THE NONPROFIT MANAGEMENT CENTER OF THE PERMIAN BASIN

GOVERNANCE AND FORM 990: UNDERSTANDING THE WHY AND THE WHAT

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GOVERNANCE

WHO IS WATCHING:

Attorney General, IRS, Watchdog Groups,
Public (your donors/future donors)

Governance is No Joke!

Directors/Trustees/Officers are fiduciaries with real responsibilities

Nonprofit governance matters

- To the community
- To the beneficiaries of the charity
- To state and federal regulators

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Nonprofit Corporations

A corporation whose income may not be distributed to its members, directors, or officers in the form of dividends or otherwise (note: salaries paid must be reasonable)

May be organized for any lawful purpose (with limited exceptions)

Governed by the Texas Business Organizations Code (specifically Chapter 22)

Note: While purposes are broad, care should be taken if later applying for 501)(c)(3) recognition (must be organized exclusively for charitable, educational or religious purposes)

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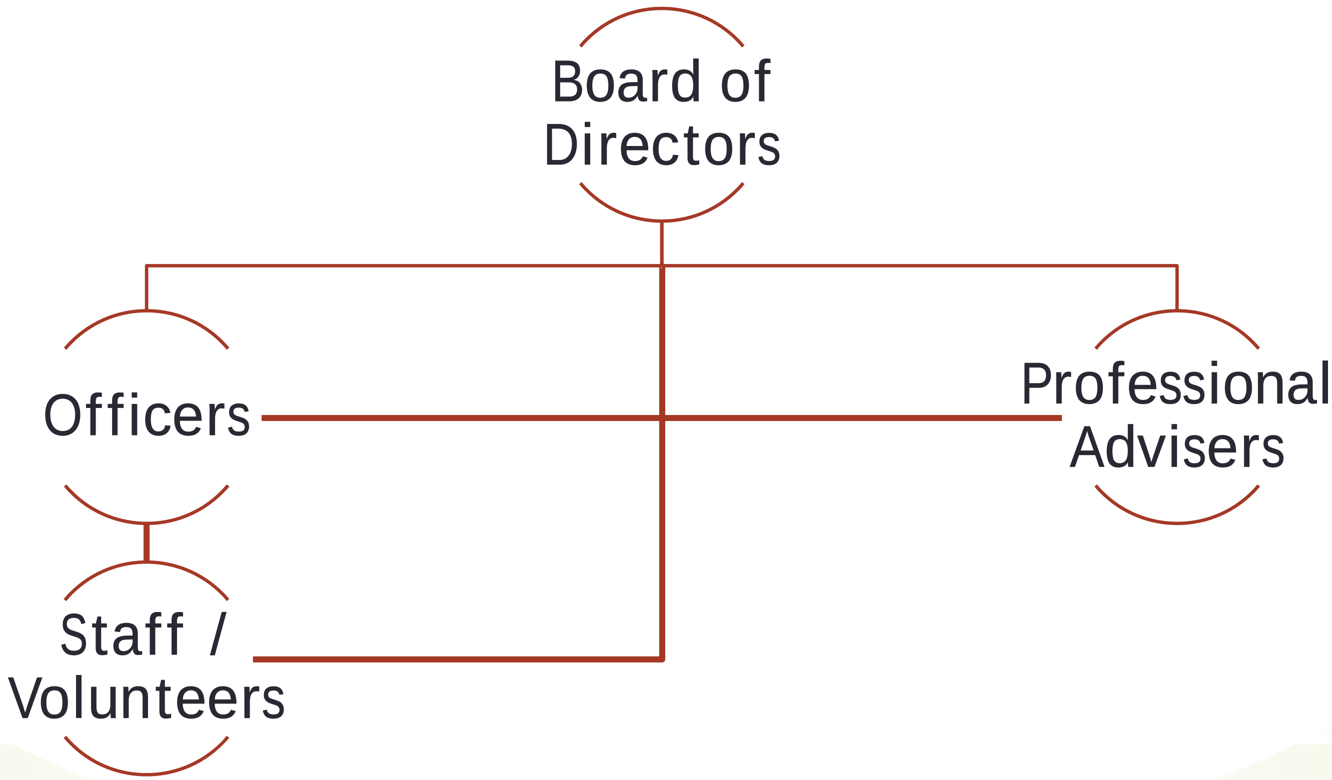
The Players:



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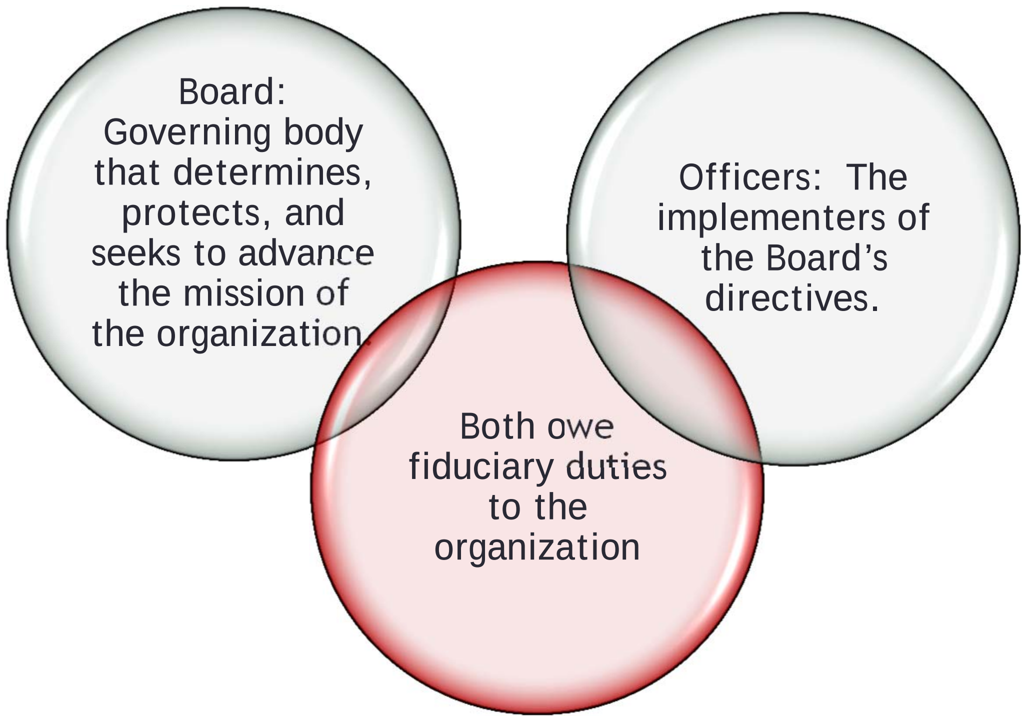
Relationship Between Board and Officers



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THE RULES:

Fiduciary Duties

- Duty of Care
- Duty of Loyalty
- Duty of Obedience

Who Owes the Duties?

Directors	Officers	Member
• At least 3 • Voting rights carry responsibility • Largely charged with making strategic decisions, evaluating, reviewing, overseeing and approving corporate actions	• May hold multiple offices but same person may not be both President and Secretary • Owe duties within the scope of implementing decisions and policies established by the Board	• In instances in which the organization is member-managed by a sole member, the member takes on the duties of a director

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Duty of Care - Directors

Act in good faith

Use care that a person of ordinary prudence would use in same or similar circumstances (reasonable skills)

Make decisions reasonably believed to be in the best interest of the corporation

- Reasonableness based on objective facts available to the decision maker

Duty of Care:
Business Judgment Rule and Directors

Directors of nonprofit corporations are not liable where they exercise their business judgment in making decisions on behalf of organization.

- Parameters not clearly defined (compare for profit context)
- Statutory law governing nonprofit corporations simply refers to the duty of care
- Essentially means directors are not liable for simple negligence absent fraud, illegality or a disabling conflict of interest

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Duty of Care Checklist

All decision makers should know the following:

- Legal form of the organization
- Mission of the organization
- Provisions of Articles of Incorporation/Certificate of Formation
- Provisions of Bylaws
- Any policies affecting decision makers (e.g. Conflict of Interest Policy)
- Financial Picture (budget and financials)
- Most recent 990
- Existence/operations of related entities
- Where the organization is conducting activities
- Tax status and applicable legal requirements of the organization
- Activities being conducted by the organization
- Management structure
- Key employees
- Committee Structure
- How directors and officers are selected

Duty of Care Checklist

With other members of the Board, develop schedules for review and approval of the strategic direction of the organization, executive compensation, legal compliance, and budget

Keep the following information accessible in a Board Book/Director's Notebook:

- Articles of Incorporation/Certificate of Formation
- Bylaws
- Conflict of Interest Policy
- Minutes for the previous year
- Most recent audit/review
- Budget and most recent financials

A director should seek to do the following:

- Familiarize herself with material aspects of the organization
- Faithfully attend meetings
- Read materials and prepare for meetings
- Ask questions before, during and after meetings
- Exercise independent judgment
- Rely on appropriate sources of information
- Review minutes of the board
- Seek to stay informed as to legal obligations and good governance

Duty of Loyalty

Exercise an "extreme measure of candor, unselfishness and good faith"

Don't usurp corporate opportunities

Transactions with organization must be fair to the organization

Maintain appropriate confidentiality

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Corporate Opportunity

- Prohibits a director from usurping corporate opportunities (i.e. opportunities in which the corporation has a legitimate interest or expectancy and the financial resources to exploit)
- Where closely related to corporate operations, must disclose (timely)
- Defenses where no disclosure:
  - Not same line of business
  - Corporation abandoned opportunity
  - Corporation lacked financial resources to pursue the opportunity

Corporate Opportunity

* Before a director engages in a transaction which he or she reasonably should know may be of interest to the corporation, the director should disclose the transaction to the board in sufficient detail (all material facts) and adequate time to enable the board to act or decline to act with regard to such transaction.

Interested Transactions

Not inherently unethical or a violation of law

- **Note: Loans to directors are a statutory violation**

Key is disclosure and how the director and board then deal with a disclosed conflict (i.e. upon disclosure the board should provide a disinterested review of the matter)

Decision makers should consider adopting a conflict of interest policy

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Interested Transactions

An officer or director is interested if he:

- Makes a personal profit from the transaction with the corporation
- Buys or sells assets of the corporation
- Transacts business in the officer's or director's capacity with a second corporation of which the officer or director has a significant financial interest
- Transacts corporate business in the officer's or director's capacity with a member of his family

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Dealing with Disclosed Conflict

Interested transactions are presumed unfair on the part of the decision maker, fraudulent on the corporation and generally voidable.

"Safe Harbor"

- Interested decision maker discloses material facts
- Majority of the disinterested directors, in good faith and the exercise of ordinary care, authorize the transaction

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Conflict of Interest Policy

If an organization chooses to adopt a policy (and all should), the policy should consider the following:

1. Identification of the class of individuals covered by the policy;
2. Definition of "actual" and "potential" conflicts of interest;
3. Articulation of the duty of disclosure of officers and directors;
4. Appropriate "trigger" mechanisms to help identify potential conflicts;
5. Annual, episodic disclosure obligations of individuals covered by the policy;
6. Written conflicts disclosure questionnaires;
7. of disclosed potential conflicts by a committee of disinterested directors with outside counsel's input;
8. The applicability of the corporate opportunity doctrine to the board;
9. Disclosure obligations regarding outside board service of officers and directors; and
10. Disclosure obligations regarding outside business activities of senior executive leadership.

Duty of Obedience

- Remain faithful to and pursue the goals of the organization
- Follow the governing documents of the organization, laws applicable to the organization (including reporting and regulatory requirements), and restrictions imposed by donors
- Ensure charitable assets are not diverted to non-charitable uses
- Liability requires personal participation or actual knowledge of the wrongful act

To Whom Are the Duties Owed?

- The founders?
- The members?
- The public?
- Persons with a special interest?
  - All may be stakeholders in the organizational mission.

❖Despite the presence of stakeholders, the fiduciary duties are owed to the corporation.

Who Has Standing to Enforce the Duties?

Nonprofit Corporations:

- Organization (directors, officers and/or members may have standing to bring derivative claim)
- Texas Attorney General
- Donors in very narrow circumstances (must retain a special interest in the donated gift)
- **Note: Venue for breach of fiduciary duty claims brought by the OAG lies in Travis County**

Policies and Corporate Records

Too Detailed

Words don't match reality

Administrative burden means lack of compliance

"He said, she said" minutes

Missing in Action

Insufficient written policies

- No conflicts policy → hard to deal with conflicts of interest responsibly
- No travel policy → invitation to trouble

No minutes → tough to prove Board was paying attention – in most audits, minutes are at the top of the IRS document request list

MINUTES:

Minimalist vs. Comprehensive

- Drafter should be skilled
- Document compliance with fiduciary duties and exercise of business judgment
- Tapes do not replace minutes

Always Include

- Date, time, location, duration, nature (regular or special), participants, quorum, materials distributed, agenda discussed, actions taken, conflicts/dissents/abstentions, professionals who provided advice

And Finally

- Circulate to Board prior to or at the next meeting to be approved and signed

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Adopting Governance Policies

One Size Doesn't Fit All
But You Need to Put on Some Clothes

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Governance and the IRS

- Form 1023
- Final Regulations on EBT
- 2009 Work Plans
- 990 and 990 Instructions
  - Policies/Procedures
- Position Paper

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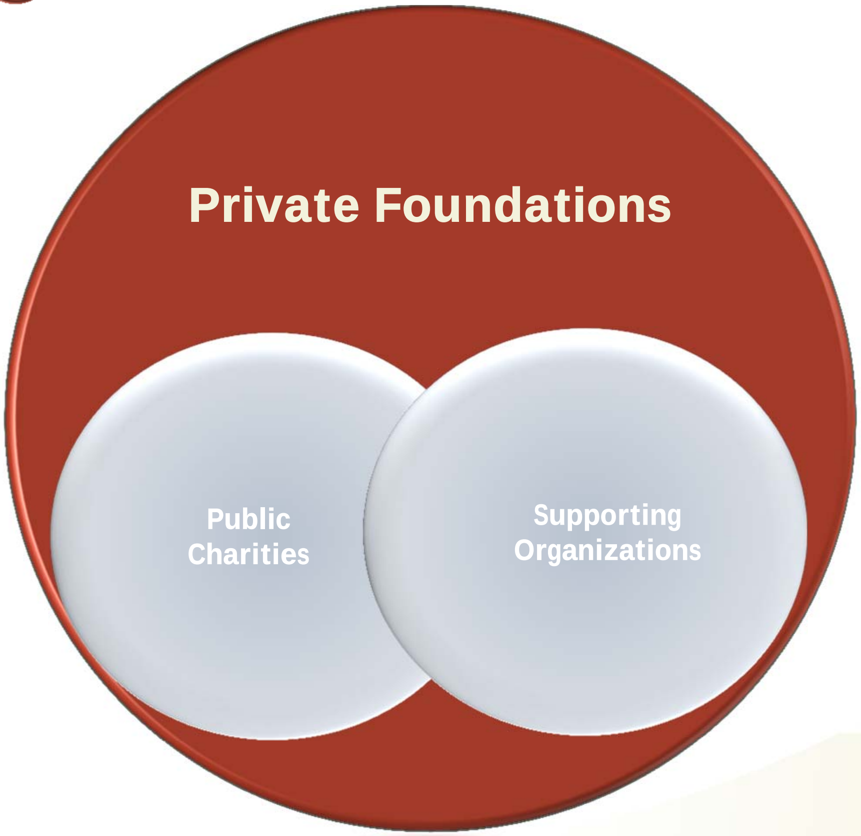
§ 501(c)(3) Elements

- Proper organizational structure
- Organized exclusively for charitable purposes
- Operated exclusively for charitable purposes
- No part of net earnings inures to benefit of private individual
- Not an action organization
- <<case law>> - not violative of public policy

Classification of Charitable Organizations

* All charitable organizations are classified as private foundations unless they can establish public charity status



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Private Foundation

Per § 509(a): Organization described in § 501(c)(3) other than the following:

- Traditional public charities
- Publicly supported charities
- Supporting organizations
- Public safety testing organizations

(a § 501(c)(3) organization is a private foundation if it fails to qualify as a public charity)

Public Charity

Traditional charities (hospitals, churches, etc.)	Publicly supported (aka gross receipts) charities (receive substantial amount of support from public or governmental agencies)	Supporting Organizations (take status from supported organization)

Excess Benefit Transactions

- Applies intermediate sanctions (excise taxes) on DP's who benefit improperly and on organization managers who participate in such transaction
- Applies to public charities and social welfare organizations
- Overlaps concepts of private inurement

EBT: Disqualified Persons

1. Any person who was in a position to exercise substantial influence over the affairs of the TE organization *at any time during a 5 year period ending on the date of the transaction*
2. A family member of a person of substantial influence
3. An entity that is 35% controlled by (1) or (2)

Substantial Influence

- President, CEO, COO
- Treasurer, CFO
- Voting member of the governing body
- Persons with a material financial interest in a provider-sponsored organization (e.g. nonprofit hospitals)

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Facts & Circumstances Tending to Show Substantial Influence

- Has or shares authority to control/determine substantial portion of the organization's capital expenditures
- Founder of organization
- Compensation primarily based on revenues derived from activities of the organization
- Substantial contributor
- Managerial authority or key advisor to person with managerial authority
- Has controlling interest in a corporation, partnership or trust that is a DP

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Excess Benefit Transaction Consequences

- Two tier excise tax on DP
  1. First tier tax of 25% of the excess benefit
     - can be abated under certain circumstances
  2. If not corrected in a timely manner, second-tier tax of 200% of the excess benefit

- Organization manager who knowingly participates pays a tax of 10% of the excess benefit not to exceed $10,000 <can be subject to both if the organization manager receives the excess benefit>

Practical Correction

1. Return the "correction amount" (the excess benefit plus interest)
2. Return the specific property where excess benefit was transfer of property (organization must agree)
   - DP (and family members) cannot vote on whether to accept the property as correction

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Unreasonable Compensation as an Excess Benefit

Compensation must be reasonable in relationship to the value of the services rendered

- Compensation paid by similarly situated organizations for comparable positions
- Availability of similar services in geographic area
- Current compensation surveys by independents firms
- Written offers from competitors for the employee

EBT Compensation: Rebuttable Presumption of Reasonableness

Transaction approved by an authorized body of the organization composed of non-conflicted individuals

Prior to making determination, authorized body obtained and relied upon appropriate comparability data

Authorized body adequately documents basis for determination concurrently with making decision

Form 990 at a Glance

11 Page "Core Form"

16 Additional Schedules

- Geared to specific activities and/or types of organizations

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Form 990 at a Glance

Core Form 11 Parts

- Part 1 - Summary
- Part II – Signature Block
- Part III - Program Service Accomplishments
- Part IV – Checklist of Required Schedules
- Part V – IRS Filings and Tax Compliance
- Part VI – Governance, Management and Disclosure
- Part VII – Compensation
- Part VIII – Statement of Revenue
- Part IX – Statement of Functional Expenses
- Part X – Balance Sheet
- Part XI – Financial Statements and Reporting

Form 990 at a Glance

16 Schedules	
	Schedule A – Public Charity Status
	Schedule B - Contributors
	Schedule C – Political and Lobbying Activity
	Schedule D – Supplemental Financial Statement Detail
	Schedule E – Schools
	Schedule F – Foreign Activities
	Schedule G – Fundraising and Gaming
	Schedule H – Hospitals

Form 990 at a Glance

16 Schedules (cont'd)	
	Schedule I – Grants
	Schedule J - Compensation
	Schedule K – Tax-Exempt Bonds
	Schedule L – Transactions with Interested Persons
	Schedule M – Non-cash Contributions
	Schedule N – Termination or Significant Disposition of Assets
	Schedule O – Supplemental Information
	Schedule R – Related Organizations and Unrelated Partnerships

Part I - Executive Summary

“Snapshot” of Organization

- Mission and activities
- Board, governance
- Summary of Information

IRS Hot Button Issues Appear Here:

- Ratio of gross unrelated business income compared to net taxable UBI
- Revenues compared to professional fundraising fees
- Broad categories of revenue and expense this year vs. prior year

Part II – Signature Block

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Part III - Programs

Information About	Accomplishments
	Donated services not reportable elsewhere
	Number of clients served
	Reports issued
	Other non-financial evidence of achievements

Part IV - Checklist of Required Schedules

Responses to 37 questions determine need to complete various schedules

Questions asked in order on the Form

- Assists filer in completing Form
- Ensures complete return

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Part V - Statements Regarding Other IRS Filings and Tax Compliance

Goal – Remind Organizations

- Required forms
- Filing requirements

Questions Pertain To

- Employment taxes
- Information returns
- Backup withholding
- Unrelated business income tax
- Foreign bank account reporting
- Prohibited tax shelter transactions
- Substantiation and reporting of contributions
- Donor advised funds

Part VI - Governance, Management and Disclosures

* Who is an **independent member** of the governing body?
* Regulations define independent for *rebuttable presumption* purposes.
* 3-prong test
  * Compensation as an employee
  * Compensation as an independent contractor
  * Schedule L Transactions Test
* Reasonable efforts to obtain – *questionnaire*

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Part VI - Governance, Management and Disclosures

Independent Board Members

A member of the governing body is considered "independent" only if all three of the following circumstances applied at all times during the organization's tax year:

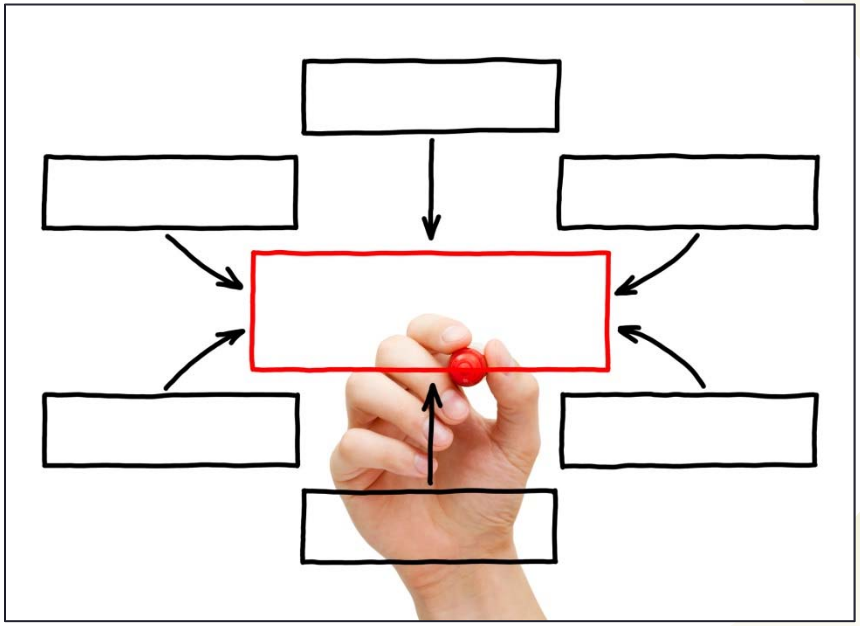
1. Member was not compensated as an officer or other employee of the organization or of a related organization (see Schedule R instructions), except as provided in the religious exception discussed below.
2. Member did not receive total compensation or other payments exceeding $10,000 during the organization's tax year from the organization or from related organizations as an independent contractor, other than reimbursement of expenses under an accountable plan or reasonable compensation for services provided in the capacity as a member of the governing body. For example, a person who receives reasonable expense reimbursements and reasonable compensation as a director of the organization does not cease to be independent merely because he or she also receives payments of $7,500 from the organization for other arrangements.
3. Neither the member, nor any family member of the member, was involved in a transaction with the organization (whether directly or indirectly through affiliation with another organization) that is required to be reported in Schedule L for the organization's tax year, or in a transaction with a related organization of a type and amount that would be reportable on Schedule L required to be filed by the related organization.

Part VI - Governance, Management and Disclosures

- Did any ODTKE have a family relationship or business relationship with any other ODTKE?
- Ordinary course of business exception
- Privileged relationship exception
  - Attorney and client
  - Medical professional and patient
  - Clergy and communicant
- $10,000 threshold for reporting
- Reasonable efforts to obtain - questionnaire
  - With name, title, date, and signature of each person sent any time during year

Part VI – Governance, Management and Disclosures

* Contemporaneous Documentation
  * Does the organization **contemporaneously** document meetings of the governing body and related committees through preparation of minutes and other similar documentation?
    * Contemporaneously means within 60 days of meeting or at the next meeting whichever is later.
    * If no, explain in Schedule O circumstances, process, or changes to be made going forward.



Part VI: Governance Policies

Conflict of Interest/Annual Disclosures

- Adopting a conflict of interest policy helps ensure that officers and directors disclose their interests.
- Adopting a conflict of interest policy is not a state or federal law requirement.

Some transactions are simply not allowed:

- loans to directors and (subject to certain exceptions) officers (prohibited under Texas law; TBOC § 22.225)
- Directors who vote for or assent to the making of any such loan in violation of the statutory prohibition are jointly and severally liable to the corporation for the amount of such loan until the loan is fully repaid.

Part VI: Governance Policies

Whistleblower Policy

- encourages staff to come forward with credible information on illegal practices or violations of adopted policies of the organization;
- specifies protection from retaliation; and
- identifies staff, board members, or outside parties to whom such information can be reported.

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Part VI: Governance Policies

- Unlike most SOX provisions, the whistleblower protection provisions of SOX apply to nonprofit corporations.
- Even if the claims are without merit, the organization may not "discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee in the terms and conditions of employment" if the employee reports suspected fraud.
- SOX makes it a crime to knowingly and intentionally retaliate against such an employee.
- Criminal sanctions include, for individuals, fines up to $250,000 and/or imprisonment of up to 10 years, and for organizations, fines up to $500,000

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Part VI: Governance Policies

Document Retention and Destruction Policy

- identifies the record retention responsibilities of staff, board members, and outsiders for maintaining and documenting the storage and destruction of the organization's documents and records.

A Document Retention and Destruction Policy

- should include guidelines for handling electronic files
- should cover backup procedures, archiving of documents, and regular check-ups of the reliability of the system.

Again, unlike most SOX provisions, the document preservation provisions of SOX apply to nonprofit corporations and carry significant criminal penalties.

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Other Policies

Joint Venture Policy

Expense Reimbursement Policy

990 to the Board Policy

Policy on Chapters, Affiliates, and Branches

Executive Compensation Policy

Gift Acceptance Policy

Political Activity Policy

Code of Conduct

Part VII - Compensation

All current officers and directors need to be reported regardless of amount.

Summary Threshold for:	Current	Former
➢ Trustee/Director	-0-	> 10,000
➢ Officer	-0-	>100,000
➢ Key Employee	$150,000	>100,000
➢ 5 Highest Employees/IC	5 highest	>100,000

Part VII - Compensation

Part VII and Schedule J reflect amounts paid on calendar year basis even if EO has non-calendar year.

Officers, directors or trustees are reported if the served in that role **at any time** during the period of the return. Payments to former officials reported during a 5-year look back period.

Part VII - Compensation

Who are the 5 Highest Compensated Employees?

The 5 highest compensated employees who received over $100,000 are determined by the amounts of reportable compensation for the calendar year ending with or within the organization's tax year (other than officers or key employees).

One of the 5 highest compensated employees of the organization can include employees of a disregarded entity of the organization.

Part VII - Compensation

Who is a Key Employee?

- Key Employee – An employee of the organization (other than an officer, director, or trustee) who meets all three of the following tests:
  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 – The employee has wide control similar to an officer, director, or trustee, or control over 10% of the organization's activities, assets, income or expenses, or has authority to control or determine 10% or more of the organization's capital expenditures, operating budget, or compensation for employees AND
  3. Top 20 Test – Is one of the 20 employees (which meet the top 2 tests) with the highest reportable compensation from the organization and related organizations for the calendar year ending with or within the organization's tax year.

Schedule J - Compensation Information - Part I

Did organization require substantiation prior to reimbursing or allowing expenses incurred by all officers, directors, trustees, and the CEO/Executive Director for all items in 1a?

Key Point: If No, organization does not have an accountable plan and reimbursements are taxable.

Schedule J - Compensation Information - Part I

Which method(s) does organization use to determine CEO/Executive Director's salary? Check all that apply.

- ❑ Compensation committee
- ❑ Independent compensation consultant
- ❑ Written employment agreement
- ❑ Compensation survey or study
- ❑ Form 990 of other organizations
- ❑ Approval by the Board or compensation committee

Parts VIII-XII - Financial Information

- Part VIII – Statement of Revenue
- Part IX – Statement of Functional Expenses
- Part X – Balance Sheet
- Part XI – Reconciliation of Net Assets
- Part XII – Financial Statements and Reporting