

REFERENCE EDITION



PRINCIPLES

**FOR GOOD GOVERNANCE
AND ETHICAL PRACTICE**

A GUIDE FOR CHARITIES AND FOUNDATIONS



INDEPENDENT
SECTOR

2015 EDITION

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Principles for Good Governance and Ethical Practice
A Guide for Charities and Foundations

REFERENCE EDITION

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Independent Sector
1602 L Street NW, Suite 900
Washington, DC 20036

independentsector.org

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Andrew Watt, President and CEO, Association of Fundraising Professionals

Angela Williams, Executive Vice President, General Counsel and Chief Administration Officer, YMCA of the USA

Donor-Advised Fund Working Group

Diana Aviv, President and CEO, Independent Sector

Ronna Brown, President, Philanthropy New York

Fred Goldberg, Jr., Partner, Skadden, Arps, Slate, Meagher & Flom LLP & Affiliates

Emily Greer, Chief Administrative Officer, ALSAC, Inc./ St. Jude's Research Hospital

Philip Hackney, Professor, LSU Law Center, Louisiana State University

Emily Lam, Partner, Skadden, Arps, Slate, Meagher & Flom LLP & Affiliates

Jill Manny, Executive Director, National Center on Philanthropy and the Law, New York University School of Law

Celia Roady, Partner, Morgan, Lewis & Bockius LLP

Lorie Slutsky, President, The New York Community Trust

Sterling Speirn, President, Stupski Foundation

Overhead Working Group

Philip Hackney, Professor, LSU Law Center, Louisiana State University

Larry Hausner, former CEO, American Diabetes Association

James Lum, Chief Financial Officer, GuideStar USA, Inc.

Rebecca Masisak, CEO, TechSoup Global

Herman Art Taylor, President and CEO, BBB Wise Giving Alliance

Samuel Worthington, President and CEO, InterAction

PANEL ON THE NONPROFIT SECTOR, 2004-2007

Co-Conveners

Lorie A. Slutsky, President, The New York Community Trust, New York, NY

M. Cass Wheeler, Chief Executive Officer, American Heart Association, Dallas, TX

Panel Members

Susan V. Berresford, President, Ford Foundation, New York, NY

Paul Brest, President, William and Flora Hewlett Foundation, Menlo Park, CA

Linda Perryman Evans, President and CEO, The Meadows Foundation, Dallas, TX

Jonathan F. Fanton, President, John D. and Catherine T. MacArthur Foundation, Chicago, IL

Brian Gallagher, President and CEO, United Way of America, Alexandria, VA

Robert Greenstein, Executive Director, Center on Budget and Policy Priorities, Washington, DC

Steve Gunderson, President and CEO, Council on Foundations, Washington, DC

Stephen B. Heintz, President and CEO, Rockefeller Brothers Fund, New York, NY

Wade Henderson, Executive Director, Leadership Conference on Civil Rights, Washington, DC

Dorothy A. Johnson, Trustee, W.K. Kellogg Foundation, Grand Haven, MI

Valerie Lies, President and CEO, Donors Forum of Chicago, Chicago, IL

Paul Nelson, Former President, Evangelical Council for Financial Accountability, Winchester, VA

William D. Novelli, CEO, AARP, Washington, DC

Jon Pratt, Executive Director, Minnesota Council of Nonprofits, St. Paul, MN

John R. Seffrin, President and CEO, American Cancer Society, Atlanta, GA

Sam Singh, Former President and CEO, Michigan Nonprofit Association, Lansing, MI

Edward Skloot, Former Executive Director, Surdna Foundation, New York, NY

William E. Trueheart, President and CEO, The Pittsburgh Foundation, Pittsburgh, PA

William S. White, President, Charles Stewart Mott Foundation, Flint, MI

Timothy E. Wirth, President, United Nations Foundation, Washington, DC

Gary L. Yates, President and CEO, The California Wellness Foundation, Woodland Hills, CA

Raul Yzaguirre, Former President and CEO, National Council of La Raza, Washington, DC

Executive Director

Diana Aviv, President and CEO, Independent Sector, Washington, DC

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PREAMBLE

Charitable nonprofit organizations in the United States—educational, charitable, civic, and religious institutions of every size and mission—represent the most widespread organized expression of Americans’ dedication to the common good. The creation of these voluntary, often grassroots organizations to accomplish some public purpose is a distinguishing feature of our national life. Since the 1835 publication of Alexis de Tocqueville’s *Democracy in America*, they have been recognized internationally as a source of social cohesion, a laboratory of innovation, and a continually adaptable means of responding to emerging ideas, needs, and communal opportunity. Individuals have continued to use their First Amendment freedoms of speech and association to create and energize organizations that define common needs, rally popular support, and pursue innovative approaches to public problems. These nonprofits have been a source of national achievement on many fronts.

The variety of purposes, forms, and motivating beliefs that make up the charitable community in the United States is one reason why it has consistently earned widespread support from large numbers of Americans. In recent decades, the percentage of survey respondents expressing confidence in the ethics and honesty of U.S. charities and voluntary organizations overall has hovered around two-thirds.¹ For individual charitable organizations, responses are even more favorable, some reaching above 70 percent. In 2012, 26.5 percent of adult Americans—about 64.5 million of them— gave 7.9 billion hours of volunteer time worth \$175 billion.² In 2013, individual donations totaled more than \$240.6 billion, which came on top of the \$94.57 billion given by corporations, foundations, and bequests.³

Preserving this diversity, adaptability, and capacity for innovation for the purpose of improving life and the natural world depends in large part on maintaining the public’s trust. The public has high expectations for both the ethical standards and the impact of the

country’s 1.44 million charitable organizations,⁴ but often has trouble distinguishing one nonprofit from another. Unethical or improper conduct by an individual organization, though rare, can thus jeopardize the human and financial support on which countless other activities rely. Yet government attempts to prevent such abuses, if not carefully pursued, can themselves diminish the unique value that charitable organizations bring to American life. Too heavy a regulatory hand, or too uniform and inflexible a set of legal restraints, could stifle the very creativity and variety that makes charitable nonprofit activity worth protecting and encouraging. Government appropriately sets rules for the organizations and activities that are exempt from taxes and eligible to receive tax-deductible contributions: for example, government has determined that such contributions may not be used for partisan political activities or the private benefit of the donor. At the same time, government has wisely avoided intruding on how organizations pursue their missions, manage their programs, and structure their operations so long as those organizations file their annual information (Form 990) returns⁵ and are accountable to their boards.

Charitable organizations have long embraced the need for standards of ethical practice that preserve and strengthen the public’s confidence. Many such systems in fact already exist, though before the Panel on the Nonprofit Sector’s 2007 *Principles*,⁶ none had applied to the entire range of American charitable organizations.

The pages that follow set forth a comprehensive set of principles that are an updated version of the Panel’s work. Their purpose is to reinforce a common understanding of transparency, accountability, and good governance for the sector as a whole—not only to ensure ethical and trustworthy behavior, but equally important, to spotlight strong practices that contribute to the effectiveness, durability, and broad popular support for charitable organizations of all kinds.

1 Independent Sector, *Keeping the Trust: Confidence in Charitable Organizations in an Age of Scrutiny*, August 2002, p. 2.

2 Corporation for National and Community Service <http://www.nationalservice.gov/impact-our-nation/research-and-reports/volunteering-america> (accessed 10/28/14)

3 Giving USA (2014) reported in *Forbes* <http://www.forbes.com/sites/tomwatson/2014/06/17/annual-philanthropy-numbers-on-the-rise-u-s-giving-nears-pre-recession-levels/> (accessed 10/28/14)

4 Nonprofit Sector in Brief 2014, Urban Institute <http://www.urban.org/center/cnp/almanac/sector-in-brief.cfm> (accessed 10/28/14)

5 Public charities with annual revenues of \$50,000 are subject to different requirements. Please see page 54 of the Reference Edition for details.

6 Independent Sector, *Principles for Good Governance and Ethical Practice*, October 2007.

Toward a Balanced System of Law and Self-Governance

Any approach to preserving the soundness and integrity of the nonprofit community must strike a careful balance between the two essential forms of regulation—that is, between prudent legal mandates to ensure that organizations do not abuse the privilege of their exempt status, and, for all other aspects of sound operations, well-informed self-governance and mutual awareness among nonprofit organizations. Such a balance is crucial for ensuring that frameworks of accountability and transparency are core pillars of our charitable nonprofit community, affording organizations the support they need to pursue their various callings and the flexibility they need to adapt to the changing needs of their communities, their fields of endeavor, and the times.

The Panel on the Nonprofit Sector

In September of 2004 Senators Grassley (R-IA) and Baucus (D-MT) encouraged Independent Sector to convene an independent panel on the nonprofit sector to consider and recommend actions that would strengthen good governance, ethical conduct, and effective practice of public charities and private foundations. In response, Independent Sector convened the Panel on the Nonprofit Sector which engaged thousands of people involved with charities and foundations to address concerns shared by nonprofit organizations, members of the public, Congress, and federal and state oversight agencies about reports of illegal or unethical practices by some charitable organizations and their donors. Their *Strengthening the Transparency, Governance, and Accountability of Charitable Organizations* report, issued to Congress in June 2005, with a supplemental report issued in 2006, offered more than 100 recommendations for improving government oversight, including new rules to prevent unscrupulous individuals from abusing charitable organizations for personal gain. *The Pension Protection Act of 2006* enacted many of these recommendations into law.

The Panel was equally committed to formulating effective, broadly applicable methods of *self-regulation*, and in October 2007, it issued the *Principles for Good Governance and Ethical Practice, A Guide for Charities and Foundations*. The work of the Panel was premised on a belief that the best bulwark against misconduct will always be well-informed vigilance by members of the nonprofit community themselves, including a set of principles they could adopt or adapt, promote sector-wide, and improve over time. These

principles should be clear enough to be practical and readily implemented in a wide variety of organizations, but flexible enough to allow each organization's governing board and management to adapt them to the dictates of that organization's scope and mission. Widespread use of such principles would enable organizations to improve their operations by learning from each other. Critically, it would also provide a common yardstick by which members of the public can evaluate how to direct their support.

Developing Sector-Wide Principles to Support Self-Regulation

Among the earliest efforts to self-regulate date back to 1918, when a coalition of nonprofits established the National Charities Information Bureau to help the public learn about the ethical practices and stewardship of organizations that raise money from donations.

Since that time, many excellent systems of self-regulation have been in use in various subsets of the charitable sector, each tailored to the goals, resources, and challenges of its particular field and constituency. In developing the 2007 *Principles*, the Panel conducted extensive research. It commissioned two studies to review, analyze, and find patterns among 50 existing systems, including selections from both the nonprofit and for-profit sectors.⁷ It established an advisory committee on self-regulation, composed of 34 leaders from charities, foundations, and academia, who after extensive deliberation, developed a comprehensive set of principles drawn from current systems and incorporating the advice of experts in nonprofit law and governance.

This first set of draft principles was circulated for public comment in early 2007. After considering the resulting feedback, the committee and the Panel made revisions and released a second draft for a longer comment period. The wide-ranging reaction to both drafts demonstrated a broad interest across the nonprofit community in creating a common set of standards or guideposts with regard to the elements of transparent, accountable, and ethical conduct. The resulting feedback further strengthened the Panel's final set of principles.

Since their publication in 2007, the *Principles* have been distributed and/or downloaded over 200,000

⁷ Independent Sector, *Principles for Good Governance and Ethical Practice: Reference Edition*, October 2007.

times. A 2010 evaluation of the *Principles*⁸ found that the *Principles* were considered to be a valuable resource that is being used to strengthen governance and ethical practice. The *Principles* are used by nonprofit organizations, by consultants, lawyers, and accountants who focus on good governance and ethical practice in organizations and as educational materials in graduate courses, and by the IRS as part of their training for oversight officials.⁹

A New Look at the Principles

In 2014, Independent Sector convened an advisory group of 21 sector leaders to consider whether updates to the 2007 *Principles* were warranted. The impetus for doing so was two-fold. First, seven years since publication of the *Principles* in 2007, the charitable sector has experienced many significant changes in the environment in which it works and those changes have raised questions about whether the principles adequately addressed some of the emerging issues. Secondly, with such broad-based reliance on these principles, IS deemed it good practice to revisit the recommendations to be sure that the thinking remains relevant today.

The advisory group recommended a series of updates that are reflected in this 2015 edition of the *Principles*. Some reflect changes in the law since the 2007 *Principles* were issued. Others reflect new circumstances in which the sector functions, and new relationships within and between the sectors.

Revisions to the 2007 Principles

Following are highlights of the revisions reflected in this 2015 edition.

Code of Ethics

All nonprofit organizations (including small ones) should have a board-approved code of ethics (principle #2); board members should sign the code of ethics at least once, although the frequency and format of reaffirming their commitment to the code should be decided upon by the organization; and organizations

should decide for themselves whether volunteers (aside from board leadership) need to sign the code. Furthermore, the code should be accompanied by specific policies and procedures describing how it will be put into practice and how violations will be addressed.

Whistleblower

Principle (#4) notes that some offenses require immediate reporting while others may warrant investigation first, and encourages an organization to have a clear process to decide whether, how, and when to report. Human resources violations should only be subject to whistleblower policies and protections when other human resources processes fail to appropriately handle the violations. The *Principles* encourage wide distribution of the whistleblower policy.

Risk Tolerance & Mitigation in Response to Technology Advances

It is the board's responsibility to decide the level of risk that the organization is comfortable with, including risk regarding its finances, its operations, and its reputation, although there are other areas in which staff are also involved. Updated principles recognize the importance of protecting an organization's data along with its business records, property, program content, integrity, and reputation (#5, 6, & 21). To mitigate risk, an organization should maintain emergency preparedness and disaster response plans; secure and back up data and electronic files; protect against outside manipulation of data; have clear and explicit privacy policies that indicate how data will be used and kept secure; and seek permission to use all individual identifying information (photographs, fingerprints, biometric data, social security numbers, etc.).

Nonprofits Taking Up New Business or Earned Income Opportunities

Principle on board's stewardship (#19) calls on board and staff: to ensure any new business opportunity furthers an organization's mission; to weigh financial returns against resources it may draw away from primary organization functions; and to regularly check back on whether such ventures are serving intended goals. Principle on role of boards (#8) calls on boards to ensure that activities of chapters, branches, or affiliates are consistent with the organization's overall values and mission.

8 Independent Sector Good Governance and Ethical Practice (Formative Evaluation Research Associates), Nov. 2010.

9 In 2011, Sarah Hall Ingram, former Commissioner of the Tax Exempt and Government Entities Division of the Internal Revenue Service, so reported to Independent Sector CEO Diana Aviv during a presentation at Georgetown University.

Transparency vs. Privacy

Updated principles recognize the important balance between organizations being highly transparent, and appropriately protecting individual privacy. Principles (#6, 7, & 33) urge that organizations are transparent to ensure that the public has an understanding of an organization's mission, purpose, and activities. For example, it is best practice for an organization to have an online presence with information that is timely and clear. This increases public trust and enables the organization to demonstrate impact and how it stewards public funding. At the same time, this proclivity towards transparency needs to be balanced by valid privacy concerns to protect clients, consumers, employees, and volunteers, bearing in mind physical risk, integrity of personnel, privacy of children, and prohibitive costs.

Executive Compensation

Principle (#13) calls on the full board to evaluate, thoroughly understand, and approve the compensation of the CEO annually in advance of any change in compensation. If a committee is designated to review the compensation and performance of the CEO, the committee findings and recommendations should be reported to the full board. In determining compensation, the board or committee should seek objective external data to support its decisions.

Overhead Costs

An important reframing of our principle of overhead costs (#24) describes administrative expenses as an integral component of program support – rather than costs that detract from program resources.

Our previous language juxtaposed the two, urging organizations to spend a significant percentage on programs while also providing sufficient resources for administration and fundraising. Our new language calls on an organization to spend a significant amount of its budget on programs while ensuring that the organization has sufficient administrative and fundraising capacity to deliver those programs responsibly and effectively. The principle also retains reference to the 65% threshold that watchdog groups recommend as a minimum to be spent on program activities.

Fundraising

Fundraising principles (#27-33) are reframed to incorporate new references to online platforms, mobile giving, social media, and crowdsourcing. They emphasize the importance of ensuring that prospective donors receiving such online communications know how to contact the organization for more information. They also raise the caution of online fundraising channels providing easy opportunities for fraudulent solicitations, and urge organizations to take steps to counter these. Principles emphasize the importance of providing training and supervision for fundraisers, the handling of donor data, and how to take control of the organization's brand if online platforms are raising funds for the particular organization without their permission.

Using and Adapting the Principles

The following pages set forth 33 principles of sound practice that should be considered by every charitable organization as a guide for strengthening its effectiveness and accountability.

Given the wide, necessary, and rich diversity of organizations, missions, and forms of activity that make up the nonprofit community, it would be unwise to attempt to create a set of universal standards to be applied uniformly to every member. While some principles reflect legal requirements, most reflect standards that are recommended to every charitable organization as guideposts for adopting specific practices that best fit its particular size and charitable purpose. Many of the principles do not prescribe a practice, but recommend factors that an organization should consider in arriving at its own conclusions. Organizations can use these principles to evaluate their current practices.

Self-regulation begins with embracing good governance. Every charitable organization, by federal and state law, must have a board of directors or, if it is established as a charitable trust, one or more trustees. The board sets the organization's broad policies and oversees its operations, including its financial policies. The board also has a responsibility to create an environment in which there is open and robust deliberation of the issues on which it takes action. Whether or not the organization has paid staff, the board bears the primary responsibility for ensuring that the organization lives up to its legal and ethical obligations to its donors, consumers, and the public. For organizations that do have staff, the chief staff officer, in partnership with the board, has responsibility

for overseeing or carrying out many of the activities implied by these principles. It is therefore to the boards and chief executives of nonprofit organizations that this document is particularly, though not exclusively, addressed.

The 33 principles that follow are organized under four main categories:

1. Legal Compliance and Public Disclosure (principles 1-7, pages 9-26)—responsibilities and practices, such as implementing conflict of interest and whistleblower policies, that will assist charitable organizations in complying with their legal obligations and providing information to the public.

2. Effective Governance (principles 8-20, pages 27-50)—policies and procedures a board of directors should implement to fulfill its oversight and governance responsibilities effectively.

3. Strong Financial Oversight (principles 21-26, pages 51-62)—policies and procedures an organization should follow to ensure wise stewardship of charitable resources.

4. Responsible Fundraising (principles 27-33, pages 63-76)—policies and procedures organizations that solicit funds from the public should follow to build donor support and confidence.

It is advisable that an organization's boards conduct a thorough discussion of the complete set of principles, and determine how the organization should apply each to its operations. It is possible that after this review, a board may conclude that certain principles do not apply to its organization. Developing a transparent process for communicating how the organization has addressed the principles, including the reasons that any of the principles are not relevant, is likely to foster a greater appreciation of the diverse nature of the sector and a deeper respect for the board's good stewardship.

This reference edition of the 2015 *Principles* includes legal background on each principle and a glossary of terms. The reference edition of the 2007 *Principles*, available on Independent Sector's website, www.independentsector.org/principles, contains two studies on self-regulation systems commissioned by the Panel on the Nonprofit Sector to inform its work. They included a review of more than 50 existing self-regulation systems and standards that were

shared with the Panel's Advisory Committee on Self-Regulation.¹⁰

Independent Sector also offers information on its website to assist organizations in finding tools and other resources for applying these principles. That can be found at www.independentsector.org/principles

A Process of Continuing Vigilance and Adaptation

Strengthening ethics and accountability is an organic process that requires an ongoing commitment by boards and staff of individual organizations and by the entire nonprofit community. Over time, discussion within organizations and across the community may well result in refinement of the principles presented here. Such discussions would provide a further demonstration of the value to the whole sector of coming together to improve its work.

For organizations whose practices do not currently meet the standards recommended by the *Principles*, and for existing systems of self-regulation that fall short as well, reaching those levels may take some time. Yet even the process of striving toward these standards will strengthen the organization and its ability to serve its community.

THE KEY IS TO BEGIN THAT PROCESS TODAY.

10 FDR Group, "Self-Regulation in the Nonprofit Sector: A Portrait of Current Issues in the Field" and National Center on Philanthropy and the Law, "Study on Models of Self-Regulation in the Nonprofit Sector," *Principles for Good Governance and Ethical Practice: Reference Edition*, Independent Sector, October 2007.

SECTION ONE

LEGAL
COMPLIANCE
AND PUBLIC
DISCLOSURE





PRINCIPLE 01

A charitable organization must comply with all applicable federal laws and regulations, as well as applicable laws and regulations of the states and the local jurisdictions in which it is formed or operates. If the organization conducts programs outside the United States, it must also abide by applicable international laws, regulations, and conventions.

Charitable organizations (other than churches) must apply to the Internal Revenue Service for recognition as tax-exempt organizations under section 501(c)(3) of the federal tax code that are eligible to receive tax-deductible contributions. They must then file annual information returns (IRS Form 990) and abide by the rules and reporting requirements set for such organizations by the federal government. They must also abide by state and local laws regarding governance, protection of charitable assets, solicitation of charitable contributions, taxes, and a range of other requirements that apply to both for-profit and nonprofit employers and providers of various types of services. An organization's governing board is ultimately responsible for overseeing and ensuring that the organization complies with all of its legal obligations and for detecting and remedying wrongdoing by management. While board members are not required to have specialized legal knowledge, they should be familiar with the basic rules and requirements with which their organization must comply and should secure the necessary legal and financial advice and assistance to structure appropriate monitoring and oversight mechanisms and manage charitable assets responsibly.

There are many resources listed at www.independentsector.org/principles to help charitable organizations and their boards understand how their operations may be affected by the law. The Internal Revenue Service provides a number of resources regarding federal laws on its website (<http://www.irs.gov/Charities-&-Non-Profits>). Many state attorneys general and charity officials also maintain helpful websites with information on charitable solicitation requirements and other rules applicable to organizations operating in their states.

Many national, state, and regional associations of nonprofit organizations provide online tools and resources that offer guidance on legal requirements and best practices for nonprofit organization management and governance. Organizations may also find it helpful to consult with state and local chapters of bar associations for referrals to individuals or firms offering low-cost or pro bono legal assistance.

LEGAL BACKGROUND PRINCIPLE 01

A charitable organization is generally organized as a corporation or a trust under the laws of the state in which it was created. Some organizations choose to operate as unincorporated associations, although that legal form leaves directors and members exposed to a higher degree of liability for financial and other legal responsibilities of the organization. Unincorporated associations are still subject to legal requirements for charitable organizations. In order to be exempt from paying federal income taxes and to be eligible to receive tax-deductible contributions

LEGAL BACKGROUND PRINCIPLE 01 (CONTINUED)

from the public, organizations (with certain exceptions¹¹) must apply for and be recognized by the IRS as tax-exempt under section 501(c)(3) of the tax code. To receive this classification, an organization must file a formal application (Form 1023) with the IRS that describes its current or planned financial and programmatic activities, organizational documents, and governance structure.¹² Depending on the organization's sources of support and other key factors, the IRS will determine whether it is recognized as a private foundation or a public charity.

Private foundations derive their primary financial support from the contributions of a limited group of sources, such as an individual, family, or corporation. Foundations are subject to substantially more restrictive rules governing their operations, and their donors receive less favorable tax treatment for donations.¹³ For example, private foundations are prohibited from engaging in most direct or indirect financial transactions with their donors, directors, and businesses and family members of those donors and directors, except for compensation or reimbursement of expenses related to personal services that are reasonable and necessary to fulfilling the foundation's charitable purposes.¹⁴ A private foundation is required to make charitable distributions every year equal to at least 5 percent of the value of its noncharitable assets and must pay an annual excise tax generally equivalent to 2 percent of its net investment income.¹⁵ Private foundations are prohibited from engaging in lobbying activities (subject to certain exceptions) and are subject to specific rules regarding its holdings in for-profit business enterprises and the types of investments it is allowed to make.¹⁶ Private foundations and their managers may be subject to severe excise taxes and other penalties for violations of these prohibitions.¹⁷

Public charities generally derive a substantial portion of their funding from the general public or from a governmental unit. Federal tax laws define four types of public charities: (1) public institutions, such as churches and religious congregations, schools and other educational institutions, hospitals and medical research organizations, and governmental units; (2) publicly-supported charities that receive at least one-third of their financial support from qualifying contributions and grants or from providing program services to a broad constituency¹⁸; (3) supporting organizations that are organized and operated exclusively for the benefit of or to carry out the functions of one or more publicly-supported charities; and (4) public safety testing organizations.¹⁹ Public charities are prohibited from engaging in "excess benefit transactions," that is, transactions with insiders (persons in a position to exercise substantial influence over the organization) that provide economic benefits in

11 IRC § 508. Houses of worship, specific related organizations, organizations (other than private foundations) whose annual gross receipts do not normally exceed \$5,000, and organizations (other than private foundations) subordinate to another tax-exempt organization that are covered by a group exemption letter, are not required to seek formal recognition of 501(c)(3) status. Further, an organization's exemption letter is retroactive to the founding date of the organization if the application for exemption was filed within 27 months from the end of the month in which the organization was formed. See Form 1023 Instructions.

12 Organizations eligible for 1023-EZ filing (average annual gross receipts of \$50,000 or less) need not disclose programmatic activities, organizational documents, or governance structure.

13 IRC § 509; IRC § 170(b)(1)(A).

14 IRC § 4941; Treas. Reg. § 53.4941(d)-3(c).

15 IRC § 4940(a); IRC § 4942; Treas. Reg. § 53.4940-1(a).

16 IRC § 4945.

17 IRC § 4940 *et seq.*

18 Alternatively, an organization which fails to meet the one-third publicly supported test may still qualify for public charity classification based on the facts and circumstances test described in Treas. Reg. § 1.170A-9(f)(3). The facts and circumstances public support test requires that an organization receive at least 10 percent of its total support from contributions made directly or indirectly by the general public or from governmental units and shows certain other facts and circumstances.

19 IRC § 509; IRC § 170(b)(1)(A).

LEGAL BACKGROUND PRINCIPLE 01 (CONTINUED)

excess of fair market value.²⁰ There are specific rules for the operation of certain public charities established as medical research organizations, charities that operate as credit counseling organizations, and certain supporting organizations, as well as for specific types of funds held by a public charity known as “donor-advised funds.”²¹

Charitable organizations are prohibited from supporting or opposing candidates for public office or intervening in political campaigns, but they may lobby public officials regarding legislation that might affect their existence, powers and duties, tax-exempt status, or the deductibility of contributions, often referred to as “self-defense lobbying.”²² Public charities (but not private foundations) may also lobby directly or conduct grassroots advocacy efforts to influence the outcome of other legislation so long as such efforts constitute an “insubstantial part” of the organization’s overall activities.²³ The tax laws permit public charities to elect to follow specific rules for the amounts they can spend on direct and grassroots lobbying activities.²⁴

Organizations that solicit charitable contributions must be knowledgeable of and abide by charitable solicitation regulations and reporting requirements of the states and local jurisdictions in which they operate or raise funds. Forty states and the District of Columbia currently require certain charitable organizations to register before soliciting residents or conducting fundraising activities within their state.²⁵ Organizations that hire third parties to raise funds on their behalf must also take steps to ensure that those third parties comply with state and local registration and reporting requirements. Charitable organizations that conduct specific types of services, such as nursing homes and other types of residential facilities, providers of health care or day care for children or adults, educational facilities, etc., must also abide by other laws and regulations that apply to any business, for-profit or nonprofit, that operates in those service areas. Charitable organizations that employ staff must abide by federal, state, and local labor laws and regulations, and applicable employment tax and income tax withholding requirements.

20 IRC § 4958.

21 IRC § 4966(d)(2) defines a donor-advised fund as a fund or account that is owned and controlled by a sponsoring organization, separately identified by reference to contributions of a donor or donors, and to which the donor or a designated advisor has or reasonably expects to have advisory privileges with respect to the distribution or investment of the assets in the fund. The definition specifically excludes a fund or account that makes distributions only to a single identified organization or governmental entity or that makes grants for travel, study or similar purposes provided that certain conditions are met.

22 Treas. Reg. § 53.4945-2(d)(2)(ii).

23 IRC § 501(c)(3).

24 IRC § 501(h).

25 Charitable Solicitation Requirements – 2013 Update, National Association of College and University Attorneys, available at http://www.nacua.org/nacualert/docs/CharitableSolicitation/2013_JurisdictionalRequirementsCharitableSolicitation.pdf.

PRINCIPLE 02

A charitable organization should formally adopt a written code of ethics with which all of its directors or trustees, staff, and volunteers are familiar and to which they adhere.

Adherence to the law provides a minimum standard for an organization's behavior. Each organization should also create or adopt a written code of ethics that outlines the values that the organization embraces, and the practices and behaviors its staff, board, and volunteers are expected to follow, such as the confidentiality and respect that should be accorded to clients, consumers, donors, volunteers, and board and staff members. The code of ethics should be accompanied by specific policies and procedures that describe how it will be put into practice and how violations will be addressed.

Both the board and the staff should be engaged in developing and implementing a code of ethics that fits the needs and character of the individual organization. The board should approve the final document. New board members, employees, and volunteers should receive a full orientation to the code and all related policies, including processes for addressing violations. Adherence to the code should be incorporated into the ongoing work of all staff and volunteers of the organization. Organizations should consider requiring every board member, employee, and volunteer to review and sign a copy of the code when they join the organization and to reaffirm their commitment by signing the code again on an annual or other regular basis.

LEGAL BACKGROUND PRINCIPLE 02

There is no legal requirement to have a code of ethics.

PRINCIPLE 03

A charitable organization should adopt and implement policies and procedures to ensure that all conflicts of interest (real and potential), or the appearance thereof, within the organization and the governing board are appropriately managed through disclosure, recusal, or other means.

Board members and officers have fiduciary duties under the laws of most states, including a “duty of loyalty” that requires them to put the interests of the charitable organization they serve above their personal interests and the interests of any other person or organization. When a board or staff member, or someone they are close to, such as a family member or business associate, has a potential financial or personal interest in a matter before the organization they serve, those conflicting interests must be managed appropriately to protect the organization and the interested parties from illegal or unethical actions. Federal and some state laws prohibit or regulate certain transactions between charitable organizations and certain insiders and parties related to those insiders. Insiders include officers, directors, and certain parties closely related to them. A full list of the types of persons that are considered to be insiders is provided in the legal background section below. Other transactions may give the appearance of impropriety, but an independent review might ascertain that they are consistent with the best interests of the organization. Establishing and enforcing a written conflict-of-interest policy can help an organization avoid or manage real or perceived conflicts of interest that could affect the decisions of board members, staff leaders, and other employees.

Conflict-of-interest policies should address the disclosure and management of situations that give the *appearance* of a conflict as well as those that involve *an actual* conflict where a board or staff member has a direct or indirect financial interest in transactions with the organization. Board members and anyone in a position to influence decisions of the organization should be required to disclose any situation in which they or someone they are close to would benefit or be harmed financially by the organization’s action. They should also be encouraged to disclose any interest they have in a transaction or matter before the organization where that interest could be reasonably viewed by others as affecting the objectivity or independence of the decision maker.

Federal law does not require organizations to have a conflict of interest policy, but the IRS requires most nonprofits to report on their annual Form 990²⁶ whether or not the organization has and regularly enforces such a policy and if so, how it is enforced. Some states do require such policies or procedures to manage conflicting interests. For example, New York State requires every nonprofit to adopt a conflict of interest policy that defines situations that present a conflict of interest, the process by which board and staff members must disclose such conflicts, and the actions that should be taken once a conflict has been identified. New York prohibits individuals with a conflict of interest from voting on or improperly influencing deliberations and decisions on matters in which they have a conflicting interest, and organizations must document how such conflicts were discussed and resolved.

Once a conflict of interest policy is developed, all board and senior staff members should be required to sign it and to disclose any material conflicts of interest, including any family or business relationship they have with any other board or staff member, both at the time they join the organization and at the beginning of each new board year (as well as promptly disclosing anything new that arises during the year). Most nonprofits are required to disclose on their annual Form 990 any family or business relationships between or among board members, officers, and key employees. Organizations should also be mindful of potential conflicts that can accompany a contribution or a request from a significant contributor, which are often addressed through a gift acceptance policy (see principle #30).

26 Throughout this document, unless otherwise stated, a reference to the 990 refers just to the Form 990. There may be different requirements for organizations filing Forms 990-EZ, 990-PF, or 990-N.

LEGAL BACKGROUND PRINCIPLE 03

While there is no federal requirement that an organization have a conflict of interest policy, board members and organization managers are subject to penalties if they are found to have approved transactions that result in an excessive financial benefit to anyone in a position to exercise substantial influence over the organization's affairs. (For a more complete discussion of excess benefit transactions, see the Legal Background to principle #13.)

Conflicts of interest may also raise issues for public charities under the “intermediate sanctions” rules in section 4958 of the Code and for private foundations under the self-dealing rules in section 4941 of the Code. The intermediate sanctions rules prohibit “disqualified persons,” defined to include officers, directors, their family members and certain other closely-related persons, from engaging in “excess benefit transactions” with public charities. An excess benefit transaction is one in which the value of the benefits provided to the disqualified person exceed the value of the consideration received by the public charity. Disqualified persons are subject to a 25% excise tax on the value of any excess benefits and an additional 200% tax if the excess benefits are not repaid to the charity. Board members who knowingly approve excess benefit transactions may also be subject to a penalty. The intermediate sanctions regulations provide for a “rebuttable presumption of reasonableness” if a transaction with a disqualified person is approved by an independent board or board committee in reliance on comparable market data and the decision is adequately and contemporaneously recorded in board minutes.²⁷ The self-dealing rules for private foundations are even more stringent and prohibit altogether many types of transactions between private foundations and their disqualified persons. IRC section 4941 imposes a 10% excise tax on disqualified persons who engage in acts of self-dealing and an additional 200% penalty if the act is not “corrected” or undone. Foundation managers who knowing approve self-dealing transactions are also subject to an excise tax penalty. Many conflict policies for public charities and private foundations are drafted to reflect these legal requirements.

27 See Treas. Reg. § 53.4958-6.

LEGAL BACKGROUND PRINCIPLE 03 (CONTINUED)

The Internal Revenue Service requires public charities to disclose on their annual information returns (Forms 990) if any officers, directors, trustees, key employees, highest compensated employees, or highest compensated profession or other independent contractors are related through family or business relationships²⁸ and whether the organization has a conflict of interest policy.²⁹ The IRS Form 1023, which an organization must file to obtain a determination of federal tax-exemption under section 501(c)(3) of the Internal Revenue Code, asks the organization to indicate whether it has adopted a conflict of interest policy and, if not, how it will handle conflicts of interest.³⁰

All states mandate that directors and officers owe a duty of loyalty to the organization, and unfairly benefiting from a transaction involving a conflict of interest, if improper, violates that duty. Some state statutes specifically penalize participation in transactions involving conflicts of interests unless the organization follows certain prescribed procedures.³¹

28 IRS 2013 Form 990, Part VI-A, line 2. The family of an individual includes only his or her spouse (see Rev. Rul. 2013-17 regarding same-sex marriage), ancestors, brothers and sisters (whether whole or half-blood), children (whether natural or adopted), grandchildren, great-grandchildren, and spouses of brothers, sisters, children, grandchildren, and great-grandchildren. A business relationship between two persons includes the following: 1) One person is employed by the other in a sole proprietorship or by an organization with which the other is associated as a trustee, director, officer, or greater-than-35% owner; 2) One person is transacting business with the other (other than in the ordinary course of either party's business on the same terms as are generally offered to the public), directly or indirectly, in one or more contracts of sale, lease, license, loan, performance of services, or other transaction involving transfers of cash or property valued in excess of \$10,000 in the aggregate during the organization's tax year. Indirect transactions are transactions with an organization with which the one person is associated as a trustee, director, officer, or greater-than-35% owner. Such transactions do not include charitable contributions to tax-exempt organizations; 3) The two persons are each a director, trustee, officer, or greater-than-10% owner in the same business or investment entity (but not in the same tax-exempt organization). Ownership is measured by stock ownership (either voting power or value) of a corporation, profits or capital interest in a partnership or limited liability company, membership interest in a nonprofit organization, or beneficial interest in a trust. Ownership includes indirect ownership (for example, ownership in an entity that has ownership in the entity in question); there can be ownership through multiple tiers of entities. See Form 990.

29 IRS 2013 Form 990, Part VI-B, line 12a. Form 990 also requires disclosure of certain business transactions and loans between public charities and their officers, directors, and certain other parties related thereto. See schedule L of form 990.

30 IRS 2013 Form 1023, Part V, line 5a. If answered in the affirmative, the conflict of interest policy must accompany Form 1023 and the organization must explain how the policy has been adopted, such as by resolution of the organization's governing board.

31 See e.g. Minnesota State Nonprofit Corporation Act § 317A.255.

PRINCIPLE 04

A charitable organization should establish and implement policies and procedures that enable individuals to come forward with information on illegal practices or violations of organizational policies. This “whistleblower” policy should specify that the organization will not retaliate against, and will seek to protect the confidentiality of, individuals who make good-faith reports.

Every charitable organization, regardless of size, should have clear policies and procedures that allow staff, volunteers, or clients of the organization to report suspected wrongdoing within the organization without fear of retribution. These policies— sometimes known as “Whistleblower Protection Policies” or “Policies on Reporting of Malfeasance or Misconduct” — generally address suspected incidents of theft; financial reporting that is intentionally misleading; improper or undocumented financial transactions; improper destruction of records; improper use of assets; violations of the organization’s conflict-of-interest policy; and any other improper occurrences regarding cash, financial procedures, or reporting. If an organization does not have a separate grievance policy with protected reporting procedures to address violations of personnel policies, it should consider incorporating such procedures in its broader whistleblower policy. Information on these policies should be widely distributed to staff, volunteers, clients, and others (such as vendors and consultants) as appropriate. Discussion of the policy should be incorporated both in new employee orientations and ongoing training programs for employees and volunteers. Some federal and state laws protect individuals working in charitable organizations from retaliation for engaging in specified whistleblowing activities, and states may also require that certain organizations have and enforce whistleblower policies.³²

A whistleblower policy should be tailored to the nonprofit’s size, structure, and capacity, and it must reflect the laws of the state in which the nonprofit is organized or operates. All policies should specify the individuals within the organization (both board and staff) or outside parties to whom such information can be reported. Small organizations with few or no paid staff may wish to designate an external advisor to whom concerns can be reported without threat of retaliation. This is a particular concern for family foundations whose board members and staff may not feel comfortable sharing concerns about suspected illegal or unethical practices directly with another family member or close associate of the family. Larger organizations should encourage employees and volunteers to share their concerns with a supervisor, the president or executive director, the general counsel, the chief financial officer and/or other senior managers of the organization, and should also provide a method of reporting confidentially to either a board member or an external entity or individual specified by the organization. Some large organizations have set up computerized systems that allow for anonymous reports, and a number of private companies offer anonymous reporting services via a toll-free telephone number, email address, or intranet site.

It is equally important that the organization have clear procedures to investigate all reports and take appropriate action. While steps must be taken to protect the anonymity of reporters as much as possible, reports must include sufficient information to enable an investigation. Reports of certain types of alleged offenses, such as abuse of a client, may require immediate reporting to appropriate legal authorities and suspension, with or without pay, of the accused volunteer or employee, while the matter is

³² See e.g. Sarbanes-Oxley Act § 1107, which makes it a crime to knowingly take any action harmful to a person with the intent to retaliate against that person for providing a law enforcement officer with truthful information relating to the commission or possible commission of any federal offense.

being investigated. In other cases, the board or senior management may wish to investigate allegations before reporting to government authorities to protect against or to minimize the risk of unsubstantiated accusations against an innocent individual. Some cases, even those involving substantiated violations, may not require reporting beyond the board and senior management.

Charitable organizations that must file an annual Form 990 information return are required to report whether they have a whistleblower policy, and whether they became aware of a material diversion of the organization's assets during the year, as well as any corrective actions undertaken to address such issues

if they arose. Boards of directors should have a clear process by which they decide whether, how, and when they should report other proven incidents of fraud, theft, or wrong-doing to relevant public and internal audiences, including, but not limited to, the IRS, state regulators, law enforcement, donors, consumers, employees, and volunteers. The process should include a review of legal obligations, implications for the organization's reputation, and consideration of whether the information may become public through public reports or private communication.

LEGAL BACKGROUND PRINCIPLE 04

Some states have enacted laws that provide protections for employees who report misconduct under specific conditions.³³ Federal law prohibits employment-related retaliation by all entities—including charitable organizations—against whistleblowers who provide information on certain financial crimes delineated under federal law.³⁴ Whistleblowers who report suspected tax fraud to the IRS are also protected from retaliation.³⁵

33 See e.g. California Government Code § 53296 *et seq.* Additionally, the widely-recognized public policy exception to at-will employment provides that an employee is wrongfully discharged when the termination is against an explicit, well-established public policy of the State.

34 The Sarbanes-Oxley Act of 2002 Pub. L. No. 107-204; 18 U.S.C. § 1513(e).

35 Tax Relief and Health Care Act of 2006, § 406, P.L. 109-432.

PRINCIPLE 05

A charitable organization should establish and implement policies and procedures to protect and preserve the organization's important data, documents, and business records.³⁶

Charitable organizations are required to maintain their organizational documents, board minutes and policies, and materials related to their state and federal tax-exempt status permanently. Other documents related to the governance, administration, fundraising, and programs of the organization, including employment and volunteer records, must be kept in paper or electronic form for specific periods, depending on applicable laws and reporting requirements. When those documents and key financial and program data are maintained electronically, the organization must take appropriate action to protect that information from unauthorized access or manipulation.

A written data and document-retention policy, consistently monitored over time, is essential for protecting key organizational documents and records, as well as protecting the privacy of individual clients, consumers, employees, and volunteers. The policy should address the length of time specific types of documents and data must be retained, as well as when it is permissible or required to destroy specific types of documents. It should include guidelines for backing up and archiving paper and electronic data

and documents (including e-mail messages), as well as procedures for verifying their security from theft, manipulation, or destruction.

Board members, staff, and volunteers should be thoroughly familiar with the policy and informed of their responsibilities in carrying it out. Board members and senior staff managers should ensure that there is an ongoing process for ensuring compliance with the policy and for updating procedures as necessary. The Form 990 requires organizations to report whether they have a written document retention and destruction policy.

Federal and some state laws prohibit the destruction, alteration, mutilation, or concealment of records related to an official legal proceeding. Policies should outline specific procedures to ensure that any destruction of documents or data is immediately halted if an official investigation of the organization is underway or anticipated.

LEGAL BACKGROUND PRINCIPLE 05

Federal, state, and local laws and regulations require both for-profit and nonprofit organizations to retain certain business records—such as applications for employment and payroll records, tax forms, and contracts—for specified lengths of time.³⁷ Failure to maintain such records may subject the organization and/or individuals to penalties and fines and may compromise the organization's position in litigation. Treasury regulations provide that taxpayers are required to keep books and records sufficient to establish the amount of gross income,

³⁶ Examples of important documents may include all tax filings, articles of incorporation, documentation relating to contributions and grants, and any evidence of transactions with related parties.

³⁷ IRS 2013 Form 990, Part VI-B, line 14.

LEGAL BACKGROUND PRINCIPLE 05 (CONTINUED)

deductions, credits, or other matters required to be shown by the taxpayer in a tax return.³⁸ The “books” or records required by this section shall be kept at all times available for inspection by authorized internal revenue officers or employees, and shall be retained so long as the contents thereof may become material in the administration of any internal revenue law.”³⁹ Additionally, exempt organizations not liable for unrelated business income tax, and therefore not technically “taxpayers”, must keep permanent books and records sufficient to show “specifically... items of gross income, receipts, and disbursements...as are required to substantiate the information required by section 6033.”⁴⁰

The Sarbanes-Oxley Act provides that it is a federal crime, punishable by a fine and up to twenty years in prison, for any corporate agent, whether of a for-profit or nonprofit corporation, knowingly to alter, destroy, mutilate, conceal, cover up, falsify, or make a false entry in any record with the intent to impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of a federal department or agency or any bankruptcy case.⁴¹ The same penalty applies to anyone who alters, destroys, mutilates, or conceals a record, or attempts to do so, with the intent to impair the object’s integrity or availability for use in an official proceeding, regardless of whether such proceeding is pending or about to be instituted at the time of the offense.⁴²

Other federal laws, such as the Privacy Act of 1974 and the Health Insurance Portability and Accountability Act of 1996 (which affects health care providers), establish rules for all types of organizations for the collection, maintenance, use, and dissemination of personal information to protect the privacy of individuals. State laws vary considerably from state to state and may supersede federal law where a state law is more restrictive.

38 Treas Reg. § 1.6001-1(a). An exempt organization is a “taxpayer”, for purposes of record retention, when it has unrelated business income tax liability under IRC § 511.

39 Treas Reg. § 1.6001-1(e). Materiality is not defined for retention purposes, but presumably extends, at a minimum, through the relevant statute of limitations period.

40 Treas Reg. § 1.6001-1(c). IRC § 6033 imposes the annual information return requirements.

41 18 U.S.C. § 1519.

42 18 U.S.C. § 1512.

PRINCIPLE 06

A charitable organization's board should ensure that the organization has adequate plans to protect its assets — its property, documents and data, financial and human resources, programmatic content and material, and its integrity and reputation — against damage or loss. The board should review regularly the organization's need for general liability and directors' and officers' liability insurance, as well as take other actions necessary to mitigate risks.

The board members of a charitable organization are responsible for understanding the major risks to which the organization is exposed, reviewing those risks on a periodic basis, and ensuring that systems have been established to manage them. Establishing and implementing sound policies and procedures for the organization's governance, financial operations, employee and volunteer management, fundraising activities, and program administration is a key part of avoiding many of the legal and operational risks that face charitable organizations. The board is responsible for approving those policies and reviewing them periodically to ensure they are up-to-date and properly enforced.

The board's responsibilities include establishing the level of risk tolerance for the organization concerning its finances, its operations, and its reputation. Board members then work closely with staff to outline the areas where managing risk is solely a staff responsibility, such as the hiring and supervision of staff, and those where both groups share responsibility for determining whether it is appropriate or necessary for the organization to assume certain risks, such as deciding to launch a new program effort. Given the high level of risk exposure associated with fraud and mismanagement of financial resources and inappropriate fundraising activities, boards should pay particular attention to the recommendations listed under **STRONG FINANCIAL OVERSIGHT** and **RESPONSIBLE FUNDRAISING**.

Many charitable organizations maintain extensive records regarding donors, employees, volunteers, clients, and consumers of goods and services, including

data used to document the impact of their services on individuals and groups. Loss or outside manipulation of such data could expose those individuals and the organization to significant risk. Organizations that gather personal information from donors, individuals who receive or purchase their goods and services, or other visitors to their websites should have a privacy policy that informs those individuals what information is being collected about them, how that data will be used and kept secure as well as how to inform the organization if the individual does not wish personal information to be shared. Organizations that gather personally identifiable information about individuals, including photographs, fingerprints, or other biometric data, should ensure that they have the appropriate permissions and protections in place. Individuals' rights to access and control their personal information is protected under federal and state laws. There are also laws that specify rules and conditions for gathering and using information from and about children and other protected populations.

The level of risk to which the organization is exposed and the extent of the review and risk management process it may employ will vary considerably based on the size, programmatic focus, geographic location, and complexity of its operations. While larger organizations may require more extensive risk management programs, all organizations should have emergency preparedness and disaster response plans in case of natural or man-made disasters or other crises that may affect their facilities, programs and operations. Every organization should have procedures for backing up, preserving, and protecting electronic and print documents and information vital to its governance, financial, and programmatic

operations, including personal data it may collect about employees, volunteers, donors, consumers, and other individuals.

Organizations that employ staff should have written personnel policies that conform to federal and state laws and that reflect the values of the organization. They should develop appropriate procedures to protect the health and safety of employees and volunteers while they are at work or participating in an event sponsored or conducted by the organization. Organizations providing services to vulnerable individuals should ensure that appropriate screening, training, and supervision procedures are in place to minimize safety risks to their consumers and clients, as well as to paid and volunteer staff.

Board members may be personally liable for fines and other penalties as a result of certain legal violations, such as failure to pay required payroll and other taxes or approval of excess benefit or self-dealing transactions. Federal and some state volunteer liability

laws provide some protection for board members who are not compensated, other than receiving reimbursement of expenses, and who act in good faith. Nonetheless, while it is rare for a charitable organization and its board to be the target of a lawsuit, each organization should nonetheless take steps to protect its assets in such an event. The board should consider including indemnification provisions in the organization's governing documents, based on a review of the laws of the states in which it is based or operates. The board should also assess periodically the organization's need for insurance coverage based on its program activities and financial capacity. Insurance is only one risk management strategy, however. Other strategies should also be considered to protect an organization's assets, such as establishing reserve funds to absorb minor losses, borrowing from lenders, and negotiating with third parties to assume certain losses.

LEGAL BACKGROUND PRINCIPLE 06

The federal Volunteer Protection Act (VPA) of 1997 and most state volunteer liability laws do not protect board members, regardless of whether they are compensated, and other volunteers from liability for “willful or criminal misconduct, gross negligence, reckless misconduct, or a conscious, flagrant indifference to the rights or safety of the individual harmed by the volunteer action.”⁴³ The VPA and most state laws do not prevent individuals from filing lawsuits against board members and other volunteers, nor do they provide charitable organizations immunity from legal actions, although some states place a dollar limit on the organization's liability.⁴⁴

The governing documents of a charitable organization may include “indemnification provisions” that allow the organization to pay the costs of defending or paying settlements or judgments board members might incur for actions related to their board service.⁴⁵ Federal or state laws prohibit the organization from indemnifying a board member who acted in bad faith and for other specific types of offenses.

43 42 U.S.C. § 14503.

44 See e.g. Mass. Gen. Laws Ann. ch. 231, § 85K.

45 Exempt organizations may shift the risk of indemnification to third parties through directors and officers liability insurance or fidelity bonds.

PRINCIPLE 07

A charitable organization should make information about its operations, including its governance, finances, programs, and activities, widely available to the public. Charitable organizations also should consider making information available on the methods they use to evaluate the outcomes of their work and sharing the results of those evaluations.

Providing clear, timely information about an organization's mission, how it operates and manages its finances, and the results of its work can have a powerful influence on the level of public trust and support that organization enjoys. Charitable organizations (other than churches) recognized by the IRS are required to file an annual information return (Form 990 series) with the IRS, a version of which they must also make available for public inspection. The IRS may assess fines on organizations that file late or incomplete returns. The IRS must revoke the tax-exempt status of any organization that fails to file a required return for three consecutive years. Beyond these legal requirements, each organization must weigh the value of greater transparency in garnering more support for its work versus the costs of gathering and producing information and the potential risks to staff, volunteers, and clients in sharing specific types of information.

For many private foundations and many public charities, the annual IRS information return serves as a primary source of information about their finances, governance, operations, and programs for federal regulators, the public, and many state charity officials. Copies of the returns (not including information on donors to public charities and selected other proprietary information) are available online through such providers as GuideStar, the Foundation Center, the National Center for Charitable Statistics, and the websites of many state charity offices. Many charitable organizations are legally required to make their three most recently filed Form 990s and their applications for tax-exempt status, if after 1987, available to the public for inspection and copying at their offices or on a readily-accessible website. Organizations should ensure that their returns are posted on their own or another readily-accessible website soon after the returns have been filed with the IRS to provide

prospective donors and the public with the most current information available.

Annual information returns, while helpful, provide a limited, and often dated view of an organization. Therefore charitable organizations should strongly consider offering additional information about what they do and how they operate through a website or other online vehicle, or through an electronic or printed annual report. Regardless of the format, this resource should provide information about the organization's mission and vision, its board and senior staff members, program activities, and current financial information including, at a minimum, its total income, expenditures, and ending net assets. Such reports or online resources need not be elaborate and can direct the reader to other readily available documents (such as the Form 990 return or audited financial statements) for further information. Online resources can generally be updated as new information is available. Organizations that choose to produce printed reports may decide to produce a new narrative every two or three years, while ensuring that readers have access to information on any intervening changes in its board and staff or programs and its current financial statements through an attachment, an online resource, or other notice.

An organization's website or other online presence can be a key vehicle for transparency and accountability and communicating the organization's work and progress. In addition to the information cited above, websites should provide links directly to or instructions on how to request the organization's most recent IRS Form 990 return and other financial statements, key organizational policies such as its code of ethics and policies on conflicts of interest, whistleblower protection, and travel policy. If the website provides a mechanism that enables visitors to

make online contributions, the organization should ensure that it includes appropriate information about how and where their donation will be processed and how the contributors' information will be protected. For more information, see Principle #33.

Information on an organization's results and how they are measured can be an especially valuable means of explaining its work and offering an accounting to donors and the public. Nonetheless, such information,

and the ability to provide it, will vary considerably from one organization to another. To the extent evaluation or information on outcomes is available, some version of it should be included in annual reports, websites, and other forms of communication. More information about program evaluation is provided in Principle #19.

LEGAL BACKGROUND PRINCIPLE 07

Federal law requires many public charities, including all supporting organizations, and all private foundations to file an annual information return (Form 990, 990-EZ, 990-N or 990-PF) with the Internal Revenue Service that provides accurate information about its finances and programs.⁴⁶ The IRS may impose penalties on any organization that fails to file timely and accurate returns, and failure to file for three consecutive years will result in revocation of tax-exempt status.⁴⁷ Charitable organizations are required to make these forms,⁴⁸ as well as their initial application for recognition of tax exemption, correspondence with the IRS in connection with that application, available for free inspection during regular business hours at its principal, regional, and district offices.⁴⁹ Copies of these documents must also be provided without charge, other than a reasonable fee for reproduction and postage costs, to any individual who submits such a request in person or in writing.

A tax-exempt organization may meet the public inspection requirement by posting those documents on a widely available internet site maintained by the organization or as part of an online database maintained by another organization that contains similar documents of tax-exempt organizations. In either case, the internet site must clearly inform visitors that the documents are available and provide instructions for downloading them. Any individual with access to the internet must be able to download, view, and print the document without having to pay a fee or acquire special computer hardware or software, other than software that is readily available free of charge.

46 IRC § 6033. Churches, their integrated auxiliaries, conventions, or associations of churches are not required to file Form 990.

47 IRC § 6652, Form 990 Instructions.

48 Each annual information return must be made available for a period of three years beginning on the date the return is required to be filed or is actually filed, whichever is later. For tax years beginning after August 17, 2006, the requirement that charitable organizations make their annual IRS returns available for public inspection also includes the requirement to disclose the Form 990-T (report of unrelated business income). A tax-exempt organization is not required to comply with a request for a copy of its application for tax exemption or an annual information return if the organization has made the requested document widely available. A tax-exempt organization can make its application for tax exemption and/or an annual information return widely available by posting the document on an internet page that the tax-exempt organization establishes and maintains or by having the document posted, as part of a database of similar documents of other tax-exempt organizations, on an internet page established and maintained by another entity. See <http://www.irs.gov/instructions/i990ez/ar02.html#d0e5765>.

49 IRC § 6104. Organizations that received tax exemption prior to 1987 are not required to make their initial application for tax-exemption available if they do not have a copy of the application.

LEGAL BACKGROUND PRINCIPLE 07 (CONTINUED)

Each public charity that is not otherwise required to file 990 or 990-EZ⁵⁰ is required to file Form 990-N, an annual notice electronically with the IRS that indicates its legal name; mailing address; web site address; taxpayer identification number; name and address of a principal officer; evidence of the continuing basis for the organization's exemption from filing Form 990; and, upon termination, notice of that termination.⁵¹ There are no monetary penalties for failure to file the notice, but failure to file the annual notice for three consecutive years will result in revocation of tax-exempt status.

50 IRC § 6033. Churches, their integrated auxiliaries, conventions or associations of churches are not required to file Form 990, 990-EZ or 990-N.

51 See Form 990-N

SECTION TWO

EFFECTIVE GOVERNANCE





PRINCIPLE 08

A charitable organization must have a governing body that is responsible for reviewing and approving the organization’s mission and strategic direction, annual budget and key financial transactions, compensation practices and policies, and fiscal and governance policies.

The board of directors bears primary responsibility for ensuring that a charitable organization fulfills its obligations in accord with relevant law, its donors, staff and volunteers, clients, and the public at large. The board sets the vision and mission for an organization and establishes the broad policies and strategic direction that enable it to fulfill its charitable purpose. The board must protect the assets of the organization and provide oversight to ensure that its financial, human, and material resources are used appropriately to further its mission and to establish a level of risk tolerance appropriate for its operations. The board is also responsible for setting policies and procedures to ensure that the activities and operations of any affiliates, chapters, or branches subject to its direct or indirect control are consistent with the organization’s values and mission.

In smaller, un-staffed organizations, the board generally has a direct role in overseeing and delivering programs and services. When the board determines the organization should add paid staff, the board is responsible for selecting, overseeing, and, if necessary, terminating the chief executive officer. The board may hire independent consultants to assist in its governance responsibilities, such as legal and financial advisors, auditors, or in larger organizations, compensation consultants to assist in establishing the fairness of compensation paid to the chief executive and other key staff. The chief executive officer is responsible for hiring and supervising all other staff and consultants within the budget approved by the board.

LEGAL BACKGROUND PRINCIPLE 08

Federal, state, and local laws governing charitable corporations and trusts require that each organization have a governing body that is entrusted with the power to act on behalf of the beneficiaries of the organization.

The duties and requirements for directors of charitable organizations are generally determined by the laws of the state in which the organization was founded or incorporated. Some states also have established requirements for the board of directors of any organization that conducts activities, particularly fundraising, within its borders.

The Revised Model Nonprofit Corporation Act, adopted in 1987 by the American Bar Association’s Subcommittee on the Model Nonprofit Corporation Law of the Business Law Section, sets forth parameters for the structure and composition of boards. It also sets forth duties of loyalty and due care by requiring that: “a director shall discharge his or her duties as a director, including his or her duties as a member of a committee (1) in good faith; (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and (3) in a manner the director reasonably believes to be in the best interests of the corporation.”⁵²

LEGAL BACKGROUND PRINCIPLE 08 (CONTINUED)

The Revised Act has been adopted in whole or in modified form by 23 states and the District of Columbia⁵³ for regulation of nonprofit entities, including charitable organizations. The original Model Act (developed in 1952) has been adopted in whole or in modified form by six other states.⁵⁴

53 The Act has been adopted in whole or with modifications in Alaska, Arkansas, California, Colorado, Georgia, Hawaii, Idaho, Indiana, Maine, Minnesota, Mississippi, Missouri, Montana, Nebraska, North Carolina, Oregon, South Carolina, Tennessee, Utah, Vermont, Washington, West Virginia, Wyoming, and the District of Columbia.

54 Alabama, New Jersey, North Dakota, Texas, Virginia, and Wisconsin have adopted the original Model Nonprofit Corporation Act as promulgated or modified.

PRINCIPLE 09

The board of a charitable organization should meet regularly enough to conduct its business and fulfill its duties.

Regular meetings provide the chief venue for board members to review their organization's financial situation and program activities, establish and monitor compliance with key organizational policies and procedures, and address issues that affect the organization's ability to fulfill its charitable mission.

Charitable organizations should ensure that their governing documents satisfy legal requirements in establishing rules for board activities, such as quorum requirements and methods for notifying board members of forthcoming meetings. The board should establish and implement an attendance policy that requires its members to attend meetings regularly. Given the time and expense involved in traveling to meetings, some boards may choose to conduct their business through conference calls or forms of online communication that permit members to hear and be heard by all other participants. If state law allows such alternative meeting methods, the organization's governing documents should specify types of board meetings and communications permitted.

Boards often form standing and ad-hoc committees and authorize them to handle assigned tasks between full board meetings. The organization's governing documents should specify whether the board may create one or more such committees. In most states, the law prohibits boards from delegating certain responsibilities, such as dissolving the organization; electing or removing directors; and amending the organization's governing documents. However, committees may investigate and make recommendations on any of these issues, subject to the full board's consideration and decision.

Keeping clear, concise minutes of board and committee meetings is a critical form of organizational record-keeping. Minutes should accurately convey the decisions and actions taken at a meeting and provide sufficient documentation to address any

future questions or challenges about how a particular decision was reached. Organizations must report on their IRS Form 990s whether they maintained minutes of meetings held and actions taken by the board and committees acting on behalf of the board.

Every board needs to establish a process to discuss its governance responsibilities without the CEO present, and then to communicate the results of such discussions to the CEO in a clear, timely manner. Most nonprofit boards include the chief staff officer and other senior staff in meetings to address key organizational business, and then conduct a part of the meeting in "executive session" with only specific staff or outside advisors invited by the board in attendance. The regular board meeting minutes should reflect when the board went into an executive session, the general purpose of the session, and any key actions or decisions made during that session. For example, the minutes might reflect that the board met in executive session to review the performance and compensation of the chief executive. The board should keep minutes of its executive sessions, including any specific decisions and actions it took regarding the compensation and performance of the chief executive, although those minutes do not have to be made available to non-board members. These minutes are usually kept by the secretary of the board.

While many charitable organization governing boards find it prudent to meet at least three times a year to fulfill basic governance and oversight responsibilities, some with strong committee structures, including organizations with widely dispersed board membership, hold only one or two meetings of the full board each year. Foundations that make grants only once per year may find that one annual meeting is sufficient.

LEGAL BACKGROUND PRINCIPLE 09

The Revised Model Nonprofit Corporation Act and many state laws stipulate that the rules regarding meetings of the board, including their frequency, should be established in the bylaws of the organization.⁵⁵ Most state laws allow a charitable organization to stipulate meeting quorum requirements, that is, the number of board members who must be present before the meeting begins, in its governing documents. In the absence of such stipulations in the governing documents, state laws generally require that organizations hold at least one annual meeting with a majority of board members present.

55 Revised Model Nonprofit Corporation Act § 2.06.

PRINCIPLE 10

The board of a charitable organization should establish its own size and structure and review these periodically. The board should have enough members to allow for full deliberation and diversity of thinking on governance and other organizational matters. Except for very small organizations, this generally means that the board should have at least five members.

The size of a board depends on many factors, such as the age of the organization, the nature and geographic scope of its mission and activities, whether it is an all-volunteer organization or there is paid staff, and its funding needs. Although a larger board may ensure a wide range of perspectives and expertise, a very large board may become unwieldy and end up delegating too much responsibility to an executive committee or

permitting a small group of board members to exercise substantial control. Conversely, smaller boards may elicit more active participation from each member, but they should consider whether their members collectively offer the full range of knowledge and experience necessary to inform their decisions, and, if not, provide opportunities to confer with outside experts or advisory groups on specific matters.

LEGAL BACKGROUND PRINCIPLE 10

Federal law currently permits organizations to qualify for tax-exempt status with a single director or trustee. The Panel on the Nonprofit Sector has recommended that Congress amend the federal tax code to require that each organization, with certain exclusions,⁵⁶ have a minimum of three members on its governing board to be recognized as tax-exempt under section 501(c)(3) of the code.

State laws in this area vary depending on whether the organization is established as a corporation or a trust. The Revised Model Nonprofit Corporation Act stipulates that a board of directors must have a minimum of three members.⁵⁷ It sets no maximum number and allows an organization to set and change the number of directors in its bylaws, so long as there are always at least three directors in place.⁵⁸ In practice, some states require only one director for nonprofit corporations, and some also permit the formation of a corporation sole.⁵⁹ One state, New Hampshire, requires public charities to have a minimum of five directors who are not related family members.⁶⁰ Charitable organizations established by trusts are governed by one or more trustees as specified in the trust instrument.

56 Excluded would be houses of worship and specific related institutions, specified governmental instrumentalities, and other organizations relieved of this requirement by the IRS.

57 Revised Model Nonprofit Corporation Act § 8.03.

58 Revised Model Nonprofit Corporation Act § 8.04.

59 Generally corporation sole pertains to houses of worship and is a form of religious organization consisting of one person only, and his or her successors in some particular station, such as the bishop or rector of a church. As a corporation sole, certain legal capacities and rights are granted in perpetuity to the individual by right of the particular station he or she holds.

60 New Hampshire requires that boards of directors of public charities (certain religious organizations excepted) have at least five voting members “who are not of the same immediate family or related by blood or marriage.” N.H. Rev. Stat. § 292:6-a.

PRINCIPLE 11

The board of a charitable organization should include members with the diverse background (including, but not limited to, ethnicity, race, and gender perspectives), experience, and organizational and financial skills necessary to advance the organization’s mission.

Boards of charitable organizations generally strive to include individuals with expertise in budget and financial management, investments, personnel, fundraising, public relations and marketing, governance, advocacy, and leadership, as well as members knowledgeable about the charitable organization’s area of expertise or programs, or who have a special connection to its constituency. Some organizations seek to maintain a board that respects the culture of and reflects the community served by the organization. Boards are encouraged to be inclusive of and sensitive to diverse backgrounds when recruiting members, in addition to recruiting board members with expertise and professional or personal experiences that will be beneficial to the organization.

The full board is responsible for ensuring that the organization conducts its financial matters legally, ethically, and in accordance with proper accounting rules. To assist the board in fulfilling that duty, it should make every effort to ensure that at least one member has “financial literacy” — that is, the ability to understand nonprofit financial statements, to evaluate the bids of accounting firms that may undertake an audit or review, and to assist other members in using

and interpreting relevant data to make sound financial decisions. If the board finds itself unable to recruit members with such skills, it should contract with or seek the pro bono services of a qualified accountant, other than its auditor, to assist it with its financial responsibilities.

Organizations should also consider the requirements of current and prospective funding sources regarding the composition of their boards. For example, some government grants require that a board’s membership include a specific number of representatives of the populations served by the organization.

Some private foundations wish to involve family members on the boards of their foundations to ensure that the donors’ philanthropic tradition will continue through future generations. If family members do not have the necessary expertise and experience to play the needed governance role, however, the board may wish to bring in advisors. Such boards should also consider the advantages of diversity and the perspective offered by representatives from outside the family.

LEGAL BACKGROUND PRINCIPLE 11

Federal laws and regulations generally do not contain requirements for the composition of a charitable organization’s board of directors, with four notable exceptions: 1) health care organizations that must have a community board to satisfy the community benefit test;⁶¹ 2) organizations that qualify as publicly-supported charities based on a “facts and circumstances” test may need to have a governing board that is representative of

⁶¹ Internal Revenue Service *Audit Guidelines for Hospitals*, 1992. See Fremont-Smith, Marion R., *Governing Nonprofit Organizations: Federal and State Law and Regulations*, The Belknap Press of Harvard University Press (2004), page 244.

LEGAL BACKGROUND PRINCIPLE 11 (CONTINUED)

the community;⁶² 3) supporting organizations that must show a close relationship with the organizations they support through specific board positions; and 4) credit counseling organizations which must meet specific rules for board composition.⁶³

However the presence of a diverse, disinterested board is often employed as a factor in determining whether an organization meets an applicable exemption standard. For instance, the presence of a “governing board composed of prominent civic leaders rather than hospital administrators” is a factor used in determining whether an exempt healthcare organization meets the community benefit standard.⁶⁴

Further, the degree to which the governing body represents the broad public or community interests is used as a factor in determining whether an organization satisfies the facts and circumstances public support test of IRC § 509(a)(1).⁶⁵

Conversely, federal law imposes strict board composition requirements for Types 1 and 2 supporting organizations and credit counseling organizations. Qualification as a Type 1 supporting organization requires that the supporting organization give the supported organization(s) the power to regularly appoint or elect a majority of the directors or trustees of the supporting organization.⁶⁶ Qualification as a Type 2 supporting organization requires that control or management of the supporting organization be vested in the same persons that control or manage the publicly supported organizations.⁶⁷ Finally, credit counseling organizations are required to have a board “controlled by persons who represent the broad interests of the public, such as public officials acting in their capacities as such, persons having special knowledge or expertise in credit or financial education, and community leaders.”⁶⁸

62 Treas. Reg. §1.170A-9(e)(3).

63 IRC § 501(q)(1)(D).

64 IRS Announcement 92-83, *Examination Guidelines for Hospitals*, Rev. Rul. 69-545. See Fremont-Smith, Marion R., *Governing Nonprofit Organizations: Federal and State Law and Regulations*, The Belknap Press of Harvard University Press (2004), page 244.

65 Treas. Reg. §1.170A-9(f)(3)(iii)(C).

66 IRC § 509(a)(3).

67 Treas. Reg. § 1.509(a)-4(h).

68 IRC § 501(q)(1)(D).

PRINCIPLE 12

A substantial majority of the board of a public charity, usually meaning at least two-thirds of its members, should be independent. Independent members should not: (1) be compensated by the organization as employees or independent contractors; (2) have their compensation determined by individuals who are compensated by the organization; (3) receive, directly or indirectly, material financial benefits from the organization except as a member of the charitable class served by the organization; or (4) be related to anyone described above (as a spouse, sibling, parent or child), or reside with any person so described.⁶⁹

Board members who are not encumbered by having a personal financial interest in the organizations they oversee will generally find it easier to exercise their “duty of loyalty” that requires that they put the interests of the organization above their personal interests and make decisions they believe are in the best interest of the organization. Organizations are expected to make a reasonable effort to determine which of their board members are “independent” based on the IRS definition, and to report the number of such members on the annual information returns they file with the IRS. In addition, most nonprofits are required to report whether any of their officers, directors, trustees, or key employees had a family or business relationship with another individual in one of those leadership positions. The IRS does not consider board members to lack independence simply because they contribute to the organization, receive financial benefits from the organization as a member of the class served by the organization, are reimbursed for expenses associated with fulfilling their board responsibilities, or are compensated for their work as a board member. (For a more complete discussion of board compensation, see principle 20.)

The founders of a nonprofit corporation sometimes initially turn to family members and business partners to serve on its board of directors, but interlocking financial relationships can increase the difficulty of exercising the independent judgment required of

all board members. It is therefore important to the long-term success and accountability of charitable organizations that a sizeable majority of the individuals on their boards be free of financial conflicts of interest. Some states laws establish a minimum number of independent members for nonprofit organizations boards.

Some charitable organizations may not find it appropriate or feasible to adopt this principle. This includes private foundations, certain medical research institutions, and certain institutions that operate under specific legal restrictions regarding self-dealing transactions, and other charitable organizations whose articles of incorporation or trust instruments include special stipulations regarding board composition. For example, an organization established under the auspices of a religious institution may be required to include clergy or other paid representatives of that institution on its board. A supporting organization may be required to have representatives of its supported organizations on its board.

When a charitable organization determines that having a majority of independent board members is not appropriate, the board and staff should evaluate their procedures and meeting formats to ensure that board members are able to fulfill their responsibilities to provide independent, objective oversight of management and organizational performance.

⁶⁹ States may vary greatly regarding board independence requirements. A state survey of charitable regulations is available on the Independent Sector website and outlines specific requirements on a state level.

LEGAL BACKGROUND PRINCIPLE 12

Independence of the board functions to ensure that an exempt organization avoid excessive benefits or private inurement.⁷⁰ Five states have legislative mandates for the independence of nonprofit boards of directors. North Dakota,⁷¹ Maine,⁷² California,⁷³ and Vermont⁷⁴ require that no more than 49% of the board may be “interested” or “financially interested” persons.⁷⁵ While the definitions vary slightly in each state, “financially interested” persons are generally those who have received or are entitled to receive compensation for personal services rendered to the organization (other than compensation for board service), and/or those who are related family members of compensated persons.⁷⁶ New Hampshire requires that at least five voting members of the board of a charitable corporation “are not of the same immediate family or related by blood or marriage.”⁷⁷ The New Hampshire provision does not apply to private foundations, and certain religious organizations including churches and integrated auxiliaries of churches.

70 See generally IRS Private Letter Ruling 201113041 (Apr. 1, 2011).

71 ND Cent. Code § 10-33-27.

72 Maine Nonprofit Corporation Act, Title 13-B, § 713-A (2).

73 Cal. Corp. Code § 5227 (a).

74 11B VT Stats § 8.

75 Dana Brakman Reiser, *Charity Law's Essentials*, 86 NOTRE DAME L. REV. 1, 16 (2011).

76 Maine and Vermont define related parties as “spouse, brother, sister, parent or child,” while California also includes ancestor, descendant, brother-in-law, sister-in-law, son-in-law, daughter-in-law, mother-in-law, or father-in-law.

77 33 N.H. Rev. Stat. § 292:6-a.

PRINCIPLE 13

The board should hire, oversee, and annually evaluate the performance of the chief executive officer of the organization. It should conduct such an evaluation prior to any change in that officer's compensation, unless there is a multi-year contract in force or the change consists solely of routine adjustments for inflation or cost of living.

Boards of directors possess the authority to delegate responsibility for maintaining the daily operations of the organization to a chief executive officer. One of the most important responsibilities of the board, then, is to select, supervise, and determine a compensation package that will attract and retain a qualified chief executive. The organization's governing documents should require the full board to evaluate the performance and thoroughly understand and approve the compensation of the chief executive annually and in advance of any change in compensation. The board may choose to approve a multi-year contract with the CEO that provides for increases in compensation periodically or when the executive meets specific performance measures, but it is important that the board institute some regular basis for reviewing whether the terms of that contract have been met. If the board designates a separate committee to review the compensation and performance of the CEO, that committee should be required to report its findings and recommendations to the full board for approval and should provide any board member with details, upon request. The board should then document the basis for its decision and be prepared to answer questions about it.

The annual performance evaluation process provides an opportunity to clarify goals and expectations of the board and the CEO, identify and address challenges, and recognize and reward achievements. The process is frequently led by the board chair, but it can also be delegated to an executive or personnel committee, as long as all members have an opportunity to provide input and vote on any final decisions. The findings are generally communicated as part of a conversation with the CEO, but it is important to have the review's conclusions in writing and that document should be shared with the full board. Many tools and resources to assist in the evaluation process are listed at www.independentsector.org/principles.

When determining the reasonableness of the compensation package paid to the chief executive, the board should ensure that the individuals involved in crafting the compensation recommendation do not have a conflict of interest. The board or its committee should examine the compensation paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions. Many professional associations prepare regular surveys that can be useful in evaluating compensation, or the committee may turn to surveys compiled by independent firms or actual written offers from similar organizations competing for the executive's services. Some organizations may find it difficult to locate salary surveys or other data to establish comparable values for executive compensation within their geographic area or field of operation, but boards should still seek objective external data to support its compensation decisions.

When governing boards use compensation consultants to help determine the appropriate salary for the chief executive, the consultant should report directly to the board or its compensation committee and should not be engaged in other business with or have any conflicts of interest with regard to the chief executive.

While governing boards are responsible for hiring and establishing the compensation of the CEO, it is the chief executive's responsibility to hire and set the compensation of other staff, consistent with guidelines set by the board. If a CEO finds it necessary to offer compensation that equals or surpasses his or her own, in order to attract and retain certain highly qualified and experienced staff, the board should review the compensation package to ascertain that it does not provide an excess benefit to that staff member.

There are some circumstances in which it is appropriate for the final decision on officer compensation to be made by the board (or applicable board committee) based on the CEO's recommendation. This procedure may help ensure that the compensation decision qualifies for the rebuttable presumption of reasonableness under the intermediate sanctions rules in IRC § 4958.⁷⁸ In addition, some state laws require that the CEO and CFO compensation be set by the board or board committee.⁷⁹

Most charitable organizations must report on their annual IRS information return the compensation paid to the CEO, officers, directors, and certain key employees. They are also required to describe on that annual information return the process used to

determine the compensation for the chief executive, officers, and key employees and whether that process included review and approval by independent persons and use of comparability data. The IRS also asks reporting organizations whether their organization engaged in an excess benefit transaction with a disqualified person during the taxable year.

The board or a designated compensation committee should also review the personnel policies and overall compensation program, including salary ranges and benefits provided for particular types of positions, to assess whether the compensation program complies with organizational values (including values of diversity and inclusiveness) and is fair, reasonable, and sufficient to attract and retain high-quality staff.

LEGAL BACKGROUND PRINCIPLE 13

A charitable organization is permitted under current law to pay reasonable compensation for services provided by its board members, its chief executive officer, and other staff.⁸⁰ Reasonable compensation is defined as the amount that would ordinarily be paid for like services by like enterprises (whether tax-exempt or taxable) under like circumstances.⁸¹ Charitable organizations are prohibited from providing excessive compensation or economic benefit to executives and other individuals who have substantial influence over the organization's affairs, and to family members of and entities controlled by such individuals.⁸² Private foundations are generally prohibited from engaging in any financial transactions with disqualified persons⁸³, other than payment of reasonable compensation for services deemed necessary to the foundation's exempt purposes, with such individuals.⁸⁴

Federal law specifically encourages public charities to have executive compensation approved in advance by members of an "authorized body" of the organization (such as the board or a board-appointed committee), none of whom has a conflict of interest with respect to the transaction.⁸⁵ If the authorized body meets certain independence standards, approves the compensation based on appropriate data that help determine comparability or fair market value and documents the basis for its determination at the time it makes its decision,

78 See Treas. Reg. § 53.4958-6.

79 See California Nonprofit Integrity Act of 2004, Government Code section 12586(g).

80 Treas. Reg. § 53.4598-4(b).

81 Treas. Reg. § 53.4958-4(b)(1)(B).

82 IRC § 4941 and § 4946; § 4958(f).

83 IRC § 4946. Disqualified person includes substantial contributors to the private foundation, trustees and officers of the private foundation, and family members and related business entities of the aforementioned.

84 IRC § 4941.

85 Treas. Reg. § 53.4958-6(a)(1).

LEGAL BACKGROUND PRINCIPLE 13 (CONTINUED)

the regulations confer a rebuttable presumption of the reasonableness as regards the compensation.⁸⁶ The IRS may not draw any negative inferences simply because an organization chooses not to follow these procedures.⁸⁷ This rebuttable presumption of reasonableness effectively shifts the burden of proof to the IRS to establish that compensation is unreasonable.

Federal tax regulations define comparable data needed to determine the reasonableness of compensation or other transactions with disqualified persons as including (1) compensation paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions; (2) the availability of similar services in the geographic area; (3) current compensation surveys compiled by independent firms; (4) actual written offers from similar organizations competing for the disqualified person; and, if the transaction involves the transfer of property; (5) independent appraisals of that property and (6) offers received as part of an open and competitive bidding process.⁸⁸ Public charities with gross receipts (including contributions) of less than \$1 million may rely on comparability data obtained by three comparable organizations in the same or similar communities when approving compensation arrangements.⁸⁹

Board members and other managers of charitable organizations who approve a transaction knowing it provides an excess benefit are generally jointly and severally liable for a tax on the transaction amount for private foundations or the excess benefit for public charities, unless their participation is not willful and due to reasonable cause.⁹⁰ Penalties on those who receive, and on charity managers who approve, compensation that is later found to be excessive may be abated if the violation is due to reasonable cause and not willful neglect, and the excess benefit transaction was corrected within the specified correction period.⁹¹ The penalty is based on that portion of the compensation which represents the excess benefit (not the *total* compensation).⁹²

To impose penalties on public charity or private foundation managers, the IRS must prove that the organization manager's actions in accepting or approving an excess benefit or self-dealing transaction were conscious, voluntary, and intentional, and that the manager had actual knowledge of sufficient facts to determine that the transaction would be an excess benefit or self-dealing transaction, was aware that such a transaction would violate excess benefit or self-dealing proscriptions, and negligently failed to make reasonable attempts to determine whether the transaction was an excess benefit or self-dealing transaction.⁹³ A board member or other manager who relies on the advice of legal counsel (or, in the case of public charity managers, certain other professionals)⁹⁴ is generally not held responsible for knowing that the transaction was improper.⁹⁵ In addition, a board member

86 Treas. Reg. § 53.4958-6.

87 Treas. Reg. § 53.4958-6(e).

88 Treas. Reg. § 53.4598-4(b).

89 Treas. Reg. § 53.4958-6(c)(2).

90 IRC § 4941; IRC 4958.

91 Treas. Reg. 59.4958-1(c).

92 IRC § 4958. That is, the amount by which the benefit received exceeds an amount which could be considered reasonable.

93 Treas. Reg. §§ 53.4941(a)-1(b)(3), 53.4958-1(d)(4)(i).

94 Public charity managers may also rely on the professional advice of certified public accountants or accounting firms with relevant tax law expertise, and independent appraisers or compensation consultants who perform such valuation services on a regular basis, are qualified to make valuations of the particular type of property or services involved, and provide certifications regarding those qualifications. Treas. Reg. § 53.4958-1(d)(4)(iii).

95 Treas. Reg. § 53.4958-3(a)(1).

LEGAL BACKGROUND PRINCIPLE 13 (CONTINUED)

or other manager of a public charity is generally not held responsible for knowing that a transaction conferred an excess benefit if an appropriate authorized body has met the requirements of the rebuttable presumption procedures with respect to the transaction.⁹⁶

Federal laws do not subject managers of public charities to the excess benefit rules when they are setting the compensation for a new chief executive officer, chief financial officer, or a chief operating officer so long as the new employee was not a board member, key manager, or substantial contributor to the organization in the preceding five years, there is a written agreement governing the terms of compensation before the new executive takes office, and the compensation is based on a fixed amount or formula over single or multiple years.⁹⁷

Charitable organizations, with some exceptions,⁹⁸ are required to report on their Form 990 or 990-PF the name, title, and average hours per week of every board member, officer, and key employee. In addition, the organizations must report the compensation, contributions to employee benefit plans and deferred compensation arrangements, expense account, and other allowances paid during the year to any current or former board member, officer, and key employee. The instructions to the forms specify that all types of compensation must be reported, including both taxable and nontaxable fringe benefits except for working condition fringe benefits and de minimis fringe benefits (for example, property or services provided to the individual of such a small value as to make accounting for it impractical).⁹⁹

96 Treas. Reg. § 53.4958-1(d)(4)(iv).

97 Treas. Reg. §§ 53.4941(a)-1(b)(3), 53.4958-1(d)(4)(i).

98 Excluded from this requirement are 990-N filers, houses of worship and specific related institutions, specified governmental instrumentalities, and other organizations relieved of this requirement by authority of the IRS. IRC § 6033(a)(2).

99 IRC § 132(e). Treas. Reg. § 53.4598-4(c)(1) (Economic benefit is not treated as consideration for services for § 4958 purposes unless the exempt organization clearly indicates its intent to treat the benefit as compensation.)

PRINCIPLE 14

The board of a charitable organization that has paid staff should ensure that the positions of chief staff officer, board chair, and board treasurer are held by separate individuals. Organizations without paid staff should ensure that the positions of board chair and treasurer are held by separate individuals.

Concentrating authority for the organization's governance and management practices in one or two people removes valuable checks and balances that help ensure that conflicts of interest and other personal concerns do not take precedence over the best interests of the organization. Some state laws require that the offices of president and treasurer be held by different individuals. Both the board chair and the treasurer should be independent of the chief staff executive to provide appropriate oversight of the executive's performance and to make fair and impartial judgments concerning the executive's compensation.

When a board's membership deems it is in the best interests of their charitable organization to have the chief executive officer serve as its chair, they should appoint another board member (sometimes referred to as the "lead director") to handle issues that require a separation of duties, such as facilitating an executive session of the board to review key governance matters or to review the responsibilities, performance, or compensation of the chief executive. The board should also consult with legal counsel regarding any state or local laws prohibiting one individual from serving in both roles.

LEGAL BACKGROUND PRINCIPLE 14

State laws generally require that a charitable corporation have a secretary, and may also require that the corporation have a president, a treasurer, and other officers as appointed by the board.

Some states permit the same individual to hold simultaneously more than one office in the corporation, while others have restrictions that specify that the offices of president and the treasurer cannot be held by the same individual.

PRINCIPLE 15

The board should establish an effective, systematic process for educating and communicating with board members to ensure they are aware of their legal and ethical responsibilities, are knowledgeable about the programs and activities of the organization, and can carry out their oversight functions effectively.

Regardless of their prior board experience or training, every board member should receive a copy of the organization's governing instruments with an orientation to the organization's governing policies and practices, finances, and program activities. Every member should be made aware of the broad oversight responsibilities of the board and of the specific legal and ethical responsibilities of individual members. The board should establish and include in the orientation process clear guidelines for the duties and responsibilities of each member, including meeting attendance, preparation and participation; committee charters and assignments; and the kinds of expertise board members are expected to have or develop in order to provide effective governance. Every member should receive information and training in any specific protocols the board follows for conducting meetings, such as Robert's Rules of Orders. The board should establish and approve charters for each of its standing committees. These should outline the responsibilities, length of service, and authority granted to the committee. The board should also clearly communicate the duties and authority of any ad hoc committees or other convening vehicles they appoint to provide advice or reach decisions on organizational matters, although a full charter may not be necessary for these entities.

Members should be made aware of the need for their active preparation and participation in board meetings and their personal liability for the board's actions — or for its failure to take action — and of the protections available to them. Charitable organizations, if needed and funds permit, should provide opportunities for board members to obtain special training or advice on legal and financial issues and responsibilities. It is also advisable for an attorney or insurance expert who is knowledgeable about board liability to explain the legal protections available to board members, as well as the options for insurance.

The ongoing process of board education includes ensuring that members have received and reviewed sufficient information on the issues to be addressed at each board meeting. Agendas and background materials should be distributed far enough in advance of all board meetings so that all members can reasonably be expected to read and consider the issues prior to attending the meeting.

LEGAL BACKGROUND PRINCIPLE 15

There are no specific federal or state legal requirements regarding orientation and ongoing training of board members. Because the law requires board members to exercise reasonable care in making decisions on behalf of the organization, however, they must make an effort to obtain adequate information to inform their decisions.

PRINCIPLE 16

Board members should evaluate their performance as a group and as individuals no less frequently than every three years, and should have clear procedures for removing board members who are unable to fulfill their responsibilities.

A regular process of evaluating the board's performance can help to identify strengths and weaknesses in processes and procedures, provide insights for strengthening orientation and educational programs and the conduct of board and committee meetings, and identify means to improve interactions between board and staff leadership. Many boards will find it helpful to conduct such a self-assessment annually; others may prefer a schedule that coincides with the terms of board service or regular long-range planning cycles. A number of available print and online tools, ranging from sample self-assessment questionnaires to more complex evaluation procedures, can help an organization design a board evaluation or self-assessment process that best meets its needs.

Many boards assign responsibility for oversight of the board evaluation and development function to their executive committees or to a separate governance or board development committee. Board members with this responsibility should be empowered to discuss problems of attendance or other aspects of board performance with individual members to ascertain whether the problem can be corrected or the individual needs to resign or be removed from the board. The process for removing a non-performing board member is typically outlined in the organization's bylaws and generally requires the action of the full board or, if the organization has members, the action of its membership.

LEGAL BACKGROUND PRINCIPLE 16

There are no federal or state laws or regulations requiring governing boards of nonprofit organizations to evaluate the performance of the board as a group or as individuals.

The Revised Model Nonprofit Corporation Act stipulates that directors may be removed through judicial proceedings or by a vote of the board if “a director has engaged in fraudulent or dishonest conduct, or gross abuse of authority or discretion, with respect to the corporation...and removal is in the best interest of the corporation.”¹⁰⁰ In judicial proceedings, a court may also stipulate that the director who is removed may be barred from serving on the board for a proscribed period of time.

100 Revised Model Nonprofit Corporation Act § 8.05.

PRINCIPLE 17

Governing boards should establish clear policies and procedures setting the length of terms and the number of consecutive terms a board member may serve.

Every charitable organization should determine whether its best interests are served by limiting the length of time an individual may serve on its board. Some organizations have found that such limits help in bringing fresh energy, ideas and expertise to the board through new members. Others have concluded that term limits may deprive the organization of valuable experience, continuity and, in some cases, needed support. They believe organizations should rely solely on rigorous procedures for evaluating board members and removing those who are not able to fulfill their governance responsibilities effectively. Some family foundations may decide not to limit board terms if their donors expressed a wish that family members continue serving as long as they are willing and able.

Organizations that do limit the terms of board service should consider establishing a staggered term process that provides a continual flow of new participants while retaining a cadre of more experienced members. Many organizations find it useful to establish policies making board members eligible for re-election after taking a year or more off. It is always valuable to find ways in which members who have completed their service can continue to be engaged in the organization's programs and services.

Organizations that choose not to limit the terms of board service should consider establishing a regular process whereby board members actively reflect on their own performance and ability to fulfill their board responsibilities and renew their commitment to continue serving on the board. Some organizations create an alumni council or honorary board to provide an easy option for board members who feel it is time to leave active service but still wish to be involved in the organization. Others specify the age at which a member must retire from the board.

Whether or not the organization establishes board term or age limits, it is always helpful to have a process for involving prospective board members on committees or task forces until there is an appropriate opening on the board.

LEGAL BACKGROUND PRINCIPLE 17

There are no federal or state laws or regulations limiting the length of time an individual may serve on the board of a charitable corporation. Some state laws establish the length of a term of board service if such terms are not specified in the organization's articles of incorporation or bylaws, but they do not limit the number of terms an individual may serve. Trust laws in all states permit trustees to serve as appointed without any limitation on the term.

PRINCIPLE 18

The board should review organizational and governing instruments no less frequently than every five years.

Regular reviews of the organization's articles of incorporation, bylaws, and other governing instruments help boards ensure that the organization is abiding by the rules it has set for itself and determine whether changes need to be made to those instruments. The board may choose to delegate some of this deliberation to a committee, but the full board should consider and act upon the committee's recommendations. Charitable organizations are required to report any significant changes to their governing documents and policies on the annual information returns they file with the IRS, and they may be required to report such changes to state regulatory bodies as well.

Most state laws permit the state attorney general to file suit asking the court to hold a board accountable for failure to abide by the requirements set forth in its charter documents. If it becomes impractical or no longer feasible to carry out the purposes of the organization as outlined in its articles of incorporation, the board should take appropriate action to amend that document and to file the revised articles with state officials, as required. In some instances, a charitable organization may need court approval to modify its organizing documents.

LEGAL BACKGROUND PRINCIPLE 18

Each organization's articles of incorporation and governing instruments set forth the requirements for its conduct and that of its board of directors. Charitable organizations are required to submit these articles and instruments to the Internal Revenue Service when applying for recognition as a 501(c)(3) exempt organization. If an organization amends its governing instruments, it must notify the IRS of the changes on its next Form 990.¹⁰¹

101 IRS Publication 557, Tax-Exempt Status for Your Organization, page 16.

PRINCIPLE 19

The board should establish and review regularly the organization's mission and goals and should evaluate, no less frequently than every five years, the organization's programs, goals, and activities to be sure they advance its mission and make prudent use of its resources.

As stewards of the public's trust and the resources invested in an organization, board members have an obligation to ensure that the organization uses its resources as effectively as possible to advance its charitable mission. Every board should therefore set strategic goals and review them annually, generally as part of the budget review process. This assessment should address current needs and anticipated changes in the community or program area in which the organization operates that may affect future operations. It should also consider the financial and human resources needed to accomplish the organization's goals and mission. Such periodic performance reviews and assessments are a common feature of many self-regulation, accreditation, and funding programs in which nonprofit organizations participate.

Although discussions of individual program activities and accomplishments are typical of most board meetings, these are not a substitute for a more rigorous periodic evaluation of the organization's overall impact and effectiveness in light of the goals and objectives the board has approved.

Because organizations and their purposes differ, it is incumbent on each organization to develop its own process for evaluating effectiveness. Most organizations should have at least an informal review of their progress on goals and objectives annually, but, because of the time and cost involved, they may choose to conduct a more rigorous evaluation less frequently.

Even for organizations whose work is not properly measured in one-year increments, such as scientific research or youth-development programs, interim benchmarks can be identified to assess whether the work is moving in the right direction. It is important to acknowledge that some organizations are tackling intractable and other problems, challenges, and opportunities that do not readily provide evidence significant progress from year to year, yet they are nonetheless being effective and contributing to better overall outcomes.

When an organization considers taking on a new business or earned income opportunity, the board and staff should examine whether and how that activity will further the organization's mission and how it will fit in with the organization's overall revenue mix and staffing allocations. Income derived from activities unrelated to the organization's charitable mission may be subject to an unrelated business income tax and, if sufficiently substantive, could have ramifications for the organization's tax-exempt status. It is important to weigh the potential financial returns from a new business venture against the time and resources it may draw away from the organization's primary program and management functions. The board should establish regular check-points to evaluate the progress of new ventures it decides to undertake and assess whether those ventures are appropriately advancing the goals they were intended to serve as well as the impact they are having on the organization's overall services and programs.

LEGAL BACKGROUND PRINCIPLE 19

Some legal scholars argue that a board member's duty of loyalty to the beneficiaries of a charitable organization requires that he or she ensure that the organization's purposes are carried out effectively.¹⁰² If it becomes

102 Marion Fremont-Smith, *Governing Nonprofit Organizations: Federal and State Law and Regulations*, The Belknap Press of Harvard University Press (2004), pp. 225-226.

LEGAL BACKGROUND PRINCIPLE 19 (CONTINUED)

impractical or no longer feasible to carry out the purposes of the organization as outlined in its articles of incorporation, the board should take appropriate action to amend the articles and to file the amended articles with state officials and notify the Internal Revenue Service as required.¹⁰³

State charity regulators in some states take the position that a fundamental change in purpose may require approval from the state attorney general, and/or that funds previously received by an organization while it operated under one purpose cannot be used to support a new purpose.

103 See Form 990 Instructions.

PRINCIPLE 20

Board members are generally expected to serve without compensation, other than reimbursement for expenses incurred to fulfill their board-related duties. A charitable organization that provides compensation to its board members should use appropriate comparability data to determine the amount to be paid, document the decision, and provide full disclosure to anyone, upon request, of the amount and rationale for the compensation.

The vast majority of board members serve without compensation, although some organizations reimburse travel costs and other expenses necessary to ensure board members are able to participate in board functions. In fact, board members of public charities often donate both time and funds to the organization, a practice that supports the sector's spirit of giving and volunteering.

When organizations find it appropriate to compensate board members due to the nature, time, or professional competencies involved in the work, they must be prepared to provide detailed documentation of the amount of and reasons for such compensation, including the responsibilities of board members and the services they provide. The amount of compensation for each board member, and whether a board member received a grant or other assistance from the organization, must be reported on the organization's IRS Form 990. Any compensation provided to board members must be reasonable and necessary to support the performance of the organization in its exempt function. Compensation paid to board

members for services in the capacity of staff of the organization should be clearly differentiated from any compensation paid for board service.

Board members of charitable organizations are responsible for ascertaining that any compensation they receive does not exceed the compensation provided for positions in comparable organizations with similar responsibilities and qualifications. When they establish their own compensation, board members generally cannot be considered independent authorizing bodies and therefore generally cannot avail themselves of the legal protections accorded to such bodies. Nonetheless, boards that do provide compensation for some or all of their members should seek independent data, such as surveys available from national and regional associations or compensation consulting firms, to substantiate the reasonableness of the compensation they provide, and should review compensation decisions on an annual basis.

LEGAL BACKGROUND PRINCIPLE 20

Charities and foundations are permitted under current law to pay reasonable compensation for services provided by board members.¹⁰⁴ The rules and penalties regarding excessive compensation of and delivery of excess economic benefits to board members are the same as those applied to the compensation of the chief executive officer or other disqualified persons (see Principle #13).

104 See Principle 13 *supra* for discussion of reasonable compensation.

LEGAL BACKGROUND PRINCIPLE 20 (CONTINUED)

Charitable organizations¹⁰⁵ are required to report on their Form 990 or 990-PF the name, title, and average hours of service per week of every board member, officer, and key employee. In addition, the organizations must report the compensation, contributions to employee benefit plans and deferred compensation, expense account, and other allowances paid to any board member by the organization and its affiliated entities. Public charities must also provide this information for former employees and board members who received any compensation or benefit during the reporting year. The instructions to the Forms specify that all types of compensation must be reported, including both taxable and nontaxable fringe benefits except for working condition fringe benefits and de minimis fringe benefits (for example, property or services provided to the individual of such a small value as to make accounting for it impractical).¹⁰⁶

105 Excluded from the Form 990 filing requirement are organizations, other than private foundations and supporting organizations, with annual gross receipts of \$50,000 or less, houses of worship and specific related institutions, specified governmental instrumentalities and other organizations relieved of this requirement by authority of the IRS. IRC § 6033(a)(2).

106 IRC § 132(e).

SECTION THREE

STRONG FINANCIAL OVERSIGHT





PRINCIPLE 21

A charitable organization must keep complete, current, and accurate financial records and ensure strong financial controls are in place. Its board should receive and review timely reports of the organization's financial activities and should have a qualified, independent financial expert audit or review these statements annually in a manner appropriate to the organization's size and scale of operations.

Complete and accurate financial statements are essential for a charitable organization to fulfill its legal responsibilities and for its board of directors to exercise appropriate oversight of the organization's financial resources. A board that does not have members with financial expertise should retain a qualified paid or volunteer accounting professional to establish whether financial systems and reports are organized and implemented appropriately.

Having financial statements prepared and audited in accordance with generally accepted accounting principles and auditing standards improves the quality of the information and provides external input on the strength of financial controls that help prevent mismanagement or fraud. Each organization must ensure that it has its annual financial statements audited or reviewed as required by law in the states in which it operates or raises funds or as required by government or private funders. When an audit is not legally required, a financial review offers a less expensive option that still provides the board, regulators, and the public with some assurance of the accuracy of the organization's financial records. Many smaller organizations that have opted to work with an independent accountant have noted that the accountant provided invaluable guidance.

The IRS Form 990 asks organizations to report whether their financial statements were compiled, reviewed, or audited by an independent accountant, and whether they have an audit committee to oversee the audit process and select an independent auditor. Every charitable organization that has its financial statements independently audited, whether or not it is legally required to do so, should consider establishing an audit committee composed of independent board members with appropriate financial expertise. The audit committee should meet directly with the auditors in executive session, unfiltered by the organization's paid staff, thereby reducing possible conflicts of interest and providing the board greater assurance that the audit has been conducted appropriately. If state law permits, the board may appoint non-voting, non-staff advisors rather than board members to the audit committee, or invite a financial expert to serve in an advisory non-voting basis.

Organizations with small boards of directors or limited organizational structures may choose not to delegate the audit responsibility to a separate committee and instead have the full board handle audit related issues. Audit committees may also be inappropriate for charitable organizations that are organized as trusts rather than as corporations.

LEGAL BACKGROUND PRINCIPLE 21

Federal law requires many public charities and all private foundations to file an annual information return (Form 990, 990-EZ, or 990-PF) with the Internal Revenue Service with accurate information on the organization's finances and programs. IRS regulations permit any authorized officer of the organization¹⁰⁷ to sign Form 990 returns certifying, under penalty of perjury, that the return and accompanying schedules and statements are true, correct, and complete. The Internal Revenue Code provides for penalties if an organization fails to file a required return or to include required information on Form 990 series returns.

Public charities with annual revenues of \$50,000 or less are required to electronically file Form 990-N, an annual notice that indicates its legal name; mailing address; web site address; taxpayer identification number; name and address of a principal officer; evidence of the continuing basis for the organization's exemption from filing Form 990; and, upon termination, notice of that termination. There are no monetary penalties for failure to file the notice, but failure to file the annual notice for three consecutive years will result in revocation of tax-exempt status.

The Revised Model Nonprofit Corporation Act requires that a nonprofit corporation with members (other than religious corporations) must furnish on request from a member its latest annual financial statements with a balance sheet and statement of operations.¹⁰⁸ If the statements are prepared by a public accountant, they must include the accountant's report.¹⁰⁹ Otherwise, the statements must include a statement from the organization's president or the individual responsible for the corporation's financial records stating whether the statements were prepared on the basis of generally accepted accounting principles or, if not, the basis of preparation.¹¹⁰ Some states also require public charities to file their IRS annual information returns with the state and may impose additional penalties for failure to meet their filing requirements.

There is currently no federal requirement for audits of charitable organizations (except under OMB Circular No. A-133 for organizations that expend \$500,000 or more in federal grant funds). Eighteen states require a charitable organization that solicits contributions in the state to submit a copy of an independent audit report or a certified review of financial reports annually if it meets certain financial criteria. The budget thresholds for audit requirements vary substantially. California requires charitable organizations, other than educational organizations and hospitals, to file audited financial statements if their gross annual revenues are \$2 million or more,¹¹¹ whereas Maryland requires organizations soliciting contributions in its state to file audited financial statements if annual total contributions to the organization equal or exceed \$200,000.¹¹²

107 See Form 990 Instructions. For a corporation or association, this officer may be the president, vice president, treasurer, assistant treasurer, chief accounting officer, or other corporate or association officer, such as a tax officer. For a trust, the authorized trustee must sign.

108 Revised Model Nonprofit Corporation Act § 16.20(a).

109 Revised Model Nonprofit Corporation Act § 16.20(b).

110 Revised Model Nonprofit Corporation Act § 16.20(a).

111 CA Govt. Code § 12585.

112 Maryland Solicitations Act § 6-402.

PRINCIPLE 22

The board of a charitable organization must institute policies and procedures to ensure that the organization (and, if applicable, its subsidiaries) manages and invests its funds responsibly, in accordance with all legal requirements. The full board should review and approve the organization's annual budget and should monitor actual performance against the budget.

Overseeing an organization's financial management is among the most important responsibilities of the board of directors. Board members should establish clear policies to protect the organization's financial assets and ensure that the organization has strong internal controls that ensure no one person bears the sole responsibility for receiving, depositing, and spending its funds. Day-to-day accounting and financial management should be the task of staff or, in the case of organizations with no or one staff member, designated volunteers who have the necessary time and skills. The board is responsible for reviewing practices and reports to ensure that those staff or volunteers are adhering to the board-approved policies.

The organization's annual budget should reflect the programs and activities the organization will undertake in the coming year and the resources it will need to raise or generate to support those activities. Careful review of regular financial reports showing both budgeted and actual expenditures and revenues will permit the board to determine whether adjustments must be made in spending to accommodate changes in revenues. Financial reports should also reflect how the organization has adhered to any restrictions placed on funds by donors or grant programs.

Prudent financial oversight requires that the board look beyond monthly or annual financial reports to consider how the organization's current financial performance compares with that of previous years as well as to gauge its future prospects. If the organization's net assets have been declining over a period of years, or if future funding seems likely to change significantly, the board may need to take steps to achieve or maintain stability.

Whenever possible, an organization should generate enough income to create cash reserves for its future. When an organization has built sufficient reserves to allow for investments, the board is responsible for establishing policies that govern how the funds will be invested and what portion of the returns, if any, can be used for immediate operations or programs. The boards of organizations with sizeable reserves or endowments generally select one or more independent investment managers to handle the organization's investments. In those cases, the board or a committee of the board should monitor the outside investment manager(s) regularly.

LEGAL BACKGROUND PRINCIPLE 22

Federal law generally does not regulate the management of investment assets by public charities.

Private foundations and their managers, however, are subject to penalties under federal tax law if the board approves investments “in such a manner as to jeopardize the carrying out of any of (the organization’s) exempt purposes.”¹¹³

Under all state laws, directors must exercise their “duty of care” by providing careful oversight of the organization’s assets and financial transactions in order to protect the interests of the organization and its charitable purposes. Board members must exercise ordinary business care and prudence in providing for the short- and long-term needs of the organization when evaluating both the overall investment portfolio and individual investment decisions.

Uniform Prudent Management of Institutional Funds Act (UPMIFA) has been adopted by 49 states and the District of Columbia. UPMIFA applies to charitable corporations and provides more guidance for boards and others responsible for managing the investments of charitable organizations. It defines the following principles of prudence for those who manage and invest funds of charitable organizations:

1. Give primary consideration to donor intent as expressed in a trust instrument;
2. Act in good faith, with the care an ordinarily prudent person would exercise;
3. Incur only reasonable costs in investing and managing charitable funds;
4. Make a reasonable effort to verify relevant facts;
5. Make decisions about each asset in the context of the portfolio of investments, as part of an overall investment strategy;
6. Diversify investments unless, due to special circumstances, the purposes of the fund are better served without diversification;
7. Dispose of unsuitable assets; and
8. In general, develop an investment strategy appropriate for the fund and the charity.¹¹⁴

113 IRC § 4944.

114 Uniform Prudent Management of Institutional Funds Act (as approved by the National Conference of Commissioners on Uniform State Laws, July 2006), Prefatory Note, page 2.

PRINCIPLE 23

A charitable organization should not provide loans (or the equivalent, such as loan guarantees, purchasing or transferring ownership of a residence or office, or relieving a debt or lease obligation) to directors, officers, or trustees.

The practice of providing loans to board members and executives, while infrequent, has created both real and perceived problems for public charities. While there may be circumstances in which a charitable organization finds it necessary to offer loans to staff members, there is no justification for making loans to board members. Federal laws prohibit private foundations, supporting organizations and donor-advised funds from making loans to substantial contributors, board members, organization managers, and related parties. Many states also forbid such loans or allow them only in very limited circumstances.

When a charitable organization deems it necessary to provide loans, including salary advances, to an employee — for example, to enable a new employee to purchase a residence near the organization’s offices — the terms of such loans should be clearly understood and approved by the board. Board members should consult with legal counsel about any special requirements under state or federal law that could affect such loans, including any requirements that loans and advancements be treated as compensation. Such loans and advances must be reported on the organization’s Form 990.

LEGAL BACKGROUND PRINCIPLE 23

Federal laws prohibit private foundations, supporting organizations, and donor-advised funds from making loans to disqualified persons.¹¹⁵ The Revised Model Nonprofit Corporation Act states that a nonprofit corporation “may not lend money to or guaranty the obligation of a director or officer of the corporation,”¹¹⁶ and most states allow such only in very limited circumstances.

Charitable organizations must report any loans to current and former officers, directors, trustees, key employees, and other “disqualified persons” on their annual information returns (Form 990 and 990-PF). For public charities permitted to make such loans, the IRS generally scrutinizes lending transactions to determine whether they qualify as an arm’s length loan or disguised compensation. In making its determination, the IRS examines information reported on the Form 990, including the maturity date of the loan, repayment terms, the interest rate charged, any security or collateral provided by the borrower, and the purpose of the loan. The IRS also expects that the organization maintain and be able to provide written documentation of the loan.

The financial benefit of a loan that is provided at below-market interest rates must be added to the borrower’s other compensation to determine if the total qualifies as an excess benefit transaction. Note, however, that an economic benefit is not treated as consideration for services for § 4958 purposes unless the exempt organization *clearly indicates its intent* to treat the benefit as compensation. Consequently, a loan determined to be disguised compensation will automatically be treated as an excess benefit transaction under § 4958.

115 IRC §4941(d)(1)(B), § 4958(f), and § 4958(c).

116 The Revised Model Nonprofit Corporation Act § 8.32.

PRINCIPLE 24

A charitable organization should spend a significant amount of its annual budget on programs that pursue its mission while ensuring that the organization has sufficient administrative and fundraising capacity to deliver those programs responsibly and effectively.

Charitable organizations have an obligation to devote their resources to the charitable purposes for which they were granted tax exemption, including ensuring that they have appropriate management and support services in place to oversee and deliver their programs and services effectively, while also adhering to relevant legal and ethical requirements.

Administrative activities include financial and investment management, personnel services, recordkeeping, risk management, soliciting and managing contracts, legal services, and supporting the governing body of the organization. Not only do these elements ensure that the organization complies with all legal requirements, but they also help provide complete, accurate, and timely information to donors, the public, and government regulators.

Charitable organizations rely on other supporting services to carry out their missions. Most public charities have fundraising operations to encourage potential donors to contribute money, materials and other assets and to ensure that donors receive necessary reports about how their contributions were used. Some public charities also rely on membership development activities to solicit prospective members, collect membership dues, and ensure that members receive promised benefits. Private foundations and some public charities also have expenses associated with making grants and contributions to other organizations and individuals.

Qualified personnel are crucial for providing programs, recruiting and managing volunteers, raising funds, and ensuring proper administration. The costs of compensating personnel, including salaries

and benefits, must be allocated to the particular functions they perform for the organization based on appropriate records.

Charitable organizations are required to report separately on their annual IRS Form 990 the amounts they expend on program services, the management and governance of the organization, and fundraising activities. The percentage of an organization's budget spent on direct program services and the percentage used to manage and govern an organization and to raise the necessary revenues to support its programs and operations will vary substantially depending on its age, size, and type. For example, an organization may devote more resources to raising funds when it is launching a new program or preparing to purchase or upgrade a building. Similarly, an organization may make a greater investment in administrative operations when it is adding new information technology or hiring and training staff and volunteers to offer new or expanded services. Some self-regulation systems and "watchdog" organizations recommend that public charities spend at least 65 percent of their total expenses on program activities. This standard is reasonable for most organizations, but there can be extenuating circumstances, such as those cited above, that require an organization to devote more resources to administration and fundraising. Boards should review budget, financial, and program outcome reports to determine whether the organization is allocating its funds appropriately and making the investments in program, administrative, and fundraising activities necessary to fulfill its charitable mission.

LEGAL BACKGROUND PRINCIPLE 24

Both private foundations and public charities are permitted to incur reasonable and necessary “administrative expenses” to further their charitable missions.¹¹⁷ Congress has never placed a general limitation on the amount of administrative expenses public charities can incur.

Public charities that are required to file Form 990 must disclose their total expenditures for administration or what the instructions to the form calls “management and general” expenses. The IRS defines management and general expenses as the organization’s expenses for overall function and management, rather than for its direct conduct of fundraising activities or program services. Overall management usually includes the salaries and expenses of the chief officer of the organization and that officer’s staff. If part of a manager’s time is spent directly supervising program services and fundraising activities, the appropriate portion of his or her salary and expenses should be allocated to those functions.¹¹⁸

Rental income expenses and program-related income expenses are not included in management and general expenses. Administrative expenses are further distinguished from “indirect expenses” such as rent, reception services, etc. which can be allocated to various program cost centers and to management and general.

There is no comparable definition of administrative expenses for private foundations in the instructions to the Form 990-PF. Private foundations are permitted to count all “reasonable and necessary” administrative expenses against their five percent payout requirement.¹¹⁹ Federal law does not permit expenses for ongoing investment management, such as investment consultant fees, custodial fees, attending investment conferences, etc., to be counted as qualifying distributions.

117 [Treas. Reg. § 53.495-6\(b\)](#).

118 [IRS 2013 Form 990 Instructions](#).

119 [IRC § 4942\(g\)\(1\)\(A\)](#).

PRINCIPLE 25

A charitable organization should establish clear, written policies for paying or reimbursing expenses incurred by anyone conducting business or traveling on behalf of the organization, including the types of expenses that can be paid for or reimbursed and the documentation required. Such policies should require that travel on behalf of the organization is to be undertaken cost-effectively.

A charitable organization's travel policies should be unambiguous and easy to follow, and should reflect the organization's principled judgment about what it considers "reasonable" expenditures for individuals who travel to conduct business on its behalf. These policies should include procedures for properly documenting expenses incurred and their organizational purpose.

As a general practice, travel policies should ensure that the business of the organization is carried out in a cost-effective manner. Decisions on travel expenditures should be based on how best to further the organization's charitable purposes, rather than on the title or position of the person traveling. Charitable funds generally should not be used for premium or first-class travel, but boards should retain the flexibility to permit exceptions when they are in the organization's best interest. Such exceptions,

if any, should be explicit, consistently applied, and transparent to board members and others associated with the organization.

An organization's policies should reflect the requirements and restrictions on travel expenditures imposed under current law. Payments of travel, or entertainment expenses for federal, state or local government officials must be reported on the organization's annual IRS Form 990. Some travel expenses may be considered as part of reportable compensation, such as the cost of leasing vehicles on behalf of key employees if the vehicles are used for personal purposes (such as commuting). The detailed guidance provided in IRS Publication 463: Travel, Entertainment, Gift and Car Expenses should serve as a guide for managers of charitable organizations in avoiding lavish, extravagant, or excessive expenditures.

LEGAL BACKGROUND PRINCIPLE 25

Public charities and private foundations, like taxable organizations, are permitted to pay for or reimburse ordinary and necessary expenses incurred in carrying out the organization's activities, including the costs of travel. Under federal tax regulations, expenses for transportation, lodging, and meals must be documented to establish that they were incurred in connection with the work of the organization and not the personal activities of the individual. Federal tax regulations also require that these expenses not be "lavish or extravagant under the circumstances," though "lavish" and "extravagant" remain undefined in the tax code or in regulations.¹²⁰

¹²⁰ IRC § 162(a)(2); Treas. Reg. §§ 1.162-2, 1.162-17.

LEGAL BACKGROUND PRINCIPLE 25 (CONTINUED)

Special rules apply to many types of travel-related expenses and reimbursement methods, including per diem payments, car allowances, employer-provided vehicles, security expenses, and travel expenses of spouses or other family members.¹²¹ Travel expenses also have specific documentation requirements; for example, proper receipts and an indication of the business purpose of the travel or expenditure must be provided.¹²² Taxable organizations also have limitations on deductions for meals, entertainment expenses, and some travel expenses.¹²³

Travel expenses that are paid or reimbursed but are not properly documented or are “lavish or extravagant” must be treated as additional taxable compensation to the individual benefiting from them. The law requires public charities intending to treat an expenditure as compensation to provide contemporaneous written substantiation by reporting the amounts on a Form W-2, a Form 1099, or a Form 990, or otherwise documenting such compensation in writing; otherwise, the compensation will be treated automatically as an “excess benefit.”¹²⁴ Board members and executives of charitable organizations who approve or receive excessive travel benefits are subject to penalties under existing law.¹²⁵

121 Treas. Reg. §§ 1.162-2, 1.132-5.

122 IRC § 274(d); Treas. Reg. §§ 1.274-5, 1.274-5T.

123 IRC § 274 and the regulations thereunder.

124 IRC § 4958(c)(1)(A); Treas. Reg. § 53.4958-4(c)(1).

125 IRC §§ 4941, 4958.

PRINCIPLE 26

A charitable organization should neither pay for nor reimburse travel expenditures for spouses, dependents or others who are accompanying someone conducting business for the organization unless they, too, are conducting such business.

If, in certain circumstances, an organization deems it proper to cover expenses for a spouse, dependent, or other person accompanying someone on business travel, the payment generally must, by law, be treated as compensation to the individual traveling on behalf

of the organization. This principle need not apply to de minimis expenses such as the cost of a meal at organization functions for which participants are invited to bring a guest.

LEGAL BACKGROUND PRINCIPLE 26

Federal law generally requires that payments of travel expenditures for spouses, family members, and others accompanying an individual traveling on behalf of the organization must be treated as taxable income to the individual they are accompanying.¹²⁶ As with other travel expenses, the law requires public charities intending to treat such expenditures as compensation to provide contemporaneous written substantiation by reporting the amounts on a Form W-2, a Form 1099, or a Form 990, or otherwise documenting such compensation in writing; otherwise, the compensation will be treated automatically as an “excess benefit.”¹²⁷ Board members and executives of charitable organizations who approve or receive excessive travel benefits are subject to penalties under existing law.¹²⁸

126 Treas. Reg. §§ 1.162-2, 1.132-5.

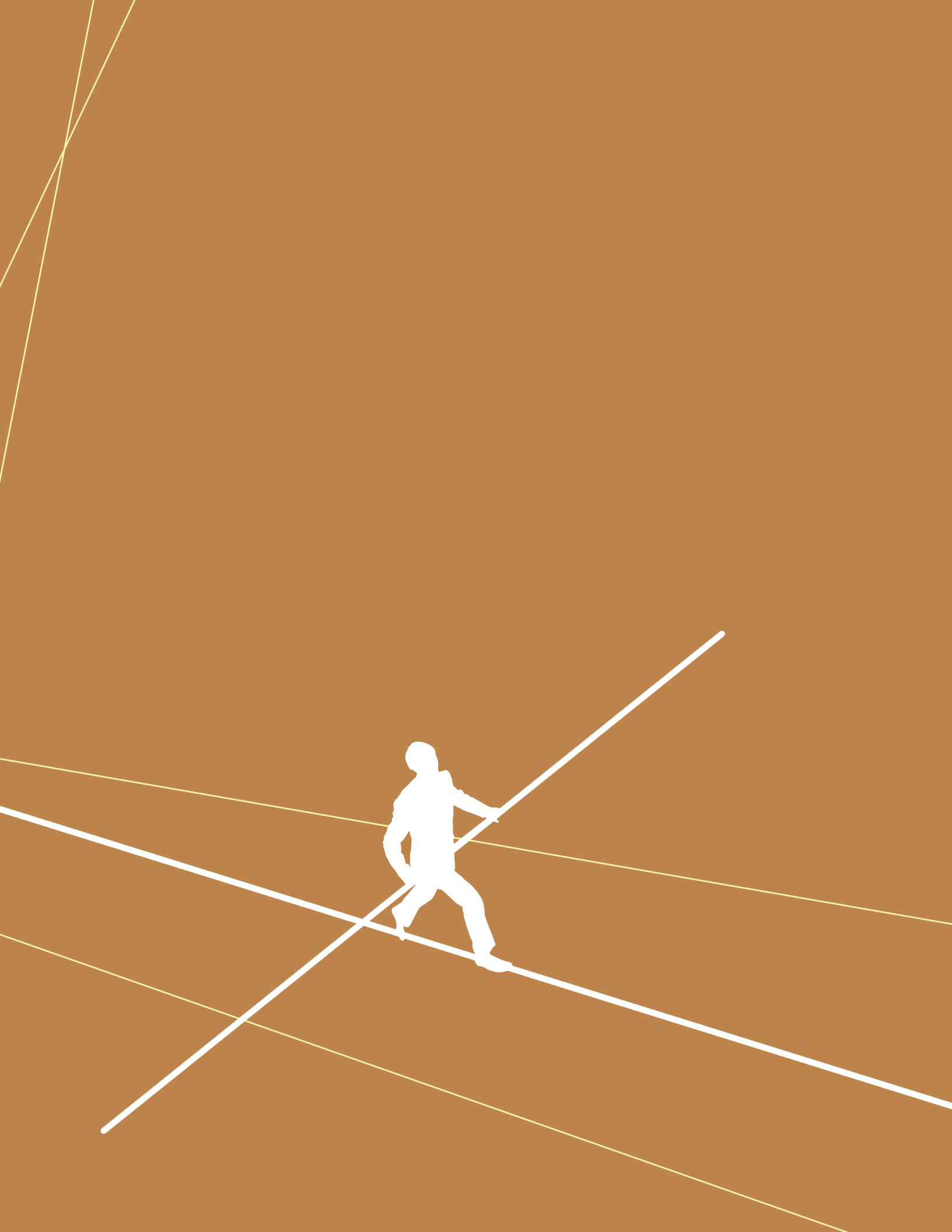
127 IRC § 4958(c)(1)(A); Treas. Reg. § 53.4958-4(c)(1).

128 IRC §§ 4941, 4958.

SECTION FOUR

RESPONSIBLE FUNDRAISING





PRINCIPLE 27

Solicitation materials and other communications addressed to donors and the public must clearly identify the organization and be accurate and truthful.

A donor has the right to know the name of anyone soliciting contributions, the name and location of the organization that will receive the contribution, a clear description of its activities, the intended use of the funds to be raised, contacts for obtaining additional information, and whether the individual requesting the contribution is acting as a volunteer, employee of the organization, or hired solicitor. Descriptions of program activities and the financial condition of the organization must be current and accurate, and any references to past activities or events should be dated appropriately. Charitable organizations should be sure that all of their online, mobile, and print communications and any online or mobile fundraising platforms they use to process contributions include current, correct information on how anyone can contact the organization directly for more information. (A Donor Bill of Rights, created by the Association of Fundraising Professionals and endorsed by many organizations, is available at <http://www.afpnet.org/>.)

If an organization is not eligible to receive tax-deductible contributions, it must disclose this limitation at the time of solicitation. Similarly, a charitable organization that the IRS has recognized as eligible to receive tax-deductible contributions should clearly indicate in its solicitations how donors may obtain proof of that status. The organization is required to provide a copy of the IRS letter awarding or confirming its tax-exempt status to anyone who

requests it, or it may choose to post its determination letter on its website.¹²⁹ If the solicitation promises any goods or services to the donor in exchange for contributions, the materials should also clearly indicate the portion of the contribution (that is, the value of any goods or services provided) that is not tax-deductible.

Social media and online fundraising channels offer many opportunities for charitable organizations to raise funds and generate support for their work. These channels also provide easy opportunities for inappropriate or fraudulent solicitations in the name of a charitable organization. Charitable organizations should counter attempts by others to use their name and reputation, or a similar name and purpose to misdirect donors, by providing warnings on their solicitation materials and encouraging donors to email, call or visit the organization if they have any question about either the charity or a fundraising solicitation. For more information about supervision and oversight recommended for online and mobile fundraising campaigns and platforms, see Principle 31.

129 An exception is provided for organizations that applied for exemption prior to July 15, 1987, and that no longer have a copy of their exemption letter. The IRS will issue a letter to charitable organizations requesting confirmation of their tax-exempt status, often to satisfy donor requests.

LEGAL BACKGROUND PRINCIPLE 27

Overlapping federal, state, and local laws regulate charitable solicitations. States play the leading role, with 40 states and the District of Columbia requiring state-level registration prior to soliciting donations from the public¹³⁰. Most states can also prosecute fraudulent or misleading charitable solicitations under their anti-fraud and consumer protection statutes. Many cities and counties have enacted their own solicitation ordinances. The Federal Trade Commission has jurisdiction over fraudulent solicitations in interstate commerce by for-profit organizations, including those who solicit on behalf of charitable nonprofits, while the Postal Service can prosecute fraudulent or misleading solicitations conveyed via the U.S. mail.

Over the years, state and local governments have attempted to prevent fraudulent fundraising, as well as curb what they perceive to be a waste of charitable assets, by limiting the amount that could be paid for fundraising (including amounts paid to professional fundraisers) or by requiring point-of-solicitation disclosures about the proportion of the funds that the charity would receive. The U.S. Supreme Court struck down three of these efforts on the grounds that they infringed on charities' First Amendment free speech rights.¹³¹ While the Court expressed sympathy for state regulators' desire to protect their citizens from deceptive practices, it noted that existing antifraud statutes were adequate and that there were much less restrictive tools for combating fraudulent solicitations than percentage caps and point-of-solicitation disclosures, which it found to be excessive burdens on or unlawful compulsion of speech and thus unconstitutional. However, when the Court affirmed these precedents in 2003, it also upheld the Illinois Attorney General's right to pursue an action for fraud against a professional fundraiser that made representations to donors that a "significant amount" of each dollar donated would be going to the charity, when only 15 percent actually did.¹³²

130 Charitable Solicitation Requirements – 2013 Update, National Association of College and University Attorneys, available at http://www.nacua.org/nacualert/docs/CharitableSolicitation/2013_JurisdictionalRequirementsCharitableSolicitation.pdf.

131 See *Village of Schaumburg v. Citizens for a Better Environment*, 444 U.S. 620 (1980); *Secretary of State of Maryland v. Munson*, 467 U.S. 947 (1984); and *Riley v. National Federation of the Blind of North Carolina, Inc.*, 487 U.S. 781 (1988).

132 *Illinois ex rel. Lisa Madigan v. Telemarketing Associates, Inc.*, 538 US 600 (2003).

PRINCIPLE 28

Contributions must be used for purposes consistent with the donor's intent, whether as described in the relevant solicitation materials or as specifically directed by the donor.

When a donor responds to a charitable solicitation with a contribution, he or she has a right to expect that the funds will be used as promised. Solicitations should therefore indicate whether the funds they generate will be used to further the general programs and operations of the organization or to support specific programs or initiatives. A donor may also indicate through a letter, a written note on the solicitation, or a personal conversation with the solicitor or another official of the charitable organization how he or she expects the contribution to be used.

Before accepting a gift, the organization should review whether the gift is consistent with the organization's gift acceptance policy (see Principle #30) and should ascertain whether the donor has stipulated any specific terms for the use of the gift. If the organization will be unable or unwilling to comply with any of the terms requested by a donor, it should negotiate any necessary changes prior to concluding the transaction. Particularly in the case of substantial contributions, the recipient should develop an agreement that specifies any rights it may have to modify the terms of the gift if circumstances warrant. Some charitable organizations include provisions in their governing documents or board resolutions indicating that the organization retains "variance powers," the right to modify conditions on the use of assets. Such powers should be clearly communicated to donors through a written agreement.

If the organization accepts a gift that the donor expects will be maintained in a separate account or fund over which the donor expects to have advisory privileges as to the distribution or investment of those funds, it may be defined as a sponsoring organization of a

donor advised fund.¹³³ In such cases, organizations should consult with legal advisors regarding specific Form 990 and other reporting requirements and rules applicable to sponsoring organizations that hold donor advised funds particularly with regard to transactions with donors, either directly or by organizations receiving gifts from a donor-advised fund.

In some cases, an organization may not receive sufficient contributions to proceed with a given project or it may receive more donations than it requires to carry out that project. If the organization is unable or unwilling to use the contribution as stated in its appeal or in the donor's communication, it has an obligation to contact the donor and request permission to apply the gift to another purpose or offer to return the gift. Charitable organizations should strive to make clear in materials that solicit contributions for a specific program how they will handle such circumstances.

133 Internal Revenue Code section 4966(d)(2) defines a donor-advised fund as a fund or account that is owned and controlled by a sponsoring organization, separately identified by reference to contributions of a donor or donors, and to which the donor or a designated advisor has or reasonably expects to have advisory privileges with respect to the distribution or investment of the assets in the fund. The definition specifically excludes a fund or account that makes distributions only to a single identified organization or governmental entity or that makes grants for travel, study, or similar purposes provided that certain conditions are met.

LEGAL BACKGROUND PRINCIPLE 28

If a donor provides a clear, written directive about how funds are to be used at the time a charitable gift is made, the board of the recipient organization has a fiduciary obligation to comply with the donor's directive and state attorneys general may enforce compliance. In some states, the donor (or his or her heirs) may have legal standing to ask a court to enforce those terms. This type of instruction would include a contract or grant agreement between a private or public funder and a charitable organization. An organization's communications while it is soliciting contributions may also create a legally binding restriction that can be enforced under state and federal fraudulent solicitation prohibitions.

When carrying out a donor's clear, written directive on how to use a contribution becomes impossible, impracticable, or illegal, a charitable organization or the state Attorney General may appeal to a court for authority to alter the original purposes of the gift or deviate from directions provided by the donor.¹³⁴

134 See Comment to § 413 of The Uniform Trust Code, promulgated by the National Conference of Commissioners on Uniform State Laws (NCCUSL) in 2000, and amended in 2001, 2003 and 2005, which provides in part: "if a particular charitable purpose becomes unlawful, impracticable, impossible to achieve, or wasteful ... the court may apply cy-pres to modify or terminate the trust ... in a manner consistent with the settlor's charitable purposes." UPMIFA, as adopted July 2006, Comment to Section 6, similarly allows a release of restrictions with donor permission, and permits deviations to modify or release a restriction, through court order or upon notification to the State Attorney General (or other applicable charity official). Modifications from the original intent of the donor must be "in accordance with the donor's probable intention" for deviation, and "in a manner consistent with the charitable purposes expressed in the gift instrument" for cy-pres.

PRINCIPLE 29

A charitable organization must provide donors with specific acknowledgments of charitable contributions, in accordance with IRS requirements, as well as information to facilitate the donors' compliance with tax law requirements.

Acknowledging donors' contributions is much more than a tax requirement, it is a critical part of building donors' confidence in and support for the activities they help to fund. Organizations should establish procedures for acknowledging all contributions in a timely manner, whether by mail or electronically. Donors must have written documentation to claim a tax deduction for charitable contributions on their annual income tax returns, and that documentation must come from the charitable organization for gifts of \$250 or more. Charitable organizations are required to make a good faith estimate of the value of any goods and services (such as a meal at a fundraising banquet) the donor received in exchange for a contribution of more than \$75. IRS publication 526 provides more information on the requirements for charitable organizations, including exceptions for benefits considered to be insubstantial, certain membership benefits, and intangible religious benefits.

In addition to thanking donors for their contributions, such acknowledgements should indicate how the donor can find more information on the activities they support through a website, print publications or visits to an organizational office. It is often helpful

to provide regular email or newsletter updates so that donors can receive ongoing information about how their contributions made a difference through the organization's work. Many organizations also choose to include in the acknowledgement an easy way for donors to indicate that they do not wish their names or contact information to be shared outside the organization and how they can "opt out" of receiving communications from the organization going forward.

Acknowledgements of other gifts of property and other non-cash contributions should include a description, but not the value, of the item or items contributed. Specific rules apply to the deductions taxpayers are permitted to claim for various types of non-cash gifts, such as donations of motor vehicles, appreciated art, or non-publicly held stock. Organizations that accept such gifts should consult with qualified legal and accounting professionals regarding their obligations. They are also advised to alert donors to the IRS rules for substantiating such claims and encourage them to seek appropriate tax or legal counsel when making significant non-cash contributions.

LEGAL BACKGROUND PRINCIPLE 29

Federal law requires charitable organizations to provide a written disclosure statement to donors who contribute more than \$75 if the organization has provided the donor with goods or services in exchange for the contribution.¹³⁵ The disclosure statement must inform the donor that the amount of the contribution that is deductible for Federal income tax purposes is limited to the excess of the amount of any money (and the value of property other than money) contributed by the donor over the value of the goods or services provided to the donor

135 IRC §§ 6115, 6714.

LEGAL BACKGROUND PRINCIPLE 29 (CONTINUED)

by the charity, and must provide a good faith estimate of the value of the goods or services received by the donor. The IRS indicates on its website that no disclosure statement is required if “the goods or services given to a donor have insubstantial value.”¹³⁶

A taxpayer who itemizes deductions on his or her annual income tax return is required to have a contemporaneous written acknowledgement from the charitable organization to substantiate deductions for contributions of \$250 or more.¹³⁷ The written acknowledgement must include the amount of cash and a description (but not the value) of any property other than cash contributed; whether the charity provided any goods or services in consideration, in whole or in part, for the contribution; and a description and good faith estimate of the value of any goods or services received by the donor.¹³⁸ Additionally, taxpayers are required to have bank records or a written communication from the organization (indicating its name and the date and amount of the contribution) to substantiate a deduction for a charitable contribution of any amount.¹³⁹

For non-cash contributions, the taxpayer is generally allowed to deduct the fair market value of property donated to a public charity or to a federal, state, or local governmental entity. The amount that taxpayers may deduct varies depending on the type of property contributed, the type of organization to which the property was contributed, and the taxpayer’s income. In the case of tangible personal property (e.g., artwork), the taxpayer is entitled to a fair market value deduction only if the property is given to a public charity that uses the property in its exempt purposes. If the taxpayer is claiming a deduction of more than \$500 for any single item other than publicly-traded stock, the taxpayer must submit Form 8283 (Noncash Charitable Contributions) with his or her tax return. If the deduction claimed for any single item (other than publicly traded stock) exceeds \$5,000, the taxpayer must have the item appraised by a qualified appraiser, then attach to the tax return a copy of the appraisal, a signed declaration of the appraiser, and a signed acknowledgement from the charitable organization that received the donation.¹⁴⁰ If the charity sells contributed property valued at \$5,000 or more within three years of the property’s receipt, the charity must file Form 8282 (Donee Information Return), which reports that sale to the IRS.¹⁴¹ Taxpayers can only claim deductions for clothing and household items donated to charity if the items are in good used condition or better.¹⁴²

136 See IRS Publication 1771; <http://www.irs.gov/pub/irs-pdf/p1771.pdf>.

137 IRC § 170(f)(8)(A); Treas. Reg. § 1.170A-13(f).

138 IRC § 170(f)(8)(B)(i), (ii) and (iii).

139 IRC § 170(f)(17).

140 Form 8283 Instructions.

141 IRC § 170(e)(7).

142 IRC § 170(f)(16).

PRINCIPLE 30

A charitable organization should adopt clear policies, based on its specific exempt purpose, to determine whether accepting a gift would compromise its ethics, financial circumstances, program focus, or other interests.

Some charitable contributions have the potential to create significant problems for an organization or a donor. Knowingly or not, contributors may ask a charity to disburse funds for illegal or unethical purposes, and other gifts may subject the organization to liability under environmental protection laws or other rules. Donors may also face adverse tax consequences if a charity is unable to use a gift of property in fulfilling its mission and must instead sell or otherwise dispose of the property soon after its receipt.

The policy should address how the organization will address relationships and sponsorship offers from businesses and other organizations to ensure that all communications with customers and prospective donors are clear and accurate, and that the terms of any payment to the charitable organization and any related tax consequences (such as payment of unrelated business income tax for advertising provided to the business sponsor) are clearly understood by both parties. The policy should discuss how contributions will be disclosed to the public and should stipulate that the organization will retain complete

control over use of its name and logo and of all content related to a sponsored event or program activity. The board and staff leaders should also consider how affiliation with a particular business or product might affect the organization's reputation with donors and the public.

A gift-acceptance policy provides some protection for the board and staff, as well as for potential donors, by outlining the rules and procedures by which an organization will evaluate whether it can accept a contribution even before an offer is actually made. The policy should make clear that the organization generally will not accept any non-cash gifts that are counter to or outside the scope of its mission and purpose, unless the item is intended for resale or would otherwise produce needed revenue. It should list any funding sources, types of contributions, or conditions that would prevent the organization from accepting a gift. Charities should also consider establishing rules and procedures for determining whether a gift is acceptable and should identify circumstances under which a review by legal counsel or other experts would be required before accepting a gift.

LEGAL BACKGROUND PRINCIPLE 30

Federal law designates certain transactions as prohibited tax-shelter transactions and imposes excise taxes and disclosure rules on certain tax-exempt entities that are party to such transactions, regardless of whether the transaction was initiated by a charitable contribution.¹⁴³ Guidance provided by the Internal Revenue Service outlines the circumstances in which excise taxes may be imposed pursuant to Internal Revenue Code Section 4965 on charity managers and organizations on income derived from a prohibited tax shelter transaction.¹⁴⁴

143 The Tax Increase Prevention and Reconciliation Act of 2005 P.L. 109-222; IRC § 4965.

144 See IRS Notice 2007-18. The IRS has indicated that it will issue further guidance on charitable abusive tax-shelters in late 2007.

PRINCIPLE 31

A charitable organization should provide appropriate training and supervision of the people soliciting funds on its behalf to ensure that they understand their responsibilities and applicable federal, state, and local laws, and do not employ techniques that are coercive, intimidating, or intended to harass potential donors.

Staff, volunteers, donors, and other stakeholders can be valuable allies in raising funds to support the charitable organization's work, but without proper training and oversight support, they can also mislead or misdirect donors and put the organization's reputation at risk. A charitable organization should provide careful training and supervision of all those who solicit donations on its behalf to make sure they understand their legal and ethical obligations, as well as procedures to follow in representing the organization and working with donors. Training courses and materials are often available through local nonprofit education programs and associations of professional fundraisers. It is particularly important that fundraisers are respectful of a donor's concerns and do not use coercive or abusive language or strategies to secure contributions, misuse personal information about potential donors, pursue personal relationships that are subject to misinterpretation by potential donors, or mislead potential donors in other ways. All those who solicit contributions on the organization's behalf, including volunteers, should be provided with clear materials and instructions on what information to provide to prospective donors, including the organization's name and address, how the donor can learn more about the organization, the purposes for which donations will be used, whether all or part of the donation may be tax-deductible, and who the donor can contact for further information.

If a charitable organization decides to use an outside professional fundraising firm or consultant, it should have a clear contract — as required by law and guided by good practice — that outlines the responsibilities of the organization receiving the funds and of the firm or consultant. The contract should stipulate that donor lists will be treated as the proprietary information of the organization and should specify how information about donors will be handled and protected, and how

funds will be transmitted to the organization. The fundraiser must agree to abide by any registration and reporting requirements of the jurisdictions in which fundraising will be conducted, as well as federal restrictions on telephone, email, or fax solicitations. The charitable organization should verify that the outside solicitor is registered as required in any state in which the solicitor will be seeking contributions.

Many charitable organizations contract with third-party fundraising platforms to accept and process donations online or through mobile technologies. Just as with any outside fundraiser, the charitable organization should have a written contract with such entities that details any fees that will be charged to the donor or the charitable organization, how the site will protect donors' information, how contributions will be transmitted to the charitable organization, and whether the site has a privacy policy and process for preventing solicitation fraud.

Because some individuals may launch online and peer-to-peer ("crowdsourcing") fundraising campaigns without the beneficiary organization's knowledge, many charitable organizations have established written policies regarding who is permitted to raise funds on their behalf and the process for requesting and receiving authorization to do so from the charity. Charitable organizations that regularly solicit funds from the general public should routinely conduct website searches to identify whether and how their names are being used. If a charitable organization finds that others are soliciting contributions on its behalf, it should contact the soliciting individual or organization to determine whether the donors' information and contributions are being appropriately transferred to the charitable organization. If the charitable organization does not choose to be listed

on a site or included in a campaign for any reason, it should send a written request that its name be removed and notify relevant charitable solicitation regulators of any problems.

questions arise, fundraisers should encourage donors to consult their own legal counsel or other professional advisors before finalizing a contribution.

In general, those soliciting funds on behalf of charities should refrain from giving specific legal, financial, and tax advice to individual donors. Rather, when such

LEGAL BACKGROUND PRINCIPLE 31

Most states require charitable organizations and professional fundraisers that solicit contributions in their jurisdiction to register and provide reports on their activities.¹⁴⁵ Many states require a charitable organization that has paid solicitors or professional consultants working on its behalf to have a written contract with those fundraisers that delineates the specific purpose, time, and fees to be paid under the contract; the obligations of both the organization and the paid solicitor or consultant; whether the solicitor or consultant will have custody or control of contributions at any time and how such contributions will be transmitted to the organization; and how information about donors and potential donors will be treated by the solicitor during and following completion of the contract. Some states impose fines on charitable organizations that engage professional fundraisers to solicit contributions on their behalf if those fundraisers fail to register or provide reports as required.

Federal law requires for-profit firms soliciting for charitable nonprofits via telephone to follow specific rules that include (1) disclosing the purpose of the call and the name of the organization for which the call is made promptly and “in a clear and conspicuous manner,” and (2) honoring requests by the recipient of the call not to call again.¹⁴⁶ The law also prohibits professional solicitors from misrepresenting, directly or by implication, the nature or purpose of the charitable organization, the purpose for which the contribution will be used, the percentage of the contribution that will go to that purpose, and the organization’s or the solicitor’s affiliation with or sponsorship by a specific organization, business, individual, or government entity.

145 See Principle 27.

146 The U.S.A. Patriot Act, P.L. 107-56, 15 U.C.S. §§ 1600 *et seq.*, brought charitable solicitations by for-profit telemarketers within the scope of the Telemarketing Sales Rule, (2003) 16 C.F.R. §§ 310 *et seq.*

PRINCIPLE 32

A charitable organization should not compensate internal or external fundraisers based on a commission or a percentage of the amount raised.

Compensation for fundraising activities should reflect the skill, effort, and time expended by the individual or firm on behalf of the charitable organization. Many professional associations of fundraisers prohibit their members from accepting payment for fundraising activities based on a percentage of the amount of charitable income raised or expected to be raised. Basing compensation on a percentage of the money raised can encourage fundraisers to put their own interests ahead of those of the organization or the donor and may lead to inappropriate techniques that jeopardize the organization's values and reputation and the donor's trust in the organization. Percentage-based compensation may also lead to payments that could be regarded by legal authorities or perceived by the public as "excessive compensation" compared to the actual work conducted. Percentage-based compensation may also be skewed by unexpected or unsolicited gifts received by the charitable organization through no effort of the fundraiser.

A similar logic applies to employees. Some charitable organizations choose to provide bonuses to employees for exceptional work in fundraising, administrative, or program activities. If so, the criteria for such bonuses should be clearly based on the quality of the work performed, rather than on a percentage of the funds raised.

Some online and mobile fundraising platforms and credit card providers charge charitable organizations transaction fees for processing donations that is often based on a percentage of the donation or transaction, but these fees should not be viewed or treated as fundraising compensation. Charitable organizations should ensure that the fees are reasonable and comparable to those charged similar organizations and businesses, whether they are applied to contributions or payments for services.

LEGAL BACKGROUND PRINCIPLE 32

While there are no specific federal or state laws prohibiting percentage-based compensation, federal law does prohibit charitable organizations from providing excessive compensation or economic benefit to executives and other individuals who have substantial influence over the organization's affairs, and to family members of such individuals.¹⁴⁷ Further, the private benefit limitation doctrine prohibits a public charity from providing a substantial economic benefit to individuals who do not exercise any substantial control over the org (i.e. non-insiders).¹⁴⁸ For a more complete discussion of excess compensation rules, see principle #13.

147 IRC § 4941; § 4958(f).

148 See e.g. *United Cancer Council Inc. v. Commissioner of Internal Revenue*, 165 F.3d 1173 (7th Cir. 1999).

PRINCIPLE 33

A charitable organization should respect the privacy of individual donors and, except where disclosure is required by law, should not sell or otherwise make available the names and contact information of its donors without providing them an opportunity at least once a year to opt out of the use of their names.

Preserving the trust and support of donors requires that donor information be handled with respect and confidentiality to the maximum extent permitted by law. Charitable organizations should disclose to donors whether and how their names may be used, and provide all donors, at the time a contribution is made and in any future solicitations, an easy way to indicate that they do not wish their names or contact information to be shared outside the organization.¹⁴⁹ In all solicitation and other promotional materials, organizations should also provide a means, such as a check-off box or other “opt-out” procedure, for donors and others who receive such materials to request that their names be deleted from similar mailings, faxes or electronic communications in the future. The organization should immediately remove a donor’s name from any lists upon request and should ensure that at least once a year all donors are provided information about how they may request that their names and contact information not be shared outside the organization.

Organizations that gather personal information from donors and other visitors to their websites should have a privacy policy, easily accessible from those websites, that informs visitors to the site what information, if any, is being collected about them, how the information will be used, how to inform the organization if the visitor does not wish personal information shared, and what security measures the charity has in place to protect personal information.

In addition, the board of directors should adopt and enforce a policy stipulating that all information about donors is to be treated as the proprietary information of the organization, and not of internal or external fundraisers. The policy should further stipulate that such information cannot be sold, shared, or otherwise transferred to another organization without clear written permission of both the donor and the organization.

¹⁴⁹ IS position on donor disclosure to 501c4 organizations and related issues can be found at http://www.independentsector.org/is_positions

LEGAL BACKGROUND PRINCIPLE 33

A charitable organization is required to report on its annual IRS information return (Forms 990) the names and addresses of those who contributed the greater of \$5,000 or 2% of the total contributions received by the organization in the tax year covered by the return.¹⁵⁰ Federal tax laws specifically provides that tax-exempt organizations, other than private foundations or political organizations described in section 527 of the Internal Revenue Code, are not required to disclose the name and address of contributors to the public.¹⁵¹ However, to the extent that donor information is included in a public charity's application for tax exemption, or correspondence with the IRS during the application process, such information may be subject to public disclosure.

Some charitable organizations affiliated with governmental entities, such as supporting organizations affiliated with a public higher education institution, may be subject to state Open Public Records or Freedom of Information laws that require disclosure of records that include donor information. As a result of court decisions upholding such requirements, the state of Iowa recently passed legislation allowing state-affiliated university foundations to preserve the confidentiality of donors' personal financial information. The Iowa law also permits the state university foundation to uphold a donor's request to remain anonymous. Eight other states¹⁵² have enacted laws protecting donor information from disclosure.

150 Form 990, Schedule B.

151 IRC § 6104(d)(3)(A).

152 Arizona, Colorado, Georgia, Florida, Louisiana, Minnesota, Nevada and New Jersey.

GLOSSARY

501(c)(3).

See Section 501(c)(3)

Annual Information Return.

See Form 990, Form 990-EZ, Form 990-N, and Form 990-PF.

Appraisal.

An assessment of the fair market value of any type of property (clothing, household goods, art, land) by an authorized person.

Audit.

See Financial Audit.

CEO or Chief Executive Officer.

The highest ranking staff member or volunteer of the organization. Some organizations refer to this position as the executive director or the president. This report also uses “chief staff officer” to refer to the highest ranking paid employee.

Charitable Organization.

Any tax-exempt organization recognized under Section 501(c)(3) of the Internal Revenue Code. In this report, charitable organization refers to both public charities and private foundations.

Community Foundation.

A charitable organization that generally holds a number of permanent funds created by many separate donors, including donor-advised funds, all dedicated to the long-term charitable benefit of a specific community or region. A

community foundation is generally recognized as a public charity, and is therefore not subject to the more stringent rules that apply to private foundations. Typically, a community foundation provides grants and other services to assist other charitable organizations in meeting local needs, and also offers services to help donors establish endowed funds for specific charitable purposes.

Compensation.

All forms of cash and non-cash payment provided in exchange for services. In reporting compensation paid to a board member or employee, organizations are expected to include salary or wages, bonuses, severance payments, and deferred payments; retirement benefits, such as pensions or annuities; fringe benefits; and other financial arrangements or transactions treated as compensation (for example: personal vehicle, meals, housing, personal and family educational benefits, low-interest loans, payment of personal or spousal travel, entertainment, or other expenses, and personal use of the organization’s property).

Compensation Committee.

A committee authorized by the governing board to review and make recommendations or decisions regarding the compensation of the chief executive officer and often for other persons in a position to exercise substantial control of the organization’s resources.

Conflict of Interest Policy.

A conflict of interest arises when a board member or staff person’s duty of loyalty to the charitable organization overlaps with a competing personal interest he or she may have in a proposed transaction. Some such transactions may violate legal requirements; some are unethical; and others may be undertaken in the best interest of the charitable organization as long as certain clear procedures are followed. A conflict of interest policy helps protect the organization by defining conflict of interest, identifying the classes of individuals within the organization covered by the policy, facilitating disclosure of information that may help identify conflicts of interest, and specifying procedures to be followed in managing conflicts of interest.

Corporate Foundation.

A private foundation that receives its primary funding from a profitmaking business. The foundation is a separate, legal charitable organization even though it often maintains close ties with the founding company, and it must abide by the same rules and regulations as other private foundations. Also known as a company-sponsored foundation.

Disqualified Person.

For public charities, a disqualified person is someone who, at any time during the five-year period ending on the date of the transaction in question, was “in a position to exercise substantial influence

over the affairs of the organization.” Certain members of a disqualified person’s family fall into this category, as does any entity in which one or more disqualified persons together own, directly or indirectly, more than a 35 percent interest. Disqualified persons of public charities recognized as “supporting organizations” also include substantial contributors and their family members. Disqualified persons of donor-advised funds held by public charities include donors, investment advisors, and their family members. For private foundations, the definition of a disqualified person includes all of the above as well as substantial donors, owners of more than 20 percent of a corporation, trust, or partnership that is a substantial contributor to the foundation, and certain family members of any of these persons. Certain government officials are also considered disqualified persons of private foundations. See also Substantial contributor.

Donor-Advised Fund.

Section 4966(d)(2) of the federal tax code defines a donor-advised fund as a fund or account that is owned and controlled by a sponsoring charitable organization, is separately identified by reference to contributions of a donor or donors, and to which the donor (or an advisor designated by the donor) has or reasonably expects to have advisory privileges regarding the distribution or investment of the assets in the fund. The tax code specifically

excludes a fund or account that makes distributions only to a single identified organization or governmental entity or that makes grants for travel, study, or similar purposes provided that certain conditions are met.

The Pension Protection Act of 2006

(P.L. 109-280) enacted new restrictions on the administration of donor-advised funds.

Due Diligence.

The degree of prudence that a reasonable person is expected to exercise in reviewing a particular transaction or investment opportunity before deciding to act. See also Fiduciary Duty.

Excess Benefit Transaction.

An economic benefit provided by a public charity to a disqualified person that is determined to be in excess of the value of the services or property received in exchange by the public charity. See also Disqualified Person, Intermediate Sanctions.

Excise Tax. A tax that applies to a specific type of income, activity, good, or service. For example, private foundations are subject to an excise tax on net investment income. An excise tax may also be imposed on charitable organizations and their managers, and other disqualified persons that engage in certain prohibited activities or approve of prohibited transactions, such as excess benefit transactions.

Fair Market Value.

The IRS defines fair market value as “the price that would be agreed on between a willing buyer and a willing seller, with neither being required to act, and both having reasonable knowledge of the relevant facts.” If there is a restriction on the use of the property (such as a conservation easement), “the fair market value price must reflect that restriction.” (IRS publication 561, Determining the Value of Donated Property.)

Fiduciary Duty.

The legal responsibility for investing money or acting wisely on behalf of another. Members of the governing board of a charitable organization have a fiduciary duty to act in the best interests of the organization.

Financial Accounting Standards Board (FASB).

A professional standards board created by accountants to establish standards of financial accounting—known as Generally Accepted Accounting Principles or GAAP—and reporting in the private sector, including charitable organizations. FASB is officially recognized as authoritative by the Securities and Exchange Commission and the American Institute of Certified Public Accountants. FASB operates under the auspices of the Financial Accounting Foundation, a public charity, and its work is primarily funded by mandatory fees paid by issuers of securities.

Financial Audit.

A formal examination of an organization’s financial records and practices by an independent, certified public accountant with the objective of assessing the accuracy and reliability of the organization’s financial statements. An audit must follow standards set forth by the American Institute of Certified Public Accountants to be accepted universally.

Financial Review.

An examination of an organization’s financial records and practices by an independent accountant with the objective of assessing whether the financial statements are plausible. A financial review does not involve the extensive testing and external validation procedures of an audit and generally provides less credibility than an audit. A review offers a lower-cost method of providing some assurance to board members and other managers of an organization that the financial systems and statements are in reasonable order.

Form 990 Series.

Used in this report to refer to the four forms (Form 990, Form 990-EZ, Form 990-N, and Form 990-PF) filed annually with the Internal Revenue Service by charitable organizations. By law, a charitable organization must make its forms (with required schedules attached) publicly available.

Form 990.

The IRS form that tax-exempt organizations (other than private foundations) that have annual revenues of \$200,000 or more or total assets of \$500,000 or more must file annually to report on their financial and program operations. Religious congregations and specific related institutions, specified government agencies, and other organizations identified by the IRS are exempt from this filing requirement.

Form 990-EZ.

The IRS form that tax-exempt organizations (other than private foundations) that have annual revenues of more than \$50,000 but less than \$200,000 and total assets below \$500,000 must file annually to report on their financial and program operations. Religious congregations and specific related institutions, specified government agencies, and other organizations identified by the IRS are exempt from this filing requirement.

Form 990-N.

Public charities with annual revenues of up to \$50,000 are required to electronically file Form 990-N, an annual notice that indicates its legal name; mailing address; web site address; taxpayer identification number; name and address of a principal officer; evidence of the continuing basis for the organization’s exemption from filing Form 990; and, upon termination, notice of that termination. There are no monetary penalties for failure to file the notice,

but failure to file the annual notice for three consecutive years will result in revocation of tax-exempt status.

Form 990-PF.

The IRS form that all private foundations are required to file annually to report on their financial and program operations.

Form 1023

Application for Recognition of Exemption Under Section 501(c)(3). The IRS form filed by organizations to obtain recognition of exemption from federal income tax under section 501(c)(3) of the Internal Revenue Code. Its filing is mandatory for all charitable organizations that want to be tax-exempt, except for religious congregations, certain organizations affiliated with religious congregations, and charitable organizations that have gross receipts in each taxable year of normally not more than \$5,000.

Form 8282.

The IRS form that charitable organizations must file if they sell or dispose of donated property valued at \$5,000 or more (based on the value claimed by the donor on Form 8283) within two years of receiving the donation.

Form 8283.

The IRS form that taxpayers must file with their annual tax return if they claim deductions for non-cash contributions with a total value of \$500 or more. If the value of any single donated item or collection of items exceeds \$5,000, the

taxpayer must have the Form signed by the appraiser who certified the value of the property and the charitable organization that received the donation.

Generally Accepted Accounting Principles (GAAP).

The accounting principles set forth by the Financial Accounting Standards Board (FASB) and the American Institute of Certified Public Accountants (AICPA) that guide the work of accountants in reporting financial information and preparing audited financial statements for organizations.

Intermediate Sanctions.

The name given to Section 4958 of the Internal Revenue Code that allows the IRS to impose penalties on the persons (individuals or entities) who benefit from or approve an excess benefit transaction, rather than penalizing the organization. Prior to the passage of this law in 1996, the IRS's only penalty for such transactions was to revoke the tax-exempt status of the organization, thus these "intermediate sanctions" offer penalties that stop short of this severe sanction on the organization. Intermediate sanctions rules apply to all 501(c)(3) organizations (except private foundations) and to organizations exempt from taxes under section 501(c)(4) of the Internal Revenue Code. See also Excess Benefit Transactions; Rebuttable Presumption.

Lead Director.

A board member appointed by the board to serve as chair during a particular board discussion or meeting to handle issues in which the chairperson has a conflict of interest.

Non-Operating Foundation.

A private foundation that furthers its charitable purposes primarily by making grants to support charitable programs conducted by other organizations. See also Operating Foundation.

Office of Management and Budget (OMB) Circular A-133.

The instructions provided by the Office of Management and Budget (OMB) regarding audits of states, local governments, and nonprofit organizations that receive federal funding. Under OMB Circular A-133, nonprofit organizations that receive \$750,000 or more in federal funds grants per year must have their financial statements audited.

Operating Foundation.

A private foundation that uses the bulk of its income, usually earned from assets contributed by a single individual, family, or company, to provide charitable services or to run charitable programs of its own, as opposed to making grants to other organizations. See also Non-Operating Foundation, Private Foundation, Public Charity.

Premium Travel. According to federal regulations, premium travel is any class

of accommodation above coach or economy class, such as first or business class.

Private Foundation.

A charitable organization under IRS Section 501(c)(3), typically established by a single individual, family, or company, that receives most of its support from its founders or from investment income earned by an endowment. Private foundations are subject to substantially more restrictive rules than public charities governing their operations, and their donors receive less favorable tax treatment for contributions. If a public charity fails to meet its "public support test" of receiving at least one-third (or in some cases 10% public support if certain facts and circumstances are present) of its income from the public in the form of contributions and grants, it is generally reclassified as a private foundation. See also Public Charity.

Public Charity.

A charitable organization, recognized under IRS Section 501(c)(3), that generally receives at least one-third (or in some cases 10% public support if certain facts and circumstances are present) of its support from a broad segment of the general public or from a governmental unit. Federal tax laws define four types of public charities: (1) public institutions, such as churches and religious congregations, schools and other educational institutions,

hospitals and medical research institutions, and governmental units; (2) publicly-supported charities that receive at least one-third of their financial support from qualifying contributions and grants or from providing program services to a broad constituency; (3) supporting organizations that are organized and operated exclusively for the benefit of or to carry out the functions of one or more publicly supported charities; and (4) public safety testing organizations. There are specific federal rules for the operation of certain public charities established as medical research organizations, charities that operate as credit counseling organizations, and certain supporting organizations, as well as for donor advised funds held by a public charity.

Rebuttable Presumption.

A rule under intermediate sanctions law that delineates procedures a public charity or Section 501 (c)(4) organization must follow in order for the IRS to presume that the compensation provided to a disqualified person(s) in return for services or property is reasonable. The IRS may “rebut” this presumption by presenting evidence showing the compensation was excessive. The rules call for compensation to be approved in advance by the board (or other authorized committee) and further specifies that the members must not have a conflict of interest with respect to the

transaction. The board must use information such as salary surveys, appraisals, or other appropriate data to help determine comparability or fair market value of the compensation, and it must also document the basis for its decision.

Revised Model Nonprofit Corporation Act.

The Revised Model Nonprofit Corporation Act was adopted in 1987 by the American Bar Association to encourage all states to modernize and harmonize their laws governing nonprofit corporations. The model act lays out requirements for the formation and dissolution of a nonprofit corporation, as well as for multiple aspects of corporate governance, including the duties of board members. States may adapt or use the model act when drafting their own laws. It has been adopted in whole or modified form by 23 states and the District of Columbia. The original Model Nonprofit Corporation Act (issued in 1952) has been adopted in whole or in modified form by six other states.

Sarbanes-Oxley Act of 2002.

Signed into law in July 2002 in response to corporate scandals, the Sarbanes-Oxley Act imposes obligations and penalties on corporate officers and directors of publicly traded companies and mandates increased disclosure by corporations to the Securities and Exchange Commission.

Section 501(c)(3).

The section of the Internal Revenue Code that defines tax-exempt organizations eligible to receive tax-deductible contributions. To qualify, an organization must be operated exclusively for charitable, religious, educational, scientific, or literary purpose, to name a few examples. 501(c)(3) charities are further defined as public charities or private foundations. See also Private Foundation; Public Charity.

Section 509(a).

The section of the Internal Revenue Code that defines the rules for determining that an organization is a public charity (as opposed to a private foundation) and thereby eligible to receive tax-deductible contributions on more favorable terms.

Self-Dealing.

Any financial transaction between a private foundation and its disqualified persons, other than reasonable compensation for services. Such self-dealing transactions, even those that provide a below-market rate benefit to a disqualified person, are generally prohibited under Section 4941 of the Internal Revenue Code. See also Disqualified Persons, Excess Benefit Transaction.

Sponsoring Organization.

A sponsoring organization is a public charity that maintains, owns, and controls one or more donor-advised funds. See also Donor-advised fund; Public Charity.

Substantial Contributor.

A substantial contributor is generally defined as any person who contributed or bequeathed the greater of \$5,000 or 2 percent of the total contributions received by a charitable organization in a given tax year. A substantial contributor also includes the original donor or creator of a private foundation, donor-advised fund, or supporting organization. A substantial contributor to a private foundation, donor-advised fund, or supporting organization is deemed a disqualified person. See also Disqualified Person.

Supporting Organization.

A public charity that is organized and operated to support other specified public charities, and is therefore not required to demonstrate that it receives at least one-third of its support from a number of unrelated donors (as do most other public charities). There are three categories of supporting organizations, Type I, Type II, and Type III. Each of these organizations must meet a specific legal test designed to ensure that the organization(s) being supported has some influence over the actions of the supporting organization.

Tax-Exempt Organizations.

Organizations that meet an approved tax-exempt purpose and thus do not have to pay federal and/or state income taxes, except with respect to income earned by a trade or business that is unrelated to the purpose for which the organization was granted

tax-exemption. The Internal Revenue Code defines more than 25 categories of organizations that are exempt from federal income taxes, including charities, business associations, labor unions, fraternal organizations, and many others. Whereas other types of nonprofit organizations benefit the private, social, or economic interests of their members, charitable organizations must benefit the broad public interest and Congress has therefore provided, with very limited exceptions, that only those charities organized under section 501(c)(3) are eligible to receive tax-deductible contributions. See also Charitable Organization, Private Foundation, Public Charity.

Uniform Prudent Management of Institutional Funds Act (UPMIFA).

Model legislation approved in July 2006 by the National Conference of Commissioners on Uniform State Laws (NCCUSL) to govern the management and expenditure of investment assets held by charitable organizations. UPMIFA has been adopted by 49 states and the District of Columbia.

Uniform Prudent Investor Act (UPIA). Model legislation approved in 1994 by the National Conference of Commissioners on Uniform State Laws to govern the investment practices of fiduciaries. UPIA is based on the General Standard of Prudent Investment set forth in the 1992 [Third] Restatement of Trusts; it reflects modern portfolio

theory which has become universally accepted. The Uniform Trust Code promulgated by NCCUSL in 2000, and amended several times since, incorporates UPIA wholesale as the standard applicable to the investment of trust assets. UPIA has been adopted in more than 40 states and the District of Columbia.

Volunteer Protection Act of 1997, P.L. 105-19.

Federal law that limits liability of uncompensated volunteers, including board members, for injuries caused by negligent conduct of the volunteer while acting within the scope of authority provided to him/her as a volunteer of a governmental agency or a charitable organization. The Act does not provide protection from claims of gross negligence, willful or criminal misconduct, reckless misconduct, or conscious, flagrant indifference to the rights or safety of the individual harmed by the volunteer.

Whistleblower Protection Policy.

A policy to encourage staff and volunteers to come forward with credible information on illegal practices or violations of adopted policies of the organization. The policy specifies that the organization will protect the individual from retaliation. It also identifies those staff or board members or outside parties to whom such information can be reported. Such policies may be known by another name, such as a policy on reporting malfeasance or misconduct.

2015 INDEPENDENT SECTOR PRINCIPLES UPDATE STAFF

President and CEO

Diana Aviv

Project Director

Amanda Broun

Project Staff

Kendall Joyner

Marie LeBlanc

Communications Staff

Candy Hill

Ian Pullens

Blake Warenik

Project Consultant

Patricia Read, Pat Read Consulting

PANEL ON THE NONPROFIT SECTOR STAFF (2004-2007)

Executive Director

Diana Aviv

Project Director

Patricia Read

Assistant Project Director

Jennifer Chandler Hauge

Communications Staff

Patricia Nash Christel and Bill Wright

Additional support provided by Jennifer Frias and Gudrun Hofmeister

Development Staff

Sherry Rockey, Deborah Briggs

Administrative Support

Gina Catedrilla, Staci Morgan

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FOR FURTHER INFORMATION

Principles for Good Governance and Ethical Practice: A Guide for Charities and Foundations is also available in an abridged version without the legal background included in this reference edition. The Guide is available for purchase in digital form or hard copy at www.independentsector.org/principles.

Independent Sector, which provided leadership in convening and supporting the Panel on the Nonprofit Sector and continues to support the sector in its pursuit of the highest standards of ethical practice, offers resources through its programs and the **Online Principles Resource Center** (www.independentsector.org/principles) to facilitate putting these principles into practice.



**INDEPENDENT
SECTOR**

1602 L STREET NW, SUITE 900
WASHINGTON, DC 20036

INDEPENDENTSECTOR.ORG

PRINCIPLESFORGOOD.COM