject to prohibitions on actions involving self-dealing, including sales, leases or exchanges of property between the foundation and insiders. The law also substantially restricts persons to whom and purposes for which grants may be made, imposes limitations on the investments and holdings of the organization and subjects the organization’s investment income to an excise tax and requires the organization to make a certain amount of qualifying distributions (grants) each year. Because the penalties for violating such self-dealing restrictions are substantial and must be unwound, it is important that the directors have some familiarity with such rules.

Unrelated Business Income: Organizations that engage in a trade or business that is not substantially related to the exempt purposes of the organization will pay a tax on the income associated with such trade or business. Generally, passive income is excluded. If this type of income becomes the source of most of the organization’s funding, it is subject to losing its exempt status.

Avoiding the Funding of Terrorism: To avoid inadvertently funding terrorism, a charity should check the names of grantees, their boards and affiliates against lists of terrorists maintained by U.S. Treasury and U.S. Department of State. A charity should undertake a pre-grant inquiry sufficient to become comfortable about the grantee, monitor the grant on an ongoing basis, require periodic report and require the grantee to certify that it does not fund terrorism and is not associated with terrorists. Violations can result in criminal fines, jail time, freezing and confiscating of assets and loss of tax exemption. (e.g., Holy Land Foundation).

Tax Returns: All public charities are required to file an annual Form 990, 990EZ or 990N with the IRS. Private foundations are required to file Form 990PF. Failure to file can result in financial penalties and loss of 501(c)(3) status. Directors should review the Form 990 before filing.

VIII. SOLICITING CONTRIBUTIONS
Most states regulate solicitations for charitable contributions by statute and/or regulations. Some states require placement of a legend on solicitation materials. Furthermore, some charitable activities, such as charitable gift annuities, may also be affected by licensing requirements. (Charities in Texas that want to provide Charitable Gift Annuities for donors should be careful to be in compliance with the Insurance Code and Department of Insurance requirements pertaining to such annuities.) Games of chance may be further restricted (such as raffles). Texas has a very strict rule on which organizations may operate raffles.

Restricted donations should be used for the purposes specified by the donor. Directors are also generally charged with ensuring that the nonprofit’s endowment is invested and used prudently and in accordance with state law. As previously mentioned, Texas has adopted the Uniform Prudent Management
of Institutional Funds Act (“UPMIFA”) that covers investments of funds of charities.

IX. UNDERSTANDING THE FINANCIAL STATEMENTS

Similar to a for profit business, a nonprofit’s financial statements currently should include, at least, a profit and loss statement and a balance sheet. Accounting rules require nonprofit organizations to identify net assets as unrestricted, temporarily restricted or permanently restricted. Financial statements should be provided to the directors at each meeting of the board and appropriate staff members should be available to answer questions regarding the financial statements. Expense permitting, the financial statements should be audited or reviewed annually by a person outside the organization. Often funding sources or laws applicable to charitable solicitation require an audit or review. Directors should assure that the auditors are truly independent. They should also satisfy themselves that an appropriate internal control structure is in place to avoid misuse of assets.

X. RISK REDUCTION

Tools available to reduce risk that a director will be held liable for his or her actions or omissions include directors and officers liability insurance, other appropriate insurance, indemnification and limitation of liability in its governing documents.

XI. COMPENSATION

A. Private Foundations

Because of the retention of control involved with private foundations, there are restrictions upon acts of self-dealing under I.R.C. § 4941(d) by certain Disqualified Persons of the foundation.

I.R.C. §4946 defines the term “Disqualified Person.” A Disqualified Person, with respect to a private foundation, is:

(1) A substantial contributor to the foundation. Substantial contributor is defined in I.R.C. §507(d)(2) as any person who contributes an aggregate amount in excess of $5,000 to the foundation, if his or her total contributions are more than 2% of the total contributions received by the foundation (since its inception) before the close of the taxable year of the contribution. Substantial contributor also includes:

(a) A family member of a substantial contributor (i.e., spouse, descendants and a spouse of a descendant), or any other person who would be a Disqualified Person by reason of his relationship to such person.
(b) Persons owning more than 20% of an entity which is a substantial contributor to the foundation. I.R.C. §4946(a)(1)(C).
(c) Where the substantial contributor is a corporation, the term also includes any officer or director of such corporation.

(2) A foundation manager,
(3) A member of the family of anyone described in (1) and (2) above, and
(4) A corporation in which persons described in (1),(2), and (3) above own more than 35% of the total combined voting power (more than 35% of profit interest of a partnership or more than 35% of beneficial interest of a trust).

Self-dealing includes any direct or indirect payment of compensation (or payment or reimbursement of expenses) by a private foundation to a Disqualified Person, unless compensation is payment for personal services, is reasonable, necessary and not excessive Treas. Reg. § 53.4941(d)(3)(c)(1).

Reimbursement for Expenses: Reimbursement to a director (i.e., Disqualified Person) for travel expenses causes the foundation and the director (i.e. a foundation manager) to be potentially liable for an excise tax for self-dealing, for making noncharitable expenditures, or possibly both. (Additionally, a foundation can lose its exempt status if any of its net earnings inure to the benefit of a private person. See discussion of private inurement below.) Such reimbursement of expenses will not be taxed if the expenses are reasonable and necessary to carrying out the exempt purposes of the foundation and are not excessive. I.R.C. §4941(d)(2). The Code does not explain what is “reasonable and necessary.” Treas. Reg. § 53.3941(d)-3(c)(1). Generally, business expenses under Treas. Reg. §1.162-2(1) include travel fares, meals and lodging and expenses incident to travel. Travel expenses are not included if the trip is primarily personal in nature. Treas. Reg.1.162-2(a). The Code does cross-reference Treas. Reg. § 1.162-7 to determine what is “excessive.” Under Treas. Reg. § 1.162-7, an amount spent on director’s services will not be deemed “excessive” if it is only such as would be paid "for like services by like enterprises under like circumstances.” Treas. Reg. 1.162-7 (i.e. as the organization would pay to someone independent of the foundation).

Cash Advances: Additionally, a director cannot receive a cash advance for expenses in excess of $500 unless extraordinary expenses are included. Treas. Reg. 53.4941(d)-3(c)(1). Upon receipt of such a cash advance, the director must then account to the foundation under a periodic reimbursement program for actual expenses incurred. If this is done, then the
cash advance, additional replenishment of the advance upon receipt of supporting vouchers, or the temporary addition to the advance to cover extraordinary expenses anticipated to be incurred in fulfillment of the assignment will be not considered to violate any act of self-dealing. Only a director or employee is entitled to a cash advance. Treas. Reg. 53.4941(d)-3(c).

Excise Tax on Acts of Self-Dealing (I.R.C. §4941): Any Disqualified Person who engages in an act of self-dealing is assessed an excise tax of 10% of the amount involved in the transaction for each year that the transaction is uncorrected. Additionally, a foundation manager who willingly participates in the act knowing that it is prohibited is subject to a tax of 5% of the amount involved (not to exceed $20,000 for each such act) for each year that the transaction is uncorrected. If the transaction is not timely corrected and the 10% was initially assessed timely paid, the Disqualified Person is subject to being assessed an additional tax of 200% of the amount involved. Any foundation manager who does not correct the transaction may also be subject to an additional assessment of 50% of the amount involved (up to $20,000 for each such act.) If more than one foundation manager is liable under this section, such persons are jointly and severally liable.

B. Public Charities

Public charities are not subject to the excise taxes imposed on private foundations under I.R.C. §§4940-4945. (See discussion of excise taxes pertaining to private foundations above.) Rather, a public charity is subject to the intermediate sanctions rules under I.R.C. §4958 and the related Treasury Regulations (Treas. Reg. §§53.4958-1 through 53.4958-8). These rules apply to excess benefit transactions between a charity and a Disqualified Person.

Tax Imposed: Any Disqualified Person who benefits from an excess benefit transaction with an applicable tax-exempt organization is liable for a tax of 25% of the excess benefit. I.R.C. §4958. The Disqualified Person is also liable for a tax of 200% of the excess benefit if the excess benefit is not corrected by a certain date. Additionally, an organization manager (i.e., officer, director, or trustee) who knowingly participates in the excess benefit transaction (unless such participation was not willful and was due to reasonable cause) are assessed a tax of 10% of the excess benefit transaction.

Disqualified Person: A disqualified person is defined as any person who was in a position to exercise substantial influence over the affairs of the applicable tax-exempt organization at any time during a five-year period ending on the date of the transaction, a member of the family of that person, or an entity that is 35% controlled by a Disqualified Person. I.R.C. §4958(f). Note the difference between a Disqualified Person for private foundation purposes (I.R.C. §4946) and for intermediate sanctions purposes.

1. The following persons are considered to have substantial influence:
   a. Presidents, chief executive officers, or chief operating officers,
   b. Treasurers and chief financial officers,
   c. Persons with a material financial interest in a provider-sponsored organization (generally, in the context of nonprofit hospitals)

2. The following persons are deemed NOT to have substantial influence:
   a. Tax-exempt organizations described in I.R.C. §501(c)(3),
   b. Certain I.R.C. §501(c)(4) organizations,
   c. Employees receiving economic benefits of less than a specified amount (indexed) in a taxable year. This does not apply to employees who are deemed disqualified or who are substantial contributors to the organization.

3. Facts and circumstances govern in all other instances. Facts and circumstances tending to show substantial influence:
   a. The person founded the organization,
   b. The person is a substantial contributor to the organization (within the meaning of I.R.C. §507(d)(2)(A),
   c. The person’s compensation is primarily based on revenues derived from activities of the organization, or of a particular department or function of the organization, that the person controls,
   d. The person has or shares authority to control or determine a substantial portion of the organization’s capital expenditures, operating budget, or compensation for employees,
   e. The person manages a discrete segment or activity of the organization that represents a substantial portion of the activities, assets, income, or expenses of the organization, as compared to the organization as a whole,
   f. The person owns a controlling interest (in vote or in value) in a corporation, partnership, or trust that is a Disqualified Person,
   g. The person is a non-stock organization controlled directly or indirectly by one or more Disqualified Persons.
4. Facts and circumstances showing no substantial influence:
   a. The person is an independent contractor whose sole relationship to the organization is providing professional advice,
   b. The person has taken a vow of poverty on behalf of a religious organization,
   c. Any preferential treatment the person receives based on the size of the person’s donation is also offered to others making comparable widely solicited donations,
   d. The direct supervisor of the person is not a Disqualified Person,
   e. The person does not participate in any management decisions affecting the organization as a whole or a discrete segment of the organization that represents a substantial portion of the activities, assets, income, or expenses of the organization, as compared to the organization as a whole. Treas. Reg. §53.4958-3

5. Excess Benefit Transaction. An excess benefit transaction means any transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of any Disqualified Person, and the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received by the organization for providing the benefit.
   a. An excess benefit can occur in an exchange of compensation and other compensatory benefits in return for the services of a Disqualified Person, or in an exchange of property between a Disqualified Person and the exempt organization.
   b. For purposes of determining the value of economic benefits, the value of property, including the right to use property, is its fair market value.

6. Rebuttable Presumption of Reasonableness
   a. Compensation paid to a Disqualified Person is not excessive if it is reasonable. Reasonableness is determined under an I.R.C. §162 standard, which is the value that would ordinarily be paid by like enterprises under like circumstances. The standards of I.R.C. § 162 apply in determining reasonableness of such compensation and generally include the person’s qualifications, the nature, extent and scope of such person’s work, the size and complexity of the business, the existing economic conditions, rates of compensation for comparable positions in comparable organizations, and the compensation policy of the organization that is applicable to such employees and payees. Caps on revenue sharing arrangements are taken into account.
   b. All items of compensation (not just salaries and the things traditionally thought of as compensation) provided by an applicable tax-exempt organization in exchange for the performance of services are taken into account in determining the value of compensation. Compensation includes all forms of cash and noncash compensation, all deferred compensation that is earned and vested, fringe benefits, any employer paid insurance premiums, expense allowances and other economic benefits. See Treas. Reg § 53,4958-4(b)(1)(B).
   Some items that are excluded from compensation include fringe benefits excluded from gross income under I.R.C. § 132, expense reimbursements paid according to an accountable plan; economic benefits provided to the person solely as a member of or volunteer for the organization if the same benefit is available to the general public in exchange for a membership fee of no more than $75 per year, and economic benefits provided to the person who is a member of a charitable class served by the organization. I.R.C. § 53.4958-4(a)(4).

   Reasonableness is generally determinable on the date parties enter into an agreement on the payment for fixed payments. However, reasonableness may be determined based upon all facts and circumstances, including up to the date of payment, if there has been substantial non-performance. For non-fixed payments, the latter method is used.

   Additionally, organizations are required to provide a contemporaneous written substantiation of any economic benefit that it intends to treat as compensation for services. See Treas. Reg. § 53.4958-4(c)(1). Such substantiation may be provided through a W-2, Form 1099, employment agreement or through the documentation required under the rebuttable presumption of reasonableness (see below). Some economic benefits are not subject to the contemporaneous written substantiation requirement, but are still taken into consideration in determining reasonableness of the overall compensation package. See Treas. Reg. § 53.4958-4(c)(2).

   c. There is a rebuttable presumption of reasonableness, and the payments under a compensation arrangement are presumed to be reasonable and the transfer of property (or right to use property) is presumed to be at fair market value, if the tax exempt organization follows the following procedures:
1) The transaction is approved by an authorized body of the organization (or an entity it controls) which is composed of individuals who do not have a conflict of interest concerning the transaction, (See Treas. Reg. § 53.4958-6(a)(1).)

2) Prior to making its determination, the authorized body obtained and relied upon appropriate data as to comparability. Appropriate data includes: compensation paid by other similarly situated organizations (taxable or tax exempt), availability of similar services in the geographic area, independent compensation surveys, written offers from other organizations which are competing for services, independent appraisals of property to be transferred, or offers for property received as part of an open and competitive bidding process. Treas. Reg. § 53.4958-6(c)(2)(i). If the organization has gross receipts of less than $1 million, appropriate comparability data includes data on compensation paid by three comparable organizations in the same or similar communities for similar services (Treas. Reg. § 53.4958-6(c)(2)(ii).

3) The authorized body adequately documents the basis for its determination concurrently with making that determination. The documentation should include:

a) The terms of the transaction that was approved and the date it was approved,

b) The members of the authorized body who were present during the debate on the transaction that was approved and who voted on it,

c) The comparability data obtained and relied upon by the authorized body and how the data was obtained,

d) Any actions taken with respect to consideration of the transaction by anyone who is otherwise a member of the authorized body but who had a conflict of interest with respect to the transaction, and

e) The basis for any deviation from the range of the comparable data.
Treas. Reg. §53.4958-6

Additionally, the records must be prepared by the next meeting of the board (or authorized body), or within 60 days after the final action of the authorized body, if later than the next meeting, and they must be reviewed and approved as reasonable, accurate and complete within a reasonable period thereafter. Id.

If the payment is not a fixed payment, generally, the rebuttable presumption arises only after the exact amount of the payment is determined, or a fixed formula for calculating the payment is specified, and the three requirements for the presumption are satisfied.

The rebuttable presumption of reasonableness is sometimes referred to as a safe harbor; however, it does not rise to the level of protecting the organization.

Comparability Data Resources: By no means, exhaustive, the following potential resources are some that an organization might use for seeking out comparability data as recommended by the panel:

1. The Board’s Role in Approving Executive Compensation, A Governance Institute White Paper 2005;


4. Report to the University Community, Harvard Corporate Governance Review Committee, December 6, 2010;

5. A Declaration of (Director) Independence, by Michael W. Peregrine for the Governance Institute, April 2011;

6. Watson Wyatt

7. Economic Research Institute (ERI) - Executive Compensation Assessor

8. American Society of Association Executives - Association Compensation & Benefits Study

9. TexasCompensation.com

10. PayScale


12. Salary.com

13. American Research Company - Association Chief Staff Executives Survey

14. The Hay Group

15. Mercer

16. PRM - Management Compensation Report

17. Guide Star - Tax Exempt and Nonprofit 990 Data

18. Urban Institute - NCCS 990 Data

19. CompData

There are various Industry and Association Specific Surveys - Healthcare, Hospice, Colleges and Universities, Nonprofits, Etc. that are also available.. There are also local, and regional surveys that are available across the country that are too numerous to name.

C. IRS Reporting

(This section C. is adapted from materials prepared by Bob Cartwright, and used with permission.)
The IRS released a new version of Form 990 in 2008 with revisions in 2009, 2010 and 2011. **If you haven't noticed, the more recent versions of IRS Form 990 have been revised and include more reporting requirements and definitions that most tax exempt organizations will need to know and report on.** So the records you keep and processes you follow right now might need to be changed so that it will be easier for you to complete the new form going forward.

The 2011 version of the Form 990 consists of a core form completed by all filers, with supporting schedules that will be completed only when an organization's answers trigger the need for more detail. The core form's **Part VI (Governance, Management, Policies, and Disclosure)** requires answers about policies not required by the Internal Revenue Code, but all filers still need to respond to the questions. The rational between IRS’s thinking is that if nonprofits have certain kinds of policies (think whistleblower protections, conflict of interest policies, compensation processes, etc.); they are more likely to end up in compliance with regulations.

**Part VII; Section A. Officers, Directors, Trustees, Key Employees, and Highest Compensated Employees, and Independent Contractors**

All Form 990 filers (now including all tax-exempt organizations, not just charities) must complete **Part VII (Compensation of Officers, Directors, Trustees, Key Employees, Highest Compensated Employees, and Independent Contractors)** of the core form. The listing must include information requested on IRS Form W-2 or Form 1099-MISC, so the totals are now for the calendar year, which may be different from the organization's fiscal year.

**Overview:** Organizations are required to enter in Part VII, Section A, the following officers, directors, trustees, and employees of the organization whose reportable compensation from the organization and related organizations (as explained in the instructions for Schedule J (Form 990) exceeded the following thresholds.

- **All current officers, directors, and trustees** (no minimum threshold)
- **Current key employees** (over $150,000 of reportable compensation).
- **Five current highest compensated employees** other than officers, directors, trustees, or listed key employees (only if earning more than $100,000)
- **Former officers, key employees, and highest compensated employees** (over $100,000 of reportable compensation, with special rules for former highest compensated employees).
- **Former directors and trustees** (over $10,000 of reportable compensation in the capacity as a former director or trustee).

**Definitions:**

**Director or Trustee:** A “director or trustee” is a member of the organization's governing body, but only if the member has voting rights. A director or trustee that served at any time during the organization's tax year is deemed a current director or trustee. Members of advisory boards that do not exercise any governance authority over the organization are not considered directors or trustees. An “institutional trustee” is a trustee that is not an individual or natural person but an organization. For instance, a bank or trust company serving as the trustee of a trust is an institutional trustee.

**Officer:** An officer is a person elected or appointed to manage the organization's daily operations. An officer that served at any time during the organization's tax year is deemed a current officer. The officers of an organization are determined by reference to its organizing document, bylaws, or resolutions of its governing body, or as otherwise designated consistent with state law, but, at a minimum, include those officers required by applicable state law. Officers can include a president, vice-president, secretary, treasurer and, in some cases, a Board Chair. In addition, for purposes of Form 990, including Part VII, Section A, and Schedule J (Form 990), treat as officers the following persons, regardless of their titles.

1. **Top management official.** The person who has ultimate responsibility for implementing the decisions of the governing body or for supervising the management, administration, or operation of the organization.
2. **Top financial official.** The person who has ultimate responsibility for managing the organization's finances.

If ultimate responsibility resides with two or more individuals (for example, co-presidents or co-
treasurers), who can exercise such responsibility in concert or individually, then treat all such individuals as officers.

Key Employee: For purposes of Form 990, a current key employee is an employee of the organization (other than an officer, director or trustee) who meets all three of the following tests, applied in the following order:

1. $150,000 Test: Receives reportable compensation from the organization and all related organizations in excess of $150,000 for the calendar year ending with or within the organization's tax year.

2. Responsibility Test: At any time during the calendar year ending with or within the organization's tax year:
   a. Has responsibilities, powers, or influence over the organization as a whole that is similar to those of officers, directors, or trustees;
   b. Manages a discrete segment or activity of the organization that represents 10% or more of the activities, assets, income, or expenses of the organization, as compared to the organization as a whole;
   c. Has or shares authority to control or determine 10% or more of the organization's capital expenditures, operating budget, or compensation for employees.

3. Top 20 Test: Is one of the 20 employees other than officers, directors, and trustees who satisfy the $150,000 Test and Responsibility Test with the highest reportable compensation from the organization and related organizations for the calendar year ending with or within the organization's tax year.

The IRS’s revision of the Form 990 was based on three guiding principles: (1) enhancing transparency – giving the IRS and the public a more detailed and accurate view of the organization; (2) promoting compliance – allowing the IRS to efficiently assess non-compliance risks; and (3) burden minimization – reducing the compliance burden on filing organizations.

Today more than 1,000 IRS employees are charged with overseeing the IRS Tax-Exempt Division, which includes Form 990 data. The IRS has begun to increase the number of audits relating to the specific issue of excessive compensation. In addition to the IRS efforts, many state attorneys general offices regulate tax-exempt organizations. Some states take regulation of charities very seriously, and contact regarding a tax-exempt organization’s activities may just as likely come from the state level as from the federal.

New Reporting on the "Process" of Determining Compensation

Form 990 information on executive compensation has long been a focus of IRS compliance efforts, and the revisions reflect the continuing IRS interest. The IRS not only wants to know what salaries are paid but also the process you use to determine compensation levels.

IRS questions 15a and 15b on Form 990 Part VI (Governance, Management & Disclosure) asks for information on the process for determining compensation which includes:

- A review and approval by independent persons – no conflicts of interest
- Collection and use of compensation data for similarly qualified persons in comparable positions (comparability data) at similarly situated organizations
- Contemporaneous substantiation of the deliberation and decision

With this question, the IRS is again emphasizing what it wants you to do and is looking for the following components in the process of setting compensation:

- Review/approval by the executive board
- No involvement of persons with conflicts of interest
- Collection and use of compensation data for similarly qualified persons in comparable positions at similarly situated organizations
- Contemporaneous documentation and record-keeping

But now if you do have a process, you must describe it in Schedule O, identifying the positions covered and the year conducted. Obviously, checking the "No" box and saying that you do not have a process is not a good answer. And describing a process that does not include the steps outlined above is also problematic.

Both answers will clearly be red flags for IRS compliance staff

D. Best Practices

In 2007, the IRS issued its report resulting from its Compensation Compliance Initiative. (See
Prior to the release of its report, the IRS held a Phone Forum to discuss the issues of its initiative and offered suggestions on the following best practices:

1. Organizations should consider meeting the rebuttable presumption of reasonable requirements.

2. All economic benefits to directors, officers, and key employees should be timely reported on the organization’s annual reporting form 990. Organizations not indicating intent to treat economic benefits as compensation for services will have those automatically treated as excess benefit transactions.

3. The board continues to have ultimate responsibility over compensation, even where a committee has been given authority to evaluate and approve executive compensation. The level of oversight may vary, depending on the type and size of the organization, but systems should be in place to assure that the board is fully apprised of the relevant compensation matters. The IRS noted specific problem areas frequently not reported, such as the personal components of business travel, person use of employer-owned property, gifts, gift certificates, tax gross-ups, expense reimbursements that fall outside of corporate travel policies, spousal travel expenses, non-accountable expense allowances, and club memberships.

Additionally, the Independent Sector convened the Panel on the Nonprofit Sector to study the proposed reforms and best practices draft prepared by the staff of the Senate Finance Committee in 2004, which resulted in the issuance of the Panel’s “Strengthening Transparency Governance Accountability of Charitable Organizations in June of 2005, and the subsequent “Principles for Effective Practice”. See www.nonprofitpanel.org. The Panel recommended separating the paid chief executive officer, the treasurer, and the chair of the organization into different individuals in order to assure there are checks and balances. Both the board chair and the treasurer should be independent of the chief executive officer in order that they may maintain oversight of his or her performance and make fair and impartial judgments about the compensation of such individual. If such person also serves as the chair, then another individual should be appointed to handle those issues requiring separation of duties. They also advocated for having a substantial majority of the directors be unpaid in any capacity other than as directors, believing that their not having personal interests in the financial transactions of the organization may make the board more likely to exercise its responsibility of review and action. The Panel further advocated for annual evaluation of the performance of the chief executive officer prior to any compensation change, unless a multi-year contract is in existence or the change is the result of only a cost of living adjustment. They considered this one of the board’s main responsibilities and recommended full board approval of such compensation. And, if there is a compensation committee to review the chief executive officer’s performance, that a report be provided to the full board and that the board then document the basis for its decision and be prepared to answer questions about such decision. As for other officers and key employees, the specific amount may be delegated to the chief executive officer, but ranges should be approved by the board for those in a position to exercise substantial control over the organization’s resources. If any individual is to be compensated in an amount higher than that of the chief executive officer when such decision normally rests in the CEO, then the board should review the compensation package to protect against excess benefits.

E. Supporting Organizations and Donor Advised Funds

As a result of the passage of the Pension Protection Act in 2006, transactions between disqualified persons of certain supporting organizations and certain entities are subject to the excess benefit transactions rules, including the prohibition of paying compensation to a substantial contributor of the supporting organization or a person related to a substantial contributor. See I.R.C. § 4958(c)(3). Additionally, under the Pension Protection Act, I.R.C. §§ 4966 and 4967 now treat donor advised funds similarly to private foundations. Under I.R.C. § 4966, donor advised funds cannot make distributions to individuals, except for certain exceptions. Additionally, donors, donor advisors and investment advisors to a donor advised fund are treated as disqualified persons and transactions between such individuals and the sponsoring organization are subject to the excess benefit transactions rules that includes the payment of compensation. Finally, any benefit flowing from a donor advised fund to a disqualified person that is more than incidental is subject to an excise tax.

XII. ITEMS TO BE PROVIDED TO A DIRECTOR

Before beginning a term of office, the new director should become knowledgeable about the organization, or, if the director is continuing an additional term, the director should make sure that he or she is aware of the current status of various documents and policies pertaining to the organization.
In readiness the director for service, the director should be provided and should review the organization’s:

1. Articles of incorporation (a/k/a Certificate of Formation);
2. Bylaws;
3. Determination letter from the IRS;
4. Most recent tax return;
5. Most recent audited financial statement or year-end statements if audited financial statements are not available;
6. Most recent annual report;
7. List of the current officers and directors of the organization;
8. Summary of applicable insurance (including a review of any policies of Directors and Officers Fiduciary Liability Insurance);
9. Mission Statement;
10. Chart showing the relationship among the organizations, if the organization is part of a system of affiliated organizations;
11. Mission Statement;
12. Whistleblower Policy;
14. Gift Acceptance Policy (applicable to charities); and
15. Conflict of Interest Policy.

XIII. CHECKLIST

The following checklist is intended to assist directors in reducing their risk and to assist the organization in fulfilling its obligations under the law.

1. Is the organization actually incorporated?
2. Does the corporation have clear bylaws?
3. Does it conduct its affairs in a manner consistent with its bylaws?
4. Does the board meet regularly?
5. Are the other directors respected members of the community?
6. Can I devote the time necessary to carry out my duties?
7. Does the corporation have a conflict of interest policy?
8. Do I have any significant conflicts of interest that will impair my ability to serve this organization?
9. Does the corporation have directors and officers’ liability insurance and, if so, what are the policy limits, exclusions, deductibles and copayments?
10. Does the corporation maintain sufficient insurance appropriate to its activities?
11. Do the bylaws or other governing documents provide for indemnification and under what circumstances and with what limitations?
12. Do the bylaws or other governing documents provide for limitation of liability?
13. Does the organization produce regular financial statements and are they audited annually?
14. What internal financial controls are in place?
15. What restricted gifts does the organization have and how are they being used?
16. How is the endowment invested and used?
17. What is the federal tax status of the organization?
18. Is the organization a private foundation or public charity?
19. If it is a private foundation, what steps are taken to comply with the regulations imposed on private foundations?
20. Has the organization filed its federal tax return?
21. Is the organization paying its employment taxes?
22. Does the organization engage in lobbying or political activity?
23. Is the organization paying sales tax on items it buys and collecting and remitting it on items it sells?
24. Is the organization authorized to solicit contributions in each jurisdiction where it does so?