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How to Start and Run a Nonprofit Corporation

The OREGON NONPROFIT CORPORATION *handbook*

The Only Complete How-To Guide for Oregon

Legal, Accounting, & Management Resources

Includes Forms & Samples

Cynthia Cumfer & Kay Sohl

FOURTH EDITION

the OREGON NONPROFIT CORPORATION HANDBOOK

Fourth edition

Cynthia Cumfer and Kay Sohl

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To order a copy of *The Oregon Nonprofit Corporation Handbook*, visit *www.tacs.org* or *orders@tacs.org* to place your order online, or call TACS at 503.239.4001 to place your order over the telephone. Visit our website or call TACS for pricing and shipping information. If you are ordering bulk quantities, special discounts may apply.

A *Practical Guide for Boards of Directors & Officers of Oregon Nonprofit Corporations* (Chapter 13 of the Handbook) is also available. Please call TACS at the number above for more information and for prices.

TO MY FATHER, DONALD A. CUMFER, WITH LOVE

Thanks, Dad, for your sense of ethics, your faith in me, your kind heart, your good business and common sense, and your hard-headed stubbornness that sees a difficult project through from beginning to end.

CINDY

TO MY MOTHER, CAROL GEORGE SOHL

Thank you for surrounding me with nonprofit organizations, and for sharing your joys and frustrations as a nonprofit executive, a tireless board member, and lifetime civic activist.

KAY

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Most importantly, we want to thank the people who start and run nonprofit organizations. Over the past 28 years we have been privileged to meet many very dedicated and able people who often make great sacrifices of time and money for a project that enhances the public good. We all owe them a debt of gratitude.

How to Use this Book

This is a large book. It is unlikely that any group will need ALL the information in this book, so don't be daunted by the size. We have written this book for both beginners and for technical people. If you are new to the nonprofit arena and are using this book to get started, you will find that in many places we tell you sections and chapters you can skip. The parts that you do read are not meant to be read all at once – for instance, it's unlikely that you will need to know how to incorporate and how to dissolve in the same month. (At least we hope not!) Keep this book as your reference book over time.

This book has an improved **INDEX** located at the very end of the book. If you are looking for information on a specific topic, you may want to check the index first. We have learned that preparing an index is one of the great challenges of producing a book of this size. If you don't find the topic you are looking for in the index, you may want to check the **EXPANDED TABLE OF CONTENTS** as well.

There are tear-out **FORMS** near the end of the book. In order to make them more usable, the forms do not have page numbers on them. In the book, we refer to the forms by name and the forms are alphabetized by name so that you can find the form you want more easily. The Forms section does not include forms that you can get from the government on-line. Because these forms change from time to time and are now so accessible, we refer you to the websites where you can obtain them. If you don't have access to the web, you can get copies by contacting the appropriate agency. Appendix 2 provides a list of the agencies and their contact information and web addresses.

If you are a technical person – a lawyer, accountant, or similar professional– we have added a new feature to this book. Appendix 1 contains a list of **SOURCE MATERIALS** that we rely on in each chapter. The Sources section includes citations to statutes, administrative regulations and rulings, cases, generally accepted accounting principles and general reference material to assist you. You may also want to peruse the forms and the more detailed information in the Appendices. We've also included some references in Appendix 1 to materials accessible to and of interest to all readers. We alert you to these materials at the end of each chapter as appropriate.

If you want to obtain additional copies of this book or if you want extra reprints of Chapter 13 to use as a Board of Directors manual, see the **ORDER INFORMATION** on the back of the title page.

Technical Assistance for Community Services, the publisher of this book, is a §501(c)(3) nonprofit organization that is a training and consulting resource for nonprofits. TACS maintains a website at *www.tacs.org.* TACS may from time to time include updated information about matters included in this book. You should check the website.

What's New in this Book

The Fourth Edition adds 140 pages to the Third Edition and contains some exciting additions and updating. Among the most important are these:

- An extensive listing of SOURCES for professionals, including statutes, administrative regulations, cases and accounting standards, and some excellent listings for the general reader in Appendix 1

- More coverage of political activities permissible for §501(c)(3) groups in Chapters 8

- A new chapter, Chapter 26, that contains a greatly expanded discussion of federal and state campaign finance reform, election and lobbying rules as these rules apply to all nonprofit corporations

- A completely revised Chapter 6 with detailed instructions on how to fill out the new application for tax exemption under §501(c)(3) revised in October 2004 (IRS Form 1023)

- More indepth discussion of fraud prevention in Chapter 22

- QuickBook tips for nonprofits in Chapter 23

- Accounting and reporting on administrative and fundraising costs in Chapter 23

- More extensive coverage of indirect cost rates in Chapter 20 and Appendix 17

- A discussion of capacity building and sustainability strategies in Chapter 21

- Information on social enterprises and how nonprofits can earn incom while fulfilling their mission in Chapter 21

- Coverage of the new IRS regulations on excess benefit transactions for §501(c)(3) organizations in Chapter 27 with a new sample policy in the Forms section

• A discussion of the new anti-terrorism laws in Chapter 27

• The implications of the Sarbanes-OxleyAct for nonprofits in Chapter 13

• More specific discussion of board duties and policies in Chapter 13 and a new sample Conflicts of Interest policy in the Forms section

• Coverage of new laws on homeowners associations in Appendix 6

• A more indepth discussion of membership nonprofits in Chapter 14

How to Find an Attorney or an Accountant

"What?" you may be saying, "I bought this book so I wouldn't have to see an accountant or an attorney." With this book, you may be able to do much of your accounting and legal work yourself. At the least, it will provide you with a lot of information that should cut down on how much time (and money) you have to spend on a professional.

Still, there are a variety of circumstances when you may need to get help:

1. You may have special problems or issues that this book does not address.

2. You should get an accountant's help to get your books set up properly, so that your financial information can be easily conveyed to the forms that are required for nonprofit and tax exempt groups.

3. You should have a professional review your papers before you submit them to the state or federal government to be sure they are correct.

4. You should run any significant decisions you make by a professional to be sure you are doing everything properly.

There are a number of ways to choose an attorney or accountant. Keep in mind that nonprofit law and accounting are quite specialized areas within their fields and most attorneys and accountants know little or nothing about it. Technical Assistance for Community Services (TACS) operates the Nonprofit Organization Information and Referral Helpline (503.233.9240 or 1.888.206.3076), a free service providing referrals to qualified professionals with experience assisting nonprofits. This is probably your best place to start.

If you already know a professional that you feel is competent and trustworthy, you could ask that person if they do nonprofit work or can recommend someone who does. If you don't know an attorney or accountant you feel is good and the Helpline can't help you, ask around among other nonprofit groups to see who they use and like. You may also call the Oregon State Bar–Lawyer Referral Services or the Oregon Society of CPA's and tell them you are looking for an attorney or accountant who does nonprofit work. As a last re-

sort, you could call an attorney or accountant in the phone book, but your odds of finding someone who knows much about nonprofits are probably less than 1 in 100.

Before you actually call an accountant or an attorney, it is a good idea to make a list of questions. These questions might include:

• Are you familiar with nonprofits? How much of your practice is with nonprofits? Have you worked with our type of nonprofit? How long have you been working with nonprofits?

• Are you comfortable with working with a group that wants to do as much of its own work as possible?

• How much will you charge?

Part I

GETTING STARTED

1 SHOULD YOUR ORGANIZATION BE A NONPROFIT CORPORATION?

Your group has decided to provide a particular service or to make or sell a product. Now you are faced with the question of how to organize yourself to do this in the face of all the bewildering legal, accounting, tax, and licensing requirements. The first decision you must make is what legal structure best suits your needs. If you already know that you want to be a nonprofit corporation, you can skip this chapter. However, you should read this chapter if you are not certain that you want to be nonprofit and want an overview of other possible structures, if you want to be sure you understand the implications of being nonprofit, or if you want to be nonprofit but are not certain that you want to incorporate.

We start this chapter with a discussion about what structures, both nonprofit and profit, are possibilities for carrying on activities. Then we'll get you started on considering the advantages and disadvantages of becoming a nonprofit corporation.

THIS CHAPTER COVERS

- **Types of Nonprofit Organizations**
- **Other Types of Business Organizations**
- **Advantages and Disadvantages of Being a Nonprofit Organization**
- **Which Nonprofit Structure Is Best for You?**

It is essential in deciding on the legal form for your group that you understand what your options are. Following are brief descriptions of some of the more commonly used organizational forms, beginning with those that are used by nonprofit organizations. Since you are reading this book, it is very possible that the form most likely to meet your needs is the Nonprofit Corporation.

TYPES OF NONPROFIT ORGANIZATIONS

Nonprofit Corporation

A Nonprofit Corporation is an artificial entity created by law. It has no owners. In a sense, it's "owned" by the public at large or by its members. If it makes a "profit," that excess of income over expenses cannot be paid to anyone (the way a profit entity could pay it to its owners or shareholders) but must be used for nonprofit purposes. In most cases, when the nonprofit corporation dissolves, the assets that are left over after the debts are paid must be distributed to other nonprofit corporations or to its members. The nonprofit corporation is governed by a Board of Directors, who in larger organizations will usually hire an Executive Director to run the organization, who, in turn, will usually hire other employees.

A nonprofit corporation can be set up for any lawful purpose and has all the powers a profit corporation has, such as owning property, conducting a business, and making charitable contributions.

BE AWARE that setting your corporation up as nonprofit does not mean you are exempt from paying taxes or will qualify to receive grants or tax-deductible contributions. Becoming a nonprofit corporation is the first (and easiest) step in that direction. If you want to be tax-exempt, in most cases you must apply for and qualify for tax-exempt status from the federal, state, regional, and county governments (see Part II). If you do not qualify for tax-exemption, you will pay taxes just like a profit corporation and you will not be eligible for grants or tax-deductible contributions.

Formation

A nonprofit corporation is formed by filing Nonprofit Articles of Incorporation with the Corporation Division.

Liability

The Board of Directors, members, officers, and employees of the nonprofit corporation, as a usual rule, are not personally liable for the debts of the nonprofit corporation. This means that, with some exceptions described in Chapter 13, their personally-owned property cannot be taken by the corporation's creditors.

Control

The Board of Directors has final authority over the nonprofit corporation. If the nonprofit corporation has members, they have the power to elect some or all of the Board.

Continued Existence

The Board of Directors, officers, employees, and members of the nonprofit corporation can die or leave the nonprofit corporation and the nonprofit corporation will continue its existence without interruption.

Registrations, Books and Records

The nonprofit corporation must file an annual report with the state. It must file annual tax returns with the federal and state governments. If the nonprofit corporation receives tax exemption, then it will file different reports with the federal and state governments. Some nonprofits must register with the Attorney General's office. If the nonprofit has employees, it must file federal and state payroll tax reports and Unemployment and Workers' Compensation reports. The nonprofit corporation also has to maintain a variety of other records to meet legal requirements.

Tax Consequences

The nonprofit corporation pays taxes on its corporate income just as does a profit corporation, unless the nonprofit corporation gets tax exemption from the federal and state governments. The nonprofit corporation may have to pay county property and business taxes, unless the nonprofit corporation gets an exemption from the county government.

Trusts

A trust is an entity set up by a Trustor, who supplies money or property to be managed by a Trustee, for the benefit of those described as the beneficiaries in the document creating the trust. The provisions for the management and

distribution of the trust's property are set out in the trust document, and are interpreted and administered by the Trustee.

Many trusts are nonprofit. This structure is commonly used when an individual or family wishes to donate money for a nonprofit purpose and to provide some conditions for how it is to be administered. The procedures for setting up a trust are beyond the scope of this book. If you feel that this is a form you might be interested in, you should consult an attorney.

Formation

The trust is typically formed when a trust document is signed by a Trustor and property is transferred to the trust.

Liability

In many cases, the Trustee is personally liable for her or his negligent acts that cause loss to the trust or to a third party. The trust is liable for judgments involving it.

Control

The Trustor in the document setting up the trust sets out the terms under which the trust operates. The Trustee makes the decisions about how to carry out these terms. The Trustor can keep the power to amend or revoke the trust.

Continued Existence

The Trustor and Trustee can die or lose interest in the trust and the trust will continue its existence unless the Trustor has the power to, and does, revoke the trust.

Registrations, Books and Records

The trust must file annual tax returns with the federal and state government on its income. If the trust receives tax exemption, then it will file different reports with the federal and state government. Charitable trusts must register with the Attorney General. If the trust has employees, it must file federal and state payroll tax reports. If it is nonprofit, it must maintain a variety of other records to meet legal requirements.

Tax Consequences

The nonprofit trust pays taxes on its trust income just as a profit trust, unless the nonprofit trust gets tax exemptions from the federal and state governments. The nonprofit trust may have to pay county property and business taxes, unless it gets an exemption from the county.

Associations

An association is a group of people who come together for some purpose other than to do business (for example, a computer club, a cancer support group, or a labor union). If your organization has already begun a nonprofit project and you are not incorporated, you are an association. If your organization will handle substantial income and output, an association may not be appropriate for you. A group that has the word "Association" in its title is not necessarily an association. It may be a corporation.

Formation

There are no papers that are necessary to file to establish an association. Some groups, especially those planning to seek tax exemption, will write a charter, similar to the Articles of Incorporation used by corporations. However, this charter is not filed with the state.

Liability

The decision-makers for the association are generally personally liable for the debts of the association and the members of the association may also be personally liable. This means that if the assets of the association are not sufficient to pay what the association owes, the association's creditors may be able to seize the personally-owned assets of the members.

Control

The association has a great deal of flexibility as to how it is controlled and managed. Many smaller groups are run by the members through voting. Associations with a written charter may provide for a different method of management. For example, the members might elect managers, or, if the association is a branch of some larger group, the larger group might choose the managers.

Continued Existence

The association has great flexibility in changing members. Unless the association's rules provide differently, members can come and go at will. The death or resignation of one member will not affect the association's existence.

Registrations, Books and Records

The association does not have to register with the state in order to exist. The association must keep whatever books are necessary for tax purposes and may have to file tax returns. If the association has employees, it must file federal and state payroll tax reports, Unemployment and Workers' Compensation reports.

Tax Consequences

The association may be treated like a general partnership or like a corporation for tax purposes. The IRS decides which way to treat it depending upon whether the association functions more like a partnership or more like a corporation. The IRS looks at whether the association's members have limited liability, whether ownership is freely transferable, how much the management is centralized, and whether the association's duration appears indefinite. Associations can receive tax exemption from the federal, state, and county governments.

OTHER TYPES OF BUSINESS ORGANIZATIONS

Cooperative

A cooperative is an artificial entity created by law. It is owned by the people or groups that buy stock in it, called stockholders or shareholders. The stock may or may not be owned by members. The major decisions about the cooperative are made by the Board of Directors, elected by its members. The cooperative may have officers, such as a President, who manage the cooperative.

Major Features

- In almost all cases, the members and stockholders are not liable for the cooperative's debts, except for the money the members agree to put in for membership fees or stock, and except for the money the stockholders agree to put in for the stock.

• The Board of Directors, which is elected by the members, has final authority over the business affairs of the cooperative.

• Stockholders can leave the cooperative at will, as long as they can find someone to buy their stock. Stockholders can join at will if they can find stock to buy. Some cooperatives may choose to limit how freely their stock may be bought or sold, but the law generally puts no restriction on its sale. Members can also leave the cooperative at will. The conditions for becoming a member are defined by the cooperative. The business continues without interruption through stock transfers and membership changes.

• The cooperative pays federal and state income tax on its income. It may also pay property, inventory and other taxes. Shareholders pay personal income tax on the dividends received from the cooperative. These dividends are paid with dollars which have already been taxed as income to the cooperative.

Profit (Business) Corporations

A profit corporation is an artificial entity created by law. It is owned by the people or groups that buy stock in it, called stockholders or shareholders. The major decisions about the profit corporation are made by a Board of Directors, elected by the stockholders. The profit corporation may have other officers, such as a President, who manage the corporation.

Major Features

• In almost all cases, the stockholders of the profit corporation are not liable for the corporation debts, except for the money the stockholder has put in to buy stock. This means that the stockholder's personal assets are safe from the corporation's creditors. The same is true (with a few exceptions) for the Board of Directors.

• The Board of Directors, which is elected by the stockholders, has final authority over the business affairs of the corporation.

• Stockholders can leave the corporation at will, as long as they find someone to buy their stock. Stockholders can also join at will, as long as they can find stock to buy. Some corporations may choose to limit how freely their stock can be bought or sold, but the law generally puts no such restrictions on the sale of stock.

The business continues without interruption when stock is bought and sold.

• The corporation pays income tax on its corporate income. When the corporate net income is distributed to the stockholders in the form of dividends, the stockholders pay income tax on this money. The corporation also pays property and business taxes.

General Partnerships

Two or more people who carry on a business for profit and who do not incorporate are considered to be partners.

Major Features

• Partners may have a written agreement that makes them partners, but this is not necessary. A verbal agreement, or even conduct in acts showing that they are carrying on a business for profit together, can be enough to create a partnership. A general partnership does not have to file anything with the state in order to create a partnership, although the partners may have to file their business name and may have to get licenses and permits in order to operate a business.

• Each partner is personally liable for all the debts of the partnership. This means that if the assets of the partnership are insufficient to pay what the partnership owes, the partnership's creditors can seize the personally-owned assets of the partners. Even if the debt was incurred by one of the other partners, all of the partners are personally liable for all debt validly incurred by the partnership.

• Each partner, regardless of how much of the profits she or he takes, shares equally in the management and business decisions. The only thing that changes this is a written agreement by the partners that provides for different rules.

• Each partner must report her/his share of the net profit or loss figures shown on the partnership informational return on their individual tax returns. The partners must report these amounts and pay taxes on them even though the money was not withdrawn from the business.

Limited Partnerships

A limited partnership is a partnership in which some of the partners take no part in the control or management of the partnership but are entitled to a share of the profits (or losses) because they have invested money in the partnership. Those partners who take no part in the control of the management of the partnership are called limited partners. At least one of the partners must be responsible for control and management of the partnership, and this partner is called a general partner.

Major Features

- In Oregon, the limited partnership must file a certificate of limited partnership with the appropriate state agency before it will be recognized as a limited partnership.

- Each general partner is personally liable for all the debts of the partnership. The limited partners are only liable for the money they put into the partnership. The partnership's creditors can only seize the limited partner's personal assets (l) when her/his name appears in the partnership name; (2) when she or he engages in management activities in the partnership; or (3) to the extent that she or he has withdrawn the initial funds she or he contributed.

- The general partners in the limited partnership have nearly total control in management of the business. If a limited partner tries to intervene or participate in the management of the business, she or he may lose the freedom from personal liability she or he enjoys.

Limited Liability Companies

Limited liability companies are a cross between partnerships and corporations. This structure allows one or more people (called "members") to do business without incorporating but gives them the protection from liability that a corporation offers. In some very restricted circumstances, a limited liability company may function as a nonprofit organization. You will need legal assistance to structure this kind of arrangement.

Major Features

- In almost all cases, the members are not personally liable for the LLC's debts.

- The members run the business affairs of the LLC, or they can hire managers.

- The members can leave at will, as long as they find someone to buy their interests. The business continues without interruption.

- The LLC is usually taxed like a partnership.

Sole Proprietorships

A sole proprietorship is a business completely and directly owned by a single person. It may or may not have employees.

Major Features

- No formalities are required to form a sole proprietorship.

- The owner is personally liable for all of the debts of the sole proprietorship.

- The sole proprietorship is controlled by its owner.

- If the owner dies or decides to withdraw from the business, the business is dissolved. The owner can sell the business to another sole proprietor, partnership, corporation, or other entity.

ADVANTAGES AND DISADVANTAGES OF BEING A NONPROFIT ORGANIZATION

To assist you in making the decision about your group structure, you should first decide whether you want your group to be profit or nonprofit. You can start by making a list of the advantages and disadvantages of choosing the nonprofit structure. What follows is a list of the most common considerations.

Advantages of the Nonprofit Organization

Tax Advantages

Organizing as a nonprofit group may allow you to get exemptions from a variety of federal, state, and local taxes. See Chapters 5 and 11.

Funding

As a nonprofit organization, you are in the best position to attract grants and donations. In order to do this, you will probably be required to go the further step of obtaining a §501(c)(3) tax exemption. Not all groups will qualify to get a §501(c)(3) exemption, so if this is important to your decision, check to see if you will qualify. See Chapter 5 for more details.

Public Profile

People are more likely to be supportive of a group that is nonprofit rather than profit. You will generally find that the nonprofit form is more likely to encourage donations and volunteers.

Postal Benefits

Being a nonprofit organization may make it easier for you to get special postal rates. See page 45.

Disadvantages of the Nonprofit Organization

Financial Drawbacks

The income made by the group must be used for its nonprofit purposes. You can pay reasonable salaries, but cannot use any "extra" for the personal gain of the employees or members of the group. In most cases, when your group dissolves, it will have to turn over any excess funds (after the debts are paid) to another nonprofit group with similar purposes, or to its members. You or other founders and key staff cannot own the "business" nor can you "sell" it for personal gain. There are also start-up and maintenance costs for being nonprofit. You may need legal advice to run a nonprofit. If you decide to apply for tax exemption, the government has fees associated with the filings.

Paperwork

Setting up and maintaining a nonprofit structure requires a certain amount of paperwork. You must prepare organizational documents and keep minutes of your meetings, as well as maintain a variety of other records. Most profit forms that you might choose will also require paperwork. However, funders may require additional accounting records that are more detailed than those that profit businesses must keep.

WHICH NONPROFIT STRUCTURE IS BEST FOR YOU?

If you have decided you do want your group to be nonprofit, you then need to decide if you are going to be a nonprofit corporation, a charitable trust, or a nonprofit association. Individuals with a large sum of money to donate that want to exercise control over the organization often use the charitable trust. Most other groups will choose between the unincorporated association and the nonprofit corporation.

The unincorporated association is often preferred by newer and smaller groups engaged in safe activities that do not want to take on the paperwork and rules that come with being incorporated. In some cases, groups with members that do not fit within or want to comply with the rules for membership corporations (see page 23) may choose to remain unincorporated.

There are significant disadvantages to this form. If the group is sued, its members generally are personally liable for any judgment. This means that you each pay from your own pockets. Also, if your association has a bank account or property, the account or property cannot be held in the association's name. Even if the bank account has the association's name on the statement, an individual is actually the account's owner. This can create difficulties for the group and the individual. If the unincorporated association obtains an exemption from federal income tax (discussed in Chapter 5) and later incorporates, it must reapply for exemption.

The nonprofit corporation is preferred by most groups primarily because of the limited liability it offers. It is also used because the corporate model provides a more stable existence. The corporation can own property. It is also easier to get tax exemption and to attract funding as a corporation.

The nonprofit corporation is preferred by most groups primarily because of the limited liability it offers.

The nonprofit corporation has some disadvantages. There is more paperwork associated with it than with an unincorporated association. The state regulates how you can do things more closely than it does for unincorporated associations.

Consult Appendix 1 if you would like information about source material related to this Chapter.

If your group has decided to become a nonprofit corporation, the remainder of this book is written for you. Your next step is to learn about the structure and types of nonprofit corporations.

2 THE STRUCTURE AND TYPES OF OREGON NONPROFIT CORPORATIONS

If you have decided to become an Oregon nonprofit corporation, you need to become familiar with the general structure and types of nonprofit corporations.

Generally, a nonprofit corporation is governed by its Board of Directors. The Board may, but does not have to, appoint committees to exercise Board functions. In most cases, the corporation is also required to have a President and Secretary, who may be the same individual. The corporation may or may not have members.

This chapter will not try to tell you everything you need to know about your Board, officers, and members. Later chapters will cover each of these components in more detail. This chapter will orient you so that you have an idea about how to start thinking about your structure and how to fill in some structural details.

Oregon law recognizes three types of nonprofit corporations. It's important to understand the variations so that you can make an informed decision as to which kind of nonprofit corporation you will be.

THIS CHAPTER COVERS

- **The Board of Directors**
- **Officers**
- **Membership or Nonmembership Corporations**
- **Types of Oregon Nonprofit Corporations**
- **Nonprofit Corporations Connected with Governmental Agencies**

A NOTE ON TERMINOLOGY:

There are four terms that sound similar and may cause confusion.

Director

Board member

Member

Executive Director

Director *and* **Board member** *mean the same thing – someone who is on the Board of Directors. In this book, we will generally use the term* **Director** *to refer to someone on the Board.*

Member *is a person or entity with voting power in a membership corporation. This is a different role than Board member.*

Executive Director *(sometimes called Director in the working world) is the person hired (usually by the Board) to oversee the operations of the corporation. The Executive Director is not normally a Board member.*

THE BOARD OF DIRECTORS

Powers and Duties

Your Board of Directors must manage the business affairs of your corporation, unless your Articles of Incorporation provide differently. This means that your Board makes all the major decisions about your corporation. Every nonprofit corporation must have a Board of Directors, except for certain types of Religious Corporations.

Your corporation may allow someone or some group other than your Board (or a committee composed entirely of Directors) to make some or all major corporate decisions. These decision-makers may be your members, a Steering Committee (that has some non-Directors on it), or some other designated individuals. This must be set out in your Articles of Incorporation. Putting this provision in the Bylaws without putting it in your Articles is not enough. To the extent that your Articles do this, your Directors are relieved from those responsibilities.

Example: The Ross Neighborhood Association is a nonprofit membership corporation that requires that all land-use issues be decided by its members. This must be in its Articles.

Your corporation may allow someone or some group other than your Board (or a committee composed entirely of Directors) to make some or all major corporate decisions. This must be set out in your Articles of Incorporation.

The most common model in the nonprofit field is the Board-run corporation. Oregon law is built around this assumption which is why exceptions must be written into your Articles. The decision to set up your corporation to be run by someone other than the Board may have some significant consequences. You may have a hard time getting §501(c) status. You will also have difficulty getting funding. You may get questions from the Attorney General's office. You should explore this decision with an attorney.

Qualifications of Directors

All Directors must be individuals – they can't be legal entities like corporations. If you want to establish other qualifications, your Articles or Bylaws should set them out.

Number of Directors

You should plan to have enough Directors on your Board so that your Board can carry out your mission, but not so many people as to make your functioning unwieldy or impossible.

The minimum number of Directors required by law depends on what type of nonprofit corporation you are (the various types are explained on pages 25-28). Public Benefit Corporations must have at least three Directors, and Religious and Mutual Benefit Corporations may have only one. Beyond that, your Articles or Bylaws will fix the number. Your Articles or Bylaws may establish a variable range for the size of the Board by fixing a minimum and maximum number of Directors. If this is done, the number may be fixed or changed periodically within a range you set, by the Board or, in some cases, by the members.

Election, Designation and Appointment of Directors

Your corporation may acquire its Directors by one of three methods:

- election;

- appointment by some other person or entity; or
- designation in the Articles or Bylaws.

If your corporation has elected Directors, these Directors are elected by the members or by the Board of Directors:

Membership Corporations: If your corporation is a membership corporation, you must have members who are entitled to vote for some or all of the Directors. (See page 25). These Directors are elected at the first annual meeting of members. The Directors continue to be elected at each annual meeting after that, unless the Articles or Bylaws provide differently.

Nonmember Corporations: If your corporation does not have members entitled to vote for Directors but does have elected Directors, these Directors are elected by the Board of Directors.

Your corporation has appointed Directors if your Directors are named by someone outside of your corporation. A governmental agency may have the right to appoint some of your Directors. Other nonprofits are coalitions of nonprofit groups in which each constituent group has the right to name a representative to the Board. Some national organizations appoint some or all of the Directors of their local chapters.

Your Articles or Bylaws may designate Board members. Some bylaws provide that the retiring Board chair serves as an *ex officio* voting Director. Nonprofits with a governmental link may provide that the person holding a particular governmental position is a Director of the nonprofit.

Composition of Board

To the extent that your corporation is in a position to choose Directors, you should give some thought to the composition of your Board of Directors. Several key issues should be considered:

- The Board has final legal authority over the corporation. The Board composition should assure that basic organizational goals and philosophies will be maintained.

- Board composition can have a significant impact on funding and community relations. Particularly in new organizations, potential funders may look to the Directors for evidence of stability, credibility, responsibility and expertise in the field.

• Directors may be asked to contribute significant amounts of volunteer time to the organization.

• Directors may be needed to play a major role in fundraising, particularly in the cultivation of individual donors and planning and promotion of special events.

• Directors can provide significant expertise (legal, accounting, finance, program) which the corporation may not be able to afford to purchase. For some professionals, the "honor" (recognition and potential business contacts) of serving on a Board is a fair trade for sharing professional skills.

• Grassroots programs which are committed to serving and involving the entire community, including various ethnic and racial groups, low income individuals, and others traditionally denied access to resources, may need to specifically involve members of these groups on the Board of Directors. This may be done to insure that commitments will be honored, and to provide continuous monitoring of programming efforts in relation to these communities.

Terms of Directors

Your Articles or Bylaws may specify the terms of Directors. You should provide for terms that are long enough to permit your Directors to become familiar with their roles and to operate effectively in them, and with enough turnover to bring in "new blood." Except for those who are designated or appointed Directors, the terms of your Directors may not exceed five years. If your Articles or Bylaws don't spell out a term, the term of each Director will be one year. Directors can be re-elected. Despite the expiration of a Director's term, your Director continues to serve until her or his successor is elected, designated or appointed, or until there is an official decrease in the number of Directors.

Your Articles or Bylaws may provide for staggering the terms of Directors by dividing them into groups. The terms of office of the several groups do not have to be uniform. Staggering is a good idea for many groups because it avoids the situation in which a Board loses all it members at once.

Multiple Roles by Directors

Your Directors can hold any other position in your corporation (employee, officer, etc.) and can be your corporation's registered agent or incorporator. You should exercise caution in having Directors who are paid staff members.

Some funders are reluctant to fund a nonprofit corporation whose staff members are also Directors. The IRS often questions this. Staff members who are also Directors are in the position of having a conflict of interest over issues such as salaries, and the Board must follow special rules in dealing with these conflicts. (See pages 294-296 for a discussion of this issue).

Standard of Conduct for Directors

There is a myth in some parts of the nonprofit world that a person can simply list her or his name as a Director of an Oregon nonprofit corporation without taking on any responsibility. This is false. The law expects your Directors to act in accordance with certain standards of conduct. Your Directors take on both a duty of care and a duty of loyalty to the corporation.

There is a myth in some parts of the nonprofit world that a person can simply list her/his name as a Director of an Oregon nonprofit corporation without taking on any responsibility. This is false.

In order to meet the duty of care, each Director must act with the care an ordinarily prudent person in a like position would exercise under similar circumstances. Each Director should use the same care in running your corporation as she or he would use in running her or his own business. Your Board may delegate its responsibilities to officers or committees as long as the Board oversees what is done. Each Director must keep current with what is going on in the corporation by going to Board meetings and requiring operational information from your President, Executive Director, or similar responsible person; financial information from your Secretary, Treasurer, or bookkeeper; and any other information needed to run your corporation.

The duty of loyalty means that your Board must act in good faith and in the manner each Director reasonably believes to be in the best interests of the corporation. Your Board must be faithful to the mission of your corporation. Your Board must exercise care in conflict of interest situations. A conflict of interest situation could arise when the Board discusses salaries for the staff, if some Directors are also staff members. It could also arise if one of your Directors has an interest in an outside business that is doing business with your nonprofit corporation. See Chapter 13 for more information on conflict of interest situations.

The duty of loyalty means your Directors cannot exploit corporate opportunities or misuse insider information. For example, a Director of a childcare center cannot use her or his Board position to obtain a list of par-

ents with children in the center and solicit the parents to place their children with her or him in home-care.

Under special circumstances a Director can be forced to pay a judgment out of her or his pocket. Chapter 13 contains a more detailed discussion about the duties and liabilities of Directors.

Committees of the Board

Your Bylaws or the Board may create committees to help with its work. These committees fall into one of two types. One type is a committee that actually makes major decisions that the Board would otherwise be required to make. The other type is any committee that assists the Board but does not actually make final Board level decisions.

Committees Exercising Authority of the Board

Your Board of Directors may create one or more committees of the Board, which exercise the authority of the Board. Committees are commonly formed when the whole Board does not have the time to manage all the necessary details. The committees may be ongoing or temporary. Common examples of ongoing committees are an Executive Committee that makes decisions for the Board between Board meetings; a personnel committee that develops final personnel policies, hires and evaluates the Executive Director and other key staff, and may serve as an appeal route for staff grievances; and a finance committee that develops and approves a budget and monitors the financial systems. Temporary committees may be committees such as a committee empowered to choose and purchase a building.

The Board appoints Directors to serve on committees, or designates the method of selecting committee members. Although the law is somewhat unclear on this, it appears that each committee must consist of two or more Directors, who serve "at the pleasure" of the Board. These committees that exercise Board functions can only have Directors as members (unless your Articles allow otherwise).

Committees that Do Not Exercise Authority of the Board

Your Board may also appoint committees that do not exercise Board management functions. An example of this would be a committee to investigate which computer to purchase and to report back to the Board on the information discovered. Another example is any committee that makes recommendations to your Board on major policy issues, as long as your Board retains final decision-making authority. These committees may be ongoing – such as a personnel committee that recommends personnel policies about which the Board makes

the final decision. The committees may also be temporary – such as a committee to handle a special event about which the Board makes the major decisions. There are no legal limitations about who can serve on these committees.

OFFICERS

Your corporation must have a President and a Secretary (unless you are a Religious Corporation Sole described in Appendix 3). Your Articles or Bylaws may designate other titles instead of President and Secretary. Generally, your President is responsible for overseeing the operations of the entire corporation. In many groups the President is also the Chair of the Board. Your Secretary is usually responsible for keeping the corporate records, seeing that minutes are taken at all Board, committee, and members' meetings, and keeping the books and finances. The same individual can simultaneously hold more than one office in the corporation.

Your group can appoint additional officers besides President and Secretary, who may perform other functions or who may share the functions described above. For example, you may have a treasurer who handles finances.

Standard of Conduct for Officers

Each of your officers must act in good faith, with the care an ordinarily careful person in a like position would exercise under similar circumstances and in a manner your officer reasonably believes to be in the best interest of the corporation. Your officer is entitled to rely on reports prepared by competent people.

MEMBERSHIP OR NONMEMBERSHIP CORPORATIONS

Your corporation may have members or it may be a nonmembership corporation. Members are people or other entities (like corporations) who are given the right in your Articles or Bylaws to vote on more than one occasion in a Board of Directors' election and any other matter that requires a membership approval by law (see page 319). Members may be permitted to vote for some purposes and not others – such as to elect Directors but not to amend the Bylaws – depending on what the law and your Articles or Bylaws provide. Be aware that if you have any person or group in your corporation (other than your Board or committee composed of Directors) who can vote on more than one occasion for Directors, these people are probably "members," regardless of what you call them. Your corporation will need to comply with all the membership laws. You should talk to an attorney about this.

While your members must be allowed to vote for at least some of your Directors and may vote for certain other purposes (see page 319), your members cannot make management decisions for your corporation (such as approving the budget, hiring staff, etc.) unless your Articles allow this. This is the Board's job, as discussed on page 17.

You may want some of your members to have different rights with respect to voting, dissolution of the corporation, and redemption and transfer (two ways of conveying your membership shares to someone else). If so, you can set up different classes of members.

Members are people or other entities (like corporations) who are given the right in your Articles or Bylaws to vote on more than one occasion in a Board of Directors' election and any other matter that requires a membership approval by law. The law is not clear about whether a corporation can call its participants "members" if the "members" do not have the right to vote more than once in a Board election.

The law is not clear about whether a corporation can call its participants "members" if the "members" do not have the right to vote more than once in a Board election. You should read the discussion on page 52 if you are considering this.

You may require your members to take on some responsibility to the corporation (such as to pay dues). Membership is often considered when a group hopes to raise funds from its supporters or wants active participation by a large group of people or is set up to provide benefits for a group of people.

Some thought should be given before setting up a membership corporation. If you do have members, the members must consent to be members. This means that you cannot designate members by some criterion (such as, "Members are all those people who live or have a business in the area bounded by 6th and 26th Streets and Main and River Roads") that does not include the consent of the members. A vote by your members may be required for a range of decisions, including election of the Board, amendments or restatements to the Articles, mergers, sale of the corporate assets, and dissolution, unless you limit this. You must have a membership meeting every year (and provide notice of that meeting) and special membership meetings as explained in Chapter 14. If you are a Public Benefit or Mutual Benefit Corporation, you cannot terminate, expel, or suspend your members without following the procedure given in the statute. There are many other technical membership rules. See Chapter 14 to get an idea of how involved having members can get, before you make the decision to be a membership corporation. Membership corporations (especially

those that provide significant benefits to their members) may have difficulty getting some types of tax exemption. You should see a professional for help.

If you wish to avoid the membership requirements, you can organize as a nonmembership corporation. You can always raise funds by publicizing the work of your organization and lists of contributors. You can encourage interest in your group with a newsletter without having the legal complications of a membership. If your intent for a "membership" is primarily fundraising, it may be more useful to call these financial supporters "Friends" or "Supporters" rather than making them legal members.

TYPES OF OREGON NONPROFIT CORPORATIONS

There are three types of nonprofit corporations in Oregon. Prior to incorporation, you must decide which type of nonprofit corporation you are.

A **Public Benefit Corporation** is a corporation that is tax-exempt under Internal Revenue Code §501(c)(3) (see Chapter 5) or is organized for a public or charitable purpose. Upon dissolution it must distribute its assets to an organization organized for public or charitable purposes, a Religious Corporation, the United States, a state, or an entity recognized as tax-exempt under §501(c)(3).

> *Examples*: social service agencies, schools, foundations, theatres, charities, scientific and research groups.

A **Religious Corporation** is one that is organized primarily or exclusively for religious purposes. These corporations may also be tax-exempt under §501(c)(3).

> *Examples*: synagogues, churches, Buddhist meditation groups.

A **Mutual Benefit Corporation** is a nonprofit corporation that does not come within the definition of a Religious or Public Benefit Corporation. These corporations are not tax-exempt under §501(c)(3) but may be tax-exempt under some other section of the law. Generally, they are organized to provide benefits for their members or a small group of people.

> *Examples*: social clubs, business leagues, veterans groups, unions.

Which Type Is Your Nonprofit?

The majority of the readers of this book can figure out from the description above which type of nonprofit corporation describes your organization. You may want to skim this chapter to get some basic information on your type of corporation and to be sure that you are not putting yourself in a category that is not what you want.

Many groups have characteristics of two or even all three types of nonprofit corporation. For example, your group may be organized as a social club for your members and may also engage in charitable projects. In order to decide which type of nonprofit corporation you are, you should clarify your primary purpose and use this to make your choice. Before you select your type, you may want to read the next section and Appendix 3 carefully to be sure that you are making the most appropriate choice for your organization. If you have questions, you should see an attorney.

Major Features of Each Type

Public Benefit Corporations

Public Benefit Corporations have these features:

- The Public Benefit Corporation is the most heavily regulated corporation. Public Benefit Corporations must register with the Attorney General's office. The Attorney General has oversight authority and at times must approve actions by Public Benefit Corporations;

- The other rules governing Public Benefit Corporations are also somewhat more restrictive, because these corporations hold themselves out as serving the public;

- Public Benefit Corporations must have at least three people on the Board of Directors;

- If you want to be tax-exempt under §501(c)(3), you must register as a Public Benefit Corporation (unless you are a Religious Corporation);

- Public Benefit Corporations that are membership corporations can restrict, to some extent, its members' rights to inspect its records;

• When you dissolve, you must give your assets to another public benefit type of nonprofit corporation.

Religious Corporations

Important information about Religious Corporations is as follows:

• Religious Corporations are also subject to some oversight and regulation. However, because of constitutional requirements concerning government regulation of Religious Corporations, they have more freedom than Public Benefit Corporations;

• Religious Corporations can have as few as one person on the Board of Directors, or can be set up without a Board;

• Religious Corporations can qualify for exemption under §501(c)(3);

• A Religious Corporation can restrict its members' rights to inspect its records;

• Oregon law does not restrict who gets this corporation's assets when it dissolves. If it does get a §501(c)(3) exemption, its assets must be given to another §501(c)(3) group.

Mutual Benefit Corporations

General features of Mutual Benefit Corporations include:

• Mutual Benefit Corporations are the least regulated of the Oregon nonprofit corporations;

• Mutual Benefit Corporations can have as few as one person on the Board of Directors;

• Mutual Benefit Corporations are not exempt under §501(c)(3);

• A Mutual Benefit Corporation cannot restrict its members' rights to inspect its records that the law opens for membership inspection;

• You may give your assets on dissolution to whomever you want. Often a Mutual Benefit Corporation gives them to its members or the people it serves.

If you still have questions, Appendix 3 contains more detailed information about these three types of corporations.

NONPROFIT CORPORATIONS CONNECTED WITH GOVERNMENTAL AGENCIES

Not all governmental work is done by the government. The various governmental agencies often seek recommendations and input through governmental commissions, act through quasi-public corporations, or work with private nonprofit corporations to carry out governmental functions.

Commissions and Advisory Bodies. In some cases, the government appoints a commissions or advisory bodies to provide assistance to the government. These commissions often study a problem and offer suggestions to the legislature about how the problem could be handled. An example is the Warren Commission, that investigated President Kennedy's assassination.

Public Corporations. Some groups are established directly by the government as public corporations. The voters may elect a public corporation's governing body or the government may appoint it. Public corporations operate somewhat outside the traditional governmental structure. For example, some water districts are set up like this.

Private nonprofit corporations. Some private nonprofit corporations are closely connected with governmental agencies, often working hand-in-hand with the government to perform what is essentially a governmental function. In some cases, these corporations were set up in response to a specific statute enacted by the legislature or a local government. Examples are economic development corporations were set up to improve various local economies; and local watershed associations that work with the federal and state governments to promote fish habitats and water quality. In other cases, the connection between the nonprofit corporation and the government is a common desire to perform a public service and sometimes a contract that sets out how the private nonprofit will do it. One example is a Friends of the Library group that assists in maintaining and raising funds for public libraries.

If your group is a private nonprofit corporation that is working with the government, you should check to see if there is a special statute that mandates how you should operate. If there is such a statute, it will usually set out some of the terms about your operation. Often, it will include some requirements about

the composition of your Board. If a specific statute does govern you, you must follow the terms of that statute.

To the extent that the law does not place specific requirements on you, you are subject to the same laws as all other nonprofit corporations. You should also review the terms of any contract you have with the government, because that may set some limits on what you can do.

Issues

Close connections between a nonprofit and the government raises some important questions. Because the organization has one foot in the world of government and the other in the world of private corporations, these questions do not have definite answers.

One concern has to do with liability. In many situations, the law places limits on suing governmental entities and employees, and when they are sued the government usually handles the claim. The issue for the nonprofit is whether this preferential treatment will apply to them. This is quite a gray area, and may depend on the facts of each case. However, your nonprofit, if it is contracting with a governmental agency, should consider negotiating with the government to see if the government would agree to handle and pay any claims made against you.

Another gray area has to do with the Public Meeting and Public Record Laws. Most governmental agencies are required to give notice of their meetings, make decisions at the meeting and not outside of the meeting, and follow certain procedures so that the public has access to decision making. The Public Records Law similarly gives the public access to many governmental records. If your group is exercising governmental functions, does this mean you must observe and follow these laws? In some cases, it does. This issue is explored more fully in Appendix 4.

Another area of uncertainty is in employment. Governmental employees are protected by more Constitutional guarantees than are employees in the private sphere. In some cases, the courts have held that employees of private nonprofit corporations that have significant governmental connection are entitled to the protections afforded governmental employees. A related employment issue has to do with benefits. If your nonprofit is very closely connected with the government, you may be required to provide your employees the same benefits they would receive if they were employed by the government. This is determined on a case by case basis.

As you can see, private nonprofit corporations with strong governmental links do have some special issues. Some governmental agencies may also have government-mandated restrictions on what its nonprofits can do. Except for these areas, however, these corporations are subject to the same rules as all other nonprofit corporations. This book describes those rules.

Consult Appendix 1 if you would like information about source material related to this Chapter.

Once you have decided which type of corporation you are, you are ready to begin setting up your Oregon nonprofit corporation.

3 SETTING UP YOUR OREGON NONPROFIT CORPORATION

There are several steps involved in setting up an Oregon nonprofit corporation. We will go through them in order, giving you the information and instructions you need to either complete the steps yourself or to intelligently participate in the process with a professional in the field. You can use the topics covered in this chapter as a step-by-step guide to organizing your group. Check off each of the tasks below (that apply to you) as you complete them. Because Bylaws are such an important topic, this topic is covered in more depth in Chapter 4.

THIS CHAPTER COVERS

- **Choosing and Reserving a Name**
- **Filling Out and Filing the Articles of Incorporation**
- **Writing Your Bylaws**
- **Holding the Organizational Meeting**
- **Registering with the Department of Justice**
- **Applying for a Federal Tax ID Number**
- **Registering in Other States**
- **Doing Business Under Another Name**
- **Obtaining Licenses and Permits**
- **Applying for Postal Benefits**

CHOOSING AND RESERVING A NAME

Before you can file with the state as a nonprofit corporation, you must choose a name. You can choose any name you want, subject to a few restrictions:

- The name can't state or imply that your organization is other than nonprofit or is organized for a purpose other than the purpose stated in your Articles of Incorporation;

- You cannot use the word "cooperative" or "limited partnership";

- The name must be written in the English alphabet but may contain Arabic or Roman numerals and incidental punctuation;

- It must be distinguishable from other names on record with the state; and

- It cannot imply that your corporation is organized for any purpose other than that permitted by law and your Articles.

If you are a Religious Corporation Sole (Appendix 3) your name must be the same as the office within the church or religious denomination held by your incorporator and must be followed by the words "and successors, a corporation sole."

If you want to reserve your name (so that no one else takes it) before you file your Articles of Incorporation, you may do so by submitting an application to the Office of the Secretary of State. This will hold your name for 120 days. After that, you may reapply for it on the same basis as everyone else. Most groups do not bother to reserve a name, but you may want to do so if you have one that is very important to you.

If you want to reserve your name on a national basis, to protect your right to use your name and to prevent someone else from using it elsewhere in the United States, you may need to obtain trademark recognition for your name. You should see an attorney who works in the trademark area.

FILLING OUT AND FILING THE ARTICLES OF INCORPORATION

The most important papers your group will have are its Articles of Incorporation. You start your corporation by filing these Articles. They contain

the major provisions about your corporation. The provisions in the Articles govern all other corporate documents.

Your Bylaws are next in importance. They contain the rules and procedures by which the corporation is to run. The provisions in the Bylaws govern over all other corporate documents, except those in the Articles.

For most matters, the law has rules that will govern your nonprofit corporation, but the law gives you the choice of providing something different in your Articles or Bylaws. Many provisions that you may want to make for how your organization will function can go into either your Articles or Bylaws. In some cases, the law says that you must put certain provisions in your Articles if you want them to apply. You can add provisions not mentioned by the law to your Articles and Bylaws, as long as the provisions are not illegal.

In choosing between whether to put a provisions in your Articles or Bylaws, keep in mind that the Articles are usually somewhat harder to change than the Bylaws. Most groups prefer to keep their Articles simple and to include the details about how they are run in their Bylaws.

Filling Out the Articles of Incorporation

The Articles must contain certain provisions. There is a blank "Articles of Incorporation" in the back of this book in the Forms section. The instructions below are keyed to that form.

If your corporation is planning to apply for tax exemption be sure to read Chapter 5 before you fill out this form, because you will need to know under what section you will be applying in order to fill out your Articles. If you apply for exemption under §501(c)(3) and do not have the language referred to in Articles 5 and 8 (or similar language) in your Articles, the IRS will refuse to grant your request for exemption until you amend your Articles.

Article 1. **Name of Corporation**. Fill in the name of the corporation. See page 32 for a discussion about names.

Article 2. **Registered Agent**. Your registered agent is the person upon whom all legal papers, notices, and demands upon the corporation will be served. The registered agent does not respond in any way to the legal papers but turns them over to your corporation. The registered agent may also receive a yearly notice from the state that the annual fee to remain a nonprofit corporation is due. The registered agent must be

someone who resides in Oregon, an Oregon business or nonprofit corporation with offices in Oregon, or a foreign business or nonprofit corporation authorized to transact business in Oregon with an office in Oregon. This person should be responsible enough to notify the corporation that he or she has received any legal papers or the annual notice, because the corporation may need to get an attorney, and must pay its annual fees.

Article 3. **Address of Registered Agent**. The address for the registered agent should be the business office of the registered agent. It should be a reasonably permanent address. The address cannot be a post office box, because in some cases the registered agent has to be served personally with papers. The corporation must notify the Secretary of State if it changes its registered agent or the address of its registered agent. (See page 646)

Article 4. **Address for Mailing Notices**. Much of what the state sends you can be done by mail. Fill in the address where you want to receive mail. For many corporations, this may be a different address than your registered agent's, often an office address. This can be a post office box.

Article 5. **Optional Provisions**. There are a variety of optional provisions that you should consider putting in your Articles. Put them on a separate sheet of paper called "Article 5."

If you are planning to apply for a tax exemption under §501(c)(3) (see Chapter 5), the Internal Revenue Service requires that you include substantially the following provisions in your Articles:

1. "This corporation is organized exclusively for charitable, religious, educational, and scientific purposes, including, for such purposes, the making of distributions to such organizations that qualify as exempt organizations under §501(c)(3) of the Internal Revenue Code, or the corresponding section of any future federal tax code."

2. "No part of the net earnings of the corporation shall inure to the benefit of, or be distributable to its members, directors, officers, or other private persons, except that the corporation shall be authorized and empowered to pay reasonable compensation for services rendered and to make payments and distributions in furtherance of the purposes of this corporation.

3. No substantial part of the activities of the corporation shall be the carrying on of propaganda, or otherwise attempting to influ-

> ence legislation, and the corporation shall not participate in, or intervene in (including the publishing or distribution of statements) any political campaign on behalf of or in opposition to any candidate for public office. Notwithstanding any other provision of these articles, the corporation shall not carry on any other activities not permitted to be carried on (a) by a corporation exempt from federal income tax under §501(c)(3) of the Internal Revenue Code, or the corresponding section of any future federal tax code, or (b) by a corporation, contributions to which are deductible under 170(c)(2) of the Internal Revenue Code, or the corresponding section of any future federal tax code."

On pages 37-39 we discuss additional provisions you may want to consider.

Article 6. **Type of Corporation**. Oregon recognizes three types of nonprofit corporations: Religious Corporations, Public Benefit Corporations and Mutual Benefit Corporations. The type of corporation you select will have important consequences for how your corporation is run and what the law will allow your corporation to do. It may also determine whether or not you can qualify for tax exemption under §501(c)(3) of the Internal Revenue Code. Chapter 2 describes in detail the implications of selecting each of these types of corporations. You should read that very carefully before making your selection.

Article 7. **Will the Corporation Have Members?** You should only answer "yes" if your members elect some or all of your Board. See pages 23-25 and Chapter 14 for a discussion about members.

Article 8. **Distribution of Assets on Dissolution**. Here you are required to describe your provisions for the distribution of the assets of your corporation upon dissolution or final liquidation (in other words, when the corporation closes down). "Assets" refers to all the money and property (of all kinds) that the corporation owns. Pages 26-27 explain the options your group has in this situation. Corporations applying for tax exemption under §501(c)(3) (see Chapter 5) should put this provision in their Articles:

> "Upon the dissolution of the corporation, assets shall be distributed for one or more exempt purposes within the meaning of §501(c)(3) of the Internal Revenue Code, or the corresponding section of any future federal tax code, or shall be distributed to the federal government, or to a state or local government, for a public

> purpose. Any such assets not so disposed of shall be disposed of by the court of appropriate jurisdiction of the county in which the principal office of the corporation is then located, exclusively for such purposes or to such organization or organizations, as that court shall determine, which are organized and operated exclusively for such purposes."

If you are applying for tax exemption under §501(c)(3), you can name a specific organization to receive your assets as long as it is a (c)(3). However, you must state that it can only receive your assets if it is a (c)(3) at the time of your dissolution and you must make an alternative provision for disposal of your assets if it is not. Your clause might read:

> "Upon the dissolution of the corporation, assets shall be distributed to [name of corporation], a nonprofit corporation organized in the state of [name the state where it is incorporated], if such corporation is exempt from taxation under §501(c)(3) of the Internal Revenue Code, or the corresponding section of any future federal tax code. If it is not exempt, assets shall be distributed for one or more exempt purposes within the meaning of §501(c)(3) of the Internal Revenue Code, or the corresponding section of any future federal tax code, or shall be distributed to the federal government, or to a state or local government, for a public purpose. Any such assets not so disposed of shall be disposed of by the court of appropriate jurisdiction of the county in which the principal office of the corporation is then located, exclusively for such purposes or to such organization or organizations, as that court shall determine, which are organized and operated exclusively for such purposes."

Article 9. **Incorporator**. Your incorporator is the person (or persons) who signs the Articles, sees that they are filed, and arranges for the organizational meeting of the Board (pages 42-44) to be held. The incorporator can be a person over the age of 18, a corporation, a partnership, or an association.

Your incorporator needs to fill in her or his name and address here. You may have more than one incorporator and, if so, you should list the appropriate information for all of them.

Article 10. **Execution**. All of your incorporators sign here and print their names.

Article 11. **Contact Name**. The person to contact about the filing does not have to be an incorporator but can be any responsible individual who is willing to deal with the State about this filing.

If you apply for exemption under §501(c)(3) and do not have the language referred to in Articles 5 and 8 (or similar language) in your Articles, the IRS will return your application with instructions to amend your Articles.

Other "Additional Provisions" to Consider for Your Articles

Whether or not you are applying for tax exemption under §501(c)(3), there are a variety of provisions that the law says must be in your Articles if you want them to apply to you. Any of these provisions that you want to include should be written in under Article 5. Before reviewing these provisions you may find it helpful to read Chapter 13, since a good deal of what is discussed below is explained in that chapter. You may need to consult an attorney for help in wording any of these additional provisions. We have placed the items most likely to be of interest in the first and second sections below, and the more esoteric items are listed in Appendix 5.

Item of Interest to Almost All Nonprofits

Limiting Liability of Directors and Officers. Your Articles may eliminate or limit the personal liability of a Director or uncompensated officer of the corporation or its members for claims relating to their conduct as a Director, officer or member. This limitation on liability applies only to actions by the corporation or its members against the Director, officer, or members and does not apply to actions by parties outside of the corporation. (See Chapter 13 for a discussion of personal liability and under what circumstances the corporation may want to sue its Directors and officers.) This provision cannot eliminate or limit liability for:

- acts or omissions before the date the provisions became effective;
- a breach of the duty of loyalty;
- acts or omissions not in good faith or that involve intentional misconduct or knowing violations of the law;
- unlawful distributions (See page 265);
- any transaction in which the Director or officer got an improper personal benefit;
- any act or omission that violates the conflict of interest laws (See pages 275-276); or

- illegal loans to or guarantees for Directors and officers (See pages 276-277).

Despite its many exceptions, many consider a provision limiting liability to be a very important provision to be added to the Articles in order to attract Directors. Most nonprofit corporations will want to at least consider adding this.

Despite its many exceptions, many consider a provision limiting liability to be a very important provision to be added to the Articles in order to attract Directors.

If you are interested in protecting your Directors, officers, and members (if any) from claims by the nonprofit corporation, you should consider adding one of the clauses described below that limit the liability of Directors and uncompensated officers to the fullest extent possible. Put this language in your Articles of Incorporation under Article 5 as Additional Provisions:

For Nonmembership Corporations:

> "The personal liability of each member of the Board of Directors and each uncompensated officer of the corporation, for monetary or other damages, for conduct as a director or officer shall be eliminated to the fullest extent permitted by current or future law."

For Membership Corporations:

> "The personal liability of each member of the Board of Directors, each uncompensated officer, and each member of the corporation, for monetary or other damages, for conduct as a director, officer, or member shall be eliminated to the fullest extent permitted by current or future law."

Items of Greater Interest to Many Nonprofits

Limitations on Board's Powers. If you want to limit the power of your Board to exercise corporate powers, you must do so through a provision in your Articles. Your Articles may authorize one or more people (or the manner of designating a person or persons) to exercise some or all of the powers which would otherwise be exercised by the Board. For example, if your members (or a committee that has some members who are not Directors) have the right to veto Board actions, approve the budget, or otherwise participate in the management of the corporation (other than electing the Board and approving conflict of in-

terest transactions, amendments to Articles or Bylaws, sale of substantially all the assets, mergers and dissolutions), you must put these rights in the Articles.

Amendments to Bylaws (Membership Corporations only). Generally, the Board in membership corporations is entitled to amend or repeal the corporation's Bylaws. If you want to provide that only the members can amend the Bylaws and that the Board cannot amend them, the simplest way to do this is to provide in your Articles of Incorporation that the power to amend Bylaws is reserved to the members exclusively. You must put it in your Articles; putting it in your Bylaws is not enough.

Size of Board (Membership Corporations only). If your corporation has members entitled to vote for Directors, and you want to be sure that only the members can change the range or the size of the Board (if you have a variable-range Board) or can change from a fixed or a variable-range sized Board, your Articles must establish a fixed or variable-range size of the Board. If the Articles do this, only the members may make the change.

Removal of Directors for Cause (Membership Corporations only). If your Public Benefit or Mutual Benefit Corporation has Directors elected by members, and you want to provide that the members have to have reasons (called "cause") to remove the Directors (rather than removing them with or without cause), you must so provide in your Articles.

Access to Records (Membership Corporations Only). If you are a Public Benefit Corporation organized primarily for political or social action (such as political or social advocacy, education, litigation or a combination of these purposes), your members have the right to inspect and copy certain of your records (see pages 331-333). You may limit or abolish the right of your members to obtain from the corporation information as to the identity of its contributors. You may also limit or abolish the right of your members or your members' agent or attorney to inspect or copy your membership list. If you do limit or abolish any of these rights, the corporation must provide a reasonable means for the member making the request to mail communications to the other members through the corporation at her or his expense. If you wish to do this, you must include this limitation in your Articles.

Filing Your Articles of Incorporation

Your corporation is officially set up when the incorporator:

- Signs your "Articles of Incorporation" (in this book called the Articles); and

• Files the Articles (along with a filing fee) with the Secretary of State. The Secretary's office is very helpful to nonprofits. If you want to speed up the process by several weeks, you can have someone from your group hand-deliver the original with the filing fee to the above address. You can also fax the Articles with a VISA or Mastercard payment and request a return "as soon as possible." If you mail documents and use a credit card for payment, you will also speed the process.

The state has a form, called "Articles of Incorporation—Nonprofit " which can be obtained free of charge from the Secretary of State, Corporation Division or their website, or you can use the one in the Forms section. You can get the street and web address for the Secretary of State from Appendix 2. You may also draw up your own form, if you prefer.

If the Articles you file comply with the law, the Corporation Commissioner will stamp "Filed" and the date filed on the Articles. On that date (unless you specified a later date in your Articles), the corporation is officially in existence. The Articles may specify a delayed effective date as long as the date is within ninety days of the filing. For a small fee, the Corporation Commissioner will send one copy of the "filed" Articles back to the incorporators, or give it to your messenger if you arrange to have the Articles personally delivered.

Once the Articles have been filed, your corporation is like a car without a driver. Your Board is the driver. In order for your corporation to function legally, after the filing of the Articles a majority of incorporators must call an organizational meeting of the Board of Directors named in the Articles. Since the Board usually adopts its Bylaws at this meeting, the Bylaws are often drafted before this meeting.

WRITING YOUR BYLAWS

The Bylaws contain the rules and procedures by which the corporation is run. The first Bylaws generally are adopted by the Board of Directors at its organizational meeting.

There is no particular form that you must follow in drawing up Bylaws, and you do not have to file them with the Corporation Commissioner (where you file your Articles of Incorporation) unless you want to. (Most corporations do not.) If you are a Public Benefit Corporation, you will have to file the Bylaws with the Attorney General's office. (See page 42). All nonprofits have to file them with the IRS if you apply for tax-exempt status.

Typically, a corporation will want to consider putting these items in its Bylaws:

Section 6	Secretary
ARTICLE VI	Amendments to Bylaws
ARTICLE VII	Corporate Indemnity of Officers and Directors

Because writing Bylaws is an involved process, it is covered in detail in Chapter 4. You should turn to Chapter 4 for help in drafting Bylaws. Do not assume that you can simply copy or modify someone else's Bylaws. This is the most common mistake that is made in preparing Bylaws. You should also read Chapter 4 because it contains important additional information about how membership and nonmembership corporations are run.

Do not assume that you can simply copy or modify someone else's Bylaws. This is the most common mistake that is made in preparing Bylaws.

After you have read Chapter 4 and have developed your set of Bylaws, remember to return to this chapter to complete the remaining steps in order to finish setting up your corporation.

HOLDING THE ORGANIZATIONAL MEETING

After your Articles of Incorporation have been filed with the state, your corporation must hold an organizational meeting. If initial Directors are named in the Articles of Incorporation, the initial Directors must hold an organizational meeting at the call of the majority of the Directors with notice as described on page 287 for special meetings. If initial Directors are not named in the Articles, the incorporator or a majority of the incorporators must call the meeting with the same notice as described on page 287 for special meetings. The notice of the meeting does not have to be given if all the Directors sign a waiver of this notice. See the "Waiver of Notice of Meeting of Directors" in the Forms section of this book.

The purpose of the meeting is to complete the organization of the corporation. If initial Directors were not named in the Articles, the incorporators elect Directors. Once the corporation has Directors, the Directors complete the organizational meeting by appointing officers, adopting Bylaws, and carrying on other business brought before the meeting. Such business may include selecting a bank and signers on the account; authorizing borrowing; adopting a budget; setting salaries; ratifying acts previously taken on behalf of the corporation; and taking care of other business needs. Many groups have already agreed on

these items before the organizational meeting, so that the meeting is just a formality. It is important to hold it, however, so that the organization's decisions can be officially adopted and made a part of the Board's minutes. "Minutes of the First Meeting of Board of Directors" is included in the Forms section as sample minutes of the organizational meeting which your group can modify to meet your needs. After this meeting has occurred, your corporation is officially set up. The organizational meeting does not need to be held if each incorporator or Director signs a written statement consenting to the action taken as described on page 287. A "Consent to Corporate Action without a Meeting by the Board of Directors" is in the Forms section.

Setting Your Fiscal Year

One important item on the agenda at the organizational meeting is to determine the corporation's fiscal year. The fiscal year is the twelve-month cycle used by the organization for financial management purposes. You will report this year to taxing agencies on any filings you make with them. Once you set it, you will need the permission of the IRS to change it.

You should consider several factors in setting your fiscal year. First, examine your primary sources of funding. If your major funders are the state or local governments, consider setting your fiscal year to run concurrently with theirs from July to June. The federal government's cycle is October through September. If your nonprofit is very small with a volunteer or untrained staff, you may want to use the calendar year, since this is the simplest system. If your programs follow an annual cycle, you may want to adopt this cycle as your fiscal year so that all of your costs are captured in one cycle. For example, schools may chose a fiscal year from August until July, especially if they have no government funding. Generally, unless there is a compelling reason to break the rule, you will want to end on a calendar quarter (March, June, September, or December) if you are audited. Failing to do so creates extra work for your auditor. Talk over your choice with your accountant, if you have one.

Loans by Founders

Another item that deserves special attention at the organizational meeting is whether any of the founders loaned money to the corporation to get it started. This is particularly important to address if that individual is now on the Board. If someone has advanced money that the corporation is to repay, you should have a written acknowledgment of this in some form, along with a receipt showing what the money was spent for. One option would be to have the corporation sign a promissory note (a legal I.O.U.), setting out the amount of the loan and the terms of repayment. One possible form is the "Promissory Note"

found in the Forms section in this book. If that one doesn't fit, you can get others from a legal stationery store.

REGISTERING WITH THE DEPARTMENT OF JUSTICE

The Attorney General's office (in the Department of Justice) is the state office that is responsible for ensuring that nonprofit corporations comply with the law. Oregon is very fortunate to have an excellent and helpful Attorney General's office.

If you stated in your Articles of Incorporation that you are a Public Benefit Corporation and you plan to become exempt under §501(c)(3), you must register with the Attorney General's office. If you are a Public Benefit Corporation and you do not plan to apply for exemption under that section, you should also send in the registration form. It is possible that the Attorney General's office will contact you to tell you that you don't need to register. If you are not a Public Benefit Corporation, you do not have to register. You can obtain the Registration of Charitable Corporation form with instructions from the Attorney General's office. We've listed the contact information in Appendix 2. The form is available on-line and changes fairly frequently so we have not included it in the Forms section. Registration is free; however, every year you must update your registration and pay a fee based on the receipts and assets of your organization.

APPLYING FOR A FEDERAL TAX ID NUMBER

All groups that incorporate are going to need a federal tax identification number, also known as the Employer Identification Number and called the EIN. Typically, your group will encounter its first requirement for this number when you try to open a bank account. You will also need this number if you decide to apply for tax exemption and when you file tax forms.

Obtaining your EIN number is free and is relatively easy. Contact the IRS office or go to the IRS website and obtain Form SS-4. Read the instructions and fill the form out. You can then send it in electronically on the web, telephone the IRS and give the information to the operator who will give you a number, fax it in or mail it in. The electronic and telephone methods are the fastest ways to get a number. If you fax the form in, you should get a number in a few days. If you mail in the form, you should get your number in 2-4 weeks. Regardless of which method you use, be sure to save your number in a safe place. Appen-

dix 2 provides you with contact information to obtain Form SS-4 and to reach the IRS using these various methods.

REGISTERING IN OTHER STATES

You may need to register your corporation in a state other than Oregon. State laws require this if you are doing business in that state. In some cases, engaging in activity on the Internet (such as soliciting members or donations or selling products) may constitute doing business in other states. You'll have to check with an attorney to determine if you are required to register.

DOING BUSINESS UNDER ANOTHER NAME

If your corporation wants to do business under a name other than the one listed in its Articles, you can do so by submitting an assumed business name form to the Secretary of State. You can get these forms at legal stationery stores.

OBTAINING LICENSES AND PERMITS

Each local government has its own rules about business licenses and similar requirements for doing business. You will need to check with an attorney or accountant or call the government agencies in your locale to discover which affect you. In addition, the nature of your activity may subject you to other licensing, registration, or reporting requirements—for example, schools and hospitals. In some cases, your fundraising activities may require that you get special permits—for example, bingo games. (See pages 774-776.)

APPLYING FOR POSTAL BENEFITS

The Postal Services gives permits for reduced standard mailing rates to certain nonprofit organizations. These permits give you much lower mailing rates. Generally, nonprofits that would qualify as exempt under §501(c)(3) will be eligible for these benefits. Other types of nonprofits – such as agricultural, labor, veterans, and fraternal organizations – are also eligible. Some nonprofits are specifically excluded, including business leagues, civic improvement associations and service, social and hobby clubs. The postal service has an extensive set of regulations governing nonprofit preferential mailing rates that includes rules about what types of mailings and what content in the mailings are permissible. You can get the *Quick Service Guide*, that provides an overview of the rules, and Publication 417, *Nonprofit Standard Mail Eligibility*, that has more complete information, from the postal service. These publications are

available on-line at *www.usps.com/businessmail101/misc/nonprofitQualifications.html* or you can contact the United States Postal Service for copies.

Consult Appendix 1 if you would like information about source material related to this Chapter.

Chapter 4 covers how to draft your Bylaws. Then, if you want your organization to be tax-exempt, you must apply for tax-exempt status. You must apply separately to the federal government and to the state and county. Part II explains how to do this. If you are not interested in obtaining tax exemption, you should go on to Part III.

4 WRITING BYLAWS

One of the most important parts of setting up a nonprofit corporation is developing your Bylaws. Bylaws are the rules that govern the operation of the corporation. If you do not write out the rules you use, you are operating with verbal Bylaws. It is very important to get your procedures in writing. A good set of Bylaws can be used by your Board as a guidebook for procedures on operating the corporation.

The consequences of failing to write good Bylaws can range from the annoying to the disastrous. Lack of good internal procedures can subject your group to needless squabbles, as individuals with differing agendas use your procedural defects to further their own causes. If your Bylaws conflict with the law, you may be operating illegally. This could subject the Board and everyone involved with the corporation to personal liability if a court should decide that you are so out of compliance with the law that it will treat you as though you are not incorporated.

This chapter will take you step-by-step through a procedure that will help you draft Bylaws that are legal and useful.

THIS CHAPTER COVERS

- **How Bylaws Fit With Other Rules**
- **Tips for Drafting Bylaws**
- **Bylaws for Nonmembership Corporations**
- **Bylaws for Membership Corporations**

Your Bylaws should be your guidebook for how your nonprofit corporation is governed. It is critical that your corporation have a set of Bylaws that complies with the law and that is usable by your Board.

The process of drafting Bylaws requires some care on your part. In 1989, the Oregon legislature dramatically changed the law governing nonprofit corporations in Oregon. The law is now quite detailed and contains some pitfalls that most nonprofits would not expect in terms of how nonprofit corporations are to be governed.

Many groups put together their Bylaws by the "cut and paste" method. The group assembles the Bylaws by getting sample copies of Bylaws from several different groups and picking and choosing the provisions that it wants in its own Bylaws. These provisions are then cut and pasted into a new set of Bylaws.

This method is probably a good way to get an idea of what items you might consider putting into your Bylaws but is a terrible way to assemble a final product. There are several reasons for this. Often, you have no way of knowing whether the Bylaws you are using comply with Oregon law. They may have come from another state (and no state has a law exactly like Oregon's); they may have been written before 1989, under Oregon's old statute; or they may not have been drafted by someone who knew what they were doing. Even if the samples you are using are all in compliance with Oregon law, in the process of cutting and pasting you may build in inconsistencies and ambiguities without realizing it.

Many groups put together their Bylaws by the "cut and paste" method. This method is probably a good way to get an idea of what items you might consider putting into your Bylaws, but is a terrible way to assemble a final product.

In this chapter we will help you to draft Bylaws that are legal and useful. We will begin by explaining where Bylaws fit in the legal hierarchy of rules. We will then give you some drafting tips so that you can get a feel for what you are trying to do in designing Bylaws. Finally, we will examine section by section two complete sets of Bylaws – one for nonmembership corporations and one for membership corporations. We will use the sample sets of Bylaws that appear in the Forms section. For each section, we will print the section from our sample set and will let you know how you can modify it if you want to do so, and in what ways you cannot change it. To get the maximum benefit from this approach, avoid cutting and pasting from a number of sets of Bylaws and then trying to compare it to the ones in this book. Instead, you may want to bring your ideas from those Bylaws but start with our samples and amend them to fit what you want to do to the extent you can legally do that.

If at all possible, you should have an attorney review your Bylaws after you have followed the suggestions of this chapter and come up with your best product. Bylaws are critically important documents and you should be sure that you have drafted them correctly.

HOW BYLAWS FIT WITH OTHER RULES

The legal workings of your nonprofit corporation are governed by a variety of sources: the law, your Articles of Incorporation, your Bylaws, and resolutions (decisions) of your Board. These sources exist as a hierarchy: those above in the hierarchy control those below. In this hierarchy, the law controls all of your organizational documents and actions (Articles, Bylaws, resolutions). In many situations, state law allows your Articles and Bylaws to control the governance of your corporation and only steps in if you do not provide differently in your Articles or Bylaws. Your Articles then control your Bylaws, and your Bylaws control any resolutions of your Board.

Articles of Incorporation

The most important corporate document you have is your Articles of Incorporation (and amendments to it). Your Articles are typically very short and establish basic items like your name, offices, whether you have members, and distribution of assets upon dissolution. They may include other provisions you add. Your Articles and its amendments are like your corporation's constitution. If your other organizational documents conflict with your Articles, your Articles prevail. This means that you must read your Articles and amendments along with your Bylaws when you draft your Bylaws because your Bylaws cannot contradict your Articles.

Bylaws

Your next most important corporate document is your Bylaws. The purpose of Bylaws is to provide for how your organization is run. The Bylaws should contain provisions about your Board, members, officers, committees, and provisions for amending the Bylaws.

Board Resolutions

The Board may make decisions (resolutions) from time to time governing corporate matters, as long as the resolutions do not conflict with the Articles or Bylaws. These resolutions are ways of handling corporate business. For example, the Board may want to approve personnel policies or authorize the establishment of a bank account. Typically, these resolutions will not cover

matters concerning how the corporation is governed, because those matters are handled in the Bylaws (or Articles).

TIPS FOR DRAFTING BYLAWS

As you draft your Bylaws, keep these guidelines in mind.

Consistent with Laws

Your Bylaws must be consistent with the law. The discussion beginning on page 51 will describe the laws that apply to each section of your Bylaws.

Consistent with Your Articles

Your Bylaws must be consistent with your Articles. Begin drafting your Bylaws by reading your Articles of Incorporation and all of its amendments. If your Bylaws conflict with any of these documents, your Articles prevail. For example, if your Articles say that your Board is composed of 7 people and your Bylaws say your Board has 9 members, then your Board can only be composed of 7 members. If you need to change your Articles, see Chapter 28.

Your Bylaws must be consistent with your Articles. Begin drafting your Bylaws by reading your Articles of Incorporation and all of its amendments.

There are subjects that must be in your Articles. See pages 37-39 for a discussion of these items. For example, if some group other than your Board of Directors or a committee composed only of Directors makes Board-level decisions for your corporation, you must include this in your Articles. If you have these provisions in your Bylaws and not in your Articles, these provisions are very likely not valid.

Internally Consistent

Each provision in your Bylaws must be consistent with the other provisions in your Bylaws. Be careful as you include each provision that your provision does not conflict with other provisions. When you have completed your first draft, read it carefully to see if there are inconsistencies. For example, if your Bylaws provide in one section that your officers are a President and Secretary, and in another provide duties for a Treasurer, you need to harmonize these sections.

Understandability and Utility

Your Bylaws should be written so they are easily understandable. They should strike a balance between being detailed enough so that your organization knows how you are run but not so detailed that they stifle whatever flexibility you need. Items typically covered by Bylaws are listed on pages 41-42. Items like the fiscal year, the authority to sign checks, and grievance procedures are usually better handled by a Board decision than by inclusion in the Bylaws. If you put these kinds of items in your Bylaws, you have to amend your Bylaws when you want to change them.

Your Bylaws should require that the Board follow other documents like *Robert's Rules of Order* only if you are prepared to become familiar with these documents and use their procedures. If your Bylaws require that you run your meetings using some parliamentary system and you fail to do so, it is possible that your decisions are invalid.

Completeness

Be sure in preparing your Bylaws that you notice what is not in them as well as what is there. Make certain that you have covered items about voting, quorums, meetings, notice, and officers. Compare your Bylaws to the Bylaws in the Forms section for nonmembership corporations or membership corporations to be sure everything that should be covered is covered. For example, it is not uncommon for Bylaws to fail to provide for how they are to be amended.

Using Bylaws to Handle Conflict

Some groups approach their Bylaws as an instrument to manage all of the group's conflict. While a good set of Bylaws should provide a clear mechanism for dealing with governance, you should not approach the Bylaws as a cure-all for organizational disagreements. If you find that your group is focusing extensive amounts of attention on the Bylaws in an effort to settle or prevent conflict, you may want to review Chapter 18.

BYLAWS FOR NONMEMBERSHIP CORPORATIONS

In this section, we will examine the "Bylaws of a Nonmembership Corporation" found in the Forms section. This section will first present the language from that sample in italics, then provide information that should be helpful for you

in deciding whether this sample fits your situation and, if not, what the permissible modifications are.

Article I: Purpose

> *This corporation shall be organized and operated exclusively for charitable, scientific, literary, religious, and educational purposes. Subject to the limitations stated in the Articles of Incorporation, the purposes of this corporation shall be to engage in any lawful activities, none of which are for profit, for which corporations may be organized under Chapter 65 of the Oregon Revised Statutes (or its corresponding future provisions).*
>
> *This corporation's primary purpose shall be* _____.

Discussion: The reason for writing this section so broadly is to permit your corporation to operate for any legal purpose. Some corporations do not include the first sentence and simply state their current purpose. If you do this, you are restricted to operating only for that purpose. If you later change what you do, you will need to remember to amend your Bylaws. Many groups that adopt restrictive language forget to amend it when they change their purpose and operate illegally because they are then operating outside their purpose.

Article II: Nonmembership

> *This corporation shall have no members.*

Discussion: As discussed in Chapter 14, members have the right to vote, inspect records, and other rights. Many Oregon nonprofits want to have "members" who pay dues and perhaps receive a newsletter but who do not vote or have other significant rights. You are better off from a legal viewpoint calling these people something besides "members," in order to distinguish them from members who by law have the rights referred to above. For example, you might call them "contributors," "angels," "friends," or "sustainers."

There are often nonlegal reasons for calling these supporters "members." If you feel you want to use the "member" designation, your Articles of Incorporation should reflect that you are *not* a membership organization. This section of your Bylaws should still be titled "Nonmembership," but might read something like this:

> *"This corporation shall have no members as that term is defined by Oregon Revised Statutes Chapter 65, but shall have members for other purposes. These members shall have none of the rights or duties described in ORS Chapter 65 (or any corresponding future statute.)"*

Article III: Board of Directors

Section 1. Duties.

The affairs of the corporation shall be managed by the Board of Directors.

Discussion: The law requires that your affairs be managed by your Board in a nonmembership corporation. Your Board can delegate some of its authority to committees if done properly. See page 293. If your corporation allows major decisions to be made by anyone other than the Board or a committee of the Board, you must state this in your Articles of Incorporation. If you have done this, then the Bylaws in the Forms section will probably not apply to your group. You will need to see an attorney for help in drafting your Bylaws. You should be aware that, if you are applying for tax exemption, this unusual structure may create problems for your application.

Section 2. Number and Qualifications.

The number of Directors may vary between a minimum of three and a maximum of fifteen.

Discussion: If you are a Public Benefit Corporation, you must have at least three Directors. If you are a Mutual Benefit or Religious Corporation, you can have as few as one. There is no legal ceiling on how many Directors you can have.

This section of your Bylaws can specify the exact number of Directors, which is called a *fixed number* (for example, "The number of Directors shall be five."). Alternatively, as above, this section can set a *variable number* of Directors. One reason for a variable number is to allow the Board to expand or contract within the limits you set without going through the procedure to amend the Bylaws. Many organizations like the variable number provision because of the flexibility it gives them.

If you decide on a variable number of Directors, you need to be aware that it is often important to know the size of your Board. For example, this figure is used in calculating a quorum and in calculating how many votes are needed to set up a committee that exercises Board functions. You have two choices about how to set the official size of your Board for these purposes. Your Board at a meeting can set the number of Directors and reflect this in the minutes. Later, if it adds or subtracts members, it can reset the number at a meeting and reflect that in the minutes. If you follow this procedure, the Board is said to be *prescribing* the size of

the Board. This is then the figure from which quorum and committee calculations are made. There may be a difference between the prescribed number of Directors and the actual number of Directors. For example, the Board may have decided to have eleven positions and filled them; later, two Directors resigned and were not replaced. Your prescribed size is still eleven, and this is the number that should be used for calculations involving Board size, such as setting a quorum.

The second method you can use to set Board size is to simply elect Directors without setting a number. If that is what you do, your Board size is the number of Directors in office immediately before the meeting.

The sample section above does not set out any particular qualifications for Directors. All Directors must be individuals, as opposed to corporations or some other legal entity. You can set out any other qualifications that you want.

One area of some interest is whether you can discriminate in setting the qualifications for your Board. For example, an organization devoted to helping Vietnamese immigrants may want to provide that some or all of its Board consist of people of Vietnamese ancestry. The law is somewhat unclear in this area, but in most cases it appears that you can write in these types of qualifications. You should get legal advice for your own situation.

Section 3. Term and Election.

> *The term of office for Directors shall be two years. A Director may be reelected without limitation on the number of terms she or he may serve. The board shall elect its own members, except that a Director shall not vote on that member's own position.*

Discussion: The maximum term of office in Oregon for elected Directors is five years. Your Bylaws should not provide that a Director is elected until replaced, without setting a limit on the term, because this could violate the five year rule. A Director can be re-elected without limitation, although you may choose to limit the number of terms a Director may serve. Many Boards do this to assure new leadership.

Many organizations want to provide for staggered terms for their Directors, so that the Board always has some experienced members in place. One way to do this is to divide the total number of Directors into groups and elect each group at different times. For example:

> *Except for the initial adjustments of shorter terms needed in order to create staggered terms, the term of office for Directors shall be two years. The Board shall make provisions to stagger the terms of Directors so that each year the terms*

of as close as possible to one-half of the Directors shall expire. A Director may be reelected without limitation on the number of terms she or he may serve. The board shall elect its own members, except that a Director shall not vote on that member's own position.

If you have a variable size Board, you can accomplish staggering without this awkward language in your Bylaws. You can do this by setting your Board size the first year at one-half of what you eventually want, and the next year add the other one-half of the Directors.

If you have a group other than the existing Board who will be *electing* Directors, then you probably have some version of a membership corporation. You should check your Articles of Incorporation to see if you incorporated as a membership corporation and, if so, look at the Bylaws for membership corporations later in this chapter. If you have any question about which you are, you should get legal advice.

Some corporations have Directors who are appointed or designated, rather than elected. Those situations are outside the scope of these Bylaws. If you want to provide for this, you should review page 18 and get legal advice.

Section 4. Removal.

Any Director may be removed, with or without cause, by a vote of two-thirds of the Directors then in office.

Discussion: Although it sounds harsh, many corporations opt to permit removal of Directors with or without cause. This means that you do not need to have a reason to remove a Director. If you try to limit removal only to certain circumstances, you run a serious risk that a situation will arise that you did not anticipate that requires removal of a Director and that is not spelled out in your reasons for removal. You are then stuck with a Director you don't want. Alternatively, the Board may vote to terminate the Director and the Director then has grounds for a lawsuit. Many groups feel that if $^2/_3$ of the Board is willing to vote for removal, it makes no sense to leave that person on the Board. If you do decide to specify reasons for removal, you should get some legal help. These Bylaws are drafted on the assumption that the Board can be removed without the corporation having to prove its reason for removal.

If you are going to remove an elected Director under Bylaws that provide you can do so with or without cause, state law requires that you must do so by at least a two-thirds majority of all Directors in office (not just at the meeting). You cannot require a lower number than this.

A Religious Corporation may require a different procedures by which the Board or any person can remove (with or without cause) a Director elected by the Board. A Religious Corporation can even limit or prohibit the ability of a court to remove Directors.

Section 5. Vacancies.

> *Vacancies on the Board of Directors and newly created board positions shall be filled by a majority vote of the Directors then on the Board of Directors.*

Discussion: Notice that this wording requires the vote of a majority of all Directors in office, not just a majority of those at the meeting, to fill a vacancy. You could word your Bylaws to allow the Board to fill a vacancy with a majority at the meeting; however, if the directors remaining in office are not enough to constitute a quorum, the law requires that they can fill the vacancy only by a majority vote of all the directors remaining in office. To keep it simple, we suggest that you use only one approach, which will work no matter what your situation is.

If you wish, your Bylaws can make different provisions than the one above for filling vacancies. For example, your President could appoint Directors to fill the vacancies.

Section 6. Quorum and Action.

> *A quorum at a board meeting shall be a majority of the number of Directors prescribed by the Board, or if no number is prescribed, a majority of the number in office immediately before the meeting begins. If a quorum is present, action is taken by a majority vote of the directors present, except as otherwise provided by these Bylaws. Where the law requires a majority vote of the directors in office to establish committees to exercise Board functions, to amend the Articles of Incorporation, to sell assets not in the regular course of business, to merge, or to dissolve, or for other matters, such action is taken by that majority as required by law.*

Discussion: A *quorum* is the number of Directors who must be present at a Board meeting in order for it to be held. If fewer Directors than the number set as a quorum show up, the Board cannot do any business and must reschedule the meeting. This is discussed on pages 285-286. The calculation of the number of Directors needed to make a quorum is complicated by the fact that the Bylaws of some nonprofit corporations provide for a fixed number of Directors and some have a variable number.

If your Bylaws have a *fixed number* of Directors, then you should modify the wording in the sample clause above to state that the quorum is a majority (or some other percentage greater than one-third) of the fixed number of Directors. Be aware that if the actual number of Directors falls below the number fixed by your Bylaws (which can happen when a Director resigns or the term ends and she or he is not replaced or through some other cause), you still use the number fixed by your Bylaws (and not the number of Directors in office) in calculating whether you have a quorum.

If your Bylaws provide that you have a *variable Board size*, then you must determine how you set the actual number of your Directors before you can figure out your quorum rules. Some corporations with variable size Boards set the exact number of Directors by a Board resolution, and others do not do this, but simply elect the Board without ever saying what the precise number will be. The rather awkward wording in the sample clause above is wording that would be used by any corporation that has a variable size Board. The clause refers to "a majority of the number of Directors prescribed by the Board, or if no number is prescribed, a majority of the number in office immediately before the meeting begins". With this clause, if you have a variable size Board and the Board has acted to set (prescribe) the number of Directors, you would use that number as the number from which to calculate your quorum. Notice that the number the Board sets may not be the actual number of Directors you have, because you may have vacancies on the Board due to resignations, deaths, removals, or other factors. If you have a variable Board, and your Board has not set the number of its members, then under this clause you would use the number in office immediately before the meeting begins in order to calculate your quorum figure.

You can raise the number of Directors required for a quorum to be more than the majority stated above. You can lower it to be as little as one-third of the fixed or prescribed Directors as described above. You cannot set the quorum at less than one-third. Many groups feel that one-third is too few Directors to conduct a meeting. The sample Bylaw above follows the common practice of setting the quorum at a majority of the Board.

Voting: Once a quorum is present, action must be taken by at least a majority vote of the Directors present. You can require more than a majority vote but not less.

Notice that the majority must be of the Directors present, and not just the Directors voting. Consequently, if 11 Directors are present but only 9 vote (because 2 abstain), you need 6 votes to decide on an action. It is a good idea to spell this out in your Bylaws as the sample clause above does.

There are some types of action (described in the sample clause above) which require the vote of a majority of Directors in office in order to be effective. These circumstances are put into the Bylaws so that you are sure to know the proper vote needed in those circumstances.

Section 7. Regular Meetings.

> *Regular meetings of the Board of Directors shall be held at the time and place to be determined by the Board of Directors. No other notice of the date, time, place, or purpose of these meetings is required.*

Discussion: Regular meetings are those in which the time and place is regularly scheduled by the Board (for example, the first Monday of the month at 7:00 p.m. at the corporation's office). The law does not require additional notice of these meetings. If you change the time or place, this will make the meeting a special meeting, and you must give the notice you require for special meetings.

If you want, your Bylaws can require that you give notice of your regular meetings. The drawback is that, if your Bylaws require you to give notice and you don't, the action taken at the meeting may be invalid. Your Board may choose to give notice of regular meetings without such notice being required in your Bylaws.

Section 8. Special Meetings.

> *Special meetings of the Board of Directors shall be held at the time and place to be determined by the Board of Directors. Notice of such meetings, describing the date, time, place, and purpose of the meeting, shall be delivered to each Director personally or by telephone or by mail not less than two days prior to the special meeting.*

Discussion: Special meetings are all meetings that are not regular meetings. Your Bylaws may require a longer or shorter period of notice for special meetings than that stated above. There are only certain circumstances in which you are required to state the purpose of special meetings and your Bylaws could require that only in those cases do you need to state the purpose in your special meeting notice. Rather than lengthen the Bylaws with this kind of detail, these sample Bylaws provide that you will always state the purpose of a special meeting.

You should be aware that the presiding officer of the Board, the President, or twenty percent of the Directors then in office may call and give notice of the meeting of the Board. You can make different provisions than this in your Bylaws if you wish.

The law that provides for notice was drafted in 1989 before the advent of the Internet and does not provide for electronic notice. If you decide to take the risk that your notice is improper and use email or other Internet methods, consult the discussion on pages 624-625 for how to minimize your risk.

Section 9. Alternative Meeting Venue.

> *Any regular or special meeting of the Board of Directors may be conducted through use of any means of communication by which all Directors participating may simultaneously hear each other during the meeting.*

Discussion: You can hold a Board meeting by conference call as long as everyone can hear each other. It is not clear whether the law allows you to utilize electronic conferencing for a meeting. You cannot hold a Board meeting by phone by simply calling each Director individually and polling them. The reason is that individual phone calls do not give the Directors who disagree with what the majority decided the option to try to persuade them differently. If your phone calls reveal that all Directors are in agreement, however, you can take action as described in Article III, Section 11 below.

Your Bylaws can prohibit these alternative meeting venues if you desire.

Section 10. No Salary.

> *Directors shall not receive salaries for their Board services but may be reimbursed for expenses related to Board service.*

Discussion: Most nonprofit Directors serve without salary, although you can pay your Board if you want to. If your Board serves without salary and otherwise meets the criteria for "qualified" Directors, they are given some protection from lawsuits. Because of this, some Directors would prefer to serve without salary rather than to take a nominal sum. Directors can be reimbursed for their expenses and still receive this protection. See pages 305-306.

Section 11. Action by Consent.

> *Any action required or permitted by law to be taken at a meeting of the board may be taken without a meeting if a consent in writing, setting forth the action to be taken or so taken, shall be signed by all the Directors.*

Discussion: Notice that the Board can act without a meeting only if *all* Directors agree. A majority is not enough. Your Bylaws can prohibit action by consent if you want to do so.

Article IV: Committees

Section 1. Executive Committee.

The Board of Directors may elect an Executive Committee. The Executive Committee shall have the authority to make on-going decisions between Board meetings and shall have the authority to make financial and budgetary decisions.

Discussion: The law is somewhat unclear about who can be on committees that can make Board-level decisions. See page 293. The safest approach is to have these committees composed only of Directors and to set them up as specified in Article IV, Section 3 below. If you want to have non-Directors on this committee or to have them selected in some way other than as set out in Article IV, Section 3 below, you should get some legal advice.

Section 2. Other Committees.

The Board of Directors may establish such other committees as it deems necessary and desirable. Such committees may exercise the authority of the Board of Directors or may be advisory committees.

Discussion: If the committee the Board sets up does not exercise Board functions (for example, it does fundraising at the Board's direction or it makes recommendations to the Board on personnel matters but does not make the actual decisions), there are no restrictions as to who can be on these committees or how they are selected.

Section 3. Composition of Committees Exercising Board Authority.

Any committee that exercises any authority of the Board of Directors shall be composed of two or more Directors, elected by the Board of Directors by a majority vote of the Directors prescribed by the Board, or if no number is prescribed, of all Directors in office at that time.

Discussion: This section as written requires that any committee that exercises Board functions (that is, makes Board level decisions) must consist of two or more Directors, should not include anyone else, and must be elected not by majority vote of the Directors at the meeting but by a majority of Directors prescribed or in office at that time. Review the discussion on pages 53-54 about fixed and variable size Boards. If you do not have a variable Board, you could amend this to read "a majority of the number of Directors fixed by the Bylaws." Oregon law is somewhat unclear as to whether you can place non-

Directors on these committees or elect committee members by less than a majority vote as described above.

Section 4. Quorum and Action.

> *A quorum at a Committee meeting exercising Board authority shall be a majority of all Committee members in office immediately before the meeting begins. If a quorum is present, action is taken by a majority vote of Directors present.*

Discussion: Your Bylaws may regulate your Committee meetings, notices, quorum, and voting to the same extent it can regulate these matter for the Board.

Section 5. Limitations on the Powers of Committees.

> *No committee may authorize payment of a dividend or any part of the income or profit of the corporation to its directors or officers; may approve dissolution, merger, or the sale, pledge, or transfer of all or substantially all of the corporation's assets; may elect, appoint, or remove directors or fill vacancies on the Board or on any of its committees; nor may adopt, amend, or repeal the Articles, Bylaws, or any resolution by the Board of Directors.*

Discussion: The above limitations are set by the statute and cannot be changed. It is useful to include them so that your committees do not inadvertently perform some actions they cannot perform. Your Bylaws can further limit the authority of Board committees to act, if you want to do so.

Article V: Officers

Section 1. Titles.

> *The officers of this corporation shall be the President and Secretary.*

Discussion: The law says you have to have a President and Secretary, although you can use other terms for these roles and the same person can fill both jobs. The statute does not say exactly what duties these officers shall perform, except that one of them shall be responsible to see that Board minutes are prepared and that one of them shall authenticate the records of the corporation. Your corporation can have more officers than these if you want. The statute does not state that the officers must be Directors, although in many nonprofits they are. If you want to require that your officers be Directors, you can add a sentence that says "All officers of this corporation must be members of the

Board of Directors." You should change the title to read "Titles and Qualifications."

Section 2. Election.

> *The Board of Directors shall elect the officers to serve one year terms. An officer may be reelected without limitation on the number of terms the officer may serve.*

Discussion: The officers may be elected by the Board or appointed or designated as provided in the Articles or Bylaws. If you are going to select officers by some method other than Board election, you should get some legal advice. Although the law does not limit the officers' terms, if the officers are required to be Directors, the Directors' terms cannot exceed five years. Many nonprofits limit the number of consecutive terms an officer can serve to assure new leadership.

Section 3. Vacancy.

> *A vacancy in any office shall be filled not later than the first regular meeting of the Board of Directors following the vacancy.*

Discussion: You can vary this, but you generally do not want too much time to go by with a vacant office.

Section 4. Other Officers.

> *The Board of Directors may elect or appoint other officers, agents and employees as it shall deem necessary and desirable. They shall hold their offices for such terms and have such authority and perform such duties as shall be determined by the Board of Directors.*

Discussion: The Board has a great deal of authority without legal restrictions to appoint other officers. Many corporations chose to have a Treasurer to handle funds. Others may include their Executive Director as an officer so that the Executive Director can sign contracts and forms that require an officer's signature. If you do name your Executive Director as an officer, you need to review some of the provisions above about officers. You may provide that the Executive Director serves as an officer as long as she or he holds the position of Executive Director, rather than requiring the Board to re-elect the Executive Director every year. If you require that your officers be Directors, you will need to modify this unless the Executive Director is a board member. See pages 294-295 for difficulties with this arrangement. Some nonprofit make the Executive Director an *ex officio* nonvoting Board member to get around these difficulties.

Ex officio means that the Director holds a Board position by virtue of an office (in this case, the position of Executive Director).

Section 5. President.

> *The President shall be the chief officer of the corporation and shall act as the Chair of the Board. The President shall have any other powers and duties as may be prescribed by the Board of Directors.*

Discussion: You are free to state the powers of the President to suit your needs; however, keep in mind that it is generally better to draft general descriptions rather than specific ones.

Section 6. Secretary.

> *The Secretary shall have overall responsibility for all recordkeeping and all corporate funds. The Secretary shall perform, or cause to be performed, the following duties: (a) official recording of the minutes of all proceedings of the Board of Directors meetings and actions; (b) provision for notice of all meetings of the Board of Directors; (c) authentication of the records of the corporation; (d) keeping of full and accurate accounts of all financial records of the corporation; (e) deposit of all monies and other valuable effects in the name and to the credit of the corporation in such depositories as may be designated by the Board of Directors; (f) disbursement of all funds when proper to do so; (g) making financial reports as to the financial condition of the corporation to the Board of Directors; and (h) any other duties as may be prescribed by the Board of Directors.*

Discussion: The Bylaws or the Board must delegate to one of the officers the responsibility for preparing minutes of the Directors' and members' meetings and for authenticating the records of the corporation. Most Bylaws delegate this authority to its Secretary.

If your corporation has a Treasurer, the description above needs to be split. Typically, the Treasurer would perform the tasks listed in (d) through (g) above. Both the Secretary and Treasurer should perform the duties listed in (h).

Article VI: Corporate Indemnity

> *This corporation will indemnify to the fullest extent not prohibited by law any person who is made or threatened to be made a party to an action, suit, or other proceeding, by reason of the fact that the person is or was a director or officer of the corporation or a fiduciary within the meaning of the Employee Retirement Income Security Act (or its correspond-*

ing future provisions) with respect to any employee benefit plan of the corporation. No amendment to this Article that limits the corporation's obligation to indemnify any person shall have any effect on such obligation for any act or omission that occurs prior to the later of the effective date of the amendment or the date notice of the amendment is given to the person. The corporation shall interpret this indemnification provision to extend to all persons covered by its provisions the most liberal possible indemnification--substantively, procedurally, and otherwise.

Discussion: Indemnification is described in Chapter 13. This indemnification provision allows the corporation to indemnify its Directors and officers to the fullest extent allowed by law. This is the result desired by many Directors; some will not serve without this. You can choose to provide no indemnification or to provide more limited indemnification.

Article VII: Amendments to Bylaws

These Bylaws may be amended or repealed, and new Bylaws adopted, by the Board of Directors by a majority vote of Directors present, if a quorum is present. Prior to the adoption of the amendment, each Director shall be given at least two days notice of the date, time, and place of the meeting at which the proposed amendment is to be considered, and the notice shall state that one of the purposes of the meeting is to consider a proposed amendment to the Bylaws and shall contain a copy of the proposed amendment.

Discussion: In the nonmembership corporation, it is the Board that amends the Bylaws. You can require a greater vote (but not a lesser one) to amend these Bylaws. You can provide a different period for notice to the Board, either longer or shorter. However, your notice does have to state that one of the purposes of the meeting is to consider a proposed amendment to the Bylaws and shall contain a copy or summary of the proposed amendment.

It is possible to set up a nonprofit corporation whose Bylaws can only be amended with the approval of a third person. These Bylaws do not apply to those situations.

DATE ADOPTED: _____

Discussion: It is helpful to include the date your Bylaws are adopted, so that it is easier to track Bylaws and amendments chronologically and so that you can know what your current Bylaws are.

BYLAWS FOR MEMBERSHIP CORPORATIONS

This section will assist membership corporations in drafting their Bylaws. Be sure before you conclude that you are a membership corporation that you have reviewed the discussion on pages 23-24 and truly are a membership corporation as that term is defined by Oregon law.

In this section, we will examine the "Bylaws of a Membership Corporation" found in the Forms section. This section will first present the language from that sample in italics, then provide information that should be helpful for you in deciding whether this sample fits your situation and, if not, what the permissible modifications are.

If your nonprofit corporation is a homeowner's association, you should read Appendix 4 before reading this section. If your nonprofit corporation is a condominium or timeshare corporation, you should have your attorney draft your Bylaws.

Article I: Purpose

> *This corporation shall be organized and operated exclusively for charitable, scientific, literary, religious, and educational purposes. Subject to the limitations stated in the Articles of Incorporation, the purposes of this corporation shall be to engage in any lawful activities, none of which are for profit, for which corporations may be organized under Chapter 65 of the Oregon Revised Statutes (or its corresponding future provisions).*
>
> *This corporation's primary purpose shall be* _____.

Discussion: The reason for writing this section so broadly is to permit your corporation to operate for any legal purpose. Some corporations do not include the first sentence and simply state their current purpose. If you do this, you are restricted to operating only for that purpose. If you later change what you do, you will need to remember to amend your Bylaws. Many groups that adopt restrictive language forget to amend it when they change their purpose and operate illegally because they are then operating outside their purpose.

Article II: Members

Section 1. Classes and Voting.

> *There shall be one class of members of this corporation. Each member shall be entitled to one vote on all matters for which a membership vote is permitted by law, the Articles of Incorporation, or the Bylaws of this corporation.*

Discussion: If your corporation is a membership corporation, you may be a simple, one-member-one-vote group, or you may have more complex aspects (such as classes of members, chapters, cumulative voting, or delegates). The provisions about membership organizations in these Bylaws are oriented toward the simple, one-member-one-vote group, although most of it applies to all membership corporations. If your corporation has more complex aspects, you should consult Appendix 3 and should get legal help to draft your Bylaws.

The sample clause permits the members to vote on all matters on which members may vote. By law, if you call yourself a membership corporation, your members must be allowed to vote more than once to elect at least one Director. See the discussion about membership corporations on pages 23-24. However, your corporation can choose whether your members vote on other matters on which members can vote, such as amending the Articles and Bylaws (Chapter 28), selling substantially all of the corporation's assets (Chapter 29), mergers (Chapter 29), dissolutions (Chapter 30), conflict of interest matters (pages 302-305), and certain indemnification issues (pages 306-307). If you do not want your members voting on all these matters, you need to change the language in the sample clause.

Remember that your members should *not* be voting on matters pertaining to the management of the corporation, such as hiring, budgets, and policies, unless your Articles authorize this (see pages 38-39).

Section 2. Qualifications.

> *A person shall become a member of the corporation by* _____.

Discussion: You have great flexibility in setting the qualifications of your members. You should consider how much of this you want to put in the Bylaws and how much should be established by the Board. Any provisions you make for this in the Bylaws can only be changed by amending the Bylaws.

One thing you cannot do is define your members in such a way that someone is a member without their consent. Page 317 discusses this in more detail.

Section 3. Termination of Membership.

> *Membership may be terminated by the Board of Directors after giving the member at least 15 days written notice by first class or certified mail of the termination and the reasons for the termination, and an opportunity for the member to be heard by the Board, orally or in writing, not less than five days before the effective date of the termination. The decision of the Board shall be final and shall not be reviewable by any court.*

Discussion: Public Benefit and Mutual Benefit Corporations cannot terminate, expel or suspend members without a fair and reasonable procedure. The procedure set out above is deemed by law to be fair and reasonable. You may change the above procedure and set out your own procedure, but you take the risk that you may have to prove that your procedure is fair and reasonable.

Religious Corporations can expel members without providing any procedure.

Section 4. Annual Meeting.

> *The annual meeting of the members shall be held on _____.*

Discussion: Oregon law requires that you hold an annual meeting. Your Articles or Bylaws are to provide the time.

Your members can also hold regular meetings. Regular meetings are those held at a regularly scheduled time and place. Most membership corporations do not hold regular meetings, other than the annual meeting. However, you can provide for this if it is appropriate for you.

Section 5. Special Meetings.

> *Special meetings of the members shall be held at the call of the Board of Directors, or by the call of the holders of at least five percent of the voting power of the corporation by a demand signed, dated, and delivered to the corporation's Secretary. Such demand by the members shall describe the purpose for the meeting.*

Discussion: Special meetings are all meetings that are not annual or regular meetings. Your Bylaws can vary the requirements listed in the sample clause

for calling a special meeting. However, the notice of the meeting must list the purpose of the meeting.

Section 6. Notice of Meeting.

> *Notice of all meetings of the members shall be given to each member at the last address of record, by first class mail at least 7 days before the meeting, or by means other than first class mail at least 30 but not more than 60 days before the meeting. The notice shall include the date, time, place, and purposes of the meeting.*

Discussion: You must give notice to your members of all meetings. The notice must be fair and reasonable. The notice described above is deemed by law to be fair and reasonable. In some situations, this is the required notice. Those situations are when members are voting on Directors' conflicts of interest (see pages 302-305); certain indemnification matters (see pages 306-307); amendment of Articles (see Chapter 28); amendment of Bylaws (see Chapter 28); merger (see Chapter 29); sale of assets (see Chapter 29); and dissolution (see Chapter 30). If you choose to change the notice that the law deems fair, you will need to have two notice sections: one with the required notice for the actions described above, and the other for all other actions. You also take the risk that your notice may later be found not to be fair.

The notice is sent to members as of a "record date." This is discussed on pages 322-323. If you want to change how that record date is fixed, you can do so in your Bylaws.

The law that provides for notice was drafted in 1989 before the advent of the Internet and does not provide for electronic notice. It seems quite likely that electronic mail is "fair and reasonable" notice as described by the statute. If you take this risk, you are safest if you send your email notice 30 to 60 days before the meeting. You should also consider adopting as a policy the safeguards concerning email discussed on pages 624-625.

Section 7. Quorum and Voting.

> *Those votes represented at a meeting of members shall constitute a quorum. A majority vote of the members represented and voting is the act of the members, unless these Bylaws or the law provide differently.*

Discussion: A *quorum* is the number of votes required to be present at a meeting in order for business to be carried out. The minimum quorum required for a membership meeting is the number of votes present. This means that you will always have a quorum at a membership meeting.

You may require a higher quorum. However, you should think carefully about this before you do so. It is very common among membership groups for the group that requires a higher quorum not to be able to get it. The organization is then unable to elect Directors and take other needed votes. If you are having problems getting members to the membership meetings, you may want to look for other solutions that do not cripple your ability to carry on.

Voting. The majority vote described in the sample clause is the minimum vote you can set, but you can require more than a majority vote if you want. In some situations, the law requires more than a majority vote.

Your corporation can vote by ballot unless your Articles of Bylaws prohibit or limit it. Page 328 discusses how you must do this. If you want to prohibit voting by ballot, you should add to Section 7:

> *There shall be no voting by ballot.*

Section 8. Proxy Voting.

> *There shall be no voting by proxy.*

Discussion: Voting by proxy means that a member can assign someone else to vote for her/him. If you are going to allow proxy voting, you should become familiar with the rules about proxy voting. These are discussed on page 327. If you don't want to deal with proxy voting by your members, you must prohibit it in your Articles or Bylaws.

Section 9. Action by Consent.

> *Any action required or permitted by law to be taken at a meeting of the members may be taken without a meeting if a consent in writing, setting forth the action to be taken or so taken, shall be signed by all the members.*

Discussion: Notice that the members can act without a meeting only if *all* the members agree. A majority is not enough. Your Bylaws can prohibit actions without a meeting if you desire.

Article III: Board of Directors

Section 1. Duties.

> *The affairs of the corporation shall be managed by the Board of Directors.*

Discussion: The law requires that your affairs be managed by your Board. In membership corporations, the members do participate by electing at least one Director and by voting on a limited number of issues, primarily certain conflict or interest and indemnification issues, amendments to the Articles and Bylaws, sale of substantially all the corporation's assets, mergers, and dissolutions. Everything else is handled by the Board. Your Board can delegate some of its authority to committees if done properly. See pages 293.

If your corporation allows major decisions to be made by anyone other than the Board or a committee of the Board, you must state this in your Articles of Incorporation. For example, if the members vote on the budget or hire staff, this should be in your Articles. If you have this kind of structure, then the sample Bylaws in the Forms section will probably not apply to your group. You will need to see an attorney for help in drafting your Bylaws. You should be aware that, if you are applying for tax exemption, this unusual structure may create problems for your application.

Section 2. Number and Qualifications.

> *The number of Directors may vary between a minimum of three and a maximum of fifteen.*

Discussion: If you are a Public Benefit Corporation, you must have at least three Directors. If you are a Mutual Benefit or Religious Corporation, you can have as few as one. There is no legal ceiling on how many Directors you can have.

This section of your Bylaws can specify the exact number of Directors, which is called a *fixed number* (for example, "The number of Directors shall be five."). Alternatively, as above, this section can set a *variable number* of Directors. One reason for a variable number is to allow the Board to expand or contract within the limits you set without going through the procedure to amend the Bylaws. Many organizations like the variable number provision because of the flexibility it gives them.

If you decide on a variable number of Directors, you need to be aware that it is often important to know the size of your Board. For example, this figure is used in calculating a quorum and in calculating how many votes are needed to set up a committee that exercises Board functions. You have two choices about how to set the official size of your Board for these purposes. Your Board at a meeting can set the number of Directors and reflect this in the minutes. Later, if it adds or subtracts members, it can reset the number at a meeting and reflect that in the minutes. If you follow this procedure, the Board is said to be *prescribing* the size of the Board. This is then the figure from which quorum and committee calculations

are made. There may be a difference between the prescribed number of Directors and the actual number of Directors. For example, the Board may have decided to have eleven positions and filled them; later, two Directors resigned and were not replaced. Your prescribed size is still eleven, and this is the number that should be used for calculations involving Board size, such as setting a quorum.

The second method you can use to set Board size is to simply elect Directors without setting a number. If that is what you do, your Board size is the number of Directors in office immediately before the meeting.

The sample section above does not set out any particular qualifications for Directors. All Directors must be individuals, as opposed to corporations or some other legal entity. You can set out any other qualifications that you want.

One area of some interest is whether you can discriminate in setting the qualifications for your Board. For example, an organization devoted to helping Vietnamese immigrants may want to provide that some or all of its Board consist of people of Vietnamese ancestry. The law is somewhat unclear in this area, but in most cases it appears that you can write in these types of qualifications. You should get legal advice for your own situation.

Section 3. Term and Election.

> *The term of office for Directors shall be two years. A Director may be reelected without limitation on the number of terms she or he may serve. The Board shall be elected by the members at the annual meeting of the members by a majority vote of the members represented and voting.*

Discussion: The maximum term of office in Oregon for elected Directors is five years. Your Bylaws should not provide that a Director is elected until replaced, without setting a limit on the term, because this could violate the five year rule. A Director can be re-elected without limitation, although you may choose to limit the number of terms a Director may serve. Many Boards do this to assure new leadership.

Many organizations want to provide for staggered terms for their Directors, so that the Board always has some experienced members in place. One way to do this is to divide the total number of Directors into groups and elect each group at different times. For example:

> *Except for the initial adjustments of shorter terms needed in order to create staggered terms, the term of office for Directors shall be two years. The Board shall make provisions to stagger the terms of Directors so that each year the*

terms of as close as possible to one-half of the Directors shall expire. A Director may be reelected without limitation on the number of terms she or he may serve. The Board shall elect its own members, except that a Director shall not vote on that member's own position.

If you have a variable size Board, you can accomplish staggering without this awkward language in your Bylaws. You can do this by setting your Board size the first year at one-half of what you eventually want, and the next year add the other one-half of the Directors.

Your Bylaws may provide that your members elect the Board at some time other than the annual meeting. The clause above requires that the Directors are elected by majority vote. You may provide for any reasonable method of election that you want.

Some corporations have Directors who are appointed or designated, rather than elected. Others have some Directors elected by members and some chosen by the Board or appointed or designated. Those situations are outside the scope of these Bylaws. If you want to provide for this, you should review page 18 and get legal advice.

Section 4. Removal.

Any Director may be removed, with or without cause, at a meeting called for that purpose, by a vote of a majority of the members entitled to vote at an election of Directors.

Discussion: Although it sounds harsh, many corporations opt to permit removal of Directors with or without cause. This means that you do not need to have a reason to remove a Director. If you try to limit removal only to certain circumstances, you run a serious risk that a situation will arise that you did not anticipate that requires removal of a Director and that is not spelled out in your reasons for removal. You are then stuck with a Director you don't want. Alternatively, the members may vote to terminate the Director and the Director then has grounds for a lawsuit.

In membership corporations, if you want to provide that your members can only remove Directors for certain reasons (that is, "for cause"), then you must include this in your Articles of Incorporation. Putting it in your Bylaws alone is not enough. If the Articles do not require cause in order to remove Directors, the members can remove with or without cause regardless of what your Bylaws say. If you do decide to specify reasons for removal in your Articles, you should get some legal help.

In order for the members to remove a Director, the number of votes cast for removal must be a sufficient number to elect the Director. The sample provision above requires removal by a majority of members entitled to vote at an election, because under Section 3 above, Directors are elected by a majority vote. If Section 3 had required a higher vote to elect the Board, Section 4 would have to require a higher vote to remove the Board.

A membership corporation may also permit its *Board of Directors* to remove a Director. You can do this by providing in your Bylaws (or Articles) the reasons for removal. This provision must be in your Bylaws (or Articles) at the time that the Director being removed took office. If it was, then the Board can remove its Director by a vote of the majority of Directors then in office. If your Bylaws (or Articles) do not set out cause for removing a Director, the Board cannot remove the Director.

A Religious Corporation may require a different procedures by which the Board or any person can remove (with or without cause) a Director elected by the members. A Religious Corporation can even limit or prohibit the ability of a court to remove Directors.

Section 5. Vacancies.

> *Vacancies on the Board of Directors and newly created board positions shall be filled by a majority vote of the Directors then on the Board of Directors.*

Discussion: Your Bylaws can permit the Board or your members to fill vacancies. The provision above lets the Board fill it. Many groups choose to do this because they do not want to call a special membership meeting to fill the vacancy. Notice that the wording above requires the vote of a majority of all Directors in office, not just a majority of those at the meeting, to fill a vacancy. You could word your Bylaws to allow the Board to fill a vacancy with a majority at the meeting; however, if the directors remaining in office are not enough to constitute a quorum, the law requires that they can fill the vacancy only by a majority vote of all the directors remaining in office. To keep it simple, we suggest that you use only one approach, which will work no matter what your situation is.

If you chose to have members fill the vacancy, you could use the following clause:

> *Vacancies on the Board of Directors and newly created board positions shall be filled by a majority vote of the members at a membership meet-*

ing called for that purpose within a reasonable time after the creation of the vacancy or position.

If you wish, your Bylaws can make different provisions than the one above for filling vacancies. For example, your President could appoint Directors to fill vacancies.

Section 6. Quorum and Action.

A quorum at a board meeting shall be a majority of the number of Directors prescribed by the Board, or if no number is prescribed, by a majority of all Directors in office immediately before the meeting begins. If a quorum is present, action is taken by a majority vote of directors present. Where the law requires a majority vote of directors in office to establish committees that exercise Board functions, to amend the Articles of Incorporation, to sell assets not in the regular course of business, to merge, to dissolve, or for other matters, such action is taken by that majority as required by law.

Discussion: A *quorum* is the number of Directors who must be present at a Board meeting in order for it to be held. If fewer Directors than the number set as a quorum show up, the Board cannot do any business and must reschedule the meeting.

The calculation of the number of Directors needed to make a quorum is complicated by the fact that the Bylaws of some nonprofit corporations provide for a fixed number of Directors and some have a variable number.

If your Bylaws have a *fixed number of Directors*, then you should modify the wording in the sample clause above to state that the quorum is a majority (or some other percentage greater than one-third) of the fixed number of Directors. Be aware that if the actual number of Directors falls below the number fixed by your Bylaws (which can happen when a Director resigns or the term ends and she or he is not replaced or through some other cause), you still use the number fixed by your Bylaws (and not the number of Directors in office) in calculating whether you have a quorum.

If your Bylaws provide that you have a *variable Board size*, then you must determine how you set the actual number of your Directors before you can figure out your quorum rules. Some corporations with variable size Boards set the exact number of Directors by a Board resolution, and others do not do this, but simply elect the Board without ever saying what the precise number will be.

The rather awkward wording in the sample clause above is wording that would be used by any corporation that has a variable size Board. The clause refers to "a majority of the number of Directors prescribed by the Board, or if no number is prescribed, a majority of the number in office immediately before the meeting begins." With this clause, if you have a variable size Board and the Board has acted to set (prescribe) the number of Directors, you would use that number as the number from which to calculate your quorum. The number the Board sets may not be the actual number of Directors you have, because you may have vacancies on the Board due to resignations, deaths, removals, or other factors. If you have a variable Board, and your Board has not set the number of its members, then under this clause you would use the number in office immediately before the meeting begins in order to calculate your quorum figure.

You can raise the number of Directors required for a quorum to be more than the majority stated above. You can lower it to be as little as one-third of the fixed or prescribed Directors as described above. You cannot set the quorum at less than one-third. Many groups feel that one-third is too few Directors to conduct a meeting. The sample Bylaw above follows the common practice of setting the quorum at a majority of the Board.

Voting. Once a quorum is present, action must be taken by at least a majority vote of the Directors present. You can require more than a majority vote but not less. The majority must be of the Directors *present*, and not just the Directors *voting*. Consequently, if 11 Directors are present but only 9 vote (because 2 abstain), you need 6 votes to decide on an action. It is a good idea to spell this out in your Bylaws, as the sample clause above does.

There are some types of action (described in the sample clause above) which require the vote of a majority of Directors *in office* in order to be effective. These circumstances are put into the Bylaws so that you are sure to know the proper vote needed in those circumstances.

Section 7. Regular Meetings.

> *Regular meetings of the Board of Directors shall be held at the time and place to be determined by the Board of Directors. No other notice of the date, time, place, or purpose of these meetings is required.*

Discussion: Regular meetings are those in which the time and place is regularly scheduled by the Board (for example, the first Monday of the month at 7:00 p.m. at the corporation's office). The law does not require additional notice of these meetings. If you change the time or place, this will make the meeting a special meeting, and you must give the notice you require for special meetings.

If you want, your Bylaws can require that you give notice of your regular meetings. The drawback is that, if your Bylaws require you to give notice and you don't, the action taken at the meeting may be invalid. Your Board may choose to give notice of regular meetings without such notice being required in your Bylaws.

Section 8. Special Meetings.

> *Special meetings of the Board of Directors shall be held at the time and place to be determined by the Board of Directors. Notice of such meetings, describing the date, time, place, and purpose of the meeting, shall be delivered to each Director personally or by telephone or by mail not less than two days prior to the special meeting.*

Discussion: Special meetings are all meetings that are not regular meetings. Your Bylaws may require a longer or shorter period of notice for special meetings than that stated above. There are only certain circumstances in which you are required to state the purpose of special meetings and your Bylaws could require that only in those cases do you need to state the purpose in your special meeting notice. Rather than lengthen the Bylaws with this kind of detail, these sample Bylaws provide that you will always state the purpose of a special meeting.

You should be aware that the presiding officer of the Board, the President, or twenty percent of the Directors then in office may call and give notice of the meeting of the Board. You can make different provisions than this in your Bylaws if you wish.

The law that provides for notice was drafted in 1989 before the advent of the Internet and does not provide for electronic notice. If you decide to take the risk that your notice is improper and use email or other Internet methods, consult the discussion on pages 624-625 for how to minimize your risk.

Section 9. Alternative Meeting Venue.

> *Any regular or special meeting of the Board of Directors may be conducted through use of any means of communication by which all Directors participating may simultaneously hear each other during the meeting.*

Discussion: You can hold a Board meeting by conference call as long as everyone can hear each other. It is not clear whether the law allows you to utilize electronic conferencing for a meeting. You cannot hold a Board meeting by phone by simply calling each Director individually and polling them. The reason is that individual phone calls do not give the Directors who disagree

with what the majority decided the option to try to persuade them differently. If your phone calls reveal that all Directors are in agreement, however, you can take action as described in Article III, Section 11 below.

Your Bylaws can prohibit these alternative meeting venues if you desire.

Section 10. No Salary.

> *Directors shall not receive salaries for their Board services but may be reimbursed for expenses related to Board service.*

Discussion: Most nonprofit Directors serve without salary, although you can pay your Board if you want to. If your Board serves without salary and otherwise meets the criteria for "qualified" Directors, they are given some protection from lawsuits. Because of this, some Directors would prefer to serve without salary rather than to take a nominal sum. Directors can be reimbursed for their expenses and still receive this protection. See pages 305-306.

Section 11. Action by Consent.

> *Any action required or permitted by law to be taken at a meeting of the Board may be taken without a meeting if a consent in writing, setting forth the action to be taken or so taken, shall be signed by all the Directors.*

Discussion: Notice that the Board can act without a meeting only if *all* Directors agree. A majority is not enough. Your Bylaws can prohibit action by consent if you want to do so.

Article IV: Committees

Section 1. Executive Committee.

The Board of Directors may elect an Executive Committee. The Executive Committee shall have the authority to make on-going decisions between Board meetings and shall have the authority to make financial and budgetary decisions.

Discussion: The law is somewhat unclear about who can be on committees that can make Board-level decisions. See page 293. The safest approach is to have these committees composed only of Directors and to set them up as specified in Article IV, Section 3 below. If you want to have non-Directors on this committee or to have them selected in some way other than as set out in Article IV, Section 3 below, you should get some legal advice.

Section 2. Other Committees.

The Board of Directors may establish such other committees as it deems necessary and desirable. Such committees may exercise the authority of the Board of Directors or may be advisory committees.

Discussion: If the committee the Board sets up does not exercise Board functions (for example, it does fundraising at the Board's direction or it makes recommendations to the Board on personnel matters but does not make the actual decisions), there are no restrictions as to who can be on these committees or how they are selected.

Section 3. Composition of Committees Exercising Board Functions.

Any committee that exercises any authority of the Board of Directors shall be composed of two or more Directors, elected by the Board of Directors by a majority vote of the Directors prescribed by the Board, or if no number is prescribed, of all Directors in office at that time.

Discussion: This section as written requires that any committee that exercises Board functions (that is, makes Board level decisions) must consist of two or more Directors, should not include anyone else, and must be elected not by majority vote of the Directors at the meeting but by a majority of Directors prescribed or in office at that time. Review the discussion on pages 70-71 about fixed and variable size Boards. If you do not have a variable Board, you could amend this to read "a majority of the number of Directors fixed by the Bylaws." Oregon law is somewhat unclear as to whether you can place non-Directors on these committees or elect committee members by less than a majority vote as described above.

Section 4. Quorum and Action.

A quorum at a Committee meeting exercising Board authority shall be a majority of all Committee members in office immediately before the meeting begins. If a quorum is present, action is taken by a majority vote of Directors present.

Discussion: Your Bylaws may regulate your Committee meetings, notices, quorum, and voting to the same extent it can regulate these matter for the Board.

Section 5. Limitations on the Powers of Committees.

No committee may authorize payment of a dividend or any part of the income or profit of the corporation to its directors or officers; may ap-

prove dissolution, merger, or the sale, pledge, or transfer of all or substantially all of the corporation's assets; may elect, appoint, or remove directors or fill vacancies on the board or on any of its committees; nor may adopt, amend, or repeal the Articles, Bylaws, or any resolution by the Board of Directors.

Discussion: The above limitations are set by the statute and cannot be changed. It is useful to include them so that your committees do not inadvertently perform some actions they cannot perform. Your Bylaws can further limit the authority of Board committees to act, if you want to do so.

Article V: Officers

Section 1. Titles.

The officers of this corporation shall be the President and Secretary.

Discussion: The law says you have to have a President and Secretary, although you can use other terms for these roles and the same person can fill both jobs. The statute does not say exactly what duties these officers shall perform, except that one of them shall be responsible to see that Board minutes are prepared and that one of them shall authenticate the records of the corporation. Your corporation can have more officers than these if you want. If you want to require that your officers be Directors, you can add a sentence that says "All officers of this corporation must be members of the Board of Directors." You should change the title to read "Titles and Qualifications."

Section 2. Election.

The Board of Directors shall elect the officers to serve one year terms. An officer may be reelected without limitation on the number of terms the officer may serve.

Discussion: Oregon law does not require that the officers must be Directors, although in many nonprofits they are. If you want to require that all officers be directors, you can add the following sentence to the section above:

Only members of the Board of Directors can be officers of this corporation.

The officers may be elected by the Board (as above) or by your members or appointed or designated as provided in the Articles or Bylaws. If you are going to select officers by some method other than Board or member election, you should get some legal advice. Although the law does not limit the officers'

terms, if the officers are required to be Directors, the Directors' terms cannot exceed five years. Many nonprofits limit the number of consecutive terms an officer can serve to assure new leadership.

Section 3. Vacancy.

> *A vacancy in any office shall be filled not later than the first regular meeting of the Board of Directors following the vacancy.*

Discussion: You can vary this, but you generally do not want too much time to go by with a vacant office.

Section 4. Other Officers.

> *The Board of Directors may elect or appoint other officers, agents and employees as it shall deem necessary and desirable. They shall hold their offices for such terms and have such authority and perform such duties as shall be determined by the Board of Directors.*

Discussion: The Board has a great deal of authority without legal restrictions to appoint other officers. Many corporations chose to have a Treasurer to handle funds. Others may include their Executive Director as an officer so that the Executive Director can sign contracts and forms that require an officer's signature. If you do name your Executive Director as an officer, you need to review some of the provisions above about officers. You may provide that the Executive Director serves as an officer as long as she or he holds the position of Executive Director, rather than requiring the Board to re-elect the Executive Director every year. If you require that your officers be Directors, you will need to modify this unless the Executive Director is a board member. See pages 294-295 for difficulties with this arrangement. Some nonprofit make the Executive Director an *ex officio* nonvoting Board member to get around these difficulties. *Ex officio* means that the Director holds a Board position by virtue of an office (in this case, the position of Executive Director).

Section 5. President.

> *The President shall be the chief officer of the corporation and shall act as the Chair of the Board. The President shall have any other powers and duties as may be prescribed by the Board of Directors.*

Discussion: You are free to state the powers of the President to suit your needs; however, keep in mind that it is generally better to draft general descriptions rather than specific ones.

Section 6. Secretary.

The Secretary shall have overall responsibility for all recordkeeping and all corporate funds. The Secretary shall perform, or cause to be performed, the following duties: (a) official recording of the minutes of all proceedings of the Board of Directors and members' meetings and actions; (b) provision for notice of all meetings of the Board of Directors and members; (c) authentication of the records of the corporation; (d) keeping of full and accurate accounts of all financial records of the corporation; (e) deposit of all monies and other valuable effects in the name and to the credit of the corporation in such depositories as may be designated by the Board of Directors; (f) disbursement of all funds when proper to do so; (g) making financial reports as to the financial condition of the corporation to the Board of Directors; (h) maintaining current and accurate membership lists; and (i) and any other duties as may be prescribed by the Board of Directors.

Discussion: The Bylaws or the Board must delegate to one of the officers the responsibility for preparing minutes of the Directors' and members' meetings and for authenticating the records of the corporation. Most Bylaws delegate this authority to its Secretary.

If your corporation has a Treasurer, the description above needs to be split. Typically, the Treasurer would perform the tasks listed in (d) through (g) above. Both the Secretary and Treasurer should perform the duties listed in (h).

Article VI: Corporate Indemnity

This corporation will indemnify to the fullest extent not prohibited by law any person who is made or threatened to be made a party to an action, suit, or other proceeding, by reason of the fact that the person is or was a director or officer of the corporation or a fiduciary within the meaning of the Employee Retirement Income Security Act (or its corresponding future provisions) with respect to any employee benefit plan of the corporation. No amendment to this Article that limits the corporation's obligation to indemnify any person shall have any effect on such obligation for any act or omission that occurs prior to the later of the effective date of the amendment or the date notice of the amendment is given to the person. The corporation shall interpret this indemnification provision to extend to all persons covered by its provisions the most liberal possible indemnification--substantively, procedurally, and otherwise.

Discussion: Indemnification is described in Chapter 13. This indemnification provision allows the corporation to indemnify its Directors and officers to

the fullest extent allowed by law. This is the result desired by many Directors; some will not serve without this. You can choose to provide no indemnification or to provide more limited indemnification.

Article VII: Amendments to Bylaws

> *Both the Board of Directors and the members must vote to amend or repeal these Bylaws or to adopt new ones. The Board of Directors must vote to amend or repeal these Bylaws or to adopt new ones by a majority vote of directors present, if a quorum is present. Prior to the adoption of the amendment, each Director shall be given at least two days notice of the date, time, and place of the meeting at which the proposed amendment is to be considered, and the notice shall state that one of the purposes of the meeting is to consider a proposed amendment to the Bylaws and shall contain a copy of the proposed amendment. The members must vote to amend or repeal these Bylaws or to adopt new ones by a majority vote of the members represented and voting. Prior to the adoption of the amendment, each member shall be given the notice of meeting required by these Bylaws and the notice shall state that one of the purposes of the meeting is to consider a proposed amendment to the Bylaws and shall contain a copy of the proposed amendment.*

Discussion: In the membership corporation, your Bylaws may provide that they can be amended by the Board, by the members, or by both. If you want to give the Board the sole authority to amend Bylaws, you must provide in Article II, Section 1 that members do not have the right to amend Bylaws. You can do this by adding "except that members may not amend or repeal Bylaws or adopt new ones" to the Article II, Section 1 sample provision in this book. You may then use this provision as Article VII to give the Board the sole authority to amend Bylaws:

> *These Bylaws may be amended or repealed and new Bylaws adopted by the Board of Directors by a majority vote of Directors present, if a quorum is present. Prior to the adoption of the amendment, each Director shall be given at least two days notice of the date, time, and place of the meeting at which the proposed amendment is to be considered, and the notice shall state that one of the purposes of the meeting is to consider a proposed amendment to the Bylaws and shall contain a copy of the proposed amendment.*

If your Bylaws give members the right to vote on Bylaws, the Board cannot amend the Bylaws to increase the quorum required for any member action or to add to, change or delete the vote required for any member action must be approved by the members. If you want to provide that only the Board amends the

Bylaws for all other purposes but want to retain these protections for member action, you can use a provision like the one below.

> *These Bylaws may be amended or repealed, and new Bylaws adopted, by the Board of Directors by a majority vote of Directors present, if a quorum is present. Any amendment to the Bylaws to increase the quorum required for any member action or to add to, change or delete the vote required for any member action must be approved by the members. Prior to the adoption of the amendment, each Director shall be given at least two days notice of the date, time, and place of the meeting at which the proposed amendment is to be considered, and the notice shall state that one of the purposes of the meeting is to consider a proposed amendment to the Bylaws and shall contain a copy of the proposed amendment.*

You can require a greater vote (but not a lesser one) to amend your Bylaws. You can provide a different period for notice to the Board, either longer or shorter. However, your notice does have to state that one of the purposes of the meeting is to consider a proposed amendment to the Bylaws and shall contain a copy or summary of the proposed amendment.

If you want to provide that only the members can amend the Bylaws, you need to put a provision to that effect in your Articles. Putting it in your Bylaws alone is not enough.

If you want to provide that only the members can amend the Bylaws, you will need to put a provision to that effect in your Articles. Putting it in your Bylaws alone is not enough.

It is possible to set up a nonprofit corporation whose Bylaws can only be amended with the approval of a third person. You should get legal help to draft this type of provision.

DATE ADOPTED: _____

Discussion: It is helpful to include the date your Bylaws are adopted, so that it is easier to track Bylaws and amendments chronologically and so that you can know what your current Bylaws are.

Consult Appendix 1 if you would like information about source material related to this Chapter.

If you were using this chapter to draft your Bylaws as part of the process in Chapter 3 of setting up your Oregon nonprofit corporation, you should now return to Chapter 3 and finish that process.

Part II

THE TAX-EXEMPT ORGANIZATION

5 FEDERAL TAX-EXEMPT STATUS

Your group becomes a nonprofit corporation by meeting the requirements of Oregon law. However, being a nonprofit corporation does not automatically mean that you are exempt from paying all federal, state, regional and county taxes. In order to avoid paying corporate income taxes and property taxes, you must apply for and receive tax exemption from the federal, state, regional and county governments separately. Not every nonprofit corporation will qualify for these exemptions.

This chapter discusses federal tax exemption; Chapter 11 discusses state, regional and county tax exemptions.

Internal Revenue Code Section 50l(c)(3) of the federal tax code allows an exemption for religious, charitable, scientific, literary, and educational groups, and groups testing for public safety, or working to foster national or international sports competition, or to prevent cruelty to children or animals. Because this exemption offers the most benefits, it is the exemption that most groups that provide public benefits seek and will be the focus of most of this chapter. When people talk about "being tax-exempt," they are usually referring to exemption under §501(c)(3).

Many groups with a "public service" orientation that cannot qualify under §501(c)(3) (usually because of lobbying rules – see Chapter 8) seek exemption under §501(c)(4) as a social welfare organization. Mutual benefit groups may be exempt from income taxation under a number of different sections; this chapter will discuss the major ones. Groups that primarily pursue a political agenda may be exempt under §527. At the end of the chapter is some information that may be of interest to all types of tax-exempt groups.

THIS CHAPTER COVERS

- **Tax Exemption: Do You Want It?**
- **§501(c)(3): Public Benefit and Religious Organizations**
- **§501(c)(4): Civic Leagues and Social Welfare Organizations**
- **Other Exempt Groups**
- **General Information for Organizations Seeking Any Type of Tax Exemption**

TAX EXEMPTION: DO YOU WANT IT?

Being recognized as a nonprofit group is a status that state law confers on your group. The fact that you are nonprofit does not mean that you are automatically exempt from paying taxes. Whether or not you are tax-exempt is decided by the federal, state, county, or local taxing agency involved. This chapter discusses federal tax exemption.

The federal taxing agency is the Internal Revenue Service. If your group is granted an exemption under any of the sections of the Internal Revenue Code that grant tax exemption, you will not have to pay federal income tax (except on unrelated business income). There are a few exceptions to this rule that will not apply to most readers. However, groups exempt under §501(c)(3) have some additional benefits:

- Donors who make donations to §501(c)(3) groups (except to public safety groups) can deduct the donations as a charitable contribution on their tax returns (to the extent allowed by law). This encourages contributions to (c)(3) groups.

- Foundations can make grants to §501(c)(3) groups without jumping through special hoops. Consequently, most foundations will give only to §501(c)(3) organizations.

Because of these advantages, §501(c)(3) exemption is the status that many public benefit and religious groups seek.

There are some drawbacks to applying for tax exemption under any of the sections granting exemption, and particularly under §501(c)(3). To apply, you must fill out a fairly involved application and pay a fee (see page 111). In addition, your organization will have to file informational returns and may be subject to IRS scrutiny. There are more rules to follow, and occasionally the consequences can be quite drastic if you fail to follow the rules (see, for example, the discussion about Board liabilities on pages 270-272).

For many groups, the benefits outweigh the disadvantages. However, you should examine whether you need tax-exempt status before you go through the process. If you are applying to be exempt because you do not want to pay federal income tax, consider whether you will have a federal income tax obligation. Many nonprofit groups will not pay federal income tax even if they file the profit corporation return, because their income comes from sources (like gifts and grants) that are not taxable, or because they spend all their income on items that are deductible as expenses.

If you are operating for public benefit, are you looking to attract funding (such as foundation money or donations that require a charitable deduction) that requires you be exempt under §501(c)(3)? If not, but you want protection from paying income tax, you may want to consider applying under §501(c)(4), which is not as closely regulated as §501(c)(3).

If you are nonprofit but not tax-exempt, you should be aware that this creates some interesting accounting issues for you. You may need to get professional help.

§501(C)(3): PUBLIC BENEFIT AND RELIGIOUS ORGANIZATIONS

§501(c)(3) grants an exemption from income taxation for charitable, religious, educational, scientific, literary groups and for groups testing for public safety or operating to foster national or international amateur sports competitions or to prevent cruelty to animals or children. The advantages to having this status are described above.

This section will discuss:

- Who qualifies for §501(c)(3) exemption,
- Classification of §501(c)(3) groups as private foundations and public charities and what this characterization means,
- Who must file the application,
- When the exemption is effective, and
- What type of ruling you should seek.

Who Qualifies for §501(c)(3) Exemption

In order to qualify as exempt under §50l(c)(3), your group must be able to show these things:

- You are a nonprofit corporation, community chest, fund, foundation or association; *and*
- Your purposes are exempt; *and*

• You are both organized and operated exclusively for exempt purposes; *and*

• No private person or profit corporation is profiting from your group; *and*

• You group does not do substantial lobbying or engage in any political activity.

Structure

The law requires that your group be a corporation, a community chest, a fund, or a foundation. In some very restricted circumstances, the IRS recognizes limited liability companies as exempt. You will need legal help if you are a limited liability company.

• You are a *corporation* if you are organized and operate as a corporation under Oregon law, or under the laws of another state. Associations and insurance companies that are taxed as corporations are also considered corporations for purposes of this definition.

• The law provides very little definition of a *community chest*, a *fund*, or a *foundation*. A *community chest* results from a cooperative fund-raising effort. Where the funding comes from a single individual or is established for a very specific purpose, it may be treated as a *fund*. A *foundation* is generally considered to be a nongovernmental nonprofit organization having a principal fund of its own managed by its own directors or trustees, whose purpose is to serve the common welfare. In most cases, unincorporated associations and trusts will be treated as foundations.

In general, the law is quite expansive about including all kinds of nonprofit group structures as eligible for tax exemption as long as the structure complies with the other requirements of the tax-exempt laws. This book focuses primarily on corporations.

Exempt Purposes

501(c)(3) recognizes these purposes as exempt: charitable, educational, scientific, religious, literary, testing for public safety, fostering national or international amateur sports competitions or prevention of cruelty to animals or children. Health clinics, synagogues, churches, women's centers, schools, social services, foundations and charities are examples of groups that can qualify under this section.

Charitable

Your group is classified as *charitable* if you provide for the relief of the poor or underprivileged; work to advance science, religion or education; assist in maintaining public works; promote the arts; or promote social welfare by lessening the burdens of government, lessening neighborhood tensions, eliminating discrimination, defending civil rights secured by law, or combatting community deterioration. Your group must benefit a broad class of beneficiaries. A group that expects all of its costs to be paid by the users or beneficiaries of its services will frequently have difficulty obtaining exemption as a charitable organization. To be exempt, charitable groups usually must get some of their finances elsewhere, such as from government subsidies or private donations. Nonprofit hospices, low-income housing organizations, hospitals, land conservancies, the American Red Cross and relief organizations are examples.

Educational

The term *educational* refers to teaching individuals to develop their capabilities or instructing the public on subjects useful to the individual or beneficial to the community. Schools, resource centers for racial and ethnic groups, museums, orchestras, and public discussion groups are examples of educational groups. By virtue of a special statute, childcare agencies qualify as educational if substantially all of the care is for the purpose of permitting individuals to be employed, and the services are provided away from the child's home and are available to the general public.

The IRS and the courts have struggled with groups that advocate for a particular viewpoint and the rules are not clear for these groups. Generally, the IRS seems to accept a fairly wide range of advocacy, unless your viewpoints are quite extreme.

The IRS and the courts have struggled with groups claiming to be educational that advocate for a particular viewpoint and the rules are not clear for these groups. Generally, the IRS seems to accept a fairly wide range of advocacy, unless your viewpoints are quite extreme. If your group represents a particular position, the IRS looks to the method you use to present your views. Your method should present a factual foundation for your viewpoint. The IRS views the following as indications that your method is not educational: viewpoints unsupported by fact that are a significant part of your communications; distorted facts; substantial use of inflammatory and disparaging terms and conclusions based on emotions rather than objectivity; and approaches that are not aimed at developing an understanding on the part of those you communicate with, given their backgrounds.

Scientific

Organizations with *scientific* purposes are exempt only if they serve a public rather than a private interest. Scientific research is regarded as carried on in the public interest if the results are made available to the public; if the research was conducted for a government agency; or if the research was directed toward benefiting the public. Special rules apply for scientific research funded by for-profit companies. Read IRS Publication 557's section on "Scientific Organizations" if you plan to do scientific research. Organizations that promote motion picture photography and medical services for poor communities have been found exempt.

Religious

A *religious* organization is one in which its particular beliefs are truly and sincerely held and in which its practices and rituals are not illegal. Not all religious organizations are churches. Exemptions as religious organizations have been given for nonprofits that prepare food products to satisfy religious dietary rules, facilities that bring together young people and religious leaders, and federations of religious groups. If you are a religious organization, you should get and read IRS Publication 1828 "Tax Guide for Churches and Religious Organizations." Because of the constitutional protections for religious groups, the tax laws often contain twists to avoid unconstitutional actions. This publication contains a great deal of information helpful to religious organizations about the special provisions of the law.

Literary

The law does not define what a *literary* organization is. Any group that would qualify as a literary organization would probably also qualify as an educational organization.

Public Safety

Organizations that test for *public safety* are nonprofit groups that do consumer testing. An example would be an organization that tests electrical appliances for safety. Unlike all other groups exempt under §501(c)(3), contributors to organizations that test for public safety cannot claim a charitable deduction for their contributions.

Amateur Sports

If your group fosters national or international *amateur sports* competitions, you may receive tax-exempt status under §501(c)(3) as long as no part of your

activities involve the provision of athletic facilities or equipment. However, if your group is a *qualified amateur sports organization*, you can provide facilities and equipment to your members, and your group can be local or regional in nature, rather than national or international. A qualified amateur sports organization is any organization organized and operated exclusively to foster national or international amateur sports competition primarily by conducting national or international competition in sports or by developing amateur athletes for national or international sports competitions. Examples are the U.S. Olympic Committee and Little League organizations.

Prevention of Cruelty

There has been little definition of the term *prevention of cruelty to animals and children*. Types of organizational purposes that would qualify under this section include organizations working against child abuse, humane societies, animal rights groups, and animal sanctuaries.

Special Issues

There are some kinds of groups for which the IRS has developed special guidelines, including low income housing, environmental organizations, organizations providing legal services, organizations doing research and schools. If your organization seems to fit one of these categories, you should get some professional help *before* you file your application.

Organized and Operated

In order to qualify for tax exemption under §50l(c)(3), you must be both *organized* and *operated* exclusively for an exempt purpose. In true legal fashion, the word *exclusively* has been interpreted to mean "primarily" or "substantially."

To determine if you are organized for an exempt purpose, the IRS will look at your Articles of Incorporation and your Bylaws. Chapter 3 contains the provisions that should be inserted in the Articles to meet the organizational requirements.

To determine if you are *organized* for an exempt purpose, the IRS will look at your Articles of Incorporation and your Bylaws. These documents must limit your purposes to one or more exempt purposes and cannot contain words allowing you to engage in activities that further a nonexempt purpose, except as an insubstantial part of your activities. Chapter 3 contains the provisions that

should be inserted in the Articles to meet the organizational requirements. Be sure that you are prepared to comply with these provisions before you copy them.

You are *operated* for an exempt purpose if in your actual operations you engage primarily in activities which further your exempt purpose. There must be a fairly direct connection between the activity of your group and your exempt purpose. For example, a group that is set up to provide music and cultural enrichment to the public but which in fact spends most of its time and earns most of its money from the sale of food and drinks will probably not be given an exemption. The IRS engages in an ongoing check to be sure this requirement is observed through your annual filing of Form 990.

One problem encountered by some groups seeking tax exemption is that the group's main activity is to run a business (provide goods or services for a fee) and the business is similar to a commercial (for-profit) business. The IRS believes that running this kind of business is not an exempt purpose.

One problem encountered by some groups seeking tax exemption is that the group's main activity is to run a business (provide goods or services for a fee) and the business is similar to a commercial (for-profit) business. The IRS believes that running this kind of business is not an exempt purpose. You need to distinguish your group from a commercial business in order to get an exemption. To do this, it will help if you can show that you engage in other exempt activities besides the business; the business is charitable because it provides goods or services at less than your cost to the needy; or the goods are provided or the service is performed in some way that is different than a commercial business and that furthers your exempt purpose. The fact that you plan to use the money from the business for your other exempt purposes does **not** help you.

> *Example*: A nonprofit bookstore will probably be denied an exemption as long as there is nothing to distinguish it from other bookstores. However, a nonprofit theater group charging for theatrical performances by little known playwrights may get an exemption, if it can show that it chooses plays based on their artistic merit and not on their commercial value.

No Inurement or Insubtantial Private Benefit

The third criterion for exemption is that no private person or profit corporation can receive any part of the net earnings of your group. The net earnings are what is left of the gross receipts of the group after the expenses are paid. (People who perform work for the group can be paid for their work, since this is part of

the legitimate expenses of the group.) Upon dissolution, the assets of your group after paying off the debts must be distributed for exempt purposes or to other groups which qualify as exempt under 501(c)(3). Both of these provisions must be included in your Articles of Incorporation (see Chapter 3).

Lobbying

Your group cannot engage in lobbying as a *substantial* part of your activity. IRS considers these things to be lobbying:

- Engaging in activities designed to influence legislation or the outcome of an initiative or referendum;

- Having a primary purpose which may be attained only by legislation or defeat of legislation and advocating for the attainment of this goal. For example, a group whose main purpose was to work for passage of a constitutional amendment allowing or prohibiting abortion would be considered a "lobbying" group.

Your group may advocate social or civic changes or present opinions on controversial issues with the intention of molding public opinion, as long as it does not do substantial "lobbying" as defined above. The law allows most groups to engage in limited lobbying. See Chapter 8 for a more detailed discussion of lobbying. *Note that lobbying has nothing to do with candidates or political parties. Those kinds of activities are political activities.*

Political Activity

Your group cannot participate in any political campaign on behalf of or in opposition to a candidate for public office and the Articles of Incorporation must include a prohibition of political activity. If you engage in *any* political activity of this type, you will not get an exemption. Chapter 8 discusses this in more detail.

Classifications of §501(c)(3) Groups

§501(c)(3) organizations are divided into two broad groupings.

- Private Foundations
- Public Charities

Private Foundations are groups that are usually funded largely by one or a few donors. They generally make grants to other §501(c)(3) organizations, although some provide tax-exempt products or services.

Public Charities are churches, schools, hospitals, public safety groups, governmental units, or related organizations or are groups that provide tax-exempt products or services and that are funded by a number of sources.

Most groups that can do so prefer to qualify as public charities, because there are no taxes to pay (except for the unrelated business income tax), fewer restrictions, and fewer reporting requirements (which means less paperwork and lower legal and accounting fees). In addition, some donors get a greater tax deduction for giving to public charities. Also, funding organizations have fewer restrictions on giving to public charities. Private foundations generally pay more attorney and accountant fees to comply with the heavier government regulation.

Most groups that can do so prefer to qualify as public charities, because there are no taxes to pay (except for the unrelated business income tax), fewer restrictions, and fewer reporting requirements (which means less paperwork and lower legal and accounting fees).

Because most groups prefer the public charity status, because the private foundation rules can get very complex, and because most private foundations have funds to obtain professional help, this book will focus mainly on the public charities. We will include some information on private foundations so that you have some idea what to expect if your group is a private foundation. If you know you want to apply as a public charity, you should skip this Private Foundations section and move on to page 100. A good deal of what is covered in this book applies to all §501(c)(3) groups, including private foundations.

Private Foundations

Every §501(c)(3) is assumed to be a private foundation, unless it establishes that it is a public charity. Charitable trusts are usually classified as §501(c)(3) private foundations. Private foundations have been the subject of a lot of abuse in the past. This frequently occurs because a wealthy donor sets a foundation up for tax purposes and then finds ways to use the foundation for his or her own private benefit. To prevent this, Congress has enacted a number of complex regulatory laws which you will see reflected in the discussion that follows.

Reporting Requirements

Private foundations are subject to substantial recordkeeping and reporting requirements. A private foundation must keep records to protect itself against penalties and to protect the various persons who may be part of, or otherwise

related to, the foundation against penalties. It must also keep records to establish that transactions it engages in do not involve self-dealing, satisfy minimum distribution rules, do not violate excess business holding laws, do not jeopardize its charitable purposes, and are otherwise acceptable to the IRS. If it makes grants, it must keep records of the grant and, if it makes grants to individuals, it must get advance approval from the IRS of its grant criteria. In addition, a private foundation is required to file Form 990-PF and may be required to file other returns, depending on what it does.

Restrictions on Operations

Congress has enacted a variety of restrictions on the operations of private foundations in an effort to ensure that their assets and income are used for the public benefit and not for the private benefit of those who control the foundation. These restrictions include:

- *Prohibitions against self-dealing*. A private foundation and certain related persons ("disqualified persons") are restricted from dealing with each other in a variety of transactions, such as the sale, exchange, or leasing of property; lending of money or extension of credit; furnishing of goods, services, or facilities; payment of compensation for expenses to a disqualified person; and the use of the foundations assets and income by disqualified persons.

- *Minimum distribution requirements.* A private foundation must distribute a minimum percentage of its noncharitable assets each year.

- *Divestiture of excess business holdings*. The law imposes limits on the combined holdings of a private foundation and disqualified persons.

- *Prohibitions of jeopardizing investments*. A private foundation cannot make investments that jeopardize the carrying out of its exempt purposes. Generally these are investments that are made without exercising ordinary business care and prudence in providing for the long- and short-term financial needs of the foundation.

- *Program limitations*. Private foundations are subject to restrictions on lobbying; election activities; making grants to individuals for travel, study, or similar activities; making grants to organizations that are not public charities; and spending money for noncharitable purposes.

Taxes and Penalties

Private foundations may be subject to a variety of taxes and penalties, including:

- Taxes on unrelated business income.
- Taxes on net investment income.
- Taxes on self-dealing.
- Taxes on failure to distribute income.
- Taxes on excess business holdings.
- Taxes on investments that jeopardize charitable purposes.
- Taxes on expenditures in violation of the program limitations rules.

Private Operating Foundation

In the private foundation category, an important subcategory is the private operating foundation. A private operating foundation is a private foundation that, although it lacks general public support, runs its own programs for its educational, charitable, or religious purposes, as opposed to making grants to other organizations for these purposes. A private operating foundation must meet two tests:

1. an *income test*, that requires it to spend a specified minimum of its income directly for its exempt purposes; *and*

2. either
   i. an *asset test*, which ensures that the bulk of its assets are devoted directly to exempt activities, or
   ii. an *endowment test*, which requires that a substantial part of its investment returns be used for its exempt purposes, or
   iii. a *support test*, which requires a broader base of public support for the foundation.

The advantages of being classified as a private operating foundation include more relaxed requirements about what percent return on its investment assets must be distributed each year, a greater ability to attract grants to it, and greater tax deductions for donors who contribute to it. Private operating foun-

dations are sometimes better able to build an endowment fund. In some cases, the private operating foundation does not have to pay the excise tax.

Public Charities

Your organization will be recognized by the IRS as a public charity if you can show you fall in at least one of these categories:

1. A church or a convention or association of churches

2. A school, college, or university

3. A hospital or medical research organization

4. A governmental unit

5. A supporting organization (one that is connected with a group described in #1-4 above or #7-9 below)

6. A public safety organization

7. A development foundation for a state or local government college or university

8. A publicly supported organization (PSO)

9. A fee/activity supported organization (FASO)

The first 6 groups on this list are largely defined in terms of their purposes. The groups referred to as #7, #8, and #9 are defined in terms of where they get their support. (This means that a group might qualify as a church, based on its purpose and might also qualify as a PSO and FASO based on where its support comes from.) Remember that in addition to meeting the terms of the definitions, you must also meet the other requirements set out in the chapter if you want §501(c)(3) status.

Glance at the list above. If none of the first seven seem to describe you, you will probably need to qualify under #8 or #9. Most public charities that are not churches fall in categories #8 or #9.

1. Churches

The IRS and the courts have had some difficulty in defining what is (and what is not) a church. Although most of the terminology used by the IRS is drawn from

Christian faiths, Jewish and other non-Christian religious organizations do qualify as churches. The IRS makes the determination of what is a church on a case by case basis. It typically looks at whether the organization has:

- a distinct legal existence;
- a recognized creed and form of worship;
- a definite and distinct ecclesiastical government;
- a formal code of doctrine and discipline;
- a distinct religious history;
- a membership not associated with any other church or denomination;
- a complete organization of ordained ministers ministering to their congregations;
- ordained ministers selected after completing prescribed courses of study;
- a literature of its own;
- established places of worship;
- regular congregations;
- regular religious services;
- schools for the religious instruction of its young;
- schools for the preparation of its ministers.

This category has been the subject of some abuses by individuals and groups who attempt to set themselves up as churches mainly in order to obtain favorable tax benefits. The IRS is aware of this. Although the IRS does not ordinarily try to determine the religious merit of a group, it will reject the application if it finds that the organization is not exclusively organized or operated for religious purposes or that private persons are profiting from the group.

2. *Schools*

In order to qualify for exemption as a school, college, or university, your group must be an educational organization that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at the place where your educational activities are regularly carried on.

If you seek classification as a school, you must demonstrate to the IRS that you follow racially nondiscriminatory policies toward students in admissions, school programs, and educational policies. To establish this, you must, at a minimum, do the following:

- include in your Articles or Bylaws or in a resolution adopted by your Board a statement that the school has and pursues a racially nondiscriminatory policy;

- include a statement of this policy in all your brochures and catalogues dealing with student admissions, programs, and scholarships;

- refer to the policy in all written advertisements;

- publish notice of the policy in a newspaper of general circulation or through one of the broadcast media every year (some schools are exempt from this requirement);

- provide a schedule showing the racial composition of the students, faculty, and staff;

- provide a listing of the racial composition of loan and scholarship recipients; and

- supply the names of your incorporators, founders, Directors, and donors of land or buildings and state whether any of these have as an objective the promotion or maintenance of segregated public or private education.

3. *Hospitals and Medical Research Organizations*

A *hospital* is an organization whose principal purpose is to provide medical or hospital care or medical education or medical research for the community's benefit. The organization must provide medical or hospital care to patients on its premises or in its facilities on an in-patient or out-patient basis. A hospital

may include a rehabilitation institution, an out-patient clinic, or a mental health or drug treatment center if its principal purpose is the provision of hospital and medical care. It does not include a home for the aged, a home for children, or a convalescent home.

A *medical research organization* is one that engages directly in the continued active conduct of medical research in conjunction with a hospital.

4. Government Unit

This includes any federal, state, county, regional or local government unit.

5. Supporting Organizations

A *supporting* organization is one that benefits one of the types of organizations described on page 100 in #1, 2, 3, 4, 7, 8 or 9 (called the *supported* organization) in carrying out its mission. To qualify as a public charity *supporting* organization, the supporting organization must be operated, supervised or controlled by or in connection with supported organization. For example, a church may consider one of its purposes the care of the sick and elderly. It could set up an old age home as a supporting organization to carry out these purposes. Similarly, a college may set up a publishing company as a supporting organization to do its printing and publishing.

The *supported* organization can be exempt either under §501(c)(3) or under §501(c)(4), §501(c)(5), or §501(c)(6) as long as the (c)(4), (c)(5) or (c)(6) organization meet the requirements of the FASO test (see Chapter 7). For example, a §501(c)(6) chamber of commerce, funded by dues from the area's businesses, could have a (c)(3) *supporting* organization that supports the chamber's downtown business rehabilitation project.

Requirements

To get §501(c)(3) public charity status as a supporting organization, your group must meet all of these tests:

> 1) It must be organized and operated exclusively for the benefit of, to perform the functions of, or to carry out the (c)(3) purposes of, one or more of the groups described in #1, 2, 3, 4, 7, 8, or 9 above or of a §501(c)(4), (5), or (6) organization that meets the FASO test; *and*
>
> 2) It must be operated, supervised, or controlled by one or more of those groups; *and*

3) It must not be controlled directly or indirectly by one or more disqualified persons (see pages 155-157 for a description of disqualified persons) other than foundation managers and other than the public charities described in #1, 2, 3, 4, 7, 8 or 9 above; *and*

4) It must itself meet the criteria to be a §501(c)(3) organization.

If you are setting up a supporting organization, you are most likely to qualify for §501(c)(3) status if:

- you specify in your Articles that your purpose is to benefit a specific public charity that you name;

- your Articles provide that the public charities you support elect a majority of your Board, and

- there are no disqualified persons on your Board.

A complex set of rules does allow you to vary from this model. IRS Publication 557 has much more detailed information on setting up these types of organizations under "§509(a)(3) Organizations." You will probably need legal help if you decide to apply for public charity status as a supporting organization.

Reasons for Setting Up Supporting Organization

A supported organization may choose to set up a supporting organization for several reasons. PSOs and FASOs (see #8 and 9 below) may get funding for a project that supports their mission but the funding will tip them into the private foundation category. In some circumstances, placing the money in a separate supporting organization may preserve their public charity status. In other cases, the services provided by the supporting organization require the attention of a separate or different kind of Board than the one running the supported organization. Some supported organizations spin off a supporting organization that runs risky programs to avoid having the supported organization's assets subject to claims made against the risky program. Or the supported organization may protect its endowment funds by spinning off a separate supporting organization that manages those funds.

The supporting organization is being used increasingly by PSOs (#8 above) and FASOs (#9 above) that engage in fee supported ventures. It is important to note that your group cannot set up any business it desires as a supporting organization. The supporting organization must meet the §501(c)(3) requirements discussed above: it must have an exempt purpose; it must be organized and operated for that purpose; it cannot provide a private benefit to anyone; and it

cannot do substantial lobbying. For example, an organization that helps at-risk youth develop job skills may set up a supporting organization that runs a furniture factory to teach young people skills and that sells the furniture they produce as long as the organization makes its business decisions based on what is most likely to develop job skills rather than on what would make the factory most profitable.

Chapter 9 has more information on nonprofits that conduct a business. If your group sells a product or service, you should read that chapter to determine if you can qualify for exemption with your business and for information on how to separate your business from your other activities in order to get an exemption for your exempt activities if you need to do this.

6. Public Safety Organizations

Organizations that are recognized as exempt under this category commonly engage in testing consumer products to determine if they are safe for use by the general public. The exemption is denied if the IRS feels the testing is being done to further a private interest (e.g., a drug company testing a drug before marketing it). Unlike the other public charities, contributions to a public safety organization are not tax deductible, although the organization is exempt from paying income taxes.

7. Development Foundation for State Universities

These are organizations that receive a substantial part of their support from the government or the general public and manage and invest them for the benefit of state or local government colleges and universities.

8. Publicly Supported Organizations

Groups whose support comes largely from public sources are exempt under this section. The IRS uses a very complicated test to determine whether your group's support comes from what it considers public sources. Chapter 7 describes this test in excruciating detail. Generally, if at least one third of your funding comes or will come from government grants (and not a payment for services), small donations, or small non-governmental grants, you should qualify under this section. "Small" means that each person's donation or each funder's grant is less than 2% of your total funding. If this does not clearly describe you, you should get professional help or wade through Chapter 7.

9. Fee/Activity Supported Organizations

If a substantial part of your group's support comes from membership fees and activities related to your group's exempt purpose, you can qualify as a Public Charity under this section. This test is also very complicated and is described in Chapter 7. To meet this test, at least one third of your support must come from membership fees, grants from PSOs, and gross receipts from related business activities. No more than one third of your support can come from the combination of gross investment income and unrelated business income. If you do not clearly meet both of these tests, you are doomed to read Chapter 7 or get professional help.

Who Must File the Application

All groups wanting to obtain federal tax exemption under 501(c)(3) must file Form 1023 (the application form) with the Internal Revenue Service, with a few exceptions. Your group does not have to file in order to be exempt, if you are one of the following:

- A church.

- An organization that otherwise meets the criteria for exemption under §501(c)(3), that is not a private foundation (see page 97) and that has low annual gross receipts, normally not more than $5,000 per year. The government defines "normally" to mean that your group has $7,500 or less in gross receipts in your first year; $12,000 or less in your first two years; or, if you have been in operation three or more years, $15,000 or less in gross receipts in the immediately preceding three years. "Gross receipts" means the gross amount received by your group from all sources – including contributions; grants; dues; sale of goods, services, or assets, and interest – without deducting for expenses.

- A subordinate organization covered by a group exemption letter (see pages 118-119.)

Although you are not required to do so, if you meet one of these exceptions, you may file Form 1023 if you want to receive the IRS letter recognizing your exempt purposes. Many funders and donors will want to see this letter before they give funds to you.

Effective Date of the Exemption

If Form 1023 is filed within 15 months from the end of the month in which your group was organized and your application for §501(c)(3) status is approved, you will be treated as exempt retroactive to the time of your organization. The IRS grants an automatic 12-month extension of this period so that in fact your exemption is retroactive if you file within 27 months from the end of the month in which your group was organized. You are usually treated as being organized on the date you were incorporated. That is the date stamped on your Articles that the Secretary of State returned to you after your Articles were filed.

If your organization is required by IRS to alter your activities or to make substantive amendments to your Articles or Bylaws, your exempt status will begin on the date the changes are made. It is very important that you be sure from the start that your Articles and Bylaws will satisfy the IRS.

If Form l023 is filed after the 27-month period, your exemption will date from the time of filing Form l023 unless the IRS grants you an extension. The criteria that the IRS uses in granting an extension are discussed on pages 140-141.

Your exemption is retroactive if you file within 27 months from the end of the month in which your group was organized.

If your group has not filed within the first 27 months, you may request §501(c)(4) status for the period between your founding and date of application for §501(c)(3) status. The §501(c)(4) status for this period will protect your corporation from corporate income tax for this period. However, donations during the §501(c)(4) period will not be tax-deductible as charitable contributions.

If your organization is a new one and is applying for tax exemption, your tax year may end before you hear from the IRS as to whether you are exempt. You must then determine whether you need to file a tax return and which one to file. You have a choice. You can choose to file a Form 1120 (the one used by nonexempt corporations) and pay taxes, then file for a refund if you get your exemption. Tax-exempt organizations with gross receipt greater than $25,000 file an annual informational return called the Form 990. (This is discussed in greater detail in Chapter 12.) If your gross receipts are less than $25,000, you do not to file the Form 990. If your gross receipts are greater than $25,000, you must file Form 990 and check the box that says "exemption applied for." However, if you are denied your exemption, you will then owe back taxes, interest, and penalties. Many groups choose the second option in spite of its risks. If you

are fairly certain you will qualify or if your tax liability is small, the second option is a relatively safe bet and permits you to avoid going through the procedure of applying for an income tax refund.

Soliciting Contributions Before You Receive Your Exemption Letter

Not surprisingly, many nonprofits want to accept donations before they have received their ruling from the IRS that they are tax-exempt. Your nonprofit can certainly accept contributions but most donors will want to deduct their contribution as a charitable gift on their own tax returns. You must be careful about what you say to donors about the deductibility of their contribution. Even if you feel confident that you will get your exemption, you cannot tell your donors that their contributions are deductible. You can tell them that you have applied for the exemption. As described above, if you applied within 27 months of the date you incorporated, your exemption will probably be retroactive to the date of incorporation. If your donor made the contribution to you after you incorporated, he or she can take the deduction if you get your retroactive exemption. But again, because you don't yet know that your exemption will be retroactive, you must be careful that you don't deliver assurances on this point.

What Type of Ruling to Seek

As discussed earlier in this chapter, groups seeking exemption under §501(c)(3) may be classified as either private foundations or public charities. If you are applying as a public charity, the IRS will issue one of two types of ruling as to whether you qualify as a public charity:

- a definitive ruling
- an advance ruling

A *definitive* ruling means that you are permanently recognized as a public charity, unless your public charity status is revoked. A definitive ruling is given to all public charities when the IRS rules on the application for exemption, except some PSOs and FASOs. A PSO or FASO can get a definitive ruling only if it has been in existence for at least one tax year of 8 months or more at the time it applies.

An *advance* ruling means that you are recognized as a public charity for the period granted in the ruling. At the end of that time, you must submit documentation to show you met the PSO or FASO test in order to get a definitive ruling. PSOs and FASOs in existence for a tax year of less than 8 months must apply for this. A PSO or FASO in existence longer may, if it chooses, apply for this.

If your group is a PSO or a FASO, and you are trying to decide when to apply and which ruling to apply for, these considerations might be helpful:

New Groups

If your PSO or FASO is newly created and doesn't have a taxable year of at least eight months at the time you submit your application, you cannot get a definitive ruling at that time as to whether you are a public charity. Newly created groups that cannot get a definitive ruling have 2 choices:

1. You can request that the IRS issue an advance ruling:

Most groups choose this route. This would allow you to be treated as a PSO or FASO for an "advance period" – your first 5 taxable years. The advance ruling is issued if you can reasonably expect to meet the requirements for a PSO or FASO. The IRS typically grants the advance ruling unless your application discloses information that suggests that most of your funds will come from a source that would disqualify you. The IRS does not have to give you an advance ruling.

When applying for the advance ruling, you must file two Forms 872-C, extending the time during which the IRS can assess taxes against you. Within 90 days after your advance period ends, you must submit information to the IRS to show that you do meet the PSO or FASO tests based on your advance period, in order to get a final ruling on your status. A copy of Form 872-C is included with the Form 1023 in the Forms section of this book. You can make a copy of it to use as your second Form 872-C.

If you fail to qualify as a PSO or FASO at end of your advance ruling period, you are still tax-exempt as a §501(c)(3) organization, but you are classified as a private foundation. You will not have to pay back taxes, except for the net investment excise tax that is imposed on private foundations. You will have to pay that tax with interest but without penalties. After that, you will be liable for the investment tax on private foundations and subject to the other restrictions imposed on private foundations.

Anyone who has made grants or contributions to you is protected by your advance ruling, even if you are found not to be a PSO or FASO at the end of your advance period, unless the grantor or contributor was responsible for, or aware of, the action that caused you to lose your PSO or FASO classification, or knew that the IRS was going to change your classification.

2. You can wait until you have been in existence at least one taxable year of 8 months or more and apply for a definitive ruling at that time:

You may want to go this route if you are uncertain as to whether you will ever qualify as a PSO or FASO and prefer to pay the private foundation taxes now in order to avoid having to pay back taxes with interest and penalties later. Penalties on these back taxes are assessed if you fail to obtain an advance ruling that you are a PSO or FASO.

Groups Less than Four Years Old

If your organization has been in existence for at least one taxable year of at least 8 month but no more that 4 taxable years, you have 2 choices:

1. You are eligible to receive a definitive ruling now:

If you choose to apply for a definitive ruling now, you need to be sure that you will meet the PSO or FASO support test. Your definitive ruling will be based on testing the information you supply about sources of income over the preceding 4 year period. If you have not been in existence that long, the number of years you have been in existence immediately preceding each current taxable year being tested will be substituted for the 4-year period and will be your normalcy period. If you have a material change in support for the current taxable year that does not qualify for the unusual grant exclusion, then the normalcy period will be the period of your existence, including the current year.

If your organization did not obtain an advance ruling and the IRS turns down your application to be treated as a PSO or FASO, you will be liable for back payments of net investment excise tax and penalties and interest. You would be better off to pay the tax as it is due and seek a refund at such time as you get PSO or FASO status.

2. You can seek an advance ruling, as described above:

You may choose to do this if you do not yet meet the support requirements for a PSO or FASO but believe that you can meet one of these tests over the advance period. This may occur, for example, if too much of your funding now has come from a source that disqualifies you (and does not qualify for the unusual grant exclusion), but you anticipate getting much more qualified support in the future.

Groups More than Four Years Old

If you have been in existence for more than 4 tax years, you must apply for the definitive ruling. However, if you apply for §501(c)(4) status for the period between your founding and your application (see page 142), the IRS may treat you as coming into existence for (c)(3) purposes as of the date of your application. In that case, you would not be eligible for a definite ruling on your private foundation status. The IRS is erratic about how they treat long-established groups making the §501(c)(4) request.

Final Reminder

The advance ruling and definitive rulings are **not** rulings about whether your organization is tax-exempt. If the IRS has gotten to the point of making advance or definitive rulings, it has recognized your group as exempt. The rulings determine whether or not your group is a private foundation.

Cost of Applying

See page 116 for the fees you must pay to apply for a §501(c)(3) exemption.

§501(C)(4): CIVIC LEAGUES AND SOCIAL WELFARE ORGANIZATIONS

If your organization is a public benefit organization but does not need or want to become exempt under §501(c)(3) or does not qualify under that section, you may want to consider applying for exemption under §501(c)(4). The advantage of obtaining exemption as a §50l(c)(4) is that there are no restrictions on the amount of the group's resources devoted to lobbying or to participating in ballot measures as there are for 50l(c)(3) groups. You can also participate in political campaigns, as long as campaigning is not your primary purpose. However, you should be aware that if you do any lobbying, you are not eligible to receive most federal funds. See pages 613-614. §50l(c)(4) groups can participate in some political activity for or against candidates for public office, which is forbidden to (c)(3) groups.

The disadvantage of obtaining a §50l(c)(4) exemption instead of a §501(c)(3) is that donations to a §501(c)(4) organization do not qualify as charitable deductions for the donor. Contributions to a §501(c)(3) organization do. Also, private foundations will generally not make grants to a §501(c)(4) organization.

In order to qualify for exemption as a civic league or social welfare organization under §501(c)(4), your group must meet two requirements:

- You must be civic and operated primarily for the promotion of social welfare; *and*

- You must not be organized or operated for profit.

A civic group is one which offers benefits or services which are public, and not private, in nature. In other words, the services must benefit a fairly large segment of the public and not just a few specific individuals. Social welfare is promoted if the organization serves some broad community need. A membership group that limits its services or benefits to its members may have trouble qualifying unless it can show that the general public will benefit from its activities. For example, a homeowners' association that maintains a park open to the public may be exempt. (For more on homeowners' associations, see Appendix 6.)

The disadvantage of obtaining a §50l(c)(4) exemption instead of a §501(c)(3) is that donations to a §501(c)(4) organization do not qualify as charitable deductions for the donor.

Private benefit that is more than incidental will disqualify the group from this exemption. Here again, membership groups have faced problems. For example, automobile clubs and dairy farmer cooperatives have been denied exemption because the government felt that their members benefited in a substantial economic way (in a sense, made a "profit") from their membership in the club, even though there were also important public services provided by the groups.

OTHER EXEMPT GROUPS

A wide range of other types of group can apply for exemption from federal income tax, although contributions to these groups are not deductible. (There are minor exceptions for volunteer fire organizations, charitable activities of some lodges, cemetery associations, certain charitable funds, war veterans organizations, and certain organizations that work in conjunction with §501(c)(3) groups.) These other exempt groups and the subsection of Internal Revenue Code §501 under which they qualify are discussed briefly here. You should consult IRS Publication 557 for additional information and get professional help if you need it.

Labor, Agricultural and Horticultural Organizations– (c)(5)

§501(c)(5) exempts several categories of organizations—labor, agricultural and horticultural groups— that seek to better the conditions of people working in those pursuits. A labor organization is an association of workers organized to protect and promote the interests of labor in connection with employment, by bettering the conditions of workers, the improvement of the products of the workers, and the development of a higher degree of efficiency in occupations of the workers. Unions are a common example. Agricultural and horticultural organizations are those that encourage the development of better agricultural or horticultural products and that seek to better the conditions of farmers and others in the industry. Contributions to a (c)(5) organization are not deductible as a charitable donation but are deductible as a business expense if they meet the test for that deduction.

Business Leagues– (c)(6)

Business leagues, chambers of commerce, boards of trade, and real estate boards, among others, are exempt under §501(c)(6). A *business league* is an association of persons having some common business interest, the purpose of which is to pursue the common interest and not to engage in regular business activities. An organization of businesses in the pulp and paper industry is an example. A *chamber of commerce* is usually composed of merchants and businesses of a particular city or town. A *board of trade* is composed of persons engaged in similar lines of business who operate a commodities exchange. A *real estate board* consists of members working to improve the business conditions in the real estate field.

To be exempt under §501(c)(6), your group must be working to improve business conditions in your line of business (for your entire industry or all components of that industry in a geographical area) as opposed to performing services for your members. This means, for example, that you would be exempt if your business league operates to improve standards of communications throughout the computer industry but not if you operate to improve standards of communications for one company within the computer industry or if you operate primarily to offer your members discounts on computer equipment. You are also not exempt if any part of your net earnings privately benefit any individual.

Contributions to organizations exempt under §501(c)(6) are not exempt as charitable contributions but may be deductible as business expenses if they meet the test for that deduction. However, the deduction may be limited if it is used for certain types of lobbying. (See Chapter 8).

Social Clubs – (c)(7)

Social clubs are clubs that are organized around a common purpose such as pleasure or recreation. Personal contact, a sense of community, and commingling should be a material part of the life of your club. To show that your club has an identity of purpose, membership should be limited consistent with the character of your group. However, you cannot discriminate on the basis of race, color, or religion, except that you can limit your membership to persons of a particular religion in order to further the teachings of that religion (or, in some cases, if you are connected with a fraternity or sorority), as long as you do not exclude people based on race or color.

Generally, your club may not engage in business, although you may provide meals, refreshments, and services related to your exempt purposes to your members and guests. The rules concerning unrelated business income are somewhat different for social clubs than for most other exempt groups. You should consult an accountant if you are a social club with unrelated business income. Because the club exists to serve its members, your facilities cannot be open to the general public except on an limited basis. No part of the organization's earnings may be used to privately benefit any individual. Examples of social clubs include country clubs, hobby clubs, college fraternities and sororities, and amateur sports clubs.

Fraternal Societies – (c)(8) and (c)(10)

Organizations that operate exclusively under the lodge system are fraternal organizations. Your organization operates under the lodge system if you have a form of organization that comprises local branches chartered by a parent organization and that are largely self-governing. Before applying for your own exemption, you should check your parent organization to see if your organization has been included in a group exemption or if you can be added. (See pages 118-119 for a discussion of group exemptions.)

Two types of fraternal organizations are tax-exempt. Under §501(c)(8), a fraternal organization is exempt if it provides life, sickness, accident or other benefits to its members or dependents. Under §501(c)(10), a fraternal organization is exempt if it devotes all of its net earnings exclusively to religious, charitable, scientific, literary, educational and fraternal purposes and if it does not provide life, sickness, accident or other benefits to its members.

Generally, only donations to §501(c)(3) organizations are deductible as charitable contributions. There are a few exceptions to this rule. One exception is that donations to §501(c)(8) and (c)(10) organizations that are used exclu-

sively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to animals and children are deductible.

Examples of §501(c)(8) and (c)(10) organizations are the Elks and the Masons. College fraternities and sororities are generally denied exemption under these sections and are classified as social clubs under §501(c)(7).

Veterans Organizations – (c)(19)

An organization of past members of the Armed Forces of the United States is exempt from taxation. §501(c)(19) exempts veterans groups if the post or organization is organized in the United States or one of its possessions; at least 75% of the members are past or present members of the U.S. Armed Forces and at least 97.5% are such members, are cadets, or spouses, widows, or widowers of members or cadets; and no part of the earnings benefits any individual. Your organization must be operated exclusively to promote the welfare of the veterans' community. If at least 90% of your membership consists of war veterans, donations to your organization can be deducted as charitable contributions.

Political Organizations – §527

Political organizations that are organized primarily for the purpose of collecting contributions and making expenditures to influence the election or appointment of individuals for federal, state or local public office are exempt from federal income tax, except on their investment income. Examples of such organizations are the Republican and Democratic National Committees, various candidate committees and political action committees (PACs). These organizations are described in more detail in Appendix 8.

Miscellaneous Exempt Groups

A variety of other exempt groups are exempt from federal taxation. We have listed them below, along with the subsection of Internal Revenue Code §501 under which they qualify:

- title holding companies–(c)(2)
- homeowners' associations–(c)(4) and §528
- agricultural–(c)(5)
- garden clubs–(c)(5)
- employee insurance associations–(c)(9)
- local teachers' retirement fund associations–(c)(11)
- certain cooperative organizations–(c)(12)
- cemetery companies–(c)(13)
- credit unions–(c)(14)

- reserve funds for banks–(c)(14)
- small mutual property and casualty companies–(c)(15)
- crop financing corporations–(c)(16)
- supplemental unemployment benefit trusts–(c)(17)
- employee supported pension plans–(c)(18)
- black lung benefit trusts–(c)(21)
- multi-employer benefit trusts–(c)(22)
- religious and apostolic organizations–(d)
- cooperative hospital service organizations–(e)
- cooperative school service organizations–(f)
- farmers' cooperatives–see §521(a)

If your group does not qualify for one of the exemptions we discussed in this chapter and one of these categories above seems to apply to your group, you should contact the Internal Revenue Service for application forms and the appropriate publication that describe which groups qualify. If you still have questions, you should contact an attorney or accountant. You can also call the IRS hotline for exempt organizations at 1.877.829.5500.

GENERAL INFORMATION FOR ORGANIZATIONS SEEKING ANY TYPE OF TAX EXEMPTION

Cost of Applying

The IRS charges a fee for considering your tax-exempt application. If your annual gross receipts, averaged over the last 4 years, do not exceed $10,000 per year (or, if you are a new organization, and your anticipated average annual gross receipts are not more than $10,000), you must pay $150. If they exceed $10,000 per year, your fee is $500. There is a $500 fee for a group exemption letter. The fee must be paid when you submit your application. If you do not pay, IRS will return your application. You must also submit a Form 8718 (User Fee for Exempt Organization Determination Letter Request) with the application and fee.

Public Inspection of Application & Annual Returns

If you receive tax exemption status, you should be aware that both you (see pages 631-632) and the IRS (see below) must make certain of the documents that you file with the IRS available for public inspection.

Applications

The public can inspect tax-exempt applications that have been approved by the IRS, and the supporting documents filed by the tax-exempt group. It can also inspect documents or letters issued by the IRS relating to the approved applications. This means that you can obtain a copy of the applications filed by organizations you know are exempt prior to filing yours. See pages 631-632 for how to obtain copies of the applications of other exempt organizations. The IRS is not required to grant your exemption just because it granted the exemption of a similar organization but your review of another group's application may give you ideas about how to approach the application.

The IRS charges for considering your tax-exempt application. If your annual gross receipts, averaged over the last 4 years, do not exceed $10,000 per year, you must pay $150. If they exceed $10,000 per year, your fee is $500.

Of course, other people will also be able to look at your application. If your application or supporting documents contain any trade secret, patent, process, style of work, or apparatus that you want to withhold from public inspection, you must request in writing that this information be withheld. The request is filed with the IRS office where you filed the information. Your request must clearly identify (by document, page, paragraph and line) what is to be withheld and why it is to be withheld. The IRS will withhold the information if it decides that its disclosure would adversely affect your organization. The IRS will also not disclose the names and addresses of your contributors unless you are a private foundations (see page 97) or a political action committee (see Appendix 8).

Annual Returns

Annual returns are also subject to public inspection and available on the Internet at *www.guidestar.org*. However, the following information will not be disclosed:

- The names and addresses of contributors to tax-exempts, other than private foundations, will not be disclosed.
- If the amount of a contribution or bequest could reasonably expect to identify the name or address of the contributor, it may be withheld, except that amounts to private foundations can be inspected.
- The names, addresses, and amounts of contributions and bequests of persons who aren't U.S. citizens to a foreign organization will not be disclosed.

Unrelated Business Income

Note that the rules concerning taxation on unrelated business income discussed in Chapter 9 apply to almost all tax-exempt groups. Be sure to read that chapter.

Group Exemption

An organization (called the central organization) that is composed of subordinate organizations (such as chapters, locals, posts, or units) can request a group exemption on behalf of itself and its subordinates. If granted, the IRS will send a determination letter to the central organization that establishes the exempt status of the central and subordinate organizations. Subordinate organizations may be separate corporations, or they may be established by some other organizational scheme. If the central organization has a group exemption letter, the subordinate organizations don't have to apply separately to get their own exemptions.

To get a group exemption, the central organization must get exempt status for itself. At that time or later, the central organization can apply for a group exemption. You do this by letter to the IRS rather than by filling out an IRS form. Before you apply, you should get written authorization from each of your subordinates to include them in the group exemption request. In order to get a group exemption, you must establish that your subordinates are:

- Affiliated with you;
- Subject to your control (including at the very least, your power to determine which organizations are subordinates and the power to suspend them);
- All exempt under the same paragraph of §501(c), although this paragraph does not have to be the same one as yours (for example, you could be a §501(c)(3) educational group and your subordinates could be §501(c)(4) social welfare organizations);
- Not private foundations if the subordinates are seeking a §501(c)(3) exemption;
- On the same accounting period as you, if the subordinates are going to file annual group returns.

If your subordinate is seeking §501(c)(3) status, it must have been formed within 15 months before the filing of the application if it wants its exemption to be retroactive to its formation. If it was created before that, its exemption will begin on the date of the group application.

When applying for the group exemption, you must supply:

- Facts showing your subordinate is affiliated with you and subject to your control;
- A copy of a uniform governing instrument adopted by your subordinates;
- A detailed description of the subordinate's activities and purposes, including sources of funds and nature of expenditures;
- An affirmation by one of your principal officers that the purposes and activities of the subordinates are as stated to the best of her/his knowledge;
- A statement that such subordinate has given written authorization to be included in the group exemption letter;
- A list of each subordinate that has received an IRS exemption ruling;
- If §501(c)(3) is involved, an affirmation by your principal officer that to the best of her/his knowledge, no subordinates are private foundations;
- Special information if you are schools;
- A list of all subordinates that you want included, with their addresses and separate employer identification numbers. If they don't have separate numbers, your application should contain separate SS-4 forms for each subordinate.

Consult Appendix 1 if you would like information about source material related to this Chapter. Appendix 1 has references of interest to all readers, not just professionals.

If your group wants to apply for tax-exempt status, the next chapter explains how to fill out the appropriate application.

6 FILLING OUT THE TAX-EXEMPT APPLICATIONS

If you have decided that you want to apply for federal tax-exempt status, you do so by filling out an application and sending it to the Internal Revenue Service. Groups applying for §501(c)(3) status fill out Form 1023. Groups applying for §501(c)(4) status and for most other §501(c) exemptions fill out Form 1024.

Filling out these forms correctly requires some understanding as to what information the Internal Revenue Service is looking for. It is very important that you have filled these forms out correctly before you send them to the Internal Revenue Service. This Chapter provides a line-by-line explanation of how to fill out Form 1023 and Appendix 7 does the same for Form 1024.

THIS CHAPTER COVERS

- **Filling Out Form 1023**
- **Filling Out Form 1024**
- **Questions Back From the IRS**

FILLING OUT FORM 1023

Groups that apply for exemption under §501(c)(3) fill out IRS Form 1023. Form 1023 and instructions for filling it out can be obtained from the Internal Revenue Office free of charge. Publications 557 has additional information about §501(c)(3)s and is also free. Appendix 2 explains how to contact the IRS. You should obtain and read the IRS instructions for Form 1023. Brace yourself for a pretty long and detailed exercise in filling out this application!

If your group has some unusual feature and you know of a similar group that has been ruled exempt or if you just want to look at how someone similar filled out their application before you file yours, you can obtain a copy of the other group's application by contacting that group or the IRS. Pages 631-632 explain how to do this. Let the other group or the IRS know if you want copies of the supporting documents that the other group sent in with its application. You may also request documents and letters issued by the IRS relating to the approved application. This is a particularly good idea if you are obtaining the application because your group is somewhat unusual and the group who qualified is similar to yours. The IRS is not required to grant your exemption just because it granted an exemption to a group similar to yours but this information should be very useful to you in preparing your application. The IRS or the group may charge you a copying fee.

As you fill out the application, the following (based on Form 1023 revised in October 2004) may be helpful. The IRS revises this form from time to time, so the line references in this chapter may not be quite right. Even if the form has been revised, you should find the concepts in this chapter helpful in filling it out.

Part I – Identification of Applicant

Lines 1-3 – Name

Part I of Form 1023 is for identification of your group. Under Line l, put your organization's name as it appears in your Articles of Incorporation. Lines 2 and 3 are self-explanatory.

Line 4 – Employer Identification Number

Line 4 asks for the employer identification number. Every exempt organization is required to have an employer ID number (also called a taxpayer identification number) whether or not you have employees. You may have applied for and received this number when you opened a bank account. If so, put this number in the blank. If you do not have such a number, see page 45 for instructions

about how to obtain an employer ID number. You must obtain this number *before* you file the Form 1023.

Line 5 – Annual Accounting Period

This line calls for the month your annual accounting period ends, written as a double digit. (For example, April is 04). The annual accounting period your Board chooses should be the one you actually intend to use for maintaining financial records. See page 43 for a discussion of accounting periods (also called your fiscal year). Whatever month is stated here will be considered binding for future tax requirements. If you are granted exempt status, your annual report, the Form 990, must be filed by the l5th day of the 5th month after the close of your annual accounting period. (See Chapter 12 for a discussion of the Form 990 and who must file it.) Your annual accounting period may be changed only through following specific IRS procedures.

Line 6 – Primary Contact Person

Fill in Line 3 with the name of someone in your group that the IRS can contact during normal business hours for more information. Be sure this person has a copy of the application, is knowledgeable about it and can talk to the IRS competently. If this person is not an officer, your organization will need to file Form 2848 (an IRS power of attorney form that you can obtain from the IRS) to permit the IRS to talk to this person.

Line 7 – Authorized Representative

If you have an attorney or accountant or other person that you have authorized *to deal with the IRS for you in connection with this application*, you must provide the IRS with your representative's name and address and submit a completed Form 2848 with this application. If you are handling this application process yourself, check "No."

Line 8 – Paid Consultants

If you have paid or promised to pay anyone, other than an officer, director, trustee, employee or authorized representative (Line 7), to help you set up your organization, raise funds or otherwise advise you, you must provide their name, their firm's name and address, how much you paid and what you paid for.

Line 9 – Website and E-mail

This is self-explanatory. The IRS may look at your website so be sure that the information on the website agrees with what you say in the application and otherwise complies with the rules concerning §501(c)(3)s.

Line 10 – Required to File Returns

Form 990 or 990-EZ is the informational tax form that most §501(c)(3) groups must file every year with the IRS. Some groups are not required to file it. See Chapter 12 to see if your group must file this return. For many small groups, the explanation for not filing a return is that the group does not anticipate having gross receipts of more than $25,000 annually.

Line 11 – Incorporation or Formation Date

This asks for the date incorporated. Put in the date stamped on the Articles of Incorporation that the Secretary of State returned to your organization. If you are not incorporated, fill in the date your Articles of Association or your Constitution was adopted. The IRS wants this in the MM/DD/YY format.

Line 12 – Foreign Country

This question is self-explanatory. If you were formed in a foreign country, you should get legal advice. Indicate whether you are a corporation, trust, or association. Trusts and associations should submit the documents indicated.

Part II – Organizational Structure

You must be a corporation, unincorporated association or charitable trust to be tax exempt.

Line 1 – Corporations

Most groups that use this book are corporations. Groups that are incorporated as nonprofit corporations should check the "yes" box. You must enclose a copy of your Articles of Incorporation and a copy of any amendments or restatements of the Articles. The Oregon Secretary of State does not issue a separate Certification of Filing but they will provide you with a copy of your Articles, amendments and restatements *that includes the stamp from the Corporation Commissioner showing the date filed.* The copy that you submit to the IRS must have this information stamped on it. If you don't have a copy with the date stamped on it, you can submit a substitute copy. You have to submit a declaration, signed by an authorized officer, that this is a correct copy. You can

do this by writing, either the beginning or the end of both your Articles, amendments, restatements, and Bylaws, the following:

> *This is to certify that this is a complete and correct copy of the Articles of Incorporation [or the amendment or restatement to the Articles, or Bylaws] of [name of corporation]. It contains all the powers, principles, purposes, functions and other provisions by which this corporation governs itself.*

*BY:*_____
(NAME)
Officer for [Name of Corporation]

This should be signed by an officer authorized by your Board to sign these papers for your group. The Articles of Incorporation must contain the provisions listed on pages 33-36 pertaining to your purposes and the distribution of your assets on dissolution for 50l(c)(3) corporations or the IRS will return them to you for amendment. Be sure that you keep a copy for your records. These documents will not be returned.

Lines 2-4 – Other Organizations

If you are a limited liability company, an unincorporated association or a trust, fill check "yes" on the appropriate line and supply the requested information. Corporations should check each of these lines "No."

Line 5 – Bylaws

This line is self-explanatory. Be sure that the copy of your bylaws that you attach shows the date of adoption.

Part III – Required Provisions

In this section, the IRS wants to be sure that you have included in your Articles of Incorporation the provisions concerning your purpose and how you dispose of your assets on dissolution that the IRS requires. If you followed the instructions on pages 33-36 in filling out your Articles, then you can check the boxes in lines 1 and 2.

Line 1 – Purposes

If you followed the instructions in this book, your language on purposes is in your Articles of Incorporation, Article 5, paragraph 1. Include the page num-

ber (and paragraph number if it is different) on the line provided and check the box.

Line 3 – Dissolution Clause

If you followed the instructions in this book, your language on dissolution is in Article 8. Check the box in 2a and include the page and paragraph number (if you have one) on the line provided in 2b. Skip 2c.

Part IV – Narrative Description

This requests a narrative description of your groups's past, present and future activities. The IRS is interested here in your programmatic activities, not your administrative activities or your efforts at fund-raising. Part IV is the heart of the application. Begin by listing any other names by which you operate. In describing past activities, some groups that began as unincorporated associations or as programs of other organizations and are now incorporated tend to describe their past programs as activities of the corporation. They are not, but your description will help the IRS get a sense of what you do. Clarify for the IRS that these activities were those of the nonprofit association or of another nonprofit corporation.

Your answer should describe the activities that you carry out in ways that allow the IRS to see why they are charitable, educational, religious or otherwise exempt. It is probably most helpful in answering this question to group your activities in categories and to describe the categories. For example, an organization devoted to reducing drug addiction among at-risk youth may offer a counseling program, workshops, and referral services. As you detail each activity, include the following information:

• The IRS wants you to describe each activity, who conducts it (board, staff, employees, volunteers, independent contractors or other organizations that you hire) and when and where it is conducted. You should explain how each activity furthers your exempt purpose. Often this will be obvious – for example, the workshops you present on how to prevent drug addiction are educational and charitable.

• For each activity, you must allocate the percentage of total time you devote to it. Remember to include volunteer time in your estimate. These are obviously rough estimates, particularly for new organizations. Make your best guess here and move on. Your answer should give the IRS a rough idea of which activities will engage most of your energy and which are more minor programs.

• You should explain how each activity is funded – for example, through grants, donations or charges for your services. If you charge for goods or services, explain how you arrive at your charges. If you set your charges based on the costs of the good or service to you, the IRS may determine that you are not providing an exempt service. Your willingness to forego a profit does not make your service charitable in the eyes of the IRS. This is particularly the case if the good or service you provide is also provided by commercial sources. In order to show that you are charitable even though you are providing commercial products at retail or at cost, you should explain why the provision of these goods or services is important to your exempt purposes, how your provision of these goods or services is different from those offered by businesses and what noncommercial factors inform your decision-making. This is a confused area of law and you should get professional help. If you have funding from other sources that allows you to provide your goods or services to charitable recipients at substantially less than your cost, then explain this to the IRS. You are providing a charitable service.

You should carefully review all the activities that you provide and make sure that those that carry out your exempt purposes are listed (for example, newsletters, referral services, phone counseling, free or low-cost services, etc.). If part of your group's activities might disqualify you for the exemption, your answer to Question 1 should either point out the insignificance of these activities to your overall activities or should explain what facts exist that prevent these activities from disqualifying you.

Part IV is the heart of the application.

> *Example*: A Native American center that provides information and referral services and counseling and that sells at retail price literature on Native American people should stress in their answer to Question 1 the educational, cultural, and any charitable aspects of their work.

This group would do this by detailing the information and referral aspects of their program: by explaining their information and referral work, by describing their newsletter, and by elaborating on any classes or educational programs that they have. The same would be done for counseling. This group would minimize its chances of being disqualified as a business for the sale of literature and materials at cost in these ways (if true, of course):

> • The group should explain how the particular literature it sells is related to its exempt purpose of educating the non-native public and aiding the Native American community.

• The Center should point out the unavailability of this information in other places.

• The group should point out that it makes its decisions about what literature to sell based on how the literature advances its exempt purpose, not on how commercially profitable the literature might be.

Do not assume that the IRS reviewers are familiar with your type of organization or any jargon or abbreviations commonly used by your organization. Explain your group's activities clearly.

Do not assume that the IRS reviewers are familiar with your type of organization or any jargon or abbreviations commonly used by your organization. Explain your group's activities clearly, as if the reader had no knowledge of any similar groups or activities.

Part V – Compensation

This section asks for information about your Directors, employees and independent contractors. For all of these categories, compensation includes wages and salary, deferred compensation, retirement benefits, fringe benefits and bonuses.

Line 1a – Board of Directors and Officers

Fill out the schedule with the names, titles (either Director or position as officer) and addresses of the people on your Board of Directors and your Officers. You may list your organization's address rather than each Director's address if you wish. You must state all compensation that Directors receive from your organization, whether they are paid for their services as directors or employees or in another position. Write "none" if your Directors are unpaid. The figures you use here should match up with your expenses in Part IXA, line 17.

Line 1b – Highest Compensated Employees

Fill in the name, job title and mailing addresses of your five highest paid employees *who receive or will receive more than $50,000 per year*. If you do not have and do not now reasonably anticipate having such employees, write in "none." You may list your organization's address rather than your employees' addresses if you wish.

Line 1c – Highest Compensated Independent Contractors

Fill in the name, title and mailing address of your five highest compensated independent contractors *who receive or will receive more than $50,000 per year*. If you do not have and do not now reasonably anticipate having such independent contractors, write in "none." Independent contractors are persons who provide goods or services for compensation and who are not employees for employment tax purposes. Your agreement with a provider to call them an independent contractor rather than an employee does *not* make them an independent contractor. See the discussion about independent contractors for federal income tax withholding purposes in Chapter 16 on pages 373-376 for a more extensive discussion of this category.

Lines 2-9 – Handling Relationships with Insiders

Lines 2-9 are a series of "yes" and "no" questions. These questions relate to your past, present and planned relationships, transactions and agreements with your Directors and the highest compensated employees and independent contractors that you disclosed above.

Line 2 – Relationships

Read carefully the instructions for definitions of "related," "family relationships" and "business relationships." The relationships defined in the instructions are the only ones you have to disclose. For example, you do not have a family relationship with your stepfather (unless he adopted you and therefore became your legal father) but you do have a family relationship with the spouse of your grandchild. If you have two Directors who have together own a 30% interest in a business, they do not have a business relationship as that term is defined in the instructions.

Line 3 – Compensation from Related Organizations

Line 3a is self-explanatory. In Line 3b, the IRS is trying to determine whether your Directors, officers and highest compensated employees and independent contractors receive compensation from another organization that is related to your organization through "common control." You fall in this category if (1) an organization appoints or elects a majority of your Board and the Board of another organization; (2) a majority of your Board or officers are also the majority of the Board or officers of another organization; or (3) your organization and another organization described in (1) or (2) above have a majority ownership interest in a corporation, partnership or trust. If you fall in any of these categories *and* your Director, officer or highest compensated employees or indepen-

dent contractors are paid by that other organization, you must identify those individuals and explain the relationship.

Line 4 – Control over Compensation Arrangements

Although the IRS does not require that you follow the practices listed in this question, we highly recommend that you do. In connection with 4a, we discuss conflicts of interest on pages 275-276 and conflict of interest policies on page 272. The IRS provides a Sample Conflict of Interest Policy in Appendix A of their instructions. This policy satisfies the IRS that you will follow their rules about compensation arrangements but it does not cover you for other types of conflicts that are regulated by Oregon law. We have included a sample Conflict of Interest policy in the Forms section that complies with Oregon law. You may find it less confusing to adopt this policy. If you adopt the IRS policy, you will need to instruct your Board about how state law is different. The IRS allows you to adopt state-specific policies like the one in the Appendix.

Lines 4b through 4f seek to determine if your approval of compensation for your Directors, officers and highest compensated employees and independent contractors may run afoul of the IRS excess benefit transactions rule. See pages 634-640 for a discussion of the excess benefits rules. If you adopt the Excess Benefits Policy in the Forms section you can answer Lines 4b through 4f "Yes." If you answer any question in this section No," you must explain how your procedure for setting compensation is reasonable.

Line 5 – Conflict of Interest Policy

We recommend that you adopt a conflicts policy. See the response to Line 4 above. If you adopt a conflict of interest policy, you must provide a copy and explain how the policy was adopted. Generally, your Board will adopt it. If you don't adopt a conflicts policy, you must answer lines 5b and 5c.

Line 6 – Non-Fixed Compensation

A non-fixed payment is one that has an element of discretion. The instructions give two examples. Most small to mid-sized nonprofits will answer this question "No." If you do compensate anyone in your organization with non-fixed compensation, you must answer these questions and provide the information required. This kind of compensation is not generally recommended.

Line 7 – Purchases from Insiders

This question aims to solicit information so that the IRS can determine if your organization pays *more than fair market value* for any property or services

that you buy from your Directors, officers or highest compensated employees or independent contractors. If you do that, you are giving the organization's property to private individuals on a noncharitable basis and that is not an exempt purpose. It is okay if you pay these insiders fair market value or less than fair market value. You need to attach proof of fair market value. See the discussion on excess benefits transactions in Chapter 27 for more information.

Line 8 and 9– Agreements with Insiders

These questions are self-explanatory. Under Oregon law, you cannot make loans to your officers and Directors. See pages 276-277.

Part VI – Your Members and Others You Benefit

If you answer "Yes" to any question in this section, you may find it simplest to be sure that your narrative statement in Part IV provides the information that the IRS requests in this section and refer the IRS to your narrative statement by saying "See Part IV, Narrative Statement" after any "Yes" answer here.

Line 1 – Benefits to Individuals and Organizations

Most nonprofits provide goods, services or funds to individuals or to organizations, so you will probably be answering at least one of these questions "Yes."

Line 2 – Limitation of Your Programs

This is a confusing question. Many exempt organizations limit their programs to a class of charitable recipients – for example, the homeless – and the IRS does not intend that this kind of limitation requires that you answer this question "Yes." (You should have already disclosed this in your narrative statement in Part IV.) The IRS is trying to determine if you limit your programs in some other way that singles out particular individuals. For example, you may be raising money to help a particular child with cancer or to provide scholarships for the children of employees of a particular company. In addition, if you provide benefits to your members *that are not available on the same terms to the general public*, you must answer this question "Yes" and provide a copy of your membership application and a schedule of your membership dues and describe the different membership levels and the benefits your members receive. Your members cannot receive benefits that are worth more than what they contribute in dues. If you offer your members benefits that are available to the public on the same terms, you do not have to answer this question "Yes." For example, many nonprofits offer a newsletter to their members but also supply copies to the public on request.

The IRS asks this question because it must determine if your organization is *improperly* benefiting individuals. Some programs that benefit specific individuals may be exempt and others are not. See page 95 for a discussion on improper private benefit. You probably need legal advice if you answer this question "yes."

Your members cannot receive benefits that are worth more than what they contribute in dues.

Line 3 – Relationships

If you give goods, services or funds to individuals who have family or business relationships with your Directors, officers or highest compensated employees or independent contractors, you must disclose this here and explain why these individuals are qualified to receive these benefits. Family and business relationships are described in Part V, Line 2. For example, in order to ensure that your nonprofit serves your needy clients well, you may include as Board members representatives from your client population or their family members and you can easily explain this to the IRS. You should assure the IRS that these individuals follow the same procedures as your other clients in order to obtain services.

Part VII – History

Line 1 – Successor Organizations

The instructions explain who are successors. The most common successor organization is one that originally began as an unincorporated association and later incorporated as a nonprofit corporation. If this describes your situation, you may think of yourself as one organization but in fact these are two separate legal entities. Your corporation took over (was a successor to) the property and activities of the unincorporated association. You will need to answer this question "yes" and fill out Schedule G.

Line 2 – Date Application Is Submitted

Generally, if you file your application within 27 months after the end of the month in which you were incorporated (if you are a nonprofit corporation) or in which you were formed (if you are a charitable trust or unincorporated association), your exemption will retroactive to the date you were organized. (See page 140.) You must complete Schedule E if you submit this application after the 27 month period.

Part VIII – Specific Activities

The IRS has special rules about and concerns about certain types of activities. In this Part, the IRS is seeking to determine if and how you conduct these activities.

Line 1 – Political Activity

Line 1 asks about political campaign activity. If you answer this question "yes," your application will be denied. See Chapter 8.

Line 2 – Lobbying

This asks about your attempts to "influence legislation" – that is, lobbying. Read Chapter 8 for information about this and about the lobbying election referred to in Line 2b.

Line 3 – Bingo and Gaming

Because of past abuses, the IRS monitors bingo. Answer these questions thoroughly. If you engage in bingo, it is likely that the IRS will take longer to process your application. In Oregon, the Attorney General's office will not give you a bingo license until you have been in existence at least one year. See page 474-476 for more about bingo.

Line 4 – Fundraising

Most nonprofits conduct some of the fundraising activities listed here. Be sure to attach a description for each type of fundraising you check. You do not have to list individual donors (and you may not want to, since your application is available to the public) but you should explain briefly how you develop donor lists and pursue contacts. Question 4b covers both individual grant writers you may hire and professional and commercial fundraising firms. The latter are heavily regulated and are often abusive. (See pages 493-496.) If you hire individual grant writers but not professional fundraisers, be sure that you make this clear to the IRS. Question 4e seeks to determine if you maintain donor-advised funds in which you segregate the donor's funds and allow the donor to make recommendations for their use.

Line 5 – Governmental Units

Read the instructions to see if you are affiliated with a governmental unit. The fact that you receive some or even all of your funding from governmental sources does not make you affiliated with a governmental unit. You need to be

created by, controlled by or closely related to the government to be considered affiliated with a governmental unit.

Line 6 – Economic Development Organizations

This question is aimed at organizations that seek to assist *businesses* (not unemployed or low income *individuals*) that are located in economically depressed areas. If this described you, read the instructions. If your organization seeks to assist individuals who need help to function in the economy (for example, with job retraining), answer this question "no" and move on.

Line 7 – Development and Management of Your Facilities

Some nonprofits contract out the development or management of their operations. For example, many low income housing groups hire developers to oversee the construction of their facilities and to handle financing. Some hire management companies to run the operations. A school may hire a food service to provide meals for the students. If you have or will have persons other than your employees and volunteers develop or operate your facilities, you must answer 7a or 7b "yes" and follow the instructions. If you are using for-profit management, you should get legal advice.

Line 8 – Joint Ventures

If you are part of or plan to enter into a joint venture or partnership with another organization that is not exempt under §501(c)(3), you must answer this question "yes" and describe the arrangement. The rules about these partnerships are quite restrictive and you should get legal advice before you file your application.

Line 9 – Childcare Organizations

A childcare organizations may be exempt under §501(c)(3) if it qualifies as a school (see Line 19) or if at least 85% of the children in its care have working parents or caregivers (this is the §501(k) exemption). If you qualify under §501(k), answer Question 9a "yes" and continue with this section. Read the instruction for more help. Get legal advice, particularly if you do not meet the 85% threshold.

Line 10 – Intellectual Property

Many nonprofits produce reports, instructional materials, artistic products, research results and similar creative products. These creative products potentially have value and are called intellectual property. If your nonprofit pro-

duced the product, the rights to this property will commonly belong to the nonprofit. If that is the case, make clear in your answer to this question that the nonprofit owns all rights to the material. In a proper case, you may make arrangements that allow the individual who created the product to retain rights to his or her creation. You must assure the IRS that the nonprofit has or will receive fair market value for its contribution to the intellectual property. You will probably need legal help to structure an arrangement that ensures that the nonprofit receives fair value for its contribution to the product.

Line 11 – Contributions

This question asks about certain contributions that the IRS is currently monitoring. The IRS will use the information you supply to determine if the donors are taking more than fair market value for their donations.

Line 12 and 14– Foreign Organizations

Questions 12 and 14 ask about your operations in foreign countries. Question 12 is interested in direct programs you operate in other countries and Question 14 wants to know about grants and distributions you make to other governments, to non-governmental organizations (commonly called NGOs) and to other foreign organizations. If you operate direct programs that are clearly exempt outside the United States, you can easily answer Question 12. You should get legal advice if you answer Question 14a "yes." The IRS has specific rules that prohibit donors from taking charitable deductions for gifts that they give to a (c)(3) organization that are earmarked for a foreign program. The IRS also wants to be sure that any money you give to a foreign grantee is being used for exempt purposes. Unless you are familiar with the rules in this area, you need help.

If you operate in foreign countries, read pages 626-630 on the terrorism laws.

Line 13 – Distributions to Other Organizations

The IRS wants to ensure that monies you distribute to other organizations are being used for exempt purposes. If you make grants or distributions to other (c)(3)s, the IRS will be unlikely to question your distribution as long as it fits within your exempt purpose. However, if you make distributions to organizations that are not exempt under §501(c)(3), you must follow a expenditure responsibility procedure to ensure that the funds are used for (c)(3) purposes. See pages 228-229 for what is required. If you follow that procedure, you should be able to answer both parts of Question 13f with "yes" and to answer Question 13g. Some (c)(3)s are affiliated with other exempt organizations, most commonly lobbying organizations exempt under §501(c)(4). (See pages 199-200.)

Question 13d requires that you disclose these connected organizations. The IRS will, of course, be particularly interested in monies flowing from your (c)(3) to a linked organization. You can make this kind of transfer only if you get goods or services of equal or greater value in return or if you properly document that your linked organization uses the funds to further your (c)(3) exempt purpose. Get professional help to be sure that you handle these transfers properly.

Line 15 – Connected Organizations

The IRS asks again (as it did in Question 13d) for any organizations with which you are linked. If you answered 13d by identifying linked organizations, you will answer this question "yes" and refer to 13d. However, many organizations that did not answer Question 13 in the affirmative because they don't make distributions to their linked organizations will also answer Question 15 "yes."

Lines 16-21 – Specific Organizations

The IRS lists particular types of organizations here for which it wants additional information. Read the instructions to see if any of these organizations describe you. If so, in some cases you will need to complete an additional schedule. You will probably need legal help.

Line 22 – Scholarships

If you provide scholarships or educational loans, you have to fill out Schedule H. If you are a private foundation that provides scholarships, you can and generally should obtain advance approval of your procedures in awarding scholarships. You do this by filling out Section II on Schedule H. Advance approval ensures that your procedures meet IRS rules. You should get legal advice, particularly if you provide scholarships to employees of a particular employer.

The question about scholarships is geared to uncover payments made to enhance an individual's capacities or talents. Many nonprofits that are not schools provide waivers or reductions of conference fees or other program expenses to low-income individuals or to other nonprofit groups. We recommend that you do not use the word "scholarship" to describe these fee waivers in order to avoid confusion about whether you must file the Schedule H.

Part IX – Financial Data

This Part contains the Statement of Revenue and Expense and the Balance Sheet that you must fill out. The IRS wants to get three years of financial infor-

mation. You will supply information for each year you've been in existence. If you have not been in existence long enough to supply three years of financial information, you must provide projected budgets for enough years so that the IRS has three years of information. The column marked *Current tax year* is for this tax year, unless you have completed more than four tax years. In that case, use *Current tax year* for your most recently completed tax year. The instructions explain how to fill out the Statement. Get your bookkeeper or accountant to help you with this part of the Form 1023.

If you have been in existence for less than four years and so must prepare projected budgets, try to project as realistically as possible but don't spend excessive amounts of time on this. Virtually all new groups are estimating. Chapter 20 on making a budget and Chapter 23 on preparing financial reports should be helpful. Use your organization's method of accounting and your accounting period in preparing projected budgets. If you use a method of accounting other than the cash receipts and disbursements method (see Chapter 23), you must attach a statement explaining the method you use. Be sure to attach itemized lists for those lines that require lists.

The main reason that the revenue portion (Lines 1-13) of Part A is divided into the categories that you see is so that the IRS can use these figures to see if you meet the support tests as a PSO, FASO, or development foundation. The categories also help the IRS to determine if a substantial part of your purpose is to run a business, if anyone is privately benefiting from your group, if you have unusual grants, etc.

There are several common confusions about the expense portion (Lines 14-24) of the Statement of Revenue and Expenses. Line 15 asks for contributions and similar amounts you pay out to others. As a (c)(3) organization, you should only make contributions to other (c)(3) groups, to groups that use your funds for (c)(3) purposes or to needy individuals. You should have described all this in your narrative statement in Part IV. If you operate programs that benefit others but which do not pay out sums of money, Line 15 will be 0. Place expenses for programs in Line 23. Line 16 describes disbursements for members. Most (c)(3)s do not make disbursements to their members. If you do, you will need to show that the dues paid by members equal or exceed the value of what they receive. If you compensate your officers or Directors, Line 17 should correspond with the information you disclosed in Part V, Line 1. Almost all nonprofits will have expenses to include on Line 23. Be sure to itemize these. If you are a new organization, group your expenses into categories and make your best estimates.

The Balance Sheet uses the same *Current tax year* that you used on the Statement of Revenue and Expenses. The "Year End" date that you fill in on the

Balance Sheet should be the same ending date that you filled in on your *Current tax year*.

Part X – Public Charity or Private Foundation Status

The IRS uses this part of the form to determine if you are a public charity or a private foundation. Review the discussion on pages 96-106 about this very important distinction. If you are a private foundation, you will answer Lines 1-4. You should get professional help.

If you are a public charity, you should answer Line 1a "no" and skip to Line 5. Use pages 100-106 to pick the category that is appropriate for you in Line 5. To match the IRS categories with the ones on page 100, use this table:

Description	IRS letter on Application	# Used in Chapter 5 (p. 100)
Church	(a)	1
School	(b)	2
Hospital/Medical research organization	(c)	3
Supporting Organization	(d)	5
Public Safety Organization	(e)	6
Development Foundation	(f)	7
Publicly Supported Organization (PSO)	(g)	8
Fee/Activity Supported Organization (FASO)	(h)	9

Be sure to complete whatever schedules, if any, are required by your choice. Use Chapter 5 to help you with the schedules.

PSOs and FASOs

Many groups can potentially qualify as a Public Charity because they are both a Publicly Supported Organization (PSO) and a Fee/Activity Supported Organization (FASO). The form allows you to permit the IRS to compute your support and place you in one of these categories. If you are applying for an advance ruling and are uncertain about exactly what your future support will be, you are generally safe to check (i) and let the IRS choose for you. If you check (i) and IRS decides you could qualify as both a PSO and FASO, it will generally designate you a PSO.

If you want to choose for yourself, you should choose the one that gives you the greatest flexibility in case your actual support is different than you antici-

pated. For most groups, the category that gives them the greatest flexibility is the PSO. This is true because:

• Often a group's largest donors are "disqualified persons." A FASO cannot count support from these people at all; a PSO can count it subject to the 2% limitation rules.

• Another common source of support is one or a few large gifts from persons who are not disqualified persons. In most cases, a PSO can count more of this support in its formula, since the 2% limitation is calculated as 2% of the total support for the whole normalcy period. A FASO can only count the gift up to 1% of the total support for that taxable year (or $5,000 whichever is greater).

Example: Your group receives a one-time gift from a donor (not a disqualified person) of $20,000 that does not qualify as an unusual grant. Your other support generally amounts to about $25,000 per year. Over your 4-year normalcy period, your total support is $120,000. In the taxable year you received the gift, your support was $45,000. The amount of the $20,000 you could claim in your support calculations would be:

As a PSO:		
2% of $120,000	=	$2,400
As a FASO:		
1% of $45,000	=	$ 450

• PSOs are also preferable to FASOs in case your group fails to meet its ⅓ support test. PSOs can fall back on a "facts and circumstances" test. FASOs do not have this option.

• If you have much investment income, the PSO test is a better choice. A PSO can theoretically have up to 90% of its support be investment income (as long as the remaining 10% was qualified public support) while the investment income of FASOs cannot exceed one-third of its total support.

Line 6 – Advance or Definitive Ruling

If you checked Line 5g, 5h or 5i, you must check either Line 6a or 6b. In this section, you notify the IRS about whether you are seeking an Advance or Definitive Ruling about your public charity status. See pages 108-111 for a discus-

sion of this. If you are requesting an Advance Ruling, check Line 6a and have an authorized person sign the Consent Fixing Period of Limitation located in the middle of the page. Your authorized official signs in the section that says "For Organization." The IRS (*not your Director*), will later sign the section that says "For Director, Exempt Organizations," and return a copy of this page to you when you get your exempt status.

If you check Line 6b for a Definitive Ruling, be sure to fill in (i)(a) and to supply the other information requested. "Disqualified persons" are described on pages 155-159.

Line 7 – Unusual Grants

The "unusual grants" referred to in Line 7 are discussed on page 159. You will want to fill this out carefully if you are a PSO, FASO or a government-operated organization that supports a college or university that wants to exclude unusual grants from your support calculation.

Part XI – User Fee Information

In this section, you indicate whether you are paying a $150 or $500 user fee. See page 116 for an explanation of these fees.

Signature Line

Form 1023 must be signed and dated by an officer authorized to sign by the corporation. The signer should review the application carefully. It may also be signed by any person who the corporation authorizes by a power of attorney to sign. Your group must use IRS Form 2848 (Power of Attorney and Declaration of Representative) or Form 8821 (Tax Information Authorization) to grant a power of attorney. The signature attests that the application and accompanying schedules and attachments are true, correct and complete.

Attachments to the 1023

You must include the Form 1023 Checklist at the end of the Form 1023. It is easy to overlook this, particularly if you do not have to fill out any of the Schedules. Review the Checklist carefully and check each box to show that you have included the material required. Every attachment (other than IRS forms) should show your organization's name, your employer identification number and an identifiable heading so that the agent reading the application knows what it refers to. Be sure to put a checkmark by the Schedules (if any) that you filled out. Notice on the second page that you must fill in the location of the Purpose Clause and the Dissolution Clause in your Articles of Incorporation or the

amendments to your Articles. Repeat here what you said in Part III, Lines 1 and 2b. Once you've checked every box, assemble the materials in the order listed in the first item on the checklist and send them with your check for the user fee on top of the pile (and not stapled to anything) to the IRS at the address at the end of the Checklist. You benefit from all this fastidiousness because it allows the IRS to process your application more quickly.

Schedules

If you are required to file Schedules, you should get professional help in most cases. The rules concerning specific groups like churches, schools, hospital, supporting organizations, housing and scholarships are more complex than we can cover in this book. We will discuss Schedule E (used by groups that file this application more than 27 months after they were formed) and Schedule G (on successor organization) as it applies to unincorporated nonprofit associations that have incorporated as nonprofit corporations.

Schedule E – Organizations Formed More Than 27 Months Before Filing

Generally, if you did not apply for exemption within 27 months after the end of the month in which you were formed, your exemption will be retroactive to the postmark date of your application and not to the date of your formation. There are two exceptions to this rule. One is for groups that are exempt whether or not they apply for exemption. These are the groups described in Lines 1-4.

Line 5 – Extensions of Time

The second exception is for groups that get an extension of time to apply for exemption. Whether the IRS grants an extension depends on whether the IRS contacted you during the 27-month period about your failure to file Form 1023. If it did contact you, you will need to show reasons for your late filing that are specific to your organization, including whether you contacted an attorney, accountant or the IRS about filing for the exemption; who you contacted and what you were told; how and when you learned about the filing deadline; whether any significant intervening circumstances beyond your control prevented you from filing the Form 1023 after you learned about the filing deadline; and any other information that might establish good cause on your part for not filing in time.

If the IRS did not contact you before the end of the 27-month period, then the IRS will be looking at the following factors to determine whether it should grant you an extension:

- whether you exercised due diligence in finding out the due date of the application and in preparing the application for filing;

- whether you took prompt action to deal with the deadline or to request an extension;

- whether you had the intention of using the extension as a means of evading the deadline;

- whether granting the extension would prejudice the interests of the government;

- whether granting the extension would be consistent with the objectives of the notice requirement and the grace period.

The first three factors are especially important. You need to show you had good reason for not seeking advice from an attorney, accountant, or the IRS about filing requirements (for instance, if you thought you were exempt from filing as an organization that normally receives less than $5,000 per year – see page 106). If you sought advice, you need to explain either that it was wrong (they failed to tell you about the filing deadlines) or why you failed to follow it. Although these criteria seem forbidding, many organizations find that it is worthwhile to file for an extension. Remember that if you fail to qualify for an extension, it does not mean that you can't get an exemption. It just means that your exemption will only be retroactive to the time that you filed your application.

Lines 6 and 7 – Advance Ruling

These questions are a bit tricky. If you agreed in Line 5 that your exemption will only be retroactive to the date you filed it, you are not eligible for a definitive ruling on your public charity status. (See Part X, Line 6.) You must either request an Advance Ruling or be treated as a private foundation. If you are not a private foundation, you should apply for an Advance Ruling by checking Line 6a as "yes." Be sure that your answer here agrees with what you said in Part X, Line 6. If you anticipate that your sources of support over the next 2-3 years will not change significantly from what you listed in Part IX, answer Line 6b "no" and go on to Line 8. You do not have to fill in the projected revenue form in Line 7. If you check Line 6b as "yes," fill out the projected revenue sheet in Line 7.

Lines 8 – §501(c)(4) Status

As the question explains, what you are deciding in this question is whether you want to clear the way for the IRS to recognize you as an organization exempt under §501(c)(4) if your §501(c)(3) exemption is not retroactive to the date you were formed. The §501(c)(4) status would cover you from the day you were organized until the date you are recognized as exempt under §501(c)(3) (that is, the day you filed your application). The advantage of getting §501(c)(4) status for that period is that you won't have to pay income tax for that period. However, remember that contributions to your group during that time would not be deductible, as they are for §501(c)(3) groups. Since the alternative to getting §501(c)(4) status at this point would be to have no tax-exempt status, most groups will want to answer Line 8 "yes" and must provide a completed Page 1 of Form 1024. You can find information on how to complete this page in Appendix 7.

Schedule G – Successors to Other Organizations

Many nonprofit corporations operated as unincorporated nonprofit associations before they incorporated. Because the law treats the corporation as a separate legal entity, the incorporated nonprofit is a successor to the unincorporated nonprofit association. We are including information about how to fill out this Schedule for those corporations. If you are classified as a successor organization for some other reason, you should get professional help to fill out this schedule.

Lines 1 and 2 – Nonprofit Predecessors

As a nonprofit corporation that succeeded a nonprofit association, you can answer Line 1a "no" and Line 2a "yes." In an attachment, explain very briefly that your corporation was created by incorporating a nonprofit association whose activities you have continued.

Keep in mind in answering Line 2b that your previous nonprofit association was probably itself exempt from taxation even though it never applied for exempt status. If it had gross receipts of less than $5,000 per year or was a church, it may have been exempt under §501(c)(3). (See page 106.) If it was not exempt under (c)(3), it was very likely exempt under §501(c)(4). (See page 111.) If it was not tax exempt, you will need to explain its tax status. Lines 2c and 2d are self-explanatory. In Line 2e, you can simply explain that you continued the activities of the nonprofit association but simply changed its organizational form by incorporating.

Lines 3-5 – Information about Predecessor

Line 3 is self-explanatory. The EIN is the employer identification number. On Line 4, you should list those who had decision-making authority over the association. If the association had no board but had members who made all the decisions, explain this on your attachment. Since the association was nonprofit, your answer under "Share/Interest" should be none. If some of the board members continue to work with you, you will need to explain their relationship in Line 5.

Line 6 – Transfer of Assets

Answer Line 6a "yes" and explain in your attachment that the nonprofit association gave you its assets. Unless an asset was quite valuable, provide a list that covers very general categories, such as "office supplies worth about $500." Most likely, you do not have an appraisal and you can simply say so. If there was no written agreement of transfer (and there almost never is in cases like this), simply tell the IRS that there was no written agreement in answer to Line 6c.

Lines 7-9 – Other Questions

Because Question 7 refers to for-profit predecessors, your answer will be "no." Your answer to Questions 8 and 9 will also be "no" unless you have the dealing described there with individuals listed on Line 4.

FILLING OUT FORM 1024

Groups that are exempt from taxation under any section other than §501(c)(3) do not have to apply for recognition from exemption. However, most groups can apply if they chose to do so. There are several reasons you may want to apply in order to get a formal letter from the IRS recognizing that you are exempt. One is that you may be somewhat uncertain about whether you qualify. If you fail to pay taxes based on your belief that you are exempt and are later audited and found not to be exempt, your group may find itself owing back taxes, interest, and penalties. Your Directors may want the formal recognition in order to eliminate any chance that they might be personally liable for these sums. Another reason you may choose to apply is that your organization may qualify for certain benefits (for example, the right to cheaper space in public facilities) if it has an IRS letter recognizing its exemption.

In most cases, organizations seeking formal recognition that they are tax-exempt under a section other than §501(c)(3) fill out IRS Form 1024. You should

contact the IRS and obtain a copy of Form 1024 and Publication 557. (See Appendix 2 for contact information.) There are a few types of exempt groups that do not file any form. Consult Publication 557 to see if you happen to fall in one of these unusual groups.

Groups that are exempt from taxation under any section other than §501(c)(3) do not have to apply for recognition from exemption. There are several reasons you may want to apply.

Appendix 7 gives a line by line description of how to fill out the main body of Form 1024. In addition, each group must fill out a special schedule that pertains to its specific exemption. If you need help with those schedules, you should see an attorney or accountant.

Even if you choose not to apply for recognition of exemption, you are still responsible for filing annual tax returns if you are an exempt organization. See Chapter 12.

QUESTIONS BACK FROM THE IRS

It is very common for the IRS to respond to your application by sending you a list of questions to answer. At this point, you should seriously consider getting professional help.

Consult Appendix 1 if you would like information about source material related to this Chapter.

The next four chapters in Part II cover in greater detail the subjects of PSOs and FASOs, lobbying, unrelated business income, and fiscal sponsorship. Read those if they are of interest to you. All tax-exempt groups should look at the last two chapters of Part II on state and local tax exemptions and on tax returns for exempt organizations.

7 PUBLICLY SUPPORTED ORGANIZATIONS AND FEE/ACTIVITY SUPPORTED ORGANIZATIONS (PSOs AND FASOs)

In Chapter 5, we discussed the difference between private foundations and public charities, and we listed and described the types of groups that could qualify as public charities. We postponed discussion of two of those groups until this chapter.

The tests described in this chapter are extremely technical. Consequently, you will probably find this chapter confusing (sorry) and boring (double sorry). We've done what we can to make this tedious area of law understandable. Before you plunge in, you should review #8 and #9 on pages 105-106. These sections describe groups that should clearly be PSOs and FASOs without having to get caught up in the details of this chapter.

This chapter will explain the financial support requirements for groups wishing to qualify for or maintain §501(c)(3) public charity status as a Publicly Supported Organization (PSO) or a Fee/Activity Supported Organization (FASO). You should read this section carefully if you are or want to be a §501(c)(3) public charity and:

- You are not a church, school, hospital; medical research organization, development foundation, governmental unit, supporting organization, or public safety organization; and either

- You receive a lot of your support from the government, grants, donations, or membership fees; or

- You receive a lot of your support from receipts from your activities (sale of tickets to events, sale of products or services) or from a business you run.

The information in this section may be necessary both to fill out the application for tax-exempt status and to complete your yearly informational return to the IRS (Form 990).

THIS CHAPTER COVERS

- **Support Requirements for PSOs and FASOs**
- **How to Calculate the Total Support Base**
- **Summary of the Formulas**
- **How to Calculate Your Support from Qualified Sources for the PSO Test**
- **How to Calculate Your Support from Qualified Sources for the FASO Test**
- **The Normalcy Period**
- **Recordkeeping Issues**

SUPPORT REQUIREMENTS FOR PSO'S AND FASO'S

Most of the organizations that are exempt as public charities (e.g., churches, schools, hospitals, etc.) are defined in terms of their purpose. PSOs and FASOs are defined in terms of where their financial support comes from.

The tests described in this chapter are extremely technical. Before you plunge into this chapter, you should review #8 and #9 on page 101. These sections describe groups that should clearly be PSOs and FASOs without having to get caught up in the details of this chapter.

The support requirements for PSOs differ from those for FASOs. Basically, they are as follows:

PSO – *An organization which normally receives a substantial part of its support from a governmental unit or from direct or indirect contributions from the general public.*

FASO – *An organization which normally receives more than one-third of its support from any combination of:*

- gifts, grants, contributions or membership fees, and
- gross receipts from related business activities;

and normally receives not more than one-third of its support from the sum of:

- gross investment income; and
- the amount of the unrelated business taxable income less the amount of the unrelated business income tax.

The words in these rules have very specific and sometimes unexpected meanings (for instance, you may be surprised to learn that "normally" means "over four years"). We'll explain the rules that have the most importance for exempt groups, and point out other areas that you should check further if they apply to your group.

In order to qualify as a public charity under these rules, you need to receive a certain percentage of your total support from "qualified sources." The percentage is determined by dividing your total support into the income from qualified sources. Thus, total support from all sources is the denominator of this fraction, and the income from certain qualified sources is the numerator.

First, we'll explain how to calculate your total support base, which will be the denominator of the fraction. Next, we'll talk about how to calculate your support from qualified sources (the numerator) and then the proper tests to apply for PSOs and then for FASOs. At the end of this chapter, there are some worksheets to help you in calculating how you come out on the support test.

NUMERATOR = Qualified Support

DENOMINATOR = Total Support Base

In several cases, the rules are too detailed to describe here, and we suggest you see an attorney if you think those rules affect you.

In order to qualify as a public charity under these rules, you need to receive a certain percentage of your total support from "qualified sources." Total support from all sources is the denominator of this fraction, and the income from certain qualified sources is the numerator.

HOW TO CALCULATE THE TOTAL SUPPORT BASE

The total support base (denominator) can come from five sources for PSOs, six for FASOs. These sources are:

1. Contributions, grants (excluding unusual grants, discussed on page 159), and membership fees;
2. Gross receipts from related business activities (NOT for PSOs; in most cases, PSOs can have this income, but don't have to count it in either the denominator or numerator);
3. Net income from unrelated business activity, whether or not such activities are carried on regularly as a trade or business;
4. Gross investment income;
5. Tax revenues levied by a government unit for the benefit of an organization and either paid to or expended on behalf of the organization;

6. The value of services or facilities furnished by a government unit to an organization without charge (unless furnished also to the general public without charge).

These six sources are explained below.

1. Contributions, Grants and Membership Fees.

Contributions: A contribution (or gift) occurs when money or property (or the use of property) is given to your group with nothing given by you in return or when what you give in return is worth less than the gift or contribution. In the latter situation, the amount of the contribution is usually the difference between its value and what is given in return. To figure out the value of the contribution, read IRS Publications #526 – Charitable Contributions and #561 – Determining the Value of Donated Property, which you can get free from the IRS. See Appendix 2.

Grants: Grants are made to organizations, often by governmental units and foundations, to make it possible for the group to operate programs which are part of carrying out its exempt purposes. When the government provides the money, it can be difficult to determine whether the government is funding an activity that will benefit the general public (for example, the government grants you money to rehabilitate low-income housing at no cost) or is really contracting for a benefit which the government receives (for example, the government pays an educational organization to train governmental employees in the principles of management and administration). Generally, the government imposes fewer restrictions on grants and is less likely to solicit for grantees. In the case of contracts, the money the organization receives is not a grant but is instead a payment for services. It is either gross receipts from related activities (see #2 below) or income from an unrelated business (see #3 below).

Membership Fee: Groups often have members: people who share a common goal or concern. Sometimes the organization charges a fee to each prospective member as a requirement for joining the group. Payment of a membership fee often entitles the member to certain benefits, such as receipt of a newsletter, the right to attend meetings, and the right to vote. The membership fee is usually used for the general support of the organization.

In some cases, what looks like a membership fee may be something else. If one class of members pays a greater membership fee than another class of members and does not receive any additional benefits, (e.g., individual member, $10; patron, $100), the difference is classified as a gift or contribution rather than a membership fee. Similarly, if the membership fee is really a ticket price to a performance or event or the price of merchandise or services which are

sold to the general public, then the fee is not a membership fee but rather income from a related or unrelated business activity.

Caution: Remember that in Oregon members also have the right to vote for the Board. If you have members who pay dues but do not vote, review page 52 for how to handle this.

2. Gross Receipts from Related Business Activities

Receipts from related business activities may come from the following activities:

- Admissions;
- Sales of merchandise;
- Performance of services; or
- Furnishing of facilities.

This category counts gross receipts, not net receipts after expenses are paid. The activity must be related to the charitable, educational or other exempt purpose of the organization. (See Chapter 9 to determine what is related and what is unrelated business activity.)

This support source is usually counted only for the FASO formula, not for the PSO formula. This is an advantage for PSOs because this support is also counted in the numerator for FASOs but *only to a limited extent*. As you read on, you will see that this can make it difficult for a group to pass the required support test. PSOs don't have to count it in either the denominator or the numerator. The exception to this is if substantially all of your organization's support is from gross receipts from related activities and an insignificant amount comes from governmental units and the general public. If this is the case, you cannot qualify as a PSO.

3. Net Income from Unrelated Business Activities

It's important to know the difference between related and unrelated business activity for three reasons. First, if the activity is related, all the gross receipts are counted in the total support base for FASOs in #2 above. If it's unrelated, only the net income is counted (and probably the net loss). Second, net income from unrelated activities is counted in the support base for both FASOs and PSOs. PSOs will also have to be able to make this determination. Third, both FASOs and PSOs are subject to a tax on some unrelated business income, but not on gross receipts from related activities. Chapter 9 discusses the difference between related and unrelated business activities.

The net income from unrelated business activities is counted as support if the income comes from a trade or business and if the income is not substantially related to your exempt purpose. It does not matter whether the activity is carried on regularly or is sporadic. Note that this is a broader test than the test for determining if you must pay unrelated business income tax. (See Chapter 9). The unrelated business income tax only applies if your activity is regular.

4. Gross Investment Income

This support element includes the gross income from interest, dividends, rents and royalties, unless the income is taxable as unrelated business income. (See Chapter 9 to figure out what is included in this exception.) Examples of these four sources are as follows:

- Interest on savings accounts or investments or interest you charge on loans to individuals or groups;

- Dividends on stock, shares (savings) in credit unions, etc. (In connection with the interest and dividends, you will get a statement from the bank or the credit union at the end of the year showing the total amount credited to your account throughout the year as dividends or interest);

- Royalties (for example, payments to you from sales of a book your group has written);

- Rents from real property and from personal property, leased with real property, to the extent that the rents are not taxable as unrelated business income.

If income from any of these sources comes from activities which further your exempt purpose in any important way, that income would be *gross receipts from related activities* (#2 above) and *not* gross investment income. For instance, if the purpose of the group is to provide facilities or make loans to sick or poor people, rent or interest from such individuals would be gross receipts from related activities.

5. Certain Tax Revenues

Tax Revenues levied by a government unit for the benefit of an organization and either paid to or expended on behalf of the organization must be counted in the total support base.

6. Certain Services and Facilities Furnished by the Government

You must count in your support base the value of services or facilities furnished by a government unit to your organization without charge, unless these services or facilities are furnished also to the general public without charge.

SUMMARY OF THE FORMULAS

PSO

NUMERATOR = Qualified Support

DENOMINATOR = Contributions, grants (excluding unusual grants), membership fees, *plus*
Net income from unrelated business activities, *plus*
Gross investment income, *plus*
Tax revenues from government, *plus*
Value of free services/facilities from government

FASO

NUMERATOR = Qualified Support

DENOMINATOR = Contributions, grants (excluding unusual grants), membership fees, *plus*
Gross receipts from related business activities, *plus*
Net income from unrelated business activities, *plus*
Gross investment income, *plus*
Tax revenues from government, *plus*
Value of free services/facilities from government

The total support received from these sources – all six for FASOs and five (excluding "gross receipts from related business activities") for PSOs – represents the total support base of your group. (Use the worksheet at the end of this chapter to help you calculate your denominator.) This is the denominator for

the percentage calculation explained next. The remainder of this chapter describes the different support tests for PSOs and FASOs and explains the "qualified" sources of support which make up the numerator for your calculations.

HOW TO CALCULATE YOUR SUPPORT FROM QUALIFIED SOURCES FOR THE PSO TEST

A Publicly Supported Organization is an organization which:

- normally
- receives a substantial part of its support
- from a governmental unity, or
- from direct or indirect contributions from the general public.

Two very specific tests are used to determine whether a PSO is "publicly supported" (as defined by the IRS). One is called the "mechanical test"; the other is the "facts and circumstances" test. If you pass the first, you don't need the second. If you fail the first, you still might pass the second.

Both tests involve a fraction or percentage calculation:

> First you determine your overall support. This is the denominator. (We've already covered this.)
>
> Second, you determine how much of that total support came from certain qualified specific sources. (We cover this next.)
>
> Finally, you see what percentage of your total support (denominator) came from qualified sources (numerator).

If support from qualified sources equals 33⅓ % of your total support, you have passed the "mechanical test" and are therefore a Publicly Supported Organization.

If not, you and the IRS apply the alternative "facts and circumstances" test: if your percentage of qualified support is at least 10% of total support, and you attract public support, and considering all the facts and circumstances you have the nature of a "publicly supported" organization, you have passed this test.

The Mechanical Test (or One -Third Support Test)

An organization qualifies as a Publicly Supported Organization if it *normally* receives at least 33⅓% of its total support (the denominator) from *qualified sources*.

The meaning of *normally* under this test is discussed on pages 167-168.

Qualified sources of support (numerator) are governmental unit support, direct public support, and indirect public support. These are defined and calculated as follows:

Governmental Unit Support

Governmental unit support includes all donations and contributions from governmental units. It also includes grants from governmental units if the grant is made to an organization to provide a service or facility for the direct benefit of the general public. If the grant is to serve the direct and immediate need of the payor, it cannot be included.

Direct Public Support

Contributions, grants and membership fees from individuals, corporations, or trusts, are included. However, there is a limit on how much from each source can be counted. If you have some donations which are large, in comparison with other donations, read this section carefully.

Per Person Two Percent Limitation

There is a two percent per person limitation on how much direct public support you can include in your numerator. Each contribution, grant or fee amount will be fully included in the numerator only if it is not larger than 2% of the total support base (the denominator). If it is larger than that, then only the amount which represents 2% of total support is counted. This "2% limitation" is a sub-test to which each individual donor is subject. Since these calculations are over the whole normalcy period (usually 4 years, see pages 167-168), you have to know what each donor has given for each year in that period.

> *Example*: Carol donates $120 a year to the local Senior Center, an exempt organization, for the four-year "normalcy" period. During this normalcy period, the Senior Center's total support base was $10,000. Two percent of $10,000 is $200, so $200 is the support limitation per individual donor. Carol has given a total of $480 over the four year period ($120 a year for 4 years). Only $200 of

that $480 can be counted in the numerator for the mechanical test. However, it will all be counted in the denominator.

Disqualified Person Two Percent Limitation

There is a special "lumping" rule where the donor is part of certain disqualified person groups. The five types of disqualified person/groups are:

- Substantial contributors
- Foundation managers.
- 20% owner/entity substantial contributors
- Family members
- 35% disqualified persons/entity owners

For individuals who are not disqualified person, the two percent limitation rule applies only to that individual. Where the donor is a disqualified person, the two percent limitations rule for disqualified persons states that all contributions will be lumped together and treated as one contribution if they are made by a donor and by any entity that is related to that donor in the form of a 20% owner/entity substantial contributor, a family member, or 35% disqualified person/entity owner. The purpose of this lumping rule is to prevent a donor from getting around the 2% rule by giving part of her/his contribution in the donor's name and part through a family member or an organization controlled by the donor.

The starting point for determining if you have contributors who are disqualified persons is to see if you have substantial contributors who contribute to your organization. If so, you then need to examine their business and family relationships to see if you have other disqualified persons as contributors. You also need to examine whether your foundation managers or their families or businesses contributed to your group.

Substantial Contributor

A substantial contributor is any person, trust, corporation, estate, partnership, or association who gives an aggregate amount of more than $5,000 to your group, if that aggregate amount is more than 2% of the total contributions and bequests (gifts made by a will) received throughout your existence up to the close of the taxable year in which the contribution is received. Although the calculation is made based on total contributions at the end of your tax year, a person who is a substantial contributor at that time actually became a substantial contributor on the date that he or she made the contribution that pushed that donor into the substantial contributor category.

Note that the denominator for this 2% calculation is not your total support for four years but is the total of your contributions and bequests throughout your existence up to the close of the taxable year when you got the contribution. Once a person becomes a substantial contributor, she or he is always a substantial contributor, even though later on as the organization receives more support, her or his contribution may become less than 2% of the total contributions. It is these twists in the test that separate substantial contributors from other contributors subject to the Two Percent Limitation discussed on page 154.

> *Example*: On July 19, 2000, Claire gave $2,500 to the Rural Assistance Project. On May 17, 2005, she gave an additional $3,000. From its beginning until the close of 2005 (the taxable year that it received Carol's gift), the Rural Assistance Project received $200,000 in contributions from all sources. 2% of $200,000 = $4,000. Since $5,000 is more than $4,000, $5,000 is the floor that marks substantial contributions and Claire exceeded that limit. Claire is a substantial contributor as of May 17, 2005, as it is on that date that her aggregate contributions of $5,500 met the $5,000 test. Claire will always be a substantial contributor even though the organization receives donations after 2005 that reduce her contribution to less than 2% of its total contributions.
>
> *Example*: Suppose that Claire contributed as described above but that the Rural Assistance Project received a donation from an unrelated source of $100,000 in November of 2005. At the close of its tax year in 2005, the Rural Assistance Project's contributions now totalled $300,000. 2% of $300,000 = $6,000. Claire with her donations of $5,500 is not a substantial contributor because her donations did not meet the test *as of the end of the year that she donated*.

The consequence of becoming a substantial contributor is that this donor is now a disqualified person. This means that your organization must aggregate the donor's contributions with her or his family and business connections in applying the two percent limitation rules.

Once a person becomes a substantial contributor, she or he is always a substantial contributor, even though later on as the organization receives more support, her or his contribution may become less than 2% of the total contributions.

The government and other PSOs are not substantial contributors, unless their contributions to your group were given to them by a donor who earmarked them to be given to you.

Foundation Manager

This category includes:

- officers and directors of a foundation, or individuals having similar powers or responsibilities; or
- with respect to any act, or failure to act, the employees of the foundation having authority or responsibility with respect to such act or failure to act.

A person will be considered an *officer* if:

- she or he is so designated in the Articles or Bylaws;
- she or he regularly exercises general authority to make administrative or policy decisions on behalf of the organization.

> *Example*: If your group received a contribution from a foundation manager and a contribution from the family members of a foundation manager or a contribution from a foundation manager and from an entity of which the foundation manager owns 35%, these contributions must be combined for purposes of the 2% rules.

There is some ambiguity between the statute and the IRS interpretation on the issue of whether the director or officers of a public charity are "foundation managers." The statute and regulations appear to define this category with reference to private foundations. The IRS seems to interpret foundation managers to include managers of public charities. If the definition makes a difference to your group, you may want to see a lawyer.

Twenty percent Owner/Entity Substantial Contributor

This type of "disqualified person" is an owner of more than 20% of:

- the total combined voting power of a corporation which is a substantial contributor;
- the profits interest of a partnership which is a substantial contributor; or
- the beneficial interest of a trust or unincorporated association which is a substantial contributor.

In other words, if one of these entities is a substantial contributor, its owners of more than 20% of the voting power, profits, or beneficial interest

also become substantial contributors. Thus, organizations need to inquire into the ownership of entities which are substantial contributors.

Family Members

Your organization must lump contributions from family members of substantial contributors, foundation managers, and 20% owner/entity substantial contributors with the contributions of those substantial contributors and foundation managers. Family members include the spouse, direct ancestors, lineal descendants, or spouses of a lineal descendant. A brother or sister is not a family member; the spouse of a grandchild is.

35% Disqualified Person/Entity Owner

When a substantial contributor, foundation manager, twenty percent owner/entity, or family member owns 35% of a corporation, partnership, trust or estate, the entity also becomes a disqualified person. This is the reverse of the 20% owner/entity substantial contributor.

There are many special rules in addition to the definitions given here. If you need further information, see an attorney or accountant.

Comprehensive Example of the Mechanical Test:

Raoul is a substantial contributor to the Community Resource Fund because of large donations made in previous years. During the 4-year normalcy period, his donations total $50,000. Raoul owns 60% of Solarheat Company, which also has donated a total of $50,000 to the Resource Fund. The Fund's total support base for the normalcy period is $3,000,000, 2% of which would be $60,000.

Raoul contributed	$50,000
Solarheat contributed	$50,000
TOTAL	$100,000
2% limitation	$60,000
Excess over 2% not counted	$40,000

Thus $40,000 will be excluded from the numerator for purposes of the mechanical test. If the disqualified person relationship had not existed between Raoul and Solarheat Company, each contributor could have been fully counted in the numerator.

Amounts excluded from the Two Percent Limitation

The 2% limitation applies only to direct public support, and not to unusual grants (described below), support from governmental units (see page 154), or indirect public support (see below).

Unusual Grants Excluded from the Two Percent Limitation Rules

Many small groups dream of someday receiving the huge contribution that will end their financial problems. Such a grant could, instead, cause them to lose their public charity status and be classified as a private foundation. Why? Recall that the whole contribution would be counted in the support base (denominator) but in many cases only a small part of it could be included as qualified support (numerator) because of the 2% per person limitation. So, such a gift could throw off a group's financial support percentage so that it failed both the mechanical and the fact and circumstances support tests. This phenomenon is referred to as "tipping." Some private foundations consider this problem when evaluating large grant requests from small organizations.

In some cases, such a grant qualifies for an "unusual grant exclusion" and can be excluded from both the numerator and denominator, thus avoiding the 2% limitation and the distortion of the support test percentages.

To qualify, the grant must come from a disinterested person and:

- Was attracted because of the publicly supported nature of the organization;
- Is unusual or unexpected because of its size or because it is not regularly received (e.g., a bequest in a will);
- Would, because of its size, adversely affect the status of the organization because of its effect on the organization's support percentages.

The IRS has a longer list of facts and circumstances to consider in determining whether a grant qualifies for the exclusion. If you should be so fortunate as to encounter this mythical beast, consult an attorney or accountant immediately and before actually receiving the gift if possible.

Indirect Public Support

The third qualified source of support that goes into the numerator of the PSO calculation is indirect public support. This includes contributions received from another Publicly Supported Organization or any public charity (i.e., non-private foundation) that could also qualify as a Publicly Supported Organiza-

tion. For example, a group classified by the IRS as a church might also meet the IRS criteria for a Publicly Supported Organization. If it did, its contributions to your group would be considered indirect public support and would not be subject to the 2% limitation. Other nongovernmental contributions are direct public support and subject to the 2% limitation rules.

However, if a donor makes a contribution to a government unit or PSO (or a public charity that could qualify as a PSO) and earmarks it for your organization, the pass-through gift will be counted as *direct* public support from the original donor and will be subject to the 2% limitation.

Example: The Women's Alliance for Peace is an exempt organization. For the four years 2000 through 2004 (the applicable normalcy period for tax year 2005), it received support as follows:

State of Oregon (a governmental unit)	$20,000
United Fund (a PSO – indirect pub. support)	$45,000
Contributions (direct public support)	$25,000
Women's Cultural Center (a FASO) (direct public support)	$15,000
TOTAL	**$105,000**

33⅓% of total = $35,000

To apply the mechanical test, WAP calculates which of those sources listed in total support are qualified sources, and whether they amount to 33⅓% of total support, keeping in mind the 2% per person limitation on direct public support.

State of Oregon (no limit)	$20,000
United Fund (no limit)	$45,000
Contributions (no individual gave more than $2100 which is 2% of total support)	$ 4,500
Contributions (5 contributions exceeded $2100, so 5 X $2,100=maximum countable)	$10,500
Women's Cultural Center (max. $2,100)	$ 2,100
TOTAL	**$82,100**

Note that only $2,100 of the Women's Cultural Center's $15,000 contribution was included in the numerator because the Women's Cultural Center is a FASO. If the Women's Cultural Center could also qualify as a PSO, the entire amount of its $15,000 would be

counted. The Women's Alliance for Peace has normally received more than $33^1/_3$% of its support from governmental units and the general public. Therefore, it passes the mechanical test.

PSO:

NUMERATOR =
Governmental unit support, plus
Direct public support, plus
– below 2% limitation, and
– subject to 2% limitation
Indirect public support

DENOMINATOR = Same as PSO on page 152

Use the worksheet at the end of this chapter to calculate your numerator as a PSO.

Facts and Circumstances Test

If an organization's qualified support does not equal $33^1/_3$% of its total support, it fails the mechanical test. But if its qualified support equals at least 10% of its total support and it is organized and operated in such a way as to attract public support, then it can turn to the "facts and circumstances" test. "Organized and operated to attract public support" means the organization has a continuous and genuine program for soliciting funds from qualified sources (discussed above), such as governmental units, and direct and indirect public support.

If your organization meets these minimum requirements, the following factors will be considered to determine if your groups has the nature of a publicly supported organization:

- financial support percentages
- support sources
- representative government body
- public facilities, services, programs, policies and participation
- membership relations

Financial Support Percentage

The closer to $33^1/_3$% the organization's qualified support is, the less public support it has to demonstrate with the other factors. Of course, the closer it falls

to the 10% bottom line, the greater burden it will have with regard to the other factors.

Support Sources

Favorable consideration is given to your organization when your existing sources of support come from a number of individuals that are representative of the community you seek to reach, rather than from the members of a single family. Factors to be considered in determining whether the number is representative are:

- the type of organization
- length of time it has existed (has it had time to gather wide support?)
- whether it limits its activities to a particular community or region (so then it only has to show wide support within that region)
- whether it limits its activities to a special field which can be expected to appeal to a limited number of persons (then it only has to show wide support from people within that field).

Representative Governing Body

Here the IRS is looking for a governing body (generally the Board of Directors) which represents the interests of the public, not the personal or private interests of a limited number of donors or officers. They will be satisfied with a Board made up of:

- public officials
- persons selected by public officials
- experts in the field in which the organization is operated
- community leaders representing a broad cross-section of the community
- persons selected by a broadly-based membership according to procedures established in articles or Bylaws

Public Facilities, Services, Programs, Policies and Participation

Favorable factors include:

- providing a service or facility for the general public; for example, museums or libraries;
- regular publication of studies that are widely used by colleges or the public;

• participation in or sponsorship of programs by civic or community leaders or experts in the field;
• maintaining a well-defined ongoing program to accomplish charitable work in the community;
• receiving a significant part of the organization's funds from a public charity or governmental unit to which the organization is held accountable as a condition of the grant or contract.

Membership Relations

The IRS looks for:

• whether solicitation for members is designed to enroll a large number of people in the community or area of special interest;
• whether the individual membership charge is affordable by many persons and not what only a few could afford;
• whether the activities of the organization will be likely to appeal to persons having a broad common interest, such as educational activities, musical activities, etc.

An organization does not have to show favorable facts under every category. In each case, the importance of each factor will be different depending on the nature and purpose of the organization and how long it has existed. The ultimate objective is to find out whether the organization is "publicly supported."

HOW TO CALCULATE YOUR SUPPORT FROM QUALIFIED SOURCES FOR THE FASO TEST

A FASO is an organization which normally receives:

• More than $^1/_3$ of its support from any combination of contributions, grants, or membership fees, and gross receipts from related business activities; and
• Not more than $^1/_3$ of its support from the sum of gross investment income; and the amount of the unrelated business taxable income less the amount of the unrelated business income tax.

The meaning of normally is the same as that discussed on pages 167-168.

You must use the cash method of accounting (see Chapter 23) for purposes of calculating your support.

One-Third Support Test

The basic strategy to determine whether more than $^1/_3$ of your support comes from the listed sources is the same as the one for Publicly Supported Organizations (PSOs). Qualified support (numerator) is divided by the total support base (denominator) and has to equal more than $^1/_3$ (mechanical test). The difference is in what support counts as "qualified." Also, there is no facts and circumstances test for FASOs.

Qualified support (numerator) is divided by total support base (denominator) and has to equal more than $^1/_3$.

Qualified Support

The terms "contributions," "grants," and "membership fees" are defined in the same way as they were for PSOs. However, the contribution, grant, or membership fee is only counted in the numerator if it comes from a "permitted source" (see page 165).

FASOs count their gross receipts from related activities (defined on page 150) in both the denominator and numerator but there are two limitations on including this figure in the numerator. First, the gross receipts must come from a permitted source (see below). Second, FASOs can only count in the numerator up to $5,000 or 1% of their support in the taxable year (not the normalcy period), whichever is greater, from any one person or governmental bureau. The gross receipts from related activities from public charities listed as #1, 2, 3, 4, 7, and 8 on page 100 are not subject to the 1% limitation and can be included in full in the numerator. The entire amount of the related business income must be included in the denominator.

In this test, "person" includes any individual, trust, estate, partnership, association, company, or corporation. "Government bureau" refers to specialized operating units of the government functioning at the operating, rather than policy-making level. Consult an attorney if you need help in assessing how these terms apply to your group.

The rules discussed on page 159 pertaining to the unusual grant exclusion also apply here and should be considered in figuring qualified support.

Permitted Sources for the One-Third Support Test Numerator

Permitted sources of support include:

- persons (as defined in the section above) other than disqualified persons
- governmental units
- the public charities that are listed as #1, 2, 3, 4, 7 and 8 on page 100.

If a donor makes a contribution to a FASO by earmarking it for the organization and funneling it though one of the permitted sources, it will be treated as though it were made from the original donor. If that donor is a prohibited source (see next section) it will be excluded from the numerator (i.e., it will not be qualified support).

If a donor makes a contribution to a FASO by earmarking it for the organization and funneling it though one of those permitted sources, it will be treated as though it were made from the original donor.

Prohibited Sources

Support cannot be included as part of the numerator if it is from any of these prohibited sources:

- Disqualified persons
- Private operating foundations and certain private foundations
- The public charities that are listed as #5, 6, and 9 on page 100.

Disqualified Persons

A disqualified person is:

- a substantial contributor;
- a foundation manager;
- a twenty percent owner/entity substantial contributor;
- a family member; or
- a 35% disqualified person/entity owner.

These terms are defined on pages 154-158.

FASO: Support Test

NUMERATOR = Contributions, grants, membership fees from permitted sources, plus
Gross receipts from related business activities from permitted sources
– below 1% limitation, and
– subject to 1% limitation

DENOMINATOR = Same as FASO on page 152.

One-Third Gross Investment Income Test

In your normalcy period (see pages 167-168), no more than $^1/_3$ of your support in each taxable year can come from the sum of:

- your gross investment income and
- the excess of your unrelated business taxable income over the amount of your unrelated business tax, if your business was acquired or started after June 30, 1975.

Gross investment income is your gross income from interest, dividends, rents, and royalties, to the extent this income is NOT taxable as unrelated business income. See page 151 for a discussion of gross investment income. Note that the One-Third Support Test for FASOs requires a *minimum* of one-third of qualified support, while the One-Third Gross Investment Test states that one-third is the *maximum* investment income permissible.

Use the worksheet at the end of this chapter to calculate your numerator for both the one-third support test and the one-third gross investment income test.

The denominator for this test is the total support described on page 152.

FASO: Investment Income Test

NUMERATOR = Gross investment income, plus
Unrelated business taxable income less the amount of your unrelated business tax

DENOMINATOR = Same as FASO on page 152.

THE NORMALCY PERIOD

General Rule

The mechanical test and the facts and circumstances tests for PSOs and the support test/investment income test for FASOs all are defined in terms of what normally occurs. Normally is usually the four years preceding the tax year in question. The long time period is used to get a more accurate picture of an organization's usual sources of support. Once an organization meets the test for a given tax year, the test is satisfied for that year and the next year.

As an example, the Women's Alliance for Peace (see page 160) has satisfied the test for the years 2005 and 2006. This allows donors to make contributions throughout the year and count on taking their deductions; otherwise, they'd have to wait until the end of the year to see whether the organization they were donating to still qualified. Chaos at the IRS!

If your organization has been in existence for at least one taxable year of more than eight months but less than five taxable years, the number of years you have been in existence immediately preceding the current taxable year will be substituted for the four- year period described above and will be your normalcy period. If you have not been in existence for at least one taxable year of eight months, you are not yet eligible for a definitive ruling and so the normalcy period rules have no meaning for you. See page 109 for how to proceed.

In figuring out how many years you have been in existence, start with the date you were formed if you are an unincorporated association and the date you were incorporated if you are a corporation. If you operated as an unincorporated association for a period of time (and did not file for tax-exempt status) and are now a corporation, you can only use the years since incorporation toward the normalcy period.

Exception: Substantial Changes in Sources of Support

If there is a substantial and material change in an organization's sources of support (for instance, an unusually large contribution which doesn't qualify for the unusual grant exclusion), the normalcy period becomes five years: the usual four-year period preceding the year of substantial and material change plus the taxable year of substantial and material change.

If despite using this five- year normalcy period, the organization fails to meet the test percentages, contributors still get their tax deductions until the IRS makes public the organization's change in status. This protection may not

apply to the donor who caused or was aware of the material and substantial change. If you encounter this problem, consult an attorney or accountant before you receive the gift, if possible.

RECORDKEEPING ISSUES

It should be clear from reading the complex set of rules above that detailed recordkeeping about contributions is critical. Your organization needs to know not only who has contributed how much over the life of the organization, but also a considerable amount of detailed information about the contributing individuals and organizations and their family and business connections.

Detailed recordkeeping about contributions is critical.

We have included as appendices some sample letters to be sent to grantors, organizations and individuals. The purpose of the letter to granting organizations (Appendix 10) is identification of their tax status. This will be essential for your determination of whether the grant from this grantor should be classified as direct or indirect support, etc. The second sample letter (Appendix 11) is intended for individuals who you think may be disqualified persons. Remember that these disqualified persons may include foundation managers and individuals contributing both individually and through corporations, partnerships or other entities in which they hold significant ownership interests and their family members.

On the following pages are some worksheets you can use to calculate the numerators and denominators for the support tests for PSOs and FASOs.

Consult Appendix 1 if you would like information about source material related to this Chapter.

Now that you've sorted out your nonprofit's status as a PSO or FASO, you'll want to clear your thoughts to tackle the challenge of understanding the IRS rules regarding political activity and lobbying by tax-exempt organizations. Chapter 8 is designed to help you understand these very important restrictions and prohibitions.

PSO
WORKSHEET
NUMERATOR
FOR NORMALCY PERIOD

QUALIFIED SOURCES OF SUPPORT

Governmental unit support (page 154)	$_____
Direct Public Support:	
Contributions, grants and membership fees below the 2% limitation (page 154)	$_____
Contributions, grants, and membership fees subject to the 2% limitation (page 154) [Take the number of such items and multiply it by 2% of your denominator]	$_____
Indirect Public Support: Contributions, grants and membership fees (page 159)	$_____
Subtract unusual grants (page 159) (if included above)	$_____
TOTAL	$_____

FASO
WORKSHEET
NUMERATOR
FOR NORMALCY PERIOD

ONE-THIRD SUPPORT TEST

Contributions, grants, and membership fees from permitted sources (page 165) $_____

Gross receipts from related business activities from permitted sources not subject to the 1% limitation (page 164) $_____

Gross receipts from related business activities from permitted sources subject to the 1% limitation (page 164) $_____

[If your total annual support is $500,000 per year or more:

1. Add together the receipts that are each less than 1% of your total support;
2. Multiply the number of items that are equal to or more than 1% of your total support by the figure equal to 1% of your total support;
3. Add 1 and 2 together.

If your total annual support is less than $500,000 per year:

1. Add together the receipts that are each less than $5,000;
2. Multiply the number of items that are $5,000 or more by $5,000;
3. Add 1 and 2 together.]

Subtract unusual grants (page 159) (if included above) $_____

TOTAL $_____

FASO
WORKSHEET
NUMERATOR
FOR NORMALCY PERIOD

ONE-THIRD GROSS INVESTMENT INCOME TEST

Gross investment income(page 166)	$_____
Your unrelated business taxable income less the amount of your unrelated business tax	$_____
TOTAL	$_____

PSO
WORKSHEET
DENOMINATOR
FOR NORMALCY PERIOD

TOTAL SUPPORT BASE

Gifts, grants, contributions, membership fees (page 149) – Exclude "unusual grants" (page 159)	$_____
Net income from unrelated business business activity (page 150)	$_____
Gross investment income (page 151)	$_____
Tax revenues levied by government for your group (page 151)	$_____
Value of free services or facilities furnished by government to your group (page 152)	$_____
TOTAL	$_____

FASO
WORKSHEET
DENOMINATOR
FOR NORMALCY PERIOD

TOTAL SUPPORT BASE

Gifts, grants, contributions, membership fees (page149_) – Exclude "unusual grants" (page 159)	$_____
Net income from unrelated business business activity (page 150)	$_____
Gross investment income (page 151)	$_____
Tax revenues levied by government for your group (page 151)	$_____
Value of free services or facilities furnished by government to your group (page 152)	$_____
Gross receipts from related business activity (page 150)	$_____
TOTAL	$_____

8 POLITICAL ACTIVITY AND LOBBYING BY TAX-EXEMPT ORGANIZATIONS

Political activity is defined by the IRS as supporting or opposing the election of a candidate for public office. If you are a §501(c)(3) organization, you will lose your exemption if you have any political activity. You can engage in neutral election-related activities. Most other tax-exempt groups can engage in at least some political activities. This chapter will explain the IRS rules.

All exempt organizations can lobby, including §501(c)(3)'s. However, there are limits on how much lobbying (c)(3)'s can do. If the limits are exceeded, you will have to pay a tax and, in some cases, will lose your exemption. This chapter will give you the information you need to keep within the limitations imposed by the IRS and help you decide whether you should consider an alternative structure if your activities will go beyond those allowed for §501(c)(3) organizations.

If you are exempt under any subsection of §501(c)(6) and have members who pay dues, this chapter will also explain the special impact the lobbying rules have on you.

If your group engages in political activity or lobbies, you may be subject to other federal and state laws concerning political campaigns and lobbying that apply to everyone. See Chapter 26.

THIS CHAPTER COVERS

- **Who Needs This Chapter?**
- **Political Activity**
- **Lobbying and §501(c)(3) Groups: Two Tests**
- **Understanding the Lobbying Election**
- **The Lobbying Election Computations**
- **Proving Compliance with the Lobbying Rules**
- **The §501(c)(4) Alternative**
- **Affiliated Organizations**

- **Notice to Members About Deductibility of Dues Used for Lobbying**
- **Other Laws Concerning Political Activity and Lobbying**

WHO NEEDS THIS CHAPTER?

This chapter deals with issues involving organizations exempt under §501(c)(3), or organizations exempt under any subsection of §501(c) that have members who take a business deduction for their membership dues.

If you are exempt under §501(c)(3) and engage in any efforts to support or oppose a candidate for any elective office, you should read the section on political activity.

If you are exempt under §501(c)(3) and do some lobbying, read page 181 to see if you qualify to make the lobbying election. If so, and if your lobbying activities are very insignificant and you engage in NO political activities, you can simply file the lobbying election form, Form 5768.

To determine if your lobbying activities are very insignificant:

- Figure out how much you spend directly on your programs and your salaries for those programs that directly fulfill your exempt purposes. (You cannot count capital expenditures, expenditures that are related to fundraising or unrelated business income in this.)

- If you are spending less than 5% of that figure for lobbying, you should be able to skip a detailed reading this chapter by making the lobbying election. Read the section on how to make the lobbying election. However, you should skim this chapter to be sure that you are in compliance with the lobbying election and to understand when you are engaging in political or lobbying activities.

If you have any questions about what lobbying is or whether or not an expenditure should count as a program expense, you should read the chapter. You may be taxed or even lose your exempt status if you do too much lobbying.

POLITICAL ACTIVITY

Most people would probably consider political activity to be any activity that promotes their political agenda, such as publishing information to persuade others, holding rallies, attending meetings to further these goals, or voting. According to the IRS, *political activity* includes any involvement in political campaigns on behalf of or in opposition to *candidates for public office or any political party*. Note that the IRS definition is quite a bit narrower than the common understanding.

Virtually all exempt groups, except §501(c)(3) organizations, can engage in at least some political activity. Most groups that do engage in political activity must pay a tax or establish a separate, segregated fund called a Political Action Committee, or PAC, to be used solely for political purposes. (See page 614 for more on this.)

Prohibited Activities for (c)(3)s

§501(c)(3) exempt organizations are *prohibited* from participating in, or intervening in (including publishing or distributing statements) any political campaign on behalf of or against any candidate for public office or any political party. If you do this, you will not be granted a §501(c)(3) exemption or your existing exemption can be revoked.

According to the IRS, political activity includes any involvement in political campaigns on behalf of or in opposition to candidates for public office or any political party. §501(c)(3) exempt organizations are prohibited from participating in, or intervening in (including publishing or distributing statements) any political campaign on behalf of or against any candidate for public office or any political party.

If you have a §501(c)(3) exemption and engage in forbidden political activities, the IRS can take several actions against you:

- The IRS may require your group and your managers to pay stiff excise taxes on your political expenditures, *and/or*
- The IRS can get a court order against you barring your political expenditures, *and/or*
- The IRS may revoke your §501(c)(3) exempt status. If this happens, you cannot apply for §501(c)(4) status.

Permissible Activities for (c)(3)s

§501(c)(3) organizations can engage in a variety of election-related activities as long as the exempt organization does not support or oppose a candidate for public office and its activities are nonpartisan. Candidates include people who have filed to run for an elective office, who are considering running, and who are being considered in the media. Individuals who are appointed to public office, such as federal judges and Cabinet level positions in the federal government, are not candidates and a (c)(3) can take a position on these positions. Nonpartisan election-related activities include voter education, voter registration, issue advocacy and candidate education.

Voter Education and Candidate Forums

Education is a permissible activity for (c)(3) organizations. Your (c)(3) can educate the voters with candidate questionnaires, voter guides, candidate debates, and voting records as long as you do so in a nonpartisan manner. Generally, this means that you give all candidates the same opportunities to respond and that you can't focus on specific issues. You may use candidate questionnaires if you send the questionnaires to all the candidates, ask unbiased questions about a broad range of issues, present the candidates' responses in the same manner, and avoid supporting one candidate in any way. You can publish the responses in a voter guide if you do so without editing or favoring one candidate. Your publication cannot comment on the position that you take on the issues. You should include a statement that your organization does not support, oppose or otherwise endorse any candidate for public office.

Your organization can sponsor candidate debates and forums if you do so in a neutral fashion. You must invite all viable candidates, cover a broad range of issues, ask impartial questions, use a neutral moderator, invite an impartial audience and stick to fair rules in the debate or presentations.

If you want to publish voting records or scorecards, you can do so as long as you do not time them to correspond to an election. Many groups avoid this problem by publishing voting records annually. If you distribute your publication to the *general public*, you must include all the records of all legislators for a geographical area and you must cover a broad range of issues. If you limit your scorecard for distribution to *members*, you must include all legislators in the area and cannot time the scorecard to appear at election time. However, you can focus on issues that your organization is concerned about (rather than cover a broad range of issues) and you can comment on the results.

You may have occasion to invite a candidate to an event for some reason other than their candidacy. For example, your group may hold an annual din-

ner as a fundraiser and may invite supporters who are also candidates. You may do this as long as you avoid mentioning the candidacy of your supporters and do not time the dinner to coincide with the elections. You are not required to invite all of the candidates to this event. If your supporter is already in office, you may introduce her or him at the same time you introduce all public officials, but you cannot mention that supporter's candidacy. When you invite supporters running for office, protect yourself by stating in the invitation that you are a (c)(3) organization and that both the candidate and you need to refrain from mentioning their candidacy at the event in order to protect your (c)(3) status.

Voter Registration

Your organization can engage in voter registration as long as your goal is to encourage people to vote. You must make registration available to everyone and you cannot ask people how they will vote. You must target your location and audience based on nonpartisan criteria. You can focus on disadvantaged or underrepresented groups. If you are a private foundation, you are subject to additional requirements if you engage in voter registration activities. Get legal advice.

Issue Advocacy

Not surprisingly, many groups want to press their cause at election time. You may advocate for your issues during the campaign period as long as you do so in a nonpartisan manner. The issue has to be related to your exempt purpose. You cannot coordinate your advocacy with a candidate or political party and should avoid referring to candidates with code words like "conservative" or "pro-choice" that might associate you with a candidate or party. The line between commenting on the issues (which you can do) and endorsing or opposing a candidate based on your statements about the issues can be a very thin one. If your comments seem to focus on the candidates rather than the issues or if your communication contains a reasonably overt indication that your organization supports or opposes a candidate, you have crossed the line. Obviously, what people think is a focus on the candidate over the issues or is a reasonably overt indication of support may differ, so you wander into a gray area when you link issue advocacy with candidates. At a minimum, your advocacy piece should contain a disclaimer that your organization does not support, oppose or otherwise endorse and candidates for public office. You may also want to include a statement that voters should consider more than just one issue in selecting a candidate.

Candidate Education

The law allows your organization to inform candidates about your organization and to educate them about your issues. To avoid electioneering, you should use information that you had before the election, not newly-created publications. You must offer your materials to all candidates.

The Internet and Political Activity

The growth of the Internet has vastly expanded the ability of advocacy groups to support or oppose candidates. Generally, (c)(3)s using the Internet are subject to the same rules that govern them in their other communications about political campaigns. However, the use of email, listserves and websites has created some novel issues about how the IRS rules on political activities apply to this new medium. The IRS and the courts have not yet answered most of these questions. We discuss some of them in this section so that you can think about how you want to approach them.

One issue is whether a (c)(3) can link its website to websites for candidates, political parties or PACs. If you conduct nonpartisan voter activities, your (c)(3) should be able to do this as long as you treat all candidates equally. This means you must link to the websites of all the candidates and, if a candidate does not have a site, provide information on how to contact the candidate's campaign. It is considerably riskier to link to just one candidate, political party or PAC since this suggests an endorsement.

The Internet offers exciting opportunities for interaction between the producers of a message and the general public. A (c)(3) could produce an internet forum that allows discussion and on-line debate between candidates and voters. You should use the candidate forum guidelines described above. Invite all candidates, be sure that you treat them equally in terms of how you place information about them on the web site, make the event available to the general public, and avoid advocating for one candidate. You may also operate listserves or chat rooms that include discussion about campaigns. You should alert participants that they cannot endorse or oppose candidates on your listserve or in your chat room. You should enforce policies that prohibit this by monitoring and deleting messages that violate your policy and by excluding repeat offenders. You need to state that the participants are responsible for the contents of individual posting and not your organization. If your listserve has a moderator, be particularly careful to screen partisan messages.

If you produce legislative scorecards for your members that focus on issues of concern to your organization (see page 177), you cannot post them on your

web page unless you have a page that is accessible only to your members. Such a posting amounts to a dissemination to the general public.

One area of concern for §501(c)(3) organizations is the use by employees of the corporation's email or other web facilities to advocate for or against a candidate. The IRS may attribute the actions of your employees to your organization. You should have a policy in place forbidding employees from using your facilities and resources for political activities. Your employees should be given a copy of the policy. If you have reason to believe that the policy is being violated, you must investigate and take action to protect your organization.

Penalties for Engaging in Campaigning

If the IRS discovers that your (c)(3) organization engaged in political activity not allowed by the law, your group will almost certainly lose your exemption. The IRS may also impose a tax on your organization and on your Directors, Board members, Executive Director, or other responsible person, if she or he agreed to the expenditures knowing they were for political expenditures.

LOBBYING AND §501(C)(3) GROUPS: TWO TESTS

Most people think of lobbying as contacting a governmental decision-maker to try to influence a decision. To the IRS, lobbying means communications that attempt to influence legislation, both by grassroots type organizing and by direct lobbying of legislative bodies. Note that the IRS definition is both broader and narrower than the common understanding: broader in that it includes grassroots communications with the public, who are not necessarily decision-makers, and narrower in that it only refers to legislation and does not include decision-makers in administrative agencies and the courts.

To the IRS, lobbying means communications that attempt to influence legislation, both by grassroots type organizing and by direct lobbying of legislative bodies.

All organizations exempt under §501(c) are permitted to lobby, but there are some restrictions on how much lobbying a §501(c)(3) organization can do. We will discuss those at some length. At the end of the chapter, we will provide some information about lobbying that other types of exempt groups should have.

Lobbying Tests

The IRS has two tests to determine whether your §501(c)(3) is doing excessive lobbying. The determination of what expenses and activities count as lobbying is not necessarily the same under each test.

The "Substantial Part" Test

The law provides that "no substantial part of the activities of an exempt organization shall be the carrying on of propaganda or otherwise attempting to influence legislation." The problem with this language is its vagueness. Groups exempt under §501(c)(3) that want to do some lobbying need to know how much is permissible. What constitutes "lobbying" is not as well-defined under this test as under the subsection (h) election. More importantly, what constitutes a "substantial part" of a group's activities is very vague. To determine whether lobbying is a substantial part of a group's activities, courts and the IRS have taken a variety of approaches. One approach looks at the quality of the activities directed toward influencing legislation. Who does the work – outsiders or members? What kind of organizational set-up is used? What kind of efforts are used to exert influence – direct contact with legislators, appearances at hearings, volunteered testimony or invited testimony? Do you use public advertisements? Another approach is to look at the amount of money and time an organization spends on lobbying. Cases have found that an organization spending less than 5% of its time and budget on legislative activities is not doing "substantial" lobbying. Some courts balance the public, charitable activity against the nonpublic, lobbying activity. This test gives greater latitude to a larger organization who does the same lobbying as a smaller one.

The Mathematical Test: The Lobbying Election [the §501(h) Election]

Because of the uncertainties of the substantial part test, Congress developed an alternative test, based on a mathematical formula, that most §501(c)(3) groups can choose to use. Most organizations who are entitled to should choose to use the lobbying election, if the group does any lobbying. Because this test is outlined in subsection (h) of Internal Revenue Code §501, it is often called the Subsection (h) election or the (h) election.

Who Can Make the Lobbying Election?

Most §501(c)(3) groups that are not private foundations can choose the lobbying election. These eligible groups include:

- Schools
- Hospitals and medical research organizations

- Development foundations for state universities
- Publicly supported organizations (PSOs)
- Fee/Activity supported organizations (FASOs)
- Supporting organizations

(See pages 100-106 for further discussions of who these groups are.)

Some §501(c)(3) organizations are not permitted to make the lobbying election. These are:

- Private foundations
- Churches and church-related groups
- Governmental units

The substantial part test continues to apply to groups who cannot or do not make the lobbying election.

Choosing Whether to Come Under the Lobbying Election Rules

Since these provisions are elective, you can choose whether to remain under the old substantial part rules or to elect to come under the Lobbying Election rules.

You should consider electing to come under the lobbying election rules:

- If you spend money on lobbying but will stay within the expenditure limits, you can avoid the uncertainties of the substantial parts test.

- If your lobbying activities will be controversial and attract considerable or intense public attention, you may lose under the substantial part test since the IRS considers the quality, not the quantity, of your lobbying.

- If you exceed the nontaxable limits but not the absolute ceiling amounts, the 25% tax may be cheaper than risking loss of exempt status. (See page 191 for information about the tax.)

- If you anticipate greatly exceeding all the limits for one year (one particularly crucial piece of legislation), the high tax cost may be worth it, especially if by not electing, your activities would be considered substantial for that year, resulting in loss of exemp-

tion. The lobbying election gives you a four-year-period to average out your expenditures. (See page 192.)

• If volunteers do most of your lobbying, volunteer time is not counted under the lobbying election rules, but it is considered under the substantial part test.

• If you're a member of an affiliated group, your expenditures alone may exceed the limits, but when combined with other groups may be less than the limit for the group. (See page 193.)

You should probably *not* elect to come under the lobbying election rules in these circumstances:

• If you are a large nonprofit with an EPE of more than $17,000,000 per year and if an insubstantial part of your activity is more than $1,000,000, you can avoid the $1,000,000 cap in the lobbying election.

• If you have significant expenditures that are not EPE, the amount that you can spend on lobbying will be greatly reduced, so you may be able to do more lobbying under the substantial parts test. For example, organizations that purchase land for conservation purposes may have significant expenses that are not EPE.

• If you do too much lobbying to qualify as exempt under the lobbying election rules and you have very substantial volunteer time devoted to non-lobbying activities and very little to lobbying and other factors that might put you avoid the substantial parts test, you may refuse the election and try to qualify as exempt under the substantial parts test. This is a very long shot.

How to Make the Election

If you intend to or have engaged in lobbying and wish to come under the lobbying election rules, you need to fill out and send to the IRS Form 5768. It's a very simple one-page form which states the name of the organization and either elects (or revokes a previous election) to come under the lobbying election rules. It has to be postmarked within the taxable year to which it applies. It is effective until you revoke it as described below.

Thus you can, at any time before the end of the taxable year, choose to come under the lobbying election rules for that year. Once you've made the choice,

however, it can be revoked only prospectively – you can't revoke for a taxable year after that year has begun. If you have doubts about whether the election is your best choice, you can protect yourself best by making your decision late in the year, when you will have a good idea as to whether it will be to your advantage.

UNDERSTANDING THE LOBBYING ELECTION

The rules governing those who make the lobbying election are fairly complex. We will start by describing how lobbying is defined for groups who make the lobbying election. We'll then talk about what kinds of advocacy are not lobbying, some special rules about communications, and the use of the internet in lobbying.

What Is Lobbying

Lobbying means communications that are intended to influence legislation. To understand this, you need to know what legislation is and what influencing legislation means.

Legislation

Legislation refers to action by a legislative body. Such an action could be the proposal, introduction, enactment, or defeat of a bill or other action before Congress, the state legislature, local governing bodies, or voters (as ballot measures).

Influencing Legislation

Influencing legislation refers to either grassroots lobbying or direct lobbying:

Grassroots Lobbying

Grassroots lobbying (also called indirect lobbying) is an attempt to influence legislation by encouraging the public to contact legislators about a specific piece of legislation. It does not include informing members of your organization about legislation or proposed legislation of direct interest to the organization and your members, unless the communication *directly encourages* the members to take steps to influence legislation. In order to be considered grassroots lobbying, the communication must refer to specific legislation, must reflect your view of the legislation, and must issue a *call to action* by:

- asking the recipient to contact legislators to influence the legislation;

• providing a legislator's or legislative employee's address, phone number, or similar information;

• providing a petition, tear-off postcard, or similar material for the recipient to send his or her views to a legislator; *or*

• specifically identifying the stands of legislators who will vote on a piece of legislation or identifying legislators as being on a committee that will vote on the matter (unless it is part of a non-partisan analysis).

Grassroots lobbying is an attempt to influence legislation by encouraging the public to contact legislators about a specific piece of legislation.

The first three of the above actions are considered to be *direct encouragement* and the last is *indirect encouragement*. These categories are important later.

Example: Children's Advocates wants to support a bill in the Oregon legislature that would protect people who report child abuse. The organization sends a letter to its members and other interested people, describing the legislation, explaining that the organization supports it, and asking them to contact their legislators in support of the bill. This is grassroots lobbying. If Children's Advocates had simply described the legislation and explained why it supported it, without issuing the call to action requesting that the recipients contact their legislators, this would not be grassroots lobbying or any type of lobbying.

Direct Lobbying

Direct lobbying is an attempt to influence legislation through communications with legislators and their employees, or government officials who participate in the formation of legislation, if the principal purpose of the communication is to influence legislation. The communication counts as direct lobbying only if it refers to specific legislation and reflects your view on the legislation.

Direct lobbying is an attempt to influence legislation through communications with legislators and their employees, or government officials who participate in the formation of legislation,

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Legislation includes initiatives and referendums, so attempting to influence the public on referenda and ballot measures is also considered direct lobbying.

Because of the way the lobbying election works, you can have more direct lobbying expenses than grassroots lobbying.

> *Example*: The Executive Director of Children's Advocates on behalf of the organization contacts her State Senator and urges her to support the bill protecting those who report child abuse. This is direct lobbying.

What Is Not Lobbying

Legislation does not include actions before an executive officer or administrative agencies, unless you are lobbying to persuade the executive or the agency to take a position for or against a legislative bill. For example, a meeting to persuade the governor to appoint more minorities to high-level positions is not lobbying but a meeting to urge the governor to veto an affirmative action bill is lobbying. You may advocate for or against administrative rules and may take positions with respect to cases being heard by an administrative body. None of this is lobbying. Administrative agencies include bodies like school boards, housing authorities, zoning boards and other similar federal, state and local bodies, whether elective or appointive. Legislation also does not include cases heard by courts, so you can be involved in impact litigation or file *amicus* briefs without lobbying.

Legislation does not include actions before administrative agencies, unless you are lobbying to persuade the agency to take a position for or against a legislative bill.

Influencing legislation does not include:

- *Nonpartisan analysis*, which is an independent and objective discussion of a subject. You can advocate a particular position as long as there is a sufficiently full and fair description of the facts to enable the public to form an independent opinion. The communication must be made available to the public, or a segment of it, or to governmental bodies or employees. The communication becomes lobbying if it refers to specific legislation, reflects a view on legislation, and directly encourages the recipient to contact legislators in favor of or opposed to specific legislation in the manner described on page 184 as direct encouragement. Your communication is not lobbying if it refers to specific legislation, reflects a view, and *indirectly* encourages contact with a legislator.

Example: Art for All develops and distributes to the public a 15 page educational piece detailing the importance of art for everyone and describing the dangers of censorship. It refers to specific legislation designed to curtail unpopular artistic expression, explains why this is harmful, and identifies the legislators that are supporting the legislation. It does not directly suggest that the legislators be contacted. This is nonpartisan analysis, since the document does not *directly encourage* the public to contact the legislators.

• *Discussions of broad social, economic, and similar problems* with the public and legislators, as long as they don't address specific legislation or *directly encourage* the recipients to take action.

• *Requests for technical advice* given to a governmental body in response to a *written* request from the body, and not just one member of it.

• *Self-defense communications*, which are communications with a governmental body regarding legislation which would affect your existence, your powers or duties, your tax-exempt status, or the deductibility of contributions to your group. This exception does not include legislation that affects the funding of your group.

Special Rules About Communications

The IRS has developed some special rules about communications.

Communications with Members

You are given more leeway to communicate with your members than with nonmembers. For IRS purposes, members are people who contribute more than a nominal amount of time or money or are certain honorary or lifetime members. Note that this is quite different from the definition of members under Oregon law, which defines a member is someone who votes for the Board. Under the IRS definition, some of your voting members who give only nominally to you may not be members. On the other hand, you may be a nonmembership corporation under Oregon law and yet have members by the IRS definition.

The IRS divides your communications to your membership into three categories: those in which you communicate only with your members, those in which you communicate primarily with your members but include some nonmembers, and those in which you communicate primarily with nonmembers.

Communications Only with Members

Most communications by a (c)(3) organization to the public that include a direct or indirect call to action are grassroots lobbying. (See page 184.) However, the IRS considers that dedicated members of a nonprofit group that address a legislative issue that is important to the nonprofit's mission are different from the general public. When a nonprofit speaks to its members about issues related to its mission, the nonprofit is not rousing the support of the general public as it does with grassroots lobbying but is speaking to an unusually committed set of individuals. Because its members are committed, the nonprofit's desire to educate them about the stands that legislators take on its issues is not necessarily lobbying. If the nonprofit provided this kind of information to the general public, it would be an indirect call to action. If the nonprofit urged its members to contact legislators directly, this would be very similar to the nonprofit making the contact itself, an action that would be direct and not grassroots lobbying.

Based on this rationale, the IRS allows nonprofits with committed members some leeway in how it defines lobbying. If you direct your message only to your members and you include an *indirect call to action*, your communication is not lobbying if you meet several conditions. The specific legislation that you refer to must be of direct interest to your organization, your communication cannot include a direct call to action and it cannot encourage your members to contact nonmembers and urge them to contact a legislator. If you include a *direct call to action*, your message is treated as direct lobbying and not grassroots lobbying.

Communications Primarily with Members

The IRS has a different set of rules if you send communications primarily to members but the materials also reach nonmembers. A communication is designed primarily for members if more than one-half of the recipients are members. As in the case of communications directed only to members, the IRS rules concern materials that are of direct interest to your organization. If you design this type of material primarily for members and if your communication *directly encourages* your readers to engage in direct lobbying, you have engaged in direct lobbying with your members and grassroots lobbying with your nonmember readers.

Communications Primarily with Nonmembers

If you distribute your communication primarily to nonmembers, you do not qualify for any special exceptions to the normal lobbying rules. If your com-

munication contains a lobbying message, it is generally grassroots lobbying. In the case of ballot measures, it is direct lobbying.

Mass Media Advertisements

Generally, you must make a call to action in order to engage in grassroots lobbying. However, grassroots lobbying includes some paid mass media advertisements that do not include a call to action. An advertisement on TV, the radio, billboards or in magazines or newspapers about highly publicized legislation that runs within two weeks before the vote by the legislative body or committee is grassroots lobbying if the ad reflects a view on the legislation and either refers to the legislation or encourages the public to communicate with the legislators. (There are some exceptions to categorizing these ads as grassroots lobbying. If this concerns you, you need legal advice.)

The Internet and Lobbying

The Internet can be an excellent tool for advocacy. Generally, you must follow the rules above when your internet activities constitute lobbying. We'll consider some special issues raised by the internet here. Because these issues are relatively new, many situations do not have definitive answers.

Websites offer the ability to reach the world. Consequently, the IRS will consider lobbying material posted on your website as grassroots lobbying. If you have pages that can only be accessed by your members, lobbying messages on these pages are direct lobbying. Remember that members are people who contribute more than a nominal amount of time or money. If you post your newsletter on your website and make it accessible to the public, any lobbying messages that would have been direct lobbying when the newsletter went primarily to your members now becomes grassroots lobbying. Similarly, if you post information from third parties that contains a lobbying message, you have probably also engaged in lobbying.

Your website can contain links to legislators and other government officials. If the link is embedded in a lobbying message with a call to action, then it becomes lobbying. If not, the IRS should just treat it as informational.

If you maintain listserves or chat rooms, participants may turn these into lobbying sites and you may have to report the expenses associated with them as part of your lobbying expenditures. If you want to avoid this result, you need to establish and enforce policies to prevent lobbying messages. You should have a clear exempt purpose for the listserve or chat room and you should explicitly and repeatedly state that the participants and not your organization are responsible for the postings. If your listserve has a moderator, the modera-

tor must carefully screen out lobbying messages. You must exclude repeat offenders who violate your "no lobbying" policy.

THE LOBBYING ELECTION COMPUTATIONS

The lobbying election test uses a mathematical formula to determine if your lobbying activities are within acceptable limits. In order to apply the test, you must calculate your *lobbying expenditures* and your *exempt purpose expenditures*.

Lobbying Expenditures

Lobbying expenditures are expenditures for direct and grassroots lobbying and other lobbying-related expenditures. These expenditures include compensation paid for an employee's services attributable to lobbying, all costs of preparing the lobbying communication, and the portion of administrative, overhead and general expense reasonably attributable to the lobbying effort. You must break these expenses down into direct lobbying and grassroots lobbying expenses.

If a communication is both a direct lobbying and grassroots lobbying communication, the communication is classified as grassroots lobbying, unless you can show it was made primarily for direct lobbying purposes. If you can show this, you can make a reasonable allocation between a direct and grassroots classification. The allocation rules are somewhat complex and you will need to get help with those.

Exempt Purpose Expenditures (EPE)

Exempt purpose expenditures are amounts you spend to accomplish your exempt purposes. They include:

- amounts for exempt purposes;
- amounts to pay employees for services connected with exempt purposes;
- lobbying expenditures (see above);
- amounts for communicating with members;
- amounts for activities not attempting to influence legislation
- reasonable depreciation and amortization of assets to the extent used for one of the above purposes (computed on a straight-line basis); and
- fundraising expenses.

Exempt purpose expenditures do not include:

- expenses connected with unrelated business income
- certain amounts related to property that is transferred;
- amounts for a separate fundraising event of your organization or affiliated organization;
- amounts paid primarily for fundraising to any non-employee or non-affiliated organization;
- capital expenses;
- taxes not imposed in connection with an exempt purpose; and
- amounts for the production of income (whether or not it is an unrelated business activity).

Making the Calculations

There are two limits involved. One is the absolute limit: if you exceed it, you lose your exempt status. The other is a smaller limit: if you exceed that you are taxed on your excess expenditures. The amount that you are permitted to spend on lobbying each year is not based on your income. Your lobbying expenditures limits are based on your exempt purpose expenditures (EPE) for any taxable year. There are four limits to be calculated: two are for total lobbying expenditures and two are for "grassroots" activities alone. Of each two, the smaller limit (the nontaxable amount) is the amount you can spend without being taxed and the other, larger limit (the ceiling amount) is the maximum you can spend without automatically losing your exempt status.

The amount that you are permitted to spend on lobbying each year is not based on your income. Your lobbying expenditures limits are based on your exempt purpose expenditures for any taxable year.

The limits are based on percentages of your EPE and the percentages vary according to the amount of your EPE. If your EPE is $500,000 a year or less, your total lobbying nontaxable amount is 20% of your EPE. Your total lobbying nontaxable amount is 15% of the second $500,000, 10% of the next $500,000 and 5% of the remaining EPE, up to a maximum of $1,000,000 that you can spend for lobbying. The total lobbying ceiling amount is 150% of the total lobbying nontaxable amount and the grassroots ceiling amount is 25% of the total lobbying nontaxable amount and the grassroots ceiling amount is 150% of the grassroots nontaxable amount.

Example: If your exempt purpose expenditures are $500,000 a year or less, the limits of your lobbying expenditures are:

Total lobbying ceiling amount:	30% of EPE

Total lobbying nontaxable amount:	20% of EPE
"Grassroots" ceiling amount:	7.5% of EPE
"Grassroots" nontaxable amount:	5% of EPE

If you exceed either the total lobbying nontaxable amount or the grassroots nontaxable amount, you will be taxed on the excess expenditures at the rate of 25%. If you exceed both, you will only be taxed on one, whichever is greater.

If you engage in excessive lobbying activities, your group will probably have to pay an excise tax of 5% of your lobbying expenditures, or, in extreme cases, lose your exemption.

If you "normally" (average amount over any four year period) exceed either the total lobbying ceiling amount or the grassroots ceiling amount, you will automatically lose your exempt status. In other words, your total lobbying spending could be within the 30% limit, but if your grassroots spending exceeded the 7.5% limit, you would still lose your exempt status. Conversely, if your grassroots spending was within the limits, but your direct lobbying expenses caused your total spending (counting both areas) to exceed 30%, you would lose your status. This would not happen if you exceeded the limits for one year; you have to "normally" exceed them, and "normally" means an average amount over a four year period. If you are in your first, second, or third year since you made the lobbying election, only those years will be used to average your expenditures for the purpose of the normally exceeds test. There are special allocation rules for activities that have both lobbying and nonlobbying purposes. You should get professional help if your lobbying activities involve these kinds of complexities.

Additional Whammy for Failure to Comply

If you engage in excessive lobbying activities, your group will have to pay the tax described above or, in extreme cases, lose your exemption. In addition, your Directors, Board members, Executive Director, or other responsible person may also have to pay a tax, if she or he agreed to the expenditures knowing they were likely to result in revocation of tax-exempt status.

Calculating the Lobbying Expenditures–An Example

At the end of the year, add up all the lobbying expenditures you've made, including both direct lobbying and grassroots lobbying. This is your total lobbying expenditure. Let's say this was $l4,000.

Add up separately the amount you've spent (expenses, salary, etc.) on grassroots lobbying. Let's say the total is $3,000.

To make your calculations with these figures, you also need to know your exempt purpose expenditures (EPE) for the year. Let's say this amount was $50,000.

For this example, then, your EPE was $50,000; your total lobbying expenditures were $14,000, and your grassroots expenditures were $3,000. Have you kept within the limits so that you don't lose your exempt status? Those limits are 30% of EPE for total lobbying expenses, and 7.5% for grass roots.

In our example, 30% of $50,000 is $15,000, so your total lobbying expenses are within the limits. 7.5% of $50,000 is $3,750, so your grass roots expenses are also within the limits.

Do you have to pay any taxes for excess lobbying expenditures? Those limits are 20% of EPE for total lobbying, and 5% for grassroots lobbying. 20% of $50,000 is $10,000, so you have excess total lobbying expenditures of $4,000. 5% of $50,000 is $2,500, so you have excess grassroots expenditures of $500.

Since you exceeded both limits, you will have to pay the tax but only on the larger amount. The tax rate is 25%, so on $4,000 you would have to pay an excise tax of $1,000 on your excess total lobbying expenditures.

Special Rules for Affiliated Organizations

There are special rules defining affiliated organizations and providing that their budgets and lobbying expenditures will be aggregated as though they were one group. This is basically to keep organizations from getting around the limits by splitting up into several groups, or affiliating themselves with separate groups over which they have control and through which they can do some of their lobbying.

Organizations are affiliated if:

- The governing instrument (Articles of Incorporation, Charter, Bylaws, etc.) of one group requires it to be bound by the decisions of the other group on legislative issues; *or*

- The governing board of one group includes people who are designated representatives (or Directors, officers, or executive staff) of the other group, and those people have sufficient voting power to cause or prevent action on legislative issues by the first group.

Groups which think they may come within this definition should carefully check the rules governing the aggregation of their lobbying expenditures and plan accordingly. These groups will probably need professional help.

PROVING COMPLIANCE WITH THE LOBBYING RULES

Keep Good Records

Under the Substantial Part Test

If you lobby under the substantial part test, you should keep careful records of the money you spend on lobbying. If you are a public charity (see page 100) with receipts of more than $25,000 per year, you will need to list your total lobbying expenditures on Form 990's Schedule A and attach a statement giving a detailed description of your lobbying and a schedule of your expenses. If you do not have to make this filing, it is still wise to maintain your records showing lobbying expenses in case you are audited.

You should also maintain a record of your volunteer (unpaid) time, both for lobbying purposes and for other purposes. If you have substantial volunteer time for non-lobbying purposes, this can help you to establish that your lobbying activities are an insubstantial part of what you do.

Under the Lobbying Election

In order to comply with the lobbying election rules, you must keep careful records of the money you've spent. Count both non-personnel expenses (like telephone, printing, postage) and salary paid to individuals spending their time on lobbying or grassroots organizing. Do *not* count volunteer (unpaid) time. Note that people – paid staff or volunteers – who make out-of-pocket expenditures for lobbying purposes cannot take charitable deductions for that amount.

You must keep records of the following expenditures separately for direct lobbying and grassroots lobbying:

- direct costs, including payments to other organizations
- allocable portion of amounts paid as compensation for your employees' services
- allocable portion of administrative, overhead, and other general expenditures
- amounts for communications with members

- research
- amounts for direct lobbying or grassroots lobbying of a controlled organization (see the discussion above on affiliated organizations).

In determining some of these figures, you will probably deal with some expenses that contain a lobbying portion and a nonlobbying portion. Common examples are employees who do both lobbying and nonlobbying work, joint usage of space and equipment, and communications that have mixed lobbying and nonlobbying messages and that may go to both members and nonmembers. You need to allocate those expenses between their lobbying and nonlobbying components.

Allocating Employee and Overhead Expenses

Organizations that lobby keep employee time sheets in which the employees that do some lobbying keep track of how much of their time is spent on research (in case it later becomes a lobbying expense as described on page 196), direct lobbying, grassroots lobbying, and nonlobbying activity. Overhead expenses are more challenging, since things like lightbulbs can't keep time records. Your group must use a reasonable method to allocate overhead expenses that are not tracked separately for lobbying purposes. One method is to use the percentage of staff time calculated for direct and grassroots lobbying as the percentage to apply to total overhead expenses to compute direct and grassroots overhead.

Allocating Expenses on Mixed Member and Nonmember Communications

Communications with members and nonmembers can be a more complicated allocation. As we discussed on page 187, many communications sent only to your members are not lobbying if they contain only an indirect call to action and are direct rather than grassroots lobbying if they include a direct call to action. If the communication is direct lobbying, it may contain some material that is not lobbying. For example, your newsletter may contain an article that issues a call to action, a report on your annual conference and an appeal for donations. The IRS requires that you make a reasonable allocation of the costs. You have some leeway to determine what is reasonable. If your newsletter contains three articles of roughly the same length and one contains a lobbying message, you might assign one-third of the cost of producing and distributing the newsletter to lobbying.

The rules get more complicated when you communicate with both members and nonmembers in the same publication. Here you have to juggle several variables. You need to consider who receives the communications (primarily

members or nonmembers), what is the content of the communication (entirely lobbying or mixed lobbying and nonlobbying messages) and whether the lobbying message is direct or grassroots lobbying.

Your communication is sent primarily to members if more than half of the recipients are your members. If your communication is addressed primarily to members and has both lobbying and nonlobbying content, you must first determine what part of the costs are lobbying. To do this you use the same rule of reasonableness that you use for communications directly solely to members. Since your communication contains a lobbying message, you have engaged in direct lobbying of your members and grassroots lobbying of the nonmembers who received it. The allocation rules for allocating between the direct and grassroots lobbying in this situation are quite complex and you should get professional help.

If the majority of those receiving your publication are not members, then your communication is addressed primarily to nonmembers. You have engaged in grassroots lobbying unless the subject of your lobbying is a ballot measure. To sort out what part of the costs are lobbying, you must allocate costs attributable to the lobbying message *and* also costs attributable to all parts of the communication that cover the same specific subject as the lobbying message. For example, if the first page of the newsletter that you send primarily to nonmembers describes the problems working parents face getting childcare and the second page discusses a bill that offers tax credits for working parents who use childcare and includes a call to action, you must allocate both pages as grassroots lobbying expenses.

Organizations often include in their newsletter a statement encouraging members to urge their friends to contact legislators about a bill. This is a form of grassroots lobbying. If your communication contains both direct and grassroots lobbying, the IRS will treat it as grassroots lobbying, except to the extent that you can show you made it primarily for direct lobbying purposes. If you can do this, you can make a reasonable allocation between direct and grassroots lobbying. If you are close to the limit on your grassroots lobbying, you should consider whether you want to incur this additional grassroots expense. You may choose instead to leave out the language suggesting that members issue a call to action to their friends.

Conversion of Expenses for Research

Many organizations research and develop policy positions before they engage in lobbying. An organization may later decide to use this material as part of its lobbying efforts. Are these expenses lobbying expenses? Generally, they are not a lobbying expense if they are used in direct lobbying. They may be a

lobbying expense if you use the materials for grassroots lobbying. The IRS classifies as grassroots lobbying those expenses for materials and research that are later used in grassroots lobbying. You may avoid this reclassification by showing that the expenses were paid more than six months before their use in grassroots lobbying. You can also avoid a lobbying classification if you can show that the research and materials had a non-lobbying primary purpose. You do this by showing that you distributed a substantial amount of your materials to those not connected with lobbying or by showing other facts and circumstances that prove that your main purpose for producing the materials was some purpose other than lobbying.

Educate and Monitor

Whether you make the lobbying election or fall under the substantial part test, you should:

- Inform any staff involved in the activity of the rules and record keeping requirements; and

- Monitor your systems, especially for the first two years. Check on how records are being kept, how lobbying expenditures are being tabulated, how decisions are being made about whether a particular activity is lobbying activity, etc.

THE §501(C)(4) ALTERNATIVE

If your Articles of Incorporation state that one of your purposes is to influence legislation, that alone will be enough to deny you tax exemption under §501(c)(3). In other words, if an official, stated purpose of your group is lobbying, then you are not organized exclusively for exempt purposes, and you won't qualify for exemption. The IRS would consider you an action organization, as opposed to a charitable or educational one. If you are – or want to become – an action group in which one of your primary purposes or activities will be grassroots organizing for the passage of legislation, initiatives, etc., or lobbying for or against legislation, consider organizing or changing to or adding a §50l(c)(4) organization.

An Internal Revenue Code §501(c)(4) exemption is available to social welfare organizations which are operated to promote the common good and general welfare of the community (not just of the organization's members or other select groups). §501(c)(4) organizations are exempt from federal income tax (except unrelated business income tax); however, foundations generally cannot

give to §501(c)(4) groups, nor can donors give and take a charitable deduction. We discussed (c)(4) groups on pages 111-112.

As a §501(c)(4) organization, you can engage in lobbying, draft proposed legislation, organize for or against legislation, referendums, and initiatives and advocate a viewpoint on a controversial subject as long as your lobbying is related to your exempt purpose. Lobbying cannot be your exempt purpose but it can be your primary activity to achieve your exempt purpose. You can also engage in limited political activity. However, under federal law, you may face tax consequences if you campaign for a federal candidate. Federal law encourages the creation of a political action committee for these purposes. See Chapter 26 for more on this.

As a §501(c)(4) organization, you can engage in lobbying, draft proposed legislation, organize for or against legislation, referendums, and initiatives, and advocate a viewpoint on a controversial subject, when such activity is beneficial to the community.

Restrictions on Federal Funds

If you do engage in lobbying, the Lobbying Disclosure Act (LDA) prohibits you from receiving any federal funds under a grant, award or loan. The law does not prohibit you from obtaining federal contracts. You should be aware that the definition of lobbying under this act is different than the definitions we have been discussing in this chapter. Lobbying under the LDA includes oral or written communications to certain federal executive branch and legislative branch officials with regard to federal laws, rules, regulations, Executive Orders, the administration of a federal program or policy, and the nomination or confirmation of a person for a position subject to confirmation by the Senate. Lobbying also includes preparation, research, planning and other background work to be used in the above lobbying. This is much broader in one way than the IRS definition of lobbying, since it includes contacts with executive branch officials as well as legislators. The LDA lobbying definition is more restrictive than the IRS definition in that it does not apply to state and local lobbying. There are a variety of exceptions to the LDA. There are also other restrictions on the use of federal monies for lobbying and political activities that apply to (c)(4)s and other nonprofits. See pages 613-614. You should get legal help if you are planning to engage in federal lobbying, plan on getting federal government monies and want to become a §501(c)(4) organization.

If you are exempt under §50l(c)(3) and lose your exempt status because of excessive lobbying, you cannot then change to §50l(c)(4). Therefore, it's important to make a good decision about the proper exemption for your group ahead

of time. Read this chapter, think about your goals and purposes and how you intend to achieve them, and decide whether you are an educational (charitable, etc.) organization, an action organization or both. If you want to achieve both (c)(3) and (c)(4) goals, you should consider affiliated organizations.

AFFILIATED ORGANIZATIONS

Many groups have both an educational purpose and a social welfare purpose that requires significant lobbying. In order to realize both objectives, these groups may decide to form several separate corporations. One of the corporations limits its purpose and activities to those which would qualify for §501(c)(3) status. A second corporation includes action work as a purpose and can conduct more lobbying as a §501(c)(4) organization than the (c)(3) could do. If the organization wants to run or raise money for federal political campaigns, it may also form a §527 political action committee. If the organization wants to run or raise money for state political campaigns or ballot measures, it may form a political committee under Oregon law. All affiliated organizations are exempt from paying most federal income taxes, but the (c)(3) can offer tax-deductible contributions to its donors and can receive grants from private foundations. The other organizations generally cannot do this.

The corporations are affiliated because there is a method of common control. In many cases, the Board of either the (c)(3) or the (c)(4) appoints the Directors of the other group. The (c)(3) should have no direct link with the PAC. The PAC should be controlled and funded through the (c)(4). Although it is tempting to appoint the same people to each Board, this is a poor practice. Each Board needs at least two Directors who do not sit on the other Boards. These Directors can be disinterested Directors in the event that two of the organizations engage in a transaction that creates a conflict of interest among the common Directors. For example, if the (c)(3) and (c)(4) discuss a grant from the (c)(3) to the (c)(4), the disinterested Directors need to determine if the grant can be made without jeopardizing the (c)(3)'s exempt status. See pages 275-276 for a discussion of conflicts of interest. Some groups do not have a formal mechanism of control but rely on the presence of a majority of the same Directors on each Board to coordinate their activities.

The IRS scrutinizes such linked organizations carefully. Consequently, great care must be taken in structuring the Articles and Bylaws, operating structures and financial procedures of such linked organizations. Each organization must be kept separate with separate corporations, different names, different Boards with different meetings and minutes, separate bank accounts and records and different employer identification numbers. If the groups share space or staff, you must allocate the costs fairly between the organizations. You must ensure

that the (c)(3) pays no more than its fair share of the expenses. For example, the (c)(3) cannot benefit the (c)(4) by compiling a mailing list and simply giving it away to the (c)(4). Some linked groups develop joint lists. You should obtain professional advice from attorneys or accountants familiar with the IRS rules regarding affiliated organizations.

NOTICE TO MEMBERS ABOUT DEDUCTIBILITY OF DUES USED FOR LOBBYING

Tax exempt organizations frequently are supported by dues. In many cases, the members can write off these dues as a reasonable and necessary business expense. However, there are some special rules that disallow part or all of these deductions when the organization engages in certain lobbying or political expenditures described below. Before we discuss what the disallowance rules require, you should determine whether these rules apply to you. The disallowance rules only apply to social welfare organizations exempt under §501(c)(4) that are not veterans groups, agricultural and horticultural organizations exempt under §501(c)(5) and groups exempt under §501(c)(6). If you are not exempt from taxation under one of these subsections, you can skip this section.

If you are a §501(c)(4), (5) or (6) that is covered by the rules, you may have another "out." You do not have to follow the disallowance rules if you receive substantially all of your dues from members who do not deduct their dues as a business expense. For (c)(4) and (c)(5) groups, this means that you receive more than 90% of your dues from members who pay annual dues of $75 (in 1998) or less. This amount is adjusted for inflation (the figure was $88 in 2005) so you may need to update the amount to determine if you must follow the disallowance rules. (c)(4), (c)(5) and (c)(6) groups are also excepted from the rules if you receive more than 90% of all your annual dues from §501(c)(3)s or any other exempt organization to whom these rules do not apply (described in the paragraph above) or from state or local governments.

The reporting requirement exceptions are broad enough to eliminate almost all exempt groups except §501(c)(6) business leagues and some (c)(4)s and (c)(5)s. Even if these rules apply to you, you do not have to report to the IRS or send notices to your members if your in-house lobbying expenditures are less than $2,000.

If you are subject to the disallowance rules, your members cannot deduct that portion of their dues that is attributable to amounts that your group expended on lobbying the federal or state legislature (but not the local level) and some federal executives. Amounts paid for political campaigning are also not

deductible. The rules are complicated and lobbying here is not necessarily defined the way this chapter defines lobbying for other purposes.

If your nonprofit makes these kinds of federal or state expenditures, you must either:

- Send a notice to each of your members specifying what portion of dues are allocable to the lobbying or political expenditures, or
- Pay a lobbying tax (if you elect this option, you must also pay a state proxy tax).

For most nonprofits, your best option is to notify your dues-payers about what portion of their dues are allocable to lobbying and political expenditures. You should do this at the time you assess the dues. You also have to report your political campaigning and lobbying expenses and the portion of dues allocable to them to the IRS.

OTHER LAWS CONCERNING POLITICAL ACTIVITY AND LOBBYING

This Chapter discussed laws about political activity and lobbying that apply to organizations exempt from federal income taxation. There are a number of other federal and state laws that pertain to electioneering and lobbying that cover non-exempt as well as tax-exempt organizations. Your exempt group needs to be familiar with those as well. We've covered those in Chapter 26.

Consult Appendix 1 if you would like information about source material related to this Chapter. Appendix 1 has references of interest to all readers, not just professionals.

9 BUSINESS ACTIVITIES BY TAX-EXEMPT ORGANIZATIONS

Exempt organizations usually need money. Funds from private donations and foundation grants often fall short of expenses. Consequently, groups develop new and innovative strategies to generate income. Some turn to corporate sponsorships or advertising income. Many nonprofit organizations have been exploring setting up business ventures or social entrepreneur activities to generate profits to be used to support the organization's nonprofit work. The income from such ventures or social enterprise activities, as well as the income from other more traditional fundraising activities, may be income that is classified by the IRS as Unrelated Business Income. If so, you must pay an Unrelated Business Income Tax on it, even though you are tax-exempt. If your Unrelated Business Income activities are too substantial, you can lose or be denied your tax-exempt status.

This chapter will help you avoid the pitfalls.

THIS CHAPTER COVERS

- **Unrelated Business Income**
- **How to Protect Your Tax-Exempt Status**

You can find additional information on specific types of income generating activities you may be considering in Chapter 21.

UNRELATED BUSINESS INCOME

Tax-exempt organizations often generate income from the goods and services that they offer. In many cases, the activities of the exempt organization that generates income are directed related to its exempt mission. For example, a church that offers Sunday school classes may charge for them. In other cases, the activity may itself be unrelated to the organization's exempt mission although it may be important to the organization because it provides funds for activities that are related to its exempt mission. For example, a university may run a macaroni factory or a school may hold an auction in order to generate funds for their educational programs. Although generally any income generated by your exempt organization is exempt from federal income taxation, the IRS does describe a category of income – unrelated business income – that is taxable. The object of this tax on unrelated business income is to reduce unfair competition between exempt nonprofits and businesses by placing exempt organizations on the same tax basis as nonexempt organizations with whom they compete. In cases where an organization generates too much unrelated business income or expends too many of its resources on its unrelated business activities, the IRS can refuse to recognize the organization as exempt or can revoke its exemption. Consequently, understanding the IRS concept of unrelated business income is important for organizations exempt under any section of §501(c).

Who is Subject to the Unrelated Business Income Tax (UBIT)?

The unrelated business income tax is imposed on almost all tax-exempt organizations, except for state colleges and universities, certain charitable trusts, certain title-holding companies, and certain government corporations. Groups that are covered by the unrelated business income tax include those exempt under §501(c)(3), (c)(4), (c)(5), (c)(6), (c)((7), and (c)(19). The unrelated business income tax is imposed in a somewhat different way than is described in this chapter on social clubs [§501(c)(7)], veterans organization [§501(c)(19)], and a few other specialized categories of exempt organizations. If your organization is one of these specialized groups, you should see an accountant or an attorney for advice specific to you.

What is Unrelated Business Income?

Unrelated business income is defined as income derived from the *regular* conduct of a *trade or business* that is *not substantially related* to the organization's exempt purpose.

This definition breaks down into three requirements which, if met, mean that you have unrelated business income:

1. You conduct a trade or business; *and*
2. You do so regularly, *and*
3. Your trade or business is not substantially related to your exempt purpose.

All three parts of the unrelated business income test must be met before you have to classify your income as unrelated business income.

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Trade or Business

A trade or business includes any activity carried on for the production of income from the performance of services or the sale of goods. This description has been broadly defined. Most types of income producing activities will be a trade or business.

Excluded from being a trade or business are activities which are not being operated in a commercially profitable manner – for example, a book publisher that published books based on their artistic merit and not on their profitability. Activities that encourage people to donate, rather than to give money in exchange for something of value, are not income producing and therefore are not a trade or business – for example, a solicitation campaign by mail.

Regularly Carried On

Your trade or business is not subject to unrelated business income tax unless it is regularly carried on. In determining whether your trade activity is regularly carried on, the IRS will generally compare the way you conduct your activity to the way a commercial business carries on similar activities. The IRS will look at the frequency and continuity with which the activities are conducted and the manner in which they are pursued.

If the activity is the kind normally conducted by commercial businesses on a year-round basis, and you conduct the activity for a few weeks, then this would not be construed to be regularly carried on. For example, if you sponsor an arts and crafts sale once a year for a week in December, your income should not be taxable. However, the conduct of a year-round business one day a week would constitute the regular conduct of business. An example would be if you sold books year round and were open only on Saturdays. If your activities are the

type that commercially are only conducted seasonally (e.g., the sale of Christmas wreaths), then you are regularly conducting business if you engage in that activity during a significant portion of the season.

If the activity is the kind that is normally carried on intermittently by commercial organizations (for example, the publication of advertising at a play), the IRS will compare the manner that you conduct the activity with the way that commercial groups conduct the activity. If you conduct the activity without the competitive and promotional efforts typical of commercial endeavors, the activity will not be considered to be regularly carried on. Similarly, where you engage in the incidental sale of goods (for example, refreshments sold at a workshop), this activity is not treated as a regular business.

Substantially Related to Exempt Purpose

It is a common misunderstanding to think that a business activity designed solely to raise money for your exempt activities is substantially related to your exempt purpose and is therefore not an unrelated trade or business simply because the funds will be used for exempt purposes. This misunderstanding comes from confusing what is essential with what is substantially related. Having money is usually essential to carrying on exempt activities. But the method of raising that money is not *necessarily* substantially related to the exempt purposes of the group. Consequently, the need for funds to realize your mission does not constitute an exempt purpose or make fund-generating business activity exempt from unrelated business income tax.

It is a common misunderstanding to think that a business activity designed solely to raise money for its exempt activities is substantially related to its exempt purpose, and is therefore not an unrelated trade or business.

For an activity to be substantially related, there must be a substantial causal relationship between the activity and the accomplishing of the exempt purpose. The causal relationship must be an important contribution to the achievement of those purposes. This test basically requires a comparison between the group's program for accomplishing its purposes, and the purpose of the income producing activity in question.

> *Example*: A charitable organization that seeks to improve the lives of the poor in a village in Nigeria and to support Nigerian culture may sell artwork produced by artists in the village. The proceeds from the sales are substantially related to the charity's exempt purposes and are not UBI. However, a soccer club that regularly

sells Nigerian artwork to raise proceeds for its programs generates UBI.

Mixed Activities

In determining whether your fee-generating activities contribute importantly to the accomplishment of your exempt purpose, the IRS considers the size and extent of your activities in relation to the purpose they are supposed to serve. If your activities relate in part to your exempt purpose but are performed on a larger scale than necessary, the income attributable to that portion of the activities in excess of your exempt needs is unrelated income. Similarly, if you have unrelated income mixed in with related income, you must separate that out and count it as unrelated.

> *Example*: A museum has a theater auditorium which is used for showing educational films in connection with its program of public education in the arts and sciences. The theater is an important part of museum activities and is operated continuously during the hours the museum is open to the public. Income from admissions would be considered income from related activity, not unrelated business income. However, if the organization were to operate the theater as an ordinary motion picture theater showing commercially made films for public entertainment during the evening hours when the museum was closed, income from that operation would be from an unrelated trade or business.

Advertising

The area of advertising has come under increased IRS scrutiny. The IRS is concerned with both the sale of commercial advertising space in tax-exempt publications, with events sponsored by profit corporations and with income generated by websites.

Sale of Advertising

Many organizations publish papers or periodicals that contain advertisements. In the area of ad generated income, you must first decide if your advertising income is from an unrelated business. In some rare cases, ad money can be considered related business income. This occurs where the ads themselves further an exempt purpose. For example, an AIDS related periodical that published only ads related to the latest medical advances in combatting AIDS with the intention of educating its readers might be exempt. However, an exempt medical organization that publishes medical ads for the purpose of generating additional revenue has unrelated business income.

Recall also that even if the advertising is unrelated to your exempt payroll, it must be a business that is regularly carried on in order to be taxable. If your money comes from ads in your annual fundraising concert program and you are involved for a fairly short time in putting together the ads, the income is not taxable.

If your ad income is unrelated business income, the IRS has developed special rules for calculating how you are taxed on this income. IRS Publication 598, *Tax on Unrelated Business Income of Exempt Organizations* explains how these rules work.

Corporate Sponsorships

Businesses frequently sponsor nonprofit events or organizations in exchange for an acknowledgment by the exempt organization of the business's sponsorship. The IRS may classify the money you receive from the business as a contribution that you acknowledge by naming the sponsor or as advertising income that you receive in return for publicizing the sponsor. Obviously, your organization would prefer that the money be characterized as a contribution on which you pay no taxes. The IRS has developed a series of rules spelling out what you must do to call this payment a contribution. If the sponsor gets no substantial benefit from the event (other than an incidental acknowledgment of the sponsorship), the payment is a donation and is not unrelated business income. You are allowed to promote your sponsor in limited but important ways. You can display the sponsor's logos and slogans as long as there are no comparative or qualitative descriptions. You can list the sponsor's locations and phone number and offer a value-neutral description of the sponsor and the sponsor's brand names, trade names, and listings. You may list your sponsors on your website and include the sponsor's address and a hyperlink to their website. The sponsor can condition its payment on the occurrence of the event; that is, if it does not occur, the sponsor does not have to pay. The sponsor can also distribute its product at the event, as long as it does not engage in the conduct described below that constitutes advertising. These are acknowledgments and are not unrelated business income.

Donations by a profit corporation to your fundraising events or other activities that the profit corporation sponsors may also be classified as advertising income, reportable as unrelated business income.

Messages that contain any of the following elements are advertisements and generate unrelated business income: qualitative or comparative language ("We have the best shoes in town."); price information, value, or savings ("10% off on Fridays."); an endorsement ("Our nonprofit believes these shoes are the best");

an inducement to acquire the sponsor's product ("Shop with Big Corp and get a free watch."). If the amount of the sponsor's payment is contingent on factors like the number of people attending the event or ratings on television or the radio, then the income is advertising. Corporate sponsorships that appear in any of your regularly published periodicals are generally advertising income.

If the sponsor receives a substantial return benefit, part or all of the sponsorship payment becomes unrelated business income. Such benefits include advertisements, exclusive provider arrangements, goods, facilities, services, privileges, and the right to use an intangible asset (for example, your mailing list). If the value of these benefits is more than 2% of the sponsor's payment, then the entire fair market value of these benefits is a substantial benefit. Only the portion of the sponsorship payment that exceeds the value of these benefits is a qualified sponsorship payment.

You should consult a lawyer if you have corporate sponsorship of events of a significant size.

Payments for Website Links

If you receive payments to link your website to another nonprofit or for-profit organization, that payment may constitute advertisement income unless you make the linkage to accomplish part of your exempt purpose. The IRS may also treat your income as a corporate sponsorship acknowledgment or a royalty. You need professional advice on this.

Examples of Unrelated Business Income

You might generate unrelated business income by providing services or goods. The best way to understand whether activities generate unrelated business income is through examples.

Services

> *Example*: An organization operating to combat racial discrimination presents an annual conference with workshops for organizations, governmental entities and businesses interested in eliminating racism. The fees received for the conference are related to the organization's exempt purpose. These fees are not unrelated business income.

Sales of Goods

Where the Exempt Activity Itself Produces the Product

Sometimes an exempt activity produces a product. If that product is sold in its original state, the income produced is not from an unrelated business. But if the product is exploited beyond what is necessary to prepare it for sale, then the income would probably be from an unrelated business.

> *Example*: An exempt vocational education program maintains a dairy herd to provide students with educational experiences related to dairy herd management. The sale of milk and cream produced by the herd would not be income from an unrelated business because milk is an inevitable by-product of maintaining a dairy herd. But if the organization used the milk and cream in the further manufacture of cheese, ice cream, etc., the sale of those products would be from an unrelated business, unless the manufacturing activities themselves contribute importantly to the accomplishment of the exempt purposes of the organization.

Other Sales of Goods

> *Example*: An art museum's gift shop sales of watches and souvenirs are unrelated business income, because the primary purpose of the items is ornamental or utilitarian. However, the sales of reproductions of artwork and books about artists are not unrelated business income because they are chiefly educational and enhance visitor awareness of art and culture.

> *Example*: An exempt organization publishes an educational magazine which furthers its educational purposes. It also sells commercial advertising space in the magazine; the latter income is derived from an unrelated business activity. In contrast, selling subscriptions to the magazine generates income which is related to the organization's exempt educational purposes.

> *Example*: An exempt organization which trains children in the performing arts (singing, dancing, acting) presents performances by students and receives income from the sale of tickets to the performances. The students' participation in the performances is an essential part of their training. Since the income is produced from activities which contribute importantly to the accomplishment of the organization's exempt purpose, it is not income from an unrelated trade or business. If the performance included a program that

contained advertising, the advertising income would not be unrelated business income because it did not result from conduct regularly carried on.

Example: A Cherokee community center that works to preserve Cherokee culture rents out its auditorium on a regular basis to a Cherokee dance group in order to promote Cherokee culture. The rentals received are related to the group's exempt purpose.

Exceptions to the Unrelated Business Income Rules

There are a number of exceptions to the rules defining unrelated business income. The more significant ones are listed below. In each of these cases Congress has excluded the income from what seems like unrelated trade or business from taxation:

- A trade or business where substantially all the work in running the business is done by volunteers; for example, an exempt organization that operates a retail store run by volunteers.

- A trade or business which consists of selling merchandise which has been donated to the organization; for example, a thrift shop operated by an exempt organization with donated clothes, books, furniture, etc., which are sold to the public.

- A trade or business which is operated primarily for the convenience of the organization's members, students, patients, officers or employees; for example, a college laundry operated by the college for laundering dormitory linens and students' clothing.

- Bingo, if operated in states in which only nonprofit organizations may operate such groups. Oregon is such a state.

- Distribution of low cost articles and member lists. This exception applies to §501(c)(3) organizations (except public safety groups) and a few other exempt organizations to whom contributions are deductible. Your organization can distribute low-cost articles as part of certain solicitation campaigns and you can rent or sell your mailing list.

- Certain conventions and trade shows, by §501(c)(3), (c)(4), (c)(5), and (c)(6) groups.

In addition, income from the following is specifically excluded from unrelated business income:

- dividends
- interest
- some rental income (unless it is debt-financed) and
- royalties (in most cases)

There are also exceptions to the above exclusions for debt-financed property and income from controlled corporations and various other special rules. Throughout the 1990's, the IRS disputed whether items like income from the sale of mailing lists (by non-§501(c)(3) groups) and income from affinity cards (credit cards promoted by your nonprofit) were royalties. The IRS took the position that they were not royalties and thus were taxable. Recent court cases appear to have settled this issue, allowing mailing list sales and affinity card income to avoid classification as unrelated business income. These rules are complicated. If you think they may apply to you, read the free IRS Publication 598 "Tax on Unrelated Business Income of Exempt Organizations" or talk to a professional for more information.

How to Calculate and Pay the Unrelated Business Income Tax

If you have determined that some part of your organization's activities fall within the IRS definition of unrelated business income, you may have to file an additional annual return with the IRS, Form 990T. Organizations with gross annual business income of $1,000 or more must file the 990T. However, the IRS assesses the unrelated business income tax only if the net income from unrelated business activities is greater than $1,000. For example, if you have paid staff operating a gift shop, you would compute net unrelated business income by subtracting all the expenses of operating the shop from the income the shop brings in. You are only taxed on the net income from unrelated business activity.

In computing the expenses which can be attributed to the unrelated business income activity, you are permitted to consider both direct and indirect costs. Direct costs such as salaries and commissions, long distance phone calls, and expenses incurred to buy needed materials paid in connection with the unrelated activity are clearly deductible. Indirect costs may include a proration of the organization's total cost for rent, phone service, utilities, etc.

For organizations generating significant amounts of unrelated business income revenue, good recordkeeping is essential for costs incurred for both the exempt and the unrelated business income activity. You will have to be able to

prove to the IRS that your allocation of shared costs has a reasonable basis. It's important to record all the costs of unrelated business income activity because these costs will reduce the unrelated business income net income, and consequently reduce the tax you must pay. IRS Publication 598 "Tax on Unrelated Business Income of Exempt Organizations" is essential reading, preferably before you begin your unrelated business income activity, and definitely before you file either your 990 or your 990T. The Unrelated Business Income Tax Return (990T) is due the 15th day of the 5th month after the close of the fiscal year (November 15th for June 30th fiscal year organizations; May 15th for December 31st calendar year organizations), the same deadline as for the 990. The filing of the 990T is required in addition to the filing of the 990, not as a substitute.

For organizations generating significant amounts of unrelated business income revenue, good recordkeeping is essential for costs incurred for both the exempt and the unrelated business income activity.

If you must pay unrelated business income tax, you must make estimated tax payments in the same manner as profit corporations. Contact the IRS or your accountant for the proper forms and time deadlines for your group.

When Does Unrelated Business Income Threaten Your Tax Exemption?

If your organization engages in too much unrelated business activity, the IRS can deny your exemption or revoke your exempt status. The question of how much unrelated business income activity an exempt organization can conduct without threatening its tax-exempt status is difficult to answer. The IRS considers that an organization whose unrelated business activities are "more than an insubstantial part" of the organization's activities is not exempt. In determining when your unrelated business activities become substantial, you should consider what percentage of your income is attributable to unrelated business income, how much of your organization's time is spent on your UBI activities, whether and how much your UBI activities have influenced the composition of your Board, how much volunteer energy goes into your organization's exempt mission that may not show up on your books, and how your UBI activities affect the public perception of your organization. The IRS seems to consider factors other than the percentage of income that an exempt organization realizes from its unrelated business. For example, occasionally groups that make 50% of their income from unrelated business activities have been granted an exemption. Although the regulations are uncertain, this does not have to close off the possibility of participating in successful business ventures. It just requires careful planning and good professional advice.

In recent years, exempt organizations have increasingly entered into joint ventures with businesses. This is an area of great interest to the IRS because the IRS is concerned that the business partner may be taking advantage of its partner's exempt status to realize private benefit and because the exempt organization may be diverted from carrying out its exempt purposes. You need legal advice if you plan to enter into a joint venture with a non-exempt organization.

HOW TO PROTECT YOUR TAX-EXEMPT STATUS

If your group's unrelated business activity appears to be substantial or clearly heading toward substantial, you may want to consider protecting your tax-exempt status through the formation of a separate corporation to conduct unrelated business income activity. In this approach, the new corporation can be either nonprofit or profit. If it is nonprofit, you will want its Articles of Incorporation to specify the right of your existing corporation's (the parent) Board to appoint a controlling interest of the new corporation's Board. If the new corporation is a profit entity, you will want the existing nonprofit (parent) corporation to own a controlling interest in the shares of the profit corporation.

Whether profit or nonprofit, the new corporation is designed to conduct the unrelated business activity and generate profits which will be given to the tax-exempt parent corporation. You will need good legal and accounting advice to set up the new corporation and minimize its tax liabilities. Your accountant or attorney can help you evaluate the benefit of choosing a nonprofit or profit structure for the new corporation. Remember that the new corporation can purchase goods or services from the parent exempt organization at fair market value. This may permit transfer of significant amounts of the new corporation's income to the parent while creating deductible expenses for the new corporation, reducing the new corporation's net income and corporate income tax liability.

If the new corporation is a profit entity, it can pay dividends to the parent nonprofit corporation out of after tax profits. The dividends are not considered unrelated business income to the exempt organization. If the new corporation is a nonprofit corporation, it can make contributions to the exempt corporation. These contributions are also not considered unrelated business income to the exempt corporation. Structuring the arrangement as a partnership by the exempt organization does not offer the same benefits as these corporate alternatives. Income from partnerships is unrelated business income to the exempt organization.

These alternative structures are necessary and desirable only for exempt organizations with substantial unrelated business income activity. If your group is testing a small profit-making idea, it's probably best to wait until it succeeds before investing in the legal work necessary to set up a new corporation to conduct the activity. However, you should obtain experienced legal and tax advice before beginning even a small business venture type activity.

Consult Appendix 1 if you would like information about source material related to this Chapter.

10 FISCAL SPONSORSHIP

There are occasionally situations in which a group, usually one that does not have §501(c)(3) recognition from the Internal Revenue Service, needs the assistance of a group that has received its §501(c)(3) recognition of exemption. This commonly occurs when a group is told by a donor or funder that it will give the group money but that it will only do so if the group has received §501(c)(3) status. The group may not be planning to apply for its own §501(c)(3) status or it may have already submitted its application but needs or wants to get the money before it will get its notice of exemption from the Internal Revenue Service. In many cases, the group will look for a §501(c)(3) group that will "sponsor" it by letting the new group use the existing §501(c)(3) tax exemption number and by receiving the money in its name and then passing the money on to the nonexempt group.

This relationship is often referred to as a fiscal sponsorship. The exempt §501(c)(3) organization may be called a "fiscal sponsor," or an "umbrella organization." These terms all generally describe the same relationship. In this book, we will use the terms "fiscal sponsorship" to describe the relationship and "sponsor" to refer to the §501(c)(3) organization. The sponsored group is the "project." In the past, such relationships have been referred to as "pass throughs" or "fiscal agent" relationships. Both terms are misleading and can result in serious problems with the IRS.

Many of the groups that enter into this relationship are unaware that there are serious implications for the sponsor, the project, donors to the project, and foundations that make grants to the project. If you are considering entering into this type of relationship, or are already in such a relationship, either as the sponsor or as the project, or if your group is thinking about giving money to a project, you should read this chapter. You will need a basic understanding of Chapter 5 to follow some of the material in this chapter.

THIS CHAPTER COVERS

- **Proper Uses of Fiscal Sponsorships**
- **Misuses of Fiscal Sponsorships**
- **Consequences of the Misuse of Fiscal Sponsorships**
- **Issues in the Fiscal Sponsor Relationship**
- **How to Structure a Fiscal Sponsorship**

PROPER USES OF FISCAL SPONSORSHIPS

A good fiscal sponsor relationship can have many positive advantages for all the parties and the community. The most successful sponsorship relationships are generally those in which the project complements the mission of the sponsor. For example, the sponsor may provide education to the community about AIDS and the project may provide financial assistance for those who have the disease and who have used up their resources. Many would argue that these are the only types of fiscal sponsorship that an exempt organization should consider.

Fiscal sponsorship may allow a new organization to get off the ground and can give birth to a worthwhile project or service that would otherwise not exist. If the service provided by the project is a needed one, sponsorship can enhance the sponsor's reputation in the community as well.

Fiscal sponsorship relationships can be properly set up in a variety of situations. In some cases, the project will not itself be tax-exempt and in others it will be. In most of these situations, you must set your relationship up very carefully, so don't try these at home until you have read this entire chapter.

Fiscal sponsorship relationships can be properly set up in a variety of situations. You must set your relationship up very carefully.

New and Small Projects

A sponsor may support a project, often new or small in scope, that would itself qualify to be tax-exempt but it hasn't received an exemption letter. The project may be in the process of applying for its own exemption or it may have decided that it doesn't want to do the paperwork and go to the expense of getting its own exemption. The project needs sponsorship because there are donors or foundations that want to give it money but who will only give to a §501(c)(3) organizations. *In a carefully constructed arrangement*, this can be done. For example, a drug prevention program has begun its work and has an interested funder but has not yet received its own tax exemption.

Ongoing Project with a Major Donor/Funder

Occasionally, a project may be ongoing, or at least have a duration of several years, and have one or a few primary funders whose support is substantial.

An example would be a group organized to raise support for and build a memorial to a hometown hero.

Assistance to Qualified Individuals

A donor may be interested in giving money to a particular individual but cannot take a charitable deduction if she or he does this. If that individual is within a category of individuals to whom §501c)(3) organizations can make grants (for example, the poor, artists, or students), *in a carefully constructed arrangement* the donor can give the money to a sponsor who makes grants to that type of individual. The sponsor cannot accept monies to be passed to specific recipients, but it can pre-qualify the specific individuals that the donor is interested in, as long as any person meeting the criteria could apply for and have the same chance of receiving funds as that individual. The sponsor has to have objective criteria for providing assistance to individuals that would meet the requirements of §501(c)(3). For example, a musician has a donor that wants to support her music. These types of arrangements require legal help to arrange.

The sponsor cannot accept monies to be passed to specific recipients, but it can pre-qualify the specific individuals. These types of arrangements require legal help to arrange.

Private Foundation Project

Private foundations are subject to a variety of restrictions. (These are discussed on pages 97-100). Occasionally, the foundation will want to set up a program it funds but does not want this program to be subject to the private foundation restrictions. However, because the foundation is the sole funder, the project cannot get a Public Charity classification (see pages 105-106). Similarly, a project that is not itself exempt may have substantial support from just a few funders. Fiscal sponsorship by another Public Charity may solve this problem. An example would be a program to help at-risk children that Gomez Foundation wants to develop and fund as a Public Charity.

Support for Common Issue Organizations

A group of leaders who have a shared area of concern want to encourage the development of numerous types of organizations to work on all facets of that shared issue. The group can do this by setting up a central organization that can pool common knowledge, avoid duplication of efforts, and avoid the cost and time of getting §501(c)(3) organization for each organization. This central organization will be a kind of sponsor. For example, an environmental or-

ganization with subordinate organizations devoted to issues concerning the ozone, rain forests, species preservation, etc.

Bookkeeper for Another §501(c)(3) Organization

In a some cases, the project that has itself been recognized as exempt under §501(c)(3) wants a sponsor to handle its bookkeeping or other administrative matters in order to provide credibility and assurance of experienced management to funders.

MISUSES OF FISCAL SPONSORSHIPS

Fiscal sponsorship relationships are misused in a variety of circumstances.

Pass-Through Donations and Grants

A donor cannot take a charitable deduction for a contribution to an organization that is not recognized as exempt and most foundations cannot give money to an organization that is not recognized as exempt unless the foundation follows certain accountability procedures. Frequently, an organization that has not been recognized as exempt (often a new organization) has an interested donor and will ask a §501(c)(3) group to act as an umbrella or a pass-through organization. The donor or funder writes the check to the (c)(3), which has agreed to and does pass the money through to the new group without exercising any control over the money or requiring the specific accountability mandated by the IRS rules. The IRS treats this arrangement as a gift or grant directly from the donor or funder to the new nonexempt group. This is an improper use of a fiscal sponsorship. The donor cannot legally take a deduction for the donation and the (c)(3) has made an improper grant.

Conduit for Gifts or Grants to Individuals

IRS rules forbid donors from making tax deductible contributions to specifically named individuals. Fiscal sponsorships are sometimes used by a donor who gives money to an exempt organizations with instructions to pass it on to a specific individual who is not properly qualified to receive the money. The donor then takes a tax deduction. Since the donor could not get a tax deduction had she or he given this money directly to the individual, this type of fiscal sponsorship is a misuse of the fiscal sponsorship arrangement. The donor cannot take a deduction for the donation and the (c)(3) has violated IRS rules that require certain procedures before making gifts to individuals.

Conduit to Nonexempt Organizations

Occasionally an organization that would not qualify for exemption under §501(c)(3) asks a §501(c)(3) organization to act as its sponsor. Funders and donors who could not give to the non-§501(c)(3) organization then give to the (c)(3) organization. The (c)(3) organization is supposed to pass the money through to the nonexempt organization. This is a misuse of the fiscal sponsorship arrangement. The donors cannot legally take a deduction and the (c)(3) has jeopardized its own exemption by giving money to a group that does not meet the (c)(3) criteria.

Fiscal sponsorships are sometimes used by a donor who gives money to an exempt organizations with instructions to pass it on to a specific individual who is not properly qualified to receive the money. This type of fiscal sponsorship is a misuse of the fiscal sponsorship arrangement.

Avoidance of the Public Support Test

The IRS classifies all §501(c)(3) organizations as either private foundations or public charities. Private foundations generally are groups that get much of their income from one person or family. There are significant constraints and legal and accounting rules that private foundations must meet. Most groups prefer to avoid this classification if possible. (See pages 97-100 for a more detailed discussion of private foundations.)

The private foundation classification is commonly avoided by showing that an organization receives support from a variety of public sources. Chapter 7 discusses the tests that establish this in considerable detail. Sometimes a private donor wants to give a small organization a large sum of money that will tip the organization out of the publicly supported category and into the private foundation category. Occasionally the donor will donate that money to another §501(c)(3) organization (that is, a PSO – see Chapter 7). If the PSO is large enough, the donation does not tip it into the private foundation category. The donor requires that the PSO give the money to the smaller organization. PSOs cannot tip public charities into the private foundation category. Because the PSO and not the donor is giving the money to the ultimate recipient, the recipient does not appear to be tipped into the private foundation category. However, the IRS will characterize this gift as having been made by the original donor to the intended recipient organization, since the original donor has controlled its direction. The IRS will classify the smaller organization as a private foundation.

Avoidance of the Lobbying Excise Tax by Private Foundations

Private foundations are restricted from using money to lobby and must pay excise taxes when they do. In order to avoid this tax, some foundations will attempt to give the money to a §501(c)(3) group that is not a private foundation and which can do limited lobbying without paying a tax. When the gift is to be disbursed for lobbying purposes, the fiscal sponsorship arrangement does not prevent the IRS from characterizing this as lobbying by the private foundation.

CONSEQUENCES OF THE MISUSE OF FISCAL SPONSORSHIPS

All the parties involved in the misuse of a fiscal sponsorship may face consequences. The sponsor may lose its own tax exemption for its involvement in activities that are improper for (c)(3) organizations. The project may be classified as a private foundation based on the reclassification of the source of funds by a large private donor. If the donor is a private foundation, it may have to pay a penalty tax. If the donor is a private individual or corporate donor looking for a tax deduction, the donor can lose the tax deduction.

The organizations and the officers and directors face some additional potential liabilities. The IRS may impose excise taxes or other penalties on the officers and directors of the exempt organization(s) for misuse of funds. Donors who have lost an expected tax deduction may have sufficient losses to consider legal action against the organization and its officers and directors. The future directors of the sponsor may bring suit against the former officers and directors whose negligent conduct caused the organization's loss of tax-exempt status.

ISSUES IN THE FISCAL SPONSOR RELATIONSHIP

Three different participants have an involvement in the fiscal sponsor relationship: the sponsor, the project, and the funders. A number of issues come up in the fiscal sponsor relationship that will impact each of the participants differently.

Control

Control is a central issue for both the sponsor and project. In order to protect its §501(c)(3) status, the sponsor must exercise some control over any money

that it gives to the project if the project is not itself exempt. At a minimum, the sponsor should collect all pertinent financial information and records; it should approve all financial expenditures, hiring and firing, and all significant decisions in running the project; and it should have the power to terminate the relationship if the project engages in any activity that jeopardizes its tax-exempt status. To the extent that the sponsor maintains control, it may also find itself taking on responsibility for the liabilities of the project.

Control is a central issue for both the sponsor and project. In order to protect its §501(c)(3) status, the sponsor must exercise some control over any money that it gives to the project.

The project typically wants to exercise as much control as possible over policy and administration. It can set policy about the project, subject to the sponsor's right to veto its decisions if these decisions threaten its tax-exempt status. It may want to run the day-to-day activities of the project. In some cases the project may want the sponsor to provide bookkeeping, hire employees, and handle other administrative matters.

The two parties will want to examine the models described on pages 227-231 with an eye toward choosing those that assign control in a way that is most satisfactory to both.

Handling of Donations and Grants

How donations and grants are handled will generally differ greatly depending on whether the project has itself been recognized as tax-exempt. If it has, then the funds can generally be given directly to the project, unless the parties choose to have the sponsor administer them.

If the project has not been recognized as exempt, then the donations and grants must be handled with considerably more care.

Donors

Donors, whether individual or corporate, generally want to be able to take a charitable deduction for their donations. They can only safely do this if they donate to an organization that has been recognized as exempt under §501(c)(3) (and a few other specific types of groups). This is why they are insistent that the project have a tax-exempt number. The obvious strategy, and one that many groups unfortunately employ, is to find an exempt organization that consents to the use of its name for the donation but that agrees to pass the money through to the project. As this chapter has explained, this strategy is not acceptable to

the IRS and the IRS, if it becomes aware that this has occurred, will construe such an arrangement as a direct donation to the project and deny the deduction, on the grounds that the gift was not really made to a §501(c)(3) organization. The IRS may also exact other penalties, as described on page 221. Consequently, individuals or corporate donors who are looking for a charitable deduction cannot give the money to the sponsor with instructions to pass it through to the project.

The obvious strategy, and one that many groups unfortunately employ, is to find an exempt organization that consents to the use of its name for the donation but that agrees to pass the money through to the project. This strategy is not acceptable to the IRS.

Private Foundations

Private foundations operate under somewhat different constraints. Virtually all private foundations are themselves §501(c)(3) organizations. This means that they can only give their money to other (c)(3) organizations or to organizations that would qualify as exempt under §501(c)(3) if they were to apply. Unlike the private and corporate donors seeking the charitable deduction, the private foundation can make grants to groups that do not have the (c)(3) exemption if the private foundation follows certain steps to ensure that the money is being used properly. These steps are often referred to as expenditure responsibility and are described on pages228-229.

A few private foundations are willing to make grants backed by expenditure responsibility. In those cases, the project does not need a sponsor. It simply gets the grant from the private foundation and submits the paperwork to show it has complied with the terms required by expenditure responsibility. Most private foundations do not want to deal with nonexempt groups and therefore require the use of a sponsor.

Options for Handling Funds

The sponsor can handle the funds received as donations or grants in two ways. The grants and donations can be given to the sponsor without any binding commitment on the sponsor's part to the funder to give these monies to the project. The funder must be willing to give the funds to the sponsor knowing that the sponsor may choose to use these monies for its own projects. In practice, this is quite unlikely to happen, since most sponsors will not be willing to antagonize their potential funding sources by exercising this right, but the sponsor must have this right. The sponsor, if it chooses, can then give the money to the project, as long as it exercises expenditure responsibility.

The second option is that the funders may give the money as a restricted fund to be used for the project. In order to avoid having this classified as an illegal pass-through arrangement, the sponsor must pre-approve the project before the funds are received, must exercise expenditure responsibility after the funds are dispersed, and must exercise certain other precautions, described on pages 228-229.

Recordkeeping

How the sponsor handles recordkeeping will also vary depending on whether the project has been recognized as exempt under §501(c)(3). If it has, the funds will not show up on the sponsor's books.

If the project has not been recognized as exempt, the proper uses of fiscal sponsorship do result in revenue and expenses for the sponsoring organization. Be sure to avoid the use of terms like pass-through or acting as an agent. These terms have specific meanings to both the accounting profession and the IRS. If the sponsor has an independent audit, and presents the relationship to its auditor as a pass-through or an agency relationship, the auditor will not include the amounts received and expended as revenues and expenses. Instead, only the balance of funds remaining at year end will show up on the sponsor's audited financial statements – and it will be classified as a liability. This will mean that the independent audit does not support the donor's claim to have made a contribution to the organization. The proper treatment of a fiscal sponsorship project will be reflected in the audit in both revenues and expenses. Thus the audit report will agree with the 990 and the tax returns filed by the donors.

An important implication of showing the project's figures on the sponsor's books is that if the sums are large, this may distort the sponsor's true financial picture and may create problems with the sponsor's own funders or donors.

Ownership of Property

In many cases, the project will generate or acquire property. It may generate property by producing a work of art, a book, or some other marketable item. It may acquire property, such as office furniture. The sponsor and project need to decide who will own this property upon the termination of the sponsorship.

Another contingency to plan for is the possibility that the relationship may be terminated while the sponsor still has some of the funds it has received for the project. If the sponsor has terminated the relationship because it believes that the project is not operating in compliance with §501(c)(3)

requirements, it cannot turn those funds over to the project without jeopardizing its own exemption. The project can negotiate an agreement with the sponsor to allow the project to recommend a §501(c)(3) organization to get the remaining unrestricted funds. The recipient will need to be one engaged in activities that fits the sponsor's mission. The right to name the recipient will allow the project the opportunity to look for another (c)(3) organization that will sponsor it, if it can get its activities in compliance with §501(c)(3). If it can do this, it can have the original fiscal sponsor transfer the funds to the new fiscal sponsor. At the least, the right to name the recipient will allow the project to play a role in the choice of who gets the money if it can't have it. The project should realize that, in many cases, the grant will include a provision requiring its return to the funder in the event it is not used for the purpose for which the grant was awarded. In those situations, the sponsor and the project will need to comply with this provision.

Payments to the Sponsor

The parties need to decide what fee, if any, will be paid to the sponsor for its administrative services. The amount of the fee will vary depending on whether the project has been recognized as exempt under §501(c)(3) and other factors. If the project has its own tax exemption, and if the sponsor is not handling funds for the project, the sponsor will probably not be justified in taking a significant fee. If the project is not tax-exempt, or if the project is exempt but the sponsor does handle its funds, then the parties need to discuss compensation. In order to exercise the control needed to protect its own tax-exempt status, the sponsor will need to provide, at a minimum, some bookkeeping services and some supervision of the project. It needs to decide how much time and energy the fiscal sponsorship will take. Factors it may want to examine are whether the project has employees; what the sources of the project's income are; how much control the sponsor is exercising; and how much bookkeeping and compliance reporting on the sponsor's part is required.

Many sponsors charge for their services. Often they charge a percentage of the funds that they handle for the project. If you are considering a percentage charge, both parties need to be sure that this will not violate the terms of any grants that are being given to the project. In some fiscal sponsorship relationships, the sponsor takes a hefty percentage of the funds that it is handling. The sponsor is entitled to cover its expenses for the fiscal sponsorship, but should be aware that profits in excess of its expenses on this service may be classified as unrelated business income (see Chapter 9). Although there are no hard and fast rules about usual percentages, projects can expect to pay up to about 15% for the service. Percentages over 30% are probably excessive. 15-30% is somewhat negotiable.

In addition to a fee for acting as a sponsor, some sponsors charge for other costs. Many grants permit adding overhead costs on top of the amount granted for the program. Some institutions add the cost of employee fringe benefit to their sponsorship fee. If you want to work with one of these large institutions, explore whether this add-on method would be acceptable to your funder. You will also want to have an explicit agreement about what costs the institution cover as part of its fee.

Liabilities

Typically, the sponsor will prefer not to assume the liabilities of the project, but the law may impose liabilities, depending on how much control the sponsor exercises over the project. The parties should plan for this and discuss insurance and the payment of insurance premiums.

Public Relations

To some extent, the project will be perceived as associated with the sponsor. Each party needs to evaluate the reputation of the other to determine whether this association will help or hurt it with funders and with the community it serves.

Special Issues of the Sponsor

If you are planning to act as sponsor for a project, there are two additional issues you must consider.

Mission and Purpose

The proposed project must fit within your own mission statement and purposes. You should review your Articles of Incorporation, your Bylaws, and any Board resolutions on the subject to see what your mission statement or purposes are. If the mission of the project does not fit within your own mission, you need to decide whether you are the most appropriate sponsor for this project. If you decide to sponsor the project even though it does not fit within your current mission or purposes, you may need to amend your purposes and mission statement so that they include this type of activity.

Activities Disclosed to IRS

When you applied for tax exemption, you submitted an application to the IRS that listed the activities in which you planned to engage. It was on the basis of those activities that the IRS granted you an exemption. The IRS rules provide that if you substantially change those activities, you must notify them.

You need to find your Form 1023 application for tax-exempt status and review what you told the IRS you would be doing. This is usually found in Part II, Question 1 of the application. If you cannot locate your application, contact the IRS to see if it can supply a copy. If the activities of the project fit the activities in your narrative description to the IRS, you do not need to do anything further. However, if the activities are substantially different from those you described to the IRS, the funds you are giving to the project are substantial, and your sponsorship is going to extend for a period of time, you need to notify the IRS that you have substantially changed your activities.

> *Example*: Neighborhood Health Clinic, a §501(c)(3) organization that provides health services to those who cannot afford them, has been approached by an environmental group that wants to preserve scenic areas to act as its sponsor. Neighborhood Health Clinic needs to review its IRS application, because it is very likely that this kind of project was not disclosed to the IRS.

You can notify the IRS with a letter or in your Form 990 (see Chapter 12) that includes a brief paragraph explaining briefly what your new activities are. The IRS can inquire if it wants to know more.

HOW TO STRUCTURE A FISCAL SPONSORSHIP

In this section, we will present six models of fiscal sponsorship. The first set of models are for projects that are *not* recognized as exempt, and in the second set of models the projects are recognized by the IRS as exempt. Keep in mind that all of these projects should qualify to be recognized as exempt by the IRS; those in the "nonexempt" group have simply not applied. Projects that would not get exemption under §501(c)(3) cannot legitimately enter into fiscal sponsorship arrangements.

Projects that would not get exemption under §501(c)(3) cannot legitimately enter into fiscal sponsorship arrangements.

Nonexempt Projects

Sponsor's Project

This model treats the project that is sponsored as a special in-house project of the sponsor. The project fits within the sponsor's mission, the sponsor maintains control of the project and the ultimate use of the funds, and the project is

the type of activity that the sponsor described as one of its activities to the IRS on its own §501(c)(3) application. The project has no separate legal existence or Board of Directors that controls the project, although it may have a board of advisors that makes recommendations to the sponsor.

Under this model, the sponsor has more control over the project than any other model, because the project belongs to the sponsor. The sponsor is also going to be responsible for all liabilities. Those working on the project will be employees of the sponsor. The sponsor will own any property of the project.

Independent Contractor

In this model, the project itself has no separate legal existence. It is an in-house project of the sponsor. However, the sponsor contracts the project out to the individual who is going to carry out the project in a carefully constructed independent contractor agreement. To create this relationship, the parties must become familiar with the requirements for establishing independent contractor status (see Chapter 16).

If the parties successfully create an independent contractor relationship, the monies from donors and foundations will belong to the sponsor, as will any property acquired or created by the project. Generally, the independent contractor is responsible for the project's liabilities, but, depending on the factual situation that gives rise to the claim, the sponsor may also be liable.

Sponsor As Grantor

This is probably the most common model used by new projects. The projects who use this model are not exempt but have found a source of funding that will only give to a §501(c)((3) organization. The project approaches such an organization to act as its sponsor and the organization agrees. To avoid the improper pass-through arrangement, both parties need to recognize is that there are actually two granting relationships taking place, and each grant-making must follow proper procedures. The funder is making a grant to the sponsor. This grant may be unrestricted, or it may be restricted. In either case, it must follow the rules discussed below about funding. The second grant occurs when the sponsor becomes a funder by granting the money to the project.

Expenditure Responsibility

As a funder under the second grant, the sponsor must exercise *expenditure responsibility* by engaging in these steps to correctly complete this type of funding process:

• The project is pre-approved by the Board of the sponsor in a Board action after receiving a written request from the project and ensuring that the project fits within the sponsor's mission in its Bylaws or Articles and within the activities for which it received its tax-exemption, all as described on pages 226-227.

• The sponsor and project must comply with expenditure responsibility rules by signing a *written grant agreement* setting forth the terms and conditions of the grant from the sponsor to the project, the use of the money by the project, the control by the sponsor, the ability of the sponsor to terminate the grant and demand return of the funds if they are misused, and reporting requirements to the sponsor about the use of the money. This grant agreement needs to be carefully written. You should have an attorney with some experience in this area prepare this agreement.

• The funding sources are made aware of the sponsor's control in writing.

• The project makes periodic written reports to the sponsor, showing its actual expenditures of the funds and its progress toward accomplishing the purposes of the grant.

In this model, the sponsor maintains control over the right to use the funds as it wants and must have the ability to pull the plug if the grant that it makes to the project is being misused. The project can control the use of the funds, as long as they are used within the parameters of the grant.

Both parties need to recognize is that there are actually two granting relationships taking place, and each grant-making must follow proper procedures.

Any property that is acquired in connection with the project is generally owned by the project, although the parties have some room to negotiate about this.

The responsibility for the liabilities of the project is somewhat uncertain. The parties will generally agree that the project is liable, but this is not necessarily binding on third persons who are owed money. The ultimate resolution of liability questions may rest on the amount of control the sponsor retains and on the circumstances giving rise to the liability.

Exempt Projects

Supporting Organization

The supporting organization discussed on pages 103-105 can be used to accomplish fiscal sponsorship goals. This model is useful for projects that would like to get §501(c)(3) status but are going to be classified as private foundations rather than public charities because they get too much support from a few donors. If the project's purposes and activities would advance the mission of a similar existing §501(c)(3) organization, and the parties are interested in setting up the relationship required of a supporting organization, then this relationship will allow the project to be exempt as a Public Charity.

The project is subject to the control of the sponsor as required by the rules governing Supporting Organizations. The project will receive its own funds as an exempt organization and own its own property. Generally, the project will be responsible for its liabilities.

Group Exemption

The group exemption discussed on page 118 can also be a form of fiscal sponsorship in some cases. This model will work when a sponsor wants to support a number of similar organizations with common goals. The sponsor would act as the central organization and get a group exemption. The other organizations would in essence be chapters of the sponsor. Under a group exemption arrangement, the central organization must exercise some control, but it can be fairly minimal. This form would permit the groups with similar goals to share information and avoid duplication of efforts. It would also mean that the chapters would be exempt without having to apply. The central organization must file annually certain information with the IRS, but it can choose whether it does the IRS filing for the chapters or whether the chapters file their own Form 990s. The general requirements for setting up this type of organization are explained on pages118-119.

The project is subject to the control of the sponsor required by the rules governing group exemptions. The project will receive its own funds as an exempt organization and own its own property. Generally, the project will be responsible for its liabilities.

Technical Assistance

In this model, the project obtains its own §501(c)(3) exemption without any assistance from the sponsor. It may use the sponsor for bookkeeping or other technical services. This is most likely to happen if a funder wants to make a grant to the project that is considerably larger than the sums of money the project is used to handling. The funder may require or prefer that the money be handled by a larger, more established organization. In other cases, the project may choose to enter into a fiscal sponsorship with another (c)(3) organization because it does not want to take the time and organizational energy to deal with grant or funds management. The sponsor will not exercise any control over the project. All funds received by the project should be deposited in the project's bank account and the project will own its own property and be responsible for its own liabilities.

The tricky issue in these arrangements has to do with the compensation paid to the sponsor. Because the provision of bookkeeping or other technical services is not itself an exempt purpose, the providing of these services is only exempt if the sponsor can show the services are charitable or in some other way further the sponsor's exempt purposes. If the sponsor cannot establish this, then this income may be unrelated business income and could subject the sponsor to a tax or, in a severe case, could threaten its tax exemption (see Chapter 9).

If you use this model, you should enter into an agreement with each other setting out the terms of your technical assistance contract and addressing the question of compensation.

Consult Appendix 1 if you would like information about source material related to this Chapter. Appendix 1 has references of interest to all readers, not just professionals.

11 STATE AND LOCAL TAX EXEMPTIONS

State and local laws impose a variety of taxes on groups doing business, having employees, and owning property in Oregon, including state income tax, regional taxes, county business taxes, and county real and personal property taxes. The law grants exemption from these taxes for many nonprofit groups. Although you may have federal income tax exemption, this does not mean you are automatically exempt from all state and local taxes.

This chapter will help you understand if your group is exempt from state and local taxes.

THIS CHAPTER COVERS

- **State Income Tax Exemption**
- **Tri-Met and Lane Transit District Taxes**
- **County Business Tax Exemption**
- **County Property Tax Exemption**
- **Local Business License Fees**

STATE INCOME TAX EXEMPTION

Who is Covered by the Exemption?

All organizations that are exempt from taxation under any subsection of §501(c), as well as many other sections of the federal law, certain insurance companies, and public utility districts, are exempt from income taxation under Oregon law.

In addition to §501(c) groups, Oregon also exempts from state income taxation nonprofit corporations organized and operated primarily to furnish permanent residential, recreational, and social facilities primarily for the elderly. In order to qualify, you must:

- Receive not less than 95% of your operating gross income (excluding investment income) solely from payments for your services and facilities, paid on or behalf of the elderly who use your facilities, and

- Not permit your earnings to benefit a stockholder or any individual, and

- Provide in your Articles or other governing instrument that all your assets (after paying your lawful debts) be distributed on dissolution to tax-exempt religious, charitable, scientific, literary, or educational corporations.

How to Apply for the Exemption

Most groups do not need to apply to the state for an exemption. Your IRS exemption letter is sufficient. There are a few exceptions for homes for the elderly, some health maintenance organizations, some insurance companies, and people's utility districts.

Other Forms You Must File

If your group has taxable unrelated business income under the federal law (see Chapter 9), you must also pay state income tax on this. Use the Oregon Department of Revenue's Form 20 and attach to it a copy of your federal Form 990-T. If your group is a charitable organization, you may be required to file an annual state form, the CT-12. (See Chapter 12.)

Homeowner's associations may elect to be treated as tax-exempt for purposes of its exempt function income. You should contact the Department of Revenue for what to file to claim this exemption.

TRI-MET AND LANE TRANSIT DISTRICT TAXES

All employers who pay wages in the tri-county Portland area (Tri-Met district) and in the Eugene-Springfield (Lane Transit District) must pay an excise tax, unless they are exempt. Among the exempt employers are all organizations, except hospitals, that are exempt from taxation under §501(c)(3). If you are going to claim this exemption, you must send a copy of your exemption letter and your request for exemption from the excise tax to Personal Tax and Compliance Division, Oregon Department of Revenue, P.O. Box 14800, Salem, OR 97309-0920.

COUNTY BUSINESS TAX EXEMPTION

Some counties have county business taxes, assessed on the income on entities doing business in their county. You should check with your county to see if there is such a tax and if your group is exempt. Multnomah County, for example, has a business tax but exempts from it §501(c) groups and many nonprofit old age homes. These groups do have to pay taxes on unrelated business income (see Chapter 9).

It is important here to distinguish these county business taxes (and potential opportunities for exemption) from county level individual income taxes. Multnomah County adopted a special income tax and other counties are requesting permission to do so. These income taxes impact employees of nonprofits and are discussed in Chapter 23 but are not taxes on the employer.

COUNTY PROPERTY TAX EXEMPTION

Each county assesses taxes on the real property (land and buildings) and the personal property (including computers, vehicles, and other equipment) used by businesses, in that county. The law exempts certain nonprofit groups from paying these taxes.

Having a §501(c) exemption, even a §501(c)(3) exemption, does not automatically mean you will get the county property tax exemption. On the other hand, some groups are eligible for the exemption that may not be exempt un-

der any provision of the federal law. Because of the property tax limitations passed by the voters, many counties that in the past were lenient about exemptions for nonprofits now take a much harder line about granting the exemption. If your group does not clearly qualify, you may want to get professional help before you file your application.

Having a §501(c) exemption, even a §501(c)(3) exemption, does not automatically mean you will get the county property tax exemption.

Whether to Apply for the Exemption

The county property taxes are used to pay for purely local services. These include things such as local roads, fire services, schools, libraries, and sheriff departments. Some of these are services that your group will use. The effect of your group's obtaining an exemption from the property tax is that either fewer funds are available for county services or that other property owners (many of whom are not wealthy people) must pay more. This may cause resentment among your neighbors, particularly if your group is in a small or poor county. Consequently, your group may want to first decide whether to apply for the property tax exemption.

What Groups Are Covered by the Exemption

A variety of types of nonprofit group can qualify for a property tax exemption.

Literary, Charitable, Scientific Groups, Art Museums

Property is exempt if it is owned by a literary, charitable, or scientific corporation or art museum and is used primarily for the corporation's literary, charitable, or scientific work. Although the meaning of "scientific" has not been much discussed, the meaning of "literary" and the meaning of "charitable" has been. "Literary" has been interpreted to refer to written materials, including plays, which means that nonprofit theatres may be exempt.

Generally, an organization is charitable if it meets three criteria: (1) the organization must have charity as its primary, if not sole, object; (2) the organization must be performing in a manner that furthers its charitable object; and (3) there must be an element of a gift or giving in the organization's work. An organization cannot be denied an exemption solely because its primary source of funding is from one or more governmental entities or because the organization's purpose or use of property is not limited to relieving pain, alleviating disease, or removing constraints.

The law also exempts as charitable the property of a corporation that provides vocational training or employment for the handicapped. Retail thrift stores which deal only in donated goods and which either give the goods to the poor or give the money received from the sale of the goods to the poor are entitled to an exemption from property tax as charitable.

The property for which the exemption is sought must be *reasonably necessary* to accomplish the literary, charitable, or scientific purposes of the corporation. This is sometimes a very hazy criterion. For example, a literary society that uses its property as space for free poetry readings and discussion groups is entitled to an exemption but other property that it owns on which it operates a retail bookstore may not be exempt (although bookstores are sometimes granted an exemption, so it is worth applying for the exemption). If your corporation buys land on which it plans to erect buildings for its exempt purposes, the exemption will not be granted while the land is vacant but will be granted once the buildings are under construction.

Religious Groups

Religious organizations are entitled to exemption from property tax. The exemption extends to property used for administration, education, and literary, charitable, entertainment and recreational purposes.

Some Schools and Educational Organizations

Schools, academies and student housing owned by charitable or religious corporations are exempt from property taxes. A day care center that has a significant educational component and that is certified by the state of Oregon to provide educational daycare can qualify as a school. The county will decide if the educational component is significant enough to qualify. If a day care center serves a significant enough number of low-income people and charges them rates that are less than its costs to provide the service, the county may grant it an exemption as a charitable corporation.

Fraternal Organizations

Fraternal organizations, other than college fraternities or sororities, can also claim property tax exemption. These are nonprofit groups which are not solely social clubs that have a ritualistic form of work, a representative form of government, and regularly engage in charitable activities. The organization's income cannot be distributed to its members, directors, or officers, and any salaries paid must be reasonable and fixed and approved by the members, directors, or other governing body of the corporation. Examples of fraternal orga-

nizations are the Masons, the Grange, the Knights of Columbus, and the American Legion.

Other Groups

There are also exemptions available for specialized purposes for which nonprofit organizations may qualify. These include property used for public parks or public recreation, housing assistance for the elderly, student housing, low income housing, senior centers and cemeteries. You should consult an attorney if your group is involved in any of these projects.

How to Apply for the Exemption

The state property tax exemption for both real and personal property is administered through the counties. Most organizations claiming an exemption obtain it by filing a form listing the property for which you are claiming your exemption with the county assessor. The form or forms you need can be obtained from the county assessor's office. Be careful that you describe the nature and purpose of your organization in such a way that it reflects the exempt purposes of your organization.

For example, a day care center that offers a preschool program might describe itself as a preschool. A day care center or other group that wishes to qualify as a school should stress on its application and in its conferences with the county those parts of its program designed to stimulate learning, the qualifications of its staff in terms of academic background or prior experience in teaching, the availability of educational materials, degrees granted, etc.

Once the application is submitted, the county will probably send an inspector out to visit the property and talk to you about your group. Be sure to give the inspector all the information you have that is favorable to your group obtaining an exemption. Be prepared to give him or her copies of written statements you may have about your group, copies of advertising that you have done, statements you have prepared for funding sources, etc. The exemption is not automatic, and you might want to consult with an attorney before sending in your application or before the inspector's visit to get an idea of what you can present to the county to enhance your chances of getting an exemption. If you obtain an exemption and your use of the property changes, you must file a new application for the new use.

The state and county tax year runs from July 1 through June 30. The application must be filed on or before April l to get the exemption for that assessment year. If you file a late claim for exemption, you can get an exemption for that year if you pay a late filing fee. The claim must be filed before April l of the

following year to get the exemption for the following tax year unless ownership remained unchanged. If the county denies the exemption, your group may appeal to the state Department of Revenue. Your group should probably hire an attorney for the appeal. If your use of the property changes to a use that is not exempt, you must notify the county assessor within 30 days.

Leases and Lease Options

Building/Land

If you meet the qualifications for property tax exemption and you lease space, you should negotiate with the owner of your building to get a rental reduction. The owner can then qualify for a partial tax exemption on your space. Your lease or lease option agreement must specifically state that your rental amount reflects the savings below market rent that your organization receives from the tax exemption so be sure to put this clause in your lease.

If you are leasing or have an option to lease on your space and want to obtain an exemption, you must request the form for this purpose from the county where your space is leased.

The exemption applies to the tax year beginning July 1 of the year for which the claim is filed. Your application must be filed on or before April 1 unless the lease or lease-option agreement was entered into after March 1 and before July 1. In that case you must file your application within 30 days after the agreement is entered into if the exemption is claimed for that year. The exemption continues as long as use of the property remains unchanged and during the period of the lease or lease-option agreement. If your agreement terminates before July 1, the exemption expires on January 1 of the same calendar year. If your use changes you must file a new application.

Personal Property

Leases for personal property (such as telephone equipment, copiers, etc.) are not covered by your organization's general property tax exemption. If your lease for personal property requires your organization to pay the property taxes, you will need to obtain an exemption for the specific property. The process for seeking this exemption is the same as described above.

LOCAL BUSINESS LICENSE FEES

Many local jurisdictions create requirements that businesses obtain licenses. These business license fees are primarily a revenue-generating mechanism.

Most jurisdictions will exempt charitable nonprofits from business license requirements. Check with your local government to determine whether your nonprofit is required to obtain a license and how to request an exemption from fees.

Consult Appendix 1 if you would like information about source material related to this Chapter.

Even if your nonprofit becomes exempt from all of these state, regional and county taxes, as well as exempt under Section 501(c)(3) of the Internal Revenue Code, you may still need to file tax returns with the various taxing authorities. Chapter 12 offers guidance about which returns you'll need to file, where to file them, and most importantly, when to file them. Even when no tax is due, there are some penalties for failure to file and filing late. Check out Chapter 12.

12 TAX RETURNS FOR TAX-EXEMPT ORGANIZATIONS

Just because you are a tax-exempt organization and do not pay income taxes does not mean that you don't have to file tax returns. This chapter will give you basic information about filing the following:

- Federal informational tax returns (Form 990 or Form 990 EZ and Form 990 Schedule A);
- State tax return (CT-12) that applies to most §501(c)(3) tax-exempt groups; and
- The county's personal property tax statement.

This chapter does not cover, but you should be aware of, the following:

- If your group is a trust, you may have additional annual forms to file.
- If your group is a private foundation that has at least $5,000 of assets at any time during the tax year, you will file Form 990-PF, rather than Form 990. You may also have additional forms to file.
- If your group had unrelated business gross income of $1,000 or more, you must file Form 990-T, and state Form 20. See Chapter 9. There are special rules for churches and certain governmental groups.

Tax-exempt organizations with employees also must file a variety of payroll tax returns. Those requirements are discussed in Chapter 24. Additional information about specific tax forms for exempt organizations is in Appendix 12 and for both exempt and nonexempt organizations is in Appendix 13.

THIS CHAPTER COVERS

- **Filing Federal Returns**
- **Filing State Returns**
- **Filling Out the Inventory and Personal Property Assessment**

FILING FEDERAL RETURNS

Nonprofit corporations which have received federal tax-exempt status under §501(c)(3) and other §501(c) provisions file Form 990 or 990 EZ. This is an informational return rather than a tax return. The purpose of Form 990 or 990 EZ is to document for the IRS and the public that the purposes and activities of the group still merit tax-exempt status. Although there is no tax to pay with Form 990 or 990 EZ, the IRS has a stiff daily penalty if the return is filed late.

Although there is no tax to pay with Form 990 or 990 EZ, the IRS has a stiff daily penalty if the return is filed late.

Who Must File Form 990 or 990 EZ and Form 990 Schedule A

All groups which qualify for tax exemption under §501 (c) of the IRS code must file Form 990 or 990 EZ, unless they are one of the groups which are specifically exempted. Your group may be specifically exempted if:

1. It normally has gross receipts in each taxable year of not more than $25,000. "Gross Receipts" are defined as all income received by the organization from all sources without any reduction for any costs or expenses. The income may be in any form including cash, property, or promises to give. An organization's gross receipts are normally considered to be $25,000 or less if the organization is:

   - up to a year old and has received, or donors have pledged to give, $15,000 or less during its first year;

   - between one and three years old and averaged $12,000 in gross receipts during each of its first 2 tax years; or

   - three years old or more and averaged $25,000 or less in gross receipts for the immediately preceding three years (including the year for which the return would be filed).

2. It is a church or church-affiliated group, a state institution, or governmental agency.

3. It is a special kind of trust or is a private foundation which files Form 990-PF.

See the IRS Instructions for Form 990 if you are unsure if your group will need to file. If your gross receipts were less than $100,000 and your organization's total assets are less than $250,000, you may file form 990E-Z which is considerably easier to complete.

Organizations which *normally* have gross receipts of $25,000 or less may either fill out Form 990, lines A through F or ignore Form 990 altogether. However, organizations which don't at least complete lines A through F of the Form 990 or file Form 990EZ may find that the IRS has removed the organization's name from its publication "Cumulative List of Exempt Organizations" even though their tax-exempt status is still in effect. This publication is frequently used by foundations and large donors to determine if an organization qualifies to receive tax deductible contributions.

What Is Schedule 990A and Who Must File It?

Schedule 990A is an addition to Form 990 or 990 EZ and is intended to give more information about the corporation. It must be filed by all organizations described in §501 (c)(3) of the IRS code, except private foundations filing Form 990-PF. Schedule 990A must be attached to Form 990 or 990 EZ. It calls for, among other things, a list of people who provided large contributions to the corporation.

When and Where to File Form 990, 990 EZ or Schedule 990A

Forms 990, 990 EZ and Schedule 990A must be filed on or before the 15th day of the fifth month following the close of your accounting period. Groups which use a calendar year accounting period must file by May 15th each year. Groups with a fiscal year ending June 30th would be required to file by November 15th; and year end September 30th would require filing by February 15th. The instructions to Forms 990, 990 EZ and Schedule 990A indicate where to file them. (See Appendix 2 for the address for Oregon filers.) If you know you will not be able to file the 990 by its due date, request an extension of time by completing Form 2758. The request for extension must be filed on or before the due date of the return or it will not be granted.

How to Deal with 990, 990 EZ and Schedule 990A Late Filing Penalties

Because the penalty for late filing of the Form 990, 990 EZ or Schedule 990A is assessed for each day the return is late, failure to file on time can pose a major threat to your organization. If you have filed late and received a penalty notice you may be able to get the penalty waived. Follow these steps:

1. Respond to the penalty notice immediately. Ignoring it will escalate the problem, eventually leading to the possibility of the IRS seizing funds from the corporation's bank account.

2. Don't pay the penalty without at least one request for waiver or abatement of penalties. If you respond to the notice with a request for waiver/abatement the IRS must respond to your request before taking any action to seize the funds.

3. To request a waiver you must identify the name and ID number of the corporation and explain that you "request a waiver or abatement of the penalty for late filing of Form 990 or 990 EZ and Schedule A, if required, for the year ending_____." You must give a reason for the lateness and state the hardship the penalty would impose on your organization.

4. Don't assume your request for waiver or abatement has been denied because you get another penalty notice. The IRS will eventually respond to the request stating either that the penalty is waived or denying the request. If it is denied, request that the denial be reconsidered. Be sure to respond to each penalty notice with a copy of your request for waiver until you get a response to the request.

5. If you have not received a response to your request for a waiver or abatement of penalty within six weeks of submitting it, you are entitled to call your local IRS office and request help. Explain your situation and the IRS representative will see that you receive a response to your request.

What Is the Accounting Period for Form 990, 990 EZ and Schedule 990A?

In filing Form 990, 990 EZ and Schedule 990A, you use the established accounting period of your corporation – either the calendar year or a fiscal year. Your fiscal year is established when you file the Form 1023 or 1024 application for tax-exempt status by your answer to the question "what month is the end of your fiscal year?" The IRS letter of determination of tax-exempt status will also state your fiscal year end. If you are using a fiscal year accounting period, you must use the 990, 990 EZ or Schedule 990A form for the calendar year in which the fiscal year began. For example, if your fiscal year is 7/1/04 to 6/30/05, file Form 990, 990 EZ or Schedule 990A on the form labelled Form 990 or 990 EZ-2004.

How to Change Your Fiscal Year

A tax-exempt organization wanting to change its fiscal year must file Form 1128 with Form 990 or 990 EZ by the due date for the year end to which the organization is changing. For example, an organization with a current year of June 30, that wants to change to a September 30 year end must first file on time (by November 15) a 990 or 990 EZ for the year ended June 30. Then, before the 15th day of the 5th month after September 30 (which is February 15) the organization must file a 990 or 990 EZ for the "short" year, July 1 through September 30, and a Form 1128. Directions about where and when to file are on the back of Form 1128.

What Are the Acceptable Accounting Methods for the 990, 990EZ and Schedule 990A?

An accounting method is a set of rules under which:

- you determine when and how to record income and expenses in your books; *and*

- you determine how to prepare the financial statements necessary for your accounting period.

Each nonprofit corporation must choose an accounting method since the annual report must be computed on the basis of a *fixed* accounting period and in accordance with a *fixed* set of rules which determine the time and manner of reporting income and deductions. No particular method of accounting is prescribed by the IRS for nonprofit corporations. Each nonprofit corporation is allowed to choose the accounting method that is best suited to its needs as long as that method clearly reflects its activity. The corporation must be consistent from year to year. Thus, once an accounting method is chosen by the nonprofit corporation, it is often necessary to receive written consent from the IRS to change to another accounting method. The methods of accounting considered "generally acceptable" by the accounting profession are discussed in Chapter 23. You should read that chapter before deciding which methods your nonprofit will use.

The following four methods are generally permissible:

1. Cash method

2. Accrual method

3. Special methods – such as those for installment sales (deferred-payment methods and long-term contracts are not discussed in this book – an accountant should be consulted before using these)

4. Any other method that clearly reflects income including combinations of the three preceding methods.

Any combination of accounting methods will be permitted by the IRS as long as the records clearly reflect income and are applied consistently. There are many specialized tax rules which apply to various accounting methods. Each nonprofit corporation should consult an accountant or similar person if there is no one in the group who is thoroughly familiar with all of the rules and regulations which apply to the various accounting methods. See Chapter 23 for a more detailed discussion of accounting methods.

How Do You Change Your Method of Accounting?

On filing your first tax return with the IRS, your nonprofit corporation may choose any appropriate accounting method without the consent of the IRS Commissioner. Thereafter, any change in the accounting method requires the consent of the IRS Commissioner before making the change. Also, if within a particular accounting method, you decide to change the way you treat any material item, you must also receive prior consent from the IRS Commissioner. Some examples of changes requiring consent are:

- a change from the cash to the accrual method or vice versa;
- a change in the method used in the valuation of inventories;
- a change in the method of computing some forms of depreciation.

To secure the consent of the IRS Commissioner for a change in accounting method or practices, you must file IRS Form 3115 within the first 180 days of the tax year in which the change is to become effective.

Public Inspection of Your 990, 990EZ and Schedule 990A

Forms 990 and 990 EZ and Schedule 990A must be made available for public inspection. The lists of contributors on both Form 990 and Schedule A may be excluded from public inspection. This is discussed on page 631. Many nonprofits find it easiest to meet the requirements for public inspection by posting their 990/990EZ, and 990A on their website or being certain that it is correctly posted on the *www.guidestar.org* website which has been given 990 info by the IRS. If you decide to use the website posting approach, be sure to remove the lists of donors which you are not required to disclose.

Many fundraisers and individual donors now routinely check out nonprofit organizations on Guidestar. Your organization has an opportunity to provide a

compelling description of your activities on the 990. Nonprofits can no longer dismiss the 990 as something of interest only to accountants. Be sure that you compare your description of your work on the 990 to what you regularly tell donors and funders about your organization.

How to Complete the 990, 990EZ, and Schedule 990A

Because the 990, 990 EZ and Schedule 990A forms are revised frequently, this book does not offer line by line instructions. Instead, we will define many of the terms most likely to frustrate 990 or 990 EZ filers and explain the key rules for tax-exempt organizations which questions on the 990 or 990 EZ and Schedule 990A are designed to address.

First, some general tips:

1. Be sure you are using the correct form. Each year the IRS should mail you Form 990 or 990 EZ and Schedule 990A. If you do not receive the forms, you may print them from the IRS web site, *www.irs.ustreas.gov*, or call to request them 1.800.829.1040. Be sure to download or to request the instructions as well as the forms.

2. Answer every question. If the answer is zero, enter "0" or "none." If the question doesn't apply, enter "N/A" for not applicable. Failure to supply answers to all the questions can be construed by the IRS as failure to file the return on time and result in a late filing penalty.

3. Use your actual accounting records to complete the answers. Don't estimate answers or supply budget figures. If your organization maintains a general ledger, the numbers on the 990 or 990 EZ should agree with the year-end general ledger balances. If your organization has an annual audit, use the audit report numbers. If you simply keep a cash receipts and cash disbursements journal, use the year-end totals from these journals.

4. Form 990 asks for two different types of financial information:

- revenues and expenses; *and*

- balance sheet accounts (assets, liabilities and net assets)

If you are unclear about these two different types of information, read Chapter 23. If your are still unclear, get help from an accountant.

5. The most common problem non-accountants have with the Form 990 is making the two types of information described above connect. For Form 990 to be completed successfully the following equation must be true:

Net Assets (Fund Balance) at beginning of the year
plus
Net Income for the year (difference between Revenue and Expenses)
equals
Net Assets (Fund Balance) at the end of the year

This equation proves the books are in balance. If you cannot make it work with the numbers in your books, get help from an accountant.

6. Be sure to look at the 990 or 990 EZ filed for the previous year. The opening balances you enter for the current year must agree with the closing balances for the previous year as reported on that year's 990 or 990EZ.

7. Keep a copy of every 990 or 990 EZ and Schedule 990A that had been filed with the IRS in your organization's files.

8. The instructions to the 990 or 990 EZ and Schedule 990A include line by line definitions of terms. This guide does not reiterate these definitions. Don't assume that you know the IRS's definition of terms without reading the instructions. Some terms have very specific meanings to the IRS.

Most Common 990 Mistakes and Problems

Recent studies show that many nonprofits have difficulty completing the 990 or 990EZ accurately. The IRS is working to improve the instructions. The order of questions on the form change slightly each year, so we will focus here on some of the most troublesome areas. The IRS is moving towards requiring that nonprofits complete the 990 electronically. Their efforts will begin with the very largest – nonprofits with total assets over $100 million – and then extend to those with assets over $10 million. But within the next few years, we expect that much smaller nonprofits will have the option to report electronically. However, whether you use paper or the electronic option, you will still need to understand some of the most puzzling concepts.

Functional Accounting

The expense portion of Form 990 is set up for a functional presentation of expenses. In other words, you must separate expenses associated with management and fundraising from those associated with program or services activity. This concept is discussed in Chapter 20 and again in Chapter 23. If your organization has gross receipts above $100,000, you are required to present the expense information on a functional basis. If you haven't maintained your records on a functional basis you will have to estimate. Start by analyzing salary and related personnel costs (the salary of a development director is a fundraising cost, the salary of a bookkeeper is a management cost, etc.) Once you've broken the personnel costs down correctly, you can use percentages based on personnel cost to allocate remaining costs.

Reporting Fundraising Expenses

Form 990 requires reporting the cost of raising funds in two distinct ways. First, if your nonprofit has held fundraising events (dinners, auctions, etc.), you will report the gross proceeds from the events (everything you took in), and the direct costs you incurred for the event, in Part I, the income section on the first page of the 990.

For example, if your nonprofit held a fundraising dinner at a hotel, you will report the total you received for through selling tickets for the dinner as fundraising event income, and you will report the amount you paid the hotel for the dinner, plus any costs for decorations, door prizes, signage, etc. as fundraising event expenses. The line for these expenses is directly below the fundraising event income in the revenue section. You will subtract the event expenses from the event income to report the net income from the event.

These same rules will apply if you conduct BINGO or raffles. You will list the gross handle from Bingo or the gross sales of raffle tickets as income and then show the cost of the Bingo or raffle prizes as expense. Once you subtract the event expenses from the event income, you will have your net income from Bingo or the raffle.

This reporting of event income and expenses is separate from reporting the cost of your general fundraising activity. You will report the cost of staff time, direct mail appeals, fund raising brochures, and other costs associated with you efforts to generate contributions in the Expense section of the 990. The 990 requires that you report your expenses on both a line-item and functional basis. Chapter 20 provides more discussion of the concept of functional expenses. For 990 purposes, you will need to divide each line item expense (like salaries, sup-

plies, postage) into three categories – reporting the portion of that line item expense which was used for fundraising, program, and management purposes.

Even if you don't employ a staff member with a title like "fundraiser" or "development director", you probably have some staff time spent to raise funds. Fundraising is defined as making unsolicited requests for contributions. So, if you have a staff member who is creating direct mail appeals or meeting with donors to ask for contributions, some portion of the Salary expense should be put in the Fundraising column. Of course, if you hire a professional fund raising firm or consultant, the entire amount of their fee will go into the Fundraising expense column.

As discussed in Chapter 23, GAAP accounting has very specific rules (SOP 98-2) regarding the allocation of costs when an activity or publication has a dual purpose, working both to carry forward your mission and to solicit contributions. The IRS now also requires compliance with these rules. The primary concept is that unless an activity carried out for both program purposes and fundraising purposes meets three specific tests, the entire cost of the activity should be considered fundraising expense. If the activity meets the three tests, you are permitted to allocate the cost between fundraising and program expenses. If you are using your newsletter or other publications or events for both program and fundraising purposes, be sure to read the 990 directions carefully in this area.

Loans

Among the most common mistakes made in completing Form 990 is the incorrect reporting of borrowing and repaying funds. The proceeds of a loan (borrowed money) are not revenue and should not be listed as income. The repayment of the principal of a loan is not an expense; payment of interest is an expense. Loans received and payments made on loans will not be included in revenue and expense totals (nor in the gross receipts test). Instead, the amount of money still owed – the loan balance payable on the last day of the fiscal year – appears on the Balance Sheet as a Liability. Oregon nonprofits cannot make loans to officers or Directors except in very limited circumstances. (See pages 276-277.)

Unrelated Business Activities

Another common misunderstanding involves the definition of activities unrelated to the organization's exempt purpose. See Chapter 9 for an extensive discussion of unrelated business activity. Most tax-exempt organizations do not have unrelated business income. Instead, in most organizations, any revenue generated by charging fees or selling products is considered related activity income because

the services or products are an essential part of the organization's exempt purpose activity. However, the fact that your organization needs the income generated by an activity to continue in existence does not make the income into related business income. This is an area of concern to the IRS. So, if your organization charges fees or sells products, be sure to review Chapter 9.

The IRS is interested in the sources of income of tax-exempt groups and is probing for possible under-reporting of unrelated business activity income. Consequently, Form 990 now requires a detailed analysis of different types of revenue. The goal of this part of the form is to classify all the revenue as either related to the exempt purpose; specifically excluded from the definition of unrelated business income by an IRS code section; or unrelated business income. Since most organizations do not have unrelated business income, if you think yours does this may be a signal to get help from an accountant.

Another source of great confusion is the distinction between political activity and lobbying.

Political Activity and Lobbying

Another source of great confusion is the distinction between *political activity* and *lobbying*. Organizations exempt under §501(c)(3) may not engage in any political activity but may engage in limited lobbying. Political activity is defined as activity in support of or in opposition to the election of candidates (see Chapter 8). It includes contributions (cash or in kind) to candidates, political parties or political action committees and actual or implied endorsements. Lobbying is not candidate related. Instead lobbying is activity intended to influence legislative outcomes. The IRS defines two types of lobbying: grassroots and direct, and requires organizations exempt under §501(c)(3) to maintain records of the costs of both types. For a complete discussion of this, see Chapter 8. In completing Form 990 or 990 EZ, answering "yes" to questions relating to political activity will be a definite red flag if you are a §501(c)(3) organization. The 990 and 990 EZ ask whether your organization has made the Lobbying Election by filing Form 5768. See Chapter 8 for a discussion of the benefits of making the Lobbying Election.

Private and Non-private Foundation Status

Perhaps the most mystifying of all parts of the 990 is found on Schedule 990A in questions relating to private or non-private foundation status and disqualified persons. The key to understanding these questions is being very clear about whether your organization is or is not a private foundation. If it is, it should be filing Form 990PF, not Forms 990 and 990A. (The questions on 990A

are designed to help you verify that your organization is not a private foundation, i.e., that you are a public charity. See Chapter 5 for a general description of private foundations and public charities. Remember that "non-private foundation" means "public charity.")

The key to understanding these questions is being very clear about whether your organization is or is not a private foundation.

The issue is first addressed in the application for tax-exempt status (Form 1023) in questions that ask organizations that claim not to be private foundations which exception to being a private foundation they meet. (See pages 137-138 for an explanation of what each exception requires.) Review your copy of the Form 1023 which your organization submitted to the IRS to see which exception you claimed. If you can't find a copy of it, look at the IRS determination letter which granted your organization tax-exempt status. Your determination letter assigned you an advance ruling or a definitive ruling on your status as "not a private foundation." (See pages 137-138 for a discussion of advance and definitive rulings.) Compare the code section referenced to the list given on the 990A list of exceptions to private foundation status. When you find the match to the code section referenced in your advance or definitive ruling you'll know which exception the IRS thinks that your group meets. You should check the box identifying this exception on the 990A and proceed to answer the questions.

Most social service, art, and education organizations (other than schools) will be covered under code sections 509 (a)(1) or 509 (a)(2), having established themselves as either a Publicly Supported Organization (PSO) or a Fee/Activity Supported Organization (FASO). (Chapter 7 provides a detailed discussion of concerns related to each category.) The 990 Schedule A requires different information for each of these two types of public charities. Answer only the questions which pertain to your type of public charity.

The 990 Schedule A instructions explain the calculations required of each type of public charity. It's helpful to understand the purpose of these questions. They are designed to identify major contributions to your organization in order to see whether or not these major contributions can be included as public support for the purpose of deciding whether your organization is a private foundation. Organizations which receive substantially all their funding from United Ways, public charities, and numerous small donors have very little likelihood of running afoul of the public support test. Organizations primarily funded by a limited number of major donors (individuals, private foundations or businesses) may have difficulty establishing public support. Such organizations should seek professional advice regarding alternative methods available to establish public charity status.

Related Organizations

Schedule A now requires disclosure of certain relationships between §501(c)(3) and other types of §501(c) organizations such as §501(c)(4)s or §501(c)(6)s. Elements which may comprise a relationship include purposeful common Directorships (your Bylaws require that a portion of your Directors also serve as Directors of the other organization), shared facilities, shared staff, regular coupling of the organizations through joint publications, etc. The IRS does not consider incidental overlaps in membership or Directors to comprise a relationship.

The point of the relationship disclosure question is to identify situations in which contributions to the §501(c)(3) organization may, in fact, be benefiting a non-§501(c)(3) group. §501(c)(3) organizations that work closely with a §501(c)(4) related organization should seek professional advice to be certain that they are maintaining adequate records, including financial records and corporate minutes, to document that tax-deductible contributions to the §501(c)(3) corporation are not, in fact, supporting activities not permissible for (c)(3) organizations through financial arrangements with the (c)(4) organization. You may also find useful information on this challenging subject at the Alliance for Justice website at *www.allianceforjustice.org*.

Signatures

An officer of the corporation must sign and date the completed Form 990 or 990 EZ. This person must be the President, Vice-President, Treasurer, Assistant Treasurer, chief accounting officer, or other corporate officer (such as tax officer) authorized by the Board of Directors to sign. Your officer should review the Form 990 for accuracy before signing it.

If the Form 990 return is prepared by someone outside of the corporation who is paid to prepare the return, the paid preparer must also sign the return. If the return is prepared by a regular full-time employee of the corporation, that employee's signature is not required. If the 990 or 990 EZ return is prepared by a volunteer or group member paid for this task, they must sign the return in addition to the officer.

FILING STATE RETURNS

Public Benefit Corporations that were required to register with the Attorney General (see page 44) and that file Form 990 or 990 EZ must file the Oregon Form CT-12 with the Charitable Trust Division of the Oregon Department of Justice. If your group has gross receipts not more than $25,000 and assets not

more than $50,000, you should file Form CT-12E instead of Form CT-12. You do not have to pay a fee if you file Form CT-12E.

Who Must File Form CT-12 and When Is It Due?

Form CT-12 must be filed by the officers of any group described above. Form CT-12 is due no later than the 15th day of the 5th month following the close of the calendar year or tax year of the corporation. This is the same as the 990 filing deadline. Groups which have received an extension to file their federal annual tax returns can apply for an extension to file Form CT-12. Enclose a copy of the federal extension form with a request for extension and submit it to the Department of Justice before the due date of the return. The extension of time to file the CT-12 is not automatic. The Department of Justice has the right to make its own decision without regard to that of the IRS.

Form CT-12 is a public record and is maintained by the Office of the Attorney General of the State of Oregon. You may reach the Attorney General's charitable office at 503.229.5725 or obtain information from their website at *www.doj.state.or.us*.

Filling Out Form CT-12

Form CT-12 has three parts as follows:

> *Part I*: must be filed by all groups required to file the CT-12
>
> *Part II*: must be filed by all groups unless all required information is present on the Form 990 (a copy of which must be included when Form CT-12 is submitted).
>
> *Part III*: must be filed by all groups that solicit funds for charitable purposes and collect more than $500 in any 12-month period.

"Solicitation" means any request or appeal, either written or oral, or any endeavor to obtain, seek or plead for funds, property, financial assistance or other thing of value, including the promise or grant of any money or property of any kind or value for a charitable purpose; but *excluding*:

> •Direct grants or allocations of funds received or solicited from any affiliated fundraising organization by a member organization; and

•Unsolicited contributions received from any individual donor, foundation, trust, governmental agency, or other source unless such contributions are received in conjunction with a solicitation drive.

FILLING OUT THE INVENTORY AND PERSONAL PROPERTY ASSESSMENT

If your group has received an exemption from the property tax, you will probably still have to fill out a Statement of Assessable Personal and Affixed Real Property or, if you own nonexempt land or buildings, a combined return of real (land or buildings) and personal property. Check with your county to see what is required. Get assistance from the county assessors office if you need help filling these forms out. If you don't file timely statements, you will be assessed a penalty.

If your group has already obtained an exemption from the county and still has to fill out the Statement, be sure to send a letter to the County when you send in this Statement explaining you are exempt and enclose a copy of the letter from the County giving you your exemption. Keep a copy of the letter you sent to the County.

Consult Appendix 1 if you would like information about source material related to this Chapter.

Part III

SUCCESSFUL FUNCTIONING: PEOPLE

13 BOARD OF DIRECTORS AND OFFICERS

The Board of Directors is the group charged with governing your nonprofit corporation. Those who serve on the Board are called Directors or Board members. Be careful not to confuse the Board's Directors with the Executive Director (sometimes also called "Director"), which is generally a staff position. (See page 17 for a discussion of terminology.) The Board is assisted in its work by your corporation's officers, who may or may not be Directors, and by its own committees. Chapter 2 has described the mechanics of putting together a Board: how many Directors you must have; how to select the type of Directors you will initially recruit; how your Board is elected or chosen; and the types of committees your Board may have.

This chapter is quite long and is intended to serve as a "Board manual" that you can use to recruit and orient new Directors and to educate your current Directors.

THIS CHAPTER COVERS

- **Recruiting and Retaining the Directors Your Organization Needs**
- **The Duties and Responsibilities of Directors**
- **Board Styles: How Different Boards Fulfill Their Duties**
- **Board Meetings**
- **Board Committees**
- **Staff as Directors**
- **The Duties and Responsibilities of Officers**
- **Personal Liability of the Board and Officers**
- **Protection of Your Board and Officers**
- **Replacing Directors and Officers**
- **Evaluating the Effectiveness of Your Board**

If you would like to obtain reprints of this chapter to give them to your Directors, please see the Order form at the beginning of this book. Contact TACS at 503.239.4001 or www.tacs.org.

The Board of Directors is charged by law with the ultimate responsibility for managing the affairs of the nonprofit corporation. How the Board handles this in a particular organization depends in part on the size and complexity of the corporation. Generally, the Board of Directors carries out these duties:

- Sets the direction and makes the policies for the corporation;
- Raises money, or makes provision to have adequate resources available;
- Oversees the finances, including adopting the budget, ensuring that financial safeguards are in place, ensuring that taxes are paid and creditors are provided for;
- Adopts personnel policies; and
- Hires, evaluates, and may terminate an Executive Director.

RECRUITING AND RETAINING THE DIRECTORS YOUR ORGANIZATION NEEDS

Your Board will want to develop a process for recruiting new Directors and for supporting their involvement on the Board. Start with an honest assessment of how you've gone about finding new Directors in the past. Have you used the "warm body" method – i.e. "Are they breathing? Will they serve? Let's take them!"

Not surprisingly, there is a better way. Start with a discussion of the types of experiences, skills, and contacts your Board needs. Consider the strengths and contributions of current Directors but keep in mind that they won't serve forever (hopefully). Once you're clear about the types of qualities and experiences you're seeking, develop a list of prospects. Your best Board prospects will be people who already have some connection to your organization – volunteers, individuals active in your organization, or professionals in related fields.

If you cannot find all the qualities you need from among this group of individuals already connected to your organization, work through connections to people associated with your group. Friends and colleagues of Directors may not be aware of your organization, but their respect for a Director may translate into willingness to learn about your nonprofit. You can also ask funders, donors, and Directors of similar organizations for suggestions and for personal introductions to promising candidates. Remember, for most organizations, capturing the "big fish" – the prestigious or wealthy community member – won't really help your Board if the person will lend only their name. You need Directors who can become involved, participate in decisions, and carry your message into the community.

Once you've identified good prospective Directors, have a current Director meet individually with them. Focus the conversation at this pre-invitation meeting on both the individual you are recruiting and the work of your Board. Be sure you take time to find out about the prospect's interests, time commitments, and other Board experiences. Be honest about your organization and its strengths and weaknesses. And be clear about the expectations you have of Directors. If your organization expects all Directors to help with fundraising or to make a personal contribution, let the prospective Director know. If you sense that the prospect is interested and would be a good addition to your Board, you'll want to let them know if your organization is facing some difficult choices or financial problems.

Your Bylaws will guide the length of Directors' terms of office. Many nonprofits find it helpful to bring on new Directors in groups rather than as isolated individuals throughout the year. The group approach allows you to focus attention on orienting the new Directors and taking time to build relationships between the newcomers and the continuing Directors. You may want to consider using a buddy system in which each new Director is paired with a continuing member. Buddy systems work best when the continuing Directors are clear about their roles. In some Boards, this may include meeting the new Director buddy for coffee before the first few Board meetings or offering rides home from meetings. The goal is to provide an informal opportunity for the new Director to explore the issues and practices which puzzle them outside the context of a formal Board meeting. The buddy approach also yields useful information for placing the new Director on committees or with special projects based on their interests and enthusiasms.

You'll want to be sure your Board leadership finds at least one specific responsibility for each new Director within the first three months of their Board service. Just assigning new Directors to committees may not achieve this goal. The new Director needs to feel that something important to the organization hinges on their effort. Even something as short-term as making a phone call or representing the organization at a meeting can help the new Director feel certain the she or he has a real role in the organization.

It seems to be human nature to take more interest in things we plan for ourselves than those already put in place by others. You can build interest and commitment in new Directors by scheduling your annual Board planning retreat shortly after the new Directors join your group. Planning retreats typically include the type of background briefing and analysis which is most useful to new members, and a well structured retreat will involve the new members in setting the Board's agenda for the year.

You may also want to structure a check-in with new Directors somewhere in the three to six months of service period. The check-in should be an indi-

vidual conversation with a continuing Director designed to determine the extent to which the new Director feels satisfied with their work on the Board. The check-in can provide useful insights into difficulties with the Board's structure, use of time, or openness to new members.

Beyond the issues of building involvement of new Directors, your Board may face great challenges in leadership development. One good leader isn't really enough. You'll want to be developing new leaders continually through your committee system or through special projects. Leaders are willing to look at issues in the context of the whole, willing and able to help Directors bring their best contribution to Board work, and able to set priorities for the use of Director time.

Some Board consultants tell new Board chairs that their first job as chair is to identify and cultivate their replacement. Your Board may want to develop ongoing strategies to be certain that new leaders will be available to replace current leaders. Some Boards work with the formal or informal expectation that the individual serving as vice chairperson will become chair the following year.

But many Boards are finding this approach no longer works consistently. Many good Directors find their lives so full of work, family, and community demands that they are hesitant to make commitments beyond one year. In fact, a growing number of Boards are finding members unwilling to commit to a full year of holding an office or leading a committee. If your Board is experiencing this time pressure or commitment pressure problem, you'll want to explore ways to fulfill Board responsibilities through short term, project oriented commitments.

The increasing time pressures which many Directors are experiencing heighten the importance of individual attention to the quality of each Director's experience on the Board. You may want your executive director or Board chair to plan an individual conversation with each Director at some point in each year. The conversation should provide opportunities to learn more effective ways to utilize the individual Director's time and skills.

In practice, providing support for Board involvement is one of the most important responsibilities within a nonprofit organization. Some Boards meet this need through assigning explicit responsibility for Board support and development to an individual Board leader or a Board committee. Other organizations assign primary responsibility for Board support to the staff. In many organizations, the responsibility is shared, with staff providing dependable information (Board packets, briefing papers, etc.) and Board leadership providing recognition and personal appreciation.

THE DUTIES AND RESPONSIBILITIES OF DIRECTORS

Many Directors in Oregon nonprofit corporations are unaware that by agreeing to serve on the Board of Directors they take on certain legal duties and responsibilities. This ignorance may be due in part to the fact that most Directors in Oregon serve on nonprofit Boards without being paid. Perhaps because the Board is volunteering its time and expertise, Directors may not expect that they will take on legal responsibilities by agreeing to serve.

Many Directors in Oregon nonprofit corporations are unaware that by agreeing to serve on the Board of Directors they take on certain legal duties and responsibilities.

It may be easier to understand why duties and responsibilities are forced on a volunteer Director if we look at the nonprofit corporation from the state's point of view. When the state gives an organization the status of "nonprofit corporation," the organization gets certain benefits. It can hold itself out to the public as nonprofit. Its nonprofit status may be a necessary step in order to obtain tax-exemption. It may be able to engage in certain types of activities, for example, bingo, denied to other groups.

Because the organization has no owners, there is no particular individual or group to whom the state can look to be responsible for the actions of the corporation. Unlike a sole proprietorship or a partnership, a corporation is really just a legal fiction. However, someone has to be responsible for it. By law, that group is the Board of Directors. In some cases, the corporation may change this (see page 17) but generally the law looks to the Board to be responsible for directing the corporation.

If you are a Director of an Oregon nonprofit corporation, you have two duties. You must act with due care in managing the affairs of the corporation, and you must be loyal to the corporation. We will explore both of these in some detail.

Duty to Act with Due Care

You as a Director have an obligation to act with due care in managing the corporation's affairs. This is the care an ordinarily prudent person in a like position would exercise in similar circumstances. The law holds the Director responsible for running the organization much as a director of a profit corporation is responsible for its operation. You must be attentive to the affairs of the corporation and to be sure that you have the information you need to make respon-

sible decisions. You should be exercising the same care in running a nonprofit corporation that you would exercise in running your own business.

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If you are on the Board of a homeowners association, most of what is said in this chapter will also apply to you, but you should be aware that the Boards of homeowners associations have specific requirements imposed on them by special statutes in addition to those listed here. See Appendix 6 for more information.

Generally, in order to exercise due care, you must do the following:

Observe Corporate Formalities

You must observe the corporate formalities. Your corporation must be operated as a separate entity from your Directors and the members of the corporation. This means that your corporation must be properly registered with the state; must follow the law, your Articles and your Bylaws; must have a separate bank account; and cannot mix its funds in an account with anyone else's. It must have its own business records; must have an active Board holding regular meetings as needed, with minutes kept; and must file annual reports with the state. If your corporation is dissolved, your Directors must be sure your assets are distributed as the law requires. (See Chapter 30.)

> *Example*: The Articles of Incorporation of The Friends of the Library provide that it is a membership corporation and its Bylaws state that each member has one vote. The attendance at membership meetings has been very light in the last 3 years. The Board decides to forego the membership meetings and to elect its own directors but does not amend its Articles and Bylaws to allow this. The Board is not following the proper corporate formalities and is not exercising its duty to act with due care.

Act as a Nonprofit Corporation

The major characteristic that distinguishes a nonprofit corporation from a profit organization is that the nonprofit corporation cannot pay a dividend or any part of its income or profit to its members, officers, or Directors (other than reasonable payment for goods received or services performed in furtherance of the corporation's purposes). If the nonprofit corporation does make this kind of

payment, it is called an *illegal distribution*. You as a Director cannot vote for these distributions.

> *Example*: In a rare occurrence which caused some staffers to believe they were living in the Twilight Zone, Coalition for Community Progress, a nonprofit membership corporation composed of both business leagues (which are mutual benefit corporations) and Oregon community development corporation members, found itself with a substantial surplus at the end of its fiscal year. Because most of its funding came from the government, the Board was concerned that reporting this would result in cuts of its future funding. The Board voted to divide the surplus among the members. Any distribution to a member that is not a Religious or Public Benefit Corporation is unlawful.

In certain limited cases, your corporation may make distributions to a member, if that member is a Religious or Public Benefit Corporation or a foreign nonprofit corporation which, if incorporated in Oregon, would qualify as a Religious or Public Benefit Corporation. However, if your corporation is or plans to become tax-exempt under §501(c)(3), you must limit yourself (in your Articles) by agreeing not to make any distributions to anyone, including members.

Actively Manage

Oregon law does not make provision for honorary Board positions. If you are on the actual Board of Directors (as opposed to an Advisory Board), you must keep current with what is going on by going to Board meetings.

If you simply lend your name to the organization by agreeing to be on the Board but do not attend meetings, you are violating your duty of care to the corporation.

You must attend a sufficient number of meetings to keep apprised of what is going on and to be able to make informed decisions. If you simply lend your name to the organization by agreeing to be on the Board but do not attend meetings, you are violating your duty of care to the corporation.

You must require operational information from the Executive Director, bookkeeper, etc. This means you should be getting periodic financial statements and reports on how the organization is doing.

> *Example*: Bob, a wealthy businessman, agreed to serve on the Board of Government Oversight, a (c)(3) organization that moni-

tored government spending and reported on corruption. Bob did not attend Board meetings. Government Oversight operated improperly by distributing most of its funds to political action committees, a violation of its mission and (c)(3) rules which resulted in heavy penalties by the IRS. Subsequent Board members sued the former Board, including Bob, for failing to exercise their duty of due care. If the former Board did fail to exercise due care, Bob will be personally liable for the judgment.

Make Reasonable Decisions

You must make reasonable decisions. The law gives you a wide scope for what is reasonable. You don't have to make perfect decisions, just reasonable ones.

Example: Your Board received a grant to build a million dollar Youth Center, but the site under discussion for the facility was yours only by virtue of a short-term lease. The Acquisitions Committee recommended a contractor who had the qualifications for the job. Some Directors wanted to choose a different contractor. After some discussion, the Board decided to build on the property with the short-term lease and went with the original choice for contractor. The organization subsequently had to pay cost overruns on the property and then lost its lease. The choice to build a million dollar facility on property on which you had only a short term lease was probably not an exercise of due care at the time it was made. This decision just doesn't make sense. However, in connection with the selection of the contractor and the cost overruns, the Board did not breach its duty of due care. The decision about whether the selection of that contractor was reasonable is based on what the Board knew or should have known at the time of hire and is not based on what hindsight shows.

Provide Financial Management

One of the major responsibilities of the Board is to provide prudent financial management of the corporation. This requires that you know the financial condition of your corporation and make reasonable financial decisions.

Knowledge of Financial Affairs

Your Directors are presumed by law to know the financial condition of your corporation. This means that the Directors should be sure accurate books and records are kept. Your Directors should get financial reports from the person

who keeps the books and should be aware of the extent of the corporation's assets. You should have someone on your Board that understands financial statements and how to read them, particularly if your organization has a budge to more than $400,000-500,000 or if a significant part of your funds are restricted funds. If your organization often operates with minimal funds in your checking account, your Directors, particularly if they are check signers, should know the checking account balance. Otherwise, the Directors may be personally liable for checks they sign that bounce.

Prudent Management

You must act reasonably in the financial management of the corporation, which typically involves adopting a budget, acting reasonably to secure funding and control expenses, planning for prudent fund management, and maintaining controls to prevent fraud and theft. Chapters 20-25 describe in detail how to do this.

> *Example*: The Timber League received an unexpected bequest of $500,000 last year. The Board has placed the money in a bank checking account while it engages in a lengthy planning process for its expenditure. Unless the Board has a good reason for its action, this may be imprudent management of funds that could be more reasonably and safely invested to earn a better return.

Restricted Funds

You must use restricted funds (where the restriction was imposed by an outside source and not the Board) in accordance with the restrictions.

> *Example*: The Children's Assistance Project has received a substantial bequest that is restricted to use for teen programs. The Board experiences a funding problem with its pre-school program and wants to divert some of the bequest temporarily to the pre-school program with the promise that the money will be replaced when finances improve. It may not. If the restriction of funds had initially been created by the Board, rather than the funder, and had not been communicated to the funder as an inducement to make a bequest, the Board could change its own restriction.

Payment of Taxes

You must be sure that all taxes are being paid. This includes payroll, unemployment, and unrelated business income taxes. Be sure to provide worker compensation coverage on workers where it is required. You do not have to

personally write the check for the taxes withheld but you should get a financial report or bookkeeper's statement that shows it is being done.

> *Example*: Your corporation is experiencing cash flow problems and your bookkeeper has paid the staff salaries but has not deposited the federal and state withholdings for several months. The Board is aware of the situation but is anticipating a large grant. The grant does not come through. Your Board has not exercised reasonable care in failing to pay these taxes, even if to do so means that you must lay off personnel.

You must be sure that all taxes are being paid.

Independent Contractors

If your organization has independent contractors, be sure they are correctly classified. It is very common for nonprofits to classify those providing services to the corporation as independent contractors in an effort to save on tax payments and paperwork. The various government agencies (the IRS, Oregon Department of Revenue, The Worker Compensation Department, State Unemployment, Bureau of Labor, etc.) involved in this classification all have somewhat different standards for what makes a person an independent contractor or an employee. In some cases, your worker may be an employee under some laws and an independent contractor under others. Your agreement with the person providing services that she or he is an independent contractor carries very little weight with these agencies. If you have or are contemplating the use of independent contractors, review Chapter 16 for more information.

If your organization has independent contractors, be sure they are correctly classified.

Contracts with Professional Fundraising Firms

If you engage professional fundraisers, you must be familiar with the law concerning such agreements. The law assumes that your officer or Director has breached her or his duty if the officer or Director enters into certain kinds of contracts with a professional fundraising firm. Pages 494-496 define what the law means by professional fundraisers and describes what contracts are improper. Your officer or Director can challenge the assumption that her or his actions were a breach of duty.

Investigate Suspicious Circumstances.

You must report to the Board and to investigate suspicious circumstances that come to your attention.

> *Example*: A reliable staff member of a nonprofit corporation tells a Director that the bookkeeper is siphoning money from the savings account. The Director has a duty to inform the rest of the Board and the Board must investigate.

Establish Proper Employee Policies

Employee claims are one of the most likely sources of lawsuit against your corporation and against Directors personally. An important Board duty is to set policy for the hiring, supervision, and termination of employees. If your organization has employees, one mechanism for implementing Board policies for employees is through personnel policies. You can delegate responsibility for addressing the day-to-day issues concerning employees. Chapter 15 discusses personnel policies.

> *Example*: Your organization has 30 employees. Your Board has a very relaxed hiring procedure. Individual Directors often talk to the candidates outside of formal Board meetings. You have no personnel policies and no written employment contracts. You are presently hiring a new Executive Director. Your Program Manager is claiming that a former Director promised her when she was hired that she would get the Executive Director position when it became vacant. The Board does not want to hire her as Executive Director but has no way of knowing what she was told by the former Director. The Board of an organization this size may be negligent in utilizing this type of hiring procedure.

> *Example*: The Board of the Jackson Childcare Center, a nonprofit corporation, has not established any policy to investigate potential employees who will work with the children. The Executive Director approved the hiring of a man with an Oregon record of several child abuse convictions. The Board may be negligent for failing to have proper hiring policies in place.

Avoid Excess Benefits Transactions

If you are exempt under §501(c)(3) as a public charity or under §501(c)(4) (see Chapter 5), your Board needs to be aware of the new regulations enacted by the IRS pertaining to excess benefit transactions involving "disqualified per-

sons." Disqualified persons are insiders such as Board members, high-level employees, substantial contributors and others with influence over your organization. If you violate the IRS regulations by paying a high-level employee too much or by otherwise engaging in a transaction with an insider that unduly enriches them, the board members *personally* and the insider must pay penalties. These rules are covered in Chapter 27 and the board should be familiar with them if you have employees or if you pay or enrich insiders for any reason. If you are not exempt under these sections, you don't have to follow the detailed rules of the IRS but you should have some policies in place to ensure that you pay only reasonable salaries and benefits to your employees and that transactions that you engage in with insiders (founders, Board members, officers, important contributors and other people who may have a special relationship with your organization) are fair to the organization.

Observe Laws on Tax-Exempt Status

If your organization is tax-exempt, you should be familiar with the provisions relating to your tax-exemption in addition to the excess benefit rules. In some cases, you may be personally liable for your actions that violate the law. If your group is a private foundation and engages in self-dealing (page 98), if you are a §501(c)(3) and do excessive lobbying (Chapter 8), or if you are a §501(c)(3) and engage in forbidden political campaigning (see Chapter 8), you as a Director may find yourself personally liable for IRS penalties. You do not need to memorize the rules on these topics but be aware that if one of these issues comes up in your organization, you need to educate yourself at that time and exercise care in how it is handled.

Make Policies

Many of the issues discussed above can best be handled by adopting policies rather than by responding to each issue as it arises or after you get in trouble. Your Board adopts the major policies of the nonprofit corporation. Policies are decisions of the Board but are different from other Board decisions. Policies are a set of principles and procedures that Board, staff and volunteers can consult to determine how to act in the situations covered by the policies. These policies may be drafted by the Board members, the Executive Director, another staff member or a consultant but the Board should have final authority over their adoption (unless your Articles of Incorporation allow another group to do this, as discussed on page 17). The Board can delegate the authority to flesh out the details of the policies to the Executive Director or other appropriate staff. The types and details of policies vary, depending on the size of your organization and the work that you do. Most nonprofits should consider the following:

• *Fiscal policies and procedures*. The Board needs to ensure that financial controls are in place to prevent embezzlement and financial mismanagement, as discussed in Chapter 22. Appendix 16 is a sample table of contents of a fiscal policy and procedures manual that lists many of the items you will want to consider. In addition to establishing basic fiscal practices, the Board also needs to set limits on the expenditures that the staff can make and on the amounts that your organization can borrow without Board approval. You need to ensure that restrictions on contributions are honored. Nonprofits with significant funds to invest need an investment policy. If you receive endowments, you need a gift acceptance and endowment policy. Your policy should provide for regular reports from your financial staff to your finance committee or to the board. If you use professional fundraisers, you should consider adopting policies to enure that you follow the law in this area. As your organization grows, you will want to consider additional financial controls and the point at which the Board must be consulted on other matters.

• *Employment policies*. If you have employees, you should consider personnel policies. These are discussed in Chapter 15. If you are exempt under §501(c)(3) as a public charity or under §501(c)(4), you should have a set of excess benefit transactions policies as described on pages 634-640.

• *Governance policies*. Your Bylaws (and possibly your Articles of Incorporation) contain the basic governance rules. However, the Board will generally need to flesh out how these are carried out. How will you give notice for meetings? Will you establish a Nominating Committee or adopt some other procedure to identify likely Board candidates? How will the Board set goals and evaluate its progress? Do you need a mechanism to track absences by Board members and to encourage regular attendance? To avoid dealing with these and other questions on an ad hoc basis, you should establish governance policies. Remember that your policies cannot conflict with what is in your Articles or Bylaws without amending those documents.

• *Conflict of interest policy*. Oregon law provides some minimum standards for how nonprofit Boards must handle transactions in which a Board member or officer has a conflict of interest. See pages 275-276. Many nonprofits adopt a set of policies explaining how to handle conflicts, either because they want to put the Oregon law in writing to ensure that the Board is aware of it or be-

cause they want to set higher standards than those required by law. The IRS prefers, although it does not generally require, that tax-exempt organizations have a conflict of interest policy. (See page 129). The Forms section contains a conflicts policy for public benefit nonprofits that complies with Oregon law.

• *Program policies*. Not all nonprofits need program policies. In many cases, these can be established by your Executive Director or other staff member. Before you reach this conclusion, think carefully about the kinds of programs your organization runs. Do you deal with vulnerable populations? If so, there are issues that the Board needs to address. For example, if you deal with children, should you run criminal checks on your staff and volunteers that work with them? Does your organization engage in work that is dangerous? If so, does the Board need to ensure that there are policies in place to protect your employees or volunteers or third parties who might be injured? For instance, if you operate a climber rescue operation, do you need to ensure that your volunteers are physically able to perform? Do they get the equipment that they need? Do you serve alcohol at events? If so, do you have procedures in place to prevent alcohol from being served to minors or to intoxicated drivers? Although policies for these and similar types of issues may best be established by your staff, your Board should check to ensure that policies have been developed and should review them.

• *Evaluation policies*. As part of your duty to oversee the management of your organization, you need to evaluate the effectiveness of your Executive Director, employees, volunteers and programs. Evaluation policies clarify for all parties how you plan to monitor their work.

• *Grievance procedures*. Employee grievance procedures are commonly covered in the personnel policies. Your staff may also have established a set of procedures to encourage those that you serve to comment on the services they receive. If you are a membership organization, you may want a procedure in place to hear member complaints.

• *Whistleblower policy*. Your nonprofits may want to establish a whistleblower policy to protect employees who communicate with the Board about serious wrongdoing. The Sarbanes-Oxley Act, the federal legislation passed in response to the Enron and

other corporate scandals, makes it a criminal offense to retaliate against a whistleblower who provides law enforcement officers with truthful information relating to the commission or possible commission of a federal crime. Your policy forbidding such retaliation may both prevent illegal retaliation and act as evidence that your corporation does not endorse such actions.

• *Record retention/destruction policy*. Some nonprofits may want to consider a policy preventing record tampering. The Sarbanes-Oxley Act makes it a crime to alter, destroy, conceal or make false entries into records with the intent to impede the investigation or administration of any matter with the jurisdiction of a federal agency. For example, if your corporation falsifies records in response to an IRS audit of your Form 990, you have committed a crime.

Your organization needs to maintain a copy of its policies in one place (generally a policies manual) so that they are accessible. Simply adopting them and recording them as part of the Board minutes does not ensure that individuals in the future will know about them and be able to find them. You also need to be sure that future Board members, staff and volunteers (as necessary) get a copy of the policies that pertain to them and familiarize themselves with your policies.

Duty to Be Loyal to the Corporation

In addition to your duty to act reasonably in managing your corporation, you as a Director also have a duty to be loyal to your corporation. The duty to be loyal to the corporation means that you must place the corporation's interests above your own in any transaction in which the two may come into conflict.

The duty to be "loyal" to the corporation means that you must place the corporation's interests above your own in any transaction in which the two may come into conflict.

In lay terms, you might apply "the smell test". If you or another Director are in a situation that "smells" funny, the duty of loyalty may be involved. The most common circumstance in which this occurs is a conflict of interest.

Conflicts of Interest

In some situations, you may find that you have a direct material interest or an indirect interest in transactions with the corporation on whose Board you sit. A direct conflict of interest occurs when a Director stands to benefit personally by a transaction of the corporation.

> *Example*: You are a Director of an Oregon nonprofit corporation and also are a staff member. The Board is deciding whether to raise your salary. You have a conflict of interest, since you have a direct material interest in this decision.

> *Example*: You are the Director of an Oregon nonprofit corporation that is about to buy computer equipment. You are the sole proprietor of a company that sells computers. The Board wants to buy from you. You have a direct material interest in this transaction and so have a conflict of interest.

An indirect conflict of interest is present when another entity in which the Director has a material interest or in which the director is a general partner is a party to the transaction. An indirect conflict of interest is also present if the Director is on the Board of or an officer or trustee of another profit or nonprofit corporation and the transaction is significant enough that it should be considered by the Board of the other corporation.

> *Example*: Your nonprofit corporation is about to buy a building. You are on the Board and are a partner in a commercial real estate firm. One of the other Directors suggests that your partner handle the sale for which your firm will receive a commission. You have an indirect material interest in this transaction and so have a conflict of interest.

> *Example*: Animal Rights, Inc., an Oregon nonprofit corporation, does lobbying for animal rights. Animal Rights has established an educational arm, Center for Animal Education, that has a §501(c)(3) exemption. Center for Animal Education has some common Directors with Animal Rights, Inc. and some independent Directors. You sit on both Boards. The two organizations are having a disagreement on how to split the proceeds from a very successful fundraiser. You have an indirect conflict of interest.

In an ideal world, perhaps, a Board would not engage in any transactions in which its members had a conflict of interest, and it is best if you can avoid conflicts. However, conflicts of interest are quite common in the nonprofit

world, particularly among small and mid-size nonprofit corporations. The fact that a transaction involves a conflict of interest with one of your Directors does not mean that your corporation cannot engage in that transaction. However, your Board does need to carefully follow the rules for situations in which a Director has a conflict. (See pages 302-305).

Duty to Act in the Corporation's Best Interest

As a Director, you must act in good faith, in a manner you reasonably believe to be in the best interests of the organization. You must be faithful to the corporate mission. You cannot borrow money from the corporation, nor may you allow another Director to do so, except in very limited circumstances. You cannot exploit corporate opportunities or misuse insider information.

> *Example*: You are on the Board of a nonprofit homeowners association that is incorporated. You also sell cable television services on a commission basis. The Association has decided to market cable television services to its members and has compiled a list of members in order to begin its marketing campaign. You use that list to do a mailing before the Association does in order to solicit subscribers for your service. You have breached your duty of loyalty by putting your interests ahead of the corporation's interests.

> *Example*: You are on the Board of Directors of a nonprofit church that is planning to build a hospice for the terminally ill. You have been personally involved in securing verbal funding commitments for your church. Shortly before the funders sign the loan documents, you break away and start your own nonprofit for the purpose of building and operating a hospice. You use your contacts with the funders to persuade them to renege on their verbal commitment to the church and to fund the new nonprofit's hospice. You have probably breached your duty of loyalty to the church by usurping this corporate opportunity.

No Loans to Directors and Officers

If you are on the Board of a *Public Benefit* or a *Religious Corporation*, you cannot borrow money from the corporation, nor can you allow another Director or officer to do so. Your corporation also cannot guarantee the loan of a Director.

A *Mutual Benefit* corporation may not lend money to a Director of the corporation unless the particular loan is approved:

- by a majority of the votes of members entitled to vote, excluding the votes of members under the control of the benefited Director; or
- the corporation's Board of Directors determines that the loan benefits the corporation and either approves the transaction or a general plan authorizing it.

Balancing Board Protection with Sensible Management

This section has pointed out the responsibilities that you as a Director must meet in order to carry out your duties and obligations. While you should follow these recommendations, it is important not to swing to the other extreme and try to micro-manage the day to day running of your corporation. The extent to which your Board maintains oversight of your corporation will depend on a number of factors, such as the size of your corporation, the level of expertise of your employees, the existence of serious problems in your corporation, and your Board's style.

BOARD STYLES: HOW DIFFERENT BOARDS FULFILL THEIR DUTIES

While all nonprofit Boards of Directors share some common legal responsibilities, the ways they go about fulfilling those responsibilities and providing effective leadership for their organizations can be quite different. The role of the Board in start-up nonprofits is usually quite different than that of the Board of a well established nonprofit institution. The expectations of individual Directors are different, as are the structures for decision making and the distribution of responsibilities among staff and Directors.

Size, purpose, history, and underlying values will all influence the way your Board chooses to fulfill its responsibilities.

Let's take a look at several "typical" Boards to highlight some of the differences.

Community Based Start-up Board

Some nonprofits grow from the volunteer efforts of community members who see an opportunity to improve their community by banding together in a nonprofit organization. Typically, the founding group of individuals becomes the Board of Directors, and wants to play a very active role in setting direction for the organization. After all, they created the nonprofit to work together on their common mission.

Many of these community based groups operate for months or years with no paid staff. Directors divide up responsibilities for the activities of the organization as well as assuming the Board governance responsibilities discussed earlier in this chapter. For example, in a community based environmental organization, Directors may be organizing public events, writing and producing newsletters, testifying at hearings, keeping the membership list on someone's home computer, taking messages off the answering machine, and doing anything else that needs doing.

During this all volunteer period, Directors often have little awareness of the distinction between their role as Directors and the volunteer roles they have assumed. In fact, time may be spent at Board meetings working out the details of volunteer projects rather than focusing on strategic planning, financial management, or other typical Board roles. And expectations of Directors may include a mixture of Board legal responsibilities and volunteer duties, like answering the phone or taking tickets at events.

At some point, many of these all volunteer groups decide that the organization can be much more effective if it hires paid staff. This decision may reflect plans for more activity than can be sustained by volunteers, need for greater skills than the volunteers possess, or simply a sense of exhaustion by volunteers trying to keep the organization together while working and caring for their families. In many groups, the decision to have paid staff is prompted by one of the founders deciding that she or he would rather work for the organization than in their current job.

The transition from being an all-volunteer organization to having paid staff is challenging. The Board has taken on new responsibilities. First, there is the commitment to pay for work done and to comply with payroll tax regulations. Next, there is the need to make responsible choices about the selection of staff, provide ongoing supervision, and evaluate the executive director. Exercising due care in the selection and supervision of staff may be particularly challenging when the first staff are individuals who were part of the founding volunteer group. Directors may be uncomfortable shifting from being peers to being supervisors.

The person accepting the first paid position in an all-volunteer organization confronts challenges as well. Will the volunteers slip away – reassuring themselves that now paid staff is available to do all the tasks formerly performed by volunteers? Will very active volunteers resent the fact that one person is being paid for work that others are doing for free?

The hiring of paid staff frequently spurs Directors to define more clearly the specific responsibilities they are fulfilling in their Board capacity, and to differ-

entiate the functions which result from Directorship from general volunteer responsibilities. While in the past volunteers working together may have made major decisions for the nonprofit in an informal manner, the advent of paid staff usually requires more formal decision making.

One of the great challenges for these Boards is to let go of some of the day to day decision making to allow the staff the flexibility they need to do their jobs effectively. Without paid staff, Directors have probably made every decision – from major choices about priorities for the year to selection of stationary and organization of the filing system. Now Board energy must be focused on direction setting and oversight, and responsibility for management shifted to staff.

Institutional Start-up Board

Not all nonprofits are created through the grassroots process described above. Some nonprofits begin life as spin-offs from larger nonprofits or are created by coalitions of government and civic groups to meet specific community needs. Increasingly, we're seeing nonprofits created by spinning off programs formerly operated by government agencies.

Nonprofits which are formed in response to institutional decisions like these almost always begin life with paid staff. The process which leads to the creation of these nonprofits usually includes obtaining start-up funding which will support at least one paid position.

Directors are recruited as part of the start-up process. In many cases, few of the Directors know each other before being asked to serve. Or, in cases where the individuals do know each other, they may know relatively little about the specific types of work the organization has been formed to undertake. For these groups, the start-up process will require a great deal of attention to building Board relationships and understanding of the issues the organization will address.

One of the great challenges for these organization is building Board ownership. Directors frequently report they feel like spectators – listening to the interesting ideas presented by the planners for the organization and its initial staff, but not really prepared to provide leadership.

Community Based Boards After Start-up

Many nonprofits are committed to remaining community based after the start-up period. The term "community based" generally describes a Board composed of individuals with direct knowledge of the issues the nonprofit addresses. For example, community development corporations, which develop and manage affordable housing in low income communities, generally have

51% of their Directors reside in the low income community they serve. Or, a battered women's program may decide that more than half of its Board should be composed of individuals who have experienced domestic violence or worked closely with victims.

Community based Boards face particular challenges around differences in experience, education, and access to resources. Typically, as the organization develops and expands the range of its activities, new Directors are recruited who have particular professional skills or experiences – accountants, attorneys, human resource managers, etc. These Directors can make important contributions, not only to the Board's understanding of increasingly complex issues, but also in connecting the organization to the larger community.

However, if some Directors have little formal education or professional expertise, they may feel intimidated by those Directors who do. Yet, these community members have great expertise about the experiences, values, and needs of their community. These Boards will need to work actively to be sure the expertise of all Directors is brought to bear on the issues the Board confronts.

Community based Boards frequently struggle with differing Board expectations and preferences for Board style and meeting format. For some members, the Board provides an important opportunity for networking and socializing, and an informal, relaxed approach to Board meetings is preferred. For others, particularly those with intense business and family commitments, a more focused, brief, and business-like format for Board meetings is preferred.

Institutionally Based Boards After Start-up

Typically, the institutionally based Board is composed of individuals with professional expertise and social, economic, and political contacts which can benefit the organization. Directors may be motivated to serve by factors outside the organization's work – general community service, opportunity for business or political contacts, community recognition, etc.

Ironically, institutionally based Boards often struggle to achieve the diversity of members which characterizes community based Boards. Many of the institutionally based nonprofits are designed to address the needs of specific populations or communities. Directors recognize that the perspective of members of the target community is really important for priority setting and evaluation of the work of the organization. So, institutionally based Boards actively recruit Directors who can reflect the diversity of income, culture and values of the communities they serve.

The typical Director for these nonprofits is an extremely busy business or community leader with extensive business and family responsibilities. They perceive their time as very valuable, and expect staff to manage the affairs of the corporation and to provide concise briefings to the Board on all key decision items.

Clarifying Your Board's Expectations

We've only touched on a few of the differences among the Boards of nonprofit corporations. The needs and preferences of the Board of each nonprofit will change over time. In this atmosphere of variety and change, there really is no single right way for a nonprofit Board to approach its roles and responsibilities.

Instead, each Board will need to set aside time periodically – at least every two years – to focus attention on how Directors perceive the Board's role, and structures and decision making processes which will help them work together effectively to fulfill their responsibilities. Because most Boards find that regular Board meetings are filled with ongoing business, special Board planning retreats may be needed to focus on the Board's roles and responsibilities. Your Board may want to consider asking a professional facilitator to help you plan and conduct your Board planning retreat to be sure all Directors are encouraged to participate actively.

While Oregon law and your Bylaws provide the basic framework for both the Board and corporate officers, each Board must choose its own way of conducting business. Directors need to reach agreement about the extent to which they will rely on committee work or address all items in committee reports for further discussion by the whole Board.

You'll also want to make explicit your Board's expectations of individual Directors. Are all Directors expected to serve on a committee, to help raise funds, or to contribute financially? Boards may change their expectations of Directors over time. Whatever your current expectations, you'll want to be sure that they are communicated clearly to prospective Directors. Remember, not all Boards are alike. Prospects for your Board may assume its expectations are the same as those of other Boards on which they have served unless you give them specific information about your Board's expectations.

You will also need to clarify your expectations about the type of leadership your Board chair and committee chairs will provide. Do you want your leaders to see their roles as primarily facilitation, seeing that all are heard and consensus is reached? Or do you expect leaders to exert control, and take special responsibility for setting directions? Like all the choices we've described, your Board's answers to these questions may change over time. Most importantly, a variety of approaches can work, as long as all Directors understand the expec-

tations and you are careful to match expectations to your organization's values and stage of development.

Board/Staff Relationships

Each Board must define the relationship it wants to have with its Executive Director and staff. Different Boards may choose significantly different approaches to differentiating Board and staff roles.

In larger organizations, with well compensated, professionally prepared managers, the Board may choose to delegate virtually all responsibility for operations to the Executive Director. In fact, some Boards limit their role to setting the mission of the organization, exercising oversight of financial management and key decisions and hiring and evaluating the Executive Director. They rely entirely on their paid managers to set priorities, develop strategic plans, raise and manage funds, represent the organization in the community, and establish and implement all policies necessary for operation.

In smaller organizations, with few professionally trained managers, Boards typically retain responsibility for strategic planning, setting priorities, authorizing policies, and raising money. In this approach, the Board expects the Executive Director to manage the work of the staff, be responsible for implementation of strategic plans and funding strategies, and implement Board policies.

One of the great challenges for Directors is recognizing the changing needs of their organizations. Over time, an organization which has relied on Directors for detailed financial planning may need to move to employing a professional financial manager who takes the lead in budget development and handling the finances. Similarly, over time a Board may need to move from developing each year's funding strategy and making detailed decisions about fundraising activities, to employing professional fundraising staff who provide leadership and management for fundraising functions.

Boards who have made these transitions to relying on professional staff must find new ways to be certain that their legal responsibilities for oversight of the organization are met. Staff need to understand that the Board has ultimate responsibility and ultimate control. The Board needs policies in place to ensure that it has the information it needs to ensure that the nonprofit is being managed responsibly. (For a discussion of common Board policies, see pages 271-274.) However, the Board must understand that professional staff need flexibility and authority to do their jobs effectively.

BOARD MEETINGS

In order to carry out your responsibilities as a Director, you will need to attend Board meetings. To hold legal and successful Board meetings, you need to be familiar with the rules concerning meetings, notices for meetings, and minutes. The rules discussed below are what the law generally states about Board meetings. However, it is possible that your Articles of Incorporation or your Bylaws provide for different practices. If so, you should follow your Articles or Bylaws if the provisions are legal. In order to determine if your provisions are legal, read the sections that apply to you in Chapter 4.

We follow our discussion about the legal rules for meetings with some practical tips that may assist you in holding more productive meetings.

Meetings

Why Have Meetings?

Many of us don't like meetings, so why have them? The answer may seem obvious, but it is worth reflecting on. A nonprofit corporation is a legal entity. It is run by people, almost always in the plural. The people who run it need a mechanism for making decisions. One possible model would be a dictatorship model, in which one person makes all the decisions. However, the model required by law is a more democratic model, in which a group of people, commonly a Board of Directors, makes decisions, with each person on the Board having one vote.

The democratic model envisions that the Board makes its decisions in a setting in which each member has a chance to be heard, if there is any dissent on an issue.

The democratic model envisions that the Board makes its decisions in a setting in which each member has a chance to be heard if there is any dissent on an issue. This generally requires that meetings take place in an environment in which each Director can hear and respond to each other unless there is no disagreement.

Holding Legal Meetings

Who Attends Board Meetings

Each member of your Board of Directors must attend Board meetings on a regular enough basis to be able to effectively govern the corporation. As this chapter discussed above, when a person agrees to serve on a Board, he or she has agreed to take on the responsibilities of governance of the corporation.

In most cases, your Board can decide if anyone else can attend the Board meetings. Your Articles or Bylaws may state that the meetings are open, in which case those documents must be followed. Generally, the law does not require that Board meetings to be open to the public or to members. There is some question about whether the Board meetings of Oregon nonprofit corporations are subject to Oregon's Open Meeting Law (also called Public Meeting Laws). The Open Meeting Law requires that all meetings of governing bodies of a *public body* shall be open to the public, with certain exceptions. The law also requires that certain public notice be given and that minutes be kept and made available to the public. Most Oregon nonprofit corporations are not subject to the Open Meeting Laws. However, if your organization exercises sufficient governmental functions, Open Meeting Laws may apply to you. See the discussion in Appendix 4 about Open Meeting Laws. You should get legal advice if you think that the Open Meeting Laws might apply to you.

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Kinds of Board Meetings

Oregon recognizes two types of Board meetings: *regular* and *special*. A regular meeting is one in which the date, time and place is fixed by the Articles or Bylaws or one that is regularly scheduled by the Board. For example, an annual meeting of the Board in which the date, time and place is the same each year is one type of regular meeting. Another regular meeting would be a meeting set on the first Monday of every month at 7:00 p.m. All other meetings that are not regular are special meetings.

Your Board is not required to have any particular type of meeting. There is no requirement that you have an annual meeting. As a matter of convenience, most Boards will schedule regular meetings, because this makes planning easier for the Directors and because the requirements about notice are easier.

Oregon law also makes provision for *emergency meetings*. An emergency exists if a quorum of your corporation's Directors cannot readily be assembled because of some present or imminent catastrophic event. In the case of an emergency, your Board or the corporation has the power to modify lines of succession to accommodate the incapacity of any Director, officer, employee or agent. Unless you have emergency Bylaws that provide otherwise, one or more of your officers present at the meeting of the Board shall be deemed to be Directors for the purposes of the meeting in order of the officers' ranks as necessary to achieve a quorum. Of course, if your officers are already Directors, this provision does not apply to you.

Frequency

Your Board is required to meet as often as necessary in order to run your corporation. This requirement varies widely depending on the size and complexity of what you do. You are not required to have any particular number of Board meetings. Some smaller groups with very little in the way of ongoing activity may have Boards that meet only three or four times a year. Most groups probably have Board meetings at least monthly. It is hard to imagine a group in which the Board would meet less than once a year.

How Meetings Are Held

Most meetings are held in one location with everyone coming together. In this setting, everyone can see and hear each other. Oregon law also allows you to hold meetings by telephone conference or by any means in which all the Directors can *hear* each other at the same time. This would appear to rule out teleconferencing by computer.

There is a common misconception that your Board can take action without a quorum. This is not true.

Conduct of the Meeting

You have a great deal of flexibility about how you conduct your meetings. The law does state that decisions can only be made at a meeting with a quorum. A quorum is the minimum number of Directors needed at the meeting for the meeting to validly held. Oregon law allows you to set your own quorum in your Articles or Bylaws but requires that the quorum be at least one-third of the number of Directors. If your corporation has a fixed number of Directors, it must be at least one-third of that number. If you have a variable size Board (e.g., between 3 and 15 directors), the quorum must be at least one-third of the number of Directors set by the Board, or, if the Board did not set a number, one-third

of the number in office just before the meeting begins. If you fail to set a quorum in your Articles or Bylaws, the law sets the quorum for you as the majority of the number of Directors described above. There is a common misconception that your Board can take action without a quorum if no one calls for a quorum count or challenges the absence of a quorum. This is not true. The only decision that the Board can make without a quorum is to adjourn the meeting for another time.

There is no provision in Oregon law that permits a Director to vote by proxy.

Once you have a meeting with a quorum, you can do business. Generally, groups elect a Chair or designate that the President of the Board is to preside at Board meetings. You decide how to structure your meetings. Many groups begin by creating or approving the agenda for the meeting. Agendas commonly include correcting and approving the Board minutes of the last meeting (which have been circulated prior to the meeting so that the Board has had an opportunity to read them), ratifying the actions of any committees which require Board approval, making announcements, hearing committee reports and handling old and new business. You have quite a bit of discretion in how you conduct business and decide issues but there are some rules you need to be aware of. Check your Articles, Bylaws, and Board resolutions to see if there is anything governing how you conduct your meetings. For example, some Bylaws require that you follow *Roberts Rules of Order*. If your Bylaws requires this, you must familiarize yourself with *Roberts Rules* and follow them or amend your Bylaws to eliminate this requirement. The law requires a majority vote of the number of Directors at the meeting in order to take action, unless your Articles or Bylaws require a greater vote. *Note that this is not a majority of directors voting, but a majority of directors present.* There are some types of actions that require a greater vote than a majority vote: for example, to remove a Director from office in a nonmembership corporation, to amend your Articles, to merge, to dissolve, etc. See pages 55, 648, 672 and 681 for a discussion of these types of actions. If you are a Director that objects to an act of the Board, you must promptly enter the objection. You should check to be sure that the minutes accurately reflect your name and the nature of your objection.

Occasionally, a Director that cannot attend a meeting seeks to vote by proxy. Proxy voting occurs when someone with the right to vote cannot attend a meeting and wants to give someone else the authority to vote in their place. Although members of a nonprofit can vote by proxy (see page 327), there is no provision in Oregon law that permits a Director to vote by proxy. It is quite likely that an Oregon court would not uphold this type of voting in a Board meeting. If the court allowed proxy voting, this would mean that dissenters at the meeting would not have the ability to influence Director voting by proxy.

Action Without a Meeting

Actions by Consent

If *everyone* on the Board is in agreement about an action, there is no reason to require a meeting. In that case, action can be taken without a meeting if all of the directors sign a written consent or consents describing the action taken and these are included in the minutes or filed with the corporation. The action is effective when the last director signs the consent unless the consent specifies an earlier or later effective date. Consequently, the directors should date as well as sign the consent. Note that to act by consent without a meeting *all* the Directors must agree; a majority is not enough. A sample "Consent to Corporate Action Without a Meeting" by the Directors is included in the Forms section. You must file these consents with your corporate records.

Voting by Ballot or Telephone Poll

Oregon law does not authorize the Board of Directors to vote outside of a meeting by ballot. This means that you cannot conduct a telephone poll by calling each director individually and then assuming that a majority vote allows you to act. This method does not give dissenters a chance to influence the majority. However, if you conduct a telephone poll and *all* of the Directors are in agreement, you can use the consent procedure described above.

Notice

In order for your meetings to be validly held, you must give your Directors the proper notice. The actions you agree upon at a meeting may not be valid if you did not give proper notice. The very detailed rules about when notice is given are described on pages 624-626. The type of notice you must give varies depending on the type of meeting.

Regular Meetings

Regular Board meetings can be held without giving notice of the meeting, unless your Articles or Bylaw require differently. In some special circumstances, the law requires notice: for example, when the Board is voting on mergers and dissolution. See Chapters 28 and 29.

Special Meetings

Special Board meetings must be preceded by at least two days notice to each Director of the date, time, and place of the meeting. In some cases, the notice

must include the purpose of the meeting. Your Articles or Bylaws may change these requirements, so check them.

Emergency Meetings

In the case of an emergency meeting, you must give notice only to those Directors whom it is practical to reach. You may give notice in any practical manner, including telephone calls, publication in a newspaper, radio announcements or other public manner.

Calling a Meeting

The presiding officer of your Board, your President or 20% of your Directors then in office may call and give notice of a Board meeting. Your Articles or Bylaws may provide for a different means for calling a meeting.

Waiver of Notice

Your Director can at any time waive (give up his or her right to) any notice of meeting. If your Director is not present at the meeting, the waiver must be in writing, must be signed by the Director entitled to the notice, must specify the meeting for which notice is waived, and must be filed with the minutes or corporate records. See the "Waiver of Notice of Meeting of Board of Directors" in the Forms section. If your Director attends the meeting, she or he waives notice of it, unless at the beginning of the meeting, or promptly upon arrival, she or he objects to holding the meeting or transacting business at the meeting and after that does not vote for or agree to any action taken at the meeting.

Minutes

Your Secretary or some other officer designated by the corporation needs to keep, or be sure that someone else is keeping, records (called minutes) of your meetings. At a minimum, your minutes should reflect the date, time and place of the meeting; the notice given, if any; what Directors (and what others) were present and whether this made a quorum; what items were submitted for a vote; and who voted for, against, or abstained. The minutes should be very clear about what decision was made. It is up to you as to how much of the discussion about issues you want to record; if the issue is likely to come up again, sometimes a record is helpful.

The minutes should also include references to any item that the Board should be doing to fulfill its legal obligation to oversee the corporation: e.g., budgets and financial reports, personnel matters, investigation of suspicious

circumstances that come to the Board's attention, and proper handling of conflict of interest situations.

At a minimum, your minutes should reflect the date, time and place of the meeting; the notice given, if any; what Directors (and what others) were present and whether this made a quorum; what items were submitted for a vote; and who voted for, against, or abstained. The minutes should be very clear about what decision was made.

There is no specific law stating how minutes are validated as being accurate. Some corporations review the minutes of the previous meeting and approve them at the current meeting. Others have the Secretary or President sign the minutes. You should consider having the Board develop a policy to handle this so that there is some way to authenticate minutes. As a practical matter, the whole Board needs to read the minutes to be certain that they accurately reflect the decision made at the meeting. Without review and approval by the whole Board, you may find the same issues returning for discussion repeatedly because some Directors do not agree that the decision recorded in the minutes was the decision really made.

The minutes should be kept with the corporate records. A skeleton outline of "Minutes of Meeting of the Board of Directors" is included in the Forms section.

Holding Effective Meetings

Boards do much of their work in meetings, so it's very important for your Board to find effective ways of conducting meetings. It's probably worth discussing your meeting format and style regularly because the membership of your Board will change over time and many of the choices in Board meeting style really come down to individual preferences. The very act of discussing how the Board will conduct its meetings tends to re-energize Boards. Most people are more committed to processes they feel they helped to design.

The box on page 291 lists some common agreements for Board meeting format. You may want to use this list as the starting point for a discussion of your meetings. Ask members which of the items on the list they would like to see incorporated into your meeting process and which they may find particularly unappealing. Then ask for other suggestions. Be sure you write down the outcomes of this discussion and agree upon a trial period for your new approach to meetings. At the end of three or six months, take a few minutes to discuss how the new approach to meetings is working and decide whether you will continue it or try other ways.

As you work out your Board's approach to meetings, pay special attention to the distinction between items which require Board decisions, items for which Board input is sought, and items which are really just information you want to share with the Board. While information can be shared in writing and input can be collected through individual conversations or written feedback, decisions can be made effectively only in meetings. So, you'll want to be sure that your format for Board meetings emphasizes using meeting time for decision items, with second priority given to input discussions.

Watch out for these common Board meetings problems:

Late Starts and Late Endings

Directors notice when meetings actually get going. If your Board forms the habit of starting well after the announced starting time, you'll find Directors come later and later.

Without an agreed upon ending time, Board meetings tend to go on well past the point of good concentration. Besides, meetings which lack ending times place considerable power in the hands (or bottoms) of people who can stay the longest, thus excluding those with family or work responsibilities from participating in important decisions.

Lack of Clarity on Decisions

If your Board discusses the same issues again and again, you may be having difficulty with the clarity of your decisions. Good minutes can help, but the problem may go deeper. Be sure that each decision is made in response to a specific, clear proposal for action. Even if your Board chooses not to use parliamentary procedure with formal motions and seconds, you will still need to work with specific proposals and to be sure they are correctly recorded in your minutes.

Not Getting to the Important Issues Until There's No Time Left

If you find the ends of your meetings filled with conflict and frustrations, take a good look at what has taken up the time earlier on in the meetings. Many Boards find that they inadvertently delay getting to important but difficult issues by spending a great deal of time on minor matters. Encourage your chairperson to plan your meeting agenda so that the really important issues come up relatively early in the meeting. Ask your chair to help members keep focused on the need to keep moving.

CHECKLIST FOR EFFECTIVE MEETINGS

1. Each participant receives adequate *notice* of the *date*, *time*, *place*, and *purpose* of each meeting.

2. The closing time for each meeting is agreed to at the beginning and changed only with consent from the group.

3. The agenda for the meeting is announced at the beginning and changed only with the consent of the group.

4. A *timed agenda* (which sets limits on the time spent on each item) is used if there is difficulty in covering all the topics within the overall meeting time limit.

5. Information items and decision items are clearly defined.
   - Information items are brief and relevant
   - Decision items are discussed at a time when most group members are present

6. The limits of the group's decision making authority are known by all. Decision items are considered in light of the presence or absence of final authority within the group.

7. Committee reports recommend action with clearly stated proposals.

8. Financial information is presented with written copies for everyone.

9. The Chairperson or Facilitator:
   - Keeps the discussion on one topic at a time
   - Helps all members be heard
   - Recaps points of the discussion
   - Restates proposals clearly
   - Announces the decisions made on proposals
   - Refers issues to committees for more detailed work when necessary

10. Minutes or notes are maintained as described on pages 288-289.

11. All items which are referred to committees and deferred to future meetings are clearly stated in the notes and reviewed at subsequent meetings.

Re-doing Committee Work with the Full Board

If the whole Board discusses all the issues which committees have discussed, not only will the meetings be long, but the committees will grow discouraged. What is the point of committee members meeting outside the Board and working through issues if the Board revisits each issue in detail at its meeting? Committees can help prevent this detailed rehash by preparing recommendations which clearly urge the Board to adopt a specific course of action and present a summary of the reasons for the recommendation.

Failing to Provide for Directors' Needs

Many Boards find that Directors have two sets of needs around Board meetings. They want to feel their time is used well – that they are making a real contribution, and that it really does matter whether they are present at the meeting or not. They also want the Board meeting to provide opportunities to get to know other Directors and to feel connected to one another and the work of the organization. If some of your Directors still aren't sure of other Director's names or roles in the community, you probably aren't meeting these connection needs.

BOARD COMMITTEES

Many Boards, especially in mid-sized and large nonprofits, work extensively through committees. Even Boards for smaller nonprofits often use some committees to carry out their work.

Your Board may set up two types of committee: those that exercise Board functions by making Board level decisions and committees that carry out Board tasks or make recommendations to the Board but do not make Board level decisions. (See page 22 for a discussion about these types of committees.) Because committees that actually exercise Board powers are in effect acting as the Board, Oregon law has some very specific (and somewhat ambiguous) rules about how these committees are set up and who can be on them.

The creation by the Board of committees *that exercise the authority of the Board* and the Directors who are going to serve on them must be approved by the greater of:

- a majority of all the Directors in office at that time; or
- the number of Directors required by your Articles or Bylaws to take action in voting matters. *Example*: Your corporation has nine Directors but only seven show up for the meeting at which committees are formed. Your Bylaws require a majority vote of the Directors present at a meeting with a quorum in order to take

action. (At this meeting 4 of the 7 would be enough.) In your group, the majority of all Directors in office at that time (5 of 9 Directors) would be a greater number of Directors. That number is needed to set up a committee that can exercise Board functions and to name Directors to the committee.

Because committees that actually exercise Board powers are in effect acting as the Board, Oregon law has some very specific (and somewhat ambiguous) rules about how these committees are set up and who can be on them.

Board Level Committees

Duties and Responsibilities

Committees that exercise Board level responsibilities must be composed of at least two Board members. Although the statue is ambiguous, it is likely that only Board members can serve as members of these committees. This means that your Executive Director (if not a Board Member) and others interested people cannot be members of these committees, although they can certainly sit in on meetings if the committee desires. Generally, each committee of your Board may exercise the authority of your Board of Directors to the extent specified by the Board or given in the Articles or Bylaws. However, a committee of the Board may *not* :

- Authorize the payment of a dividend or any part of the income or profit of a corporation to its members, Directors or officers (except as payment for value of property received or services performed or payment of benefits in furtherance of the corporation's purposes);
- Approve or recommend to members that the corporation dissolve, merge, or sell, pledge or transfer all or substantially all of the corporation's assets;
- Elect, appoint or remove Directors or fill vacancies on the Board or on any of its committees; *or*
- Adopt, amend or repeal the Articles or Bylaws.

Meetings, Notices, and Minutes of Board Level Committees

The provisions concerning meetings, actions taken without meetings, notice, waiver of notice, quorum, voting requirements, and minutes of the Board described above in this chapter apply to committees exercising Board authority and their members as well.

Advisory and Task-Oriented Committees

Many committees of the Board do not make policy-level decisions but act as advisory committees making recommendations to the Board or as task-oriented committees carrying out Board policy. For example, a Bylaws Subcommittee may meet to make recommendations to the Board about the amendment of the Bylaws. A Fundraising Committee may carry out the Board decision to hold an annual dinner. These committees do not exercise any corporate powers. The Board may select members for these committees and the committees may be run as the Board sees fit. Although these committees are advisory, they may be very important to your organization and you should give them some thought to make them as valuable as possible. Important committees may be both permanent and temporary. For example, you may have a permanent Finance Committee that works with your chief financial officer to ensure timely and accurate financial reports to the board and that flags problems for the Board. You'll want to recruit committee members who are knowledgable about finances to sit on such a committee. You may also have a temporary Capital Campaign Committee if you are engaged in a major fundraising effort to remodel your building. You will probably place members on this committee who have had experience with fundraising and construction.

Responsibilities of Non-committee Members

Each Director has an obligation to keep abreast of what the committees are doing. Your Board cannot ignore problems which come up in connection with the committees but must deal with them.

STAFF AS DIRECTORS

One frequently asked question is whether staff members can also sit on the Board of Directors. The answer is that they can, with the possible exception of private foundations. (See page 97 for a discussion of private foundations.) Oregon law contains no prohibition against this. However, the presence of staff on the Board can raise a number of other problems: internal problems with conflicts of interest, IRS concerns about excess benefits, wage and hour issues, and unfavorable responses from funders.

Staff members who sit on the Board will find themselves in situations in which the staff member will have a conflict of interest. Whenever the Board votes on the salary for that staff member or on other conditions of employment, the Board must observe the rules for conflicts covered on pages 302-305. The Board must be very careful to document that the compensation paid to that staff member is reasonable. State law requires this. In addition, your Board

member who is paid as staff may lose the protection from personal liability offered to volunteer directors under federal and state law. (See page 305.)

One frequently asked question is whether staff members can also sit on the Board of Directors. The answer is that they can, with the possible exception of private foundations.

If the organization is exempt as a public charity under §501(c)(3) or under §501(c)(4), the IRS will almost always view your employment of a Board member as an excess benefits transactions. This is currently an area of great concern to the IRS. If you fail to follow the excess benefit rules, you risk having both the staff member who is a Director and the Directors and managers who approved the staff member's salary and benefits be personally subjected to severe taxes. See pages 634-640 for more information about this important topic.

The wage and hour laws contain some restrictions on voluntary overtime by hourly (non-exempt) employees. (See pages 339-340.) The drafters of the law were concerned that employers could put unfair pressure on workers to work extra hours without pay. Consequently, the law restricts the right of employers to avoid paying workers for what either party characterizes as volunteer work. This part of the law applies to those workers who are labelled as non-exempt. Generally these are non-managerial hourly employees and the prohibition covers work that they perform that covers the same function for which they are also paid. In most instances, Board service will be completely distinct from a non-exempt employee's paid duties and will not fall under the wage and hour restraint. However, if that employee does end up performing tasks for the Board that are similar to those he or she perform as an employee, you need to take notice. For example, if your computer expert sits on the Board and begins to assist the Board with the design of its web page, you may have problems. If your nonprofit would like non-exempt employees to serve on the Board, you may want to review the specifics of your situation with your attorney.

Board members who are also managerial employees of the organization do not have wage and hour issues. They may not want to consider time spent at Board meetings or on Board activities as work time. Instead, they are volunteering their time as Board members. Treating their Board service as unpaid allows them the protection against liability offered to volunteer Board members.

Many funders also frown on the practice of having staff members sit on the Board and may refuse to fund you if a substantial portion of your Directors are also paid staff.

THE DUTIES AND RESPONSIBILITIES OF OFFICERS

Oregon law requires that your nonprofit corporation have at least two officers: a President and a Secretary (unless you are a Religious Corporation Sole as described in Appendix 3). You can call these officers by different names. There is no requirement in the law that these officers be on your Board of Directors although in practice many, if not most, corporations elect its officers from its Board. You may put such a restriction in your Articles or Bylaws if you want.

Generally, your President is responsible for overseeing the operations of the entire corporation. In many groups the President is also the Chair of the Board. Your Secretary is usually responsible for keeping the corporate records, seeing that minutes are taken at all Board, committee, and members' meetings, providing proper notice of meetings, certifying records for the corporation, and overseeing the books and finances. The same individual can simultaneously hold more than one office in the corporation. Other corporations add the position of Treasurer and that officer handles the oversight of the books and finances. This is generally the better practice in all but small nonprofits. Your group can appoint additional officers besides President and Secretary, and these officers may perform other functions or may share the functions described above.

Some nonprofit corporations choose to have the highest ranking staff position, called Executive Director by other nonprofits, serve as the President of the corporation. This structure parallels that of some profit corporations. Typically, this position is described as President and CEO (Chief Executive Officer). If your corporation decides to make your Executive Director the President, be certain that the President is aware of her or his legal duties as a corporate officer.

Standard of Conduct for Officers

Each of your officers must act in good faith, with the care an ordinarily careful person in a like position would exercise under similar circumstances and in a manner your officer reasonably believes to be in the best interest of the corporation.

PERSONAL LIABILITY OF THE BOARD AND OFFICERS

Personal liability refers to the circumstance in which you as a Director or officer may be required to pay out of your own pocket a judgment that arose out of your actions as a Director or officer. One of the major reasons most

organizations incorporate is to protect the Directors and officers who run the organization from being personally liable for actions that they perform on behalf of the organization.

To a large extent, incorporation accomplishes this. Most lawsuits against nonprofit corporations can only reach money, property, and other assets the corporation owns, and not those owned by individual Directors and officers. However, there is a myth in some parts of the nonprofit world that Directors and officers are never personally liable for their actions. This is false. There are circumstances where you as Director (and occasionally as officer) may be found to be personally liable.

When You Are Personally Liable

You as a Director or officer face the risk of personal liability if you:

- Fail to act with due care in governing the corporation or in otherwise acting for the corporation;
- Engage in a conflict of interest or other act of disloyalty to the corporation; or
- Agree to be personally liable.

There is a myth in some parts of the nonprofit world that Directors and officers are never personally liable for their actions. This is false.

Failure to Act With Due Care or Breach of Duty of Loyalty

You can be personally liable as a Director if you negligently fail to carry out your duties and responsibilities to act with due care and to be loyal to the corporation. Those duties were described earlier in this chapter. Directors are particularly vulnerable to lawsuits by unhappy employees. In addition, various statutes impose personal liability on Directors who do not exercise due care to ensure that the corporation meets its obligations to the government. Your Directors can be personally liable for the corporation's failure to pay payroll and other taxes (page 562), failure to maintain workers' compensation insurance (page 564), failure to follow the lobbying and political activity rules if you are exempt under §501(c)(3) (Chapter 8), and engaging in excess benefits transactions (pages 634-640).

Example: Your corporation has a §501(c)(3) exemption and has engaged in excessive lobbying. The IRS does hold Directors personally liable for taxes, interest, and penalties in some cases where

the lobbying rules are violated. If your actions caused the organization to lose its tax-exempt status, the future Board of the organization may sue you for damages caused by the loss.

Example: The Board of the Jackson Childcare Center, a nonprofit corporation, has not established any policy to investigate potential employees who will work with the children. The Executive Director approved the hiring of a man with an Oregon record of several child abuse convictions. The employee abuses a child at the Center. If the Board is found to have been negligent in failing to have instituted proper hiring procedures, the Directors may be personally liable to the child for the damages caused by this employee.

Agreement to Be Liable for the Corporation's Debt

You may become personally liable for the liabilities of the corporation if you agreed to do so. This commonly happens in one of two circumstances. You may have knowingly agreed to personal liability. This often happens if the corporation is attempting to obtain a large loan (often to purchase property) and the lender is only willing to grant the loan if Directors co-sign individually for the loan. As a co-signer, you will be personally liable if the corporation fails to meet its obligation.

You may also agree to be personally liable without realizing it. This occurs if you sign a document that imposes liability (for example, a lease, promissory note, or contract) that you think you are signing on behalf of the corporation but you fail to indicate in the document that you are signing as an agent for the corporation. If you are signing as an agent for the corporation, be sure that your signature is followed by the words "Agent [or President or Secretary] of _____ Corporation."

Who Can Sue You

There are several parties that might bring a lawsuit against you as a Director or officer of a nonprofit corporation.

Your Nonprofit Corporation

The remainder of the Board of Directors of your nonprofit corporation or a future Board of Directors may sue you for your actions in your capacity as a Director if they feel you have breached a duty to the corporation which caused the corporation injury. For example, if a future Board feels you failed to properly invest the funds of the corporation, it may sue you for lost income.

Employees, Members, and Others Associated with the Corporation

A very common source of suits against the individual Directors are claims by former or unhappy employees. These claims may take the form of discrimination suits or unlawful termination cases. Members may also sue if they believe you have mismanaged the corporation or improperly terminated their membership. An injured volunteer may sue if she or he believes the Board actions in some way contributed to that volunteer's injury.

The Government

Several government agencies are particularly concerned with laws that impact nonprofit corporations. In Oregon, the state Attorney General's office is charged with overseeing Public Benefit Corporations. If the Attorney General's office believes there has been fraud, mismanagement or other wrongdoing, it can investigate and proceed against the corporation and its Board and officers. Often an Attorney General investigation is initiated by a complaint by an unhappy member, Director, or other person connected with the nonprofit.

Although it occurs less frequently, other state agencies could impose personal liability on your Board or officers. The Oregon Department of Revenue could proceed against the Board and officers personally for failing to withhold state taxes. Oregon law provides that the Board can be personally liable if an organization fails to provide worker compensation for its workers. The Worker Compensation Department might choose to enforce this.

The Internal Revenue Service may also, on occasion, proceed against Directors, officers, and even the check signers personally. This can happen if the organization fails to perform mandatory payroll withholding or recklessly classifies a worker as an independent contractor rather than an employee. (See Chapter 16). The IRS may also impose personal liability on Directors and officers who are responsible for violations of the lobbying rules (see Chapter 8), unrelated business income tax laws (see Chapter 9), or excess benefits transaction rules (see pages 634-640).

Outsiders

Individuals not connected with the corporation may be injured by someone connected with your nonprofit. If the individual alleges that the Board failed to act reasonably or violated its duty of loyalty, you may find yourself individually named in the suit.

Example: Your nonprofit drives children on field trips. Your Board has no policy in place to be sure that the drivers are licensed. An unlicensed driver runs a red light and the children in the van are injured. The parents sue the Board individually for negligence in failing to have policies in place to ascertain that your drivers were licensed and competent.

Which Boards Are Most Vulnerable to Being Sued

Boards of certain corporations are more vulnerable to being sued. Consider whether your organization has or deals with any of the following:

- employees
- children, the elderly, the disabled, clients with mental or emotional conditions, or other vulnerable populations
- food, drink (e.g., sold by your group or available at special events), drugs, or medicines
- alcohol (e.g., at holiday parties, fundraisers)
- driving
- activities that can cause injuries (e.g., construction, mountain climbing, rescue operations, dealing with violent people, medical care, sports)
- activities that may create opposition (environmental activities, neighborhood issues, political causes, unpopular publications, etc.)

The above activities are associated with a significant risk of lawsuit. You need to pay particular attention to the protections that your corporation has in place for your Board and officers if your corporation has any of these risk factors.

PROTECTION OF YOUR BOARD AND OFFICERS

As the discussion above indicated, there is some risk that Directors and officers can be personally liable for their actions as Directors or officers. Fortunately, there are a number of actions the nonprofit and its Directors can take to cover or minimize this risk.

Create an Advisory Board

If your Board has members who want to lend their name to the corporation but who do not intend to exercise the duties of a Director, consider creating an Advisory Board, clearly designated as such, for these people. The Advisory

Board cannot make decisions for the corporation, but it can, if it chooses, make recommendations to your Board. Because the Advisory Board does not have any power to govern the corporation, its members would have no personal liability.

Educate Your Board

Some corporations provide training for new Directors and officers to ensure that these individuals understand what their service as an officer or Director entails and how to carry out their duties. Another avenue that many corporations use to educate their Board is to provide a Board manual that is given to each new Director. The manual may contain:

- a copy of the Articles of Incorporation and any amendments;
- the current Bylaws;
- Board policies and procedures;
- a brief background on the corporation, its mission, and its programs and activities;
- the current year budget;
- the most recent financial statements;
- the most recent independent audit;
- a summary of the duties of the Board;
- a listing of the Board's committees and who serves on them;
- a flowchart showing the organization's structure;
- a phone list of the names and address of the other Directors and any individuals (e.g., the Executive Director, the Controller) the Board may need to reach.

We suggest that your Board also be given this chapter to read to orient them about their legal duties and how to handle them.

Maintain Proof of Correct Behavior

There is often a big difference between what actually happened and what you can later prove happened. It is important to maintain written records that verify events you may later need to prove.

- Keep accurate minutes of Board meetings. You need to keep records (called minutes) of your meetings. Pages 288-289 explain what should be in your minutes in order to protect the Board.

- Make or confirm resignations as Director and other important matters in writing if these matters do not appear in your minutes. Keep a copy for your own records.

- Keep your records for the period of time for which proof may be required. See Chapter 27.

There is often a big difference between what actually happened and what you can later prove happened. It is important to maintain written records.

Reliance on Reports

The law does not expect you to know everything about running a corporation. You as a Director can rely on information, opinions, reports, and statements from reliable officers and employees, reliable Board committees as to matters within its jurisdiction, reliable religious authorities (in the case of Religious Corporations) and outside experts such as attorneys and public accountants.

> *Example*: The Board is considering hiring an independent contractor on a half-time basis to write grants for the corporation. The Board has obtained a written opinion from its accountant that this person is properly classified as an independent contractor. The Board can rely on this opinion. If the IRS later classifies this individual as an employee, the Board would not be personally liable for the tax owed (although the corporation would be and may have a claim against its accountant).

However, if you have information suggesting reports are unreliable, you must investigate.

Proper Handling of Conflicts of Interest

The fact that a Director has a conflict of interest with the corporation does not necessarily mean that the transaction cannot occur. Generally, the Board is best advised to avoid approving transactions where a conflict is present. However, there may be occasions when the Board wants to engage in the transaction even with the conflict.

If your organization is a private foundation (described on page 97), your conflict of interest is probably an act of self-dealing and you cannot engage in it. You should get legal help. If your corporation is not a private foundation, you can engage in transactions that involve conflicts of interest if you follow the rules for these situations.

You should first check your own Articles, Bylaws, and Board policies. If your corporation has established rules for conflicts of interest, you must follow

those rules, even if they are stricter than the rules below. However, your rules cannot be more lenient than the rules set out below. If they are, you need to follow the rules in this chapter. If your organization is tax-exempt as a public charity under §501(c)(3) or is exempt under §501(c)(4) and your conflict of interest involves a transaction between your corporation and a Board member, you must follow the more stringent rules pertaining to excess benefit transactions discussed on pages 634-640.

The Fairness Doctrine

Your Board can always engage in a transaction that involves a conflict of interest if the transaction is fair to the organization at the time it is entered into or approved. This rule applies to all types of nonprofit corporations and applies whether or not the vote of the Director with the conflict is counted. However, it is extremely important that the corporation document carefully its proof that the transaction is fair to the corporation.

Approval by Disinterested Vote

It can be quite risky to rely on proving that a transaction was fair to the corporation, particularly if there was any dissent on the Board. The law provides another method for approving conflicts. This method involves a favorable vote by Directors who are not involved in the conflict. The rules for voting vary depending on what type of nonprofit corporation is voting. Even if you rely on the voting method to resolve your conflicts, it is still a good idea to document that the transaction is fair to your organization.

Public Benefit and Religious Corporations

Public Benefit and Religious Corporations can approve a transaction in which the Director has a conflict of interest by a vote of the Board or committee of the Board if the material facts and Director's interest are known. To be approved, the transaction must receive a majority vote by those on the Board or committee who have no interest in the transaction. *Note that this is a majority of everyone on the Board or committee and not a majority of those who are present at the meeting.* Also, that majority must be more than one Director.

Public Benefit and Religious Corporations can approve a transaction in which the Director has conflict of interest.

Although the law does not forbid the Director with the conflict from participating in the discussion and the vote, the corporation's best policy would be to exclude the member with the conflict from voting and from at least some of the

discussion so that the corporation could arrive at a truly independent assessment that the transaction was fair to the corporation.

> *Example*: Your nonprofit corporation is a public benefit corporation. You want to purchase a computer system from a company completely owned by one of your Directors. This is a direct conflict of interest. You may make the purchase as long as a majority of your Board in office, knowing about the conflict, and without counting the vote of the interested Director, vote to purchase. The Board would best protect itself if it documented facts showing this transaction was fair to the corporation (for example, with a couple of written price quotes from competitors).

Mutual Benefit Corporations

Mutual Benefit Corporations can approve a conflict of interest transaction in advance by the Board or a committee if the material facts and director's interest are known, or it may be approved or ratified by the members if the material facts and director's interest are known. If the *Board* is voting on the transaction, the transaction must receive a majority vote by those on the Board or committee who have no interest in the transaction. *Note that this is a majority of everyone on the Board or committee and not a majority of those who are present at the meeting.* Also, that majority must be more than one Director.

Although the law does not forbid the Director with the conflict from participating in the discussion and the vote, the corporation's best policy would be to exclude the Director with the conflict from voting and from at least some of the discussion so that the corporation could arrive at a truly independent assessment that the transaction was fair to the corporation.

If the *members* of a Mutual Benefit Corporation are voting on a conflict of interest transaction, the approval is effective if it receives a majority of the votes entitled to be counted. In that case, all votes, even those controlled by a Director with a conflict, are entitled to be counted.

A quorum for this vote is a majority of the members, whether or not present, that can vote on this transaction. If your Bylaws state that a quorum is the members present at a meeting, note that the quorum for the conflict vote is a higher number since it requires a majority of the voting members, whether or not present.

Approval by Outside Sources

Public Benefit Corporations and Religious Corporations have one additional route to obtain approval of a conflict of interest transaction. The transaction can also be approved by the Attorney General or a judge. In practice, this almost never happens.

Limited Liability of Directors and Officers

Federal Law

Federal law extends some special protection from liability to volunteers, including volunteer Directors, of many nonprofit organizations. See page 408.

State Law

Oregon law offers some special protection from liability to "Qualified Directors." You are a qualified director *if you serve without pay* and:

- if your organization is or could be tax-exempt under any section of §501 of the Internal Revenue Code;
- if your organization has as its primary purpose religion, charity, providing goods or services at no charge to the general public, education, scientific activity, or medical or hospital activities at reduced costs; or
- if your organization is a trade and business organization, a condominium, a planned community, or a homeowners association.

In most cases, unpaid officers of these organizations are also entitled to the protections offered to qualified directors. If you have more specific questions about whether you are covered, you should see an attorney.

You are not a qualified director if you receive any payment for your services (other than reimbursement for expenses). Payment is not necessarily in the form of cash but can include anything of value. Examples of such payment might be reduced tuition, free admissions to events; or discounted merchandise. If your Board is unpaid, your Bylaws or Board minutes should reflect this. You may be paid for your services in some other capacity for the organization without losing this protection. If that is the case, the corporate records should be clear that that is what the payment is for.

Qualified directors cannot be sued by *anyone* for their negligence but only for gross negligence and intentional acts. This makes it considerably harder for anyone to get a judgment against you.

> *Example*: You are an unpaid member of the Board of a §501(c)(3) community center. You and the other Directors negligently failed to institute proper policies to ensure that the pool had a lifeguard on duty at all times and a child drowned. You are personally sued by the child's parents, who allege gross negligence. The jury finds that you were negligent but not grossly negligent. Because you are a qualified director, there will be no judgment against you.

The protection offered to qualified directors is helpful but does not end your concerns about personal liability. Many suits brought against Directors personally are by ex-employees and do not involve a claim of negligence, so you continue to be at risk for those. In addition, while the law protects you from your ordinary negligence, you are still responsible for your gross negligence. Although this is much harder to prove, you may still face lawsuits alleging this. At the very least in those cases, you will incur legal costs to get you out of the lawsuit.

All Directors and Uncompensated Officers

Your Articles of Incorporation may contain provisions limiting liability for all your Directors, whether qualified or not, and for uncompensated officers. These provisions may provide that the director has no personal liability *to the corporation or its members* for monetary damages for conduct as a director. Many potential Directors want to see this provision in the Articles before they will agree to serve. Provisions that provide this protection are found on pages 37-38. There are some actions for which your Articles cannot eliminate liability. These are listed on page 37. Your Articles also do not eliminate liability for actions by parties *outside the corporation* (although remember that the law provides some protection for Qualified Directors against these types of situations).

Reimbursement by the Corporation When You Are Sued

If you are an officer or Director who does get sued or threatened with a lawsuit in your personal capacity arising out of your actions as a Director or officer, you may potentially incur two kinds of expense. One expense is a judgment against you if you lose a lawsuit or settle a claim. The other expense is legal fees and costs you incur whether you win or lose a lawsuit. It is not uncommon for the cost of defending a lawsuit to be $20,000 - $30,000 which you will owe whether you win or lose. You may then want to look to the corporation to reimburse you for your expenses and any amounts you had to pay to the other party.

"Indemnification" means the corporation will pay for an attorney to defend its Director or officer who is threatened with a lawsuit and will repay its Director or officer for any expenses (such as legal fees and the amount of the judgment or settlement) that the Director or officer must pay as a result of being sued because of being a Director or officer.

> *Example*: A former staff member sues the corporation for discrimination and names all the Directors personally in the lawsuit. If the corporation has indemnified its Directors, it will be required to pay their legal fees to defend against the suit as well as any judgment the court awards the staff member against them.

The law provides that there are some circumstances in which a nonprofit corporation *must* indemnify its Directors and officers, some circumstances in which it *may* indemnify its Directors and officers, and some circumstances in which it *cannot* indemnify its Directors and officers.

When the Corporation Must Indemnify Its Directors and Officers

Your corporation *must* indemnify its Director or officer when the Director or officer wins the lawsuit (unless the Articles provide otherwise).

When the Corporation Can Indemnify Its Directors and Officers

Your corporation *can* indemnify its Director or officer when:

- the conduct of the Director or officer was in good faith;
- the Director or officer reasonably believed his or her conduct was not opposed to corporation's best interest; or
- in criminal proceedings, the Director or officer had no reasonable cause to believe his or her conduct was unlawful.

When the Corporation Cannot Indemnify Its Directors or Officers

The corporation *cannot* indemnify its Director or officer when:

- the corporation sued the Director or officer and won; or
- the Director or officer improperly received personal benefits.

Many corporations, to attract Directors, agree in their Articles or Bylaws to indemnify their Directors and officers to the maximum extent permitted by law. Check your Articles or Bylaws for a provision similar to this:

> This corporation will indemnify to the fullest extent not prohibited by law any person who is made or threatened to be made a

> party to an action, suit, or other proceeding, by reason of the fact that the person is or was a director, officer, member, employee, volunteer, or agent of the corporation or a fiduciary within the meaning of the Employee Retirement Income Security Act (or its corresponding future provisions) with respect to any employee benefit plan of the corporation. No amendment to this Article that limits the corporation's obligation to indemnify any person shall have any effect on such obligation for any act or omission that occurs prior to the later of the effective date of the amendment or the date notice of the amendment is given to the person. The corporation shall interpret this indemnification provision to extend to all persons covered by its provisions the most liberal possible indemnification--substantively, procedurally, and otherwise.

There are a number of very detailed laws about indemnification. You need to see an attorney if you are concerned about this.

Insurance

Indemnification is only good if the corporation has assets or insurance that will cover your expenses when indemnification is needed. You can't get money from a bankrupt and uninsured corporation. Consequently, unless your corporation is very financially secure, you may want to look into insurance coverage to cover your Directors and officers in the event you are threatened with a lawsuit.

Directors and Officers Insurance

Directors and Officers insurance (D & O insurance) is a policy the corporation buys to protect its officers and directors from the types of liability we have been describing in this chapter. Ideally, every nonprofit would have this insurance. The problem is that not everyone can afford it. You should look for an insurance agent who has dealt with nonprofits. Don't be discouraged by someone else's story about how expensive the coverage is. Each nonprofit is rated differently, depending on what the insurance company feels your risk is. Check it out. Your Directors and Officers insurance should advance defense costs during the course of the lawsuit, not just reimburse them after it is over. It should cover employees, committee members, volunteers, and the organization itself. You should look for broad coverage for employment-related claims.

Errors and Omissions Insurance

This is similar to Officers and Directors insurance but may cover some of your employees as well as your officers and directors.

Personal Insurance Coverage

If you have checked out Officers and Directors insurance and found you can't get it or you don't have enough to make you feel comfortable, your Directors can check their own insurance policies. Occasionally, a homeowner's policy will cover your Board services or you may be able to add this coverage for yourself at little or no charge. A more common source of coverage is in the umbrella policies many people purchase to supplement their other insurance. Insurers for these policies more often are willing to cover your service on nonprofit Boards, sometimes for free and sometimes for an additional premium. Talk to your insurance agent. The major limitation to these policies is that they cover bodily injuries and property damage. Many lawsuits initiated against Directors and officers are for other types of claims (such as employee claims or poor financial decisions) so your homeowners or umbrella insurance would not cover you for those suits.

Other Types of Insurance

Your corporation should have other types of insurance to protect itself in the event of a problem or lawsuit. These types of insurance coverage are discussed on page 514. However, be aware that having these other coverages does not protect your Board from its own errors. The insurance described above is what is needed for this occurrence.

Conclusion

This chapter has pointed out the major areas that a Director may be personally liable for her or his actions on behalf of the corporation. It is important to plan for this possibility. However, before you panic too much, remember that most Directors are never sued personally. You will decrease considerably the chances that you will be sued by exercising the care described in this chapter and will protect yourself if you are sued by following the recommendations above to protect the Board.

REPLACING DIRECTORS AND OFFICERS

Every nonprofit corporation needs to plan for transitions in the Board of Directors. Your Board will change when terms of office expire, when the Board expands to take on new Directors, when a Director dies, resigns, or otherwise vacates an office, or when your Board removes a Director. You should, as much as possible, anticipate and plan for these occurrences. Although most Directors of nonprofit corporations are elected, some are appointed or designated (see

page 19). The manner in which a Director took office will affect how she or he is replaced.

You should consult your Articles of Incorporation and your Bylaws to see if your corporation has addressed these issues. If your Articles or Bylaws have these provisions, check them against the rules below to be sure your Articles and Bylaws are legal. If your Articles and Bylaws do not address the election of Directors and officers, the filling of vacancies, and the removal of Directors and officers, you should amend them to include these provisions. It is very important that the corporation be clear about how these matters are handled.

Expiration of Terms of Office of Directors

Your Bylaws (or possibly your Articles) should contain provisions for replacing Directors whose terms have expired. Your terms for elected Directors cannot exceed five years although the Director may be re-elected for an indefinite number of terms. *Designated* and *appointed* Directors can serve for terms of any length. Many groups provide for staggered expiration dates so that the Board has continuity in its membership.

Resignation of Directors

A Director may resign at any time by delivering written notice to the Board of Directors, its presiding officer, or to the President or Secretary. The resignation is effective when the notice is effective as described on page 624 unless the notice specifies a later effective date. Once it is delivered, the notice of resignation cannot be revoked unless the Board of Directors permits it to be revoked.

Removal of Directors

The decision to remove a Director is not an easy one. Because removing a Director may result in an unhappy individual or faction, your Board must exercise great care to follow the correct procedure for removal. In determining what your procedure is for removal, you need to look at whether you are removing an elected, designated or appointed Director; whether you are a nonmembership or membership corporation; and whether your Articles or Bylaws provide for removal with or without cause or require that there be cause for removal.

Removal with or without cause means that your Board does not have to establish a reason for removing its Directors. This may seem harsh to some, but from the point of view of the corporation it is generally the preferred method. Correctly describing what constitutes cause in your Articles or Bylaws can be tricky and organizations often find out too late that they did not cover all the

bases they would like to have covered. Proving cause can also be very difficult. An unhappy ex-Director may take you to court and require that you prove cause in exactly the way it was written in your Articles or Bylaws. To avoid this kind of fight, you may prefer to permit removal without requiring yourself to prove cause. As you will see below, if your Articles or Bylaws provide for removal of a Director with or without cause, you must have a large vote for removal. For most corporations, this provision should be enough to protect its Directors from casual removal by the Board.

Removal with or without cause may seem harsh to some, but from the point of view of the corporation it is generally the preferred method.

If your corporation is a Religious Corporation, your Articles or Bylaws may use any procedure to remove a Director, and you are only bound by the rules in this section if your Articles and Bylaws do not set out a different procedure.

Removal of Directors Elected by Directors

A Director elected by your Board may be removed with or without cause, unless your Articles or Bylaws provide that your Directors can only be removed for cause. If removal is with or without cause, it requires a vote of two-thirds of the Directors *then in office*.

If removal by the Board is with or without cause, it requires a vote of two-thirds of the Directors then in office.

If, at the beginning of a Director's term on the Board, the Articles or Bylaws provide that the Director may be removed for reasons specified in the Articles or Bylaws, the Board may remove the Director only for such reasons. A vote of the majority of Directors then in office is required.

Removal of Directors Elected by Members

A Director may be removed *by the members* with or without cause unless the Articles of Incorporation provide that a Director may only be removed for cause. Note that a provision to this effect in your Bylaws is not enough; it must be in your Articles. Your Director may be removed only if the number of votes cast to remove her or him would be sufficient to elect the Director at a meeting to elect directors. If your organization is a complex membership organization (see Chapter 15), consult pages 330-331 for rules on removal of your Directors.

A Director elected *by your Board* to fill the vacancy of a Director elected by the members may be removed by members but not the Board.

Removal of Designated or Appointed Directors

A *designated* Director may be removed by an amendment to the Articles or Bylaws deleting or changing the designation. An *appointed* Director may be removed with or without cause by the person appointing the Director. The person removing the Director must give written notice of the removal to the Director and either the presiding officer of the Board or the corporation's President or Secretary. The removal is effective when the notice is effective, as described on pages 624-626 unless the notice specifies a later effective date.

Vacancy on the Board

If a vacancy occurs on the Board of Directors (including a vacancy that results from an increase in the number of Directors), it may be filled in one of several ways:

- Your members entitled to vote for Directors, if any, may fill the vacancy;
- Your Board of Directors may fill the vacancy; *or*
- If the Directors remaining in office constitute fewer than a quorum of the Board of Directors, they may fill the vacancy by a majority vote of all the Directors remaining in office.

There are two exceptions:

- If a vacant office was held by an *appointed* Director, only the person who appointed the Director may fill the vacancy, unless your Articles and Bylaws provide otherwise.
- If the vacant office was held by a *designated* Director, the vacancy must be filled as provided in the Articles or Bylaws. If the Articles or Bylaws do not provide for how to fill the vacancy, the vacancy may *not* be filled by the Board.

Your Articles or Bylaws may provide some other way to fill vacancies.

Resignation and Removal of Officers

An officer may resign at any time by delivering notice to the corporation. The resignation is effective as described on page 624, unless the notice specifies a later effective date. If the resignation specifies a later effective date and the corporation accepts that date, your Board or any other person authorized by

the Articles or Bylaws may fill the pending vacancy before the effective date if the Board or such other authorized person provides that the successor does not take office until the effective date. Once it is delivered, a notice of resignation cannot be revoked unless revocation is permitted by the Board.

Your Board or any other person authorized to do so by the Articles or Bylaws may remove any officer at any time with or without cause.

EVALUATING THE EFFECTIVENESS OF YOUR BOARD

Because Board roles and priorities change over time and because the composition of a Board changes regularly, evaluation of the effectiveness of your Board needs to be based on both your understanding of the legal responsibilities of the Board and on the specific roles your Board has decided to play within the organization. Your evaluation should focus on the needs of your organization, not comparison with other organizations and other Boards.

Hopefully, you will use a Board meeting style which encourages Directors to provide feedback on how the Board is working throughout the year. Directors should feel free to express both pride in accomplishment and frustration with process. Most importantly, Directors should be encouraged to ask questions and be honest about areas of confusion or reservation.

Beyond striving for a supportive, open atmosphere on the Board, you may also want to set aside time at Board retreats for explicit evaluation of how the Board is doing. Focus evaluation discussions on Director agreements about Board roles and activities and recognition of what has worked well – as well as acknowledgment of difficulties. Use the evaluation as an opportunity to reach new agreements about Board roles and develop more realistic plans about Director commitments and activities.

Your Board can provide the deep community roots necessary for your organization to grow strong and serve the community effectively. Just as allowing roots to dry out or be severed will eventually damage the tree, allowing Board interest to wither and Board connections to be severed will weaken your organization. Time devoted to Board cultivation, support, and evaluation can build the strong roots your organization needs to achieve its mission and sustain its efforts.

Consult Appendix 1 if you would like information about source material related to this Chapter. Appendix 1 has references of interest to all readers, not just professionals.

There are many people besides the Board that are needed to operate a successful nonprofit organization. The next chapters discuss members, employees, independent contractors, and volunteers. The last chapter in this Part describes how to constructively handle conflict. You should read any chapter that applies to you.

14 MEMBERS AND MEMBERSHIP CORPORATIONS

The law defines a "member" as someone who votes for one or more of your Directors more than once. This means that if your members do not vote, they are not members for legal purposes. As we discussed in Chapter 2, the legal definition of a member is quite a bit different from the common understanding of member in the nonprofit world. Most people understand a member to be someone who supports the goals of an organization and is associated with it in a special way, often by paying dues or providing volunteer services.

Because members (as the law defines that term) have the special right to vote, membership corporations are subject to quite a bit of regulation. If you don't have voting members, you don't want to be subject to the rules of this chapter. In order to clarify your situation for legal purposes, you should review the discussion on pages 23-25 about this and consider talking to an attorney. This chapter assumes you have read pages 23-25 and have determined you are a membership corporation as the law defines that term.

THIS CHAPTER COVERS

- **Admission of Members**
- **Rights, Obligations, and Liabilities of Members**
- **Notice of Meetings**
- **Meetings of Members**
- **Voting by Members**
- **Election of the Board**
- **Inspection of Your Records by Members**
- **Resignation and Termination of Members**

As you read this chapter, keep in mind that your own Articles of Incorporation or Bylaws may have provisions for how your membership corporation is regulated. If those provisions comply with the law, you must follow them.

Membership corporations can be very simple or quite complex. The most common type of membership corporation is probably the one-person, one-vote variety. Others have different classes of members with different voting rights or different privileges. There are many examples of large national organizations that have state chapters, including a chapter in Oregon, and local chapters throughout the state. In these corporations, the members may have voting rights at the chapter level and the right to elect delegates to the state or national meetings.

ADMISSION OF MEMBERS

Criteria for Admission

Generally, your corporation can set any criteria that you want for admitting members. This is often done in the Bylaws and occasionally in the Articles. If your criteria discriminate against members based on race, religion, national origin, gender, handicap, and in some cities, sexual orientation, they may be illegal if your activities cause you to be classified as a public accommodation. If you do have discriminatory criteria of these types, you will need to get legal advice.

Your corporation can admit members without charging dues or can permit the Board to set a fee unless your Articles or Bylaws provide differently. The Articles, Bylaws, or a resolution adopted by the Board can set membership dues and assessments. Generally, the amount of dues is best set by Board action so that it can be changed without having to amend your Articles or Bylaws.

The law requires that your members consent to be members. There are significant problems with having members who do not consent.

Consent of Members

The law requires that your members consent to be members. This is not a problem in most groups. However, some groups define membership in a very broad way so as to encompass people who have not consented.

> *Example*: The Park Neighborhood Association, an Oregon nonprofit corporation, defines its members as all residents and business owners within the geographical boundaries of the Park Neighborhood. This definition describes as members people who have not consented to be members and conflicts with the law.

There are significant problems with having members who do not consent. One is that membership corporations are required to keep a list of the names and addresses of its members, which would not be possible for a group with undetermined members. Another is that the group must give all its members notice of meetings (see page 320) which is extremely difficult with an undetermined membership. Finally, the nonprofit corporation must allow members access to certain of its books and records (see page 331) which may be awkward when you cannot know with certainty who your members are.

There are several possible solutions to this dilemma:

- You may choose not to incorporate. The rules in this chapter only apply to nonprofit membership corporations, not to unincorporated groups. However, being unincorporated has other disadvantages. (See Chapter 1).

- You may decide to incorporate in another state. Oregon law is considerably more regulatory than that of other states. However, many groups find this idea awkward.

- You may reword your membership requirement to add an additional step in order to be a member. For example, you may state as follows:

  Anyone that lives in or works in Park Neighborhood is eligible to be a member of this corporation. The law requires that all members must consent to become a member. Anyone that lives or works in Park Neighborhood can consent and become a member by signing a Statement of Membership with this corporation and supplying this corporation with their name and address.

  Your corporation would have everyone who expressed an interest in your corporation and who met your other criteria sign a Statement of Membership that stated they consented to membership and that listed the date and their names and addresses, so that you could keep proper records.

RIGHTS, OBLIGATIONS, AND LIABILITIES OF MEMBERS

Classes of Members

Many corporation have one class of members in which each member has the right to one vote and the same rights as all other members. Some corporations want to give some members different rights than others. For example, some members may have the right to vote and others may be nonvoting members. Some corporations may distinguish between members who pay annual dues and those who make greater contributions and receive special benefits or rights in return. These various groupings of members are referred to as "classes" of members. A class is a group of members who have the same rights with respect to voting, dissolution, and all other important matters. Rights are considered to be the same if they are determined by a universally-applied formula. Oregon law permits you, if you want, to set up your membership in classes. You may want to consider doing this if there are reasons to group your members. Your Articles or Bylaws must provide for the rights and obligations of classes. If your Articles and Bylaws are silent about classes of members, then the law assumes each member has the same rights.

Members' Rights and Obligations

Your Bylaws (or Articles) should spell out whether your members vote only for the Board or whether they vote in connection with other matters. In addition to voting for the Board, your corporation can permit them to vote on amendments to Articles and Bylaws, a sale of substantially all of the corporate assets, merger, dissolution, removal of directors, conflicts of interest, and some matters connected with indemnification. Your Articles or Bylaws should set out their voting rights. Remember that members do not have the right to manage the affairs of the corporation – that is the Board's job. Review the discussion on page 17 about this.

Liability of Members

Your members are protected from personal liability for the acts, debts, liabilities, or obligations of the corporation. However, if there are unpaid dues, assessments, or fees for which the member is liable to the corporation, the creditors of the corporation, if they are unable to collect their judgment against the corporation, can, in a proper proceeding, require the member to pay to them the amount that the member owes to the corporation for her or his unpaid dues, assessments, or fees. Although your members are not liable to the corporation by virtue of their membership, they may of course incur liability for some other

reason. For example, a member of a church is not liable for the church debts outside of the amount of unpaid pledges or dues, but the church and the member may be liable if she or he abuses a child while volunteering in the church nursery. (See Chapter 17.)

Membership Dues

One important contribution of members is the revenue generated by the payment of dues. The payment of dues as a fundraising strategy is discussed at length in Chapter 21.

NOTICE OF MEETINGS

Members tend to be a larger and more dispersed group than Directors and consequently the provisions for giving notice of membership meetings are more complicated. Actions your members agree upon at a meeting may not be valid if you did not give proper notice. Since one of these actions is frequently the election of Directors, it is vital that your notice be given correctly.

Who Gets Notice?

The first issue about notice is who must get it. You are required to give notice to members entitled to vote at any meeting. Since the corporation may be adding new members all the time (and losing some), you need to know what date you are using for purposes of membership notice. This date is called the "record date." Page 322 describes how to determine your record date. You then mail the notice to everyone who is entitled to notice of the meeting as of that date.

Contents of Notice

Your notice should state the place, date, and time of the meeting. Unless your Bylaws (or Articles) provide differently, you are not required to state that the purpose of an *annual* or a *regular* meeting is to elect the Board of Directors. However, you may choose to do this to keep up good communication with your members.

In most other situations in which members may be voting, you are required to let them know what the issues are. Notice of an *annual* meeting must include a description of any matter or matters which must be approved by the members in connection with removal of Directors, Directors' conflicts of interest, determination and authorization of indemnification and certain indemnification expenses, amendments to the Articles, amendments to the Bylaws, adop-

tion of a plan of merger, sale of corporate assets other than in the regular course of business, and dissolution of the corporation. In the case of *special* meetings, your notice should always include a description of the purpose or purposes for which that meeting is called.

How Notice Is Given

Your notice must be given in a fair and reasonable manner and must comply with any provisions in your Bylaws. The law provides a definition of what is fair and reasonable. Your notice is fair and reasonable if it tells the members of the place, date, and time of the meeting at least seven days before the meeting or, if the notice is mailed by other than first class registered mail, at least thirty and no more than sixty days before the meeting. The law that provides for notice was drafted in 1989 before the advent of the Internet and does not provide for electronic notice. We don't know yet how the courts might treat this and, since it is not first class mail, whether it must be given in the 30-60 day period.

Some corporations find that it is impracticable to follow the notice deemed fair. This may happen if the corporation has a large number of members and does not send out a regular newsletter. You should consider getting some legal help to develop fair and reasonable notice that varies from that described above.

In some situations, the notice described above defined by the law as fair is the *required* notice. Those situations are when members are voting on Directors' conflicts of interest (see page 302); certain indemnification matters (see page 306); amendment of Articles (see Chapter 28); amendment of Bylaws (see Chapter 28); merger (see Chapter 29); sale of assets (see Chapter 29); and dissolution (see Chapter 30).

Notice of Adjournment of Meetings

If an annual, regular or special meeting of members is adjourned to a different date, time or place, notice does not need to be given of the new meeting if it is announced at the original meeting before adjournment, unless your Bylaws require new notice. If a new record date (see below) for the adjourned meeting is or must be fixed, then notice of the adjourned meeting must be given to those who are members as of the new record date.

Waiver of Notice

A member may at any time decide that he or she does not need or want the notice to which they are entitled. The member's action in declining notice is

called a waiver. The waiver must be in writing, be signed by the member entitled to notice and be delivered to the corporation for inclusion in the corporate records. See the sample "Waiver of Notice of Meeting of Members" in the Forms section.

Record Date

In a number of circumstances, your membership corporation needs to fix a "record date." Although this has a rock 'n roll flavor, the record date is the date used by your corporation to determine which members are entitled to notice of a members' meeting, which members may demand a special meeting, which members may vote, or which members may take other lawful actions.

Your Bylaws may make provisions for how your record date is set. If the Bylaws do not fix a record date, your Board may fix one (and how could your Board miss a chance to do something this exciting?). If neither your Bylaws nor your Board have addressed this issue, the record dates are set as follows:

- To determine the members entitled to *notice* of a members' meeting, the record date is the day before the day on which the first notice is mailed (or otherwise transmitted to the members) as described above; or, if notice is waived, the day preceding the day on which the meeting is held.

- To determine the members entitled to *demand* a special meeting, the record date is the date the first member signed the demand for the meeting.

- To determine the members entitled to *take action without a meeting*, the record date is the date the first member signs the consent to take action without a meeting.

- To determine the members entitled to *vote* at a members' meeting, the record date is the date of the meeting.

- To determine the members entitled to *exercise any other legal rights*, the record date will be the date on which the Board adopts the resolution that is involved or the 60th day prior to the date of any other action, whichever is later.

In no case can your record date be more than 70 days before the meeting or action requiring the determination of members.

A determination of members entitled to notice of or to vote at a membership meeting is effective for any adjournment of the meeting unless the Board fixes a new record date, which it must do if the meeting is adjourned to a date more than 120 days after the date fixed for the original meeting.

MEETINGS OF MEMBERS

As we discussed in the section about meetings of the Board of Directors, the law assumes a democratic model for Board meetings in nonprofit corporations. This model is also used for membership meetings. This means that the decision-makers vote and that a majority vote usually prevails. Your Bylaws and Articles can regulate this to some degree but, in the absence of such regulation on your part, this is the model you must use.

Unlike the Board model, in membership corporations decisions can be made without everyone being able to hear and persuade each other. The law allows members to vote by ballot if the corporation chooses. Consequently, membership meetings are not subject to the same rules as Board meetings. In order to give members a chance to persuade each other, the law permits members access to the membership list (and other records) so that members can communicate their viewpoints with other members. Pages 331-323 discuss your members' rights to inspect and copy records.

Who Attends the Membership Meetings

All voting members can attend the membership meetings. Oregon law is not clear as to whether nonvoting members have a right to attend membership meetings. There is no requirement that anyone else be allowed into the meetings except that the President and any other officers designated by the Board or President shall attend the annual meeting and report on the activities and financial condition of the corporation. Your Articles or Bylaws may state that the meetings are open in which case those documents must be followed.

There is some question about whether membership meetings of nonprofit corporations are subject to Oregon's Open Meeting Laws. The Open Meeting Law requires that all meetings of governing bodies of a *public body* shall be open to the public with certain exceptions. The law also requires that certain public notice be given and that minutes be kept and made available to the public. The issue for nonprofits is "Are nonprofits 'public bodies?'" A second issue for membership corporations is whether membership meetings are meetings of a "governing body." The answer in most cases to both questions is "no." However, if your nonprofit exercises sufficient governmental functions, the Open

Meeting Law may apply to you. See Appendix 4 for more information about this.

Types of Members' Meetings

There are two types of meeting: regular and special. A *regular* meeting is one that is regularly scheduled as to time and place. A regular meeting that is held once a year is called an annual meeting. *Special* meetings are all meetings that are not regular meetings.

Annual Meeting

Oregon law requires that you hold an annual meeting of your members. Your Bylaws (or Articles) are to provide the time for the meeting. The annual meeting is held at your principal office unless your Bylaws fix another location. At the annual meeting, the President, or another officer designated by the Board or the President, must report on the activities and financial condition of your corporation. You also elect your Directors unless your Articles or Bylaws provide for some other time for election. Your members can act on any other matters that may be raised consistent with the notice requirements described on page 320. Many nonprofits use their annual meeting as an opportunity to encourage members to socialize or to offer educational presentations or workshops about the work that the nonprofit is doing. These meetings can be an excellent occasion to deepen member loyalty and to encourage financial support from the members.

Oregon law requires that you hold an annual meeting of your members.

Regular Meetings

Your membership corporation can but is not required to hold regular membership meetings. The regular meetings are held at the corporation's principal office unless your Bylaws state another location. At regular meetings, the members consider matters that are raised in the meeting's notice, consistent with the notice requirements given below.

Special Meetings

Your Board of Directors or those authorized to do so by the Articles or Bylaws can call a special meeting of the members of a corporation. The holders of at least five percent of the voting power of the corporation can also call a special meeting. They do this by signing, dating and delivering to the Corporate Secretary one or more written demands for the meeting, describing its purposes. The

record date (see page 322) for members entitled to demand a special meeting is the date the first member signs the demand. These meetings are to be held at your principal office, unless your Bylaws make a different provision. However, if the corporation fails to send out notice for a special meeting that was called by five percent of the members holding voting power within thirty days after the date the written demand was delivered to the corporation's Secretary, the person signing the demand may set the time and place of the meeting and give the required notice. Only matters within the purpose set out in the meeting notice may be conducted at a special meeting of members.

Conduct of Meeting

You have great flexibility in conducting your meetings. You do need to check your Articles, Bylaws, and Board resolutions to see if they govern how to conduct meetings. For example, some Bylaws require that you follow *Roberts Rules of Order*. If your Bylaws requires this, you must familiarize yourself with *Roberts Rules* and follow them or amend your Bylaws to eliminate this requirement.

Minutes

You need to keep minutes of your membership meetings. The minutes should reflect the date, time, and place of the meeting and the notice given (with a copy of the notice). They should indicate the count of voting members attending and the presence of a quorum. If members have differing voting rights, the minutes should be broken down to reflect attendance by category. The minutes should reflect what matters were voted on and the outcome of the vote, with the decision clearly stated and with a vote count. If proxies were submitted, the minutes should have the proxy or a copy. It is up to you as to how much of the discussion about issues you want to record; if the issue is likely to come up again, sometimes a record is helpful. A skeletal outline of "Minutes of Meeting of the Members" can be found in the Forms section.

Action Without Meeting

If all your members agree about an action, there is no reason to require a meeting. An action required or permitted to be taken at a members' meeting may be taken without a meeting if *all* your members entitled to vote sign a written consent describing the action taken and it is delivered to the corporation for inclusion in the minutes or filing with the corporate records. Notice that a majority vote is not enough; all voting members must consent. The action is effective when the last member signs the consent unless the consent specifies an earlier or later effective date. See the "Consent to Corporate Action Without

a Meeting by the Members" in the Forms section for a sample. Your Bylaws (or Articles) may prohibit actions without a meeting.

Delegates

A delegate is a person elected or appointed to vote in a representative assembly for the election of Directors or on other matters. Larger organizations, usually those with geographical chapters and a regional or national central organization, are most likely to utilize delegates. The delegates represent the members at regional or national meetings so that the meetings can be conducted without having huge numbers of people there. Your corporation may provide in your Articles or Bylaws for delegates who have some or all of the authority of members. If you do this, your Articles or Bylaws should describe the characteristics, qualifications, rights, limitations, and obligations of delegates, including their selection and removal. Your Articles or Bylaws should establish how notice is to be provided for meetings of the delegates and should provide for carrying on corporate activity during and between meetings of delegates.

VOTING BY MEMBERS

Voting by your members is a critically important part of properly running your corporation. The members' votes determine who is on your Board. Since the Board is the group that directs your corporation, it is essential that you conduct your voting procedures in such a way that you leave no doubt as to who the properly elected Director are.

Voting by your members is a critically important part of properly running your corporation.

Quorum Requirements

In order to make binding decisions at a meeting, you must have a quorum. A quorum is the number of votes that need to be cast in order for the action taken to be valid. In membership corporations, a quorum is set by law to be those votes represented at a meeting of members. This very liberal provision means that you will always have a quorum. Some corporations in their Articles or Bylaws do require more than this legal minimum. Often a quorum is set at a percentage of the votes. If you have a provision requiring more than the legal minimum, you should seriously think about amending it. Many membership corporations get into difficulty when they do not have a quorum at their annual meeting. Often, the group votes on the Board without a quorum and continues to operate. Occasionally, the Board will begin to elect its own members without

amending its Articles and Bylaws to reflect that it is no longer a membership group. In both cases, the corporation is no longer operating legally. It is possible that all decisions made by the improperly elected Directors are invalid. This could be avoided by using the legal minimum for your quorum requirement.

One of the reasons that many corporations are tempted to require a higher quorum is that the group wants to maintain the commitment of its members to the organization. This is a laudable goal but potentially crippling the organization in order to encourage involvement is like shooting yourself in the foot in order to run faster. We encourage you to pursue membership loyalty by other means. You might consider combining the annual meeting with an event that is more attractive to your members. You might also consider providing services to your members that will increase their sense of identification with the organization.

Voting Requirements at Meetings

If a quorum is present, a majority vote of those represented and voting at a membership meeting is sufficient to act unless your Bylaws (or Articles) require a higher number.

Voting by Proxy

Proxy voting means that the member gives someone else the right to vote or to otherwise act for the member. Your members may vote by proxy. You must allow this unless your Bylaws or Articles forbid it. In order to authorize a proxy, the member must sign a form and deliver it to the Secretary (or other officer or agent authorized to tabulate votes). See the "Proxy Vote" in the Forms section for a sample. The appointment of a proxy is valid for eleven months unless a different period is stated in the form. The member can revoke the appointment of a proxy. If the member who appoints a proxy dies or becomes incapacitated, the corporation can continue to accept the proxy's authority until the Secretary (or other officer or agent authorized to tabulate votes) receives notice of the death or incapacity of the member.

The person who appointed the proxy can revoke it by attending any meeting and voting in person or signing and delivering to the Secretary (or other officer or agent authorized to tabulate proxy votes) either a statement that the appointment of the proxy is revoked or a form appointing a new proxy.

Voting By Written Ballot

Unless your Articles or Bylaws prohibit or limit voting by ballot, any action that can be taken at any meeting of members can be taken without a meeting if your corporation delivers a written ballot to every member entitled to vote on the matter. Some nonprofits prefer voting by ballot, especially those with large memberships who are committed to the goals of the organization but don't have the time to attend a membership meeting. The ballot must list each proposed action and provide an opportunity to vote for or against each item. Approval by written ballot is valid only when the number of votes cast by ballot equals or exceeds any quorum required to be present at a meeting authorizing the action. The number of approvals must equal or exceed the number of votes that would be required to approve the matter at a meeting if all those voting by ballot had voted at the meeting.

All solicitations for votes by written ballot must indicate the number of responses needed to meet the quorum requirements, state the percentage of approvals necessary to approve each matter other than election of Directors and specify a reasonable time by which a ballot must be received by the corporation in order to be counted. The Forms section includes samples of balloting for the election of Directors and for other actions. See the "Ballot for Election of Directors" and "Ballot for Proposed Action" in the Forms section. A written ballot may not be revoked.

If your corporation does vote by ballot, pay close attention to the unusual requirements listed above.

If your corporation does vote by ballot, pay close attention to the unusual requirements listed above. As discussed on page 326, you must be very careful that your voting is properly done so that there is no doubt about what the result of your elections is.

Voting and Vote Splitting

Each member is entitled to one vote on each matter voted on by the members unless your Bylaws or Articles make other provisions. If the membership of record is in the names of two or more people and only one votes, that vote is counted as the vote of all of them. If more than one of them votes, the vote is divided on a pro rata basis unless your Bylaws or Articles provide differently. Your Articles or Bylaws may provide for classes of members in which members of some classes have more votes than those of other classes.

The law allows nonprofit organizations to choose a procedure called cumulative voting. Cumulative voting refers to a type of voting in which a member

may multiply the number of votes that that member is entitled to cast by the number of Directors for whom the member is entitled to vote and to cast the entire product for a single candidate or distribute the product among two or more candidates. For example, if each member has one vote on each of 8 Board seats up for election, a member under cumulative voting could cast all 8 votes for one position or 5 for one position and 3 for another. Cumulative voting is sometimes used by business corporations so that members who are in a minority may have some representation on the Board. In order for a corporation to use cumulative voting, the Articles or Bylaws must provide for it. Very few nonprofits employ this procedure and you should get legal help if you decide to draft a provision like this.

Corporation's Acceptance of Votes

If the name signed on a vote, consent, waiver of notice or proxy appointment corresponds to the name of a member, your corporation, if acting in good faith, is entitled to accept it and give it effect as the act of the member. If the name does not correspond to the record name of a member, your corporation, if acting in good faith, is still allowed to accept it and give it effect as the act of the member if:

- The member is an entity (such as another corporation) and the name signed purports to be that of an officer or agent of the entity;

- The name signed purports to be that of an attorney of the member and, if the corporation requests, evidence acceptable to the corporation of the signer's authority to sign for the member has been presented;

- Two or more people hold the membership and the name signed purports to be the name of at least one of the co-holders and the person signing appears to be acting on behalf of all the co-holders;

- If the corporation is a Mutual Benefit Corporation and the name signed purports to be that of an administrator, executor, guardian or conservator representing the member and, if the corporation requests, evidence of the fiduciary status acceptable to the corporation has been presented; or

- If the corporation is a Mutual Benefit Corporation and the name signed purports to be that of a receiver or trustee in bankruptcy of the member, and, if the corporation requests, evidence satisfac-

tory of this status acceptable to the corporation has been presented.

Your corporation may reject a vote, consent, waiver of notice, or proxy appointment if the Secretary (or other officer or agent authorized to tabulate votes) acting in good faith, has reasonable basis for doubt about the validity of the signature or about the signer's authority to sign for the member. The corporation and its officer or agent who acts in good faith and follows the above standards is not liable in damages to the member for the consequences of the acceptance or rejection. Corporate action based on the acceptance or rejection of the vote is valid unless a court determines otherwise.

ELECTION OF THE BOARD

Election of Directors

In nonprofits with one class of members, the Directors are elected by the members at the annual meeting of the members. Your corporation may provide in your Articles or Bylaws for the election of Directors by delegates, on the basis of chapter or other organizational unit, by region or other geographical unit, by preferential voting, or by any other reasonable method.

Vacancy on the Board

A vacancy that occurs in the case of an elected Director or a vacancy that results from an increase in the number of Directors is often filled by a vote of the Directors. This occurs because calling special membership meetings to fill vacancies is often expensive and time-consuming. If the vacant office was held by a Director elected by a class, chapter, or other organizational unit, or by region or other geographic grouping, only members of that unit or grouping are entitled to vote to fill the vacancy (if it is filled by the members). The Articles or Bylaws may make different provisions for filling these vacancies.

Removal of Directors

If you have a nonprofit with one class of members so that your members elected your Directors, a Director can be removed as described on page 55. If your Director is elected by a class, chapter, or other organizational unit or by region or other geographic grouping, only the members of that unit or grouping entitled to vote may participate in the vote to remove the Director. That Director may not be removed if the number of votes against removal equals the number of votes of that unit or grouping sufficient to elect the Director. Similarly, if you use cumulative voting, your Director may not be removed if the

number of votes against removal equals the number of votes sufficient to elect a Director.

Your Articles or Bylaws may permit the Board to remove a Director elected by class, chapter, or other organizational unit, by geographical grouping, or by cumulative voting. To do this, your Articles or Bylaws must contain a provision at the beginning of the Director's term providing that the Director may be removed for reasons set forth in that document. The Director can then be removed by a majority of the Directors in office at the time of the removal.

INSPECTION OF YOUR RECORDS BY MEMBERS

Your members are entitled to inspect and copy certain of your records described below if the member gives you notice at least five business days in advance. These records are divided into two categories: those which the member is entitled to inspect without having a reason and those for which you can require a proper reason.

Records Subject to Inspection Without a Reason by the Members

In the case of the records in this section, your members do not have to give any reason for inspection but you may charge a reasonable amount for copying to cover the costs of your labor and materials.

- Articles of Incorporation, Restatements of Articles, and amendments
- Bylaws and amendments
- Resolutions adopted by the Board related to the characteristics, qualifications, rights, limitations and obligations of members
- Minutes of all meetings of members and records of all actions approved by members for the past three years
- Written communications required by law (e.g., notices of meetings) and those regarding general membership matters made to members within the past three years

- List of the names and business or home addresses of your current Directors and officers

- Most recent annual report delivered to Secretary of State

- Financial statements, if any, for last three years at least

- Last three years of accountants reports, if annual financial statements are prepared by a public accountant.

Inspections That Require a Proper Purpose

In the case of the records listed below, you must allow your member to inspect and copy these records if the member's demand is made in good faith and for a proper purpose, the member describes the purpose and the records she or he wants to inspect, and the records are directly connected to this purpose. You may charge a reasonable fee to cover the cost of your labor and materials for copying these records.

- You must allow inspection of all minutes of meetings of your members and Board, all records of actions approved without a meeting by your members and Board, and records of all actions taken by committees of the Board making Board level decisions that you did not have to provide for inspection above.

- You must allow inspection of your accounting records.

- You must allow inspection of your membership list of the names and addresses of all members in alphabetical order by class (if you have classes of members) showing the number of votes of each member as long as the member's purpose is related to their interest as a member. Without the consent of the Board, membership lists cannot be used to solicit money or property unless the money or property will be used only to solicit the votes of members in an election to be held by the corporation. Membership lists cannot be used for any commercial purpose and they cannot be sold or purchased by anyone.

- Your members always have the right to inspect the membership list with the names, addresses, and membership dates for the purpose of communicating with other members concerning membership meetings, beginning two business days after notice of the meeting is given for which the list was prepared and continuing

through the meeting. The member is also entitled to copy the list at a reasonable time, during the period it is available for inspection.

Your members always have the right to inspect the membership list with the names, addresses, and membership dates for the purpose of communicating with other members concerning membership meetings.

What Is a Proper Purpose?

A critical question for many groups is "What is a proper purpose?" This phrase is not defined but a proper purpose would be the desire to contact other members in order to influence their votes on issues before the members. An improper purpose would be to obtain the list in order to use it for commercial solicitation. Another improper purpose would probably exist where a person joined a group in order to obtain a list of the members in order to harass them for their membership in the group.

Example: A developer joins an environmental membership organization in order to discover the names of its members so that he can embarrass them in their communities. This would almost certainly be an improper purpose.

Restrictions on Members' Rights to Inspect and Copy

Your Articles or Bylaws may restrict or abolish the rights of your members to inspect and copy corporate records in these circumstances:

If you are a *Religious Corporation*, your Articles or Bylaws may restrict or abolish the right of a member to inspect or copy any record referred to above.

If you are a *Public Benefit Corporation* organized primarily for political or social action (such as political or social advocacy, education, litigation or a combination of these purposes), your *Articles* may limit or abolish the right of your members (and their agent or attorney) to obtain information as to the identity of contributors to the corporation and to inspect or copy the membership list. *Notice that this must be in your Articles; a provision in your Bylaws is not sufficient.* If you limit access to the membership list, you must provide a reasonable means to mail communications to the members through the corporation at the expense of the member making the request.

RESIGNATION AND TERMINATION OF MEMBERS

Resignation

Your members may resign at any time. Resignation does not relieve the member from any obligations the member may have to the corporation that were incurred prior to the resignation.

Expulsion, Suspension, or Termination

Many membership corporations operate as democracy at its rawest and it is not uncommon for corporations to attract a wide variety of personalities among its members. Some of these members may be disruptive or dishonest or engage in conduct that the corporation believes is harmful to it or the corporation may have other reasons for wanting to expel, suspend, or terminate a member.

You may expel, suspend, or terminate your members for any reason unless your Bylaws (or Articles) provide differently. It is generally a good idea to permit your corporation to expel members for any reason rather than to try to list reasons for termination. If you try to list reasons, you will almost always miss something and then may find your corporation stuck with a member who causes serious problems. If you are concerned that the organization treat its members fairly, you may want to try to ensure this by requiring more than a majority vote in order to terminate a member rather than requiring that good cause be shown in order to expel a member.

> *Example*: Parents Preschool Helpers, a membership corporation, has Bylaws that require each parent to work at least 5 hours a month with the children at the community preschool. Its Bylaws also provide that members shall not be expelled unless the member "engages in conduct harmful to the preschool." The preschool has just learned that one of the member/parents was convicted of child abuse fifteen years age. The member has not currently engaged in conduct harmful to the preschool. The Helpers may have difficulty expelling this member under its current Bylaws.

However, Public Benefit and Mutual Benefit Corporations may not expel or suspend members or terminate or suspend memberships in the corporation unless this is done through a *procedure* which is fair and reasonable and is carried out in good faith. Your procedure is considered fair and reasonable when it provides at least 15 days' prior written notice of the expulsion, suspension or

termination and the reasons for the action. You must also offer an opportunity for the member to be heard, orally or in writing, at least five days before the effective date of the expulsion, suspension or termination by a person authorized to decide that the action not take place. A procedure may also pass muster if it is fair and reasonable, taking into consideration all of the relevant facts and circumstances. Notice that these provisions require a certain procedure but do not require that you have *cause* to suspend, expel, or terminate members.

Any written notice given by mail must be given by first class or certified mail sent to the last address of the member shown on the corporation's records. If a member wants to challenge an expulsion, suspension or termination, or claims that defective notice was given, that member must file a proceeding within one year after the effective date of the action.

A member who has been expelled or suspended, or whose membership has been suspended or terminated, may be liable to your corporation for dues, assessments or fees incurred prior to the expulsion, suspension, or termination.

Consult Appendix 1 if you would like information about source material related to this Chapter.

15 EMPLOYEES

Many nonprofit organizations have employees and are faced with the challenges of employee/employer relationships. To function well as an employer, you need to be educated about the various employment-related laws pertaining to compensation and to discrimination. Employees of nonprofit corporations have the right to form employee associations or to affiliate with unions and the right to bargain collectively with their employer. Your nonprofit must know your responsibilities and potential liabilities as an employer if your employees make efforts to organize and to bargain collectively. In addition to being familiar with the laws that affect employers, you should develop and adhere to good personnel practices. Being fair, consistent and clear about how you deal with your employees is key to good employee relations. Your Board needs special policies to evaluate your Executive Director.

The subject of employment law is too complex to be covered adequately in one chapter. As a result this chapter informs you about the special issues faced by nonprofits as employers and directs you to other resources for Oregon employers. This chapter also assists you in developing personnel policies.

THIS CHAPTER COVERS

- **Wage and Hour Laws**
- **Excess Compensation**
- **Discrimination Issues**
- **Unionization**
- **Personnel Policies and Employee Handbooks**
- **Evaluating the Executive Director**

You may also want to consult Chapter 24, which covers how to handle payroll issues for employees.

In almost all situations, nonprofit organizations are governed by the same employment laws and regulations as profit businesses. Nonprofit employers should not hesitate to call the Bureau of Labor and Industries (BOLI) with questions or for employment related information. The BOLI Technical Assistance for Employers telephone is 503.731.4200. Oregon is fortunate to have a state agency such as BOLI which offers useful workshops and publications for employers. The Board and staff of all nonprofits should make a concerted effort to be well informed about employment laws.

WAGE AND HOUR LAWS

Who Is Subject to the Laws

Both the federal government and the state of Oregon have laws that set some standards for how employers must treat employees with respect to wages, hours and working conditions. The U.S. Department of Labor, Wage and Hour Division (DOL) is responsible for enforcement of *federal* wage and hour laws. In Oregon, the Bureau of Labor and Industries is responsible for enforcement of *state* wage and hour laws. Virtually all nonprofits with employees are covered by state law and many are covered by federal law. While the minimum wage amount and certain requirements regarding working conditions (like mandatory breaks) vary between the state and federal rules, there are many regulations imposed by both.

Federal Law Coverage

The federal law applies to all organizations that fall in one of these categories:

- the organization has employees engaged in commerce and has a gross volume of sales or business equal to or greater than $500,000 per year, or

- the organization is a hospital, a nursing home, a residential institution for the aged or mentally ill, or a school.

Smaller nonprofits with receipts of less than $500,000 are not covered by the federal law. Some nonprofits with receipts over that amount may also fall outside the coverage because you are not engaged in commerce or because your receipts, if they are contributions, may not be categorized as coming from a "business." You will need to get legal advice to make the determination about whether you are covered by the federal law if you have receipts greater than $500,000.

State Law Coverage

Oregon wage and hour law covers every employer with at least one employee. If you have only volunteers, you are probably not covered by Oregon's wage and hour laws but you should review the discussion on pages 339-340 to be sure that your volunteers really are volunteers and not employees.

Exempt and Nonexempt Employees

Both Oregon and federal law use a classification scheme that divides employees into exempt and nonexempt categories. To understand how wage and hour laws apply to your organization, you must first determine which employees will be considered "exempt" from the law and which are "nonexempt." All employees are classified as exempt or nonexempt.

To understand how wage and hour laws apply to your organization, you must first determine which employees will be considered "exempt" from the law and which are "nonexempt."

Exempt employees generally are in executive, administrative, professional or certain high-level technology positions and regularly exercise independent judgement and discretion. These employees are paid on a salary basis and are not subject to minimum wage and overtime requirements.

Nonexempt employees are subject to minimum wage and overtime requirements. Nonexempt employees generally are paid on an hourly basis. Whether they are paid on an hourly basis or whether compensation is described as a weekly or monthly salary, nonexempt employees must be paid time and one-half for all hours worked in excess of 40 hours per work week.

In general, all positions are nonexempt except those that meet specific exemption requirements. The main exemptions are for administrative, executives, professional and computer positions (sometimes referred to as "white collar" exemptions). Both the state and federal agencies have publications defining each type of exemption. Job title has little bearing on the determination of exemption; rather, the key factors generally are:

- the nature of the duties performed; and how often the employee performs these duties in an average work week;

- whether the employee regularly exercises independent discretion and judgement;

- whether the employee regularly supervises other employees; and

- whether the employee is paid on a salary basis and the amount of that salary.

Overtime and Volunteer Time

Wage and hour laws restrict the right of *nonexempt* employees to work in a volunteer capacity for their employer. The laws were written with profit employers in mind and lawmakers feared that employers could pressure employees to work some hours without pay. Unfortunately, the same laws apply to nonprofits. You will need professional help to figure out if these laws apply to you in your specific situation.

Both state and federal rules require that any *nonexempt* employee permitted to work more than forty hours in a seven-day work week must be compensated for all hours worked in excess of forty at time-and-a-half the employee's regular pay rate. Personnel policies stating "we do not pay overtime" do not excuse an employer from this obligation. Even when the employee chooses to work the extra hours and states that she or he does not want overtime (or any payment), the employer is bound to pay at the time-and-a-half-rate. Consequently, the only way an employer can avoid overtime pay for nonexempt employees is through controlling the hours they are permitted to work and limiting the work time to forty hours within a work week.

Even when the employee chooses to work the extra hours and states that she or he does not want overtime (or any payment), the employer is bound to pay at the time-and-a-half-rate.

Because employees of nonprofits often are deeply committed to the cause the organization is addressing, many nonprofits have difficulty limiting the hours worked by nonexempt employees. It is important to understand that even extra hours worked voluntarily can result in wage or overtime claims.

What can an employer do to prevent nonexempt employees from working extra or volunteer hours? First, the employer should provide the employee with a written statement regarding the number of hours to be worked and the procedure required to obtain authorization for overtime. Next, supervisors should counsel or discipline employees who work beyond their authorized hours. *All hours worked must be paid even if the employee has been directed not to work the hours.* Ultimately, and unfortunately, the employer's control over the hours worked by employees rests in the employer's ability to terminate any employee who con-

tinues to work beyond the established work hours. This approach may be distasteful but the consequences of permitting extra work hours are quite serious, including liability for unpaid overtime for up to three years, penalties, and attorney fees.

Employers may choose to pay *exempt* employees time-and-a-half for hours over forty per week or to pay *part-time* employees time-and-a-half for hours worked beyond their normal work week (as long as it's less than forty hours per week), but this is not required by law.

"Comp" Time

"Comp" (short for compensatory) time systems are set up to allow employees who are required to work hours beyond their normal work week to take time off with pay at some future time. It is important to understand however, that comp time is not permitted for private sector employees, including nonprofits, in Oregon.

The *only* permissible type of comp time system for *nonexempt employees* is one which requires the employee to use up the comp hours *within the same work week* they are acquired. For example, if nonexempt employee Mary worked ten hours on Monday instead of her normal eight, she may be allowed to work two hours less than normal at some point within the *same* work week. If her hours are not reduced within the remaining work week, she must be paid time-and-a-half for the hours worked beyond forty.

The only permissible comp time system for nonexempt employees is one which requires the employee to use up the comp hours within the same work week they are acquired.

Most employment law specialists discourage using any form of comp time for *exempt employees* as well. The recording and exchanging of extra hours worked for extra paid time off endanger an exempt employee's exempt status, thus triggering overtime and other requirements for nonexempt employees. Instead, employment law advisors encourage employers to reach an understanding with exempt employees that their jobs require them to fulfill the responsibilities assigned to their position and that their compensation is based on satisfactory fulfillment of their responsibilities, not on hours worked. Under this approach, a supervisor may encourage an exempt employee to take an afternoon off (without reduction in pay) after a period of peak effort. However, an employer is not advised to keep records of "extra" hours and employers should not create any expectation of an hour off for an extra hour worked.

If your organization uses a formal approach to comp time for exempt employees, you should discuss it with an employment law attorney to determine whether your nonprofit may be exposed to substantial risks under applicable wage and hours laws.

Attendance at Training, Conference and Staff Meetings

Both state and federal rules require that nonexempt employees be paid for all hours worked. Consequently, any activity that the employer *requires* the employee to attend must be considered part of the employee's hours of work. Staff meetings, training events, Board meetings and conferences are part of the employee's hours of work if the employee is required either explicitly or implicitly to attend. Stating that attendance at staff meetings or training events is voluntary does not prevent such activities from being hours of work if the employer attaches explicit or implicit negative consequences to failure to attend or attaches explicit or implicit positive consequences to attendance.

Out of town conferences pose special problems. You must pay employees for travel that is a principal part of that employee's work duties. For example, you must pay your employees for the time it takes to travel to a one day assignment in another city more than 30 miles from your employee's fixed work station, regardless of the day of the week. In addition, you must compensate your employees for any work that is required to be performed while traveling, even if such work occurs outside the employee's normal work day. If the out of town conference will keep the employee away overnight, then you must pay the employee for all time spent driving (if the employee drives) or for all travel time that occurs during business hours (if the employee is a passenger).

If the investigation also reveals other employees with similar amounts owing, they must be paid as well even though they have not filed claims.

Employers concerned with controlling wage and overtime costs develop systems and policies to clarify which meetings or other events are required and for which staff, and which employees will have authority to require attendance.

Enforcement of Wage and Hour Laws – the Real Whammy

Employees who believe they have not received the wages or other compensation they are owed may file complaints with BOLI or DOL or the employee can file a private lawsuit. An agency or a court can compel the employer to pay any unpaid back wages, additional penalties and, in some cases, the attorney fees incurred by the employee in recovering unpaid compensation.

If an agency investigation reveals that other employees also are owed unpaid compensations, the agency may require the employer to repay those employees as well, even though they have not filed claims. Consequently, the stakes can be quite high for employers failing to follow wage and hour rules.

Employers also should remember that there are Oregon laws regulating payroll deductions and final paychecks. A violation of these laws also can result in money damages, civil penalties and attorney fees against the employer.

EXCESS COMPENSATION

If you are exempt from taxation under §501(c)(3) as a public charity or under §501(c)(4), you are subject to IRS regulations aimed at ensuring that you do not pay too much to certain of your high-level employees. This includes employees like your Executive Director, your chief financial officer, your chief operating officer, and others. The IRS will assume that you are paying too much unless you follow certain steps *before* you agree to a compensation package. This is an area of great concern to the IRS. We urge you to read pages 634-640.

DISCRIMINATION ISSUES

Nonprofit employees are governed by a variety of state and federal laws designed to prevent discrimination in employment. These complex laws and regulations lie outside the scope of this book. However, every nonprofit employer should become familiar with at least basic employment discrimination laws. Not only is employment discrimination morally unacceptable, violation of civil rights laws and regulations can result in costly litigation and penalties. Classes protected by federal or state law include race, national origin, religion, gender, age, marital status and disability. Some cities include protection based on sexual orientation and source of income. In addition, the law protects employees in a variety of other circumstances--such as those who testify at Employment Division hearings, file lawsuits and donate bone marrow. The Oregon Bureau of Labor and Industries provides a more complete list of protected classes on its website and is a good resource for employers.

UNIONIZATION

Workers in nonprofit organizations are increasingly turning to unions to represent them in bargaining with their employers. Like discrimination law, labor law is complicated and outside the scope of this book. We do discuss

what you as an employer can say and do about a union so that you can avoid mistakes before you have the chance to consult your attorney.

Employees can organize a union in one of three ways. The most common route is through a certification election conducted by the National Labor Relations Board. A second route is by the employer's voluntary recognition of a union without an election. You should be aware that you may be violating the law by entering into an agreement to recognize a union that does not have the support of the majority of the workers in the bargaining unit, so get legal advice even if you are agreeable to accepting a union. In rare cases, the government may order a union. This only occurs if the employer engages in serious illegal behavior.

If any of your workers have begun a campaign to unionize, you need to educate your supervisors about what they can and cannot do. Generally, your supervisors can oppose unionization openly, can tell your employees that you oppose the union, can tell your employees that the law allows them to vote against unionization, can explain your benefits to your employees and compare them to benefits in unionized companies, and can campaign against the union. However, you and your supervisors cannot make threatening statements (for example, if the union wins your nonprofit will cut back on positions), ask questions about the unionization campaign, make promises to generate opposition to the union or engage in spying or creating the impression of surveillance of union activities.

As soon as you become aware of a union campaign, you should consult a labor attorney. Various laws regulate what you can and cannot do and carry penalties that apply even if you violate a law without knowledge of it.

PERSONNEL POLICIES AND EMPLOYEE HANDBOOKS

Most people associated with nonprofit corporations (whether Directors or staff) share a strong commitment to working together to provide needed community services. It is sometimes uncomfortable for both staff and Directors to acknowledge that an employee/employer relationship exists between staff and the nonprofit corporation. This is particularly true in small or new organizations where both Board and staff may perceive the work as service to a cause rather than as traditional employment. Nonetheless, the nonprofit must make decisions about how it treats its employees. If those decisions are made based on a consistent set of guidelines or rules rather than on a case-by-case basis, these rules are commonly called personnel policies. Many organizations

print their personnel policies in a booklet form often called an employee handbook that they distribute to some or all employees.

The law does not specifically require that you have personnel policies or an employee handbook, and with few exceptions, most of the personnel policies or provisions in employee handbooks discussed below are optional. Yet, Directors are charged by law with the duty of responsible administration of the corporation, including assuring that the corporation obeys all laws governing employees. Employees of nonprofit corporations need the same clarity with respect to their relationship with the nonprofit organization as they would in any other employment situation.

A clear and explicit employee handbook helps to reduce intra-organizational conflicts.

There are many reasons to consider adopting at least a basic employee handbook.

1. A clear and explicit employee handbook helps to reduce intra-organizational conflicts and reduce the amount of staff time and effort spent discussing such conflicts.

2. An employee handbook may facilitate preserving good working relationships among staff members because the handbook often sets forth mutual and reciprocal responsibilities for staff members. Most people function better if they know what is expected from them and what is expected from others.

3. An employee handbook often protects the nonprofit because it can help reduce misunderstandings and bad feelings between the organization and staff members. Solving conflicts within the nonprofit may reduce complaints to outside agencies that generally are made by employees who feel they were treated unfairly.

The development of an employee handbook can be a useful process for both the Board and staff because the process often assists in the goal of striking a balance between the needs and desires of employees and the responsibilities and capabilities of the nonprofit organization and results in protecting the interests of both the employee and the corporation.

Developing an Employee Handbook

There can be significant variations in the procedures Boards of Directors use to prepare, adopt, and administer an employee handbook or personnel policies. The Board may direct its Personnel Committee to draft an employee handbook or personnel policies for approval by the full Board. Or the Board may hire a professional consultant to draft a handbook for Board approval. The Board also may direct the executive director or other staff to prepare draft a handbook or personnel policies or direct the Personnel Committee to work with the executive director and other staff to prepare the first draft of policies.

Whichever method is selected, the Board of Directors retains the responsibility for approving the final version of the employee handbook or personnel policies and assuring that they are administered fairly. Directors should realize that adopting personnel policies which contain provisions which cannot or will not be followed (such as granting four weeks paid vacation when funds will not be available to cover this benefit) can lead to serious difficulties.

The Board of Directors retains the responsibility for approving the final version of the employee handbook or personnel policies and assuring that they are administered fairly.

Your Approach to an Employee Handbook

Before an employer begins to make decisions about specific policies, the employer needs to make some basic decisions about three key issues. One issue is whether you want to be legally bound by your personnel policies. *In Oregon, the courts treat your personnel policies as a contract between you and your employees, unless you clearly state that this is not the case.* If the policies are a contract, then an employee who feels that you have violated a policy can sue you for damages or to enforce the policy. If your policies make it clear that they are not a contract and that your internal decisions about the policies are final, then your employees generally cannot successfully sue you for a violation of the policies. Offering your employees an employee handbook rather than personnel policies may help employees understand that you are not entering into a contract with them. A disclaimer that your handbook is not a contract does not, however, limit the responsibility of your corporation to comply with employment related state and federal laws (e.g., discrimination, wage and hour requirements, treatment of injured workers and employment benefits).

The second issue you must decide is *whether you want to retain the right to fire your employees without having to prove a reason for the termination.* This is called *employment at will*, and, from the employer's perspective, represents the flip

side of the fact that your employees can typically quit without having a reason. Although retaining the right to terminate an employee at will is a harsh result for the employee, many employers prefer this because it gives them greater flexibility to manage their personnel and to reduce the chances of losing a costly lawsuit for wrongful termination. On the other hand, employment at will can create some unhappiness among your employees and may not be consistent with your organization's goals about how you want to treat employees. It is important to remember however, that even if you adopt an at-will policy, most at-will employers do not terminate an employee without a reason because of the fact that such decisions are more likely to be challenged legally.

The third area you need to consider is what kinds of other specific commitments you plan to make in your personnel policies. Virtually all policies make specific commitments about benefits, such as vacation time, sick leave, etc. However, there are numerous other items about which you need to decide whether you want to bind yourself to specific commitments or whether you want to be more flexible. For example, you may want to promise your employees that you will promote from within or you may want to maintain flexibility by stating that you look first at employees within your nonprofit but maintain the right to promote as you choose. The thread running through all of these issues is the extent to which you make legal commitments to your employees versus the flexibility you keep to make decisions as the employer.

The thread running through all of these issues is the extent to which you make legal commitments to your employees versus the flexibility you keep to make decisions as the employer.

As you fashion your approach to your relationship with your employees, you might consider three models:

> **Employer Flexibility Model**. In the first model, you retain maximum flexibility and make no commitments other than to specific benefits. In this model, you do not refer to personnel policies, because the word policies suggests a commitment. Instead, you have an "Employee Handbook." The handbook makes clear that it is not a contract with the employees and that the employer's decisions about all personnel matters are final. The handbook also makes clear that employment is at-will. Because the employer can fire employees at any time, for any reason, the handbook does not include specific statements about actions that might lead to termination, because to do so implies that other actions would not lead to termination. The handbook avoids the use of "probationary employees" and "permanent employees," because these categories suggest that permanent employees have more job se-

curity. The handbook also does not provide for progressive discipline and a grievance procedure, since these tools suggest that immediate termination is not an option.

Employee Protective Model. The second model is a contract that is very protective of the employees. In this model, the personnel policies are called "Personnel Policies." They are a contract with the employees, providing employees with a firmer base to file a lawsuit for a violation of policy. These policies make specific commitments about a variety of personnel issues. They protect the employees by limiting the circumstances under which an employee can be disciplined or terminated and provide for progressive discipline. These policies also provide a grievance procedure for employees who are unhappy with a personnel action.

Because employment law is complex, and lawsuits arising from employment relationships are potentially costly, your nonprofit should strongly consider having its employment policies reviewed by an attorney with specialized knowledge in employment law.

Mixed Models. A variety of "mixes" of the above two models are possible. Some employers want to be protective of their employees and will draft policies similar to the second model but provide that the employees must handle all complaints through the employer's grievance procedure and that the decision of the grievance committee is final. Other employers will produce a Handbook that retains at-will employment but provide for progressive discipline and a grievance procedure that is "generally" used, retaining discretion to vary from the procedure in specific cases. Some employers may provide carefully worked "guidelines" to avoid actual commitments. Any set of policies that tries to "mix" the first and second models must be carefully drafted because creating such "mixes" typically is more complicated.

Regardless of the approach you take, you should consider consulting with an employment lawyer. Drafting clear personnel policies or an employee handbook that reflect your intentions requires legal input.

You can reduce your organization's legal expenses by considering the following issues before consulting with an attorney. Decide what approach you want to take among those described above and consider what specific policies will be appropriate for your organization.

What to Include in Your Employee Handbook or Personnel Policies

The list that follows is intended to raise questions, provide information, and encourage you to select the policies and approaches most compatible with the financial resources and philosophy of your group.

The Philosophy and Purpose of your Program

This section serves as an introduction to your employee handbook or personnel policies. A short statement of the philosophy and purpose of your organization establishes a context for the document. Being explicit about your mission and values establishes your general expectations in terms of attitude and approach to clients and the community.

Space considerations prevent this Chapter from including a detailed discussion on all policies that employers may want to consider when drafting and implementing personnel policies or an employee handbook. However, the following is a list of policies an employer should consider as topics for personnel policies:

- Nondiscrimination policies
- Personnel and medical records
- Hiring policies
- Job descriptions
- Conditions of employment
- Job reclassification
- Employee evaluation
- Disciplinary action
- Amendments to policies

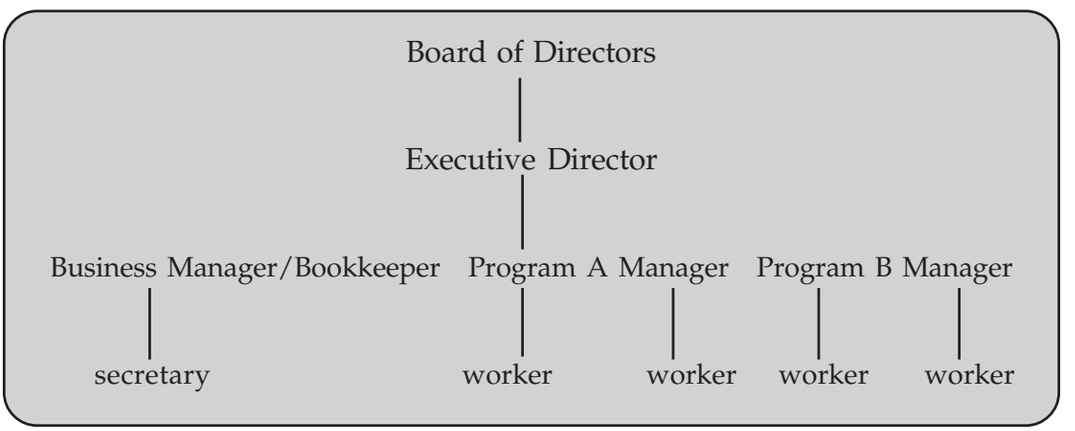
This list is only an example of possible topics. Employers may want to consider consulting with a human resources specialist or employment lawyer for consideration of additional topics.

Noncontractual Nature of the Employee Handbook or Personnel Policies

If you want language making it clear that your handbook or personnel policies is not to be construed as making a contract with your employees, that should be included here in capital letters or bold type so that the language is not easily overlooked. If you choose to deny that your handbook or policies is a contract, be sure that other language in the document does not contradict this. For example, statements like "the employer *shall* provide the following grievance procedure," suggest a contractual commitment.

Organization Chart

It's a good idea to include a chart illustrating the lines of authority within the organization. A typical chart is shown here. The one in your personnel policies should reflect the way things really are managed in your organization, not some idealized version.



Nondiscrimination Policies

Many groups want to make a statement indicating that the organization does not discriminate based on various factors that are then listed. Some organizations include a statement to the effect that the organization is committed to affirmative action. This is one area in which the approach you decided on for your policies is important. If you state that you hire based on qualifications, this is a type of commitment. A current employee who is trying to move into that job may have grounds to sue if she or he believes you did not hire based on qualifications.

An additional commitment is made by a statement that your organization does not discriminate. Federal, state and local laws protect certain groups from discrimination and provide legal remedies against employers who do discriminate. Those remedies generally require action by the employee within a year or two of the discriminatory act. However, if your policies promise that you don't discriminate and your policies are treated as a contract, this can extend to six years the time that your employee has to sue. In addition, the contract can be interpreted to include protections the law does not give other employees with a discrimination claim. Employers who want to avoid this result but who do want to include a nondiscrimination clause may choose to draft a clause that states that the employer obeys the laws against discrimination. If you take this approach you may want to commit to prohibiting some types of discrimination

that are not covered by law — for example, you may want to add a provision that you will not discriminate based on sexual orientation.

Policies that refer to affirmative action need to be carefully reviewed in light of current court cases that suggest that affirmative action is illegal in some circumstances. One option here would be to draft the policy to state that the employer is committed to affirmative action to the maximum extent permitted by law if you have decided you do want to make a commitment on this issue.

Sexual Harassment and Other Forms of Harassment

Most nonprofit employers are committed to maintaining a workplace environment that is free from harassment. Your employee handbook can assist in this effort by spelling out what is acceptable and unacceptable conduct. Court cases have underlined the importance of having a sexual harassment policy and other anti-harassment policies in place.

Your harassment policy should describe harassment in terms that your employees can understand and that correspond with the legal definitions. The policy should also clearly outline a procedure that the employee can follow to complain about harassment. The procedure should provide some alternative for the employee if the person the employee would normally complain to is the alleged harasser. The policy should state that complaints will be investigated and that, if harassment is found, you will take prompt corrective action. In addition, the policy should clearly prohibit retaliation against employees who make harassment complaints in good faith.

Court cases have underlined the importance of having a sexual harassment policy and other anti-harassment policies in place.

Personnel and Medical Records for Each Employee

A personnel record should be maintained for each employee. The record should contain:

- A completed application (including address, phone and education)
- Letter of agreement for employment
- Date of employment
- Form W-4 and I-9 (proof of citizenship or permission to work)
- Payroll records
- Any evaluations
- Record of accrued vacation and sick leave

- Job description
- Record of any training certificates required for employment

The personnel policies should state who (what position) maintains the personnel records. The personnel records of the employee must be made available to the employee, who must be given a copy if it is requested. The personnel policies should include a statement as to whether the records are open to anyone else.

The personnel records of the employee must be made available to the employee, who must be given a copy if it is requested.

You should keep any medical records concerning your employees separate from the employees' personnel files. It is important that your system maintain confidentiality of the medical records.

Hiring Policies

The Application

- How does a potential employee submit an application?
- What form is used?
- Must a formal application be submitted?

Recruitment

Clear provisions should be made for the recruitment and selection of personnel. This should be consistent with the organization's affirmative action policy. See the discussion on page 349 about the legality of affirmative action policies.

- How will potential employees be recruited?
- Is an Affirmative Action Plan in effect?
- Will an effort be made to fill vacancies by promotion of employees within the organization?

Again, this provision needs to reflect your decision about whether you are making commitments in connection with recruiting or are merely establishing some flexible guidelines.

Job Posting

You need to decide whether the job is posted first to your employees before it is announced to the public.

Hiring Process

- How will applicants be screened, interviewed and hired?
- Who makes the hiring decisions?
- How are potential employees notified of employment?
- Of non-employment?

Letter of Hire

Each new employee should receive a letter of hire stating:

- the title of the position
- the compensation
- the beginning date of employment
- the ending date of employment, if known
- the number of hours to be worked per week
- the work schedule or who will determine it
- the name and title of the new employee's supervisor
- orientation procedures the employee will be required to complete.

(See Appendices 14 and 15 for Sample Letters of Employment.) Letters of hire can be interpreted as employment contracts if not written carefully. You should consider obtaining legal assistance when drafting these letters.

Other Policies to Be Included Here:

- Is there anyone ineligible for employment with the organization? (Members of the family of the Directors? Of clients? Members of the family of staff members?) Be careful if you plan to limit the employment of family members. In Oregon, it is illegal to refuse to hire someone solely because another member of that person's family works for or has worked for your nonprofit. There are exceptions to this law, including an exception for those cases in which you lose eligibility for government benefits if you employ family members and for those situations in which the hire would place one employee in a supervisory position over a family member. You should get legal advice if you need further information.

- Will the organization pay for the expenses of potential employees who interview? Applicants for which jobs can receive these payments?

- Will the nonprofit pay for moving expenses for employees? For which employees?

Job Descriptions

- Job descriptions should be as complete as possible and should accurately reflect position duties and responsibilities (and be realistic for the salary provided and the organization's budget.)
- Job descriptions should include:
  - Job title
  - Qualifications
  - Description of general responsibilities
  - Description of specific duties, divided into essential and non-essential duties or functions
  - Position responsible for supervision of this position
  - Number of hours required per week
  - Salary
- Each employee should receive a copy of the job description.

Conditions of Employment

Attendance

- How are attendance records kept?

- How does an employee call in sick or late?

- If substitutes are required, state clearly the process for obtaining a substitute. Who calls the substitute?

The Work Day

- Define the minimum work day for each job classification (How many hours per day? How many days per week? When is "starting time" and "quitting time"?)

- Specify when and how lunch breaks and rest breaks are to be taken. Oregon law requires that employees working shifts of six hours or more be given a lunch break of at least one-half hour of uninterrupted time. If that period is completely uninterrupted, you do not have to pay for it. Also, for each period of two to four hours worked, employees must be given a ten minute paid break during which they are completely relieved of all duty. The rules are slightly different for minors.

- Specify when and if staff meetings will be held. Who is required to attend?

- Describe the procedure to get authorization for overtime.

- Inform employees if you will be expecting them to work long hours or to be available outside normal work hours.

Standards of Personal Behavior

- List any standards that you require such as dress codes.

- Include here who can make statements as an official spokesperson of the organization.

Drug and Alcohol Use

Many employers are developing drug and alcohol policies. These policies are useful to avoid and defend against negligent hiring and retention claims. You are certainly permitted to prohibit illegal drug use on the job. In dealing with prescription drugs, your policy will need to accommodate employees who need these drugs. If you want to conduct drug searches or drug tests, your policies should be drafted by a knowledgeable attorney.

If your drug or alcohol policy refers to "under the influence," you should define that term. Otherwise, you may be challenged by employees who claim that some drug or alcohol use does not constitute "under the influence." One option would be to define "under the influence" as "any detectable level."

Be aware that many contracts for government funding will require that your policies meet the requirements of the federal Drug Free Workplace Act. If you accept funding that requires compliance, be sure your employee handbook or personnel policies contain all required provisions.

Smoking

This is an area where employers can be caught in the middle. Employees who are offended by smoke are bringing lawsuits to require smoke-free environments. Some employees who are sensitive to smoke may be protected under federal and state disability laws. In Oregon, state statutes prohibit smoking in public places, which is any area open to and frequented by the public.

On the other hand, smokers have some legal protections. Oregon law prohibits an employer from requiring that employees refrain from smoking in non-working hours unless the restriction relates to a genuine occupational requirement.

If you choose to have a smoking policy, your policy should clearly communicate your expectations and should avoid the legal problems described above.

Confidentiality

If your organization does work in which confidentiality is important, you should indicate this to your employees and explicitly describe your policy regarding confidentiality. If your approach is to require cause for discipline and termination, you should state the consequences of violating this policy.

Outside Employment

You should make a clear policy on whether an employee can have outside employment.

- Must the employee inform your organization of outside employment?
- Can outside employment be restricted if it appears to be detrimental to or in conflict with your policies?

Controversial Activities

- Is there any restriction on employees' participation in any type of political activity or political campaign?

Conflict of Interest

- Can the corporation purchase or rent goods, space or services from employees, including the director?
- Can employees receive gifts, money or gratuities from persons receiving benefits from the program? From funding sources? From contractors?

Employment Categories

Exempt and Nonexempt Employees

You should specify who is an exempt or nonexempt employee. See page 338 for a discussion about these categories and their significance. You may want to indicate that exempt employees may find that additional hours of service are necessary and that it's the organization's expectation that exempt employees will work sufficient hours to accomplish the duties of the position and will not receive overtime pay. Be sure to define the impact of exempt or nonexempt employee status on the availability of specific benefits.

Trial Period

Your approach toward at-will employment will in part determine whether you have a trial period and what its meaning is. If you are an at-will employer, you can fire anyone, anytime, for any legal reason, so a trial period is meaningless for purposes of job security. Some at-will employers will have an introductory period for purposes of determining when employees become eligible for benefits.

Your approach toward at-will employment will in part determine whether you have a trial period and what its meaning is.

If you are not an at-will employer, then you will want to consider in more detail issues about a trial period. Here are some decisions you will need to make:

- Is there a trial period?
- How long is it for each job classification?
- Do employees who are transferred within the organization or promoted within the organization have a new trial period?
- How is termination to be handled within the trial period? (Many employers allow for termination during the trial period without cause. This avoids time consuming steps to document cause when it is clear the relationship just isn't working out. If your organization wants to be able to do this be sure the personnel policies say explicitly that "during the trial period an employee may be terminated without cause.")
- Who can terminate an employee during the trial period? How is notice of termination given in this case?
- Do vacation time, sick time and other benefits accrue during the trial period? Can they be used during the trial period?
- Are benefits given at all during the trial period?

Employee Classifications

Your approach toward termination will also govern how you handle the classification of employees. If you are an at-will employer, you may want to refer to your employees as "regular full-time," "regular part-time," "temporary full-time," and "temporary part-time" employees. The use of the word

"regular" rather than "permanent" avoids the implication that the job is somehow protected.

If your employees do have protection from termination without cause, then possible employment classifications might be permanent full-time, permanent part-time, temporary full-time employees, and temporary part-time. These classifications could be further defined by whether there was a predetermined terminal point of employment and how many hours per week will be worked.

Regardless of the approach you take, you should define clearly which benefits can be received with each classification at what rates.

Compensation

Salary Range

You will need to familiarize yourself with the minimum wage laws to be sure your salaries comply with them. You may also want to consult compensation studies that report wages and benefits paid by other nonprofits or businesses with similar positions. If you are exempt under §501(c)(3), you should also consult the IRS rules on excess benefit transactions discussed on pages 634-640. Some issues to consider as you develop your policies about salaries include:

- How will salary ranges be determined?
- Are they to be comparable to similar positions in other nonprofits?
- Are they determined primarily by budgetary considerations?
- Explain how employees will be notified of the salary range currently in effect.

Salary Increases

- What are the criteria for raises?
- How does this fit with availability of funds?
- Are salary raises automatic or earned?
- If salary raises are automatic, are merit increases in salary available?

Payroll Procedures

- Describe the basis (hours, days, weeks, months) on which payroll is calculated.

- How often do employees get paid? (Employees must be paid at least every 35 days, unless you have a written agreement with your employee before work begins to pay in a different manner.)
- What if payday is on a weekend or a holiday?
- Can employees take a draw on their salary?
- What is the procedure for draws?
- Who will maintain the time sheets?
- Who will sign and approve them?
- Inform your employees that IRS Form W-4 and U.S. Department of Justice I-9 will be filed by the employee on the first day of employment. Your manual may also inform your employees that on or before January 3lst of each year, each employee will receive a statement showing total earnings and the amount of tax, by type, withheld.
- List all the deductions which will be made from the employee's salary. Which are voluntary? Which are involuntary? (Health care and insurance benefits may require voluntary deductions, for example.)

Benefits

Paid Holidays

The employee handbook or personnel policies should list the regular paid holidays such as Christmas, New Year's Day, Memorial Day, July 4th, Labor Day, and Thanksgiving, as well as any other paid holidays specific to the organization, such as Washington's Birthday, Martin Luther King's Birthday, or President's Day. A policy for days such as the Friday after Thanksgiving or Christmas Eve can be included.

If an employee is on vacation during a paid holiday, it is usually added to the accrued vacation days. Your policy should explain your position on this.

Vacation

You are not required to provide any vacation time for your employees. Most employers recognize that they need to provide this to keep employees for any length of time. If you do elect to provide vacation time and especially if you elect to pay out accrued but unused vacation time on termination, your employee may be able to enforce her or his right to this under the wage and hours laws. Your employee handbook should clarify these issues:

- Do employees receive vacation time? Paid or unpaid?
- How does it accrue for each employment classification?

- Is there a minimum period of employment before vacation can be taken?
- Is there a limit on the amount per year?
- How is it to be scheduled? Is advance notice required? Usually vacation time is taken at a time which is mutually agreeable to all the parties concerned so as not to disrupt the efficient operations of the organization.
- Who approves vacation leaves? In writing?
- Is there any limitation on the amount of vacation time which may be accrued? "Use it or lose it" policies force the employee to take the accrued vacation time within a specified time period or lose the benefit. Some organizations offer to cash out unused vacation time once a maximum amount is accrued.
- Will you pay out any accrued but unused vacation time upon termination of employment?

Sick Leave

There is no legal requirement that you provide any sick leave, other than the unpaid leave required for employees with long-term or serious health conditions under the disability acts (see page 361) and unpaid family leave (below) required under federal and state family leave acts. If you do want to provide for short-term sick leave in addition to that required under those laws, you might consider the following issues:

- Do employees receive sick leave? Paid or unpaid?
- How does sick leave accrue for each job classification?
- Is there a limit per month? Per year?
- Can accumulated sick leave be added to vacation leave?
- Will employees be paid for sick days accrued but not taken by end of year?
- You should define what is considered sick leave (apart from employee illness). Illness in the immediate family? Who is the immediate family? Exposure to contagious disease? Do mental health days to relieve stress qualify for sick leave?

Family Leave

State and federal law contain some requirements about family leave. Not all employers are required to follow these statutes.

Oregon Law

Under Oregon law, you must provide family leave if you have 25 or more employees for 20 or more weeks in the year in which the leave is taken or in the preceding year. Your employee has to have worked at least 180 days to be eligible. For most types of leave, the employee also has to have worked at least 25 hours per week to be eligible.

You must give family leave for an eligible employee to care for an infant or newly adopted child or newly placed foster child, to care for a family member with a serious health condition, to care for the employee's own serious health condition that keeps that employee from performing at least one essential function of the job, and to care for the employee's child who does not have a serious health condition but requires home care. "Family member" includes parents, children, spouses, same-sex domestic partners and parents-in-law.

Generally, you must give your eligible employee at least 12 weeks of leave every year in the circumstances listed above, with an additional 12 weeks for women who cannot perform their regular duties because of an illness, injury or medical condition related to pregnancy or childbirth. Employees may be eligible for more leave under some circumstances. You do not have to pay for the leave. However, your employees are entitled to use any accrued paid vacation and may be entitled to use paid sick leave if it is consistent with your sick leave policy. Employees who are taking leave to care for a newborn or newly adopted child are also entitled to use any accrued leave, including sick leave. When an employee's leave is over, you must reinstate that employee to his or her former position, even if it is currently filled. If the position was eliminated, you must return the employee to an available, equivalent position.

Federal Law

Under federal law, you must provide family leave if you have 50 or more employees for each working day during 20 or more calendar weeks in the current or preceding calendar year. You must give leave to any employee who has been employed at least 12 months and for at least 1,250 hours during the 12 months preceding the start of the leave.

Generally, you must give your eligible employees at least 12 weeks of leave every year in the circumstances similar to those covered by the Oregon statute, except that federal law does not require leave for a sick child who is home but not seriously ill. Federal law also does not provide leave for the serious illness of a same-sex domestic partner or parent-in-law. You do not have to pay for the leave. Federal family leave and Oregon family leave run concurrently when an employee is eligible under both laws.

The scope of coverage is generally similar to that provided by Oregon law, with a few exceptions. Employees covered by the federal law who are taking leave to care for seriously ill family members are entitled to use any paid accrued leave. Under the federal law, the employer must generally continue the employee's coverage under any group health care plan, a benefit Oregon law does not require. There are other minor differences between the two laws. Because the Oregon and federal leave laws can sometimes overlap in complicated ways, it is important that you understand what each law requires and consult an attorney when you have questions.

Worker Compensation

Employers are required by law to provide employees with Worker's Compensation insurance. You should take care that any policy you write concerning this does not promise your employee more than the law provides, unless that is your intention. Many employers also want to provide an explicit description of the return to work rules required under the worker compensation law, so that the injured employee and those dealing with her or him follow the correct procedure.

Jury Duty

You must permit your employee to leave work to serve jury duty. You are not required to pay for jury duty service, except for exempt employees. Even where not required by law, employees are often granted leaves with pay when they are required to report for jury duty. Will the employee be paid regular earnings less the per diem compensation received for jury duty? Must the employee present a jury summons before the leave is granted? Should the employee report to work during periods when excused from appearing for jury duty?

Military Leave

You must give leave for members of a Reserve Unit of the U.S. Armed Forces when they are required to report for duty and for other military service. You do not have to give the leave with pay. If you do grant the leave with pay, will the employee be paid full salary or full salary less the per diem compensation received for duty?

Disability Leave

Both state and federal laws require that an employer provide reasonable accommodation for employees with disabilities as long as that accommodation does not create an undue hardship for the employer. Such accommodation may include a leave of absence to receive treatment for disability. Because disability

laws require employers to deal with each request for accommodation on a case-by-case basis, you may want to keep any policies fairly general.

Other Common Optional Leaves

Many employers do want to clarify policies about other leaves. You need to decide which leaves will be granted with pay and which without pay. In deciding this, you will need to consider the effect on your budget and operations of having employees gone for extended periods of time.

You will also need to decide how long the employee must have been working to receive a leave, the length of the leave granted, and who has the final authority to grant leaves or to extend leaves. You should also coordinate this leave with your other leave policies.

Finally, you need to consider what arrangements you will make when the employee returns to work. Your policies should address whether any type of doctor's letter is required and whether you will guarantee the employee reinstatement.

Emergency Leave

In what situations will emergency leave be granted? Who will decide if it should be with pay or without pay? How many days will be granted? Death in the immediate family of an employee is usually considered an emergency. You should state clearly other such emergency situations where leaves could be granted with pay. Under unusual circumstances, can leave with pay be granted on an individual basis? By whom?

Bereavement Leave

Many employers provide for bereavement leave to cover bereavement situations not otherwise covered by family leave. If you do so, the questions detailed in the Emergency Leave section must be answered.

Educational Leave

Some employers grant educational leave for their employees, particularly if the education improves the employee's job skills. If you elect to provide this, your policy should clearly state the circumstances in which leave applies, who has the authority to approve the leave, whether the leave is with or without pay, and whether the employee has to present any documentation to substantiate the leave.

Miscellaneous Leaves

Can other types of leave with or without pay be approved? By whom? Under unusual circumstances, can leave with or without pay be granted on an individual basis? By whom?

Time Bank Concept

Many employers are moving away from the separate vacation and sick leave policies to a time bank concept. Under this approach, each employee accrues a defined number of paid leave hours for each pay period. The employee is free to use these paid leave hours for vacation, personal illness, illness of a family member or friend, mental health days, or whatever they choose. These policies must be carefully drafted to ensure that they comply with all of the mandatory leave rules.

Other Benefits

List all other benefits available to employees:

- Health Care and Dental Insurance
- Dependent Care Assistance Plans
- Tax Sheltered Annuity (a type of retirement plan)
- Other Retirement Plan (State whether or not you have a retirement plan; they are not mandatory, but if you have one, it must meet certain requirements.)

The handbook should state whether benefits are transferable when an employee transfers or is promoted within the organization.

Note: Fringe benefits and retirement benefits planning is an area of complex regulation. Some nonprofits now offer flexible benefit plans which permit employees to choose from an array of benefits such as health insurance, dependent health insurance, dependent care assistance plans, medical reimbursement plans, etc. In order to maintain the tax-free status of such a flexible fringe benefit approach, the organization must have a written §125 flexible benefits plan which meets IRS requirements. Tax-exempt groups may establish a special type of retirement plan known as a Tax Sheltered Annuity (403(b) plans) or they may offer certain types of retirement plans also available in for profit organizations. Professional assistance from an attorney, accountant or retirement and fringe benefits planner is essential. It is easy to make serious errors in this area. Many fringe benefits carriers provide excellent assistance for low fees or for free. Be sure that any plan documents have been reviewed by an attorney who

has expertise in the appropriate legal specialties. Penalties for failure to comply with fringe benefit and retirement plan regulations can be extremely costly.

Fringe benefits and retirement benefits planning is an area of complex regulation. Professional assistance from an attorney, accountant or retirement and fringe benefits planner is essential.

Reimbursements

- Which expenses can be reimbursed (telephone calls, parking fees, field trip expenses, conference and meeting fees)?
- Is advance approval necessary? By whom?
- How are reimbursements paid to employees?
- If travel expenses are reimbursable, what is the rate per mile?
- If a chauffeur's license (beyond the expense of an individual driver's license) or food handler's card is required in the line of duty, will this expense be reimbursed?
- For travel expenses, do mileage records need to be kept on specific forms?

Job Reclassification

Because of budgeting uncertainties, many nonprofits need the flexibility to reclassify jobs. If you are an at-will employer, you have this flexibility. If you are not, you will need to address the adjustments needed when you reclassify a job. If the reclassification results in an upgrade, what is the employee's new salary level? If the reclassification results in a lower salary grade, does the employee take a pay cut?

Employee Evaluation

Employee evaluation is a complicated topic that is the subject of many books. For purposes of your policies, you should consider stating the frequency, content, methods, procedures, and goals and objectives of staff evaluations. Be sure to indicate who will perform the evaluation and what will be done with the evaluation when completed. Make provision for employees to disagree with evaluations of their performance.

Indicate different evaluation procedures for different job classifications, if any. Be careful if you are an at-will employer not to include language that implies that employees have any job security resulting from the evaluation process.

Disciplinary Action

At-will employers will often not have a disciplinary action section, since the employer can discipline at any time for any reason. In order to maintain consistency and to protect against future discrimination claims, some at-will employers develop a separate supervisor's manual which includes disciplinary procedures so that the organization can enforce an organization-wide policy of discipline without making commitments to the employees subject to discipline.

If your corporation is not an at-will employer, the disciplinary policy is important because it establishes the procedures by which you handle employee problems and also provides some protection against discrimination claims by showing you use a uniform nondiscriminatory discipline procedure for everyone.

Disciplinary action might be one or more of the following:

- A verbal warning or discussion
- A written reprimand (placed in the personnel record)
- Suspension (with or without pay)
- Dismissal

Each of these actions is independent of one another and need not follow in the order of the sequence listed above.

The following might be grounds for disciplinary action:

- Misconduct
- Inefficiency
- Incompetence
- Insubordination
- Dishonesty
- Disloyalty
- Willful violation of established corporate policy
- Any other conduct that the company deems to be detrimental to its interest.

The personnel policies should state when and how written notice is to be given to the employee against whom disciplinary action is being considered.

- How are allegations to be made?

- How are they substantiated? By whom?

- For suspension without pay, clearly state the grounds for the suspension and how long the suspension shall last. Also indicate

how the employee is notified of the suspension, the date of the suspension and its cause.

• For dismissal, the typical policy by employers who require cause for dismissal is to provide that dismissal will be for just cause. It is important to list the causes and to be sure that your list both covers all circumstances for which you will want to dismiss and provides one clause that is general enough to justify dismissal in those cases that fall outside the list but for which dismissal is needed. Causes for dismissal or suspension might include:

- Failure to perform the job adequately
- Drinking on the job
- Taking illegal drugs on the job
- Arriving for work under the influence of alcohol or drugs
- Habitual absence or tardiness
- Unauthorized release of information
- Stealing
- Repeated instances of conducting personal business on office time
- Failure to maintain businesslike relationships with others
- Disobedience or insubordination
- Any other circumstance in which the company deems dismissal to be in its interest.

Termination of Employment

At-will employers will generally not have this section, except possibly to address questions about benefits. Other employers may want to consider these issues:

Layoff

You need to retain the flexibility to reduce your work force if funding changes or other actions require it. Your policy should state the circumstances that could result in layoff, provide for notice, and describe the system which will be used to determine order of lay-off and recall.

Voluntary Termination

- How much notice is necessary?
- Should it be written notice? To whom?

- Who can approve an early termination date if it serves the interest of the employee or the nonprofit?

Retirement

You should be aware that imposing a mandatory age for retirement is illegal in most cases as age discrimination. You can impose age limitations if the limitation is a bona fide occupational qualification, but these are rare. You should get legal advice if you are considering mandatory retirement.

Involuntary Termination

- How much written notice is required before the effective date of termination? (Usually ten days to two weeks.)
- Is a termination interview required?
- If the reasons for dismissal are serious, can the employee be suspended without pay until the effective dismissal date?
- If necessary, can pay be provided to personnel in lieu of proper notice by the organization?

Appeals Procedures for Discipline and Termination

If you are not an at-will employer, your appeals procedure should describe the mechanism for appeal, including how the employee accesses the system, what the time limit is for appeal, who the employee contacts, what evidence the employee must submit, who makes the decision and in what time frame, whether there is a further level of appeal, and how the employee is notified. If you want this appeal procedure to be final, without the option to resort to the courts, your policies must provide for this.

Grievance Procedure

The term grievance means a complaint, dispute, or employee expressed feeling of dissatisfaction with working conditions or working relationships. At-will employers who decide to use a grievance procedure need to be careful that the grievance procedure is written in such a way that it does not implicitly suggest that an employee cannot be disciplined while using it.

It is important to establish a channel for grievances, a time limit for appeals and a clear statement of final authority. The usual steps for a grievance procedure are to specify that:

First, the aggrieved parties must talk to each other (with or without a facilitator).

Second, there is discussion between them and the executive director or chairperson of the Board of Directors.

Third, a hearing is conducted before the personnel committee of the Board of Directors. Personnel policies usually state that employees may file a grievance without fear of recrimination although at-will employers may not want to include this commitment.

In addition, your organization should consider these questions:

- Must all grievances be in writing to be considered?
- Who should receive grievances?
- How much time is allowed to attempt to resolve the grievance at each step?
- Who has the final authority in resolving grievances?

Amendments to Personnel Policies or Employee Handbooks

Your policies or handbook need to have a provision that reserves your right to change them. The policies or handbook should state who has the authority to amend them. Many employers add a specific provision alerting employees that no one else has the authority to amend the policies or to make any promises about employment that are not contained within the policies. The reason for doing this is to prevent a claim by an employee that a promise about employment was made verbally to her or him by a supervisor.

Many employers add a specific provision alerting employees that no one else has the authority to amend the policies or to make any promises about employment that are not contained within the policies.

The policies should indicate whether employees must be given notice of the changes in order for the changes to be effective. Whether or not your policies require you to notify the employees, it is a good practice to do so and to have the employees sign to indicate they have received a copy of the new policies. Some corporations give the changes to the staff with their paychecks and require a sign-off at that time.

Distribution of the Employee Handbook

You need to decide whether to give a copy of your personnel policies to some or all of your employees. Most organizations that decide to do so print the policies in the form of an employee handbook, although you can of course

call the document by another name. The advantages of distributing your policies is that your employees are clearly informed about what their benefits are and what your expectations are concerning the employment relationship. The policies prevent employee confusion and incorrect expectations about your policies that may arise from gossip or mistaken information from other employees. If your employees have access to your policies, the law often charges them with knowledge of the policies whether or not they actually read them.

There are some disadvantages to distributing policies. Some organizations do not want non-managerial employees to know what benefits managerial employees enjoy. These groups may choose to have separate sets of policies for managerial and non-managerial employees or may choose not to distribute their policies. Occasionally, your organization may be constrained by your employees' knowledge of your policies. If your employee was aware of a policy and relied on it, you may be legally bound to follow it, a result that may not have occurred had the employee not been familiar with your policies.

If you do decide to distribute an employee handbook, be sure to have each employee sign to acknowledge that he or she received a copy and to keep these acknowledgments in your employee files. Acknowledgments should include statements indicating the employee's understanding the at-will standard (if you use it), harassment policies and any other appropriate disclaimers.

Administering Personnel Policies or the Employee Handbook

Most Boards of Directors delegate responsibility for day-to-day administration of personnel policies or handbook to the executive director and other key supervisory staff. However, ongoing involvement by the Personnel Committee of the Board is essential if your policies are to have the full support of the Board.

How the Personnel Committee functions will vary depending on the approach to personnel policies or your employee handbook your organization has chosen. If your corporation is an at-will employer and has avoided making specific commitments in your employee handbook, the job of your Personnel Committee may be limited to reviewing and revising the policies as needed.

If your organization has chosen a model that makes specific commitments and provides for a grievance mechanism, the Personnel Committee is typically needed to fulfil policy making and appeal functions including:

- resolution of grievances;
- final interpretations of personnel policies; and

- preparation of annual revisions and updates of personnel policies.

EVALUATING THE EXECUTIVE DIRECTOR

While most personnel policies provide a supervisory structure within the staff, the Board itself must provide a structure for supervision and evaluation of the executive director. Typically, the Personnel Committee or Executive Committee of the Board conducts an annual evaluation of the Executive Director. Ongoing consultation and feedback can be provided through regular meetings between the Board Chair and the Executive Director. Information on approaches to evaluating the Executive Director is available in the Helpline Online section of the Technical Assistance for Community Services website at *www.tacs.org*.

Consult Appendix 1 if you would like information about source material related to this Chapter.

Many nonprofits attempt to avoid the issues created by having employees by designating their service providers as independent contractors. In many cases, this designation is incorrect and can have serious consequences for your organization. The next chapter discusses this very important issue in depth.

16 INDEPENDENT CONTRACTORS

One of the most common mistakes made by nonprofits is to classify incorrectly people who are providing services for them as independent contractors, rather than as employees. A mistake in this area can be very costly and can result in liability for taxes, interest, penalties, unemployment claims, worker's compensation claims, wage and hour claims, and other employment related issues. The fact that you and the person who is providing the services have agreed that your relationship is that of an independent contractor does not necessarily protect the organization. If you currently have or are contemplating hiring independent contractors, you should be familiar with the topics covered in this chapter.

THIS CHAPTER COVERS

- **Who is an Independent Contractor?**
- **Federal Income Tax and Social Security Issues**
- **State Income Tax Issues**
- **Worker's Compensation Issues**
- **State Unemployment Issues**
- **Federal and State Wage and Hour Laws**
- **The Importance of Complying With the Laws**
- **Danger Signals**
- **Protections for Your Nonprofit Organization**

WHO IS AN INDEPENDENT CONTRACTOR?

Many nonprofit groups designate someone who is performing services for them (referred to as a "service provider" in this chapter) as an independent contractor, rather than as an employee. This designation often is made because the group does not want to pay employer taxes and fringe benefits and complete paperwork associated with having an employee. Nonprofits often are unaware that the agreement of the nonprofit and the service provider to call that person an independent contractor is not binding on state and federal agencies and courts and can have little or nothing to do with how that person is legally classified.

If you are trying to determine whether your service provider is an independent contractor, you may find that that question is answered with another. The answer is often "For what purposes?" You need to determine if you are trying to figure out the status for purposes of personal injury law, federal taxation law, state income tax law, worker compensation law, state unemployment law, labor law, pension law, federal civil rights law, state civil rights law, health and safety laws, wage and hour law, agency law, copyright law, or other laws. There is no single definition of independent contractor, although most definitions have some common features.

What many groups are unaware of is that the agreement of the nonprofit and the service provider to call that person an "independent contractor" is not binding on the various agencies or individuals that may disagree with that classification and can have little or nothing to do with how that person is actually classified.

Because these tests do not use the same guidelines, this means a service provider may be an employee for some purposes and an independent contractor for others. Although the many tests used in this area have different wrinkles, at the heart of virtually all of them is this: how much control does the nonprofit exercise over the manner and means by which the service provider does his or her job?

This is a complicated area of the law and much of it is a gray area, so you should not expect to become an expert. Instead, this chapter describes the general rules, some specific factors to look for, and some danger signals that should alert you to seek an expert opinion. This chapter will focus on the areas of federal tax law, state tax law, workers' compensation, state unemployment tax, and wage and hour laws because these are the areas most likely to be of interest to nonprofits. If you have questions about whether your service provider is an

independent contractor for purposes of other laws (such as personal injury law, labor law, pension law, civil rights law, health and safety law, agency law, copyright law, etc.), you should consider getting the advice of a lawyer.

FEDERAL INCOME TAX AND SOCIAL SECURITY ISSUES

The federal tax law requires that you withhold a portion of the salary you pay to your employees for income and social security taxes. Employers must also match the amount withheld for social security with their own funds. You do not have to withhold income or social security tax or pay a share of the social security tax of independent contractors.

The key question is: who does the IRS consider to be your employee? For purposes of IRS withholding (income tax), FICA withholding (Social Security and Medicare), and FUTA (federal unemployment tax), the government focuses on the extent of control that your nonprofit exercises over the service provider. The IRS looks at behavioral and financial controls and at the type of relationship you have. As a guideline to the particular items the government considers, check out the Federal 20-Factor Test. The test appears on pages 374-375. The IRS test seeks to determine if the nonprofit exercises sufficient control over the service provider for the service provider to be classified as an employee. Because there are so many factors, the tests are very vague.

> *Example*: Your new organization is treating its Executive Director as an independent contractor and is not withholding from payments to him for federal tax purposes. Your Executive Director works about 25 hours per week at your offices. He is paid $1,500 per month. He supervises two of your part-time employees and five of your volunteers. Your organization provides all of the equipment and supplies he uses. The Executive Director reports to the Board. In all likelihood, the Executive Director is an "employee," for federal withholding purposes.

> *Example*: Your organization decides to hire a consultant to work with your Executive Director to develop a new program. She has her own consulting business with about 20 clients and provides her own supplies. She agrees to meet with the Executive Director over a two month period and will charge you a flat fee of $2,000 for her services. She has given you a written contract. In all likelihood, this consultant is an independent contractor for federal withholding purposes.

Federal 20-Factor Test

1. **Instructions**: Is the person required to comply with instructions about when, where, and how the work is to be done? If a person is required to comply with instructions as to when and how to perform the work, that person is generally considered an employee.

2. **Training**: Is the person provided training? Did the individual receive training by another experienced employee working with him or her? Training typically points to employee status, since it indicates that the employer wants the services to be performed in a particular manner and is exerting considerable control.

3. **Integration**: Are the services for the operations of the company? The more integrated the individual's task is, the more likely the company has control – making the individual an employee.

4. **Service Rendered Personally**: Are the services provided personally by the individual? If the service must be rendered by a particular individual, then the employer likely has control, meaning the service provider is likely an employee.

5. **Hiring, Supervising and Paying Assistants**: Does the company hire, supervise or pay assistants to help the person? If the company controls these activities, employee status is indicated.

6. **Continuing Relationship**: Is there a continuing relationship between the person and the company? An ongoing relationship with an individual in a company tends to indicate the existence of an employer/employee relationship.

7. **Set Hours of Work**: Does the company set the work schedule? If the company can set specific hours when the individual must be "on the job," the individual is most likely an employee.

8. **Full Time Required**: Does the person devote his or her full work time to the company? If the company requires an individual to devote full time to the business, that individual will be considered an employee.

9. **Location of Work**: Is the work performed at the company's place of business or at specific places designated by the company? Control is the key word. Control over the place of work – on company premises or a site determined by the company – indicates an employer/employee relationship.

10. **Order or Sequence of Work**: Does the company direct the sequence of the work performed? If the employer can set the sequence in which services are to be performed, then control is being exercised – and the individual providing services is an employee.

11. **Oral or Written Reports**: Are reports regularly given to the company? If oral or written reports are required by the company, then control and employer/employee relationship is indicated.

12. **Payment by Hour, Week, or Month**: Is the person paid hourly, weekly, or monthly (as opposed to "by the job")? An independent contractor is normally paid by the job or on a commission basis, rather than on a schedule or by a guaranteed amount

13. **Payment of Business or Traveling Expense**: Does the company reimburse the person for business or travel expenses? The fact that the "employer" will pay for an individual's work related expenses is indicative of control – and employee status.

14. **Tools and Materials**: Does the company supply materials or tools to the person? Providing tools and materials to an individual suggests that a company is also exercising control, which again means that the individual is an employee.

15. **Significant Investment**: Does the person have equipment or facilities to perform services? If an individual has significant personal investment in facilities or equipment, that person is likely to be an independent contractor.

16. **Profit or Loss Potential**: Is there an exposure to loss, or the potential of profit for the individual? A person who is in a position to realize a profit or suffer a loss as a result of the service provided is more than likely an independent contractor.

17. **Working for More than One Firm**: Does the person work exclusively for the company? If an individual works for more than one company at the same time, the person is normally an independent contractor.

18. **Making Service Available to the General Public**: Does the individual in question make his or her services available to the public at large? Advertising to the general public the availability to perform a particular service normally indicates an independent contractor.

19. **Right to Discharge**: Can the worker be dismissed for reasons other than nonperformance of contract specifications? The right to discharge an individual is clearly an act of control and is indicative of an employer/employee relationship.

20. **Right to Terminate:** Can the person terminate his relationship with the company without liability for failure to complete the job? Employees can usually terminate the relationship with the employer at any time without incurring any liability. An independent contractor normally has obligations to complete specific jobs or a legal obligation to satisfactorily perform a particular service.

Congress is considering changing the 20 Factor Test as we go to press. Check with a professional to be sure that the information is current. You can also check the website of our publisher, Technical Assistance for Community Services, at *www.tacs.org* where we may maintain updated information about matters in this book.

STATE INCOME TAX ISSUES

All Oregon employers must withhold part of their employees' pay for state income tax purposes; such withholdings are not required for independent contractors. The state of Oregon has a state statute to determine if a service provider is an independent contractor for several purposes, including withholding for state income tax. In case you are not already confused by all these tests, the Oregon legislature in 2003 amended the statutory independent contractors test. The new law provides for two independent contractor tests: one for purposes of state income tax withholding and another for situations like paying the state unemployment tax. The new tests become effective January 1, 2006. It is possible that the 2005 legislature may make further changes. The primary focus of both the current and 2006 Oregon statutes is whether the service provider is free from direction and control over the means and manner of providing the services and whether there is other evidence that he or she really acts as an independent business. The 2006 statute generally includes more people as independent contractors. It is also easier to meet the test if your service provider files federal and state tax returns as a business or files a business Schedule C or farm Schedule F on his or her individual tax returns. We present both the old and (what we assume will be) the 2006 tests here.

The Independent Contractor Test Before 2006

In order to establish independence under the independent contractor test in effect until 2006, you must meet *all 8* of the following criteria before you can call a service provider an independent contractor:

> 1. Your service provider must be free from your direction and control over the means and manner in which he or she provides the services, subject only to your right to specify the desired results.
>
> 2. Your service provider is responsible for obtaining all business registrations or licenses required by law to conduct his or her business.

3. Your service provider furnished the tools or equipment (e.g., computer, phones, supplies) necessary to perform the services.

4. Your service provider has the authority to hire and fire employees to perform the services.

5. You pay your service provider upon completion of the performance of specific portions of the project or by an annual or periodic retainer (rather than, for example, by the hour or on a salaried basis).

6. If the services for which you contract require a license, your service provider is licensed.

7. Your service provider filed federal and state income tax returns in the name of the business or a business Schedule C or farm Schedule F as part of his or her personal income tax returns in the previous year, if your service provider acted as an independent contractor during that year.

8. Your service provider represents to the public that his or her services are provided by an independently established business. This criteria is met if your service provider filed the Schedule F or Schedule C described in #7. If they did not, your service provider must show that he or she operates an independently established business by meeting *4 or more* of the following requirements:

a. Your service provider primarily carries out his or her services at a location that is separate from the provider's residence or in a specific portion of the residence that is set aside for the business.

b. Your service provider advertises commercially, uses business cards or is a member of a trade association.

c. Your service provider has a business telephone listing separate from his or her personal listing.

d. Your service provider requires written contracts to perform work.

e. Your service provider provides services to two or more different persons during one year.

f. Your service providers assumes financial responsibility for defective work backed by performance bonds or insurance covering the provider's work.

Because the Oregon statute is more detailed than the above described federal test, it often is easier to determine the status of a service provider under state law.

The Independent Contractor Test Beginning in 2006 (We Think)

The state income tax withholding test that is scheduled to go into effect on January 1, 2006 defines an independent contractor as someone performing services that meets *all four* of these tests:

1. Your service provider must be free from your direction and control over the means and manner in which he or she provides the services, subject only to your right to specify the desired results.

2. Your service provider is customarily engaged in an independently established business. This criteria is met if your service provider filed the Schedule F or Schedule C described in #7 above and you can move on to criteria 3 below. If your provider does not, he or she can meet this test by meeting *any 3* of the following requirements:

a. Your service provider does not rely solely on one person or one entity to obtain customers or your provider performs all services in the provider's own name or business name and collects payment for the labor or services directly from the customer.

b. Your service provider assumes the risk of loss related to his or her services as shown by factors that include fixed-price contracts, responsibility to correct defective work, purchase of performance bonds or insurance covering the work, or other indicia.

c. Your service provider provides services to two or more different persons during one year or routinely engages in business advertising, solicitation or other marketing efforts reasonably calculated to obtain work.

d. Your service provider makes a significant investment in the business, such as for tools, equipment, rent or specialized training.

e. Your service provider has the authority to hire and fire employees to perform the services.

3. If the services for which you contract require a license, your service provider is licensed.

4. Your service provider is responsible for obtaining all business registrations or licenses required by law to conduct his or her business.

Because there is a possibility that the 2005 legislature will change this test after we go to press, check with a professional to be sure that your information is current. You can also check the website of our publisher, Technical Assistance for Community Services, at *www.tacs.org* where we may maintain updated information about matters in this book.

WORKERS' COMPENSATION ISSUES

Your Service Providers

Oregon employers are required to provide workers' compensation insurance for all workers covered by the statute. An employer under the workers' compensation statutes is anyone who agrees to pay a remuneration for and secures the right to direct and control the services of any other person. A worker is a person who engages to furnish services for a remuneration, subject to the direction and control of an employer. This means that if your organization pays someone and you have the *right* to direct and control their services (whether you do so or not), you must comply with the workers' compensation laws.

The Test for "Worker"

The issue for employers is whether a person is a "worker"; that is, whether the employer has the right to direct and control that person. The courts generally look at the following four factors:

1. *The employer's right to, or exercise of, control*. If the employer exercises control over the methods of how the job is performed, this suggests the relationship is worker-employer. If your only con-

trol is over the results, this suggests an independent contractor relationship.

2. *The method of payment*. If the service provider is paid by the hour, week, month, or other time unit, this suggests an worker-employer relationship. If the service provider is paid a fixed sum for a fixed job, this is more typical of an independent contractor.

3. *Furnishing of equipment*. If the employer furnishes the equipment, supplies, or means of carrying out the job, your relationship is likely worker-employer. In an independent contractor arrangement, the contractor would furnish these items.

4. *Right to fire*. If you have right to fire the service provider, this suggests a worker-employer relationship. Where the parties have an independent contractor relationship, an employer generally can only terminate the job if the project is not being performed as agreed.

> *Example*: You have contracted with an individual to assist in putting together a major fundraiser. She will be working in your office with your staff using your supplies. She will be working about 20 hours a week for 3 months and will be paid $1,000 per month. You can fire her if you want. Although you have the right to direct her work, you leave most things up to her to handle as a matter of practice. You must pay for her workers compensation coverage because she probably is not an independent contractor under the Oregon statutory definition based on your *right* to control her work.

If the above test is inconclusive, the courts typically apply what is called "the relative nature of the work" test. This test applies various factors to see how integral the services that your service provider supplies are to the employer's business . The courts look at two sets of factors:

• the character of the provider's services (the skill level, the degree of provider's independence, and extent to which the provider can carry the burden of an accident); and

• the relationship of your service provider's business to your business (the extent to which the provider's work is an essential and regular part of your work and whether provider is hired on temporary or continuing basis).

Example: Your agency provides counseling services to low income clients. You hire 4 counselors as independent contractors. Each counselor works 20 hours a week for your organization while also maintaining his or her own half-time private practice. While working for your organization, the counselor sees your clients at your location. The counselors determine how the sessions are run but are supervised by your agency. The counselors are paid $20 per session but they provide their own licenses and pay their own professional fees. You can fire the counselor if you wish. It is very probable that these counselors would be employees under the "relative nature of the work" test because they are working on a continuous basis doing work to carry out your operations in the same manner as your employees would do it.

Exceptions to the "Worker" Test

Employers must provide workers' compensation insurance for all of its workers unless the service provider falls within certain exceptions. These exceptions generally fall into these categories:

- certain construction and landscape contractors;
- casual labor (as specifically defined);
- volunteers performing services primarily for board, lodging, meals, nominal reimbursement, or vouchers for meals, lodging, or expenses for a religious, charitable, or relief organization;
- certain amateur athletes;
- persons performing foster parent and adult foster care duties pursuant to certain statutes;
- volunteers under the ACTION program and ski patrols
- volunteer municipal personnel (unless they are covered under the municipality's workers' compensation insurance).

If any of these exceptions might apply to your organization, talk to an attorney.

Workers for Those With Whom You Subcontract

If an employer awards a contract for labor that is a normal and customary part of its business and the employer is responsible for providing workers' compensation coverage to the individual or entity that has the contract, the *employer* must also provide workers' compensation coverage for all workers under the contract, unless the person who is awarded the contract provides coverage be-

fore work begins. Because of the difficulty of knowing whether you have to provide coverage for the person you are contracting with and the possibility that you may be required to provide coverage for all of his or her subcontractors, be sure you get professional advice if you are subcontracting.

> *Example*: Your nonprofit runs several homeless shelters and contracts out the management of one of the shelters. The contract provides that the shelter manager is to pay all taxes and workers' compensation coverage for his employees. You maintain substantial control over how the shelter is run. The individual with whom you contract hires several people to run the shelter but fails to provide workers' compensation coverage for the workers. You are probably liable to provide worker compensation coverage for the individual running the shelter because of the amount of control you exercised. Therefore you are also liable for worker compensation claims filed by the manager's injured workers. Your contract with the manager does not change this result as far as the workers are concerned.

STATE UNEMPLOYMENT ISSUES

For purposes of the state unemployment tax, an employee is any person employed for pay under a verbal or written agreement to hire that person. A person who volunteers services to a religious or charitable entity without expecting adequate payment for the services is not an employee. By law, employers are required to provide for unemployment benefits coverage for their employees. Nonprofits may choose among several options for primary unemployment coverage. These options are discussed on pages 563-564. Regardless of which option your organization chooses, you will be required to provide coverage for everyone who performs services for your organization for pay, unless that person:

- Is an independent contractor as defined by Oregon law; *or*

- Is free from the control or direction over the performance of such services, under an actual contract; *and* is customarily engaged in an independently established business of the same nature as that involved in the contract with you.

If your relationship with your service provider satisfies either one of these tests, the service provider is an independent contractor. The first test is a little more certain, so you should start there to see if the service provider meets the criteria. The test is found on pages 376-378. Although the test for independent contractors for purposes of state income tax withholding will change on Janu-

ary 1, 2006, the test for purposes of the unemployment tax will *not* change. So continue to use the old test.

If your service provider does not satisfy the criteria for the independent contractor test, your provider needs to qualify under the second test. Note that if the service provider has an independently-established business but contracts with you for a different type of service, she or he will not meet the test.

> *Example*: You hire someone who operates a bookkeeping service with lots of nonprofit clients to write grants for you. You may need to provide unemployment coverage on this person, because the activities for which you are hiring him are not his normal business of bookkeeping.

There are numerous exceptions in which an employer does not have to provide unemployment coverage even though a service provider is an employee. Generally, the exceptions most likely to be of interest to nonprofits include rehabilitation centers for the disabled and certain services by students.

An employer does not have to provide unemployment coverage if its total payroll during any calendar quarter is less than $225 or if the employer does not employ one or more individuals in each of 18 separate weeks during a calendar year. You should check with your accountant or attorney if you have questions about these or other applicable exceptions.

FEDERAL AND STATE WAGE AND HOUR LAWS

Federal and state law requires most employers to pay a minimum wage and overtime wages and to comply with other wage and hour requirements, as we discussed in Chapter 15.

Federal Law

Federal courts determine whether a service provider is an independent contractor or an employee by looking at the economic realities of the relationship. The economic realities test seeks to determine how much the service provider is economically dependent on you. The test is vague and includes factors such as your right to control the manner in which the work is done; the dependence of the service provider's opportunity for profit or loss on his or her managerial skills; the service provider's investment in equipment or material required for

the job; whether the service requires special skills; the longevity of the working relationship; and whether the service is an integral part of your mission.

State Law

The state statute does not define "employee" for purposes of describing who is protected by the wage and hour laws and who is an independent contractor. The law does say an employer is anyone who employs another person (duh). "Employ" means "to suffer or permit to work," a very broad definition. "Employ" does not include voluntary services performed for a religious, charitable, educational, public service or similar nonprofit organization for free or without expectation of adequate compensation. The courts have interpreted the definition of "employ" expansively.

> *Example*: If you pay solicitors to go door to door to collect money for your cause, assign them neighborhoods, give them a script and train them on their pitch, you have probably exercised enough control that you have employed them. However, if the solicitors are volunteers or receive some compensation but work for you because they agree with your cause and they don't expect their pay to be adequate compensation for their services, you have probably not employed them under state law if you are a public benefit or religious nonprofit. Remember, though, that although you may be safe under state law, federal law may be different.

A separate statute covers other types of wage claims, such as discrimination claims and piecework wages. It also sets out rules about regular paydays and procedures for recovering unpaid wages. That statute does define "employee," but the definition does not apply to who is covered by wage and hour laws. As you can see, this is a confusing area. Get professional help if you are not observing the wage and hour law in connection with someone who you "suffer or permit to work" for you.

THE IMPORTANCE OF COMPLYING WITH THE LAWS

It is very important for employers to comply with the laws described above. An employer that incorrectly classifies someone as an independent contractor but who is later determined to be an employee may be liable for:

- Back taxes, interest and penalties (even if you had an agreement with your service provider that she or he would pay her or his own taxes);

• Payment of an injured service provider's medical bills, lost wages, and other damages in workers' compensation cases;

• Payment of unemployment benefits to a service provider who is laid off or terminated;

• Payment of unpaid wages, overtime, vacation time, penalties and attorney fees to a service provider with a wage and hour claim;

• Personal liability on the part of Directors for the above expenses from their own pockets.

DANGER SIGNALS

In practice there are some especially telling warning signs to be aware of in a relationship with an independent contractor, including:

• Telling the independent contractor how to perform the job or otherwise direct his or her activities;

• Training the independent contractor;

• Scheduling particular hours of work for the independent contractor;

• Supplying the independent contractor with a substantial portion of the supplies and materials for the job;

• Giving the independent contractor a job title that would normally be associated with one of your employees, such as "Executive Director" or "Program Manager";

• Allowing the independent contractor to use business cards identifying him/her with your nonprofit;

• Paying the independent contractor by the hour, week, or month (as opposed to "by the job");

• Retaining the ability to fire the independent contractor for reasons other than nonperformance of the contract specifications;

• The independent contractor does not have other customers or doesn't work for anyone else;

• The independent contractor does not have his or her own office (or separate office within his or her home) with a business phone number;

• The independent contractor does not maintain the licenses and insurance common to his or her profession or business;

• The independent contractor can terminate his or her relationship with you without being liable to your organization.

PROTECTIONS FOR YOUR NONPROFIT ORGANIZATION

If you have read this chapter and are feeling a little unsure, we have made our point that the laws about independent contractors are confusing and ambiguous. In many cases, you are left in a gray area. This does not mean that you have to assume all of your service providers are employees and begin withholding and paying workers' compensation and unemployment premiums on everyone. You should treat as an employee anyone who clearly is an employee. We suggest this strategy for your other service providers:

• If you have service providers in the gray area, consult with an accountant or an attorney;

•Ask the IRS for a non-binding opinion;

• Assess and limit how much exposure your organization has if individuals are incorrectly classified;

• If you are going to continue to classify your service provider as an independent contractor, be sure the factors you can reasonably control point that way and insist on a written contract.

This does not mean that you have to assume all of your service providers are employees and begin withholding and paying workers' compensation and unemployment premiums on everyone.

Expert Opinion in Writing

A significant protection in this area is to get an opinion from an accountant or attorney about the proper classification for any service provider for whom

there is a possibility that that service provider may be other than an independent contractor. Such an opinion can alert you to any problems you may have. This opinion will not protect your organization from being liable as described above if your attorney or accountant is wrong but your organization may be able to pursue a claim against the attorney or accountant for bad advice. This opinion will almost always protect Directors individually from personal liability.

Ask the IRS – Form SS-8

You can ask the IRS how they will classify your service provider. You do this by filing Form SS-8, which is available from the IRS. The IRS has also developed a computer program called SS-8 Determiner for this purpose. The drawback to requesting IRS classification is that your request may trigger an audit. Remember that the IRS opinion is issued in reference to federal withholding. Do not assume that the opinion answers the independent contractor question for all the other types of activities covered in this chapter, because the tests are different.

Assessing and Limiting Your Exposure

If you have service providers in the gray area, you might give some thought to how much and what kinds of exposure you have and how much risk you are willing to take. If you are paying large sums to a service provider, then your exposure for unpaid taxes is larger; conversely, if the amounts are small, you might be willing to risk paying the unpaid taxes, interest, and penalties. If the worker has other employment or operates her or his own business with other clients, your risk of an unemployment claim is less. If not, you may want to find out how much unemployment coverage would cost. It is usually relatively inexpensive.

The most serious potential exposure for many nonprofits is a workers' compensation claim. You can generally assess how safe the service provider's work environment is. However, a workers' compensation claim can be generated when your service provider's back goes out while picking up a pencil. In addition, unlike tax withholding claims, the amount of the workers' compensation claim may be very disproportionate to what you save by not paying the workers' compensation premium.

After assessing your organization's potential exposure, you may want to take some steps to limit your risk short of reclassifying the service provider as an employee.

- Provide workers' compensation coverage;
- Provide unemployment coverage;

- Require your service provider to submit proof to you that she or he is making her/his estimated tax payments to the federal and state governments.

There is, however, some risk in paying workers' compensation premiums and unemployment taxes and still classifying your service provider as an independent contractor. Your service provider or a government agency may later try to use this as evidence that you acknowledged that your service provider was an employee. Your best strategy here is to include in your written independent contractor agreement (discussed below) a provision stating that these payments are not evidence of an employee relationship and include a release of claims clause. Additionally, Directors are at some risk of being held personally liable for unpaid taxes and for workers' compensation claims. Your Board will want to carefully assess your policy and decisions in this area.

Independent Contractor Agreement

If you have decided that a service provider should be classified as an independent contractor, be sure that the factors that you can reasonably control agree with your classification. Here are some items you may be able to arrange to support your classification:

- Restrict as much as possible the amount of control you have over the job;
- Pay by the job and not by time spent;
- Do not allow the service provider to use your space or equipment;
- Do not give the service provider a title suggesting a job link with your organization;
- Require your service provider to get his or her own business cards and business phone listing.

You should also have a written agreement with your independent contractors, showing that you do not have the right to control their work and listing as many of the factors as are applicable to establish an independent contractor status. This agreement is not binding for purposes of establishing independent contractor status, but it is evidence of your intent. You should get legal help in drafting such a contract because each one is individual.

Consult Appendix 1 if you would like information about source material related to this Chapter.

17 VOLUNTEERS

Volunteers are the lifeblood of many nonprofit organizations. Many of the important services provided by nonprofit organizations are possible only through the volunteer efforts of individuals who care deeply about their community and its nonprofit organizations. Positive experiences of volunteering for your organization can motivate volunteers to become financial donors and active community spokespersons for your organization.

Perhaps because volunteer services appear to be free, many nonprofits do not put much thought into the recruitment, training, or supervision of volunteers. How a volunteer performs may affect the public perception of your nonprofit. Working effectively with volunteers requires careful planning, consistent attention, and dedication of organizational resources. This chapter identifies the basic elements of an effective program.

One issue of concern to some nonprofits is when volunteers should be treated as employees. This chapter addresses this question.

This chapter also addresses the challenging realities of potential legal liabilities for both volunteers and the organizations they serve. Serving as a volunteer can carry risks for the volunteer. In 1994 in Oregon, two volunteers found themselves on the losing end of a serious lawsuit which resulted in a judgment against them personally for about $3 million. Many volunteers are unaware that they may face personal liability for their actions as volunteers. Your nonprofit corporation will often be required to pay for damages caused by your volunteers. Volunteers also face the risk that they may themselves be injured while serving as volunteers. This chapter will discuss how you and your volunteers can protect yourselves from these occurrences.

THIS CHAPTER COVERS

- **Recruiting, Screening, and Placing Volunteers in Your Organization**
- **Orienting, Training, Supervising, and Evaluating Volunteers**
- **Recognizing and Rewarding Volunteers**
- **Volunteers Who Are Really Employees**
- **Volunteers and Liability**
- **When Your Volunteers Face Personal Liability**
- **When Your Organization Is Liable for the Actions of Your Volunteers**
- **When Your Volunteer Is Injured**
- **Protection for Your Volunteers and Your Organization**

Volunteers can be a great resource for nonprofit organizations. But they are not free. Finding and keeping effective volunteers for your organization will require the investment of time and energy, either by paid staff or by other volunteers. We probably all know of organizations in which volunteers have made enormous contributions – organizations which literally could not do their work without volunteers. You probably also know of organizations in which volunteers come and go, never making much impact despite their commitment to the cause and willingness to work. What makes the difference?

RECRUITING, SCREENING, AND PLACING VOLUNTEERS IN YOUR ORGANIZATION

Recruiting Volunteers

Before you put out the call for volunteers, you'll want to think very carefully about the types of tasks you want them to do and the level of responsibility you want and will allow them to take. You don't need to work out every detail of each job but you do need to make basic decisions about the type of tasks which you think are appropriate and the types of people you are looking for to do those tasks.

Before you put out the call for volunteers, you'll want to think very carefully about the types of tasks you'll want them to do and the level of responsibility you'll want and allow them to take.

Start by thinking about all your motivations for recruiting volunteers and the organizational needs you are hoping they will meet. Get clear about the basics:

- Are you really just looking to get specific jobs done without having to pay an employee or are you hoping to expand your organization's identity through volunteer involvement?

- Do you have staff or dependable volunteers available to orient, train, and supervise the volunteers you recruit or do you really need folks who can work well with very little supervision or support?

- Do you need volunteers for one-time, minimal skill activities like stuffing envelopes or are you looking for individuals who

will commit to an ongoing role which requires more knowledge of your organization?

• Are you looking for people willing to learn a set of skills which your organization has mastered or are you looking for people to contribute their own professional skills, like legal and accounting work, with no particular training from you?

• Is building diversity among your volunteers important to your organization? Do volunteers need to speak languages other than English and have a basic understanding of cultures other than their own?

• Are the jobs dangerous? Do they require special skills? Does the job demand special characteristics for its performance?

Unfortunately, nonprofits often start their efforts to recruit volunteers by thinking about ways to publicize volunteer opportunities rather than by clarifying exactly what the opportunities are. Once you've agreed upon the answers to the questions above and any others you need to ask to get clear about the types of people you want as volunteers, you can begin working on strategies to find the "right" people.

Of course, you'll want to use an approach to finding volunteers which seems likely to connect you to the types of people you want to find. There are several common approaches to finding volunteers:

• Ask people already working, volunteering, or participating in your organization to ask people they know. This approach is particularly valuable when you are looking for specific skills and qualities.

• Put notices on your website and in your newsletter or other publications, describing the types of volunteer opportunities you offer.

• Post your volunteer opportunities on CNRG (*www.cnrg.org*) or Craig's list (*http:portland.craigslist.org*).

• Announce volunteer opportunities at all your gatherings and events.

• Contact SOLV (*www.solv.org*), a statewide agency; Hands-on-Portland (*www.handsonportland.org*), or other volunteer coordi-

nation services and talk with them about how they can help you recruit volunteers.

• Contact colleges and high schools in your area to see if they have community service programs for their students. Many schools now have a community service graduation requirement.

• If you have work which would be appropriate, contact senior centers and other social service programs to see if their clients may be able to perform the services.

• If you are looking for professional services, contact the appropriate professional association in your community, i.e. the Bar Association or the Oregon Society of CPAs.

Whether you'll be talking with people face to face or using written recruitment announcements, you'll want to be sure you present your volunteer opportunity in the ways most likely to motivate the people you are seeking to follow up on your request. Start by thinking about the possible motivations your desired volunteers might have. If you already have volunteers, ask them what drew them to your group and what makes them stay.

If you already have volunteers, ask them what drew them to your group, and what makes them stay.

Remember, folks will decide to volunteer with very different motivations. Some common motivations for volunteering include:

- Commitment to your cause or to the people you serve
- General desire to serve the community
- Interest in developing new skills
- Resume building
- Forming social relationships
- Forming business relationships

Of course, your staff and volunteers can think of many more motivations. Once you've considered what may motivate folks to volunteer for your organization, craft your invitation carefully. You want to communicate to individuals that they will find what they are looking for if they volunteer for your group.

Whatever approach you decide to use, be sure you have a person ready to respond quickly when people inquire about the volunteer opportunities you have announced. If you will use a written application for potential volunteers,

keep it short and simple and be sure it's ready before you announce the opportunity. Plan your volunteer screening strategy before you make your announcements as well, so that you are totally ready to deal with responses.

Screening Volunteers

Once you are clear about the types of tasks you will be asking volunteers to perform, you can decide what types of information you will need to learn about the individuals who offer to help you. Then, you'll need to decide how you will obtain the information.

You probably will not need much information about volunteers who will only perform short-term tasks under the supervision of an individual already known to your organization. At a minimum, you'll want to make a record of their name, address, and phone number so that you can contact them again to ask for their help, send them a thank you note, or potentially, to ask for a contribution.

As the level of responsibility required increases and the amount of direct supervision your organization provides decreases, you will want to learn more about the potential volunteers. You'll have to decide how to obtain this information. You may want to ask all potential volunteers to fill out a written application form. Or, you may want to schedule group meetings to explain the volunteer opportunities. This allows people to screen themselves out before spending time completing paper work.

Some organizations like to have all potential volunteers complete a written application which asks about all of their skills and interests. If you are reasonably certain that people completing these forms are serious about helping your group, you can enter the information into a database and retrieve names by sorting for the types of activities people have indicated they are willing to perform.

Other organizations prefer to use individual interviews before asking for extensive written information. This approach will probably be necessary for recruiting professionals to provide their services.

Whichever method of collecting information you choose, you'll want to have agreements about the minimum requirements your organization will set for each type of volunteer work. Some basic questions might be:

- Will we accept volunteers with a criminal record or with mental health issues?

- Will we do a criminal records check?

- Will we require evidence that the individual has experience performing functions similar to those included in our volunteer job?

- Will we require and check references?

- Does the volunteer's performance in the job expose us to liability? (See page 403.) If so, what screening is reasonable to ensure that the volunteer is appropriate for the job?

- Are we required to conduct particular screening procedures to exclude individuals with particular histories by law, regulation, or funding agreement?

In the final analysis, screening volunteers is not that different from screening potential employees. If you have Directors or volunteers who work in personnel management or human resources, ask for their help.

Placing Volunteers in the Right Spot in Your Organization

Once you've decided to accept an individual as a volunteer for your organization, you will need to assign that person to specific responsibilities. You'll need a clear system within your organization to determine who ultimately decides which volunteers are given which assignments.

The process of placing volunteers within your organization involves matching sets of needs – your organization's need for help and the individual volunteers' needs for satisfaction in their volunteer work. You'll need a systematic way to look at both sets of needs and a perceptive person to bring the two together.

Some organizations create a common pool of pre-screened volunteers and encourage project managers or volunteer team leaders to come "shop" through the list of volunteers and contact those they are interested in directly. Other organizations feel that this may appear chaotic to the volunteer, resulting in several different phone calls from the same organization. These organizations put one person in charge of placement. That person makes the best matches they can, clears them with the person who will be supervising the volunteer, and makes the contact with the volunteer.

If you decide to use the first, more autonomous approach, be sure you create a system for letting others in the organization know that a volunteer has been "taken" so your group is not annoying the volunteer with multiple calls.

The placement function is completed after the volunteer is given a detailed explanation of what will be expected and both the volunteer and their supervisor have agreed to give it a try. You'll want to be sure your system provides opportunities for both volunteers and their supervisors to let the person doing placement know how well the matches are working out.

ORIENTING, TRAINING, SUPERVISING AND EVALUATING VOLUNTEERS

Orienting Volunteers

Many organizations provide a general orientation for all volunteers in addition to any specific training required for the volunteer to do a particular volunteer job. Your orientation can be done through written materials or group meetings. It can also be included as part of the training that the supervisor for a particular volunteer project provides to volunteers.

The orientation should provide basic information about your organization, your mission, your size, and your programs. It should also present any important philosophical basis for your work, including your values and guiding principles. Your orientation should include explanations of any organizational policies which you expect volunteers to follow, such as confidentiality and respect for all cultures. Finally, the orientation should include procedures you have established for volunteers to follow.

Training

The amount of training your volunteers will need will vary greatly depending on the type of activities they will perform. The paid or volunteer supervisor for each volunteer position should consider carefully the information and skills the volunteer will need. The supervisor should also plan to upgrade skills for volunteers who have been with you for a period of time as needed. You will also need to establish safety procedures and provide ongoing training to keep all volunteers up-to-date on them.

The paid or volunteer supervisor for each volunteer position should consider carefully the information and skills the volunteer will need.

Here are some questions which may help your volunteer supervisors develop effective training for different types of volunteers:

• What is the minimum level of information the volunteer will need to do what you are asking them to do? You'll want to be sure you provide this information both in writing and verbally.

• How available will the supervisor be while the volunteer learns the job? If the supervisor will be readily available, more things can be learned by doing than if the volunteer will need to work fairly independently from the beginning.

• How much background does the particular individual you will be training have? If they have worked in similar positions or have substantial professional training in a related area, you will want to concentrate primarily on what's different in your organization.

• How does this volunteer learn best? You'll have to ask the volunteer to find out. Some people strongly prefer reading to listening; others hate to read and get more from verbal instructions. Still others really will have to try it before they can focus on what they will need to learn. If you can't ask volunteers individually about their learning styles, try to design your training to use some of each method.

Be sure you have clear supervision for all volunteers.

• What do current volunteers believe was the most important information they needed when they began their volunteer positions? This may prove the most useful information.

• Have you developed written rules and procedures to be followed by the volunteers? The rules and procedures should be designed to minimize the possibility of problems and injuries.

Supervising Volunteers

Volumes have been written on this topic. Probably the most important piece we can emphasize here is *be sure you have clear supervision for all volunteers*. Later in this chapter, we'll discuss your organization's potential liability for the actions of your volunteers and for injuries your volunteers may sustain while volunteering for you. Adequate supervision is an essential protection against these potential liabilities.

Some nonprofits struggle with the concept of supervising volunteers because they associate the term "supervision" with oppressive bosses hounding

workers, criticizing their efforts, and threatening them with dismissal. Obviously, these techniques will not work with volunteers.

You will want the individuals who supervise your volunteers to see their roles primarily as facilitators – people whose job it is to make sure that the volunteers are able to do their best work and make the greatest contribution to the organization. The supervisor needs to check in with the volunteers to be sure they have the information and tools they need to do the job. And of course, the supervisor will want to provide positive feedback to let the volunteers know how well they are doing and that the organization appreciates their efforts.

You should also be sure to provide the support that volunteers need to carry out their jobs in the form of staff time, materials, and access to expertise when it is needed.

Evaluating Volunteers

Like supervision, the word "evaluation" has a negative sound to some individuals who have worked in situations in which evaluations were only performed as justification for termination or used as opportunities to unload criticism.

Volunteer evaluations are an important opportunity for your organization to learn from your volunteers. Volunteer evaluations should be done individually, in a confidential setting. The volunteer should be encouraged to reflect on the parts of their volunteer work which they most enjoy and those which they find most frustrating or least satisfying. The supervisor should also provide specific feedback on the areas of the volunteer's performance which are especially well done and valued by the organization. If there are areas in which the volunteer's performance has not been adequate, the supervisor should share the concern and ask the volunteer what help is needed to support improvement.

The information shared in the evaluation can help the organization learn about volunteer needs and satisfactions. The supervisor will want to consider which of the needs the volunteer has identified can be met with reasonable investment of time and resources. If some of the volunteer's needs cannot be met, the supervisor should acknowledge this.

If you determine that the supervisor cannot provide the volunteer with the level or type of supervision which the person would need to do the job adequately, you will want to offer the volunteer a different assignment within your organization. Occasionally, a nonprofit will conclude that a specific volunteer just does not fit in their organization. Be sure you have clear procedures for terminating such a volunteer's involvement with your organization. Of

course, you want the individual to remain supportive of your organization even after their volunteer experience is over, so take care to be supportive of the individual while being clear that you no longer can offer an appropriate volunteer opportunity for them.

RECOGNIZING AND REWARDING VOLUNTEERS

Many newer nonprofits consider some of the traditional methods of recognizing and rewarding volunteers to be corny and old-fashioned. They believe that pins and plaques honoring years of service will have little meaning to younger volunteers. Yet recognition and rewards are important elements in retaining valued volunteers.

Your organization may want to conduct a brief phone survey of organizations which involve volunteers similar to yours. Determine what approaches they are taking in recognizing and rewarding volunteers. You may also want to convene a volunteer committee to discuss the types of recognition and rewards they would find meaningful.

Here are a few of the ideas we've seen used lately:

- Send individual notes from the Executive Director or Chair of the Board to recognize a specific contribution by a volunteer – a call handled really well, a mailing completed quickly, a newsletter article written, etc.

- Publish thank you's to specific volunteers for their contributions in your newsletter.

- Set up a volunteer bulletin board with photos of all your volunteers and their names and roles within the organization.

- Put together an annual "volunteer book" – a publication with pictures and write-ups on key volunteers with an attractive cover – suitable for coffee table display.

- For special achievements, create customized framed certificates which recognize specific contributions and include photos or drawings of the organization's clients or work.

• Plan a fun social occasion with Board, staff, and volunteers with enough structure to assure that volunteers are introduced and commended for their work.

• Be sure volunteers are mentioned by name in newsletter articles and reports to the Board whenever possible. Share copies of these items with the volunteers.

• Consider writing letters of commendation to the volunteer's employer or church or civic group to let others know about the person's contribution to your organization. Be sure your volunteer is comfortable with this before you try it.

• Create a special place in your facility, a wall, a garden, a room, which incorporates volunteers' names into the decor.

The key to successful recognition and reward is finding a way to say thank you which conveys that your group values the individual and their specific contribution. Try a variety of approaches and let your volunteers' reactions guide you in deciding which ones to continue.

VOLUNTEERS WHO ARE REALLY EMPLOYEES

Most people think of a volunteer as someone who provides their services for free. However, there are limited situations in which the person you think of as a "volunteer" may in fact be classified as an "employee" for purposes of the wage and hour laws or other employment laws. This classification can have serious repercussions for your organization. You may find that you owe back wages and penalties or you may find that you are liable for a worker compensation claim.

The federal wage and hour laws are the most worrisome. Review page 337 to determine if your organization is covered by the federal wage and hour laws. If your organization is covered, you need to think about how you use your volunteers to be sure that the law does not classify them as employees. If your volunteers engaged in non-commercial activities, do not expect to receive material benefits from your organization, work part-time or on a temporary basis and perform services that are traditionally considered volunteer, you do not need to be concerned with this issue. However, you should be concerned if your volunteers fall in any of the following categories:

• Your volunteers work in a commercial type of enterprise (such as a publishing firm, restaurant, parking lot, mail order business, etc.)

• Your volunteers expect some form of compensation for their services. Your organization may trigger an expectation of compensation by providing your volunteers with a small payment, room, board, meals, free books, or other items of value.

• Your volunteers provide services that produce income or commercial advantage for you even though the volunteers get job skills or are rehabilitated as a result of the employment.

If you have volunteers whose service fits in any of these categories, then you should get legal advice, because this area of the federal law is unclear.

> *Example*: The Good News Church grosses more than $500,000 per year and operates a printing company to publish religious books and also does some nonreligious commercial printing. It mails its books around the country. It maintains a rehabilitation program that uses former alcoholics and drug addicts as volunteers to do the printing and provides them with meals and free copies of the religious books. Because of the commercial nature of this enterprise and because there is some payment, the Church may be required to pay minimum wage and overtime to its volunteers.

Even if you are exempt from the provisions of the federal law, you may have to comply with Oregon wage and hour laws. Oregon law is more lenient. It excludes from its definition of "employ" those volunteer or donated services performed for no compensation or without an expectation of compensation as adequate consideration for services. This exclusion applies to religious, charitable, educational, public service or similar nonprofit organizations for community service, religious or humanitarian reasons. For these nonprofits, Oregon law clarifies that these volunteers are not employees even if they receive room and board or small payments. If your nonprofit does not fit within the types described in the exclusion (for example, a social club), your volunteers may be employees.

Under both federal and state law, if any of your volunteers work for your nonprofit as full-time employees, you also need to exercise care. If the volunteer wants to work more than 40 hours per week at her or his job and call the extra work volunteer service, you cannot permit this and must pay her or him for the time. However, if the volunteer works 40 hours per week at a regular job

for your organization and then wants to volunteer to perform a service that is very different from that regular job and is one that is traditionally filled by volunteers, you can permit this.

Another circumstance that some nonprofits face is the use of trainees who are earning stipends that are less than minimum wage. In some cases, these are acceptable but in many cases these will be considered sub-minimum wage jobs. You should get legal advice to be sure that your situation is in compliance with wage and hour laws.

In addition to considering wage and hour laws, you also need to keep in mind your responsibility for worker compensation coverage if you provide your volunteers with something of value other than room and board in exchange for their work. State worker compensation laws often categorize these volunteers as workers.

> *Example*: The Regional Arts Center holds a three day art fair every year. Volunteers work the month before to prepare the site and exhibits and receive a per diem allowance. This is likely sufficient compensation to trigger worker compensation responsibilities to its volunteers.

VOLUNTEERS AND LIABILITY

Because volunteers provide services for free and often out of the goodness of their hearts, there is a tendency in the nonprofit world to treat volunteer services as "extras" rather than as services for which the organization is responsible. It may be helpful to think of your volunteers as employees as you assess the circumstances in which your use of volunteers may give rise to lawsuits.

Because volunteers provide services for free and often out of the goodness of their hearts, there is a tendency in the nonprofit world to treat volunteer services as "extras" rather than as services for which the organization is responsible.

The use of volunteers raises questions about liability in three contexts:

- When are your volunteers personally liable to those they injure?

- When is your nonprofit organization liable for the volunteer's negligence?

• When is your nonprofit organization liable to your volunteer for injuries suffered by the volunteer while volunteering?

Assessing the Risk of Harm by Volunteers

As you balance how much of your resources to devote to volunteer recruitment, screening, training and supervision, one consideration should be to assess how much risk there is that your volunteer may cause harm. To do this, you need to examine whether there are elements to your program that present a significant degree of likelihood of injury to others or may give rise to lawsuits. Consider whether your volunteers are involved in programs, activities, or fundraisers that deal with or include the following:

• children, the elderly, the disabled, clients with mental or emotional conditions, or other vulnerable populations
• food, drink (e.g., sold by your group or available at special events), drugs or medicine
• alcohol (e.g., at holiday parties, fundraisers)
• driving
• activities that can cause injuries (e.g., construction; mountain climbing; rescue operations; dealing with violent people; medical care; sports)
• activities that may create opposition (environmental activities, neighborhood issues, advocacy, unpopular publications, etc.)

As you balance how much of your resources to devote to volunteer recruitment, screening, training and supervision, one consideration should be to assess the degree of risk that your volunteer may cause harm.

If your program, activities, or fundraisers contain these or other elements of risk, you and your volunteers are more vulnerable to lawsuit than the average nonprofit. You should look particularly carefully at how you are handling your volunteers.

WHEN YOUR VOLUNTEERS FACE PERSONAL LIABILITY

Volunteers will be personally liable for their own negligence in the same circumstances in which any individual is liable for negligence. An individual generally is liable for negligence if that individual breaches a duty of care to another and that carelessness causes injury to the other person. The volunteer for your organization may be somewhat more likely to encounter a situation in

which negligence is an issue because the work of your organization may create a duty of care.

> *Example*: An individual stops to watch children at a youth center playing ball and sees that the players are playing too roughly. Shortly after that, one of the players gets hurt as a result of the rough play. The bystander is generally held not to be liable, since she had no duty to care for the children. However, if a volunteer at the youth center was assigned the job of supervising the play and failed to stop the inappropriate play, that volunteer is negligent, since the volunteer did have a duty to care for the children.

Volunteers will be personally liable for their own negligence in the same circumstances in which any individual is liable for negligence.

It seems harsh to many people that volunteers, who are often performing a service for free out of the goodness of their hearts, are held liable and may have to pay damages for their actions. However, it is helpful to think about the issue from the other side: the injured party. Suppose you were the parent who left your 5 year old child at the youth center because you understood the play was supervised. Your child was left brain-damaged because she was slammed to the ground by an older child who was playing too rough. The volunteer who was supposed to supervise the play saw that the play was too rough but failed to stop it because he was chatting with his friends. As you face hundreds of thousands of dollars of medical bills and a lifetime of care for your child, do you really feel that the volunteer should not be held financially responsible for his actions because he was not getting paid?

Regardless of which position you take on this issue, seeing the problem from both sides highlights the importance to the nonprofit of treating the work its volunteers do seriously.

WHEN YOUR ORGANIZATION IS LIABLE FOR THE ACTIONS OF YOUR VOLUNTEERS

Your nonprofit corporation is liable for your volunteer's negligence in two situations. One is when your own negligence put the volunteer in a position to cause injury. You are also liable for your volunteer's negligence, even if your organization was not negligent, if your volunteer was acting in the course and scope of her or his duties and was acting at least in part to further your mission. Note that both of these situations require that you or your volunteer has to be

negligent before you are liable. Generally, if neither you nor your volunteer is negligent, you should not be liable.

When You Are Negligent

You are liable for your volunteer's negligence if your negligence placed your volunteer in a position to cause harm. You may be negligent in failing to exercise reasonable care in selecting, training, or supervising the volunteer.

> *Example*: Your church has initiated nursery care for children while the parents are attending services. The nursery is staffed by volunteers. At the early service, the nursery is staffed by only one volunteer who abuses a child. The volunteer has a criminal record for child abuse. The church failed to run any background check and was unaware of the record. Your church, if found negligent, will be liable to the child for damages. (The volunteer is also liable.)

> *Example*: Your crisis line posts notices around town inviting troubled and suicidal individuals to call for help. You provide no significant training for your volunteer phone staff. A volunteer mishandles a call from a suicidal teenager. The teenager kills herself and her parents are suing your agency. Your failure to train your volunteers may be found by a jury to be negligent and, if so, you will be liable for damages. (The volunteer may or may not also be liable, depending on the facts.)

> *Example*: Your organization provides and installs weatherization on homes for low income people. One of your volunteer trainees improperly installs a window which falls onto a child and injures him. The trainee's supervisor, your employee, was supposed to check the work but forgot to do so. The supervisor's negligence makes your organization liable. (The volunteer may or may not also be liable, depending on the facts.)

> *Example*: Your agency provides services for low-income pregnant women, including providing volunteers who drive them to and from medical appointments. You screen your volunteers to be sure they have valid drivers' licenses, a good driving record, and insurance. You provide them with training. You also monitor and follow up on any complaints about your drivers. One of your drivers gets angry at another driver and deliberately rams that driver's car, injuring your client who is in the car. The volunteer driver is liable but, on these facts, your agency is not.

When You Are Not Negligent

It is a surprise to some nonprofits to learn that they may be liable for the actions of their volunteers even if the nonprofit did everything it reasonably could to prevent injury or damage. If you have the right to control your volunteer's activities, your volunteer will probably be treated as a "gratuitous employee" and subject to the same tests as an employee. As an employer, you are liable for your volunteer's negligence under the legal doctrine of *respondeat superior* when the volunteer's activities giving rise to the claim are within the scope of the volunteer's employment. The volunteer's activities fall within the scope of the volunteer's employment when the conduct is of the kind the volunteer has been solicited to perform; it occurs substantially within the authorized limits of time and space of the volunteer's tasks; and the volunteer's conduct is motivated at least in part by the purpose to serve your organization. You cannot escape liability simply by telling your volunteers to act carefully.

It is a surprise to some nonprofits to learn that they may be liable for the actions of their volunteers even if the nonprofit did everything it reasonably could to prevent injury or damage.

The reason that you are liable for the actions of your volunteers in these circumstances is that your volunteers, like your employees, are considered to be acting for you. Since they are, their actions are your actions. In most cases, you are not liable for all of the actions of your volunteers but only where the volunteers are negligent. This means you are generally not liable if your volunteer was not negligent and also not liable if your volunteer acted intentionally rather than negligently.

> *Example*: Your Boy Guides group has carefully screened, trained, and supervised its volunteers. A volunteer supervises a game of touch football among the boys, which is allowed by your rules. Your volunteer negligently fails to notice that the field is full of potholes and a boy is injured. The volunteer is personally liable for his negligence and your organization is also liable under the doctrine of respondeat superior for the volunteer's negligence.

> *Example*: Your daycare center investigates your childcare volunteer, who has a clean background. The volunteer later molests a child. The volunteer is liable, but your agency is probably not. You were not negligent in your hiring and you are probably not liable under the doctrine of respondeat superior since your volunteer's conduct was intentional and not motivated by a purpose to serve your agency.

WHEN YOUR VOLUNTEER IS INJURED

Occasionally, your volunteer is injured while performing her or his volunteer tasks. This could happen in any nonprofit. For example, your volunteer may slip and fall in your offices. A volunteer may hurt her or his back while lifting a table.

You are liable for injuries caused to your volunteer if your negligence substantially contributed to the volunteer's injury. Remember that if the injuries were negligently caused by one of your other volunteers or employees acting within the scope of their duties, this is considered to be your negligence.

> *Example*: One of your volunteers is driving your nonprofit's car with faulty brakes which your program director negligently failed to have repaired and is hurt when the brakes fail and he hits another car. Your organization is liable to the volunteer. (Note that your nonprofit will, by the doctrine of *respondeat superior*, be liable to others hurt in the collision as well. Your program director will be personally liable to the volunteer and the others hurt because of the program manager's negligence. However, the volunteer will not be liable to the others who are hurt because the volunteer was not negligent.)

Assessing the Risk of Harm to Volunteers

You should assess the nature of the work that your volunteers do to see how much risk you have that the volunteer may be injured. This is a somewhat different assessment than the one to determine how much risk there is that your volunteer may injure someone else. Consider whether your volunteers engage in the following activities as part of their volunteer tasks:

- lifting
- construction
- driving
- sports
- dealing with potentially dangerous populations (criminals, mentally or emotionally disturbed people, abusers, aggressive animals, drug addicts or alcoholics, etc.)
- dealing with natural disasters
- dangerous rescue work

PROTECTION FOR YOUR VOLUNTEERS AND YOUR ORGANIZATION

There are several methods of protection for volunteers and for your organizations. Federal law and, in very limited circumstances, state law offers some protection. Your nonprofit and your volunteers can also act to prevent or minimize problems concerning the liability of your volunteers and of your organization by using both preventive strategies and damage control.

Federal and State Law Protections

The federal Volunteer Protection Act provides considerable protection to volunteers of certain nonprofit organizations. Your organization falls under this law if you are exempt under §501(c)(3) or are organized and conducted for public benefit and operate primarily for charitable, civic, educational, religious, welfare, or health purposes, and do not engage in hate crimes. If your organization so qualifies, your volunteers are those who provide services without an expectation of pay and who do not receive anything of value from your corporation worth more than $500 per year for their services. This prevents a volunteer from losing coverage because he or she receives small gratuities, such as free admission to an organization's theatre productions. In addition, volunteers can be reimbursed for their out-of-pocket expenses. If required by law, the volunteer must be licensed or certified by the appropriate agency to be protected from liability.

Volunteers acting within the scope of their responsibilities are not liable for their negligence except to your corporation. This means that those outside your corporation cannot recover their damages from your volunteer. Your nonprofit can recover from the volunteer if the volunteer's negligence causes damage to you. Your volunteers are liable to all those they injure for gross negligence, reckless misconduct, and conscious, flagrant indifference to the rights or safety of anyone harmed by their actions.

There are a number of exceptions to the law's protection. The federal statute does not apply if your volunteer caused harm by a motor vehicle, craft, or vessel for which the volunteer must be licensed. It also does not apply if your volunteer is under the influence of alcohol or drugs at the time of the misconduct. This protection does not apply if the volunteer's misconduct constitutes a violent crime or a hate crime under federal law, involves a sexual offense under state law for which the volunteer is convicted, or is a violation of a federal or state civil rights law. The law also imposes restrictions on the type of damages for which your volunteers can be sued.

Although those outside your corporation can't recover for their injuries if your volunteer is negligent, they can still sue. The injured person may pursue a lawsuit by claiming that the volunteer was grossly negligent. Although the volunteer may win the suit, he or she will spend a considerable sum of money on legal fees and costs defending the case. Consequently, many organizations and volunteers want insurance (discussed below) even with the more favorable federal law.

In some rare cases, Oregon law protects volunteers from liability. For example, some volunteers who are transporting the elderly and disabled and some volunteers who are assisting in hazardous waste cleanup are immune from suit.

Preventive Actions

In addition to legal protections, you can act in a *preventive* way to head off problems. This means following the actions outlined earlier in this chapter to be sure that you are carefully selecting, training, and supervising your volunteers. This will permit you to avoid most problems that can occur.

You and your volunteers can take some actions to minimize the impact if your volunteer is involved in causing an injury or damage.

Damage Control

The second strategy is *damage control*: to minimize the consequences of problems that do occur. You and your volunteers can take some actions to minimize the impact if your volunteer is involved in causing an injury or damage. There are three sources to look to for help: recordkeeping, releases and insurance.

Recordkeeping

There is a big difference between what happened and proving what happened. One of the purposes of good recordkeeping is to afford a way to prove what happened. You should keep records of your volunteers and of the duties they perform. Good records would permit your organization at a later date to know who did what, when, where and how. Your records should also document the procedures you followed in recruiting, selecting, training, and supervising your volunteers. Good records can also provide you with other information to document that you act reasonably.

> *Example*: Volunteers at the Helping House are given a route slip when they deliver meals to the elderly. The route slip tracks when, where, and to whom the volunteer does deliveries as well

as provide a space for the volunteer to note any special food requests that those receiving food make and why, so that the organization can avoid sending the wrong food to those who may be allergic or have medical conditions that restrict their diet.

Of course, the amount of recordkeeping you can realistically do will be governed by factors such as your budget and staffing. However, it is important not to treat recordkeeping as an extra but to recognize that it can be an important protection for your organization and volunteers.

The most practical protection your volunteer and your organization can have is insurance.

Releases

Your organization can get written releases from the people you serve or deal with in which those people agree not to sue you or your agents, employees, and volunteers in the event that an injury occurs. Releases are often ignored by the courts, particularly if the release is signed by someone who may not be completely competent or in a position to act freely (such as some elderly people or those who fear they won't get benefits if they don't sign). Still, there are circumstances when they are enforced. Releases are discussed in more detail on page 626.

Insurance

The most practical protection your volunteer and your organization can have is insurance. Insurance is useful for two reasons: one is that it covers any judgment against the insured party; the second is that the insurance company pays the insured party's legal expenses. You and your volunteers can look to several sources to see if you have or can get insurance:

Volunteers' Personal Insurance Policies

Volunteers should check their personal insurance policies listed below to see if they have coverage. This coverage may be found in several policies. You should be aware that if the volunteer's personal policy covers the volunteer, this coverage will not protect the nonprofit organization because the volunteer but not the nonprofit is the insured party under these coverages.

Homeowners or Renters Insurance

Your volunteer's homeowners or renter insurance may cover claims against the volunteer based on personal injury or property damage. This coverage usually applies even if the injuries occurred away from home and often applies to volunteer activities. Even if it is included, most policies do exclude intentional harm caused by the insured. This would eliminate most child abuse claims from coverage. Some policies also exclude claims from commercial child care, which may cover nonprofits providing childcare if it is done for a fee. Your volunteers should talk to their insurance agents to see what their policy covers.

Automobile Insurance

Volunteers will often have personal car insurance policies which would normally cover them while driving in connection with their volunteer work.

Umbrella Policies

Some volunteers will have umbrella policies that expand the coverage available on homeowners and renters policies. Some of these umbrella policies also will cover volunteer work. If they don't, your volunteers can sometimes buy that coverage. As with homeowners or renters insurance, umbrella policies generally cover only personal injuries and property damage and so may not provide the coverage your volunteers need. Some nonprofits want to reimburse their volunteers who have to buy volunteer coverage. If you are going to reimburse your volunteer to buy coverage, you should talk to an attorney first to be sure you set this up correctly. Your nonprofit may have restrictions on providing private benefit for individuals. Providing umbrella coverage could violate that rule if you are not careful, since you are paying for coverage that not only protects your volunteer for liabilities incurred as a volunteer but also for liability elsewhere in their lives.

Organizational Policies

Organizational policies are ones your nonprofit purchases to protect itself. In most cases, you would purchase the policy to cover your volunteers as well. These policies protect you by covering any judgments (up to the limit of the policy) against your organization and the insurance company pays your attorney fees and costs incurred in connection with claims. If the policy also names the volunteer as an insured party, the insurance company would similarly protect the volunteer.

General Liability Policy

You should check your organization's general liability policy (see page 514 for a discussion of this policy) to see if it covers volunteers as well as your nonprofit. Some policies cover only your employees. The word "volunteer" should appear under the list of insureds or as an endorsement, usually called "Additional Insureds – Volunteers." If you don't have this coverage, you can usually add it quite cheaply, sometimes for free. Be aware that these policies are limited in what they cover and often exclude risks such as child abuse and car accidents. Another disadvantage is that when the volunteers are included, they share the policy limits with the organization. For example, if the volunteer and the organization are each held liable for $700,000, a million dollar policy would come up short.

Volunteer Liability Policy

Your organization can purchase a volunteer liability policy. The sole purpose of this policy is to protect volunteers who are sued. The cost of this policy is often very cheap. In the case mentioned in the introduction to this chapter, the nonprofit organization had purchased this insurance for its volunteers and it was the insurance company that paid the $3 million judgment that had been entered against the volunteers.

If you buy insurance to protect your volunteers, there are a few pointers to keep in mind. If you provide trainings to your volunteers or have operating policies or safety procedures for your volunteers, this may reduce the cost of your insurance policies covering volunteers. Give your agent a copy of your written materials. Be sure that any volunteer liability policy you purchase defines "volunteer" broadly, especially if the volunteer gets any compensation or perks from volunteering. It pays to shop around and get an agent who is familiar with nonprofit insurance policies.

Protection for Your Nonprofit Organization and Your Volunteer When Your Volunteer Is Injured

Somewhat different damage control strategies need to be considered in connection with the situation in which the volunteer is injured while acting as your volunteer.

Releases

You could consider getting a release from your volunteers in which each volunteer agrees not to sue you if she or he is injured while volunteering. How-

ever, there are obvious problems with this in terms of your ability to attract volunteers.

Insurance

In addition to the insurance described above, you may want to consider purchasing worker compensation coverage for your volunteers. In Oregon, you are not required to purchase this coverage for volunteers, but it is available. You may particularly want to consider this if you have volunteers who engage in risky activities as described above. There are advantages to the volunteer and possibly advantages to you in having worker compensation coverage. The advantage to the volunteer is that the coverage applies whether or not the volunteer can show your organization's negligence caused her or his injury and may be more extensive than the other coverage you have available.

> *Example*: Your volunteer injures his back while lifting a box in your soup kitchen. If you did not have worker compensation coverage and if your general liability policy did not cover this injury, your volunteer would be have to pay his bills through his own insurance, if any. He would not have grounds to recover from your organization because you were not negligent. Even if your liability insurance covered the volunteer, it would generally only pay for his medical bills but would not pay for any permanent disability. However, worker compensation would pay the medical bills and an award for permanent disability, if any, without regard to whether your organization was negligent.

There are two advantages to your organization. One is that your volunteers will be happier if they are covered for injuries while they are volunteering. The second potential advantage to you is that the volunteer may be prevented from suing you in those situations where you were negligent. Since you could potentially lose a lot of money in that type of lawsuit, most nonprofits would prefer not to take that risk. Instead, the volunteer has to take the coverage offered by the worker compensation system and cannot also sue you. This is the rule where employers provide worker compensation coverage for their employees. However, the law is not quite clear as to whether this would be the result where a nonprofit voluntarily elects to cover its volunteers.

There is one disadvantage to covering your volunteers under your worker compensation policy. Injuries to your volunteers could affect your premium ratings and raise your rates. You can discuss this with your insurance agent. You may decide that it is more advantageous for you to cover your volunteers under an accident policy.

Because the law is ambiguous about whether your nonprofit would get protection from lawsuits if you elect to cover your volunteers under the worker compensation system, you may want to have them sign releases agreeing not to sue you in exchange for providing the worker compensation coverage. Although the courts could strike this type of release down, its chances of being upheld are better than average. A sample "Complete Release and Hold Harmless Agreement by Volunteers" is included in the Forms section. Have your attorney review and modify this if necessary before you rely on it.

If you are thinking about providing worker compensation coverage for your volunteers and asking them to sign a release, you may want to consider talking it over with them and getting their input. If the volunteers don't understand what they are signing and what the advantages to them are, this may create some antagonism between your organization and the volunteers.

Consult Appendix 1 if you would like information about source material related to this Chapter.

18 HOW TO SUCCESSFULLY RESOLVE CONFLICT

While we may all wonder whether an organization with no conflict is dead rather than alive, there can be little doubt that too much conflict with too little resolution is a surefire road to burn-out. Many nonprofit organizations regularly help clients confront and resolve major conflicts in their lives. Yet applying conflict resolution skills to organizational problems is difficult. Most of us have been conditioned thoroughly to avoid conflict and to withdraw from conflictual situations or to engage in conflict with a combative, "I must win – you must lose" attitude. While some organizations may be particularly vulnerable to conflict avoidance, other organizations may have exactly the communication skills and well developed capacity for empathy needed to resolve conflicts.

Some of us have experienced so much injustice in society's response to our needs that efforts to ask directly for what we want, to persist in our requests, and to negotiate fair agreements, have seemed a ridiculous waste of time. Whether we have been conditioned to give in, withdraw, manipulate, or take by force, many of us hate conflict. Consequently, we may be most interested in putting our energy toward preventing conflict in our organizations.

This chapter will give you some new perspectives and practical advice on how to prevent conflict and how to deal creatively and successfully with it.

THIS CHAPTER COVERS

- **Preventing Organizational Conflict**
- **Identification of Conflicts**
- **Steps to Conflict Resolution**
- **Gaining Insight into Special Problems**
- **Communication Styles**
- **Summary**

The chapter closes with a personal support exercise to develop good listening skills.

PREVENTING ORGANIZATIONAL CONFLICT

Many conflicts among staff members, and among staff, Board, and volunteer groups, are perceived as personal when their true origins are structural. Clarity in assignment of responsibilities, communication channels, and decision-making processes can prevent conflicts.

Explicit expectations are also helpful. In organizations which include individuals from diverse backgrounds and with varied levels of skill and experience, assumptions about job expectations may be varied. Some people assume that all work for a job will be confined to defined working hours. Others assume that "dedication" means that all workers will be available at virtually all times. Some people assume that mentioning a problem once is sufficient, and that if change does not occur it is the result of disagreement or indifference. Other people assume that persistence is the best way to accomplish change. Conscious effort to make both individual and organizational expectations explicit is required to prevent misunderstandings based on incorrect assumptions.

Many conflicts among staff members, and among staff, Board, and volunteer groups, are perceived as personal when their true origins are structural.

Regular honest evaluations and immediate feedback are important tools for conflict prevention. Unspoken criticisms and misunderstandings can easily build a small problem into a large one. Organizations convey conventions about the level of honesty permitted in evaluations and feedback. If there is a covert understanding that one must never say anything "critical" or harsh, honest feedback will be meaningless. A regular system of evaluations which commends success as well as identifying problems is usually more effective than sporadic "evaluations" which are staged only when problems have built to crisis level.

Organizations that are committed to equal treatment of women and individuals from different cultural backgrounds may be vulnerable to the fallacy that all staff, Board, and volunteers are the same in all ways. Achieving goals for diversity among staff, Board, volunteers, and clients requires acknowledgment of differences. If an organization conveys an expectation that all participants are the same, conflict is likely to arise when the real differences in background, values, experience, and skills among participants emerge. If the organization exercises further effort to downplay or deny differences, resolution of conflict will be extremely difficult.

Many organizational conflicts have a lack of information at a critical time. As an employer, your organization needs to recognize orientation and supervision as valuable staff activities, not "extras" to be fit in as time allows. Commitment to any form of shared decision making requires equal commitment to structures which promote information sharing. Your Board decisions on layoffs or salary increases are contingent upon information about financial conditions and prospects. If your staff or volunteers lack this information, conflict can easily arise about the Board's decision.

Because the work you do is so important (in some cases, literally the difference between life and death) you may be tempted to focus on what is left to do, ignoring your partial successes, seeing your work as half undone rather than half done. Rewards for partial successes are essential support for individuals within your organization. Without tangible support, worker and volunteer doubts can bring a negative charge to the organizational atmosphere which sets the group up for conflict and makes resolution extremely difficult. The Personal Support Exercise at the end of this chapter may be helpful practice for Board, staff, and volunteers to help each other feel support for their efforts at difficult work. People frequently can generate the best solutions to their own problems if given the opportunity and the support for doing so.

IDENTIFICATION OF CONFLICTS

Not all conflicts can or should be prevented. Innovation and growth are products of discontent with "the way things are." Identification and resolution of conflict is essential for these positive criticisms to surface.

The stomach is probably the best organ for use in conflict identification. If you feel "tight," "uncomfortable," or "antsy" while a discussion or non-verbal interaction is occurring, chances are good it's a conflict. Some people are so frightened of conflict that they succeed in turning off the signals their bodies send them; they may honestly be astonished when someone claims there is a conflict. (Some men have been socialized to ignore emotions. Women who have made it in traditional male hierarchies may have learned to turn off to any disagreeable feedback from themselves and from others.) This toughening up is clearly a useful coping skill in some settings, but it may seriously impede recognition of conflicts.

Even without signals from the gut, organizational conflicts can be detected by observing the output. If very little seems to be accomplished at meetings or in the workplace, unresolved conflicts are a likely cause. Detecting the cause of the slowdowns may be more difficult. For example, when meetings bog down with lengthy discussions of apparently trivial details; the essential conflict is

rarely over the details under discussion. Instead, the group may be unwittingly conspiring to avoid a more significant discussion in which genuine conflicts will arise. Or the trust level among individuals may have been so severely damaged by unresolved conflict that even minor cooperation is impossible.

The stomach is probably the best organ for use in conflict identification.

Passive resistance is a common response to conflict. When proposals for change are routinely adopted but rarely implemented, passive resistance is a likely culprit. People in the group who are reluctant to express their disagreement with proposed changes openly, or are unable to persuade the majority of their views, may resort to foot dragging as a signal that the conflict is not resolved for them.

Your group can deal more effectively with conflict if there is explicit agreement that it is desirable to bring conflicts out into the open, including commenting when one senses a conflict between others. Identification is the first step toward resolution. The longer the group delays open recognition of conflicts, the more damage the conflicts can do to the work of the organization and the relationships between the individuals involved.

STEPS TO CONFLICT RESOLUTION

An absolute precondition to conflict resolution is the desire for resolution. All parties involved must have reason to want the conflict resolved. Organizations may be most damaged by conflicts which arise as staff and volunteers are leaving the group, and no longer have anything at stake in resolving the problems. While conflicts can be temporarily suppressed by fiat, or by exclusion of "troublesome" individuals, if the root of the conflict is organizational, it will reappear in the voices and feelings of new faces responding to the old problems.

1. Clarification

Frequently, people locked into conflict have difficulty identifying all the issues or root problems underlying their strong feelings. Participants quickly lose perspective on the relative importance of words or incidents, and compound basic organizational issues with personal feelings of rejection, resentment, and anger.

A person who is not so emotionally involved can be extremely helpful in clarifying the underlying issues. It may help to start by identifying all the observable performance problems. Do meetings take too long yet fail to make

important decisions? Has someone failed to complete important tasks? Clarification requires care to use neutral language and to avoid assumptions about why someone does or says something.

> *Example*: "Our meeting last night lasted three hours rather than two as we had planned, and we did not reach a decision on buying a new computer as we had planned" does more to clarify the problem than "because the Board wasted so much time visiting and exchanging recipes for the bake sale, the darn meeting lasted 'til ll:00 and we still can't buy the computer."

Frequently, conflicts involve unmet expectations. It's helpful to identify what all parties to a conflict expected of each other. This process should not be a debate. The goal is to identify what was expected, not to determine whether it was reasonable to expect it. If parties to a conflict express widely differing expectations, this should be seen as real progress toward understanding and solving the problem, not as evidence that the problem is huge or unsolvable.

Clarification requires careful attention to assumptions about others' motivations and attitudes. Frequently, our assumptions about someone else's motivation upset us more than their actual behavior.

An important part of clarification is empathizing with all parties to a conflict. Through empathy, one can understand the feelings and perceptions of another even if one disagrees with her or his action or beliefs. The understanding of how the other party to a conflict is experiencing the situation is critical to gaining a clear view of the entire conflict.

2. Negotiation – Mediation

In some cases, clarifying the issues, assumptions, and observable problems which have produced the conflict will make ways to resolve the problem clear to all parties, and little further intervention is required.

But frequently, clarification is only the beginning of a process of negotiation or mediation needed to resolve the problem. Negotiation generally involves just the parties with a role in the conflict; mediation involves a "neutral" party who attempts to assist the involved parties. In both negotiation and mediation, it is extremely important to establish explicit ground rules.

Key questions in establishing ground rules include:

- Are all parties open to change?
- Is it okay to be honest? Will there be reprisals?

- Do the parties to the negotiation or mediation have the actual power to decide the outcome or does some other individual or group (a director or Board) hold final authority? If authority to make a decision has been delegated to the parties participating in the negotiation or mediation, is there any agreement about accepting the decision reached in this process versus appealing to a higher authority to overrule it?

Of all these questions, the first is probably the most critical – Are the parties open to change? – because if they're not, and if clarification has not resolved the problem, it is quite likely that negotiation or mediation is futile.

While negative or limiting responses to the other questions will place some restrictions on the negotiation or mediation, they probably do not preclude resolution. It is possible to reach at least a partial resolution without complete honesty, and it is probably preferable to settle for a partial solution (with clear knowledge of the limits on honesty and the potential for reprisals), than to plunge unknowingly into the whole truth with a party unwilling to forgo the right of reprisal.

Environment is a critical factor in negotiation and mediation. Whose turf is the discussion held on? Whose schedule has been accommodated? Who else is present and how are they perceived by the involved parties? Progress in negotiation or mediation usually is aided by a neutral environment. Both actual and perceived power within the organization and interpersonal relationships are often major factors in conflicts. Neutral ground can give both parties "emotional space" to consider redefining power relationships and imagine changed dynamics. Remaining in the usual situation, particularly in an emotionally loaded environment may deter one or all parties from trusting each others' willingness or ability to change.

A good starting point for negotiation or mediation is the statement by each party of his or her "100%." If you could have your way entirely, and obtain 100% of the results you want, what would that be? Women are frequently conditioned to compromise and sacrifice so that stating a 100% desire may be very unfamiliar and difficult. It is important to remember that stating clearly what you want does not mean you won't settle for anything else, or that you're selfish or not considering others. Instead, your statement of your 100% will help the others understand what you really want. Fears and assumptions about others' desires are major barriers to conflict resolution.

Listening to others' 100% may be difficult. Some people are so conditioned to compromise that they feel compelled to acquiesce to every "demand," no matter how unreasonable or unwise.

For this technique to work, all parties must forego creating a case to justify why the other is wrong and they are right. Instead, the goal is finding common ground – are the 100%'s of the parties really mutually exclusive? Can all parties have a substantial part of what they want without impinging on critical needs of others?

In highly charged emotional situations, a neutral mediator may be essential. The parties involved may have stopped listening to each other or may be unable to control their "case building" approaches. The mediator can help all parties focus on "solution building." Good mediators are careful not to impose their own solutions, working instead to help parties to the conflict find their own solutions.

3. Follow-up

The success or failure of an effort to resolve conflict cannot be determined at the end of the negotiation or mediation session when all parties shake hands and agree. Success or failure is determined by results. Did the parties stick to their agreements and were the problems solved?

Verbal communication in a conflictual situation is often open to misunderstanding. Parties to a verbal resolution may remember their agreement quite differently a day or month later. Even when there is agreement on the words of a resolution, disagreement about the meaning of those words may persist. Consequently, it is extremely helpful to include as part of any resolution to a conflict, a concrete description of what actions will be taken, by whom, when, and with what desired result. It may also be helpful to write down the critical elements of the agreement. The act of writing often reveals assumptions and misunderstandings which are not clear in discussion.

In addition to describing the agreement and its intended results clearly, it is important to agree on a plan for checking-up on the progress of all parties toward fulfilling the agreement. Who will be responsible for *monitoring* the resolution of the conflict? How soon do the parties involved expect to see an observable change? How long are they willing to wait? The greater the clarity of the follow-up plans designed at the time of negotiation or mediation, the greater chance that all parties involved will feel they can risk making changes.

GAINING INSIGHT INTO SPECIAL PROBLEMS

Several circumstances may make conflict resolution particularly difficult. One problem frequently encountered is the conflict between organizational needs and personal needs of the people involved. Because nonprofits frequently

develop from the personal commitment and experiences of the people involved, they can provide an atmosphere in which employees and volunteers are encouraged to share more of their personal lives then they would in a typical employment situation. Many nonprofits consider the provision of personal support and facilitation of personal growth of staff and volunteers an important part of the organization's goals.

As in any employment situation, there are times when the needs of the organization to have a task done in a specific manner or by a specific deadline conflict with the needs of individual staff or volunteers for time-off, personal support, or emotional space. Extremely difficult conflicts arise in organizations lacking clarity about the limits for dealing with personal issues which impact on job performance. Organizations which experience repeated conflicts over issues such as tardiness, failure to fulfill job responsibilities, etc., may need to examine the expectations of staff, Board, and volunteers in regard to the relative importance of meeting personal needs versus meeting organizational needs.

Extremely difficult conflicts arise in organizations lacking clarity about the limits for dealing with personal issues which impact on job performance.

Another frequent source of extremely difficult conflict is the presence of unworkable demands for job performance. In this era of funding cutbacks, organizations frequently attempt to sustain all existing services with greatly reduced staff. The result may be the creation of jobs which cannot be adequately performed. People confronted with undoable jobs respond in a variety of ways: frozen inaction, selection of favorite tasks to perform and disregard of others; or wild efforts to touch all bases lightly. The response of Directors, volunteers and other staff to these coping mechanisms frequently escalates conflicts. Attempts to treat the resulting conflict as a personality difference or a communication problem will usually be unsuccessful since the source of the problem is structural. Instead, such conflicts must be approached through development of an organizational decision-making process which will prioritize the work to be done, and permit all involved parties (Board, staff and volunteers) to have input into the choices for use of limited staff time.

Factors beyond the control of participants in a conflict pose particularly difficult problems in conflict resolution.

> *Example*: In one child care program which used rented space in a church, conflict continually arose within the staff about a prohibition against allowing children in the hall. The director was confronted by staff who felt that the restriction was unreasonable, difficult to enforce, and a real burden to both staff and children.

> While in an effort to resolve the conflict, the director might agree to try again to get the church to change its policy, the final power to change the policy did not rest with either the director or staff. Consequently, efforts for conflict resolution between the director and staff must focus on behaviors, attitudes and policies which are within the control of the parties involved.

Particularly difficult to resolve are conflicts in which at least one party represents the needs or rules of outside parties with very little ability to modify that outside party's demands. However, the statement "I'm just following policy" *can* be a smokescreen for personal intransigence. Part of the clarification phase of conflict resolution must include investigation of the extent to which external powers actually limit options for resolution.

Finally, special barriers to conflict resolution are posed by stereotypical assumptions about attitudes or abilities based on race, sex, sexual orientation, age, disability, or class background. When one or more parties to a conflict hold stereotypical assumptions about the other parties, resolution on particular issues or situations will be followed by emerging new conflicts.

In a conflictual situation, it is very difficult for people to recognize the role that their stereotypical assumptions may play. Attempts to confront stereotypical assumptions will frequently be met with defensive responses and denial. It may be helpful to have explicit agreement to ground rules which prohibit labeling and generalizing. People are more likely to be able to see their own racism or sexism in a particular situation if they can be confident that they will not be labeled racist or sexist in every other situation. For most people, gaining self-awareness about stereotypical attitudes in a particular situation can lead to self-discovery of similar attitudes in other situations.

Recognition of stereotyped thinking is particularly important for the targets of the stereotypes.

> *Example*: Most women have had the experience of being invisible in predominantly male meetings. In such situations, suggestions and analysis offered by women may be ignored, while similar comments from males draw enthusiastic response. Resolution of the conflicts which result from this sexist treatment requires explicit recognition of the sexist attitudes involved. Without this explicit recognition, the victim is burdened with the presumption that her failure to communicate effectively is the result of some inability on her part.

Increasingly, nonprofit organizations are recognizing the value of training focusing on dealing with the impact of racial, cultural, and other types of diversity within their staff, Board, volunteer and client groups.

COMMUNICATION STYLES

Human communication is a complex art and a full exposition of communication dynamics is far beyond the scope of this book. However, the communication styles of parties to a conflict heavily influence the ease with which conflicts can be resolved.

One way of categorizing communication styles identifies four major approaches: passive, indirect, aggressive, and assertive.

- Typical *passive* communication is extremely limited. The passive participant volunteers little information or opinion, and places the burden of decision making on others. The passive individual does not discuss or argue – they merely do not carry out decisions with which they disagree.

- The *indirect* communicator does express opinion and viewpoints, but does not "own" them (take responsibility for holding their views.) Typically, the indirect individual attributes their feelings to others, and considers their actions to be the inescapable outcome of the demands or wishes of others.

- The *aggressive* communicator frequently believes that the best defense against unwanted responsibilities or views is a strong offense, or attack. The aggressive communicator focuses only on their own needs and places winning as their primary goal in discussion.

- The *assertive* communicator is clear about their own needs and feelings but open to hearing those of others and seeking mutually acceptable solutions. They consider their own needs and views to be worthwhile; take responsibility for holding them; and do not give lip service to views which are, in fact, unacceptable to them. They are able to state their views clearly without labeling other viewpoints as totally wrongheaded.

Clearly, the assertive communication style facilitates resolution of conflict. Both the passive and indirect styles make clarification and identification of

issues difficult since the passive or indirect person is reluctant to fully express their views and take responsibility for their own actions.

Groups experiencing significant conflicts among non-assertive group members may want to consider some basic assertiveness training as an aspect of conflict resolution. The aggressive communication style may pose particular problems in predominantly women's organizations. Many females in the United States are socialized to fear aggressive behavior and therefore withdraw or submit. For such women, confronting an individual with an aggressive communication style is particularly difficult. For the aggressive individual, it is difficult to actually hear the views or needs of the other parties to the conflict through the barrage of attack.

SUMMARY

Conflicts within organizations may involve either structural issues or personal communication styles and values or both of these. Resolution of conflict requires careful identification of root causes, and a shared effort to break out of communication ruts to gather new information about feelings and options for resolution. Sound organizational structures and regular honest evaluations can prevent numerous conflicts.

Some conflicts are bound to arise from the normal growth processes of organizations and individuals. Prompt resolution of conflict is important. Without resolution, conflict spreads within organizations, involving people who have no direct interest in the conflictual issues with the backlash of feelings and tensions.

~ PERSONAL SUPPORT EXERCISE ~

Tips For Good Listeners

• Listen – Don't interrupt or talk about yourself.

• Be supportive – Watch your body language as well as words.

• Encourage the speaker to express their feelings about situations which are hard to talk about.

• Help the speaker stay on the subject, especially on subjects which are hard to talk about.

• Encourage the speaker to talk about possible solutions to the problem which they have considered.

• Don't offer advice or "helpful information" until the speaker has fully expressed herself or himself. Remember that asking for advice can be a way of avoiding dealing with feelings about a problem.

The Listening Exercise

• Pick a partner you feel comfortable with and check out their willingness to listen and to keep what you say confidential.

• Talk to this partner for five minutes about one problem you face as an administrator, staff or Director, such as:

-Your own time management
-Bad employee relationship
-Service delivery problems at your organization
-Financial problems of your organization.

• Switch roles; if you talked, listen; if you listened, talk.

• Evaluate your listener. Give your listener feedback about the degree to which they:

-Listened without interrupting.
-Encouraged you to express feelings rather than restate facts or recount incidents.
-Expressed support for you personally without necessarily supporting all your actions.
-Offered advice only when you asked for it and only at end of the session.

Part IV

SUCCESSFUL FUNCTIONING: MONEY, RECORDS AND RULES

19 UNDERSTANDING FINANCIAL MANAGEMENT

Good financial management is a goal of almost every nonprofit corporation. Your Directors, staff, and volunteers want to have confidence that the resources you have worked so hard to obtain are being used effectively. And donors want assurances that their funds are being used for the purposes they intended.

THIS CHAPTER COVERS

- **Signs of Good Financial Management**
- **The Big Picture**
- **Timing for the Financial Management Cycle**
- **Financial Management Checkup**

SIGNS OF GOOD FINANCIAL MANAGEMENT

What does "good financial management" mean in a nonprofit? How will you know when you have it? Here are four key signs:

Achieving Your Mission

The most important sign of good financial management is that your organization is actually doing what it was formed to do. This means you are obtaining the resources you need to do your work and using those resources effectively. In this and subsequent chapters, we'll talk about the systems and strategies you'll need to be sure your organization stays on track financially.

The most important sign of good financial management is that your organization is actually doing what it was formed to do.

Solvency – Staying in the Black

To be sure that your organization stays around to keep fulfilling its mission, you'll need to build a positive net worth. This means your assets – the things of value which your nonprofit owns, should be greater than your liabilities – the amounts you owe to others. We'll talk about the planning and monitoring steps you'll need to take to avoid "red ink."

Liquidity – Paying What You Owe on Time

You'll want your nonprofit to have the cash it needs to meet its obligations to employees, taxing authorities, and creditors on time. Without careful planning, even a nonprofit that has a positive net worth, i.e. is solvent, can find it doesn't have the cash it needs when it needs it. We'll talk about techniques to project your cash needs, and be certain you can meet them.

Documenting the Observance of Restrictions

Nonprofits face considerably greater scrutiny than most businesses. Nonprofits regularly accept funding from governmental agencies, foundations, and individual donors which comes with strings attached – specific restrictions on how you can and cannot use the money. We'll talk about the controls, recordkeeping, and reporting needed to be sure you are staying straight with restrictions and able to prove your compliance whenever asked.

So how can you be sure your nonprofit is managing its finances in ways which will lead to these results? A good starting point is understanding that nonprofit financial management involves a recurring cycle of five basic functions. We'll tackle the details of each of the five in the chapters which follow. But first, let's start with the big picture.

THE BIG PICTURE

The financial management cycle includes five key elements:

- Planning
- Execution
- Recording
- Reporting
- Monitoring

Let's look at these five elements in the financial management cycle one by one.

Planning:

Every nonprofit needs to work with a plan for how it will obtain and use resources. The first tool you'll need is an *annual budget*. The annual budget is your plan for where you will get resources and how you will spend them over your fiscal year. Your Board will need to adopt the annual budget to provide authorization for staff (or volunteers if there are no staff) to expend the corporation's funds.

Your *fiscal year* is the twelve month period you selected to use to keep track of your financial activity. You may have chosen the *calendar year* as your *fiscal year*, meaning that you will plan and keep track of finances using the 12 month period from January to December. However, nonprofits are free to choose fiscal years other than the calendar year. Common fiscal years include July 1 through June 30 (used by many state and local governments) and October 1 through September 30 (used by the federal government).

Whatever fiscal year your organization has chosen, your annual budget should provide a complete picture of all the sources of income you will have and all the costs you will incur. See Chapter 20 for help setting up your annual budget and dealing with the specific budgets required for some grant funding.

Execution:

Once the plan is made, you're ready to act. Financially speaking, this means do the things you planned to do. Rent the office, hire the staff, buy the supplies – all the costs that were authorized in the budget. It also means raising funds, charging fees, and doing whatever else your plan calls for to generate income. Chapter 21 describes fundraising in more detail.

You'll need systems and procedures to handle receipt and disbursement of cash, authorize purchases, keep track of employee time, and perform all the other financial activities encompassed in your budget plan. Chapter 22 will help you set up the systems you need for execution, and evaluate whether the ones you already have in place are protecting your corporation from errors and dishonesty.

Recording:

Keeping good records of all financial activity is the heart of any good financial management system. In the *recording* phase of the financial management cycle, your organization will need to use standard accounting practices to track all financial activity. Chapter 23 will explain the choices you'll need to make about methods of accounting and both simple and more complex ways to handle your accounting needs. Chapter 24 will cover the more specialized topic of payrolls.

Reporting:

While in the early days of an organization it may be possible to just take a look at the accounting records and get a good idea of how things are going, once your organization is in full operation, you'll need *financial reports* in order to understand what has happened and what impact it has had on your organization's financial position.

Chapter 24 explains the standard reporting formats for nonprofit organizations and suggest some other specific reports your organization may want to develop for the Board, management, or funders.

Monitoring:

It really won't matter how great your recording and reporting is – if no one ever reads and understands your financial reports, you'll be making decisions without the information you need. In the fifth stage of the financial management cycle, the Board, the staff, and in some cases outside parties review the financial reports, compare them to the budget plan, and determine whether adjustments are needed. It's this review and the resulting need for revisions to

the plan which brings the cycle full circle, back to the planning stage. Chapter 25 is designed to help Directors and managers ask the right questions to understand your organization's financial health during the monitoring stage.

TIMING FOR THE FINANCIAL MANAGEMENT CYCLE

You'll want to establish some regular time frames for the cycle of financial management functions in your organization. First, develop the annual budget in time for the Board to discuss and adopt it before the beginning of the fiscal year covered by the budget.

Execution activities will be continuous throughout the year. Once you have a budget approved by your Board, your organization will authorize the purchases and employment covered by the budget, and keep working to get the resources and pay for them according to the plan.

Recording is also continuous. You'll need to keep written records of each check written, each bank deposit made, and all of your other financial transactions at the time the transactions occur.

Financial reports should be prepared at the end of each month. They are prepared directly from the accounting records and present the financial activity for the month just concluded and a summary of activity for the entire current fiscal year. Most nonprofits try to produce the financial reports for one month before the end of the next month, i.e. produce January's reports before the end of February. The more quickly you are able to produce the reports, the more useful they will be in your decision-making.

Monitoring is also a year-round activity. You'll want to review each month's financial statements as quickly as possible after the reports become available. Your review of the financial reports will help your decide whether your plans, embodied in your budget, are working. Many nonprofits do a mid-year budget revision process, formally revising the official organization budget to reflect revised plans for obtaining income and allocating resources.

FINANCIAL MANAGEMENT CHECK-UP

The "Nonprofit Financial Management Self Assessment Tool" in the Forms section is designed to help you determine whether your nonprofit has established all the systems and processes you need to assure effective financial management. New organizations may want to review this checklist to get a

comprehensive picture of all the steps involved in financial management. Of course, smaller and newer nonprofits may not be dealing with all the complexity of larger, more well established groups. The Assessment Tool can serve as a development plan for your financial management efforts. You can develop the needed systems and processes in stages. The key is to get the needed system or process in place before you feel overwhelmed by the need for it.

With this overview of financial management, you are now ready to look at the nuts and bolts of how to handle the financial management of your nonprofit corporation. In the next chapter, we discuss budgeting – how to plan for your financial future.

20 MAKING A BUDGET

Developing a budget for a nonprofit organization can be a relatively simple task or an extremely complex one, depending on the size of the organization, the variety of services it offers or activities it undertakes, and the number and nature of its funding sources.

This chapter presents the basics of budgeting for smaller, more single purpose organizations first, and then expands upon the basics to explore some more complex budget issues. If you or your organization are new to budgeting, the worksheet on page 440 may be particularly helpful.

If your organization receives grants from governmental entities or foundations which impose restrictions on the use of the funds, you will find the sections on functional budgeting, cost allocation, grant budgets and budgetry for restricted funds particularly important.

Most of this Chapter deals with budgets for operations, the income you will need to generate and the expenses you will incur to carry out your activities during the year. Some nonprofit will also develop capital budgets, plans for acquiring and maintaining facilities and equipment. Capital budgets may involve plans to borrow funds and plans to purchase assets (building and equipment). If you nonprofit owns or is planning to own land, buildings or a substantial amount of equipment, you will want to read the section on capital budgets and decide which approach will work best for you.

THIS CHAPTER COVERS

- **Budget Terminology**
- **Why Have a Budget?**
- **Basic Budgeting Guidelines for Nonprofit Organizations**
- **Budget Development Steps**

- **Fixed and Variable Costs**
- **Functional Budgeting**
- **Budgets for Grants**
- **Budgeting for Restricted Funds**
- **Capital Budgets**
- **Cash Flow Projections**
- **Your Budget Process**
- **Boards and Budgets**

BUDGET TERMINOLOGY

1. *Organization Budget* – Projected income and expenses for a defined period (usually the organization's fiscal year) for the operations of an entire organization.

2. *Fiscal Year* – A twelve-month period selected by an organization or funding source for financial management purposes. Typical fiscal years are: July 1 through June 30; January 1 through December 31; October 1 through September 30.

3. *Grant Budget* – Projected income and expenses for a particular project funded by a grant. The projected income and expenses are for a period defined by the grant contract or award letter. The grant period may or may not correspond to the organization's fiscal year. For example, an organization with a July 1 –June 30 fiscal year may receive a grant for a twelve-month period beginning January and ending December.

4. *Cash Flow Budgeting* – A projection of anticipated cash receipts and cash disbursements for a defined period, such as three to six months. Cash Flow budgets are used internally to manage cash, in order to assure that sufficient cash will be on hand to meet demands and that excess cash is properly invested. Cash Flow budgets focus on timing – when during the year will funds be received and required – rather than on aggregate totals used in regular budgeting.

5. *Capital Budgeting* – Some nonprofits create separate budgets to reflect plans for purchase, rehabilitation or major improvement of facilities and equipment. A separate capital budget is essential for organizations planning a Capital Campaign to raise funds to purchase or complete a major rehabilitation of their facilities.

WHY HAVE A BUDGET?

While many folks think of budgets as some type of financial diet plan which focuses on "saying no" to needed expenses and doing without, in fact, budgets play two very positive roles in nonprofits.

First, the development of the annual operating budget provides an opportunity for your Board and staff to work together to identify the important work to be done by the nonprofit during the year; to agree upon specific strategies to do the work and the investment to be made in them; and to identify the sources from which resources will be obtained. The budget document provides a specific, written plan for the generation of income and the use of resources for salaries and other costs of operation.

In addition to serving as a plan for obtaining and using resources, your budget functions as an *authorization* document. When your Board of Directors adopts the annual budget, your Board is authorizing your Executive Director to proceed to use the organization's resources in specified ways – to employ staff, rent facilities, purchase supplies, etc.

New nonprofits are often tempted to skip the creation of an annual budget because they feel everything is so uncertain. This approach frequently results in confusion and failure to cover all costs.

New nonprofits are often tempted to skip the creation of an annual budget because they feel everything is so uncertain. Instead, they may create budgets for individual projects as part of a grants application process. This approach leads to a fragmented way of looking at the organization's activities and frequently results in confusion and failure to cover all costs. Even when funding is very uncertain, your nonprofit should develop a basic budget to guide the use of funds and direct efforts to obtain needed resources.

BASIC BUDGETING GUIDELINES FOR NONPROFIT ORGANIZATIONS

Here are some basic guidelines for developing budgets for nonprofit organizations:

- Recognize that often there are not sufficient funds to do the job in the best way possible – be realistic in planning for how you are actually going operate with the limited funds available.

• Define your goals and objectives. Determine which activities are necessary to attain your objectives. Base your budget on the actual elements involved in each activity as they relate to the goals and objectives.

• Recognize that at the time the budget is developed (and possibly adopted) some funding may not yet be confirmed. Use realistic estimates based on specific fundraising strategies, not wishful thinking or vague hopes.

• Recognize that annual operating budgets which rely heavily on grant funds:

- must reflect the budget items included in the grant budgets;
- must take into account the numerous, and perhaps conflicting or unclear, regulations on the use of grant funds;
- will have to account for grant budget periods which do not coincide with the fiscal year of the nonprofit or with the budget periods of the other grants.

• Focus your expense budget planning efforts on the line items (expense categories) which will consume the largest share of your resources. In most nonprofits, salaries, payroll taxes, and fringe benefits will be 60% to 80% of the total expense budget. Concentrate on correctly projecting these personnel costs, and spend less time trying to be exact about relatively small costs.

• If your organization is trying to build up its net worth – trying to accumulate reserves – you will need to budget for a surplus rather than a break even budget. A budgeted "surplus" means that your planned income exceeds your planned total expenses. A *break even* budget is one in which projected income is exactly equal to the projected expenses. Some funders have encouraged nonprofits to use break even budgets. But planning only to break even will make it very difficult, maybe impossible, to build up your net worth. If you are dealing with a funder which emphasizes break even budgets, you may want to explore whether it may be acceptable to budget for that funder's grant on a break even basis, while projecting your overall organization budget on a surplus basis.

Be as realistic and as accurate as possible in developing a budget!!!

BUDGET DEVELOPMENT STEPS

Here are some tips for preparing your budget. The Basic Budget Worksheet on page 440 suggests a format for your finished budget document. While you'll want the final document to be concise – hopefully a one page document – you'll need to do a lot of background work to get to this summarized version. Be sure you keep the detailed schedules of assumptions described below so that you can remember the basis for each of your projections.

Projecting Income

1. Government Grants and Contracts

Start with the grants and contracts which have already been committed to your organization. Be sure you include only the portion of the grant or contract amount which will be provided for the fiscal year for which you are budgeting. If your organization will have already begun receiving and using the grant before the beginning of your fiscal year, include only the portion of the grant which will still be available for use in the year for which you are budgeting.

After you have included the government grants and contracts for which you already have commitments, make a list of those you believe that you are likely to receive. Be specific about the source and the amount you anticipate receiving.

Special note: If you are projecting government grants which have restricted line item expense budgets – i.e. specify the categories of expenses for which grant funds are to be used – be sure you include those items in your expense projections.

Finally, government contracts for services often work differently from grants. Rather than restrict the specific expense line items for which funds can be used, contracts are often based on a payment per unit of service provided. For example, you may have a USDA Food and Nutrition program contract which specifies a reimbursement amount for every meal served to an eligible child. To project your income from a *unit of service* based contract, you will need to project the number of units of service you will provide and know the contract rates. Take care that the number of units of service you project providing matches the staffing and other expense levels you project in the expense section. You won't be able to collect the contract income unless you are able to provide the planned level of service.

Basic Budget Worksheet

Date proposed_____ Date adopted _____ Budget period: From ___ to _____

SUPPORT AND REVENUE

Government Grants or Contracts	$ _____
Foundation Grants	_____
Corporate Donations	_____
Special Events (net profit)	_____
Other Contributions	_____
Program Service Fees	_____
Membership Fees	_____
Interest Income	_____
Other Income	_____
TOTAL SUPPORT AND REVENUE	$ _____

EXPENSES

Personnel

Position Title	FTE Salary	% of FTE	# of positions	Total
_____	_____	_____	_____	$_____
_____	_____	_____	_____	_____
_____	_____	_____	_____	_____
TOTAL SALARIES				_____

Employer Taxes

FICA rate _____% x taxable wage _____ =	_____
Unemployment rate _____% x taxable wage _____ =	_____
Workers' comp rate _____% x taxable wage _____ =	_____
TOTAL EMPLOYER TAX	_____

Fringe Benefits

Health Insurance	_____
Dental Insurance	_____
Other	_____
TOTAL FRINGE BENEFITS	_____
Professional Service Contracts	_____
TOTAL PERSONNEL COST	_____

Non-Personnel Costs:

Supplies	_____
Printing	_____
Postage	_____
Telephone	_____
Occupancy (rent, utilities, etc.)	_____
Insurance	_____
Travel	_____
Training/Conferences	_____
Other	_____
TOTAL NON-PERSONNEL	_____
TOTAL EXPENSES	$_____

PROJECTED EXCESS OF SUPPORT AND REVENUE OVER EXPENSES $_____

2. Foundation Grants and Corporate Donations

Start by listing any foundation grants or corporate donations for which you have already received commitments. Then make a list of all the requests you plan to submit, including the name of the foundation or corporation, the purpose for which you will ask for funds, and the amount you plan to request.

Remember, asking is not the same as receiving, so estimate the percentage of all your requests which will be successful. It may help to group your request list into three categories: very likely, somewhat likely, and really a long shot. If your nonprofit has experience with corporate and foundation requests, use your past track record to estimate the amounts you will receive. If your organization does not have experience, or is making major changes in the way it approaches foundations and corporations, be conservative in your estimates.

Many foundations and corporations prefer funding new projects rather than general operations (see Chapter 21). If you will be submitting requests for specific projects or programs, remember to include the costs of doing those activities in your expense budget if you are including the grants for them in your income. It is fairly unlikely your organization will be able to obtain large amounts of unrestricted, general operating funding from foundations and corporations, so resist the urge to use this line item to *plug*, or to fill in "wishful thinking" amounts in the grant line item to balance your budget.

3. Contributions

First, make a list of all the different types of contributions you will be working to obtain. Your list might include gifts from *individuals*, from *businesses*, and from *church* or *civic* groups. You may want to break down the category of gifts from individuals down into sub-parts reflecting the ways you will attempt to obtain these gifts, i.e. direct mail, telephone solicitation, or in-person requests.

Once you have your list of types of contributions, go item by item and estimate the total amount you will receive from each type for the year. Rather than just picking a number out of the air, think specifically about the number of individuals or groups you believe will give and the average gift size you expect from them.

Or, if your organization already has experience with this type of contribution, consider the amounts you've received over the past few years and determine whether you can realistically anticipate receiving more or less this year. Be specific in your thinking, but remember the best you can do is make an educated guess – an estimate.

4. Special Events

Start with a list of all the special or fundraising events you are planning for the year (i.e. your spring auction, your summer car wash, and your fall wreath sale). For each item, estimate the total gross receipts. This means all the money you will receive without any reductions for expenses.

Next, predict the costs involved in producing each of these fundraising events. Make a detailed list, including the cost of any products you will purchase, promotional materials, mailings, hall rentals, etc.

On your final budget document you may choose to use the *net* income you expect from fundraising events. Compute the net income by subtracting the expenses of conducting the event from the projected gross receipts. However, it will be important to keep your more detailed projections of gross receipts and expenses for each event to compare against what actually happens. This comparison will help you in your future budget efforts by letting you know how realistic your estimates proved to be. The projections will also provide guidance to the fundraising committee or staff about how much your organization is prepared to invest in each event as well as what you expect the gross receipts to be.

5. Program Service Fees

Use this line to project income from charging fees for the services or activities your organization provides, i.e. admission charges, counseling fees, etc. To estimate your program's service fees, you'll need to be clear about the types of services you will provide, the way you will charge for services, and the amounts you will charge.

For example, a child care center may decide to have different charges for different types of service, like care for infants, preschoolers, and school age children. It may also decide to charge by the month for some services and by the hour for others. Finally, it may decide to vary the charges by the income level of the parents, using a sliding fee scale.

Write out the assumptions you are using to project fee income. For example, the child care center may plan on providing full time care for 20 preschool children at a charge of $400 per month per child. This would produce $8,000 per month (20 x $400) in program service fee income. If the center also planned to provide care for 30 school age children at $200 per child per month, it would project an additional $6,000 per month (30 x $200).

Whatever basis you use to project fee income, remember that *you may not collect all that you charge*. If you extend credit by allowing people to pay after rather than before they receive your services, you will need to either budget for an expense called "bad debt expense" or reduce your projected program service fee income by the amount you anticipate losing through non-collection. You can base this estimate of uncollectible amounts on your past history, or by contacting other organizations which provide a similar service and asking them what percentage of fees they find to be uncollectible.

6. Membership Fees

If your organization charges annual membership fees, you can project your membership fee income by multiplying the number of members you expect to have by the membership fee amount. If you are projecting a significantly greater number of members than the number who paid dues in previous years, be sure to include the cost of additional member solicitation efforts in your expense budget, and be sure there are specific plans to reach new people. If your group anticipates raising more membership fee income by raising the annual dues charge, be sure to consider the possibility that more members may choose not to renew than typically drop their membership in years without a fee increase.

7. Interest or Investment Income

Project your interest (or investment) income based on the amount of cash you will be able to invest in interest bearing or other income generating accounts. You will need to estimate how long your excess cash will remain invested and the rate of return you will receive. Your bank or investment service can help you prepare this projection.

8. Other Income

Use this category for small amounts of income. Use past history or at least a list of the types of income you are considering. If you have another type of income which will contribute significantly to your overall income, be sure to list it as a separate named line item.

Projecting Expenses

1. Salaries

This will probably be the largest expense in your budget. Consequently, it's very important to project it accurately. Be particularly careful to have the salary expense you project match the assumptions you've made in the income portion of the budget. If you projected income from a government grant which will

fund four positions, be sure those four positions are included in your salary expense projection.

Create a schedule of all the positions your nonprofit will employ. List each position title, the rate of gross pay, and the number of such positions you will have. You can project the rate of pay on either a monthly or hourly basis. If you use monthly salaries, list the salary rate for full time work, and then show the percentage of full time you will use for this position. This percentage of full time is referred to as FTE or Full Time Equivalent. 1 FTE means one full time position. A half time position is shown as .5 FTE.

If you want to use hourly pay rates, predict the number of hours for each position, either by week, month, or year. To predict salary expense on an hourly basis, you'll need to know your organization's policies about paying for holidays, vacations, and sick leave. If your nonprofit will pay hourly wage employees for holidays, vacations, and sick leave, you can estimate hours based on 260 work days per year (52 weeks x 5 days). If your organization does not offer these paid non-working days, estimate the days that full time employees actually work, and then adjust it for the percentage of full time equivalent you will use for each position.

If your nonprofit pays regular employees for holidays, vacations, and sick leave, and some or all of the positions require the hiring of substitutes when the regular employee is absent, be sure to include a projection for the number of hours of substitute time you will need. Base your estimate of substitute hours on the total paid absences permitted for positions for which substitutes will be required.

Remember, all salary expense projections should be stated as gross wages – i.e., before withholding of any taxes. Do not include the cost of employer taxes or fringe benefits in your salary expense line item. These items are listed separately, as shown below.

2. Employer Taxes

Employer taxes are taxes which your nonprofit must pay in addition to the gross wages which you included in the salary line item in your budget. Even if your organization has tax-exempt status, you will be responsible for the employer's portion of social security and Medicare taxes (referred to as FICA for Federal Insurance Contribution Act), Unemployment, and Workers Compensation coverage. Details about these taxes are discussed in Chapter 24.

To project employer taxes in your budget, you will need to know both the maximum dollars in wages per employee subject to each tax and the tax rate for your particular organization. FICA rates are the same for all employers, but the

rates are periodically adjusted. Check IRS Circular E to be sure you are using current rates.

As noted in Chapter 24, certain tax-exempt organizations have some choices about how to provide unemployment coverage for their employees. Determine which method your nonprofit will use and project the cost of that method. Most nonprofits will choose to pay the state unemployment "insurance" premium which functions like a tax on a portion of the gross wages paid to each employee. If you are participating in state unemployment insurance, the Employment Division will notify your organization of the rate percentage and of the maximum amount of each employee's wages subject to the tax.

As discussed in Chapter 24, Oregon employers have choices in how to obtain workers compensation insurance coverage. All employers, including nonprofits, are required to provide workers compensation coverage. To project this line item, determine the rates and conditions of your nonprofit's worker compensation coverage.

3. Fringe Benefits

Use the Fringe Benefits line item for amounts your nonprofit will provide for employees in excess of their gross wages.

Project the fringe benefit line item based on the cost of each of the benefits your nonprofit provides. Determine which positions are entitled to which benefits and the cost per year of each of those benefits. Include only the "employer paid" benefit items (typically health and dental insurance, disability insurance, retirement, etc.). Some nonprofits have flexible benefit plans which permit their employees to pay certain costs with pre-tax dollars withheld from their paychecks. Don't include these employee withholding amounts in the fringe benefit line item. These amounts will already be included in the gross wages line of the budget.

4. Professional Service Contracts

Base this item on a list of the professional services you plan to purchase. Common professional services include audits, legal counsel, computer consultation, Board training, etc.

Some nonprofits are tempted to use professional service contracts to pay individuals who are actually functioning as employees. Check Chapter 16 to be certain that any of the payments you are considering to be professional service contracts meet the legal definitions for independent contractors. If they don't,

and the folks performing these services should be considered employees, put the costs of their work in the Salaries, Employer Taxes, and Fringe Benefits line items.

The Basic Budget Worksheet on page 440 can help you organize your organizational budget. Appendix 17 provides several sample budgets.

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5. Non-Personnel Costs

See the Basic Budget Worksheet for suggestions for the types of costs to be included in your budget. Base your projections on specific assumptions. For example, your rent line item should be based on the number of months you will rent the facilities and the monthly rent or lease amount. Include a separate line item for each significant type of cost.

If you have government or foundation grants or contracts which include specific line item budgets, be sure you use the same categories to project expenses in your annual budget as are used in your grant budgets.

FIXED AND VARIABLE COSTS

The Effect of Volume of Services and Activities on Costs

Efforts to budget accurately may be helped by differentiating fixed and variable costs:

> *Fixed Costs* are those required to keep the organization open and offer even one unit of service. Fixed costs do not vary with the volume of service provided. For example, at least one telephone line is required to provide any telephone information and referral services.
>
> *Variable Costs* are those expenses which increase as the volume of service provided increases and decrease as the volume decreases. For example, an additional set of materials is required for each additional participant in a workshop. Or, an additional paper plate service may be required for each additional senior citizen served at a meals program.
>
> *Semi-Fixed or Step Variable Costs* are costs which are fixed over relatively short ranges of volume of service. For example, supervi-

sors' salaries, if one supervisor is required for every ten direct service workers. Or, additional telephone lines if one new line is required for every additional fifty calls handled per day.

In general, increasing the volume of service will reduce the unit cost. If the program is limited in the amount which it can charge or receive for each unit of service, increasing the number of units of service provided, and consequently reducing the cost per unit, may be an effective budget balancing technique.

If fixed costs form a large part of the cost of the unit of service, and if the program has unused capacity, even a small increase in volume of service will significantly reduce unit cost.

However, if substantially all the costs of a service are variable, the increase in number of units of service provided will have to be extremely large to produce any significant reduction in cost per unit of service.

In some service organizations, income from grants, contributions, and fees is not directly related to particular services or the volume of those services provided. Instead, general operating support is provided and the organization is free to select the type and volume of service it will offer. Identification of fixed and variable costs can be useful in comparing alternatives for different combinations of services which can be provided with the funds available.

For this type of comparison, it may be useful to identify the fixed costs which exist in all options (minimum requirements to keep the organization running) and concentrate on the variable and semi-fixed costs required for differing service options. Organizations frequently must choose between offering a high volume of relatively low cost (per unit) services or a low volume of relatively high cost (per unit) services, i.e. whether an individual counseling program or a group counseling or discussion group model should be provided.

FUNCTIONAL BUDGETING

Organizations providing more than one type of service or activity may find it helpful to do functional budgeting. This approach distinguishes between costs projected for the different types of services and costs projected for the management and fundraising of the organization. Page 450 provides a sample functional budget.

Such functional budgeting facilitates determining the cost of each program and the cost of each unit of service. For example, the cost for one day of preschool for a child could be determined by dividing the total cost of the pre-

school program by the number of days of preschool times the number of children attending per day. The unit cost information would be useful for setting fees for clients and for comparing the cost to operate this preschool program to the costs incurred by other preschool programs. This functional budget approach would also be useful when presenting budget information to a funder interested in funding only one or several of the programs.

Functional budgeting distinguishes between costs projected for the different types of services and costs projected for the management and fundraising of the organization.

Management Costs

To do functional budgeting, you will need to know which of your costs are considered *management* or *administrative* costs. We're using the terms management and administrative interchangeably for this discussion even though some larger nonprofits may make a distinction between these two terms.

While there are some differences in how the IRS, the accounting profession and the federal government define management costs, they share in common the view that management costs include:

- Accounting and audit functions
- Board support
- Organization-wide strategic planning
- Human resources record keeping
- Organization-wide technology (as opposed to software for program or fund raising purposes.

Fundraising Costs

Fundraising costs include the cost of make any unsolicited requests for contributions. This includes the cost of sending out letters requesting contributions, organizing volunteers to make phone calls for gifts, or making in-person requests. Fundraising costs include the cost of staff time to solicit gifts as well as the costs of printing, postage, list management, etc. Fundraising costs also include any payments to outside fundraising firms working to help your nonprofit raise money.

While the cost of researching foundation funding opportunities and preparing grant applications are generally considered fundraising expenses, the cost of completing Requests for Proposals to continue receiving contract dollars from governmental entities are not generally considered fundraising. Chapter

12 provides more guidance on how the IRS looks at fundraising and how you will be required to report fundraising costs on the Form 990.

Cost Allocation

If your organization decides to try functional budgeting, you will need to develop a cost allocation plan to allocate certain costs among the functions. While some costs are directly related to one program element, other costs provide benefit to more than one element. For example, in an organization providing a preschool program, a senior program and emergency services, the cost of a preschool teacher's salary is clearly a cost of the preschool. But, if all these programs and the organization's administrative staff share the same facility, a method must be devised to allocate or divide the cost of the facility (rent, utilities, etc.) among the programs and the administration.

In addition to allocating shared costs like facilities expense, multiple program organizations may also allocate administrative costs among the programs to compute a "full cost" for each program. This approach recognizes that a program, such as the preschool, couldn't function alone without some administrative back-up (bookkeeping, a Board of Directors, fundraising, etc.). The allocation formula for administrative costs is designed to give each program a fair share.

Some nonprofits will include both "management" and "fundraising" costs in the "administrative" costs to be allocated. Others, particularly those receiving federal funds, will keep management and fundraising costs separated because most federal grants and contracts cannot be used for fundraising expenses.

Cost allocation systems are designed to:

- Allocate shared costs not readily identifiable as belonging to a particular program or management

- Provide information for management on the full cost of providing a service, i.e. program cost plus a share of management cost

- Satisfy restrictive funders that funds have been used exclusively to provide the specific program or service the funder wishes to fund.

In order to accomplish these goals, cost allocation systems deal with two types of costs: direct and shared.

Sample Functional Budget

EXPENSES					TOTAL	ADMIN	F.R.	PROG A.	PROG B.	PROG C. GENERAL	PROG C. GRANT 1
Salaries: Positions	# Positions	% FTE	Monthly Salary	# Months							
Executive Director	1	1	3000	12	36000	27000	9000	0	0	0	0
Fiscal Manager	1	1	2300	12	27600	27600	0	0	0	0	0
Progam Director	1	1	2500	12	30000	0	0	7500	7500	7500	7500
Prog A & B Supervisor	1	1	2000	12	24000	0	0	12000	12000	0	0
Prog C Coordinator	1	0 75	2100	12	18900	0	0	0	0	9450	9450
Case Manager	4	1	1800	12	86400	0	0	43200	21600	0	21600
Specialist	3	1	1500	9	40500	0	0	0	13500	13500	13500
Clerical Assistant	2	0 5	1300	9	11700	2925	2925	0	0	0	5850
Subtotal: Salaries					**275100**	**57525**	**11925**	**62700**	**54600**	**30450**	**57900**
Payroll Taxes (13%)					35763	7478	1550	8151	7098	3959	7527
Fringe Benefits (15%)					41265	8629	1789	9405	8190	4568	8685
Subtotal: Personnel					**352128**	**73632**	**15264**	**80256**	**69888**	**38976**	**74112**
Professional Services					16000	4000	8000	1000	500	500	2000
Occupancy					40000	8364	1734	9117	7939	4427	8419
Supplies					15000	1000	5000	4000	2000	1000	2000
Transportation					4000	500	600	0	1200	800	900
Other Expenses					20000	2000	4000	2000	3000	4000	5000
TOTAL EXPENSES					447128	89496	34598	96373	84527	49703	92431
Allocation of Admin					0	-89496	8658	24117	21153	12438	23129
EXPS W/ ALLOCATED ADM N					447128	0	43256	120490	105680	62142	115560

SUPPORT AND REVENUE	TOTAL	UNDESIGNATED	PROG A	PROG B	PROG C GENERAL	PROG C GRANT 1
Government Grants/Contracts	160560	0	20000	25000	0	115560
Foundations	40000	0	5000	20000	15000	0
ndividual Donations	85000	77000	5000	1000	2000	0
Special Events	50000	50000	0	0	0	0
Program Service Fees	115000	0	70000	40000	5000	0
nvestment ncome	4000	4000	0	0	0	0
SUBTOTAL: SUPPORT & REVENUE	454560	131000	100000	86000	22000	115560
REVENUE - EXPENSES	7432	87744	-20490	-19680	-40142	0
Allocated Undesignated Amounts	0	-80312	20490	19680	40142	0
NET INCOME	**7432**	**7432**	**0**	**0**	**0**	**0**

Direct Costs

Some types of costs can be easily classified by function. For example, if your organization operates a preschool and a senior center program, you can easily determine that the cost of employing a preschool teacher belongs in the preschool cost center (function) and the cost of a senior center staff person belongs in the senior center cost center. Similarly, the cost of supplies for the preschoolers belong in the preschool cost center while the cost of food for the seniors belong in the senior cost center. Costs which are easily attributed to a single cost center are referred to as *direct costs*, meaning that they can be directly associated with the purpose they are fulfilling.

Shared Costs

But not all costs can be assigned to a cost center so easily. Many costs actually benefit more than one program or benefit all the major functions – management, fund raising and programs. For example, if you rent one facility to house your entire operation, the rent expense provides space for management, fund raising, and all program functions. We think of costs which benefit more than one function (cost center) as *shared costs*.

In order to prepare a complete functional budget, you will need to develop a method to divide the shared costs among the functions (cost centers) that benefit from the shared cost line items. The method of dividing shared costs among cost centers is described as cost allocation. The goal of cost allocation is to identify and use a consistent and fair method to allocate shared costs. There are several common approaches to cost allocation.

Allocate based on staff time

It is relatively easy to allocate costs which can be related to the number of staff working in a particular program or function by the percentage of FTE (full time equivalent) method. This method involves creating a percentage by dividing the number of FTE positions assigned to a particular cost center by the total number of FTE positions in the entire budget. For example, if 4 of your total of 8 FTE positions are assigned to the preschool program, you would allocate 50% (4 divided by 8) of the shared costs to the preschool program.

Allocate based on dollars

Other organizations may choose to allocate shared costs based on the amount of direct cost dollars being spent in each cost center. For example, if the total of all costs which can be directly attributed to any cost center is $300,000, and the costs which can be directly attributed to the preschool cost center equal

$100,000, you could create a percentage by dividing $100,000 by $300,000 and determine that the percentage of shared costs which should be allocated to the preschool cost center should be 33%.

Allocate based on square feet

Another approach would be to measure the space utilized by each function (cost center) and create a percentage based on the square feet used by one cost center divided by the total of all square feet. So, if the whole facility you are using for all functions has 6000 square feet, and the preschool program occupies 4000 square feet, you could divide 4000 by 6000 and determine that 66.6% of the cost of the facility should be allocated to the preschool.

Choosing a Cost Allocation Method

You can see from the examples above that the different methods we've described each produce a different percentage to be used to allocate the shared costs. How will your organization know which is the best method to use? Two principles should guide your choice. First – logical association. You want to choose a method which makes sense. This will be a method that divides cost in a way that seems reasonable in relation to what actually gives rise to the expense. So, while the square feet method makes sense for allocating the cost of renting a facility, it doesn't make much sense for allocating the cost of having a receptionist answer the nonprofit's phones. In the case of the receptionist, the number of people working in each function may a more logical basis for allocating costs.

Next – simplicity. You will want to choose a method that is not unnecessarily complex and that you are certain you can do accurately. While larger nonprofits may use several different methods to allocate several different types of expenses, a small organization may want to choose just one method and use it consistently.

Allocating Management (Administration) Costs

Distinguishing program, fund raising and management costs lies at the heart of the functional approach to budgeting. In fact, both the IRS and the accounting profession want nonprofits to distinguish these three primary cost centers in their financial reporting, so budgeting in this format makes sense for organizations which want to compare what actually happens to their plan.

If you have made this key distinction in your budget, establishing cost centers for management, fund raising and one or more programs, you may want to

go one step further in order to understand the *full cost* of each of your services. The concept of *full cost* or *fully loaded costs* assigning a portion of your total management costs to each of your program cost centers and to your fund raising cost center. By doing this allocation of management costs and adding the allocated share to each program's total cost, you are computing the full cost of operating each program.

This concept of *full cost* reflects the fact that you would not be able to operate your preschool program if you didn't have a board of directors and an accounting system which are considered management or administrative costs. Once you have added the fair share of administrative costs to each program and to the fund raising cost center, you will be able to compute your *cost per unit of service.* For example, if you want to know how much it costs you to serve one child in preschool for one year, divide the full cost of the preschool program (including the preschool programs share of the administrative cost), by the number of children in the preschool. This information will be useful both for setting the fees you must charge to cover your costs and for comparing the cost of operating your preschool program to the costs experienced in other preschool programs.

You will need to choose a method to allocate administrative costs. The percentage of FTE positions and the percentage of program dollars described above are the two most common approaches.

Cost Allocation Plans

You can see by this point in the discussion that cost allocation can get a bit complicated. That's why nonprofit organizations that use this approach to preparing their budget (and then use it again in accounting and financial reporting) need to prepare a written cost allocation plan. The cost allocation plan provides a list of the cost allocation methods you have decided to use to allocate various costs and explains why you have chosen those methods. You will need to review your cost allocation plan regularly, at least once a year, to be sure that you are still satisfied with the approaches you have chosen.

Nonprofits receiving funding from governmental entities are often required to have written cost allocation plans. Organizations that receive large amounts of federal funding may also use a different method, obtaining a *federally negotiated indirect cost rate.* This a detailed discussion of this approach is too complex to include in this book. We have included a series of sample cost allocation approaches, including the federally negotiated indirect cost rate, in the Appendix section for those nonprofits who want to build a more complex approach to allocating costs.

BUDGETS FOR GRANTS

Most foundation grant applications and requests for government support require submission of a budget proposal. Some funders provide forms or lists of budget categories, but most expect the nonprofit asking for the money to develop the format for the budget proposal. Some funders specifically exclude funding for certain types of items such as equipment or conference costs. So, before you begin preparing your grant budget proposal, you'll want to read the funder's guidelines carefully.

Start with Your Annual Operating Budget:

If you have prepared your nonprofit's annual operating budget in the functional format discussed earlier in this chapter, you may be able to use the portion of your annual budget which describes the program for which you are seeking grant funding as the basis for your grant proposal budget.

> *Example*: Safe Families, a nonprofit which serves victims of domestic violence, prepares its annual budget in a functional format, showing three program components, as well as management and fund raising. The three program components are "shelter services", "non-residential counseling", and "children's program". When Safe Families is applying for a foundation grant to support components of its children's program, it will use the line item expenses shown in the children's program column of its annual budget as a starting point for it's grant budget.
>
> If Safe Families is applying to a foundation for a small amount of money in relation to the cost of the total children's program, perhaps requesting $5000 while the total cost of the children's program is $100,000, they may be able to simply show the whole plan for the children's program, including both the expenses and the other sources of revenue which will be used to support the program.

Of course some foundation and government funders will want to see more detail. In the Safe Families example above these funders would want to know which of the $100,000 in total operating expenses for the children's program would be paid for with the dollars which they would provide. To meet this requirement, Safe Families would set up a budget worksheet like the one on page 440 with the whole children's program budget, both income and expenses, as the first column (labeled Total Children's Program Budget), and then show a second column for the funds which are requested from this specific funding source in the revenue section and the specific expenses which would be met

with those funds. This second column could be labeled XYZ Foundation. To make the presentation more clear, Safe Families would add a third column labeled Other Sources, to put the remaining sources of income and all the remaining expenses (the children's program costs that wouldn't be met by XYZ Foundation's grant).

Budgets When Funders Support Only New Projects

This approach will work for funders which are interested in supporting specific projects or programs of your organization. Of course, some funders have an explicit requirement that their funds be used only for new services or expansions or enhancements of current services. Unless you are very certain that such a funder will be awarding funds to your organization, you probably will not have included the new program or program expansion/enhancement in your annual budget. In this situation, you're probably thinking that if your get the funds from this funding source you will add elements to your current program and if you don't receive the funding from this source you won't add those costs. Larger organizations may refer to this type of thinking as an "add-pack" approach to budgeting, meaning that they will add additional "packages" of expenses depending on the availability of funding.

Even if the funder you are approaching has an explicit requirement that funds will be awarded only for new services or expansion/enhancement of existing services, you will still want to develop a budget presentation which shows the whole cost of delivering the service. You'll want to be sure that you include a fair share of the shared costs which will be needed to make this new program or program expansion possible.

Let's return to Safe Families to illustrate this. Suppose Safe Families is preparing an application to a foundation which will support only new services or expansion/enhancement of existing services. Perhaps Safe Families has seen a great increase in the number of Spanish speaking families using the shelter. While they currently operate a children's program, they would like to enhance that program to do a better job serving Spanish speaking families. To do this, they will need to get training from a consultant who know more about parenting issues in the Latino community, purchase new supplies and books, offer current staff the opportunity to master basic conversational Spanish, and hire an additional staff person who is bilingual and comfortable with both parents and children.

Of course their grant budget will show the cost of the training, consultation, supplies, and new staff position, but Safe Families also recognizes that the enhanced children's program can't operate without heat, lights, access to a telephone, accounting records, and supervision. These are all costs which Safe

Families will have even if they do not succeed in enhancing the children's program to better serve Spanish speaking families. But, they are also costs which must be met in order to have a children's program for Spanish speaking families. So Safe Families will include the full cost of the children's program for Spanish speaking families in its grant budget – both the new costs and the continuing costs which can be directly related to the program they are describing.

Grant Budget Notes

Most funders really appreciate a "budget narrative" in addition to the budget document which shows line item categories with dollar amounts. Your budget narrative, on a separate page from the budget itself, will explain the basis for including each line item shown in the grant budget. In the example above, Safe Families would describe the type of consultation on working with Spanish speaking families they would purchase, the number of hours and the cost per hour of such consultation and provide a brief summary of the goals of working with such a consultant. For the supplies line item, Safe Families would describe how much of money would be spent on books, games, room decore, etc. They would not provide a list of every book or game to be purchased – this would be much more info than the funder would want.

If Safe Families had decided to include 10% of the cost of their Executive Director's salary, taxes and benefits in the grant budget, they would want to explain that 10% of the Executive Director's time would be needed to coordinate, supervise, and evaluate the new services for Spanish speaking families, including making certain that systems are in place and working to track the work accomplished and outcomes achieved in the new program. If they included a portion of the total telephone bill, they would explain that staff in the children's program must have immediate access to a phone in case of emergency and the basis for this line item is only a small portion of Safe Families total phone costs.

One final tip. When you have completed the budget component for your grant proposal, including both the numbers page and the narrative page, show both of them to someone who knows nothing about your organization. The budget itself plus the budget narrative should tell the story of what you are trying to do so well that the person does not need to read the whole proposal narrative to understand how the funds will be used. If they can't understand what you are asking the funder to support and why, you will need to revise your budget and the budget narrative until another "uninformed" person can tell what you are proposing to do.

BUDGETING FOR RESTRICTED FUNDS

The term *restricted funds* is used to describe funds that your nonprofit receives from an outside party, like a donor, a foundation or a government program, that limits or restricted how you can use their dollars. Typically the outside party puts the restrictions on the use of their funds in a letter or contract which directs your organization to limit the use of the funds to a specific program, a specific time period or in some cases to specific types of costs.

It's important to distinguish the situation in which the donor/funder is restricting the use of funds to specific line items within specific programs from one in which the restriction is only about what program the funds may used to support. If the restrictions merely direct that the funds be spent on specific program, without limiting the line item expenses, you will be able to handle budgeting for this source within the basic functional budget approach. Just consider the funding source to be a revenue source for the program function that the donor/funder wishes to support. For example, if XYZ foundation awards $5000 to support your preschool program, you will show the $5000 in both the total revenues column and in the column for the preschool program cost center. This will show that you are free to use the XYZ grant to meet any legitimate cost of the preschool program.

But, in situations in which the donor/funder restricts the use of their funds on both a program and line item basis, you will need to take some additional steps. For example, if the ABC foundation awards a line-item restricted grant to the preschool program, you will need to determine which line expenses of the preschool program may be met with funds from the ABC foundation. Once you are clear on the donor's restrictions, you may decide to create a separate column on your budget for just the ABC grant. This column will show the ABC grant as income and then show only the expense line items which the ABC grant may be used to pay. If you take this approach, you will want to remember that in order to know the full cost of the preschool program, you will need to combine the column for the preschool cost center (which won't include the ABC grant revenues or expenses) with the column for the ABC grant expenses. You will find more discussion of the challenge of planning for and tracking restricted funds in Chapter 23 which deals with accounting issues.

CAPITAL BUDGETS

The use of the word "capital" when nonprofits talk about budgets or fund raising campaign, refers to the costs of acquiring or rehabilitating land, buildings, and equipment. These are referred to as "capital" costs. Larger

nonprofits with substantial investment in land, buildings and equipment frequently prepare capital budgets as well as operating budgets. This means that they separate their plans for purchasing or rehabilitating their facilities and equipment from their plans for routine operating costs. Even when capital budgets are used, the cost of regular ongoing maintenance, like janitorial services or routine plumbing repairs, usually appear in the operating budget.

Does your nonprofit need to prepare a separate capital budget? In most cases smaller nonprofits will simply include plans to purchase new computers or furniture in the annual operating budget. But, if you are working towards the goal of purchasing new facilities or completing major rehabilitation on property your nonprofit already owns, you may find a capital budget is very helpful for communicating with potential donors, funders, and lenders for your capital projects. Of course potential donors and lenders will also want to see your operating budget to be sure that you have reasonable plans to meet the costs of operating your new facility or equipment.

Capital budgets may include an element that would not normally appear in an operating budget – the use of debt. Of course borrowing money is not a type of income (just like taking cash advances on a credit card is not a source of income for your family). But borrowing may be a legitimate strategy for nonprofits to acquire capital items, particularly buildings. In order to use debt as part of your plan to acquire facilities or equipment, you must show potential lenders that you will be able to repay the debt. If you plan to use debt as part of your capital budget, you will want to get help from an accountant or business consultant who is familiar with the preparation of pro forma style budgets. Your pro forma budget will demonstrate how cash obtained through the operation of the facilities you acquire with debt will be sufficient to meet the debt repayment requirements of lenders.

Budgeting for technology poses a particular challenge. Most foundation and government funders now expect to see line items in operating budgets for acquisition and replacement of computer hardware and software. Increasingly they also expect to see that budgets include the cost of staffing or consultants to make sure that the technology that is purchased operates dependably and is used fully. Of course, if your nonprofit has fallen far behind in meeting its technology needs, you may have to plan a special fundraising initiative to catch up. In this situation, it can be very useful to work with consultants who are knowledgable about nonprofit technology needs to develop a comprehensive technology plan. Your plan will assure potential funders that you have thought through the needs of your nonprofit carefully and prioritized your needs in relation to your resources.

CASH FLOW PROJECTIONS

Your annual operating budget is a tool to project where you will obtain the funds needed for operations for the coming year and how you will use those funds. It is designed to help with big picture thinking, focusing on your overall plans for raising funds and earning income and operating your organization. Most annual budgets focus on what will happen over the course of a year not what will happen in any specific month.

Your nonprofit may need to use another budgeting tool in order to be certain that you will have cash available when you need it. The *Cash Flow Projection* is a budget tool designed to predict when cash will come in and when cash must go out of your nonprofit. We've included a sample Cash Flow Projection (in Appendix 18) .

You can prepare a cash flow projection for any period of time, but most organizations will find that a three to six month period is most useful. First, you will need to estimate the amount of cash which will be available in your bank account at the starting point of your projection. Next, you will project how much additional cash will be deposited into your bank account during the first month of your projection period. When you add the additional cash you are expecting to take in to the cash you had at the beginning of the month, you will know the total cash available to your nonprofit in that month.

Next you will predict the amount of cash which will be needed to meet all your obligations that must be paid during that month. You'll subtract the total cash needed to be paid out from the total cash available to predict how much cash will be left at the end of the month. This projection of cash at the end of the month then becomes your projection of cash available at the beginning of the next month. You'll repeat these projection steps for each of the months to be included in your cash flow projection period.

If you see months in which the cash required to be paid out exceeds the cash you are projecting to be available, you will be able to predict that unless you alter your strategies, you will overdraw your bank account in those months. Doing the cash flow projection six months in advance will give you time to change strategies and avoid running out of cash.

Cash flow projections are generally prepared with spreadsheet software so they may be easily updated. While you will initially project out six months of cash coming in and going out of your bank account, you will need to update the projection monthly to reflect the actual cash available at the beginning of each

month and to revise your estimates of cash that will come in and need to go out based on what has actually happened.

Cash flow projections are very helpful for both nonprofits that tend to be short of cash and face periods in which they may not have the cash needed to meet obligations, and for nonprofits that actually have excess cash, more than is needed immediately. If your cash flow projection shows that you will have much more cash than is required to meet your operating cash demands, you will want to explore opportunities to invest the excess cash. Your board is responsible for setting policies on the types of investments that can be used to invest excess cash.

YOUR BUDGET PROCESS

There are many different approaches to developing the annual budget. In small nonprofits, the executive director or a board member is usually asked to prepare the first draft of the budget. That person's job is to organize all the information about both income and expenses into a document. It's very helpful if they also prepare budget notes that explain the assumptions they have made to create the document. The board discusses this first draft budget, questions the assumptions and either adopts it if the budget seems reasonable or asks the budget preparer to make revisions and bring the revised version back for further discussion.

As organizations grow larger and involve more paid staff, the executive director and/or fiscal manager begin to include the staff who will be doing the programs and fund raising in the budget planning process. Sometimes this is as simple having a discussion at a staff meeting in which each staff member is asked to identify needs for the coming year and to predict how much income will be generated through their efforts. For example, the staff involved in the preschool would be asked to predict how many children will be served and whether fees should be raised. The executive director and fiscal manager then use the information generated by the staff to create the draft budget document for board discussion.

Once the organization is large enough to have program managers and a fund development director, the executive director and fiscal manager may ask these managers to prepare the first draft of their own program or fund raising budget. Then the fiscal manager combines the various first drafts, raises questions, and ultimately creates a draft budget for board action. In this approach, the fiscal manager will typically take responsibility for estimating the shared costs and provide spreadsheet worksheet tools to help the program managers prepare their budget proposals.

No matter how small your nonprofit is, you will want to be very careful about how you project the income you will generate through fund raising and grant writing. You'll want to resist the temptation to do the whole expense budget first, and then just fill in numbers in the income section to cover the expenses. This can lead to serious overestimation of the amount of support your nonprofit will be able to raise. Instead, ask the person(s) responsible for each type of income generation – individual gifts, special events, program fees, etc. – to prepare a description of what they will do during the year to raise funds, including both the gross amount they think will be generated and the costs of raising that level of gross support. Only include in the income section amounts that you have good reason to believe your nonprofit will be able to raise.

BOARDS AND BUDGETS

Most nonprofits will try several budget process methods as they develop. Your Directors will be most likely to feel fully committed to supporting your organization if they have played an active role in setting priorities for the use of resources. Your staff are most likely to feel fully committed to working for your organization if their direct knowledge of needs has been considered in planning. Organizations which set priorities by funder preferences often find that Board and staff have little commitment to the organization if funds are no longer available.

Your Directors will be most likely to feel fully committed to supporting your organization if they have played an active role in setting priorities for the use of resources.

A strong, inclusive budget process provides a good opportunity for your Board and staff to work together to identify priorities for the organization and create effective strategies to obtain and utilize resources.

For many nonprofit Boards, the annual budget process is a vaguely unpleasant period in which trees are sacrificed to produce an endless flow of number filled pages presented by harried staff to tired Board volunteers grieved by low wages and frustrated by funder limitations. Whether the response is passive rubber stamp or randomly targeted nit-picking designed to assure someone that the Board "did its job," or conscientious and careful review of all the data, many Directors find little satisfaction in their role in the budget process.

For nonprofits funded extensively with restricted governmental or foundation dollars, the budget process may strike Directors as closer to taking orders than making significant decisions. Once the various restricted funders have directed who may be served, what methods must be used, what records must be

maintained, and what reports must be submitted, the approval of the budget may seem more like hopping aboard a carefully guided tour bus than charting a course for the nonprofit.

Directors who have participated in strategic planning may feel particularly disillusioned. What happened to that clear mission statement, those values and priorities the Board struggled to agree upon? What about the commitment to improve staff pay and benefits across the organization? What about the commitment to reach those who fall through the cracks with innovative programs?

Directors may find it difficult to connect the excitement of the planning process and the passionate commitment they feel to the organization's mission with the grim sheets of numbers placed in front of them for approval. Not surprisingly, staff can find the budget process mechanical and disheartening, too.

You can help your board members have a much more meaningful budget discussion if you prepare your budget proposal in the functional format discussed in this chapter and illustrated on page 450. This will allow board members to see the income and costs associated with each of your programs as well as your administrative functions and the cost of fund raising itself.

Using the functional budget approach can facilitate discussion of the truly important questions. It will let your board members understand which programs are fully supported or close to fully supported by grants, contracts and fees, and which ones depend upon your nonprofit's efforts to raise contributed dollars from individuals. Then the board can decide whether they are making the best use of the dollars which contributors give without restriction.

Board members will also realize that simply cutting expenses will not always solve financial problems since some grant and contract programs require that if you don't spend the money as directed by the funding contract, you must repay it to the funder. In these situations, cutting back on spending will result in cutting back on income, with no net gain to the organization and a clear loss to the people depending on your services.

On the other hand, board members may realize that the organization is being weakened by continuing to try to support a program that does not have enough support through fees, grants and contracts. They may decide that the organization would be better off to drop the program and put its energy into developing new services or more fully sustaining existing services.

The key question for Board and management: Does the use of discretionary dollars reflect the nonprofit's priorities? If not, what can be done to shift the use of discretionary dollars to resources which are the highest priorities for Board and man-

agement? You may want to challenge your finance committee to draw a pie chart on the use of discretionary dollars without getting out calculators and the current year's budget sheets. If they have no immediate sense of what consumes your discretionary dollars, try the format above for budget presentations to open a discussion of the relationship between priorities and use of funds under the Board's control.

Consult Appendix 1 if you would like information about source material related to this Chapter.

Budgeting allows you to project your future financial picture. Once you have done this, you are ready to begin finding the funds to implement your budget. The next chapter describes how to do this.

21 FUNDING: OBTAINING RESOURCES FOR YOUR ORGANIZATION

Whether your nonprofit is brand new or has been in business for a number of years, you will need to obtain funding and find other resources in order to carry out your mission. For many nonprofits, finding resources poses a substantial challenge.

In this chapter we'll take a look at many of the ways nonprofit organizations obtain funds and other resources, and provide tools to help you evaluate which approaches are best suited to the strengths of your organization. Increasingly, nonprofits are finding they must use multiple strategies to obtain all the resources they need. Think of the options described in this chapter as a menu, and plan to prepare a multi-course meal.

THIS CHAPTER COVERS

- **Foundation Grants**
- **Corporate and Other Business Giving**
- **Individual Contributions**
- **Fundraising Events**
- **Bingo, Raffles and Other Gaming**
- **Membership Fees**
- **Civic and Religious Organizations as Funders**
- **Government Grants and Contracts for Services**
- **Program Service Fees**
- **Product Sales**
- **Social Enterprise and Business Ventures**
- **Investment Income**
- **In-kind Contributions**
- **Using the Internet to Raise Funds**
- **Ethical and Legal Issues in Fundraising**
- **Final Tips**

FOUNDATION GRANTS

Foundations are tax-exempt entities which make contributions, characterized as grants, to nonprofit organizations. Almost all foundations require that their grants be given only to organizations which have obtained tax exemption under §501(c)(3). A few foundations are willing to make special grants to other nonprofits. These grants to non- §501(c)(3) organizations require the foundation to take additional steps and precautions to be certain that all funds are expended for §501(c)(3) type purposes.

Foundations may use either a formal or informal process to determine which organizations they will fund. Foundations choosing the more formal approach are open to receiving written proposals from nonprofit organizations, and considering requests from both nonprofits they already know, and others with which they have had no previous contact. Those choosing the more informal approach make grants primarily to organizations of particular interest to the foundation's Directors, frequently making decisions primarily on the basis of personal knowledge and relationship. While these informal approach foundations may also require the organizations they fund to prepare a written statement describing the proposed use of the funds, they are generally not open to considering unsolicited requests.

Most foundations which do accept unsolicited requests have fairly specific guidelines about the types of activities they will fund. While some foundations are open to providing general operating support, most prefer requests which identify specific activities or needs for which funding is sought. Many prefer that proposals focus on a new project or expansion of an existing service, rather than continuation of your organization's basic activities.

Oregon nonprofits seek support from a variety of foundations – including some with an exclusive Oregon focus, others with regional interests, and some which fund throughout the nation. Most foundations receive many more requests than they are able to fund. Asking for funding provides no assurance of obtaining funding. New nonprofits, or those that have not previously obtained foundation support, face particular challenges to obtain their first grants. Regional and national foundations often look for evidence of support of the organization by local foundations. Oregon foundations look, in turn, for evidence of support by other Oregon foundations. So the question becomes who will give your organization its first opportunity.

If you are new to the world of foundation grants, you will want to devote your initial energy to learning about foundations that are most likely to be interested in funding your nonprofit. You may find the *Oregon Foundation*

Databook by Craig McPherson (available from Nonprofit Resources at 503.274.8780) particularly helpful. The Databook is available in both print and electronic formats and facilitates searching for foundations by the types and sizes of grants they make.

You will also want to check the resources at your local or regional library. Many libraries have access to several internet based grants research tools as well as the directory published by the Council on Foundations. If your local library does not have the resources you need, ask them to help you connect with the nearest library with a foundation resource center.

You may also find it helpful to attend seminars or workshops which deal with foundation funding. You can contact the Nonprofit Organizations Information and Referral Helpline at Technical Assistance for Community Services in Portland 503.233.9240 or 1.888.206.3076 for information about upcoming training events. Staff members from foundations frequently appear on panels at a variety of training events. Plus, both the trainer and other participants in the training will have had experience seeking and obtaining funding from Oregon foundations, and can share their insights with you.

Some foundations provide a specific form or format which applicants must use to be considered. Many of the smaller foundations prefer a two page letter which contains a basic description of your organization and the project for which you are seeking funding. Foundations making larger grants often use a multi-step process in which the initial request is very brief, and more extensive information is required of organizations and proposals of particular interest to the foundation. You can learn of the specific requirements of each foundation by going to the foundation's website or by requesting their guidelines for funding and any application forms.

Foundation Funding Preferences

In our experience, there are several factors which have the greatest influence on a nonprofit organization's success in obtaining foundation support. They are:

The Strength of the Organization

Foundations prefer to support organizations which they perceive as well managed, stable, and effective. While some foundations prefer larger, older nonprofits, others are particularly interested in newer, community based organizations. In either case, foundations want to feel confident that the organization is capable of carrying out the project for which funding is sought.

The Clarity, Logic, and Importance of the Project for Which Funding Is Sought

Most foundations want to fund proposals which are well thought out and clearly explained. Many are particularly sensitive to the relationship between the amount of money sought and the scope of the issues the organization proposes to address. Discussing the need to end world hunger and then requesting $1,500 to print brochures about a free food program suggests that the organization has not thought clearly about the specific problem or issue it seeks to address.

Small organizations with big dreams face particular problems. If your organization is small or new, you will probably have greater success with proposals to do one or two small things well than with a global description of every need and every idea you have developed.

Larger organizations may confront the reverse problems. Proposals for very small amounts or limited projects may cause foundations to wonder why the organization does not meet this small cost with its own funds.

Foundation Funding Priorities

Many foundations have either permanent or periodically determined funding priorities and will not consider proposals outside these priorities unless foundation Directors or staff have a very strong personal relationship with the organization requesting funding.

Personal Relationships

Foundations are besieged by unsolicited requests. The total requests received by almost every foundation are vastly greater than the amount of funds the foundation has available for grants. Foundation decisions are made by people – the Directors and to a lesser degree, the staff. "People give to people" is a truism of fundraising. People pay special attention to suggestions made by people they know.

So you will be wise to determine whether any of the people your organization knows – its Directors, staff, volunteers, supporters, etc. – know any of the people in decision making roles for the foundations. The foundation reference books and websites noted earlier include names of the officers of each foundation. You can also request copies of foundations' annual reports, which list all the people involved. Or, you can visit the Oregon Department of Justice Charitable Activities website (see Appendix 2) or their office in Portland and examine all Oregon foundations' annual reports which also list officers and Directors.

If someone you know does have a relationship with a foundation decision-maker, ask them to introduce your organization's spokesperson to the foundation. If no one you know knows any of the foundation people you'd like to get to know, check with other nonprofit organizations you work with to see if they have relationships with specific foundations, and ask them to introduce you. Or, look for workshops and conferences with representatives of foundations speaking on panels and introduce yourself and your organization.

Organization and Persistence in Your Efforts

Do your research carefully. Submit only appropriate, well-presented applications. Systematically try again. Ask for help thinking about your project from foundation staff. Avoid putting foundation staff people on the spot by asking why their foundation did not fund your proposal. Instead, explain what your organization is trying to accomplish and ask for suggestions on how to communicate your ideas to other foundations as well as their own. Never complain about not being funded. Be positive about the progress your organization is making and appreciative of the time the foundation staff person has made available for you. Most foundation staff people are particularly wary of organizations asking "well what would you fund?" because it suggests that the organization does not have its own clear direction and is only looking for money.

Final Note: Remember, foundation funding comprises less than 5% of all charitable contributions made in the United States. It is unlikely that foundation funding will be an ongoing, primary source of general operating support for your organization. It is more likely that foundation funding will allow an established organization to launch a new project, expand a current service, or build specific organizational capacities.

CORPORATE AND OTHER BUSINESS GIVING

Some corporations and businesses have established separate foundations which make grants in ways very similar to the foundations described above. Typically, these corporate foundations have guidelines for funding, standard application forms, and staff charged with specific responsibility for charitable giving. Some of these corporate foundations are listed in the foundation directories described earlier in this chapter. In fact about the only difference between these corporate foundations and other foundations is that they are frequently influenced by the corporation's managers, and in some cases, by line level employees. Obtain their annual reports to learn what role corporate employees play in the decision making. Then check with your Board and supporters to see if you have any potential relationships with employees who could advocate for your proposal.

In addition to these corporate foundations, many businesses have active charitable giving programs and will consider requests for both money and goods and services (which we discuss later in this chapter under In-Kind Contributions) from nonprofit organizations. As with foundations, businesses will always require that an applicant for a charitable gift have proof of §501(c)(3) status.

Some businesses do make non-charitable contributions to organizations exempt under other §501(c) sections, like §501(c)(4) or §501(c)(6). These contributions are considered marketing expenses, and are thus tax deductible by the business as business expenses. Businesses also make these marketing contributions to §501(c)(3) organizations. The key issue for the business is whether associating itself with your organization will have a positive impact on customers, potential customers, or regulators with which the business seeks a positive relationship. In many businesses, the managers making decisions about charitable contributions operate separately from the managers making decisions about "marketing" contributions. If you do not have a contact in the marketing department, ask the charitable giving staff to help you think through whether your organization or project may have potential as a marketing strategy for the business, and ask for their help in contacting the appropriate person.

In our experience, there are some significant differences between seeking and obtaining funding from businesses and dealing with foundations. Among them are:

- Businesses place even more emphasis on relationships. In fact, many businesses give only to organizations recommended by managers or owners of the business.

- Most businesses want very short proposals. They are generally inclined to either like a concept or not like it. Details will not persuade them.

- Businesses may want to play it safe by funding well known and well respected charitable organizations unless they have personal knowledge of the people involved in a less known organization.

- It may help to point out the connections which exist between people interested in your organization's work and the business employers or customers or political groups with which the business would like to cultivate a strong relationship.

- Some businesses are more open to the concept of general operating support than foundations. If they are persuaded that your organization is meeting an important need and doing a good job,

they may be less inclined to want to control exactly how you use their gift.

• Some businesses are willing to make repeat grants. Be sure you keep them involved and knowledgeable about what your group is accomplishing, and give them public credit for their support in meaningful ways and they may well want to stick with a winner and fund your organization repeatedly.

Remember, corporate and business giving accounts for only 5% of all charitable giving in the United States. So, unless your organizations develops particularly strong relationships with major decision makers, business giving will probably not be your major source of funds. However, it can be an important, ongoing, and largely unrestricted source.

INDIVIDUAL CONTRIBUTIONS

Obtaining charitable gifts from individuals is the subject of countless books, workshops, and college courses. So, we will not attempt to provide a comprehensive discussion of alternative approaches to obtaining individual contributions in this book. But in order to develop your overall funding strategy, there are several key facts about individual giving which you will need to know.

Gifts from individuals may be among the most dependable, repeatable, and unrestricted sources of money your organization can find.

First, gifts from individuals comprise 90% of all charitable giving in the United States. Individuals tend to give repeatedly to the same organization and generally give because they believe in the organization's work. Most individuals do not attach specific restrictions to their gifts. However, as gift size increases, the likelihood of the donor attaching restrictions increases. Taken together, this means that gifts from individuals may be among the most dependable, repeatable, and unrestricted sources of money your organization can find.

However, obtaining gifts from individuals typically takes considerable effort, and sometimes considerable financial investment. Most organizations find that relatively few donors send money without any prompting or request to do so. If fact, many believe that one of the reasons why religious organizations receive nearly half of all charitable contributions is because they ask – often and repeatedly.

If your organization is new, and does not involve wealthy individuals or folks with access to wealthy individuals, you'll probably be interested in what's called grassroots fundraising. You may want to arrange to borrow a set of video tapes about grassroots fundraising from TACS (Technical Assistance for Community Services) by calling 503.239.4001, and watch for workshops on the topic as well.

Studies show that poorer people actually give a higher percentage of their incomes in charitable gifts than do upper-middle class or wealthy individuals. Working with a grassroots fundraising strategy will mean you have to obtain smaller gifts from more people than an organization which has access to wealthy individuals who can be cultivated to become major donors.

But whether your organization is approaching people of modest means or people with substantial wealth, you will want to start from the understanding that most people give to people, i.e. make gifts when they feel a sense of relationship with individuals involved in specific charitable organizations. Almost all of us are besieged by constant mail solicitations and sometimes phone calls from charitable organizations which are undoubtedly doing very worthwhile work. But we can't give to everything. So most of us target our giving to situations in which someone we know asks us to give, or an organization gives us such a strong sense of affinity to our values and priorities that we feel that we know the people involved with it.

Whether your organization is approaching people of modest means or people with substantial wealth, you will want to start from the understanding that most people give to people, i.e. make gifts when they feel a sense of relationship with individuals involved in specific charitable organizations.

As you plan your various strategies for seeking gifts from individuals, you'll want to build on your strengths and minimize your weaknesses. Here are some basic steps to formulate your strategy:

- Start with the people who know the most about what your group does – its Board, volunteers, program participants and their immediate families. After you have obtained gifts from this closest group, ask them to help you identify individuals who they know and think would be interested.

- Make your fundraising as personal as possible. If you send letters, have Directors or volunteers sign them by hand, and write personal notes if they know the person who will receive the letter. Try phone calls if your supporters are comfortable with this ap-

proach. Use face-to-face meetings with individuals who you believe may be able to make larger contributions. Be sure the person who has the best relationship with the prospective donor makes the introduction and indicates that she or he has given to your organization.

• Lay out your plan for asking individuals for a whole year. Avoid "nickel and diming" donors, i.e. coming back again and again for small amounts rather than being direct about the whole amount you are asking the person to give. You can still offer your donors the opportunity to make monthly or quarterly payments if they prefer, but most people get fed up with repeated small requests.

• Discuss the level of investment in fundraising that makes sense for your organization. If you will be asking a fairly large number of people for fairly small contributions, you probably will want to make the request look interesting but not lavish. On the other hand, if you are asking relatively few people for relatively large amounts, be prepared to do something special.

If your organization is exempt under §501(c)(3) and you receive a donation worth more than $75, you need to familiarize yourself with the disclosure and substantiation rules on pages 511-513.

FUNDRAISING EVENTS

Again, volumes have been written on fundraising events, and numerous workshops are available. Here are three major issues you will want to think about as you consider whether and how your organization should do fundraising events.

Determining the Purpose of the Event

First, you will want to be very clear about the purpose of any event you decide to do. Is your primary intention to raise money, or are you considering the event because it will help your organization become more visible, help you identify potential donors or volunteers, or provide a good team building opportunity for volunteers? If any of these non-money making motives is your primary purpose, you may want to clearly describe the proposed event as a "special event" rather than a fundraising event, even if there will be some money raised through it. You'll want everyone to understand the primary purpose so that you can make the numerous decisions associated with any event based on your intended goals.

Projecting the Income and Expenses for the Event

If fundraising is the primary purpose of the event you are considering, be sure you project both the gross receipts and the expenses you anticipate incurring for the event. Working with specific projections for income from the different components of the event (corporate sponsorships, tickets, food sales, etc.), will help you focus your efforts, and avoid spending too much time on a component which will not yield much. You'll also want to work with detailed projections of each cost item. These expense projections provide guidance for the volunteers and staff working on the event, and are essential for projecting what the net income will be.

Once you've done your detailed event income and expense projections, you'll be able to compare different event concepts. Increasingly, Boards and volunteers tell us that they prefer making one big effort around an event to the endless demands of multiple small events. Be sure to check this concept out with your group – they may prefer the multiple small ones.

Considering the True Cost of the Event

While you may not keep detailed staff time records, it is important to have paid staff keep some record of the time they spend making fundraising events happen. Frequently, all staff become involved as an event approaches, disrupting other work and wearing folks out. If this is true in your organization, you'll need to think about the concept of "opportunity costs." This refers to the funds you didn't raise through grantwriting or providing services because your staff were tied up working on a fundraising event.

Once you're clear about the true cost of fundraising events, you'll probably want to know "Is it worth it?" Well organized and interesting fundraising events raise your visibility, put you in touch with potential new supporters, and can create great team spirit for Directors and volunteers. Many types of events produce increasing net amounts as they are repeated from year to year. In the first year, everything takes longer, and you make mistakes. As the event develops, you should be able to increase the net. So it may be worth making a tremendous effort with a new event even if it doesn't generate a huge amount in the first year, if you can see that it has potential for increased net income in future years.

One final thought on events. Be alert for opportunities to have church or social organizations produce events for you. This can produce money and visibility for your group with very little effort on your part. If you are approached by a civic group proposing to do an event (auction, fair, etc.) with you as the beneficiary, explore the concept carefully. Be sure you are confident the group

can follow through and do a quality event. And be sure they are not counting on your staff, volunteers, and supporters to carry major roles. In fact, you may want to draft a brief and friendly letter of understanding to be sure you have a true meeting of the minds.

BINGO, RAFFLES, AND OTHER GAMING

Although the many exceptions in Oregon seem to overshadow the rule, gambling is illegal in Oregon. Generally, participation in gambling is a crime. One exception to this rule allows certain nonprofit organizations to carry on limited types of gambling (also called gaming) – specifically, bingo, raffles, and Monte Carlo events. To determine whether your organization can engage in any of these activities, you must first figure out whether you are the type of nonprofit that can engage in gaming. If so, you need to know whether the activity you want to carry on is legal and if the Attorney General requires that you get a license from the state.

The Attorney General's office permits any nonprofit, tax-exempt organization to engage in the permissible gaming activities. Your organization has to be organized primarily for purposes other than to engage in gaming. You have to have a valid organizational structure and exercise independent control over your budget and activities. If you are required to get a bingo or raffle license, you must have been exempt from federal income taxation (see Chapter 5) for at least one year preceding your application. When you apply for a license, you will need to produce your exemption letter. If you do not have an exemption letter because you are exempt under a section of the law that does not require you to apply for exemption, you must produce a written opinion from a lawyer or accountant that you qualify for federal tax exemption. Contact the Attorney General's office for more information.

Your nonprofit can only conduct certain forms of bingo, raffles, and Monte Carlo events. Pull tabs cards are illegal.

Exceptions to Licensing

In most cases, you must get a license from the Attorney General's office to conduct bingo, raffles, or Monte Carlo. However, if you are exempt from federal income tax and engage in very limited amount of gaming, you may avoid the license requirement. This is the case even if you have been exempt for less than a year. You are not required to contact the Attorney General's office but you should maintain proof that you are exempt in case the Attorney General's office contacts you. The following activities are exempt from licensing:

• Door prize drawings, which are drawings conducted at your regular meetings where you sell the ticket and conduct the drawing at the same meeting and where the total value of prizes does not exceed $500 per calendar year;

• Bingo/Monte Carlo/raffles where the total amount of sales revenue (called "handle") is no more than $2,000 per event and no more than $5,000 per calendar year;

• Raffles with a total handle of no more than $10,000 per calendar year.

Example: Handicapped Veterans, Inc., a §501(c)(19) veterans group, wants to raise money by including a raffle at its annual conference. It plans to sell $1,500 worth of tickets. It may engage in this gaming and does not need a license. If it decided to sell over $10,000 worth of tickets in connection with this single event, it would need to get a license from the Attorney General's office.

All individuals involved in the operation of bingo, raffles, and Monte Carlo events must be your employees or volunteers, with some exceptions. If you are planning to use independent contractors in connection with these events, contact the Attorney General's office to be sure that you comply with their rules. If you conduct Monte Carlo events, you should call the Attorney General's office for the rules. Some of these apply to you even though you do not have to be licensed.

Getting A License

If your activities do not meet the exceptions for licensing, you need to contact the Attorney General's office to get a license. The Attorney General issues a set of rules that applies to gaming licenses and you need to be familiar with those. The address and phone number for the Attorney General/Oregon Department of Justice is found in Appendix 2.

Note for §501(c)(3) Tax-Exempt Groups

Although Oregon law allows all tax-exempt groups, including §501(c)(3) groups, to run bingo and raffle games, the federal tax-exempt rules distinguish between bingo and raffle proceeds. Bingo proceeds are treated as related business income. Raffle proceeds are treated as unrelated business income, unless the raffle falls within some exception that allows it to be treated as related business–e.g., it is done by volunteers; it does not qualify as "regularly carried on", etc. See Chapter 9. This means that you may have to pay tax on your raffle

proceeds. In extreme cases, it also could mean that you lose your tax-exempt status if your raffle proceeds are too large. See Chapter 9.

MEMBERSHIP FEES

Many nonprofits generate income by charging fees for membership. As explained earlier in this book, the term membership has a very specific legal meaning for nonprofits in Oregon. See page 23. If your organization is not technically a "membership" corporation, you may want to find a different term to describe individuals who support your work but do not have the legal rights of members in a membership corporation.

A further distinction exists between the concept of membership as a form of being a "financial supporter," and the concept of membership as being an "exchange" method for individuals to purchase certain goods or services from the nonprofit. The typical financial support type membership offers the purchaser little of financial value in exchange for their membership fee. Such supporter-members may receive a newsletter or an opportunity to attend special social gatherings, but do not receive very large discounts on the organization's admission fees or very substantial "thank you" gifts for their donation.

Other organizations use the exchange concept of "membership" to offer forms of volume purchase discounts. Examples would include a membership to a museum or zoo which offers unlimited free admissions, or a membership in a literary society which allows the member to choose five free books with a value which almost equals or exceeds the membership fee.

The financial support type membership is really just one more variation of methods to build support from individual donors. In fact, many organizations with well established individual donor solicitation efforts find these supporter memberships a very helpful tool both for introducing new donors to the organization and for building donor commitment, particularly by moving donors through a graduated series of membership levels. Even very small organizations may find memberships an attractive way to ask individuals for relatively small contributions which are renewed each year.

The exchange concept memberships have much in common with the program service fees and product sales described later in this section. Careful planning is required to design packages of membership benefits which are both appealing to potential purchasers and financially helpful to your organization. If too many discounts, free admissions, etc. are offered in the membership package, your organization may find the cost of producing the goods and services offered consumes a great portion of the membership fee income generated. If

you are exempt or plan to apply for exemption under §501(c)(3), the IRS may deny or revoke your exemption if your members receive more in value than they pay in dues.

In planning your fundraising strategy, you'll need to be very clear about the type of support you are seeking. If you will be approaching individuals who are likely to contribute to your organization simply because they care about your work, you may not want to reduce the net value of their contribution by offering them a lot of exchange-type rewards. Simply the pleasure of knowing they have helped your group – and been thanked for their support – may be the best motivation for their gift. If so, giving other rewards or incentives simply wastes your organization's resources.

On the other hand, if your organization produces events, services, or goods which are highly attractive, even to people who would not otherwise be strongly motivated to contribute, creating membership packages which offer "deals" on volume purchases may be an effective marketing strategy. And since these exchange membership purchasers will experience your organization's work repeatedly, they may become promising contributor prospects. In other words, you may be able to motivate some of your exchange type members to become true contributors based on their appreciation for the work you do.

If you are considering developing a membership campaign, take a look at the membership programs of a variety of similar and somewhat different organizations in your area. Not only will you get good ideas about ways to approach memberships, you may also be able to offer prospective members to your group a format for membership which is familiar to them. Be sure you think through the full cost of each approach to membership, and consider the long term benefits as well. Building a significant membership will help your organization's credibility and facilitate getting the word out on issues of concern to you. The concept of membership helps supporters feel connected to your organization, and the stronger their connection, the greater the likelihood of repeat and increased giving.

CIVIC AND RELIGIOUS ORGANIZATIONS AS FUNDERS

Many nonprofits find that religious and civic groups (like Rotary, Altrusa, Kiwanas, etc.) in their communities are willing to provide financial support. While contributions from individual churches, synagogues, or civic organizations are generally relatively small, the large number of religious

organizations and civic groups in many communities can make this a more substantial source of funds.

Civic Organizations

Start exploring this source by obtaining or developing a list of civic and religious organizations in your community. The Chamber of Commerce often maintains lists of civic organizations and their current officers. While the civic groups frequently do not have listing in the telephone directory, religious organizations generally do.

Next, you will need to determine which of the civic organizations makes charitable contributions and what process they use to do so. Ask your Directors, volunteers, staff, and other friends whether they or their friends belong to any of the civic groups. You may also want to ask about fraternal organizations, like the Moose or the Elks. Ask your supporters to make the initial contact with the group to which they belong. Once they have learned how the organization goes about making contribution decisions, staff and other Directors can help them prepare the request.

One of the great benefits of working with civic organizations is their willingness to be repeat supporters.

Typically, civic groups have regular meetings and invite outside speakers to present programs. Most do not want the program to have an explicit fundraising purpose. Instead, their members are seeking information and understanding about community needs and resources. You'll need to develop a brief presentation about the work that your organization does. Slides or videos may be helpful.

Different groups use different approaches to the issue of allowing speakers to ask the group for money. Some groups allow a group member to propose "passing the hat," i.e. asking those in attendance to each contribute to the speaker's cause right at the time of the presentation. Others would be offended by this idea. Most have some time during the year when contributions from the group's treasury to community organizations are considered. For these, your presentation will be background information. You'll need an advocate who is a member of the group to promote the idea of supporting your organization. Some groups will accept written proposals for consideration.

To be effective with civic groups, you will need to learn both their process for handling requests for funds and the types of issues which appeal to their members. For example, some groups like to provide funding for vans

or other equipment so that their name can be prominently displayed on the item. Others have special interests, like children or certain health issues. You'll want to focus your presentation and requests on the things the group is interested in supporting.

One of the great benefits of working with civic organizations is their willingness to be repeat supporters. Your group will want to develop an ongoing relationship with civic groups which fund your activities, inviting leaders to special events and sending them newsletters and pieces of good news about your progress.

Religious Organizations

Religious organizations often have multiple approaches to supporting nonprofit groups. The major denominations typically have national – and sometimes regional – funding programs which operate with written applications, funding guidelines, and other formal tools. In addition to these formal funding arms, individual local congregations develop their own process for considering requests for support. Some congregations have a social concerns or missions committee which brings recommendations to the church budget process about support for local organizations. Others will consider requests made to the synagogue or church Board or rabbi or pastor throughout the year. Still others will allow nonprofit leaders to speak from the pulpit during services and take up special collections for organizations they believe are doing particularly important work.

Start exploring the potential for religious organization support by asking your Board, staff, and volunteers about any affiliations they may have with local religious organizations. Ask those who are affiliated to learn the process for their church or religious group. Generally, if the person affiliated with the religious organization will make the initial contact, others from your group can make presentations, etc. Your contact will need to find out the preferences of their organization. Be sure they explore the potential for general operating support before proposing restricted funding for narrowly defined purposes. Many religious organizations are open to general operating support requests because they want to see your organization achieve its mission, and are prepared to trust that your Board knows where the money is most needed.

Even religious groups which have no contributions process and would not consider taking up a special collection may have various youth and adult groups which would enjoy a presentation about your organization. This may prove to be an important avenue for building visibility. Ask if you may pass around a sign-up list for your newsletter. In this way you can obtain names and addresses of individuals who may be open to appeals from your organization.

The regional and national religious organization funding arms make some substantial grants to nonprofit organizations. For most of these groups, you will need to have made some connection with a local congregation and obtain letters of support from church or synagogue leaders. Sometimes individual members of local congregations are not aware of the granting process their denomination uses on the regional or national level. Consider scheduling appointments with local pastors and rabbis and seeking their advice about funding. Ask them about opportunities for national or regional funding. Once you've identified the potential sources, obtain their guidelines and determine if your organization will qualify. Many of the national and regional religious funders do not require that the applicant organizations have a primarily religious purpose. However, most will want to see some connection between your organization and their local congregations. This may be through congregation members volunteering, contributing goods, or providing advice.

GOVERNMENT GRANTS AND CONTRACTS FOR SERVICES

In general, government at almost every level other than defense is in cutback mode. Federal, state, and local decision-makers are struggling to find ways to spend less not more. Still, many government programs do provide grants to nonprofits. More significantly, many governmental entities find that contracting with nonprofit organizations to deliver specific services is a way to spend less than operating the services themselves. So if your organization delivers social, health, or targeted recreation or environmental services, you may find government contracting a good potential source of funds.

Government Grants

Government grants differ from government contracts primarily in the degree of discretion the nonprofit organization exercises in designing the project. While to some extent the terms "grant" and "contract" have begun to be used interchangeably, it is still possible to say that grants, particularly federal grants, describe a general area of interest and require the organization submitting a proposal to come up with their own plan.

In general, it is very difficult for an organization which does not have a track record of receiving government grants to get the first one. Of course there are exceptions. You may want to attend workshops specifically focused on federal grant opportunities, and consider working with a consultant who has been successful in obtaining federal grants for organizations similar to your own. The State of Oregon also makes some grants. To track down these opportunities, you will need to identify programs and departments within State govern-

ment which address your areas of interest. Start by asking other organizations doing work with similar populations about their experience with government grants. Then contact the funding sources they identify and request an informational interview so that you can get an overview of funding opportunities. You don't need to find a nonprofit which does exactly the same thing you plan to do, only one which works in related areas.

One final reality check. Government grants and contracts can be important components in your funding strategy. But be realistic in your expectations. There is intense competition for government funding. Organizations which currently work with government grants and contracts are facing cutbacks and are working very hard to sustain their funding. Cracking into the world of government funding will be very challenging, and may take several years. You should also be aware that the government often places restrictions (such as prohibitions against lobbying) on some recipients of government grants. (See pages 613-614 for a discussion of some of these restrictions.)

Government Contracts

Here are some steps your organization can use to explore the possibility of entering into contracts with governmental entities to deliver services:

- Most governmental contracts require that the nonprofit contractor provide specific types of services for specific types of clients. For example, residential care facilities for youth in trouble with the law, typically are under contract to a state or county government to provide housing and support services for a specified number of young people at a specified rate per day.

- Ask other organizations with program services similar to yours whether they have any government contracts. Find out which governmental entity and which department funds them. If you know them well, ask to see a copy of their contracts so that you can understand more specifically what they are being paid to do. Contact the government staff responsible for these contracts and ask how your organization may be considered to become a contractor.

- If you do not know other nonprofits with government contracts, try approaching your elected officials – city council, county commission, representatives in the state legislature, etc. Ask for an appointment. When you meet, explain the types of services your organization is prepared to provide and seek advice about government contracts for services. Ask the elected officials to help

you identify specific programs and the persons to contact to get more information.

• Many counties and some cities have "purchasing" offices which handle all the legal requirements for the government to enter into a contract for the purchase of services. Purchasing department staff can send you information about the general requirements to do business with their government, and they may be able to add your organization to a mailing list of interested parties who receive notice of all contract opportunities. Most governments take specific steps to assure that their decisions about contracts are fair to all parties. Be sure you ask about any Request for Qualifications (RFQ) process which may be required. Such RFQ processes are used to establish a list of organizations qualified to do business with a particular governmental entity. Only organizations which have been "qualified" to do business may submit applications through a Request for Proposals (RFP) process.

• Although there is a lot of emphasis on fair processes and sometimes a lot of formal scoring of proposals, it is unlikely that a completely unknown organization will ever be selected to be given a contract. If yours is a new group, or hasn't been involved in government contracting, you will need to establish relationships with the government staff who work in the appropriate programs and with other nonprofit providers. Frequently, nonprofit providers contracting with a specific governmental program have meetings to discuss issues of mutual concern. Ask if you may attend these meetings even without having a contract. They can provide good insights into the nature of the program and some of the challenges of working with government.

• You may need help to prepare your first proposals for government contracts. Special vocabulary is used and sometimes special formats for information are important. Look for a consultant or volunteer who is familiar with this particular government program or similar ones.

• Purchase of service agreements may contain restrictions and specific requirements for record keeping and independent audits. Be sure you understand what is required and how much it will cost you to comply.

Organizations already working with government contracts will need to be alert for changes in the contracting approach impacting many local govern-

ments. Read the actual contracts carefully to be sure you understand whether you are permitted to keep any profit generated by providing all the required services at costs which are lower than the amount you receive through the contract. Hopefully you are entitled to keep such profits, because virtually all contracts for service require that you provide the service even if it costs you more than the contract provides. Since you will be liable for any excess cost, it seems only fair that you will also be entitled to retain the profit when you are able to provide the services, and do a good job, at a lower cost. Unfortunately, many governments currently propose "lose-lose" contracts in which the nonprofit must return any surplus and bear any losses.

You'll want to weigh the pros and cons of government contracts as a potential source of revenue. On the pro side, many contracts continue for years. But, contracts may impose limitations on the way you serve the clients and on which individuals you may help.

You'll want to weigh the pros and cons of government contracts as a potential source of revenue. On the pro side, many contracts continue for years and provide substantial revenues to serve individuals and families with great needs. But, contracts may impose limitations on the way you serve the clients and on which individuals you may help. Additionally, contracts require careful bookkeeping, extra reporting, special audits, sometimes lengthy applications, and maintenance of relationships with funder staff. Finally, the government often places other types of restrictions (such as prohibitions against lobbying) on some recipients of government contracts. (See pages 613-614 for a discussion of some of these restrictions.)

PROGRAM SERVICE FEES

The term *program service fees* is used to describe the income generated by charging for the services which the nonprofit provides as a primary part of achieving its mission. For example, child care centers charge for child care, counseling agencies charge for counseling, theater companies charge admissions, etc. Program service fees may be paid directly by the person receiving your service or may be paid by a third party, i.e. an insurance company or a government contract to provide specific services for specific types of individuals, or in some cases, specified individuals. Many nonprofits set program service fees on a sliding fee scale basis, varying the amount charged for particular services by the income levels of the individuals receiving the services.

Program service fee income has become an increasingly large portion of all revenue generated by nonprofits. Some would say that nonprofits can exercise the greatest degree of control over their own efforts by developing significant program fee income. While foundations, governments, and to a lesser degree, individuals may be impacted by changing perceptions of what nonprofit work is important, income from program fees depends upon the nonprofit correctly identifying the services individuals need, delivering the services in ways preferred by the participants, and pricing the services appropriately. While none of these components of generating program fee income is easy, the nonprofit is in control of how they are accomplished, and not subject to the "whims" of funders.

Program service fee income has become an increasingly large portion of all revenue generated by nonprofits.

To successfully generate program fee income for your nonprofit you will need to consider the following issues:

• *Identify specific services*. Correctly identify specific services which are needed in your community.

• *Cost*. Determine how much it will cost you to deliver the service at varying levels of volume. It will be helpful to project the cost per unit of service you will deliver (i.e. cost per day of residential care, cost per hour of counseling, cost per theatrical production, etc.)

• *Ability to Pay*. Determine whether those who need the service can afford to pay what it will cost your organization to deliver it. If the recipients of the service cannot pay its full cost, you will need to find other parties who are able and wiling to purchase the services for the people in need. This may be a government program. For example, the State of Oregon will pay part or all of the cost of child care for certain eligible families.

• *Subsidies*. If participants can't pay the full cost of the service, and there are no outside parties to pay or the outside parties also will not pay the full cost of the service, your organization will need to decide whether you will use other income (probably contributed income) to subsidize the cost of delivering the service. This may be a good choice if the service is very close to the heart of your mission, and you have enough other funding to cover the rest of the cost. Charging something for the service will allow you

to stretch the other funds you have to provide more services or improve the quality of the current level of services.

• *Price*. Beyond the ability of your participants to pay, you will need to consider pricing in terms of what others are charging for similar services. For arts groups, your decisions on admissions pricing will be influenced by the prices charged for similar plays or concerts.

• *Credit*. Determine your policy about extending credit. Will you require that participants pay fees before they receive the service, or immediately after? If you decide to extend credit by allowing participants to delay payment, you will need to establish an accounts receivable system which includes billing the participants, keeping track of their payments, and making needed efforts to collect unpaid amounts.

• *Marketing*. Develop effective marketing strategies to inform potential participants and motivate them to choose your services.

• *Internet*. If you decide to use the internet to sell services, get professional advice. If your sales are considered commercial, you may be subject to regulation under the federal CAN SPAM Act of 2003. You may also be subject to state and local registration requirements in different jurisdictions if your activity constitutes doing business in those jurisdictions.

Simply stated, fee generation requires business planning skills. The decisions described above are similar to ones made by small businesses. You can get help working through these choices by talking with other nonprofits delivering similar services. If you have small business owners on your Board or among your volunteers, they may have exactly the skills needed to help you plan your fee generating activity.

PRODUCT SALES

Product sale income is generated by selling products related to your mission. For example, a sexual assault prevention program develops a booklet to be used in high schools to promote discussion of date rape, or a chamber orchestra produces CDs of its most popular concerts. These sales differ from the fundraising event strategy of selling candy bars or Christmas trees in several key ways. Typically, the mission-related products are sold throughout the year, not just during limited fundraising drives. Secondly, the sale of the product

furthers the mission of your organization directly, not simply by providing funds.

You will need to do careful planning to succeed in generating income through product sales. While many ideas sound promising, the process of developing products, obtaining financing, producing or obtaining the product in a cost effective way, and dealing with inventory, marketing, and distribution will require substantial business skills. Strongly consider developing a written business plan which carefully explores your organization's management and financial strengths and weaknesses; the market for your product; competitive products; costs of production, storage, and distribution; marketing strategies; pricing; and projected net income.

Many nonprofits have worked very hard to develop booklets and videos which contain needed information only to find that a market does not exist for their product.

Nonprofits are often more familiar with the concept of "need" than the concept of "market." While many individuals or organizations may "need" the product you are considering, your potential "market" for the product includes only those who perceive that need, prioritize it as important, have resources to purchase the product, can readily learn about your product, will believe your product is superior to other alternatives, and will be able to obtain the product. Many nonprofits have worked very hard to develop booklets and videos which contain needed information only to find that a market does not exist for their product.

Product sale income may be an excellent potential source of funds for your organization. But be sure you get the help you need to develop a business plan for the product you are considering before you make a substantial investment of time and money in its development.

If you decide to use the internet to sell products, get professional advice. If your sales are considered commercial, you may be subject to regulation under the federal CAN SPAM Act of 2003. You may also be subject to state and local registration requirements in different jurisdictions if your activity constitutes doing business in those jurisdictions.

SOCIAL ENTERPRISE AND BUSINESS VENTURES

Increasingly nonprofits are exploring the concept of "social enterprise". This term has varied meanings, each promoted by a cadre of consultants and trainers. It is most commonly used to describe the concept of nonprofits identifying programs which may be fully or substantially supported through the generation of income through sale of goods or services.

You may be familiar with nonprofits already using this strategy. For example, a nonprofit working to help individuals recover from alcohol or drug addiction creates a janitorial service. The nonprofit obtains contracts to clean businesses and then has program participants at various stages of recovery operate the janitorial service. Program participants who have very little job experience and are new to recovery fill the most basic jobs, while individuals who have proven their ability and stability, move up to become supervisors, bookkeepers, account managers, etc. The fees charged for the janitorial services provide funds to pay the program participants for their work and may generate enough income to pay the program staff who work with the participants to help them overcome barriers to being good employees.

The key concept here is that in carrying out the business activity, the nonprofit is also achieving its mission by help participants obtain work experience and prepare for employment once they have completed the program. A similar concept is at work in a much publicized program with a national ice cream franchise that has allowed a nonprofit working with street youth to set up an ice cream shop to employ the young participants.

You will find great resource materials about this concept at *www.redf.org*, including a study of over 100 similar projects. While many board members would like to imagine that the business ventures created in this way will be so successful that they will create profits that can be used to underwrite other portions of the nonprofit's activities, this is generally not the case. Successful social enterprise ventures are able to pay the full cost of operating the business venture, including not only wages for participants and for staff to work with them, but also a fair share of agency overhead costs.

What does it take to be successful with a social enterprise strategy? Like small businesses, social enterprises require excellent management and sufficient start-up capital to establish the business on a scale which can be sustained. All of the issues discussed in the sections on program fees and product sales

come into play in social enterprise. They also require great clarity of purpose and making some difficult choices about priorities.

Your nonprofit will need to be very clear about the relative importance of maximizing income generation and profit and giving the clients with difficult problems a chance to be employed. Like private employers, nonprofit social enterprise ventures quickly learn that skilled dependable employees lead to better customer relations and higher profits. But, the mission of many nonprofits is to serve and help individuals with very low skills and multiple barriers to being dependable employees. Managing a social enterprise business which has the dual mission of sound business operation and helping very needy clients master employment skills is extremely challenging. You will need to identify staff and advisers with multiple skill sets and clear commitment to your organization and its clients.

INVESTMENT INCOME

Obviously, the key to generating investment income is having funds available to invest. If your organization struggles month to month to have the cash it needs for payroll and basic expenses, investment income will not be a factor in your funding strategy. But if you have excess funds, or have generated specific support for an endowment or reserve fund, your nonprofit has the opportunity to use those funds to generate additional funds.

You will need to analyze your operating cash needs in order to determine how much cash you will need to set aside as operating reserve. This cash should be invested in ways that ensures that it is available for operating needs without penalty or losses. You may want to discuss the concept of a "sweep account" with a bank which renders institutional banking services. The sweep account is a bank service which invests your excess operating cash in commercial paper (debt instruments from well established corporations). Your investment strategy for operating cash reserves will be different from your strategy for funds which may be invested for longer time periods. For those funds you will want to develop a comprehensive investment policy.

Components of an Investment Policy

Your Board should develop an investment policy to guide all decisions relating to placement of excess cash. Investment policies generally have three major components: risk, return, and social responsibility screening.

Risk

In the risk section, your Board will determine the level of risk your organization is willing to take in its investments. A very conservative policy would be a no risk policy. This would require that all funds be placed in federally insured bank deposits or Treasury bills. A less conservative policy would set limits on what portion of the funds invested must be maintained in federally insured accounts, and what portion may be placed in investment opportunities with other levels of risk.

Return

Your policy on risk is highly related to your policy on return. As a general rule, return potential (what you can earn on specific investments) increases as the risk factor increases. In other words, very safe investments tend to yield lower rates of return. Of course, very risky investments may yield no return at all or they may yield significantly higher earnings than playing it safe. Your investment policy should reflect your Board's view on an acceptable level of risk and expected levels of return.

Social Responsibility

Finally, your Board will want to discuss whether your organization should limit its investments based on the level of social responsibility practiced by the corporations whose stocks you purchase. During the campaign for reform in South Africa, many nonprofits refused to invest in corporations doing business in South Africa. Now, many environmental organizations refuse to invest in corporations with particularly bad environmental policies. Some organizations working for peace refuse to invest in corporations which manufacture weapons.

Who Makes Investment Decisions?

Your Board must also determine how investment decisions will be made. Organizations with relatively large amounts to invest (over $500,000) may want to talk with trust departments of banks or other institutional investment managers about investment management services. These firms employ highly skilled investment analysts and are extremely careful to follow the investment policy guidelines established by their clients. Their fees are generally set as a percentage of your investment portfolio, i.e. not related to charges for individual stock trades or other specific activities.

Organizations with relatively small amounts of excess cash (under $50,000) may decide that simply directing staff to find the highest yielding federally

insured certificate of deposit is the simplest and safest way to manage their funds.

Organizations in the middle, with too little money to be of interest to the institutional investment managers and too much money for Directors to feel comfortable with a very basic, federally insured only policy, have some difficult choices. Some Directors will suggest engaging an investment adviser or stock broker. While these individuals will be interested in managing your funds, their fees will often be based on trades executed. Your Board will need to establish a committee of individuals highly knowledgeable about investments to monitor the performance of such an investment adviser. Committee members should be individuals who track the stock market and investment opportunities regularly, and are committed to spending enough time reviewing the reports you receive from the your investment adviser to be able to determine that the adviser is following your policies and generating an appropriate level of return.

Some organizations decide that a Board committee can function as the investment manager for the organization. Taking this approach requires very careful screening of the individuals asked to serve on the committee, and additional monitoring by others not on the committee. Your Directors have a duty to protect the assets of the corporation, so they must be sufficiently knowledgeable about current investment opportunities to determine whether your funds are being managed properly. If your Board feels it does not have this expertise, then they will need to either rely upon a reputable professional investment manager, or choose a very low risk strategy such as federally insured certificates of deposit.

If your nonprofit has an endowment fund to manage, you may want to explore working with the Oregon Community Foundation, a §501(c)(3) organization that manages over $500 million. Your organization can transfer your endowment to the Oregon Community Foundation with the stipulation that earnings on the endowment are to be awarded as grants to your organization. OCF uses its professional expertise, and the power of having substantial amounts of money to convert, to be certain that your funds are invested safely and profitably.

IN-KIND CONTRIBUTIONS

No discussion of resource generation would be complete without considering in-kind contributions. In-kind is a term used to describe the provision of free or reduced priced goods and services by a donor to a nonprofit organization. For example, you may find a printer willing to do some or all of your printing for free. You may find an attorney willing to review contracts at no charge, or a

graphic artist who gives a 50% discount to nonprofit clients. In each instance, your organization is able to reduce a cost you would otherwise have to raise funds to meet.

You'll want to build awareness of the potential for in-kind contributions into every part of your fundraising program. Individuals, businesses, foundations, and government all may make in-kind contributions. Your challenge is to determine whether a cash or in-kind gift from a particular supporter has greater value for your organization. Once you're clear about which you would prefer, you can begin by asking for what you want, and then be prepared to propose the other as an alternative if the donor declines to provide your first choice.

Like all fundraising activity, working on in-kind contributions requires cost-benefit analysis. Asking for in-kind gifts is most frequently done in person or on the phone. This means that it is relatively time consuming. You'll want to be sure that the dollars you save by getting the items contributed in-kind are worth the direct cost (letting paid staff solicit the gifts) or the opportunity cost (using volunteer time for in-kind solicitation instead of other activity). In-kind gifts can be enormously important. For example, several youth groups have received special fall-cushioning playground surfaces as an in-kind contribution from a local company. The groups would have had to pay thousands of dollars to obtain alternate playground surfacing. On the other hand, one local group devoted over 16 hours to phone calls to generate food contributions for a volunteer event at which the total food cost would not have exceeded $150 even if the group had purchased every item.

If you will be working with in-kind contributions be sure you check the In-kind Contributions record keeping information in Chapter 22. You will need to acknowledge donor's in-kind contributions. In-kind contributions can raise some sticky tax deductibility questions, particularly for businesses. Be careful to avoid giving tax advice to your donors. Many organizations use phrases like this in their acknowledgments of items received in kind: "XYZ Child Care is a nonprofit organization which is tax-exempt under §501(c)(3). Your contributions qualifies as a charitable deduction to the fullest extent allowed by law." If donors press for more information about the deductibility of their gifts, encourage them to consult their own tax advisor.

One final word on in-kind contributions. Beware of white elephants. Sometimes donors want to contribute equipment or supplies which really have no value to your organization. The equipment may be outdated, need expensive repairs, or simply not be compatible with your systems. You'll need to think carefully about your response to these offers. If you believe that the donor has real potential for more valuable gifts in the future, you may want to accept the gift and then dispose of it to another organization, or potentially to recycling. If

you do not anticipate any continuing relationship with the donor, you may choose to decline and perhaps suggest another organization for the donor to contact. If you do decide to accept the unusable gift, be sure you do not promise to use it. Instead, say you appreciate the gift, will check out how it can be used in your program, and will be pleased to pass it on to another group if it does not work out with your systems.

USING THE INTERNET TO RAISE FUNDS

Many nonprofits are now using the Internet to solicit contributions by including a "donate now" feature on their websites, by emailing solicitations for contributions to current and prospective donors and by emailing invitations to fundraisers. If you do this, your appeal will almost always cross state lines. Many states and localities regulate charitable solicitations. Some are taking the position that Internet solicitors must register with them and follow their rules. The legal rules pertaining to charitable solicitation are uncertain. You need professional help if you solicit or do business over the Internet.

You also need to be aware of the federal C-SPAM law. This law applies to commercial advertisements and to promotions that are unsolicited. If you send an email to your members notifying them of a membership meeting, this is not commercial and is not covered by the C-SPAM law. However, if you email the public invitations to your upcoming silent auction, you are probably sending a commercial and unsolicited email. You can still send the email but you need to follow certain rules:

- Send from an active email address, one from which the recipient can reach you if he or she hits "Reply."

- Identify yourself in the "From" section and include your post office address in the body of the message.

- Use the word "Advertisement" in the subject line.

- Give the recipient a way to opt out of your list and remove those who opt out within 10 days.

If you are soliciting and accepting donations on your website or through email, you will need to keep up with this evolving issue. Check with your attorney or accountant, watch the Oregon Attorney General's website and check the TACS website at *www.tacs.org* for news in this area.

ETHICAL AND LEGAL ISSUES IN FUNDRAISING

There are many ways that Directors, staff, and volunteers can raise money from individuals without help from fundraising professionals. However, as your organization expands the amount it hopes to raise from individuals, you may want to explore getting help from experts. There are several useful ways nonprofits do this, and several ways which are not considered ethical.

Ethical Fundraising

Ethical ways to obtain fundraising help include:

Consulting

A fundraising consultant can help you figure out which approaches are most likely to work for your organization at its current stage of development. She or he may also help you research prospective donors, draft specific appeals, train volunteers to do fundraising, and provide a variety of other useful advice. However, your Board, volunteers, and staff will be responsible for implementing the consultant's advice, so you will need to be very realistic and honest with the consultant about the amount of time and energy you have available.

Staff Fundraiser

Many nonprofits employ staff with specialized responsibility for fundraising. In fact, larger organizations will frequently have multiple positions for all the different types of fundraising. Typically, a fundraiser on staff will be responsible for implementation as well as development of your fundraising strategy. If you are considering a staff position, you'll need to be very clear about the types of fundraising you want the staff person to do. The skills required for most individual fundraisers are quite different than those of a "grantwriter." And success in fundraising for a large, well established nonprofit does not always predict skill in raising money for a small organization or one with little experience working with donors.

Contract with a Fundraising Organization

Some professional fundraising firms will provide help both developing and implementing specific fundraising activities. Ethical firms charge on an hourly or per project basis, and do not set fees as a percentage of the amount raised. If you are considering such a contract, request that the firm give you a complete list of all their clients, not just selected references. Determine which of their

clients have had situations most similar to your own – size, experience with individual donors, type of appeal, etc. Contact them and discuss not only what the fundraising firm did for them, but what their Board, staff, and volunteers did to facilitate the fundraising activity. Consider whether your organization can provide the back-up which the firm needs to succeed. When in doubt, contact the Oregon Department of Justice Charitable Activities Section to learn if any complaints have been filed about this firm. Also contact the Better Business Bureau, and other nonprofits in your field.

Workshops and Trainings

The National Society for Fundraising Executives and the Willamette Valley Development Officers are professional organizations for people doing fundraising. They provide a variety of conferences and trainings. Call the TACS Nonprofit Organizations Information and Referral Helpline at 503.233.9240 or 1.888.206.3076 or consult the TACS website at *www.tacs.org* for a master calendar of training events. TACS can help you select the most appropriate ones for your organization.

Unethical Fundraising

Several fundraising practices are either unethical or questionable:

Grantwriting with the Fee Determined as a Percentage of Grant Funds Received

Not only is this considered unethical by professional fundraisers, it is specifically prohibited by most grant making organizations. Grant funds are to be used for the purposes described in your proposal, not for costs of preparation of requests. Plus, this basis of payment may encourage the grantwriter to pursue strategies based solely on their likelihood of being funded rather than on their merit or appropriateness for your organization.

Fundraising Companies which Keep Most (above 60%) of the Money for Their "Costs" but Use Your Nonprofit's Name and Tax-exempt Status

You may be contacted by an individual or a for-profit or mutual benefit nonprofit business offering to do fundraising for you. If the fundraiser solicits funds by selling goods or services on a regular basis, it is called a *commercial fundraising firm*. If it manages or solicits funds other than by selling goods or services, it is called a *professional fundraising firm*. The business will often use telemarketing to solicit ticket sales or contributions, telling the purchaser that they are supporting your organization's work.

But many of these businesses actually keep 80 to 95% of what is raised, sending your organization the remaining small percentage. You will need to decide whether you are comfortable knowing that donors think they have given a dollar to you, but you have only received 10 cents. In addition, the firm may use the mailing list they develop with your help from your campaign in other of its solicitations.

In some cases, these arrangements are illegal. The law restricts your Officers and Directors from entering into certain agreements with professional and commercial fundraising firms.

Professional Fundraising Firms

If you decide to work with a professional fundraising firm, the firm must give you a written financial plan that includes a good faith estimate of total revenues and expenses for each solicitation campaign. Often one goal of your campaign is to develop a donor list. If you are targeting individual donors, the written financial plan provided by the fundraiser must specify whether the campaign is directed toward acquiring new donors, renewing prior donors or a combination of both.

The law puts some responsibilities on your officers and Directors to act responsibly in engaging professional fundraisers. Your officers and Directors *breach their duty* if they enter into an agreement with a professional fundraising firm and if the period of the agreement is more than 2 years unless your corporation has obtained written proposals from at least 2 other professional fundraising firms. Your officers and Directors also *breach their duty* if one of the purposes of the solicitation campaign is to acquire a donor base for your future solicitations and you do not keep the exclusive rights to the ownership and use of the list . You can give the professional fundraising firm a security interest in the list. The law assumes that one of your purposes is to develop a donor list unless your agreement with the fundraising firm explicitly denies this.

Commercial Fundraising Firms

If you are using a commercial fundraising firm, you should be aware of some of the limits the law imposes on your contracts with that firm. If the firm is going to identify your nonprofit as part of its solicitation campaign, it must designate the amount that will be paid to you. The amount can be specified in terms of an amount per unit of goods or services purchased, it can be a specified percentage of the gross funds solicited, or it can be a good faith estimate of the gross funds solicited. Your nonprofit must receive at least 90% of that good faith estimate, excluding any expenses your nonprofit has to pay for the solicitation campaign.

The descriptions given above for professional and commercial fundraisers are somewhat generalized. Because of the personal liability that may be imposed on your officers or Directors, you may want to get legal advice before contracting with these types of fundraiser.

Fundraising Events or Individual Donor Solicitations in Which the Fundraiser is Paid a Percentage of What is Raised

Again, fundraising professionals consider this in general to be an unethical approach. However, some professionals are comfortable with a contract which provides a basic fee to the fundraiser with a bonus if net proceeds exceed certain levels.

If you are not certain whether a fundraising practice is ethical or right for your group, you may want to talk with the staff of the Oregon Department of Justice Charitable Activities Section, with leaders of other similar nonprofits, or with representatives of the National Society of Fundraising Executives.

If you are tax-exempt under any section other than §501(c)(3), and you engage in fundraising solicitations, your solicitations (both written and verbal) may need to contain a conspicuous and easily recognizable statement that contributions or gifts to your organization are not deductible as charitable contributions for federal income tax purposes.

Rules on Solicitation for Non-(c)(3) Exempt Groups

Generally, if you are tax-exempt under any section other than §501(c)(3) and you engage in fundraising solicitations, your solicitations (both written and verbal) may need to contain a conspicuous and easily recognizable statement that contributions or gifts to your organization are not deductible as charitable contributions for federal income tax purposes. This requirement applies if you normally have gross receipts of more than $100,000 per year and the solicitation was made in writing or by television, radio, or telephone. You are exempt from the rules if your solicitations are by letter or phone call and you contact no more than ten people per year this way. These rules apply to billings for dues as well as requests for contributions, donations, or support.

The IRS has some detailed rules about how you satisfy the disclosure requirements in the various media. If these rules seem to apply to you and your media is print media, you can satisfy them by stating: "Contributions or gifts to [Name of Your Organization] are not tax deductible as charitable contributions for federal income tax purposes." The statement must appear in the same or larger print size as the primary message. It must be on the same page or in close

proximity to the request for funds. If you have a returnable card or tear-off section, the statement must appear on the message side that the contributor sends in with the contribution. The statement should be the first sentence of a paragraph or its own paragraph. If you solicit on your website, the user must see the statement without following a link. It must also appear before the user hits a button to make the contribution.

> *Example*: Preserve Our Farms, a corporation exempt under §501(c)(4), has gross receipts of more than $100,000 per year. Each year it mails a letter billing its 500 members for their dues. The bill needs to contain the statement that contributions and gifts to Preserve Our Farms are not deductible as charitable contributions in print size at least as large as that in the rest of the letter in the first paragraph or in its own paragraph.

If you are soliciting through some other media, you should get professional advice to be sure you comply with these rules.

FINAL TIPS

Consider all the funding strategies described in this chapter to be like a giant menu. You'll want to order from several sections. Most nonprofits need multiple types of funding for long-term survival and growth. You will need both short term and longer term plans for generating resources. While obtaining the funds you need to operate this year is obviously your first priority, you'll also want to think ahead to opportunities for future years and make choices about current funding activities which can lead you to your future goals.

Consult Appendix 1 if you would like information about source material related to this Chapter. Appendix 1 has references of interest to all readers, not just professionals.

After you have raised funds, you need systems and procedures for handling them. Chapter 22 describes these.

22 PROTECTING YOUR NONPROFIT FROM FRAUD AND ERRORS

Once your Board has adopted the annual budget and you have raised funds, you're ready to start doing business.

This chapter focuses on the basic steps you'll need to take to be sure you're handling funds properly. The precautions described here are designed to protect both the organization and the individuals working with its funds. You want to have systems, policies, and procedures which prevent errors from happening and make it likely that those mistakes which do slip through will be found and corrected.

If you are a new nonprofit, this chapter will provide a step by step guide to putting your protections and systems in place. If your nonprofit has been operating for a while, you may want to use this chapter as a check-in to be sure the basics are covered before moving on to the more complex issues of accounting and reporting discussed in Chapter 23.

THIS CHAPTER COVERS

- **Who Should Do What: Developing Financial Policies and Procedures**
- **Key Banking Issues**
- **Petty Cash Funds**
- **Processing Payments**
- **Handling Cash Receipts**
- **Acknowledging Donations**
- **In-kind Contributions**
- **Insurance Protection**

WHO SHOULD DO WHAT: DEVELOPING FINANCIAL POLICIES AND PROCEDURES

To protect your organization and the people working with it, you'll want to establish clear, consistent procedures to guide every aspect of accepting and using funds. Your most basic protection is an absolute policy of putting all funds given to the corporation into a corporate bank account, and paying all—or almost all—of the corporation's obligations by check from the corporate bank account. Of course, there are occasional situations in which small amounts must be paid in cash. The section of this chapter on Petty Cash Funds will help with protections for these unusual situations.

We've included a sample Table of Contents for a Fiscal Policies and Procedures Manual in Appendix 16. Your organization should draft the simplest version for itself as soon as you know you will be receiving funds or incurring expenses. Your manual doesn't need to be long or fancy. In fact, the simpler you can make it the better. The important thing is that the Board, the staff, and any volunteers working with money know that you have established specific ways to handle the organization's business matters and that they are expected to follow them.

Your most basic protection is an absolute policy of putting all funds given to the corporation into a corporate bank account, and paying all—or almost all—of the corporation's obligations by check from the corporate bank account.

As you work out the details of who will do what with money for your organization, remember to focus on protecting individuals and the corporation by separating responsibilities for fiscal functions among several different individuals whenever possible. Specifically, you want to avoid the common situation in which one person handles all receipts, makes all bank deposits, writes all the checks, keeps the bookkeeping records, reconciles the bank statement, and prepares the financial reports.

What's wrong with this picture? The problem is that one individual is totally responsible for not only doing the work without making errors, but also finding any errors which did slip through. In general, it is much easier to detect errors made by others than the ones we make ourselves. Also, this approach leaves the organization totally dependent on that one person's skill and honesty.

What can you do to protect the individual and your organization? We know you won't have a huge staff of trained accountants (at least not in the early

days), but you can be sure that you separate responsibility for making bank deposits and preparing checks from responsibility for doing bookkeeping – and most importantly, from responsibility for reconciling the bank account.

The bank reconciliation process is probably the most important control in a small organization.

Your bank reconciliation is the process by which you make sure that your organization's records of what's been put into your account, taken out, and what's left agree with the bank's records. The bank reconciliation process is probably the most important control in a small organization. Be sure you assign responsibility for the bank reconciliation to someone other than the person who makes deposits or has access to blank checks (including either preparing checks or signing checks). There are details on how to do bank reconciliations later in this chapter. The key issue is separating this responsibility from other financial functions and finding a careful, responsible person to perform it.

You can create the controls you need by asking yourself the following question about each step of handling funds for your organization: How can we be sure that more than one person verifies that this step has been done correctly without bogging down our work?

Read the section on Key Banking Issues to learn about other specific controls you can establish. You can create the controls you need by asking yourself the following question about each step of handling funds for your organization: How can we be sure that more than one person verifies that this step has been done correctly without bogging down our work? Remember, no system is fool proof. You may decide that rather than slow everything down to an unacceptable pace or expend a large portion of the organization's resources on bookkeeping activities, you will accept some risk of error or dishonesty. But be sure you have considered whether there may be other, simpler ways to obtain the same protection. If you can't think of any, check with other nonprofit organizations or consult a professional accountant.

KEY BANKING ISSUES

Proper set-up and use of bank accounts is an extremely important part of good financial management. Hopefully, you have already established an iron-clad rule that all funds which your nonprofit receives (whether in cash or by check) should be deposited intact (with nothing removed or added) into your organization's bank account, and that your nonprofit uses checks to make payments for absolutely everything it possible can. Later on in this chapter we'll

discuss Petty Cash Funds which can be used when paying by check simply won't work.

But beyond providing the mechanism for meeting this basic requirement, your banking relationship can help your nonprofit create and maintain some important controls and protections. To get the maximum benefit from your banking relationship, you'll need to think through some issues, establish some key policies, and build a positive relationship with your bank.

Opening Your Checking Account

Start your banking relationship by being certain that the bank staff person you are working with has experience opening accounts for nonprofit corporations. You should be asked to provide the Federal Employer Identification Number (EIN) that the IRS has assigned your nonprofit (discussed in Chapter 3) and to provide evidence of a Board resolution directing the opening of the account at this particular bank.

Most banks can provide you with text for the corporate resolution to open the account which your board should adopt. Be sure your board adopts the resolution as stated and that the text of resolution is in your Board's minutes. Many banks will also provide the text of a second resolution through which your Board will identify the individuals entitled to serve as signers on the account. Regardless of who your Board selects to act as signers, your Board President/Chair and Secretary will be required to sign as evidence that your Board approved both opening an account at this bank and approved specific individuals as signers for the account.

Many banks now require that nonprofit corporations submit copies of their Articles of Incorporation. Some also require copies of your IRS determination of tax exempt status, if you are asking for various fee waivers the bank provides for charitable organizations.

Common Set-up Mistakes

Unfortunately, not all banks train staff thoroughly about working with nonprofits. You will need to take care that you are not misled by a staff person who does not understand that your nonprofit corporation will be operating like a business and will require the types of services provided to business customers.

Some important tips:

• Do not agree to use your own or another individual's personal social security number as the tax identification number on the account. Even if means you must delay opening your account, wait until you have the federal EIN for your nonprofit corporation.

• Do not use the federal EIN of another nonprofit corporation unless you have their explicit written permission to do so. You will need to present authorization to open the bank account which has been adopted by the Board of that corporation. But, even if the other corporation has approved your use of their EIN, you will want to think carefully about doing this. The effect of giving the other corporation's EIN is to inform the bank that the other corporation, not your nonprofit, owns the assets that will be in the account. If you are using another nonprofit's EIN, you should consult Chapter 10 on Fiscal Sponsorships to determine if you need to follow the rules described in that chapter.

• Discuss the question of requiring dual signatures on checks with the bank. Since all check processing is automated, many banks have adopted policies stating that they will not accept responsibility for monitoring checks to be certain that two authorized signatures are provided and that they will honor any check which has at least one authorized signature. If your bank has such a policy, you can still adopt a requirement that all checks have two signatures, but it will be up to your board to monitor whether the policy is being followed. The bank will not be calling your attention to checks with only one signature. See the discussion below for the pros and cons of requiring two signatures on your checks.

• Do request a month end "cut-off" date for your statements. This will make reconciling your bank statements to your month end general ledger cash account balances much easier. Do not be put off by bank employees who insist this is a courtesy reserved for business customers. Your nonprofit is a business customer.

Check Printing Choices

In order to know what type of checks to order for your new account, you will need to know whether your nonprofit will be preparing checks by computer or by hand (manually). Whichever approach you will use, be sure you use only pre-numbered checks.

Checks for Manual Check Writing

The simplest approach to preparing manual checks is to use the three-on-a-page format check format which provides a check stub for each check directly to the left of the check. This format provides enough room for the person writing the check to describe the purpose of the check as well as the payee, and date. While in the past bookkeepers frequently prepared checks using typewriters with multiple carbons, this approach has pretty much disappeared. If you happen to be using typed checks, you'll want to be sure that you have established a good system to file the check copies in check number sequence.

If you will also be preparing your payroll manually, request the version of the three-on-a-page format which provides a double stub – one part containing the payroll information which is given to the employee attached to the check, and the second part which remains in the checkbook for recordkeeping purposes. But, we strongly recommend using a payroll service to avoid errors, so hopefully you won't be writing out paychecks manually. See Chapter 24 for more discussion of payroll issues.

Checks for Computerized Check Writing

If you will be preparing checks on a computer, you will need to follow the directions for check specifications included in your check-writing software. Some programs are designed to use with pre-numbered check stock. Other programs create the check number to be printed on each check as part of the process of printing the completed checks.

While you will want to prepare as many checks as possible using your computer software, most nonprofits find that at certain times they will need to be able to prepare checks manually as well. This typically occurs when the person who ordinarily prepares checks on the computer is not available or when you will need to prepare a check away from your office. If your computer software uses pre-numbered checks, you can use these same checks to prepare the occasional manual check. If your computer software does not work with pre-numbered check stock, you may want to consider having a separate set of prenumbered manual checks printed in addition to the computer checks so that you can be certain that any manual checks are prepared on prenumbered checks.

Keep Unused Check Stock Under Control

Regardless of what type of checks you are using, you will need to be sure that no one other than the person authorized to prepare checks has access to the unused check stock. Don't leave blank checks out where unauthorized people

can have access to them. Lock them in a drawer or filing cabinet and make sure that information about how to access them is kept confidential. This is an important control because anyone who obtains your checks can create and quite likely cash checks against your account.

Protect Your Account from Unauthorized Checks

Banks process checks almost entirely automatically. They do not compare the signatures on the checks submitted for payment to the signature cards you have had authorized signers sign. You, the account holder, are responsible for examining the checks which are cashed against your account and protesting any checks which you believe do not have the correct signatures. Your rights to protest are time limited, so examining the checks returned with your bank statement or the checks posted on your bank's website quickly is an important control.

Never Permit Blank Checks to Be Signed

You must never allow your nonprofit's check signers to sign blank checks. If a check that is signed while blank is later used for improper purposes, your nonprofit will not be able to protest it to the bank. Each check signer needs to understand that their signature should only be applied after they have examined evidence that the check has been prepared properly and is for a legitimate purchase by your nonprofit.

Should We Require Two Signatures on Each Check?

In the past, many nonprofits considered requiring two signatures on each check to be a very important control. Dual signatures protect each check signer by providing evidence that another responsible person agreed with them that the check was for a legitimate corporate purpose. Nonprofits frequently allow the Executive Director to serve as one of signers and ask a Board member to serve as the second signer. Unfortunately, most banks no longer will accept responsibility for determining that your two signature requirement has been met before honoring your checks.

Today, many nonprofits have decided that they can obtain sufficient protection with a single signature system for most checks. These organizations also ask both the Executive Director and one or more Board members to be check signers. Each signer must be committed to examining documentation justifying each check that they will sign. This approach is based on the idea that one person carefully reviewing each check is a more effective control than two people carelessly signing, each believing that the other will do a more careful review.

Even if your nonprofit decides to use just one signature on most checks, you may want to establish a threshold amount which requires two signatures. For example, you may decide that any check over $5000 must be signed by two signers. Remember, in most instances, your bank won't enforce this dual signature requirement and you will not be able to protest checks over the threshold amount because they carry only one signature. Instead, the person who examines your cancelled checks must be trained to alert the board if the two signature requirement is violated.

Should We Use On-line Payment Features?

Of course many banks now offer opportunities to pay bills on-line without the use of any paper checks. This is probably not a good idea for small organizations without professional accounting staff, audits, and carefully designed controls. If your organization is considering on-line payment options, discuss the controls you will need with an accountant familiar with your operations.

Bank Deposit Slips and Records

If you are doing your books manually, you will need to order a business-style bank deposit book from your bank. Be sure you make a carbon copy of each deposit ticket as you prepare it. You will list each check and the total amount of cash included in the deposit. You can use your carbon copy to note the source of each amount, including each check and a list of the receipt numbers you have given for cash amounts. If you have a copier readily available, you may decide to photo copy each check in each deposit to avoid making a detailed listing of the checks. Of course, you'll still need to make a list of the sources of cash included in the deposit. If you take this approach, you will want to staple the photocopy of the checks to a copy of the deposit ticket. After you have made the bank deposit, you'll attach the bank receipt to this documentation of what was in the deposit.

If you are using computer software to handle your accounting and check writing, your program will provide a system for preparing bank deposits. Many programs include a feature which prints out a listing of checks and cash which can be used as a deposit ticket for the bank. Most nonprofits find that it is still helpful to photocopy the checks being deposited so that you can always be sure you know what funds were included in each deposit.

Do We Need to Get Our Processed Checks Returned with Our Bank Statement?

Many banks no longer return cancelled checks with bank statements or do so only if the account holder pays a fee for this extra service. This change raises

questions for nonprofit organizations which have previously relied on examining cancelled checks for agreement with accounting records as a key control.

If your organization has decided to continue receiving cancelled checks with your bank statement, you will want to make arrangements to have the unopened bank statement examined by an individual other than the person with responsibility for either preparing or signing checks. In small nonprofits, the Board Treasurer will often be asked to fulfil this role of examining the cancelled checks. As nonprofits grow larger and have more checks, this job may become burdensome to a volunteer Treasurer. At that point, a staff member other than the person who prepares or signs checks may need to take over the bank reconciliation and examination of cancelled checks. In either case, the bank statement and cancelled checks should still be sent to your place of business and the person receiving the mail should save it unopened for the person who will examine the cancelled checks and reconcile the bank statement.

The person responsible for examining the cancelled checks and bank statement will need to compare the checks to the accounting record of checks written. The goal of this examination is to determine whether the accounting records have correctly recorded the payee and amount of each check and whether the bank has honored any checks that don't have valid signatures.

If you decide not to request the return of cancelled checks, your nonprofit will still be able to examine the checks which the bank has honored. Instead of receiving the actual cancelled checks, your nonprofit will be given a password to access an electronic display of the checks which have cleared your account. You will be able to examine both the front and back of each check. You can also print the checks which are displayed on your computer screen.

It is still very important to have a person other than the person who prepares or signs checks take responsibility for comparing the checks which have cleared your account with your accounting records. They will be able to do this comparison by having access to your bank's electronic display of your account. You will want to develop a procedure that requires this person to check off or in some way indicate that they have reviewed each check just as they would have reviewed each physical check returned with your bank statement.

Bank Reconciliations Are Essential

The bank reconciliation is one of the simplest and most powerful controls your nonprofit can implement. You can use the simple format for bank reconciliation which your bank provides on its bank statements or ask a trained accountant to help you design a format which will work better for you.

There are several very important aspects of doing bank reconciliations:

- The person who does the bank reconciliation should not be the same person who prepares the checks or signs checks. If possible, they should also not be the same person who makes bank deposits.

- The person doing the bank reconciliation should be given the bank statement unopened, just as it comes from the bank.

- Bank reconciliations should be done within the first 7 days after your bank statement arrives. Do not put off bank reconciliations.

- The person doing the bank reconciliation must examine each cancelled check (or electronic image of a cancelled check as described above) to determine that the name of the payee, the amount of the check, and the date of the check agree with your accounting records and that all checks have valid signatures.

- The bank reconciliation person must also verify that each deposit recorded in your accounting records agrees with the bank record of deposits.

- The bank reconciliation must prove that the ending balance in your general ledger cash account is in agreement with the reconciled bank balance for that month end.

- Bank reconciliation requires listing all outstanding checks – checks that have been prepared but have not yet cleared the bank.

- Reconciliation also requires listing deposits-in-transit – all deposits that are shown in your accounting records but that have not yet been recorded by the bank.

It is absolutely essential that you are able to match the cash balance that is in your accounting records to the balance on your bank statement. If you cannot complete the reconciliation, go to the bank and ask for help immediately.

Dealing with Multiple Bank Accounts

Corporations that will have cash in excess of their immediate needs at any time during the month should consider use of interest bearing accounts. With telephone transfer services or on-line banking, you can make use of separate

savings and checking accounts quite convenient. However, you will need to establish special controls for telephone transfers or on-line banking.

Organizations with substantial excess cash which is not required for periods of 30 days or more should consider Certificates of Deposit and other time deposit plans. In general, the larger the amount of cash available and the longer the period of time it can remain on deposit, the higher the interest rate will be. Boards of Directors must establish their own policies for funds. See page 272 for a discussion of Board investment policies.

Be sure to read contracts with your funding sources carefully. Some federal programs specifically forbid placing federal funds in interest bearing accounts. Other contracts require that funds be placed in interest bearing accounts.

Be sure to read contracts with your funding sources carefully. Some federal programs specifically forbid placing federal funds in interest bearing accounts. Other contracts require that funds be placed in interest bearing accounts. Even if your funding agreements do not specify the use of interest bearing accounts, your board has a responsibility to see that funds earn interest whenever possible. Because the opportunities for investing surplus cash are complex, and the responsibility of managing the corporation's funds is great, it may be helpful to identify a regular investment adviser, either a Director or other community supporter with particular knowledge of sound cash management and investment strategy.

PETTY CASH FUNDS

Many small purchases are easier to transact with cash (postage due requests from your mail carrier, taxi fare for an emergency, etc.). New programs are often tempted to pay these expenses with cash received from clients or with an employee's own funds. Both these methods will eventually cause bookkeeping messes. Always deposit in the bank all cash received by the program. Otherwise there will not be a complete record of program earnings. *Avoid having employees use personal funds for program expenses.* Too many checks to employees for reimbursement of purchases may appear to be disguised wages or possible misuse of program funds.

The clearest way to deal with cash purchases is through creation of a *Petty Cash Fund*. One person should be responsible for administration of the Petty Cash Fund. To set up the fund initially, write a check for the full amount of the fund (usually $25 or $50 is adequate for small to medium-sized programs). Make the first check out to "Petty Cash— name of custodian" and record it in

the Petty Cash Fund account. This person will be responsible for the Petty Cash Fund. The Petty Cash Custodian will require receipts for all purchases and may ask employees to sign for money she provides as reimbursement.

Always deposit in the bank all cash received by the program. Avoid having employees use personal funds for program expenses.

As cash purchases are made, record them in a journal or notebook. Save all receipts. When the fund is getting low, or at the end of the month, reimburse the fund for the total amount expended (add up all receipts and prepare a check for this exact amount.) The total of this check plus the cash left in the fund should equal the original fund amount. When recording this check in the accounting records, distribute the expense to the appropriate accounts according to what was purchased. Do not distribute any of the total to the Petty Cash Fund account after the initial check to set up the fund. Instead, divide up the amount of the check to reimburse the fund into the categories of expense it was used for, such as office supplies, transportation, etc. The balance of the Petty Cash Fund account remains fixed at the original level you selected.

If after establishing and using a Petty Cash Fund for a while, it seems to require reimbursing too frequently for convenience, the fund can be increased by a fixed amount. This check is entered into the Petty Cash Fund account in the accounting records, and permanently increases the balance of the fund. The regular reimbursement of the fund for expenses continues as described above except that the amount of cash available for expenditures before reimbursement is necessarily larger.

PROCESSING PAYMENTS

Your organization needs to develop clear procedures for authorizing purchases, authorizing payment of invoices, preparing and signing checks, cancelling invoices when paid, and filing paid invoices. In small nonprofits, the authorization of purchases is usually handled verbally. The director or other designated staff member merely orders or purchases the necessary supplies and services in accord with the Board approved budget.

In larger organizations, procedures for purchasing can involve either check request forms or purchase orders. The check request form requires that anyone who wishes to have a check prepared to make a purchase or pay a bill fill in specific information. Typically check request forms require the name of the vendor, the purpose of the purchase, the program or funding source the purchase

should be charged to, the date the check is needed by, and the signature of a supervisor or other person authorized to make purchasing decisions.

Purchase order systems are even more structured. They require getting approval to purchase before the actual purchase is made. The purchase order forms contain information similar to the check request forms. When the accounting department receives an invoice requesting payment, it matches the invoice to a purchase order to document that the purchase was approved properly. Purchase order systems are usually unnecessary and somewhat cumbersome in small organizations.

Your organization will need to identify individuals empowered to authorize payment of bills. These people need to have knowledge of whether the invoices are legitimate. Did the organization receive the items for which it is being billed? You'll want the person authorizing payment to initial each invoice as evidence as their authorization.

The next step in the payment cycle is actual preparation of the check to pay approved bills. Prepared checks should be attached to authorized invoices when they are given to the authorized check signer. The signer should review the authorization and check carefully. At the time the checks are signed, the invoice should be cancelled (marked "Paid" with the date of payment and the number of the check used for payment).

Finally, the paid invoices should be filed in an organized system. Two filing methods are commonly used. Some small organizations file paid invoices by the month of payment. Other organizations file paid invoices by vendor name (name of the firm or individual paid), with the most recently paid invoice at the front of the pile.

HANDLING CASH RECEIPTS

The term "cash receipts" is used to describe all funds received by the corporation, whether they are received as checks or in actual cash. Your goal is to be certain that all cash receipts are deposited in the organization's bank account as quickly as possible. To be sure this is happening, you'll need to establish procedures which create an immediate record of all funds received and then compare this record to information about each bank deposit you make, and finally to the bank's record of deposits received.

For funds which come to your organization by mail, you can establish a check log procedure for the person opening the mail. A check log is a list of each check received which notes the date received, the amount of the check, and

who the check is from. The person opening the mail should prepare the log each time she or he opens the mail, compute a total of all funds received, and initial the log.

A separate person should prepare the actual bank deposit. This person will capture more information about each check received, including notes about the purpose for which the payment was made. Some organizations simply cannot find a separate person from the person opening the mail to prepare the bank deposits. If this is true for your organization, consider having the one person handling both functions make photocopies of all the checks received. This will at least allow others to review the judgements about the intended purpose of the payment made by the person doing the deposit.

Situations in which actual cash is involved are more challenging. If people bring cash to your office, be sure that the person accepting the cash provides a written receipt at the time of taking the cash. The receipt should state the person's name, the date, the amount of cash, and the purpose of the payment. Use a pre-printed (with your organization's name), pre-numbered receipt book which produces automatic duplicate copies of all receipts given. Control access to unused receipt books just like you would unused check stock.

If you accept cash at parties, special events, or other large informal gatherings, it may not be possible to give receipts to each person providing money. In a "pass the hat" situation, donors don't want to wait around for receipts and it is generally impossible to tell who gave what. In these situations, have two individuals from your organization count the money and have both initial the count when it is completed. Make arrangements for immediate deposit of the cash collections. If the gatherings where you collect cash are held outside business hours, you may need to make an immediate deposit at your bank and arrange protection for the person making the deposit.

ACKNOWLEDGING DONATIONS

Substantiation Rules

Tax law now provides that a donor who gives more than $250 at any one time to a §501(c)(3) organization and wants to take a charitable deduction cannot do so unless the donor has contemporaneous written substantiation of the contribution from the charity. This means that canceled checks are not enough to prove the gift. "Contemporaneous" means "at the time the tax return is due." Although the responsibility for getting this substantiation from your organization lies with the donor, you need to provide it so that you don't antagonize your donors.

Your written acknowledgment of the contribution can be by receipt, letter, fax or email. It must note the amount of the gift, if the gift was in cash (which includes a check). If the gift was donated property rather than cash, your organization does not have to (and should not) value the property. If the value of the donated property was over $250, the donor must submit to the IRS a Form 8283, which you must sign, if the donor plans to deduct the donation. If the value was over $5,000 and is not stock or bonds, the donor must obtain an independent appraisal from a qualified appraiser. The donor must also submit Form 8283. If you sell or otherwise transfer the property worth more than $5,000 within two years, you have to file Form 8282 and give a copy to the donor. There are special rules for donated cars, boats and planes worth more than $500. Consult the IRS instructions for Form 4302, *A Charity's Guide to Car Donations*, and Form 4303, *A Donor's Guide to Car Donations* for how to handle these items. There are a few other items for which special rules apply. In general, get the IRS Publication 1771, *Charitable Contributions: Substantiation and Disclosure Requirements*. Appendix 2 explains how to contact the IRS.

Tax law now provides that a donor who gives more than $250 at any one time to a §501(c)(3) organization and wants to take a charitable deduction cannot do so unless the donor has contemporaneous written substantiation from the charity of the contribution.

Whether the gift was cash or property, you need to state in your acknowledgment letter whether or not the donor got anything of monetary value back. If the donor did get goods or services back, you must provide a description of what it was and a good faith estimate of the value. If the value of what the donor got back was over $75, you must follow the disclosure rules below. You must also follow the acknowledgment rules if you provide thank-you gifts unless the gift costs less than $7.60 and bears your organization's logo.

Disclosure Rules

You must provide a written disclosure statement to any donor who makes a *quid pro quo* payment to you of more than $75. A quid pro quo payment is one made partly as a contribution and partly for goods or services given by you to the donor. You can make this disclosure statement in the same document as the contribution statement under the substantiation rules, if you are careful.

> *Example*: If a donor pays $100 for a dinner worth $30, you must provide the Disclosure Statement, because the payment was more than 75, even though the actual value of the contribution was only $70.

Separate payments at different times for different fundraisers do not have to be added together to comply with the rule.

The written disclosure statement must (1) inform the donor that the deduction is limited to the excess of the donor's contribution over the value of the goods or services received, and (2) give the fair market value of the goods or services. The statement must be furnished as part of the solicitation (in a manner likely to come to the donor's attention) or when the money is received. It must be in writing. The disclosure statement is not required when the goods or services given to the donor are insubstantial, where the donor is not making a contribution at all but only purchasing goods or services, and in the case of certain religious benefits. There are a few other minor exceptions. You must pay a penalty if you fail to provide the disclosure statement. You pay $10 per contribution, not to exceed $5,000 per fundraising event or mailing.

Appendix 9 is a sample of a combination Substantiation and Disclosure Statement. If you want to use one form to meet both purposes, you could use this form whenever you receive any contribution over $75. You should provide this form to the donor at the time the contribution is made. Because you are combining two sets of rules into one form to keep things simple, this means you will be giving this form out at times when you don't need to. IRS Publication 1171, *Charitable Contributions: Substantiation and Disclosure Requirements,* contains a very good summary of the substantiation and disclosure rules. You can get this from the IRS or online from their website. See Appendix 2 for contact information.

IN-KIND CONTRIBUTIONS

Your organization may receive goods or services as contributions as well as cash. These non-cash contributions are referred to as *in-kind*. As we will discuss in Chapter 23 on accounting and reporting, these in-kind contributions pose some special problems for accounting. But regardless of how your organization handles the accounting for in-kind contributions, you'll want to be sure you keep records of the important in-kind gifts you receive.

These basic records of in-kind contributions are needed both to help you thank donors and to allow your organization to take credit for the actual level of support from the community which you have generated. In some organizations, the value of in-kind contributions of labor and goods may equal or exceed the total amounts received from all other sources.

Check the Forms section for a sample record keeping form for "In-Kind Contributions." Key elements of in-kind records are date, description of the

goods or services received, and donor's name and address. You may want to use timesheets for volunteers providing substantial services to your organization as the best basis for recording the amount of time they have contributed.

INSURANCE PROTECTION

Every nonprofit organization should consider its need for insurance protection. The list of types of insurance below is a good starting point. Certain types of insurance may be difficult or prohibitively expensive to purchase. In such cases the Board must evaluate the risk of being uninsured or only partly insured and determine whether uninsured activities must be dropped. This decision is extremely difficult because evaluation of risk involves many subjective judgments.

It is very important to find a good insurance agent or broker to work with your organization. You may want to consider using an independent agent or broker rather than a "captive agent" who sells insurance for only one company. If possible, select an agent with significant experience with nonprofit organizations, particularly with organizations similar to your own. Your agent or broker should be able to explain the coverage available in terms both staff and Board can understand.

Your Board may want to obtain legal advice about the adequacy of your insurance coverage. Additional professional advice is available through an annual audit by a CPA. Standard audit procedures require the CPA to examine your insurance coverage and alert you to problems. This provides great assistance on risk management issues.

The types of insurance most commonly used by nonprofit corporations, and the risks covered, are as follows:

- Bonding – Protects the corporation against losses from fraud or theft by covered employees, Directors, or volunteers.

- General Liability – "Trip and Fall" insurance protects the corporation from claims of bodily injury to clients or others who are injured accidentally at the corporation's facilities. It may or may not cover volunteers. It may or may not include "Product Liability" coverage for food served, goods sold, etc.

- Professional Malpractice – Protects the corporation against claims arising from the professional services of the named professional. It's available primarily for recognized professions (doctors, nurses, social workers). It may or may

not cover claims arising from actions of those supervised by the named professional.

• Errors and Omissions – This is coverage for mistakes which arise from errors and omissions in carrying out the work of the corporation. It should cover personal injury (economic harm, slander, etc.) as well as bodily injury. It may cover actions by employees only or include volunteers, Directors, etc. It may or may not provide for defense of staff, if they are named in a suit in addition to the corporation.

• Directors and Officers – This is insurance coverage for members of the Board for claims arising from their service on the Board. It may or may not include the Executive Director (who is a staff member) as well as the Board. (See Chapter 13).

• Volunteer Liability – This is coverage for volunteers and for your organization for actions by the volunteers that may give rise to lawsuits. It should provide for the legal and other costs of defense of the volunteers and of the organization. (See Chapter 17).

• Vehicle Liability – This protects the corporation from claims arising from the operation of motor vehicles by the corporation (bodily injury and property damage). It's required by law for any corporation-owned vehicle. It may or may not cover vehicles not owned by the corporation but used to do the work of the corporation (for example, those owned by staff or volunteers). The corporation may be liable for damages done by staff or volunteers driving their own vehicles on behalf of the corporation.

• Workers' Compensation Insurance – Oregon law requires all employers to carry workers' compensation insurance. It protects the corporation from claims arising from an employee's on-the-job injury. It can be purchased from SAIF (a public state agency) or a private insurance carrier. It may or may not cover volunteers.

Consult Appendix 1 if you would like information about source material related to this Chapter.

Now that you have systems and procedures in place for handling funds, you are ready to move to the next steps of the financial management cycle: recording and reporting your financial activities.

23 KEEPING BOOKS AND PREPARING FINANCIAL REPORTS

Once your organization has established its annual budget, raised funds, put systems in place for handling funds, and begun to do the things you planned, you will need to keep records of everything that happens which has a financial consequence for your organization.

In small, very simple organizations, this financial recordkeeping can be little more than a checkbook—a simple record of all the money received and paid out by the nonprofit. Simple financial statements can be little more than a list of the sources of funds received and the nature of all payments made combined with a statement of the cash in the bank the organization had at the beginning and end of the month. Most individuals with no previous background in bookkeeping can easily learn to maintain these simple records and prepare these reports.

In larger or more complex organizations, more sophisticated records and reports will be needed. If your organization receives funds which are restricted by the donor or grantor, has multiple programs or multiple sites, owns property, has mortgages or other significant debts, you'll need a more detailed set of records. You will also most likely need to employ an individual trained in double-entry bookkeeping to keep the books and produce the financial statements.

Nonprofit accounting standards changed dramatically with the release of two Statements of the Financial Accounting Standards Board, #116 and #117, which

become effective for all nonprofits in 1996. Additional changes on the treatment of investment income and changes in fair market value of investments are required by statement of the Financial Accounting Standards Board #124. Even if you have had substantial experience with nonprofit accounting and reporting in the past, you will want to check out the description of these very major changes in this chapter.

This chapter will provide a basic understanding of the types of accounting records and financial reports your organization will need.

THIS CHAPTER COVERS

- **What Is Accounting?**
- **Big Choices for Your Accounting System**
- **Accounting Requires More Than Tracking Revenue and Expenses**
- **Double-Entry Accounting Is Essential**
- **Very Small Nonprofits: Basic Accounting and Reporting**
- **Monthly Financial Statements**
- **What's Special About Nonprofit Accounting**
- **Tips for Useful Financial Reports**
- **Government Funds Accounting Requirements**
- **Whatever Happened to Fund Accounting?**
- **Accounting Software Choices**
- **Tips for QuickBook Users**
- **Who Should Do Your Nonprofit's Accounting?**

Because payroll procedures are somewhat detailed, that type of recordkeeping is described in the next chapter. Chapter 27 contains general information about the retention and inspection of records, including the financial records we discuss in this chapter.

WHAT IS ACCOUNTING?

The goal of accounting is to maintain a usable record of every financial event your organization experiences. The art of good accounting is to design a system for keeping these records of financial events that allows you to produce useful financial reports.

A good accounting system will:

- Provide essential information about your nonprofit's financial health to guide your decisions
- Help your board and staff determine whether their budget plans are working
- Make it clear where your nonprofit gets its resources and how it uses them
- Allow your nonprofit to produce required reports easily for the IRS and your funders

At its heart, your accounting system is a giant set of lists of things that happened in your organization: checks that were written, deposits that were made, buildings that were purchased, goods and services which were given to you. But to be useful, your accounting system must provide a structure to categorize all the items in the lists so that they can be grouped and summarized into meaningful reports. All organizations, businesses as well as nonprofits, share some common elements in the structure they use for accounting. But before you can design the specific structure you will need for your nonprofit's accounting system, you will need to make some choices.

Once you have made those choices, you will create a Chart of Accounts for your nonprofit. The Chart of Accounts is a list of the categories you will use to classify all financial transactions. To be really useful, your Chart of Accounts needs to reflect your decisions about the big accounting choices and the types of reports your board and management will need to make decisions and the information your funders and the IRS will expect you to have.

BIG CHOICES FOR YOUR ACCOUNTING SYSTEM

Should You Use the Cash or the Accrual Method?

Your nonprofit will need to choose between two quite different methods of maintaining financial records. The Cash method involves recording transactions at the time when cash changes hands. At its most basic, the Cash method focuses on recording everything that happens in your bank accounts – deposits, checks, etc.

In contrast, the Accrual method of accounting, focuses on recording income when it is earned and expenses when they are incurred, regardless of when payment is received or made. In the Accrual method, you record transactions that result in your organization owing an outside party for goods or services that you received but not yet paid for and transactions that result in your organization being owed money for goods or services that it has provided but has not yet received payment. These obligations to outside parties are "payables" and the amounts owed to your nonprofit are "receivables".

The Chart on page 520 provides more comparison between the Cash and Accrual methods of accounting.

A good general rule is: it is better to have accurately maintained cash basis records than inaccurately maintained accrual basis records.

The Accrual method of accounting allows you to make a more accurate comparison of revenues and expenses. For example, if you are operating a child care center, you want to know whether the income the center earned this month is sufficient to cover the costs incurred to provide the child care. In the Cash method of accounting, you will only record as income the payments your receive during the month, and record as expenses, the payments you actually made this month. If some parents don't pay for the child care until the next month or if you were unable to pay some of the center's bills this month, your Cash basis financial records will not include this information. If you use the Accrual method of accounting, you will include this information and record Accounts Receivable (for the fees the parents owe at the end of the month) and Accounts Payable (for the bills you didn't pay during the month).

While the Accrual method produces a more complete picture of what has happened financially in your nonprofit, it also requires that the person doing

the record keeping have some basic bookkeeping training. A good general rule is: it is better to have accurately maintained cash basis records than inaccurately maintained accrual basis records.

	CASH	ACCRUAL
WHAT IS IT?	A system which records income only when it is received and expenses only when they are paid out	A system which records income when it is earned, and expenses when the obligation to pay arises, regardless of when payment is made
AN EXAMPLE: Your program charges client fees and bills monthly	In a cash system, you record client fees only when payments are received	In an accrual system, you record client fee income when you have given the service for which the fee is charged, regardless of when payment comes
ADVANTAGES	1. Simple to record 2. Easy to understand 3. Requires only a little more training than maintaining a checkbook	1. Provides a more accurate picture of where the program really stands: •What you are owed •What you owe others •What it really costs to earn it 2. Standard system which is easily understood by all trained bookkeepers
DISADVANTAGES	1. Can be misleading 2. Doesn't provide a systematic way to track what you owe and are owed	1. Need trained bookkeeper or individual able to spend time learning 2. Need training to understand what the statements mean 3. Takes more time
NOTE:	A modified accrual system is used by many nonprofit organizations. Records are kept on a cash basis. When financial statements are prepared, a system is used to take into account what is owed by and owing to the organization.	

Do You Need to Track Multiple Programs or Multiple Funding Sources?

If your nonprofit will operate multiple distinct programs, use multiple locations or receive multiple grants which require reporting about the specific use of the grant dollars provided, you will want to structure your Chart of Accounts to distinguish not only line-item character of your expenses (like salaries, supplies, etc.), but also the program or functional character. You can see a sample nonprofit Chart of Accounts in Appendix 19. It may make more sense to you after your read the next few sections of this chapter.

The term "line-item" refers to the type of expense. For example, salaries, benefits, rent, and supplies are all typical line-item types of expenses. The term "program or functional character" refers to the purpose for which these expenses were incurred. For example, if your nonprofit operates both an preschool program and an after-school child care program, and you want to be able to understand how much each of these two programs costs to operate, you would structure your Chart of Accounts to create *program* or *functional* categories for "preschool" and "after-school child care". Of course, you would also have *line item* categories like salaries, benefits, rent, and supplies, but you would characterize each expense you recorded by both its line-item description (supplies) and its program description (preschool). As you will see in the next section, the IRS requires charities to use a version of this functional approach. Specifically, the IRS requires that you report what portion of each line-item expense was used for program, management and fundraising.

This same functional or program character distinction can be used to deal with the need to track the expenses which you paid for with restricted grant funds. Let's look at a really simple situation in which you had only one program – for example, you only had a preschool – but you needed to track the use of two different grant sources of funds. You could use the concept of "functional character" of expenses to create functional categories to track the two grants. This would mean that when you recorded an expense for supplies in the supplies line item, you would also use a functional character category to track which grant source you used to purchase these supplies.

While the examples we've used so far have dealt with expenses, you can use the same approach to deal with income items. First, you will need to decide on the line-item categories you will use to track income. Typically these will include: individual donations, foundations, government, program fees, etc. If you were interested in knowing which program or function each income transaction was intended to support, you could use the same approach we described above to record not only the line-item nature of a transaction (for example, pro-

gram fees) but also the program or functional character (for example, program fees for preschool).

Some organizations want to track both the program character and the source of funding which is being used to meet each line-item expense. To do this, your Chart of Accounts will need to allow characterizing each income or expense transaction on three levels: line item (for example: supplies); program (for example: preschool); and funding source (for example: xyz foundation grant).

If you are considering setting up a two or three level Chart of Accounts, it may be helpful to read over the functional budgeting section in Chapter 20 (pages 447-453). If you have created a functional budget, you will want to also use the functional approach in your accounting. This will require setting up a multi-level Chart of Accounts.

If you are receiving funds from sources which restrict how you can use them, and especially from sources which will require a line-item accounting of how you have used there funds, you will want to read the next sections carefully. You may decide that you really need to go beyond the basic approach to accounting described in this section to set up your system in full compliance with Generally Accepted Accounting Principles.

How Will You Meet IRS Reporting Requirements?

Form 990 and Form 990EZ both require nonprofits to distinguish three types of expenses: program, management, and fund raising. In order to complete Form 990, your nonprofit will have to be able to provide a line-item schedule which shows what portion of each line-item expense (like salaries, supplies, etc.) were spent on program, management, and fund raising costs. The instructions to Form 990 provide definitions for these terms.

Smaller nonprofits are often able to meet the requirements of the Form 990 by estimating the percentage of each line item expense which was used for program, management, and fund raising. But larger organizations may find that it is easier to do the type of tracking described above, characterizing expenses by function as well as by line-item. Using this approach requires that you structure your Chart of Accounts to distinguish “management” and “fund raising” costs as well as the costs of distinct “programs”. To do this, you will need the two-level Chart of Accounts described above, with one level used to categorize line items and the second level used to distinguish “function” with categories for management, fund raising, and each of your distinct program. The discussion of functional budgets in Chapter 20 will help you understand the issues involved.

Do You Want or Need to Use Generally Accepted Accounting Principles (GAAP) for Nonprofits

Does your organization want to follow Generally Accepted Accounting Principles (GAAP)? GAAP refers to a set of standards and practices which professional accountants (CPAs) consider to be the preferred methods. Many funding source contracts contain a requirement that your accounting records be maintained in accord with GAAP. If you are audited, your CPA will express an opinion about whether your financial statements present the financial condition of your nonprofit fairly in accordance with GAAP. If you have chosen methods of accounting which are not consistent with GAAP, your auditor will note that as part of the opinion letter. (See Chapter 25 for discussion of whether your nonprofit should have an audit). You may find that some or all of your board members feel that following GAAP accounting standards is an important part of your organization's credibility and accountability to donors.

You may find that some or all of your board members feel that following GAAP accounting standards is an important part of your organization's credibility and accountability to donors.

If you decide that your nonprofit should set up its accounting and reporting systems to be follow GAAP, you will probably need to get some help from an experienced nonprofit accountant. Later on in this chapter, we'll highlight some of the major requirements contained in GAAP for nonprofits. You can get more in-depth information about the key pronouncements for nonprofits in the Financial Accounting Standards Board Statements, FAS 116, FAS 117 and FAS 124, from the FASB website at *www.fasb.org*.

If you decide to set up your accounting system in accord with FAS 116 and 117, you will need create a structure in your Chart of Accounts to track a further set of distinctions beyond the ones we discussed above for line-items, functions, and sources. This additional set of categories or levels in your Chart of Accounts will allow you to characterize income items by whether your nonprofit has received the funds without restrictions from the donor (Unrestricted), with restrictions which will be met by your doing certain things or by the passage of time (Temporarily Restrictions) or with permanent restrictions such as those that require that funds contributed as an Endowment must never be used and always invested in order to produce income to support your organization (Permanently Restricted). You can see the impact of following GAAP in the Sample Chart of Accounts in Appendix 19.

You may want to read the rest of this chapter before you make these big choices for the structure for your accounting system. You will need to consider

both the size and the complexity of your nonprofit's financial activities, both now and in the immediate future.

ACCOUNTING REQUIRES MORE THAN TRACKING REVENUES AND EXPENSES

One of the most common misunderstandings that non-accountants have about accounting and financial reporting is thinking that all that nonprofits need to do is to track revenues and expenses. This misunderstanding probably arises from all the effort nonprofits go through to develop an annual budget, which of course focuses on revenues and expenses.

But accurate accounting requires that your nonprofit maintain financial records about five types of accounts: Assets, Liabilities, Net Assets, Revenues and Expenses. On a mechanical level, this means that your Chart of Accounts will need to include line-item categories in each of these five major sections. The previous section discussed some of the major choices you must make about tracking revenues and expenses. Now we need to talk about Assets, Liabilities, and Net Assets.

Accurate accounting requires that your nonprofit maintain financial records about five types of accounts: Assets, Liabilities, Net Assets, Revenues and Expenses.

First, some definitions:

Assets: things of value that your nonprofit owns.
Examples: cash, equipment, buildings, land, and accounts receivable

Liabilities: obligations of your nonprofit to outside parties.
Examples: accounts payable, mortgages payable

Net Assets: the equivalent of net worth for nonprofits, computed by subtracting your total Liabilities from your total Assets. Nonprofits following GAAP will have three potential types of Net Assets: Unrestricted, Temporarily Restricted, and Permanently Restricted.

Your decision about Cash versus Accrual accounting will make a big difference in how you record your Assets and Liabilities. If you are using Accrual

accounting, you will have Asset accounts like Accounts Receivable and Prepaid Expenses and Liabilities accounts like Taxes Payable and Accounts Payable. If you are using Cash accounting you will not have these receivable and payable accounts. In fact, in Cash basis accounting you don't record any Liabilities except for Mortgages Payable on real property (it's an exception to the rule).

One factor to consider as you evaluate Cash versus Accrual accounting: Generally Accepted Accounting Principles (GAAP), the standards which professional accountants use to determine how nonprofit financial information should be presented, call for nonprofits to use Accrual accounting. This doesn't mean you have to choose Accrual accounting for your nonprofit. It does mean that if your nonprofit is audited, and doesn't choose to present its financial statements using the accrual method, your auditor will have to comment on the fact that your statements are not presented in accordance with GAAP. This may not matter to you or it may be a serious problem if you have entered into any funding agreements which require your nonprofit to use GAAP accounting.

DOUBLE-ENTRY ACCOUNTING IS ESSENTIAL

An important distinction between list making and accounting lies in the fact that sound accounting uses an approach called "double entry" to prevent and detect mistakes. While its very tempting to assume that when you create records using a computer it's not possible to make mistakes, in fact, human error does continue to plague us despite great technological advances.

Double-entry accounting is a system which has been used for centuries to create important cross-checks to the accuracy of financial records. It also provides a framework to think about the impact of financial events on your nonprofit. The principles of double-entry accounting are in use in all General Ledger software. These important principles are often not in effect when people decide to use spreadsheets (like Excel or Quicken) to maintain their accounting records.

In double-entry accounting, we recognize that every financial event has two impacts. For example, if we write a check for $50 to purchase supplies, we have increased our Supplies expense by $50 and reduced our Cash in Bank by $50. Similarly, if we deposit a contribution of $100 into our bank account, we have both increased Contribution income by $100 and increased our Cash in Bank by $100. The double impact is usually easy to see when cash is involved, and sometimes more difficult to understand when events (called "transactions") don't involve cash. For example, if we use the accrual method of accounting and provide a month of child care to a family with the agreement that they will pay us in the following month, we need to record both the fact that we earned Pro-

gram Fee income of $400 and that we increased the amount of our Accounts Receivable by $400.

Using this approach of recording the double impact of each transaction allows us to check the accuracy of our work through use of a mathematical equation (debits = credits). This equation lies at the heart of bookkeeping training but lies outside the scope of this book. On a practical level, recording the double impact of each transaction ensures that we keep an accurate record of our Assets, Liabilities, and Net Assets as well as of our Revenues and Expenses.

The term General Ledger describes a complete set of records of all types of transactions including those which impact the Assets, Liabilities, Net Assets, Revenues, and Expenses. Unless your nonprofit is extremely small – like an all volunteer club – you will want to maintain a complete double-entry General Ledger. Computer software is readily available to maintain a complete General Ledger. And, although younger readers may doubt this is possible, knowledgable bookkeepers can maintain general ledgers manually. We'll discuss selection of software later in this chapter.

VERY SMALL NONPROFITS: BASIC ACCOUNTING AND REPORTING

Clubs, associations, and very small organizations (under $50,000 in annual expenses) will probably want to use a very simple approach to accounting and reporting. Unless they have trained accountants keeping the books, they will want to use the Cash basis of accounting. They will classify income and expenses by line-items (donations, fees, salaries, supplies, etc.) but probably won't try to track the functional character of their expenses. They will complete the Form 990 or 990EZ by using estimates of the percentage of their expenses which were used for Administration or Fund Raising.

Each month, these very small organizations will complete these steps:

1. Deposit all funds received into the nonprofit's bank account.

2. Make a record of each deposit which lists the source of each item and the category of income. For example: a check from a donor will be categorized as "donation" income.

3. Make a record of each check prepared, noting the date, the payee, the amount, and the purpose of the check. The purpose will tell you what category this check should be attributed to.

Small Nonprofit Financial Report
for the month ending September 30, 2005
and the year-to-date July 1, 2005 - September 30, 2005

	Current month Sept. 05	Year to Date 7/1/05-9/30/05	Annual Budget	Yr-to-date % of budget
Cash Received				
Individual donations	500	2,000	10,000	0.20
Jones Foundation grant	0	3,000	15,000	0.20
Program Fees	800	3,000	4,000	0.75
Total Cash Received	1,300	8,000	29,000	0.28
Cash Disbursed				
Salaries	1,000	3,000	16,000	0.19
Employer taxes	150	300	1,600	0.19
Contract services	300	1,000	6,000	0.17
Supplies	100	300	500	0.60
Telephone	40	120	480	0.25
Other expenses	50	100	500	0.20
Total Cash Disbursed	1,640	4,820	25,080	0.19
Increase (decrease) in cash	-340	3,180	3,920	0.81
Cash at beginning of month (9/1/05)	6,520			
Cash at end of month (9/30/05)	6,180			
Cash at beginning of year (7/1/05)		3,000	3,000	
Cash at end of year (9/30/05)		6,180	6,920	0.89

4. Record checks that are voided too. List the amount as zero and the payee as void. You want void checks in your records so that you can be sure that you have listed all checks in numerical order.

5. Reconcile your bank statement (see Chapter 22)

6. Produce a simple financial report like the one shown in the Small Nonprofit Financial Report on the preceding page.

These steps may be completed in a manual system- writing checks by hand and using a check register available from office supply stores to record deposits, checks, and bank balances. Or, you could use a spreadsheet or a simple general ledger accounting program. If you will do your bookkeeping on a computer, be sure to read the section of selecting software.

MONTHLY FINANCIAL STATEMENTS

Your nonprofit needs monthly financial statements to understand your financial condition and whether the plans and strategies which were the basis of your annual budget are working. By convention, financial statements report on complete calendar months. For example, you will prepare financial statements to report on all of the revenues and expenses incurred from June 1 through June 30th, not on revenues and expenses from May 14th to June 14th or any other period than a calendar month.

It is frustrating but true that nonprofit organizations use many different terms to describe reports which contain essentially the same information. We will be discussing four important types of monthly financial reports and explaining the various names which these reports may be called by various nonprofits. We'll start by using the names which are recommended by Generally Accepted Accounting Principles (GAAP).

Statement of Financial Position

The Statement of Financial Position on the next page presents the Assets, Liabilities, and Net Assets at a specific point in time or compares them at two points in time (for example: July 31, 2005 and August 31, 2005). This report is frequently called the Balance Sheet.

Statement of Financial Position
at September 30, 2005 and June 30, 2005

	9/30/2005	6/30/2005
Assets		
Cash	240,200	225,000
Investments	101,000	100,000
Accounts receivable	75,000	50,000
Grants receivable	145,000	60,000
Prepaid expenses	1,000	200
Land,buildings, equipment	250,000	250,000
less accumulated depreciation	-51,000	-50,000
Net fixed assets	199,000	200,000
Total Assets	**660,200**	**535,200**
Liabilities and Net Assets		
Liabilities		
Wages payable	80,000	78,000
Employer tax payable	35,000	25,000
Accounts payable	10,000	2,000
Deferred revenue	10,000	0
Mortgage payable	150,000	150,000
Total Liabilities	285,000	255,000
Net Assets		
Unrestricted net assets		
Available for operations	97,200	80,200
Invested in fixed assets	49,000	50,000
Board designated reserves	50,000	50,000
Total unrestricted net assets	196,200	180,200
Temporarily restricted net assets		
Purpose restrictions	20,000	0
Time restrictions	9,000	0
Total temporarily restricted net assets	29,000	0
Permanently restricted net assets	150,000	100,000
Total Net Assets	375,200	280,200
Total Liabilities and Net Assets	**660,200**	**535,200**

Statement of Activities
for the period
July 1, 2005 - September 30, 2005

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
PUBLIC SUPPORT AND REVENUE:				
Public Support:				
Government grants	$ -	$ 400,000	$ -	$ 400,000
Foundation and corporate grants	80,000	200,000	-	280,000
Donations	40,000	30,000	50,000	120,000
United Way	-	20,000	-	20,000
	120,000	650,000	50,000	820,000
Revenue:				
Service fees	150,000	-	-	150,000
Investment income	1,000	4,000	-	5,000
	151,000	4,000	-	155,000
Net Assets Released From Restrictions:				
Satisfaction of program restrictions	580,000	(580,000)	-	-
Satisfaction of time restrictions	45,000	(45,000)	-	-
	625,000	(625,000)	-	-
Total Public Support and Revenue	896,000	29,000	50,000	975,000
EXPENSES:				
Program services	700,000	-	-	700,000
Administrative	130,000	-	-	130,000
Fund raising	50,000	-	-	50,000
Total Expenses	880,000	-	-	880,000
INCREASE IN NET ASSETS	16,000	29,000	50,000	95,000
NET ASSETS AT BEGINNING OF YEAR	180,200	-	100,000	280,200
NET ASSETS AT END OF YEAR	$ 196,200	$ 29,000	$ 150,000	$ 375,200

Statement of Activities

The Statement of Activities (above) presents Revenues and Expenses for a specific period of time, for example: from July 1, 2005 through August 31, 2005. This report is commonly presented in a multi-column format in which the first column is the current month activity (for example, July 2005), and the second column is the year-to-date activity (for example: July 1 through August 31, 2005 for an organization with a July through June fiscal year). See page 43 for a discussion of the fiscal year. Frequently a third column presents the annual budget

and the fourth column presents either a variance between the year-to-date numbers and the annual budget or the percentage of the annual budget amount which has been achieved in the year-to-date.

The Statement of Activities is also called a Profit and Loss Statement, an Income Statement, a Statement of Revenues and Expenses, or unfortunately misnamed a Budget Report. Referring to the Statement of Activities as the Budget Report may lead to confusion about the distinction between accounting and financial reporting and budgets. Budgets are plans for the future. Accounting records what actually happens. Financial statements present information about what has actually happened which is taken from the accounting records. Of course, many financial statements report what has actually happened (Revenues and Expenses) in comparison to the budget plan.

Most nonprofits that track expenses or both revenues and expenses by program will produce a report in the same format as the Statement of Activities for each program or department as well as a report that combines all the departments. Nonprofits that are tracking restricted grants by line-item will often use this format to produce separate reports for each grant.

Statement of Functional Expenses

This report presents the line-item expenses for a specific time period (the current month, or the year to date) in columns for Management, Fund Raising, and the different Program expenses, as well as the total of all the functional expenses. Some nonprofits call this a Program Report. Some nonprofits use this same format with columns for Management, Fund Raising, and Programs to report revenues as well as expenses. This format makes it easy to see which programs are generating enough income to meet expenses and which require subsidy. Presenting both revenues and expenses in this report makes it easy to compare to the functional budget discussed in Chapter 20.

Statement of Cash Flows

This report explains how operating, investing, and financing activities have either increased or decreased the organization's cash over a specified period of time, usually the current month or the year to date. Many small to mid-sized nonprofits do not produce the Statement of Cash Flows as a monthly financial statement. It is one of the required statements in audited financial statements. This statement is useful for nonprofits using the Accrual method of accounting to explain why cash may have increased despite having experienced an accrual basis loss (expenses greater than income) or cash may have decreased despite having experienced an accrual basis profit (income greater than expenses). Take care to avoid confusing the Statement of Cash Flows with a Cash Flow Projec-

tion (discussed in Chapter 20). The Statement of Cash Flows is a report of what actually happened to cash. The Cash Flow Projection is an estimate of when cash will be received and used.

Key Connection Between Financial Statements

The financial statements described above should be prepared each month and presented as a set together. If your records are being properly maintained and your statements are accurately prepared, you will see a very important connection between the Statement of Financial Position (Balance Sheet) and the Statement of Activities (Profit and Loss Statement). Here's how it works. Each month, your Net Assets (on the Statement of Financial Position) will increase or decrease by the exact amount that shows on the Statement of Activities as either the Increase or Decrease in Net Assets. This line on the Statement of Activities is the equivalent to Net Income on for-profit financial statements. In fact, a GAAP format Statement of Activities will include a reconciliation section at the bottom (see example on page 530) that adds the Increase/Decrease in Net Assets to the Net Assets at the beginning of the accounting period and computes the Net Assets at the end of the accounting period. This final Net Assets amount (the end of the accounting period) must equal the Net Assets amount reported at the bottom of the Statement of Financial Position. If it doesn't, the books are out of balance and you will need to get help to get them corrected.

While doing this reconciliation is a great way to make sure your books are in balance, it has a more important meaning. Nonprofits increase their Net Assets (net worth) by having income exceed expenses. Similarly, nonprofits decrease their Net Assets when expenses exceed income. Looking at this connection will help you stay clear about your overall financial strength and your progress (or lack of progress) towards growing stronger.

WHAT'S SPECIAL ABOUT NONPROFIT ACCOUNTING?

Once your nonprofit moves beyond the "very small" category, you'll probably need to know a bit more about Generally Accepted Accounting Principles (GAAP) for nonprofits. Even if you don't plan to follow all the rules of GAAP, your funders and the IRS will be expecting you to use some of the major concepts and will wonder if you really know how to manage your finances if your don't.

GAAP consists of a series of pronouncements issued by several different professional standards bodies including the Financial Standards Accounting

Board (FASB) and the American Institute of Certified Public Accountants (AICPA). Nonprofits also have to pay attention to requirements of the Internal Revenue Service and, if they receive federal funds, to a variety of circulars published by the Office of Management and Budget (OMB). We'll discuss IRS and OMB issues later in this chapter. For now, we'll be discussing some major tenants in nonprofit accountings found in the statements published by the Financial Accounting Standards Board which are referred to by number, such as FAS -116 and FAS-117 that form the foundation of GAAP for nonprofits. We've included citations to the various accounting pronouncements discussed in this Chapter in Appendix 1.

The Financial Standards Accounting Board (FASB) really shook up the world of nonprofit accounting back in the mid-1990s by issuing FAS 116 and 117. FASB was responding to concerns that many readers of nonprofit financial statements had a hard time understanding what, if any, restrictions had been placed on funds given to nonprofits and whether or not nonprofits had fulfilled those restrictions.

As a result, some of the ways nonprofits do accounting are fairly different from the ways that business entities do their accounting. This can puzzle nonprofit board members and require that even highly trained business accountants get some additional training in order to meet the nonprofit standards.

Here are some very brief descriptions of some of the key requirements for nonprofit accounting. You can find more detail by checking out the sources listed in Appendix 1.

Three Classes of Net Assets

First recall that Net Assets represent the net worth of the nonprofit. If you add up all of your nonprofit's assets and subtract from that total your total liabilities, you will have computed your nonprofit's net assets or net worth.

GAAP requires that nonprofits break their total Net Assets down into three categories – Unrestricted Net Assets, Temporarily Restricted Net Assets, and Permanently Restricted Net Assets. The purpose of this breakdown is to let readers of the financial statements know which of the nonprofit's Net Assets the Board has freedom to use as it pleases (Unrestricted Net Assets) and which of the Net Assets can be used only for purposes specified by donors or at time periods specified by donors (Temporarily Restricted Net Assets), and which Net Assets may never be used (Permanently Restricted Net Assets).

Your nonprofit will strive to build its Unrestricted Net Assets in order to have something to fall back on in years in which it is difficult to raise funds or in

which unexpected expenses occur. If your organization receives grants, you will also want to build up your Temporarily Restricted Net Assets in order to be sure you have funding to available to launch each new year's activities.

Distinguish Contributions from Purchases of Services or Goods

Nonprofits must determine whether funds that they receive are being provided as contributions or as payments for services or goods which the nonprofit provides. In general, funds are considered contributions when the donor receives no significant benefit in return for making the gift. In contrast, funds received in exchange for the provision of services or goods are considered fees or sales.

Here's an example. If a parent pays a fee for child care provided for their child at a nonprofit child care center, the amount is considered fee income and the nature of the relationship between the child care center and the parent is considered to be an exchange transaction. In contrast, if an individual makes a gift to that child care center to help it achieve its mission but does not receive child care or any other service in return, the income is considered to be a contribution and the nature of the transaction is a gift relationship.

The distinction between contributions and exchange transactions is important in guiding the ways that the nonprofit will record the event, especially if the exchange payment is received before the service is provided or the contribution is provided before the nonprofit carries out the activities the contribution is intended to support.

Classification of Contributions

Nonprofits are expected to classify any contributions they receive as either Unrestricted, Temporarily Restricted, or Permanently Restricted. Directions from the donor of the contribution is the determining factor. Donors are considered to have made a restricted gift if they state requirements for the use of the funds (purpose restriction) or the timing of the use of the funds (time restriction). If the donor does not state any restrictions, the contribution is considered to be unrestricted whether the nonprofit organization makes any specific plans for its use or not .

Contributions to endowments are the most common type of Permanently Restricted gift. They are considered Permanently Restricted if the terms of the endowment require that the gift itself be permanently invested to generate income for the organization. Most other donor restrictions are temporary, meaning that the nonprofit will eventually fulfill the restriction by either carrying

out the activities for which the gift was given or by operating during the time period specified for the use of the gift.

The clearest way to show the classification of contributed income is shown in the Statement of Activities on page 530. This report shows three separate columns, one for Unrestricted income, one for Temporarily Restricted income, and one for Permanently Restricted income.

Fulfilling Restrictions

When the nonprofit carries out activities that fulfill a purpose restriction or enters the time period specified in a time restriction, it reflects fulfillment of restrictions by releasing amounts previously classified as Temporarily Restricted into the Unrestricted Class. You can see an example of the recording of this release in the Statement of Activities on page 530. The release from restrictions is shown as a line item at the bottom of the list of income line-items. You'll notice that the release is shown in brackets in the column headed Temporarily Restricted and as a positive number in the column headed Unrestricted. This means this amount has been taken out of the Temporarily Restricted classification (released) and added into the Unrestricted classification.

A nonprofit's Unrestricted Net Assets increase or decrease is based on whether its unrestricted income exceeds its unrestricted expenses. Temporarily Restricted Net Assets increase when a nonprofit receives temporarily restricted contributions and decrease when it releases amounts from restrictions by fulfilling the purposes or the time restrictions required by the donor.

How Can All Expenses Be Unrestricted When Some of Them Are Met with Restricted Gifts?

You'll notice in the Statement of Activities that expenses are shown only in the Unrestricted column. This is because all expenses are considered to be Unrestricted under FAS 117. This idea that all expenses should be considered Unrestricted even when the nonprofit is paying for them with restricted contributions may seem confusing. The GAAP view on this subject is that since the act of incurring the expense fulfills the restriction, the expense itself should not be considered restricted. Many people find this reasoning puzzling.

It will probably help to know that nonprofits that have multiple restricted sources of funds set up their Chart of Accounts to track line item expenses by the source of funds used to pay for them as well as by the functional character of the expense (management, fund raising, program). So in their accounting system they have a detailed record of exactly which expenses are considered to be met by each funding source. Then they summarize the total expenses met by

a specific funding source and create an entry to record the release of Temporarily Restricted funds to meet those expenses (like the release line we looked at in the Statement of Activities on page 530). But when they prepare the highly summarized Statement of Activity, they combine all the various categories of funding sources and functions together in a single column called Unrestricted Expenses.

Board Directions Are Designations, Not Restrictions

While Boards may talk about setting aside certain funds for specific purposes or may even pass resolutions directing that specific funds should be treated as endowments, under GAAP rules, these amounts are considered to be *board designations* and not treated as either temporary or permanent restrictions. This treatment reflects the fact that unlike the situation when a donor makes a gift with restrictions, Boards have the right to change their minds about the use of these funds which they have previously designated for specific purposes.

Board designated funds are considered to be part of the nonprofit's Unrestricted Net Assets. In order to make it clear that your Board has designated funds for a specific purpose, you'll want to create a separate line item within the Unrestricted Net Assets category – for example, Board Designated Funds for Scholarships. This Board Designated line item will be added into the total Unrestricted Net Assets, but breaking it out as a separate line item reminds the Board and readers of the financial statements of the Board's direction.

Recording Promises to Give

When donors make promises to give contributions in future years, GAAP requires the nonprofit to record the promised amount as a Temporarily Restricted contribution, and as a Pledge Receivable. It is considered a time restriction that will be fulfilled when the donor honors the pledge and makes the gift. When this pledged contribution comes in, the nonprofit reduces Pledge Receivable and releases the amount of the contribution from Temporarily Restricted to Unrestricted income. If your organization is planning a capital campaign or using multi-year pledges as part of your fund raising, be sure to check out the detailed requirements for recording pledges, including adjusting amounts to reflect the net present value.

One catch on recording promises to give. You'll use the treatment above only if the promise is unconditional, meaning the donor is not conditioning fulfilling the pledge based on circumstances or conditions that lie outside the direct control of the nonprofit. For example, a donor who promises to give $1 million if he wins the lottery has set a condition over which the nonprofit has no control and which is quite unlikely to occur. When a pledge is conditional,

the nonprofit does not record it as either income or as a receivable. In order to meet the test to be recorded as a Temporarily Restricted gift, the pledge must have a reasonable likelihood of being fulfilled.

Multi-year Grant Commitments

GAAP also requires nonprofits receiving multi-year grant commitments to record the entire grant commitment as temporarily restricted grant income in the year the commitment is received. This means that even if your nonprofit doesn't receive any payments in the year in which you receive the award letter, you will still record the whole multi-year committed amount as Temporarily Restricted Grant Income and Grants Receivable. As you collect payments from the funder over the life of the grant, you will reduce Grants Receivable.

You will determine when you may record a Release from Temporary Restrictions for a portion of the multi-year grant based on two criteria. First, you must have entered the time period for which the grantor has awarded the funds, and secondly, you must also have either completed the activities for which funding was supplied or incurred the expenses that the funder had approved as valid uses for the grant funds.

This treatment can be confusing to the readers of your financial statements. In the year in which you receive the multi-year award, it will appear that your nonprofit has operated with a large surplus. In other words, your total income (Restricted and Temporarily Restricted) will be much larger than your total expenses, because your income will include funds awarded for future periods.

In the following years, your financial statements may appear to show that you have been operating at a loss, because you will incur the expenses the grant was intended to cover, but you will not be recording an additional grant income because you recorded the entire amount in the year you received the award.

Readers who understand GAAP will recognize that the release of Temporarily Restricted funds is providing support to meet your expenses and that actually you are operating your nonprofit on a sound basis. But you may need to educate both your Board and potential funders to prepare them to understand your financial reports.

Program Fees Received in Advance

After all this discussion about restricted contributions, we need to return to thinking about program service fees. Fees for goods or services are considered Unrestricted. If your participants pay as they go for your services, the account-

ing will be quite simple. If you extend credit, allowing your participants to pay after they receive goods and services, you will probably want to use the accrual basis of accounting and record Accounts Receivable as well as program service fee income.

On the other hand, if participants pay you in advance of receiving services, you will need to create an account called Deferred Revenue (or Fees Received in Advance) in the liabilities section of your Chart of Accounts. You will record the whole amount of the advance payment in this Deferred Revenue account (recording no part of the amount as income at the time your receive the payment). Then each month as you provide the services for which you have been paid in advance, you will reduce the Deferred Revenue account and increase your Program Fee income account. When you have provided all the services for which you were paid in advance, your Deferred Revenue account will have a zero balance and your Program Fee income account will include the whole amount paid.

Using Deferred Revenue to Track Grant Income

Some nonprofits will use the same Deferred Revenue method to record grants received in advance. While this would not be GAAP accounting, it can work quite well as a way to keep clear about what portion of each grant remains available for your use. But, if your audited financial statements will be presented in accordance with GAAP, using this Deferred Revenue method may result in some significant audit adjustments. This means that you and your Board may have relied on financial statements during the year that report a significantly different net income than what you will see on your audited statements.

Government Grants and Contracts

If your nonprofit receives government funding, you will face a choice about how to record the income. Sometimes government grants and contracts should be considered as contributions. In other situations, government grants and contracts should be considered as exchange transactions and treated like program service fee income. How can you tell the difference?

If a government is paying your nonprofit to provide services to the government itself, you will record the income as an exchange transaction like program fees. This would be true if your nonprofit provided child care for government employees and received payment from the government for providing the care.

If the government is purchasing your services for specific groups of people but not for the government itself, it may be harder to determine whether this is

an exchange transaction or a contribution. Health care providers receiving Medicare payments are definitely involved in exchange transactions. But HeadStart grantees receiving a grant to operate a program for children who meet certain eligibility requirements are probably receiving a gift/contribution.

How can you tell? Start by talking with the funding source and reading your funding agreement. If the funds originated with the federal government you will probably see references in your contract which characterize the relationship as either a "sub-recipient" relationship which will generally mean your should treat the grant as contributed income, or as a "vendor" relationship which will mean you should treat the relationship as a purchase of service or exchange transaction. If your nonprofit is audited, you can discuss this question with your auditor who will have to investigate it in order to know how it should be presented on your audited financial statements.

Cost Allocation Plans

Nonprofit organizations that need to track the use of restricted funds or to distinguish expenses by function (management, fund raising, programs) will frequently need to allocate certain costs. We discussed the concept of cost allocation in Chapter 20. If your organization has prepared its budget using cost allocation techniques, you will want to do your accounting using those same techniques. If so, you will want to prepare a written cost allocation plan each year to document how you will allocate costs which cannot be directly attributed to specific funding source or functional cost centers.

Once you have created a cost allocation plan, be sure to follow it. If your organization is audited, your auditor will test whether the allocations you record are consistent with your cost allocation plan. If you obtain new grants and contracts during your fiscal year or experience major cut-backs or shifts in programs, you will probably need to revise your cost allocation plan to reflect the reality of how costs are actually incurring in your organization.

Most government funding agreements will require preparation of a written cost allocation plan to document the basis for attributing costs to their grant or contract. Larger nonprofits which receive substantial support through federal contracts may choose to negotiate an indirect cost rate with the federal government. Federally negotiated indirect cost rates lie outside the scope of this book, but you can learn more about them at *www.whitehouse.gov/omb/circulars/a122*.

Accounting for Fundraising Costs

Charities are under enormous pressure to minimize the costs they attribute to fundraising. Numerous charity rating efforts have emphasized that "high"

fundraising costs are a sign that a charity is either not legitimate or poorly managed. While this is true in a limited number of abusive organizations, it is also true that, just as in business, it costs money to make money. Substantial investment is often required in order to identify, cultivate, and mobilize donors to support important charities.

The IRS requires charities to report their expenses for fund raising on a line-item basis. The details of these requirements are discussed in Chapter 12 that deals with the Form 990.

GAAP accounting for nonprofits imposes more specific, and in some cases, contradictory requirements for recording fundraising costs. If your nonprofit is audited, your auditor is expected to determine whether you have met GAAP standards for recording fundraising costs. Even if you are not audited, you will have to meet the IRS requirements and your fundraising expenses will be open to public scrutiny as part of the requirement to make your 990 available for public inspection.

Both the IRS and GAAP agree that the cost of making unsolicited requests for contributions are fundraising costs. This includes costs like printing, postage, and staff time to prepare direct mail appeals for contributions. It also includes the cost of renting a hall, paying for food, and paying an auctioneer for a fund raising auction. Recording these direct costs of fund raising should be pretty straightforward if you have set up your chart of accounts to include a functional level and established a functional cost center for fund raising.

SOP 98-2 (Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Government Entities That Include Fund-Raising) , one of the GAAP pronouncements, deals with some more complicated questions. These are rules designed to address situations in which nonprofits are doing two things at the same time. For example, if you nonprofit produces a newsletter which includes both features about interesting programs you provide and requests for contributions, you will need to become familiar with SOP 98-2.

Prior to the SOP 98 -2, many nonprofits used standard cost allocation methods to divide up the cost of producing documents, events, and other appeals that had dual purposes. In the newsletter example above, the old-fashioned approach would involve measuring the amount of space taken up with the request for contributions and computing what percentage of the total newsletter was used for the fund raising appeal. That percentage would be applied to the costs of lay-out, printing, mailing, and labor for the newsletter, and the resulting amount would be considered fundraising expense.

SOP 98- 2 changed this approach. Now nonprofits will find that the entire cost of some of these dual purpose efforts must be considered fundraising expense, even if only a portion of the written materials or time at an event is devoted to requests for funds. To determine whether you need to attribute the entire cost of a joint effort to fund raising, the nonprofit applies three tests regarding the purpose of the communication, the audience it is sent to, and content of the communication. If any of the tests are failed, the entire cost of the activity is considered fundraising expense. If all three of the tests are met, you may allocate a portion of the costs to fundraising and the remaining costs to program or administration.

If your nonprofit does a significant amount of fundraising you will want to obtain a copy of SOP 98-2 and be certain that your fund development staff are aware of its requirements and communicate clearly with your accountant.

Accounting for In-Kind Contributions

" In-kind" is a term used to describe what happens when a donor provides goods or services rather than contributing cash. GAAP requires that nonprofits report certain types of in-kind contributions on their financial statements. Even if this weren't a GAAP requirement, many nonprofits would want to record in-kind contributions in order to show the true extent of the support they receive from their communities. They would also want to record the value of the in-kind goods or services in their expenses to demonstrate what it would cost to operate their services if they didn't have in-kind help.

GAAP divides in-kind contributions into two basic categories. In-kind contributions that provide goods or services that are essential to the operation of the nonprofit and are provided by an individual with a recognized skill or credential should be recorded in the financial records as in-kind income and in-kind expense. In-kind contributions that are not essential to the operations or are provided by a volunteer without a recognized skill or credential may be disclosed in notes to the financial statements, but are not recorded as in-kind income or in-kind expense on the financial statements.

While you may not record the value of an in-kind gift in your accounting records, you will want to keep a record of it and tally up the value of all such contributions to note in formal financial statements or when you are describing support for your program in annual reports and proposals. Some grant funding requires that the recipient organization demonstrate community support by tracking both types of in-kind contributions.

The definition of a recognized skill or credential can be challenging. Any service provided by a person who must be licensed to do the service will

qualify– for example doctors, nurses, plumbers, electricians, etc. What about office skills like reception or data entry? Some accountants would say that if the volunteer has sufficient skill in these areas to be hired for paid work requiring training or experience, the requirement is met. Others prefer a more narrow definition and look for advanced degrees or certifications as evidence. This can be a good subject to discuss with your auditor.

Board members' contribution of their time to carry out board responsibilities cannot be recorded as an in-kind contribution on the financial statements according to GAAP. Similarly, GAAP excludes the value of volunteer time for working on fund raising, whether the volunteers are board members or non-board members.

In most cases, you will be able to record in-kind contribution income and in-kind expenses at exactly the same value and the recording of in-kind will not impact your net income (i.e. both income and expenses will have been increased by the same amount, resulting in zero net income). One important exception to this occurs when you receive an in-kind contribution of equipment or land and buildings. These items are considered assets, so you will record their fair market value at the date you receive them in asset accounts which will appear on your Statement of Financial Position (Balance Sheet). However, you will also record the fair market value of these items as in-kind contribution income. The result will be an apparent profit caused by adding the in-kind contribution to your income but not offsetting it with an expense (since the value of the items was recorded as an asset).

How do you know the value of in-kind services or labor? Determine what the "going rate" for the same type of labor or services is. For example, if a trained accountant volunteers to do your accounting, value this contribution at the price an accountant with similar training and skills would charge to do similar work for another organization. To determine the value of in-kind labor used to make improvements to real property (for example putting a new roof on your building), determine the difference in the fair market value of the property before and after the work is done.

Accounting for Land, Building, and Equipment

Land, buildings, and equipment are assets. If your nonprofit purchases them, you will record the purchases in the assets section, not in the expense section of your Chart of Accounts. Your investment in land, building and equipment will be displayed on your Statement of Financial Position (Balance Sheet) in the assets section. These items are referred to as "fixed assets" or "capital assets".

While this sounds simple enough, there are several additional steps used in accrual accounting which can be confusing to non-accountants. If you purchase buildings and equipment you will also need to set up an asset account called "accumulated depreciation" and an expense account called "depreciation expense". Each year, you will record a portion of what you paid for the buildings or equipment as an entry to depreciation expense and accumulated depreciation. This is another example of double-entry accounting discussed earlier in this chapter.

Most nonprofits determine what portion of the cost of buildings and equipment will be used to create this annual entry by establishing standard "lives" for the fixed assets. Typically, vehicles, computers, and other equipment will be given a standard life of 5 years and buildings will be given a standard life of 25 or 30 years. You will want to be sure that the standard life you assign a fixed asset is at least as long as any mortgage debt which uses the asset as collateral. You determine the amount of the annual entry to depreciation expense and accumulated depreciation by dividing the purchase price of the asset by the number of years in the standard life. For example, if you purchased a used van for $10,000 and your policies called for a standard life of 5 years for vehicles, you would divide $10,000 by 5 years to determine that the annual entry to depreciation expense and accumulated depreciation would be $2,000.

The accumulated depreciation account is often referred to as a contra-asset. This means it goes against (contra) or offsets/reduces the value of an asset account. It will be shown in brackets (meaning it has a credit balance for readers who are familiar with debits and credits in accounting). Any time you see a number in brackets on financial statements, you know that it is a negative number which must be subtracted when totaling a column of numbers.

Let's return to the van example to illustrate how this works. When you purchased the van you recorded it in the asset account called "equipment" for $10,000. At the end of the first year, you created an entry to record $2,000 into the depreciation expense category and balanced it with $2,000 in the accumulated depreciation account. When you produce your year-end Statement of Financial Position (Balance Sheet), you will see the $10,000 amount in the equipment line of the assets section, and right below it you will see the ($2,000) in the accumulated depreciation line item. You will subtract the accumulated depreciation amount from the equipment line to compute the net book value of the van at $8,000.

Quite likely this net book value of $8,000 will not be the same thing as the fair market value of the van. Fair market value is a term used to describe the price at which a willing buyer will purchase an item from a willing seller. This illustrates a key concept. In accounting, you are recording fixed assets at their

historical cost (what you paid to purchase them) and then accumulating depreciation (through the posting of the annual depreciation entry described above). You are not trying to present the fixed asset at its fair market value.

Following the example of the van a bit further, you will post a depreciation expense/accumulated depreciation entry each year for five years (the standard life of the vehicle). At that point, your accumulated depreciation account balance will be ($10,000) and the vehicle will be said to be fully depreciated. This means that the net book value (what you get when you subtract accumulated depreciation from the initial purchase price of the van) will be zero. Since the van is fully depreciated, you won't make any more entries to depreciation expense/accumulated depreciation for it in subsequent years. You will continue to include the investment in the van and the related accumulated depreciation amount in the asset section of your financial statements to let readers know that you own a vehicle.

The basic accounting process described above for dealing with fixed assets is the same for businesses as for nonprofits, so board members or others familiar with business accounting will be able to help you understand it. One key difference between nonprofit and business accounting is that businesses typically use more complex methods to determine what portion of their investment in fixed assets will be recorded as depreciation each year. This is because businesses are permitted to consider depreciation expense as a tax deductible item and they will reduce their taxable income by claiming their deductions for depreciation expense as quickly as possible.

Some business-oriented board members will question why tax exempt nonprofits should bother with recording depreciation since they do not need to generate deductible expenses for tax purposes. A short answer might be, GAAP requires nonprofits to record depreciation. But a more meaningful reason is that by recording a portion of what your nonprofit has invested in a fixed asset as depreciation expense each year, you are taking into account what it is really costing you to run your nonprofit.

Taking the van example a bit further to illustrate this point, let's assume that your nonprofit uses the van to transport children as part of your program. You have made a choice to purchase a van rather than lease it. If you had leased the van, the cost of the lease would clearly be an expense of your program. Once you decided to purchase the van, you had a further choice. If you decided to follow standard accounting practices, you recorded the purchase of the van in an equipment account in the assets section of your chart of accounts. You didn't record the whole $10,000 purchase as an expense in the year you bought it. If you have determined that you will get at least 5 years use out of the van, the process of recording an annual depreciation expense/ accumulated depreciation entry will allow you to consider 1/5 of the cost of the van as an expense

each year. This approach let's you spread the cost of the van over the 5 year period in which you will benefit from having the van.

If you chose not to follow standard accounting practices, you would have recorded the whole $10,000 purchase price as an expense in the year in which you bought the van. This is probably the treatment most cash basis organizations would use. It has the advantage of having expenses mirror the use of your cash, and of simplicity (don't have to create the annual entry to depreciation expense and accumulated depreciation). But, this approach will mean that after the first year in which you purchase the van, there will be no record on your financial statements that you own a van. It will not appear as an asset because you already recorded it as an expense in the year you purchased it.

While this might be a reasonable choice for handling a van purchase, it would not be reasonable to use this approach if you bought a building. Even in cash basis accounting, the purchase of a building is recorded and reported as an asset. And, if the nonprofit takes out a mortgage in order to purchase the building, the mortgage debt is recorded as a liability even in cash basis accounting.

The purchase of land is also considered the purchase of an asset, not an expense. But, land cannot be depreciated. So if you purchase a building and the land under it, you will have to determine what portion of the purchase price should be attributed to the building and what portion to the land. Then compute the annual depreciation expense/accumulated depreciation expense as a portion of the building purchase cost, not of the land purchase cost.

What about donated equipment, land and buildings? As noted above in the discussion of in-kind contributions, nonprofits record receipt of donated assets as in-kind contribution income and an increase to fixed assets. You will need to determine the fair market value of the asset you receive at the time you receive it. Donors of valuable fixed assets will generally obtain an independent appraisal of the value of the item to document the value of their contribution for tax purposes. You can use that appraisal as the basis for recording the fair market value of the asset or you can obtain your own independent appraisal. For smaller items, it is probably useful to think of fair market value as garage sale prices.

TIPS FOR USEFUL FINANCIAL REPORTS

Nonprofit organizations are free to design the financial reports they use for internal purposes to meet their own preferences and needs. GAAP provides guidance for the format to be used in formal audited statements, and requires the use of the three financial statements described above (Statement of Financial Position, Statement of Activities, and Statement of Cash Flows) and, for

voluntary health and welfare organizations, the Statement of Functional Expenses.

Once your nonprofit grows beyond the "very small" category, or at any size if you are using accrual accounting, you will want to be sure your monthly financial statements include both the Statement of Financial Position (Balance Sheet) and the Statement of Activities. Both statements are needed to really understand the financial health of your nonprofit and to identify problems which must be addressed in order to assure continued success.

Most nonprofits find it helpful to present the Statement of Financial Position in two columns, comparing the Assets, Liabilities, and Net Assets at the end of the current period with the balances in these accounts at the end of the previous period. See page 529 for a sample Statement of Financial Position. This comparison may be made between:

- two consecutive months (September 30th compared to August 31st),
- the end of the current month and the end of previous fiscal year (September 30th and June 30th in an organization with a June 30 fiscal year end), or
- the end of the current month and the end of the same month in the prior fiscal year (September 30, 2005 compared to September 30, 2004).

While GAAP requirements for the Statement of Activities do not include presenting a comparison of actual revenues and expenses to budget, your internal use statements will need to compare actual year-to-date revenues and expenses to your budget so that you can determine whether your budget plan is working. See page 547 for a sample statement of Unrestricted Revenues and Expenses for Budget Comparison.

If you have set up your Chart of Accounts to track expenses (or both revenues and expenses) by function or funding source, you will also want to produce Statements of Activities reports for each function or funding source. These reports should include the same format to present current month, year to date, annual budget and dollar variance or year-to-date to budget percentages as you used in your overall Statement of Activities, but limit the information to just one function or cost center in each report.

Unrestricted Revenues and Expenses
with Budget Comparison
for the period
July 1, 2005 - September 30, 2005

	Unrestricted	Annual Budget	% of budget realized	variance
PUBLIC SUPPORT AND REVENUE:				
Public Support:				
Government grants	$ -	$ 500,000	-	$ (500,000)
Foundation and corporate grants	80,000	400,000	0.20	(320,000)
Donations	40,000	500,000	0.08	(460,000)
United Way	-	10,000	-	(10,000)
	120,000	1,410,000	0.09	(1,290,000)
Revenue:				
Service fees	150,000	1,100,000	0.14	(950,000)
Investment income	1,000	10,000	0.10	(9,000)
	151,000	1,110,000	0.14	(959,000)
Net Assets Released From Restrictions:				
Satisfaction of program restrictions	580,000	600,000	0.97	(20,000)
Satisfaction of time restrictions	45,000	50,000	0.90	(5,000)
	625,000	650,000	0.96	(25,000)
Total Public Support and Revenue	896,000	3,170,000	0.28	(2,274,000)
EXPENSES:				
Program services	700,000	2,500,000	0.28	(1,800,000)
Administrative	130,000	400,000	0.33	(270,000)
Fund raising	50,000	225,000	0.22	(175,000)
Total Expenses	880,000	3,125,000	0.28	(2,245,000)
INCREASE IN NET ASSETS	16,000	45,000	0.36	(29,000)
NET ASSETS AT BEGINNING OF YEAR	180,200	180,200		
NET ASSETS AT END OF YEAR	$ 196,200	$ 225,200	0.87	$ (29,000)

Note: Report displays Unrestricted income and expenses as well as amounts released from temporary restrictions compared to the budget for unrestricted income and expenses and the planned release of temporarily restricted net assets

You may also want to produce the "matrix format" Statement of Functional Expenses or Functional Revenues and Expenses Statement shown in Appendices 20 and 21. The Functional Revenues and Expenses Statement allows you to see the revenues and expenses associated with each of your cost centers (management, fund raising, and each of your programs), at a glance. Because this statement has multiple columns, it is usually difficult to include a detailed budget comparison for each function. You can get this information by producing the cost center Statements of Activities described in the previous paragraph.

If you are using the GAAP format for the Statement of Activities, you have probably recognized a real challenge in this discussion. While it is most helpful to have internal financial statements include a comparison of actual revenues and expenses to budget, the multi-column format of the GAAP format statement (requiring a separate column for Unrestricted, Temporarily Restricted, and Permanently Restricted activities and a final column totally the three classes together) makes adding a budget comparison column very cumbersome and the resulting statements hard to read.

There is a further complication. While you may have budgeted to use Temporarily Restricted net assets that have been carried forward from prior years, the GAAP format Statement of Activities will make it hard to compare what has actually happened to what you planned. Instead, you will see that the combined total of all classes for the line item for funds released from temporary restriction into the unrestricted column will always add to zero and appear to show that you have not followed your budget plan.

The Unrestricted Revenues and Expenses report on page 547 provides a useful format to deal with both the problem of too many columns and the problem of comparing the amounts you've actually released from restriction to your budget plan. This approach involves reporting actual to budget comparisons for the activity in the Unrestricted Class on one page and the activity in the Temporarily Restricted Class on a separate page. You can see the impact of all classes together by producing a GAAP format report like the Statement of Activities on page 530 that does not include a budget comparison. Also be sure to read Chapter 22 to learn how to protect your organization from fraud and from false accusations.

GOVERNMENT FUNDS ACCOUNTING REQUIREMENTS

If your nonprofit will receive funds from federal, state, or local government entities, you need to become familiar with accounting and financial management requirements that are referenced in your grant or contract

agreement. The federal Office of Management and Budget (OMB) publishes circulars which detail the requirements for recipients of federal dollars.

Unfortunately, it's not always easy to determine whether the dollars you receive through government grants/contracts are federal. Anytime you accept government funding, you will need to find out whether it is federal in origin. In other words, did the funds your local or state government is giving your nonprofit come from a federal source? It may be helpful to think of federal funds as being like a sexually transmitted disease. You must always know where your money has been before it comes to your nonprofit.

If you will be receiving federal dollars you will want to obtain OMB Circulars A-110, A-122, and A-133. You can download them for free from the OMB website at *www.whitehouse.gov/omb/circulars*. These circulars explain what types of costs are allowable and unallowable uses of federal funds; what type of records you must maintain; and how you must allocate costs. Chapter 20 of this book provides some basic guidance on cost allocation that may help you understand the circulars. Chapter 25 provides help in understanding the requirements of Circular A-133 that identifies which organizations receiving federal dollars must have a special type of audit conducted.

WHATEVER HAPPENED TO FUND ACCOUNTING?

Some readers will probably recall the days before 1995 when nonprofits used *fund accounting*. This approach to accounting was similar to methods used in governmental entities. In fund accounting, the organization maintained a complete set of accounts (assets, liabilities, fund balances, revenues and expenses) for each of several different types of funds – typically an unrestricted fund, one or more restricted funds, a capital or property, plant and equipment fund, and an endowment fund. While these distinctions among types of funds are somewhat similar to the distinctions we now make between classes of Net Assets (Unrestricted, Temporarily Restricted, and Permanently Restricted), fund accounting differed from current nonprofit accounting by requiring that Assets and Liabilities as well as Net Assets (then called Fund Balances) be tracked for each distinct fund.

Some nonprofits continue to use many of the tools of fund accounting. This is especially important for organizations which receive funding directly from the federal government. Tracking the receipt and use of federal cash is a key requirement for direct recipients of federal funds. Federal rules limit the amount of time a recipient organization can keep federal cash on hand without disburs-

ing it. In order to meet such requirements, a nonprofit has to be able to characterize its cash as federal or non-federal.

As noted above, nonprofits that receive restricted grants continue to structure their Charts of Accounts to distinguish the source of funds used to support specific expenses. However, systems to do this type of tracking typically focus on revenues and expenses only rather than on creating total separate self-balancing sets of Assets, Liabilities, Net Assets, Revenues, and Expenses as we used to do in fund accounting.

ACCOUNTING SOFTWARE CHOICES

Your nonprofit will find a wide variety of accounting software that can meet your needs. There is absolutely no need to create your own software or adapt database or spreadsheet programs to do your accounting. This approach will almost certainly prove more costly and less helpful than purchasing a well documented and supported product.

Start by understanding what your nonprofit needs most. All but the very smallest nonprofits will need general ledger software. These are the programs which allow you to maintain complete records of Assets, Liabilities, Net Assets, Revenues and Expenses.

Your choices will fall into two broad categories: products which have been designed for business use but can be successfully adapted to meet nonprofit needs; and products which are designed explicitly for nonprofit users. In our experience, both types of products can work well for nonprofits.

Almost all accounting software on the market today is capable of performing your accounting functions. The key questions in your selection process should be:

- How easily can the product be set up to meet your needs?
- How strong is the support provided by the software company?
- How easy or difficult will it be to find local consulting support for the product?
- How strong are the protections from error and fraud built into the product?

- How useful are the reports the product is designed to produce or how easily and safely can data be exported from the general ledger into a spreadsheet to produce the reports you need?

Beware of false price comparisons. The full cost of acquiring and using any product will include:

- Purchase price and any annual support or maintenance fee;

- Cost of any hardware upgrades needed to make the product run well (the minimum hardware requirements stated by the software maker are often insufficient to allow the product to run efficiently);

- Cost for help in setting up the chart of accounts and financial report design to meet your needs;

- Training for your staff- both the cost of the training and the cost of their time while participating in the training;

- Staff time to use the product to fully meet your accounting and reporting needs (this must include the cost of any off-the-books side efforts to create special reports that can't be drawn directly from the software);

- Cost of down-time and reconstruction if the product crashes frequently;

- Audit cost relating to ease or difficulty of tracking entries within the system;

- Cost associated with detecting and correcting errors or discovering and documenting fraud.

Once you consider all the cost factors, the actual purchase price of the accounting software will probably prove to be less than one third of the total actual cost. Beware of penny wise and pound foolish decisions like choosing the "cheapest" product and then spending large amounts of staff time (and consultant or auditor time) dealing with its limitations.

Business oriented accounting software can work very well for nonprofits if it includes the capacity to track cost centers. Business products often refer to this capacity as "departmental and division" tracking. Refer to the discussion of your Chart of Accounts earlier in this chapter to think through how many

levels you will need. If you will need to categorize expenses (and potentially revenues too) by line-item, by function, and by source, you will need three levels. This can be accomplished with business software designed to handle both departments and divisions or both departments and multiple cost centers.

If you have decided that you want to produce internal financial statements that follow the GAAP format for displaying Unrestricted, Temporarily Restricted and Permanently Restricted income and the release from Temporarily Restricted into Unrestricted, like Statement of Activities on page 530 in this Chapter, you may want to look at products designed specifically for nonprofits which provide this format as a standard report. You can accomplish this format with business software but it will require some careful set-up and will often require exporting data from your general ledger into spreadsheet software.

If you will be dealing with grants and contracts that overlap your fiscal year or funding that requires sophisticated cost allocations, you may want to seriously consider products designed specifically for nonprofits. You will need features that support cost allocation and preparing reports on grants that combine data from multiple fiscal years.

TIPS FOR QUICKBOOKS USERS

QuickBooks is rapidly becoming the most widely used accounting software for nonprofits as well as for small businesses. It is inexpensive to purchase and quite easy to use, at least at a very basic level. It is also very flexible, allowing the user to define account titles and to easily export data into spreadsheet software in which attractive reports can be designed and prepared.

The developers of QuickBooks have consistently chosen ease of use over protection from fraud and error.

QuickBooks has multiple versions designed for users dealing with differing levels of complexity. Nonprofits needing to track expenses by function and source as well as by line items will want to purchase QuickBooks Pro or QuickBooks Enterprise. If you are have decided to use QuickBooks, you will find Christine Manor's book, *QuickBooks for Not-for-Profits*, extremely helpful. As she explains, the easiest way to obtain the capacity to track both function and source is to use QuickBooks "classes" to indicate functions (management, fund raising, and programs) and to use the "customer/jobs" feature to track both income and expenses by funding source.

You may also be aware of the two competing products which adapt QuickBooks for nonprofits. Intuit, the maker of QuickBooks has created QuickBooks for Nonprofits and can be contacted at *infohttp://quickbooks.intuit.com*. The second vendor is Nonprofit Books, who can be contacted at *http://www.nonprofitbooks.com*. Both of these products have strengths and limitations. Many nonprofits find that they are able to accomplish what they need by using QuickBooks Pro in the approach described in the Manor book mentioned above.

But QuickBooks users need to be aware of some serious risks involved in using this widely acclaimed product. The developers of QuickBooks have consistently chosen ease of use over protection from fraud and error. The result of their choices is that QuickBooks can be an invitation to dishonest acts and/or a source of confusion and error for honest people who don't understand some key accounting controls.

Like messages written in sand on a beach, your records can disappear or change.

Data entered into QuickBooks can be altered without any record of the alteration, even after financial reports have been produced. While some versions have an audit-trail feature which does create a record of alterations, the audit-trail feature can be turned off and alterations made which cannot be detected when the audit-trail feature is turned back on.

Why does this matter? Because data can be altered without record, you may find that the information you reviewed in one month's financial statements no longer exists at a later point in the year. Like messages written in sand on a beach, your records can disappear or change. Dishonest people can use this weakness to cover or hide improper disbursements or create confusion that will mask dishonest acts. Honest but untrained users, may use this feature to try to correct mistakes discovered later in the year, but in doing so, destroy the integrity of your records.

There are user controls that can be implemented to reduce the risks associated with this feature. Purchase a version with multi-level password control and you will be able to adopt a procedure in which only the person designated System Administrator can turn the audit trail feature on and off or can lock the records (preventing further alteration) at the end of a period. Of course this approach works only if you find a System Administrator other than your primary bookkeeper/accountant or other persons with access to your check stock and bank accounts. Some nonprofits are contracting with outside accounting services to play the System Administrator role and handle bank reconciliations. This approach substantially increases the controls in a QuickBooks system.

Another approach involves adopting written policies which require that the audit trail feature be left on at all times and preclude altering data after financial reports are issued (requiring corrections to be posted when errors are detected in subsequent months). For this approach to work, your nonprofit will need to find someone (other than the primary accountant) to monitor whether the policies are being followed.

WHO SHOULD DO YOUR NONPROFIT'S ACCOUNTING?

Some readers may have already answered this question by throwing up their hands and shouting "anyone but me." It's important to pause and remember that size and complexity do make a difference.

Small Organizations

If your organization is small enough to use simple cash basis accounting and get all the information you need from a basic small organization financial report, your accounting can be done by a person with little or no accounting/bookkeeping training. The person you choose does need to be accurate and detail-oriented. They need to be committed to checking the accuracy of their work against bank records. They also need to be open and willing to show the details of your records to anyone in your organization and not be defensive about mistakes if others point them out.

If you will be using a volunteer bookkeeper or a staff person without formal training in bookkeeping, get help setting up your chart of accounts and financial report format. As discussed in Chapter 13, you will also want to support your bookkeeper by arranging to have a board member or other person review their work regularly.

Mid-sized or Small Nonprofits with Multiple Programs or Multiple Restricted Funding Sources

Start by investing time or money in getting your accounting system and financial reports designed correctly to do the tracking and reporting you will need. Seek help from skilled accountants who have worked with nonprofit organizations similar to yours. You may be able to obtain volunteer assistance from local CPAs or from experienced nonprofit fiscal managers. If you cannot find free assistance, it is probably worth paying for a limited amount of consultation from someone who is highly experienced with your type of funding and programs.

But even a well designed system will require some expertise to operate properly. At a minimum, you will need a person who has experience as a *full-charge bookkeeper*. This is a term that describes a person who holds responsibility for seeing that all necessary accounting entries are recorded each month, closing the books and preparing standard financial statements. A full-charge bookkeeper has considerably more responsibility than an accounts payable, accounts receivable or payroll clerk or assistant. These "clerk" positions are useful in larger organizations. They utilize less fully skilled individuals who work under the supervision of a more highly skilled accountant. But in your mid-sized nonprofit, there will probably not be anyone with the technical skills needed to supervise a clerk-level employee.

Many small and mid-sized nonprofits find that they can get better accounting and financial reporting done by using a skilled accounting service *than they can by trying to hire a skilled accountant into a staff position.*

As your organization grows, you will want to employ a person who is experienced as a *fiscal manager* or *business manager*. In addition to the technical skills of a full charge bookkeeper, this person will be able to develop budget options and help your executive director and board evaluate your financial condition and explore alternative financial strategies.

Many small and mid-sized nonprofits find that they can get better accounting and financial reporting done by using a *skilled accounting service* than they can by trying to hire a skilled accountant into a staff position. There are some accounting services which specialize in nonprofit accounting and bring great expertise to their work. In smaller communities, you may need to look first for the "best" small business accounting firm. Ask local CPAs for their recommendations about which accounting services maintain the highest standards and are most dependable.

Remember that while the hourly rates quoted by an accounting service may seem quite high compared to the hourly wages of your staff, skilled accountants can do the work much faster (and possibly better) than inexperienced staff could in your organization. Typically, the use of an accounting service turns out to cost about the same as the full cost of trying to do the work yourself, and sometimes it's actually cheaper. If your nonprofit will be audited, use of a skilled accounting service may result in lower audit cost. Check out this issue with your auditor before making a decision.

In considering whether to do your accounting work in-house with staff or contract out with an accounting service, you will want to consider the concept of "opportunity cost". If it turns out that in order to do the work in-house, your

executive director must spend significant time overseeing, directing and correcting the work of an unskilled staff person, your organization is incurring an opportunity cost by not having that time available to the executive director to work on community relationships, funding, and program direction.

Larger or Complex Nonprofits

While it's not possible to make a hard and fast rule, most organizations with annual expenses over $1 million per year will find that they need to employ a skilled fiscal manager. Typically the fiscal manager will be responsible for all accounting (including supervising assistants as the volume grows), financial reporting, compliance with financial management requirements of funding agreements and providing tools for board and staff to prepare the annual budget. In many nonprofits, the fiscal manager also provides oversight for technology, risk management and human resources functions as well.

Complexity is the driving force in compensation level. Very large or complex nonprofits will often decide they need a fiscal manager or chief financial officer with formal educational preparation, as well as strong on-the-job experience. Typically, they will prefer individuals who are CPAs or have MBA degrees. The most successful nonprofit fiscal managers combine formal training with substantial on-the-job experience and passionate commitment to the mission of the nonprofits they serve.

Consult Appendix 1 if you would like information about source material related to this Chapter. Appendix 1 has references of interest to all readers, not just professionals.

Chapter 24 details one very important part of financial recordkeeping – payroll. If you have employees, you should turn there now. If not, skip to Chapter 25 to learn how your Board and managers can use the financial reports you produce to monitor your financial systems and to ensure that they are working properly.

24 PAYROLL REQUIREMENTS AND PROCEDURES

Since wages, taxes, and benefits can account for up to 65% to 85% of the cost of running many nonprofit corporations, payroll is a very important part of financial record keeping. If you have never prepared a payroll before, you may want to visit an IRS office for a full explanation of their requirements. From time to time, the IRS offers free courses for small businesses on payroll preparation. New employers must register with appropriate state and local taxing authorities. In Oregon, the State Department of Revenue registers employers for state income tax withholding, transit district payroll taxes, and unemployment. A separate application must be made for workers' compensation insurance coverage which is required of all Oregon employers.

This chapter offers a brief outline of the steps generally followed in preparing payrolls and the records generally needed. Remember, tax regulations have the force of the law behind them. This guide is not a substitute for instructions from the IRS or other taxing authorities. Those instructions, which are regularly revised, are essential for any sound payroll system. Mistakes can be costly since tax authorities can charge interest and penalties for late payments and – in crisis situations – can pursue individual Directors to personally pay for penalties equal to the nonprofit organization's unpaid payroll taxes.

Note: Because payroll is extremely important and can be time-consuming, you may want to check into using an outside payroll service. Some payroll services are very inexpensive and will cost you less than the cost of having your own staff prepare payroll records and reports.

THIS CHAPTER COVERS

- **Establishing Payroll Procedures**
- **Explanation of Payroll Terms**
- **Employer Taxes**
- **Preparing Your Own Payroll**
- **Payroll Tax Report Requirements**
- **Payroll Reports**

Addresses for all the payroll taxing agencies discussed in this chapter are in Appendix 2.

ESTABLISHING PAYROLL PROCEDURES

Each organization must establish its own pay period and pay procedures. Most nonprofit organizations opt for a monthly or semi-monthly pay period. From a bookkeeping standpoint, a monthly system is the least time consuming. If employees have difficulty managing money when paid once a month, a system of mid-month salary advances can be developed. More frequent pay periods (such as weekly) result in extra effort and extra opportunity for error.

The rate of pay for the Executive Director should be established by the Board of Directors. In small nonprofits, the Board may also set pay rates for other positions. In larger nonprofits, the Board frequently delegates setting pay rates for staff to the Executive Director. The person responsible for actually preparing your payroll should have *written* authorization for adding new employees to the payroll or changing rates of pay. Procedures for authorizing pay rates should be clear and uniform.

Even small organizations should require timesheets from both salaried and hourly employees, recording days and hours worked in the pay period. Both the employee and the supervisor, or other person authorizing payment, should sign the timesheet. Timesheets should be retained for at least one year. These simple steps can prevent time-consuming disputes about pay, vacation, sick leave and holiday time. They also can protect the organization from wage and hour complaints from disgruntled employees.

Even small organizations should require timesheets from both salaried and hourly employees, recording days and hours worked in the pay period.

The pay system should clearly identify which positions are compensated by monthly salary and which are paid an hourly rate. Uniform procedures are needed for pro-rating monthly salaries for unpaid leave and partial months worked. Your organization must also clearly assign responsibility for maintaining records of vacation, sick and holiday time earned and used. Clear procedures and forms are required.

Each organization should become familiar with wage and hour laws. First determine whether your organization is governed by federal or state laws by calling the Oregon Bureau of Labor, Wage and Hour Division. Both federal wage and hour laws and state laws impose requirements for overtime pay (time and a half) for employees working more than forty hours in a seven day work week. Exceptions are made for supervisory and professional employees. See Chapter 15 for a more extensive discussion of these requirements.

Good timesheets are essential for employees covered by overtime pay requirements. Pay special attention to the laws addressing "comp time." Many nonprofits have erroneously used compensatory time as a way of avoiding overtime. These errors can result in costly claims and penalties. (See Chapter 15).

EXPLANATION OF PAYROLL TERMS

In order to protect your nonprofit from costly errors, you will need to become familiar with a number of terms.

Employer Identification Number (EIN) and other Identifying Numbers

The Employer Identification Number is the unique number that the IRS utilizes to identify each corporation. You should have already obtained your federal EIN when you incorporated. (See Chapter 3). You must use your EIN on all payroll related documents. The State of Oregon will issue a Firm Number to use on documents relating to the Oregon Department of Revenue and the Employment Division.

Payroll Services

These are businesses which contract to handle the entire payroll function for their clients. In most communities they are available at very low prices. A good payroll service will calculate each employee's wages, withhold all necessary amounts, create all needed payroll records, compute payroll tax deposits, produce paychecks, produce all payroll tax reports, and produce all year end payroll records needed by the employees for their taxes and your nonprofit for its reporting. Before you set up a new payroll system, at least consider using a payroll service.

Payroll Software

Many accounting software programs include a Payroll function. This is the portion of the program that is used to calculate each employee's wages and amounts to be withheld and to prepare paychecks. The software also maintains the records each employer is required to have and calculates the tax deposits the employer must make. In some cases, the software will also facilitate preparation of required payroll reports.

Gross Wages

Gross wages are the total amount of salary or wages the employee earned during a pay period before any deductions are made.

Employer Taxes

These are taxes that employers are required to pay in addition to the gross wages of your employees. Requirements for employer taxes mean that it will actually cost you more to employ an individual than the gross wages you agree to pay them. Employer taxes include:

- Employer's share of Social Security and Medicare, also referred to as FICA (Federal Insurance Contribution Act)
- Federal and State Unemployment Insurance (note that 501 (c)(3) organizations are exempt from Federal Unemployment Insurance Tax)
- Workers Compensation Insurance
- Transit District taxes in the Portland Metro Area and Lane County

We'll provide more discussion of Employer Taxes in the next section.

Mandatory Payroll Withholdings

As an employer, you must withhold certain taxes from your employees' pay. These are taxes that the employee is required to pay. The law requires the employer to withhold these amounts and pay them over to the government.

In Oregon, employers are required to compute and withhold from the employees' pay the following taxes:

- Social Security and Medicare, also referred to as FICA
- Federal individual income tax
- State individual income tax

As an employer, you are also permitted to withhold from your employees' pay an amount to cover a portion of the daily charge for workers compensation insurance. However, this daily amount is only a very small portion of the whole workers compensation insurance premium that employers must pay (see section on Employer Taxes).

Voluntary Payroll Deductions

In addition to the mandatory deductions that employers must withhold from employees' pay, you may offer your employees the opportunity to voluntarily instruct you to withhold additional amounts. Whether to allow employees to have voluntary payroll deductions or not is entirely your decision as an employer. If you do allow employees to have voluntary payroll deductions,

you must be sure that you pay over the amounts withheld from your employees' pay to the proper recipients. You are legally obligated to pay all amounts you withhold from the employees' pay.

Common types of voluntary payroll deductions include:

- Charitable contributions
- Employee contributions to health insurance costs
- Employee retirement contributions
- Dependent Care Assistance Plan contributions
- Flex Plans or Cafeteria Plans

You may only permit voluntary deductions for retirement, Dependent Care Assistance Plans, or Flex or Cafeteria Plans if you have adopted the correct plan documents. You will need help from an attorney or a person knowledgeable about fringe benefit tax issues to review your plan documents to be certain they meet IRS requirements that change frequently.

Net Pay

Once you have calculated gross wages, mandatory withholdings and voluntary payroll deductions, you will compute the net pay the employee will receive.

Payroll Tax Deposits

Employers are required to deposit (pay to the government) both employer taxes and withheld employee taxes on schedules specified by tax authorities. Penalties for failing to make deposits on time are very high.

Payroll Tax Reports

Employers are required to prepare reports of all wages paid and amounts withheld and deposited. Each taxing authority specifies what report must be prepared and when it must be submitted. Penalties for late filing or failing to file payroll reports are quite high.

EMPLOYER TAXES

Each employer is required to pay certain taxes *in addition to* the gross wages paid to employees. The payroll deductions discussed above were all part of the employee's gross wages. Through payroll deduction, the employer withholds

the employee's money for taxes and then pays it to the government. *Employer taxes are not withheld from employee wages; they are paid entirely by the employer.*

Most nonprofit employers pay some form of state unemployment insurance, and employers pay the employer's share of workers' compensation premiums. Almost all nonprofit organizations must also pay the employers share of Social Security and Medicare (FICA). Certain religious organizations which object to FICA on religious grounds can elect to be exempt from FICA. Ministers may also be exempt from FICA. Review instructions from the IRS and Employment Division for current rates and deposit requirements.

Employer taxes are not withheld from employee wages; they are paid entirely by the employer.

Unemployment

All employers must provide for unemployment compensation coverage for their employees. Unemployment is not a payroll deduction. The full cost of unemployment is paid by the employer.

Federal Unemployment

If your program is tax-exempt under §501(c)(3), it is exempt from federal unemployment tax (FUTA). If it is nonprofit but not tax-exempt under §501(c)(3), you are liable for FUTA and must file Form 940 annually and deposit quarterly with Form 8109.

State Unemployment

If your organization is tax-exempt, it may choose between two plans for meeting State Unemployment requirements. It can pay a percentage of gross wages (currently around 3% of gross wages up to $25,000 per employee); or, it can be "self-insured," paying no tax, but remaining completely responsible for payment of all unemployment claims of former employees.

For organizations required or choosing to use the percentage tax plan (called the insurance plan), the percentage is determined for each organization by the Employment Division based on an experience rating system (for example, the more claims filed by employees you have laid off, the higher your rate). State unemployment taxes are generally due quarterly. Oregon now combines reporting and payment of unemployment taxes with reporting and payment of state income tax withholding. Both the report and the combined payments are submitted to the Department of Revenue.

Tax-exempt organizations considering the "self-insure" approach may want to investigate the unemployment trusts available only to 501(c)(3) organizations. Organizations joining the trust make quarterly payments to the trust to build up a deposit. The deposit is invested by the trust with its earnings added to the specific organization's deposit. When the deposit reaches the level the trust determines to be adequate to cover potential unemployment claims, the organization stops making quarterly payments. The trust pays unemployment claims with the funds in the organization's account. The trust provides insurance against extremely high claims amounts and some financing (with interest) to assure that cash is available when needed if the organization's deposit is not sufficient to pay claims. You can get contact information to reach the unemployment trusts by calling the TACS Nonprofit Helpline at 1.888.206.3076 or 503.233.9240 in Portland.

The trust approach offers greater security than simply being a self-insured employer, but is still represents an element of risk. If the organization suffers funding cutbacks and must lay off a substantial portion of its staff, their unemployment claims will surely exceed the premium the organization would have paid under the insurance program, and will come at the time when the organization is least able to pay them.

SAIF or Workers' Compensation

All employers are required to provide workers' compensation insurance coverage for their employees.

Most Oregon employers provide for workers' compensation for on-the-job injury through the State Accident Insurance Fund (SAIF). You may choose a private carrier instead or be self-insured. For details contact SAIF or your insurance agent.

In order to participate in SAIF, the organization must submit an application form with a registration fee. If SAIF agrees to insure your organization then SAIF will send monthly, quarterly, or semiannual reporting forms. The employer completes the form and sends it with payment directly to SAIF. The SAIF premium is computed in two parts. First, there is a daily charge for each employee. The employer may deduct a percentage of the daily charge from each employee's wages, or may choose to pay the entire amount per employee per day worked directly. The second part of the premium is computed by multiplying a percentage times gross wages paid. The percentage is determined by the type of work each employee does. For example, the percentage for janitors is much higher than for office workers or teachers because janitors are more likely to be injured. To prepare the form, the employer groups the wages of employees in the same percentage categories and applies the percentage to their

gross wages. The totals for each rate group are added together with the total SAIF payment.

Wages for employees who perform two or more different types of work (for example, drive a day care center bus and work with the children as a teacher) must be divided to reflect the portion of their day expended in each activity. The employer must document that the time distribution is correct or else the higher premium rate may be assigned to all hours worked. If you will have employees performing multiple functions, be sure to discuss recordkeeping requirements with your insurer.

In some cases, premiums paid to a private carrier may be lower than those charged by SAIF, particularly if that carrier also underwrites your property or liability insurance. Talk to your insurance agent.

Local Governmental Unit Taxes

Employers located or doing business within certain geographical areas of Oregon are subject to special taxes. Usually the tax is based upon the wages paid. The amount of business conducted in the district is another basis for taxation. A partial list of such agencies includes:

- Tri-County Metropolitan Transportation District
- Lane County Mass Transit District

If your organization has tax-exempt status from the IRS, it may also be exempt from these local taxes. Request exemption through the local tax authority. See Chapter 11.

PREPARING YOUR OWN PAYROLL

Setting Up Your Payroll System

If your nonprofit will have employees, you must set up a payroll system. This is an excellent time to think about using a Payroll Service. A good payroll service can handle all the set-up steps described in this section.

If you're determined to do payroll on your own, you will need to complete several major steps:

- Inform the IRS that you will begin having employees
- Register with the State of Oregon Department of Revenue and Employment Department

- Determine whether your local area has an employer transit tax and whether you will be considered exempt. If not, register as a employer with your transit district.
- Obtain workers compensation insurance coverage.

Next you will need to require your employees to complete several forms, including:

- *Form W-4*: this form is supplied by the IRS. It requires the employee to provide their social security number and the number of exemptions they will claim on their tax return. You need this information in order to deduct the right amount of federal and state income tax from their pay.

- *Form I-9*: This form is available from the U.S. Department of Justice. Each employee must complete the form and allow you to make a photocopy of their social security card or other proof of the fact that they can work legally in the United States. You must require all employees to complete Form I-9, not just those you think may be from other countries.

- *Payroll Withholding Authorization Form*: If you will allow employees to make voluntary payroll deductions (see above) you will need to create this form and get each employee to complete and sign it. The form will give you legal permission to withhold the amounts specified by the employee from their pay.

Payroll Withholding Tax Tables

In order to meet your legal responsibility to withhold federal and state income tax from employees paychecks, you will need to obtain payroll withholding tables from the IRS and the State of Oregon Department of Revenue. These tables are available on-line and in printed form.

If you decide to use *payroll software* to do your payroll processing, your software should contain current payroll withholding tables. Be sure to check that the version of the software you are using contains the most current payroll withholding tables. Most payroll software providers supply regular updates to registered users. But if you are using an unregistered copy of the program or you have failed to load the newest version into your system, you may make serious errors in preparing your payroll.

Payroll Records

Once you have all the information described above, you are ready to begin creating your payroll records and processing payroll. While your employees are probably most interested in your ability to produce paychecks, as the employer you have many more responsibilities beyond simply issuing paychecks.

Each employer is required to maintain a complete record of every employee, including their signed forms W-4 and I-9. You must also maintain a complete record of all gross wages each employee earned, the amounts you have withheld from their gross pay, the net pay you have given the employees and any employer taxes you are required to pay.

To meet your employer responsibilities, you will need both a *payroll journal* that contains the records of all your payroll calculations and payments and *individual payroll records* that contain the record of the earnings, withholdings and net pay of each individual employee.

Your payroll journal will contain the following information for all your employees:

- Dates included in each pay period
- List of each employee you had during each pay period
- Gross wages of each employee for the pay period
- Amount withheld for federal income tax
- Amount withheld for state income tax
- Amount withheld for the employees' share of Social Security and Medicare
- Workers Comp withholding amount (optional)
- Each employee's voluntary deductions
- Total deductions from each employee
- Net pay for each employee
- Any payroll advances given to each employee
- Paycheck number, date, and amount

Your payroll journal will not only contain an accurate list of this information for each employee, it will total the amounts in each category so that you will know the total gross wages you had for the pay period, the total amount you withheld for federal income tax, etc.

Payroll Processing Procedures

Since the cost of wages and employer taxes will comprise a very large portion of your total expenses (nonprofits typically spend at least 70% of the an-

nual budget on these costs), you will want to think through your payroll processing procedures very carefully to be sure you handle this function correctly. Here are a few key procedures you should consider:

Timesheets

Require your employees to maintain a daily record of the time they work for your nonprofit. At the end of the pay period, have each employee sign their timesheet and have a supervisor review the timesheet and sign it if it is correct.

Prepare and Approve the Payroll Journal

Enter each employee's timesheet information into your payroll system. Print out a report of all the information you have put into the system. The report will show the gross wages, withholdings, advances and net pay for each employee. Have a responsible person review this report carefully to be sure it is accurate. Once they have approved the report, go ahead and produce the paychecks.

Signing Paychecks

Be sure the person responsible for signing paychecks compares each paycheck to the Payroll Journal and considers whether the pay amount seems reasonable. Investigate any concerns. Signing the check represents your authorization that the payroll is correct.

Directors may have personal liability for penalties on undeposited payroll taxes. The IRS and other taxing authorities can literally shut down and padlock the premises of organizations that do not pay their payroll taxes.

Payroll Tax Deposits and Payroll Tax Report Submission

Be sure you have a clear understanding about who is responsible for making the payroll tax deposits and for preparing the payroll tax reports. Make sure the person responsible knows when your deposits and reports are due and that at least one other person understands the due dates and will check to be sure you have met the deadline.

PAYROLL TAX REPORT REQUIREMENTS

It is essential that you learn and meet the requirements for depositing payroll taxes. Late penalties and interest on undeposited taxes can easily equal or exceed the total tax due. Directors may have personal liability for penalties on

undeposited payroll taxes. The IRS and other taxing authorities can literally shut down and padlock the premises of organizations that do not pay their payroll taxes.

The IRS and state and local taxing authorities all have different requirements concerning when withheld employee taxes and employer taxes must be paid. Get the instructions from each taxing authority and construct a calendar of when each tax deposit is due. Be extremely careful to set aside enough cash to pay quarterly taxes such as unemployment. Be sure that more than one person in the organization understands the deposit requirements and is aware that they are being met.

Payroll services can be very helpful in relation to these requirements. Your payroll service will prepare the required reports, compute the amount of tax due and either deposit the payment directly for you or instruct you on the preparation of a check to make payment and the due date for submission.

WARNING!! Taxes withheld from employees' wages do not belong to the employer. You are acting as an agent for your employees, holding their money for deposit to the IRS, so you cannot decide to spend their money for other purposes. ***The IRS will not like it if you spend their money!***

PAYROLL REPORTS

Employers are required to prepare year end reports of gross wages, federal income tax withholding, social security withholding and state income tax withholding on Form W-2, and summarize all W-2s on Form W-3.

In addition to annual Forms W-2 and W-3, employers must complete Form 941 each quarter to report on gross wages, federal and Social Security withholding, and employer Social Security taxes.

On the state level, quarterly reports are required by the State Department of Revenue for Oregon state withholding tax; by the Employment Division for state unemployment taxes; and by workers' compensation insurers.

For tax purposes, the year is divided into four quarters:

- January, February and March
- April, May and June
- July, August and September

- October, November, and December

Payroll is always reported on a calendar year, regardless of your organization's fiscal year.

Completed monthly payroll records and individual payroll records are summarized and reported on the quarterly and yearly tax forms. It is important to check to see that:

- the total of all individual payroll records is the same as that reported on the quarterly tax forms;
- the total of all individual payroll records is the same as that reported on the yearly tax reporting forms (i.e., the W-2 forms); and
- the total of the four quarters is the same as that reported on the yearly tax reports.

If all this has begun to seem overwhelming, remember that payroll services not only prepare your paychecks and payroll records, they also prepare all the payroll tax reports. You may want to consider using a payroll service even if your organization is very small.

Your Board and managers need to be able to use the financial reports you develop to evaluate your organization's financial health. The next chapter offers specific suggestions for how they can do this.

25 EVALUATING YOUR ORGANIZATION'S FINANCIAL HEALTH

Your Board and management have responsibilities for being sure your organization is managing its resources effectively to achieve your mission. You'll want to use the financial reports we discussed in Chapter 23 to evaluate the extent to which your plans, as expressed in your annual budget, are working. Beyond comparing the actual revenue you've generated and expenses you've incurred to your budget plan, you'll want to continuously evaluate your organization's overall financial health.

Many Boards and some Executive Directors are initially confused about the steps they should take to monitor their organization's financial health and financial management.

This chapter provides guidance on making good use of financial reports, and suggests specific questions Boards and Executive Directors should discuss when reviewing financial information. It also provides a step-by-step guide for Executive Directors and program managers to monitor the financial consequences of their work.

This chapter will also help you determine whether your organization needs to obtain an independent audit to be certain that your financial statements are giving you a fair picture of your financial position. And it will help you prepare for audits and reviews by funding sources and regulatory agencies.

THIS CHAPTER COVERS

- **How to Ask the Right Questions About Your Financial Statements**
- **The Manager's Role in Monitoring Financial Performance**
- **Should Your Nonprofit Have an Independent Audit or Review?**
- **Understanding and Preparing for Audits**
- **Will Your Organization Need an A-133 Federal Funds Audit?**

HOW TO ASK THE RIGHT QUESTIONS ABOUT YOUR FINANCIAL STATEMENTS

Here are the eight basic questions you'll want to ask as you review your nonprofit's financial statements:

How Financially Strong is This Organization?

Start with the Balance Sheet or *Statement of Financial Position*. This statement presents the assets, liabilities and net assets of the organization on a specific month-end date. It may present a comparison of assets, liabilities and net assets at two different dates, for example, the end of the last year, and the end of the most recently completed month.

Look first at the *net assets* line. Net assets represent the net worth of the organization at the date specified on the statement. It's helpful to think of net worth as what would be left if the organization gathered in everything it owns of value (cash, investments, land, buildings, etc.) and collected all that is owed to it (receivables), and then paid off everything it owes to others (wages, payroll taxes, payables, mortgages, etc). The *net assets* are roughly equivalent to *Owner's Equity* in business financial statements.

If the *net assets* amount is shown in <brackets>, the organization has a negative net worth, owing more than it owns. If it's not shown in brackets, the organization has a positive net worth – at least on paper. Like businesses, nonprofits report the land, building, and equipment at the amount they cost when purchased, less accumulated depreciation. This "book value" can be far from market value, that is, what the land, building or equipment could be sold for today. If the market value is much higher than the book value, the net assets will understate your organization's actual net worth. If the market value is much lower than the book value, the net assets will overstate your actual net worth.

Looking at the *net assets* is a first step. To really evaluate your organization's financial strength, you'll have to ask a few more questions.

Can the Organization Meet Its Obligations on Time?

Simply having a positive net worth doesn't guarantee that the organization can pay its employees, its payroll taxes, and its vendors on time. That depends upon its cash position or liquidity. Look again at the Balance Sheet (Statement of Financial Position). Create a subtotal of all the cash accounts and any receivables or investments which can be readily turned into cash. Next, look at the

liabilities. Create a subtotal for wages, taxes, and other accounts payable shown as current liabilities. Then compare your cash and cash equivalents subtotal to your current liabilities subtotal.

Does the organization have more cash or items which can readily be turned into cash than current liabilities, or at least as much? If so, it will probably be able to meet its obligations on time. If not, it will have difficulty paying everything on time. If it has significantly more cash than is required to meet current liabilities, it is in a good position to take on additional obligations through expansion or taking reasonable risks. Or, it may be time to invest some excess cash in longer term investments.

If the Balance Sheet (Statement of Financial Position) provides information about two points in time – the end of the current month and the end of the previous month or previous fiscal year – you can evaluate whether the cash position (i.e. cash available to meet obligations or invest) is improving or worsening. Compare the cash balances, the accounts receivable, and the accounts payable. If the accounts receivable are increasing, find out why. Does the increase simply reflect a higher volume of service and higher amounts being billed, or does the increase reflect difficulty collecting what is owed to the organization? If the accounts payable are increasing, ask for an "aging," i.e. a list which shows which of the amounts have been owed for 30, 60, 90, or more days. Then determine why payments have not been made and what will be the consequence of further delays.

Are There Limitations on What the Organization Can Do With Its Resources?

While having a positive net worth is clearly better than having a negative net worth, simply noting that the net assets line on the balance sheet is positive doesn't tell the whole story. Ask a few more questions.

Is part of the net assets balance actually a true or quasi-endowment fund? A true endowment is an endowment built by donor contributions which were specifically directed to the endowment. A quasi-endowment is one which has been created by Board action, deciding to treat certain funds as endowment, but not bound by any donor direction. Both types of endowments restrict the use of the principal and provide direction for the use of earnings generated by the principal, either directing them to general operations or to some restricted use.

In general, the principal of endowments is not available to support operation of the organization. So as you think about the organization's immediate financial strength, don't think of the endowment as available for immediate

needs. However, the endowment does contribute to overall financial strength by representing a future source of certain revenue through the income generated by investing the endowment.

Next, look for the portion of net assets which represents investment in fixed assets. Some organizations will show this as a separate line in the net assets section called *property, plant and equipment*, or *capital net assets*. Others will include it in the total net assets and you will have to do some analysis to figure it out.

To determine the portion of the organization's net assets which represents investment in fixed assets, find all the asset accounts which include land, buildings, equipment, leasehold improvements, etc. Next, find all the liability accounts which are related to these fixed assets – typically, mortgages payable used to finance the purchase of property and buildings, or notes payable associated with major equipment purchases. To compute the portion of total net assets invested in fixed assets, subtract the liabilities you identified from the assets you identified.

If your financial statements are being prepared fully in accordance with formal accounting standards, you will see net assets broken down into three groupings: unrestricted net assets, temporarily restricted net assets, and permanently restricted net assets.

Remember that the portion of the net assets invested in fixed assets won't be immediately available to support operations. The organization would have to sell its fixed assets, or borrow against them, in order to obtain cash for operations use. As you look at the organization's investment in fixed assets, think about how essential these assets are to the organization's ability to conduct its operation. Does owning them reduce operating costs or does it tend to increase operating costs by requiring constant maintenance expenses?

Finally, look for restrictions relating to operations which may have been placed on portions of the net assets. If your financial statements are being prepared fully in accordance with formal GAAP accounting standards, you will see net assets broken down into three groupings: *unrestricted net assets*, *temporarily restricted net assets*, and *permanently restricted net assets*.

The term "restricted" refers to a restriction placed on the use of assets by an outside party supplying the funds. For example, a donor may say "use my contribution only for the toys in the children's program" or a government contract may require "use these funds solely to meet the costs of the mental health services approved in the contract budget."

The term "temporarily restricted" is used to refer to restrictions which will be met through the passage of time, the use of funds for the specified purpose, or some other action. The term "permanently restricted" refers to assets which will have restrictions on their use forever, i.e., a permanently restricted endowment.

Less formally presented financial statements may not separate net assets into unrestricted, temporarily restricted, or permanently restricted groupings. If yours have no breakdown, you'll need to ask whether any of the funds the organization receives are restricted by the donor. If so, you will want to get help to modify your statements so these restrictions are presented clearly.

Your evaluation of overall financial strength should include recognition that restricted funds may be used only for their restricted purposes, and are not available for other purposes. Thus, restricted net assets represent resources that have already been received and are available to carry out restricted purposes in the future, but are not available for general, unrestricted purposes.

How Can I Tell If the Organization Is Complying with Restrictions on the Use of Funds?

In some organizations, a substantial part of the resources received carry restrictions attached by donors or grant funders. The restrictions may be either fairly general (use this money only for the children's program) or very specific (use this money only to buy art supplies for the children's program). The Statement of Support, Revenue, and Expenses (Statement of Activities) should let you see that restrictions have been established by the donor/funder, and that the spending of these funds has been in accord with the restrictions.

There are two common ways that nonprofits show the existence of restricted funds in their financial statements. If your nonprofit uses the standard GAAP reporting format, you'll see a distinction made between unrestricted and temporarily restricted gifts and grants on the statement reporting revenues and expenses. The gifts or grants that your organization received with donor restrictions will be presented in a column titled "temporarily restricted" (or "permanently restricted" if the gifts were to an endowment). In this approach, you'll also see a line at the bottom of the income section which reports on amounts "released" from temporarily restrictions and added to unrestricted income. This line indicates that you have complied with the donors' restrictions and used their funds according to their wishes.

Some nonprofits choose not to use the GAAP format. You can read more about this choice in Chapter 23. If your nonprofit is not using the GAAP format, you should still be able to see evidence that you are tracking donor restrictions

by looking at the Balance Sheet. There you will see a line item labeled "deferred revenue- grants received in advance" in the Liabilities section. This line item reports on funds which the nonprofit has received with restrictions which it has not yet used for the restricted purposes. When the nonprofit does use the funds for the purposes directed by the donor/grantor, the "deferred revenue" line item in the Liabilities section will be reduced and the grant income line item on the Statement of Activities (income statement) will be increased by the same amount. This entry reflects the fact that the nonprofit has earned the right to use the restricted funds by incurring costs which meet the donor's restrictions.

Understanding how nonprofits report on receiving and using restricted funds can be challenging, in part because different nonprofits use different methods. If you are not clear how you can see the receipt and use of restricted funds on your nonprofit's financial statements, it will be worthwhile asking an accountant to explain your current system and help you think through whether a different method would work better for your organization.

Is the Organization "Breaking Even"?

To answer this question you'll have to see the Statement of Activities (Statement of Support, Revenue, and Expenses). This statement reports on revenues and expenses over a period of time – a month, a quarter, or a year. Expect to see both revenues and expenses broken down into separate categories describing the type of revenue (grants, contributions, fees, interest, etc.) and the types of expenses (salaries, taxes, rent, supplies, etc.).

There are two important ways to look at this information. First, look at the bottom line – the *net income* which may also be called the *excess (deficit) of revenues over expenses* or the *increase (decrease) in net assets*. If revenues exceed expenses, the net income will be positive. If expenses exceed revenues, the net income will be negative and shown in brackets. This positive or negative net income for the period you are looking at is really the explanation of whether the net worth (net assets) of the organization is growing or shrinking. A positive net income will result in an increase in the net assets (net worth). A negative net income will result in a decrease in the net assets (net worth).

Another important way to look at revenue and expense information is in comparison to the organization's budget for the time period. Hopefully, the organization has a complete annual budget which shows all the planned sources of income and all the planned types of expenses. You can compare the actual revenues and expenses reported on the Statement of Activity to the planned revenues and expenses presented in the budget. Your questions will be, "Are things going as we had planned? Are we generating the income we thought we would? Are we controlling costs within the limits set in the budget?"

You will also want to look at your revenues and expenses in comparison to prior years. This can be particularly helpful when you have some revenues or expenses which do not occur evenly throughout the year. For example, if you have major fund raising activities every year in December, simply comparing your fund raising income and expense to your annual budget in October won't really tell you whether your on track. It will be more helpful to compare your current year to past years, and especially helpful to think about what percentage of fund raising income was generated by October in previous years compared to the percentage of your annual budget for fund raising income which has been generated by October this year.

This approach of comparing the current year revenues and expenses to past years allows you to look at trends. Over the past three years, has the percentage of your total income coming from individual donors or program fees increased or decreased? Has the percentage of fund raising income consumed by fund raising expenses increased or decreased? Hopefully you have already thought through what your goals are in these areas as you worked on preparing your annual budget. If you have set a goal of increasing the percentage of your total income which comes from individual donors, you can evaluate whether you are achieving that goal by looking at trend information.

Is the Organization Using Its Resources Wisely?

This is perhaps the most important question of all. To answer it, you must know what the mission of the organization is, and the financial statements must give you enough information to be able tell the purpose of the expenses as well as their descriptive character. For example, looking at a report which shows that the organization spent x dollars in salaries for the year, tells us the character of the expenses (i.e. salaries) but doesn't tell us the purpose (i.e. were the salaries spent for programs for children, seniors, or for administrators?).

We can get some information about the purpose of expenses through a functional presentation on the Statement of Activities or through a separate Statement of Functional Expenses. (See Appendix 20.) The functional presentation will distinguish expenses for program, administrative, and fundraising purposes, and if the organization has several different programs, distinguish the costs associated with each.

With functional expense data you can consider whether the organization seems to be spending its resources in accord with its mission and in a way which reflects its priorities. You may want to ask whether the organization can also convert this functional expense information into a cost per unit of service (this requires defining units of service and tracking them). The unit of service cost will allow you to compare the cost to provide a service at your organization

with the cost at another similar organization. Of course, such a comparison requires that both organizations have reliable data and have defined things similarly.

You may want to ask to have some supplemental information included on your financial reports to help you keep tabs on key indicators of both program and financial performance. For example, you may ask to see the number of clients served each month in comparison to your capacity, i.e. an average attendance of 200 in a child care facility licensed for 250 could be a sign that the organization needs to enroll children more rapidly or may have customer satisfaction problems. Average client census of nine in a residential care facility with sixteen slots would indicate potentially serious problems. This type of service utilization information is very important for organizations depending on payments per service provided.

Are the Books In Balance?

While most readers of financial statements will have to rely on someone with greater accounting knowledge to evaluate the quality of the accounting in the organization, there is one simple test you can do to alert yourself to very obvious problems with the accounting.

To do the test, you must have the financial statements for two consecutive periods, i.e. for January and February. Take the total *net assets* from the first of the two periods, and add the *net income* (change in net assets) for the second period to it. The answer should be the same number as is shown for the total *net assets* of the second of the two periods. If it's not, seek help from someone knowledgeable about accounting. This could be an indication that the books are not in balance.

How Do We Know the Financial Statements Are "Right"?

An audit completed by an independent CPA will give you the greatest assurance that the information presented on the financial statements presents the organization's financial position and activity fairly and should be relied upon. However, audits are generally done only once a year, and in small organizations, the cost of an audit may simply be too great to consider.

However, there are a number of simple procedures and cross checks which the accountant or executive director can perform each month to test the reliability of the statements. Be sure the organization has written fiscal policies and procedures and that they include the basic tests of accuracy. You could also ask a Director with a business background to review the financial records in detail at least once a year. You may also want to ask the treasurer to complete the

following checklist of simple tests in the following section to verify the financial statements and include the checklist with the financial report.

THE MANAGER'S ROLE IN MONITORING FINANCIAL PERFORMANCE

Beyond the financial health questions discussed above, organizations with paid staff will need to rely on their managers to examine the financial reports in much greater detail. Be sure you have given specific managers responsibility for performing each of the monitoring steps discussed below. And be sure all those taking parts of these responsibilities are communicating regularly with each other, and that one person has ultimate responsibility for resolving the problems you identify.

Steps to Be Sure the Reports Are Accurate:

• Verify that bank reconciliations have been completed for all cash accounts each month and that the balances shown on the financial statements agree with the reconciled balances.

• If you have accounts payable and accounts receivable, be certain that there are lists of all the individual amounts owed or owing which add to the totals shown on the financial statements.

• If you have acquired equipment, land or buildings, be sure these items are reflected in the assets section of your Balance Sheet.

• Perform the test of the connection between the Statement of Activity and the Balance Sheet described in the previous section. The c*hange in net assets (net income)* shown on the Statement of Activities should be the same as the *change in net assets* which can be computed by comparing the net assets at the beginning and end of the period reported on the Statement of Financial Position (Balance Sheet).

• Review the revenue and expense line items carefully. First compare them to the budget and be sure any significant differences between the actual revenues and expenses and the budget make sense to you. If they don't, ask the accountant to show you the detailed listing of transactions posted to the accounts which have unexpected balances. Review the transactions to see if something has been listed in an improper category.

• Review the revenue and expense line items to be sure that expenses have been correctly categorized in relation to different projects or funding sources.

Steps to Determine Whether Action Is Needed to Protect the Organization's Financial Health

• Review the revenue line items which have fallen short of the planned level. Consider whether it is realistic to think that the shortfall can be made up in the remaining portions of the year. Avoid wishful thinking. Base your evaluation on specific plans with specific estimates.

• If part of your funding is dependent upon the number of people served or the volume of service provided, check the numbers in these areas carefully. If you are not achieving your targets, figure out what is preventing it.

• Review all expense items which are significantly greater than the projected level. Determine whether your annual estimate will still prove correct (e.g., you have just expended amounts in this category at a more rapid rate than planned, but the annual estimate is correct).

• Based on your analysis, consider whether you will need to pursue additional strategies to generate the revenue you need or whether you should make reductions in your spending level.

• Review all restricted funding reports with great care. Be sure they are based on the numbers in your General Ledger and those numbers are correct.

• Be sure you are familiar with the requirements of your contracts with restricted funders. Do you have to obtain permission to move amounts from one line item to another? If so, your analysis of the reports should focus on identifying any requests for changes you will need to submit to the funder.

• Are any of your grants or contracts "use it or lose it" agreements in which your organization is not entitled to receive funds unless you expend them on specified items? In a "use it or lose it" contract, controlling costs so that you underspend the contract is not helpful to your organization. Instead, if it appears that you are underspending, consider what additional resources the project needs, or whether you can make a case to include more of

your overall operating costs into the contract budget. Once you've developed a strategy, then you will have seek approval from the funder.

• Write down the major assumptions you've made in your analysis of the financial statements. Compare these assumptions to your next month's financial statements. This will provide rapid feedback about how realistic you are being.

• Remember, the longer you wait to make revisions in your plan, the more dramatic the revisions may need to be because you will have less time to benefit from their effect.

SHOULD YOUR NONPROFIT HAVE AN INDEPENDENT AUDIT OR REVIEW?

One of the best ways to be sure that your financial reports are telling the real story about your organization's financial activity and health is to have an independent audit or review. Audits and reviews are specific procedures performed by Certified Public Accountants. In both audits and reviews, the CPA uses her or his professional training to examine your records. Both audits and reviews result in the CPA preparing a report which includes your financial statements presented in the formally correct way for nonprofit organizations.

Audits

In an audit, the CPA does enough examination and analytic procedures to feel comfortable writing an "opinion letter." The opinion letter tells readers whether they should rely on the financial statements as fairly presenting your organization's financial position. The opinion letter may be unqualified – i.e. the auditor says the financial statements are reliable – or it may be qualified. In a qualified opinion, the auditor tells readers that they can rely on the statements except for certain areas in which the organization has not used standard methods or where it has not been possible for the auditor to verify the reliability of a part of the statements. It's also possible that the auditor will issue an adverse opinion, telling readers that the statements do not fairly present your nonprofit's financial position, or a disclaimer of opinion, stating that it wasn't possible to determine whether the statements do or don't present your position fairly.

In addition to providing your Board – and funders – with assurances that your financial statements present your position fairly, the audit process should help your organization identify needed improvements in your financial man-

agement systems. You should also receive a management letter, describing any significant problems in the system discovered during the audit. It is very important for your Board of Directors to play an active role in relation to the audit. You will want to give a board committee responsibility for selecting the audit firm for your nonprofit and make sure that the auditor you select stays in good communication with the chair of that committee. At a minimum, you will want the auditor to meet with the committee at the conclusion of the audit to discuss what was learned during the audit.

Larger nonprofits may want to follow the guidelines of the Sarbanes Oxley Act (which does not actually apply to nonprofits but provides some useful guidance on the relationship between boards and auditors). Voluntary compliance with Sarbanes Oxley would require that your board appoint an Audit Committee with explicit responsibility for auditor selection and communication. The Audit Committee would have at least one financial expert, a person knowledgeable about nonprofit accounting practices and able to have a professional level conversation with the auditor.

Smaller nonprofits may decide to have the finance committee of the board serve as the audit committee. While smaller nonprofits may not have a financial expert to appoint to the finance committee, the other members of the committee should be willing to insist that the auditor meets with the committee and presents the information in a way that committee members can understand. The full board needs to be able to rely on the committee that has hired and met with the auditor to report back accurately about the soundness of your financial systems and any issues about your financial health which the auditor has identified.

You will also want to arrange an exit interview – an opportunity for the finance committee or the whole Board to discuss the audit findings with the auditor. Boards lose an important part of the value of an audit if they delegate to staff the responsibility for communicating with the auditor.

Reviews

When a CPA conducts a review rather than an audit, she or he performs fewer procedures and does not seek evidence from outside the organization to corroborate the information recorded in the organization's books. The review report does not include an opinion letter. This means that the CPA is not telling readers whether or not she or he believes that the financial statements fairly present the organization's financial position. Reviews are less expensive because they require less time from the CPA and expose the CPA to less potential liability. Your organization may decide that a review is adequate for your needs,

particularly if you are small and have little or no restricted money. Although the review does not provide the assurance of an opinion, it does require the CPA to look closely at your records, and will frequently result in the identification of significant errors and suggestions for improving your system.

Choosing Your Auditor

If you decide that you want to have either a review or an audit, you will need to select a CPA firm to conduct it. Start by asking other nonprofits about their auditors. You will want to identify CPA firms which are experienced with nonprofit organizations, and hopefully somewhat familiar with your type of nonprofit. If you will need a federal funds audit (discussed later in this chapter), you will need to find CPA firms which do these specialized procedures.

Once you have identified several CPA firms which appear qualified, ask to meet with each of them to discuss your needs. Most CPAs will want to ask you some questions about your organization and your accounting and may possibly take a look at your system before making a proposal to do your audit or review. You will want to ask them to tell you about their firm, specifically who in the firm will do what portions of the audit. In larger CPA firms, the actual field work of the audit or review – the part done in your office – is assigned to very junior staff who may have very little knowledge of common bookkeeping practices and may require a great deal of assistance from your staff. While their work will always be reviewed by someone in the firm with more experience, you may find dealing with these junior staff very time consuming and frustrating.

Some nonprofits prefer working with smaller CPA firms in which more senior staff are available to work on your audit year after year. If you are considering a smaller firm, be sure to ask about timing. How quickly can they complete the audit?

Whether you are considering small, medium, or large CPA firms, always ask for a list of all their nonprofit audit clients and make calls to check out the experiences these organizations have had with the audit firm. Scan the list first for organizations you know and for those which seem similar in size or focus.

Once you've made your selection, the auditor will prepare an engagement letter which serves as a contract for the work. Be sure every service you are expecting to receive is described in the letter. For example, if you would like the auditor to also prepare your Form 990, that service should be included in the engagement letter.

The audit business is quite competitive at this time. Most auditors are eager to have satisfied clients. So as the audit progresses, if there are things you don't understand or that you are dissatisfied with, let the auditor know so that problems can be worked out. It is usually advantageous for a nonprofit to keep the same auditor for several years. This allows the auditor to become familiar with your system and staff, and work more efficiently. It also saves your staff time by not requiring them to orient a new person each year.

UNDERSTANDING AND PREPARING FOR AUDITS

Types of Audits

Not all audits are performed by CPA's or upon the request of the nonprofit itself. The four major types of audits performed on the records of nonprofit organizations are:

Independent Audit by a Certified Public Accountant (CPA)

The Board of Directors of the corporation requests and pays for an audit by a CPA firm to provide assurances for the Board, and for outside funding sources, that the records are being kept according to Generally Accepted Accounting Principles and that the financial statements fairly state the organization's financial activities and position.

Funding Source Audit

Almost all contracts to receive government funds require that the recipient organization allow the funding agency to audit the recipient's books. The purpose of these audits is to determine whether the recipient organization spent the government funds properly within the terms of the contract. There is usually no charge to the recipient organization, although your staff time required to answer the auditor's questions represents a significant cost.

Payroll Tax Audit

The IRS, State Department of Revenue, Employment Division, and all other payroll tax authorities have the right to examine any employer's financial records to determine whether all wages have been reported and taxes properly computed and paid. There is no charge for these audits, but they may result in requirements to pay back taxes, interest, and penalties if errors or omissions are found.

990 or CT-12 Audit

Both the IRS and the State of Oregon Attorney General have the right to audit the books of nonprofit corporations. These audits focus on verifying the information which the nonprofit reported on Form 990 (the IRS) or Form CT-12 (State of Oregon). If you have had an independent audit, the 990 or CT-12 auditors will often do little more than compare your 990 or CT-12 to your independent audit. If you have not had an independent audit, the IRS or State auditors may spend a considerable amount of time checking to see if the reports you filed agree with your books. The IRS is sometimes looking for specific activities which are limited or prohibited for §501(c)(3) organizations, i.e. political activity, lobbying, unrelated business income, or private inurement. These "no-nos" are discussed in Chapters 5, 8 and 9. In most cases, there will be no consequences to an IRS or State of Oregon audit. However, both the IRS and the State can charge penalties for filing substantially incorrect returns. The IRS can assess specific taxes and penalties for Unrelated Business Income, excess lobbying, or political activity. And, the IRS may threaten to revoke your tax-exempt status if your improper actions play too significant a role in your organization.

Preparing for an Audit

All four types of audits involve a process of checking, reviewing, and verifying the accounting and financial reporting of the organization. The auditor reviews the internal financial records (including records of transactions, journals, and ledgers) and in addition seeks supporting evidence from outside. You may be asked to provide:

- Financial Statements, Trial Balance, General Ledger
- All journals, subsidiary ledgers, records of receipts and disbursements
- Canceled checks, check stubs, bank statements
- Invoices, bills, petty cash records, receipts
- All payroll records – regular wages, overtime wages, vacation pay, bonuses, commissions, profit sharing; all records of other than cash remuneration to employees – value of room and board, free rent, labor exchange, etc.; all timesheets
- All contracts, purchase of service agreements, notes, mortgages

- Your governing instruments (Articles of Incorporation, Bylaws); minutes of the Board of Directors meetings; approved budgets; personnel policies, financial policies, etc.

WILL YOUR ORGANIZATION NEED AN A-133 FEDERAL FUNDS AUDIT?

An "A-133 Audit" is an audit of financial statements done in accordance with requirements of Office of Management and Budget (OMB) Circular A-133, which is required for nonprofit organizations expending $500,000 or more in federal funds during their fiscal year. Federal funds may come directly from a federal agency or may pass through a state or local government or another nonprofit.

Generally, A-133 audits will be done by independent CPA's. OMB Circular A-110 explains standards for procurement – i.e. selecting and engaging an auditor.

A nonprofit is subject to the A-133 requirements only if it is considered a "recipient" or "sub-recipient" of federal grants or contracts. The amount of federal funds received for purposes of determining A-133 audit requirements *does not include* amounts nonprofits receive when acting as *vendors* of goods or services under *purchase of service* agreements. *However, this is a hotly contested area.* There is substantial disagreement about what constitutes a true vendor agreement.

An A-133 audit looks different than a "regular" audit. The A-133 audit will include the standard financial statements and a separate Schedule of Federal Fund Expenditures, each with an auditor's opinion. The auditor's opinion letter will reference *Government Auditing Standards* and OMB A-133. Additionally, the auditor will prepare reports on her or his review of the nonprofit's *internal control structure* and on her or his review of *compliance with law and regulation*. The auditor's reports on the reviews of internal control structure and compliance will include any findings of material weaknesses. The report on compliance must contain the auditor's opinion on whether federal funds were administered in accordance with applicable law and regulation.

The Nonprofit Organization's Responsibilities

If your nonprofit is subject to an A-133 audit, you must:

- Determine which funds received are federal in origin

• Obtain the CFDA (Catalog of Federal Domestic Assistance) number for all funds received

• Engage a qualified auditor to perform an audit under A-133 requirements

• Establish and maintain controls which will prevent or detect material noncompliance, and ensure that direct and indirect costs are computed and billed in accordance with A-133 requirements

• Maintain records which document the use of federal funds for allowable purposes

• Be certain that all reports to funders are supported by the organization's accounting records (primarily the General Ledger)

• Be familiar with all laws and regulations compliance with which is required by contracts for federal dollars and document compliance

• Document the eligibility for services of all clients served with federal dollars

• Prepare responses to all findings in the audit reports

• Submit the completed A-133 audit to the appropriate federal, state, or local entity

• Resolve any concerns of funders regarding "substandard" audit reports.

The Auditor's Responsibilities

The auditor in an A-133 audit must:

• Be fully trained and prepared to meet A-133 requirements

• Obtain a thorough understanding of the nature of the nonprofit's activities, sources of funds, and requirements of funding sources

• Conduct the audit in accordance with *Government Auditing Standards* and OMB Circular A-133

- Prepare required reports, including opinions on the financial statements, the Schedule of Federal Funds, and the compliance with law and regulation for major Federal programs; reports on the reviews of internal control and compliance; and material findings such as weaknesses in internal controls, questioned costs, and noncompliance with law or regulation

- Be certain that reports and audit work papers meet A-133 standards

- Work with the nonprofit to resolve any concerns by funders regarding "substandard" audit reports, procedures, etc.

The Focus of the Audit

A-133 audits focus on controls over the use of federal funds. The A-133 audit seeks to answer three important questions:

- Are financial statements *presented fairly* under GAAP?

- Does the organization's control structure provide reasonable assurance of *compliance with federal regulations*?

- Has the *recipient complied with applicable laws* and regulations?

The auditor examines your policies and procedures to determine whether they assure that:

- Resource use is consistent with laws, regulations, and award terms;

- Resources are safeguarded against waste, theft, misuse, or loss;

- Reliable data is obtained, maintained, and fairly reported.

The A-133 auditor will test transactions to determine if:

- Expenditures were for allowable services;

- Records show benefits went to eligible participants;

- Matching requirements and level of effort requirements were met;

- Federal reports and claims are supported by books and records from which financial statements were prepared;

- Amounts claimed for matching or cost sharing comply with appropriate cost principles.

The A-133 audit will focus heavily on your compliance with specific federal laws, regulations and requirements such as:

- Political Activity
- Davis Bacon Act
- Civil Rights Act
- Cash Management
- Federal Financial Reports
- Allowable Costs
- Indirect Costs
- Other Cost Allocation
- Drug Free Workplace Requirements
- Administrative Requirements
  - interest earned
  - program income
  - period of funds availability
  - real property
  - equipment
  - supplies
  - procurement
  - subgrants
  - revolving loan payments

Steps to Prepare for A-133 Audits

Your nonprofit will need to take the following steps to prepare for an A-133 audit:

- Select an auditor;
- Get lists of schedules and documents needed;
- Discuss review of contracts;
- Get CFDA numbers;
- Test your reports – tie to Financial Statements, General Ledger, underlying documents;
- Test your compliance – eligibility, match, allowable costs;
- Reflect on the internal controls you did have – informal as well as formal – prepare policies and procedures manual;
- Don't overprepare – check with your auditor first.

So far, Part IV has focused on financial systems and records. However, your nonprofit also has to observe other types of recordkeeping and reporting and is subject to some laws governing your operations not covered elsewhere in this book. We cover the federal and state electioneering and lobbying rules that apply to all nonprofit corporations in Chapter 26 and other recordkeeping, reporting and legal requirements in Chapter 27.

26 ELECTIONEERING AND LOBBYING RULES FOR ALL NONPROFIT CORPORATIONS

Chapter 8 described restrictions imposed by the IRS on political activities and lobbying that apply to tax-exempt organizations, primarily those exempt under §501(c)(3). The federal government, and to a lesser extent, the state, also regulates campaign finance, electioneering and lobbying by all nonprofit corporations and unions, as well as business corporations, in order to encourage fair elections and in order to prevent backroom lobbying. The definitions of what constitutes political activity and lobbying under federal and state election and lobbying laws are different than the definitions that the IRS uses, so exempt organizations need to be aware that federal and state election and lobbying laws may cover activities that the IRS does not regulate.

This chapter discusses the federal and state campaign and lobbying rules that apply to all nonprofit corporations. Organizations that are tax exempt and that engage in electioneering or lobbying must read Chapter 8 and this chapter and comply with the rules in both chapters that apply to them. Non-exempt nonprofit corporations and tax-exempt corporations that are not subject to regulation in Chapter 8 must follow the rules in this chapter but do not have to observe the rules in Chapter 8. We cannot provide complete coverage of these complex rules in this chapter, but we try to provide enough information so that you can determine if you need further professional advice.

THIS CHAPTER COVERS

- **Federal Election Rules**
- **Federal Lobbying Rules**
- **Oregon Rules Governing Political Campaigns**
- **Oregon Lobbying Rules**
- **Use of Federal Funds for Political and Lobbying Activities**
- **Political Expenditure Tax**

All nonprofit corporations that are involved in electioneering or that lobby need to be aware of federal and state election and lobbying regulations. You should start by sorting out which rules might apply to you.

• The IRS regulations on political activity and lobbying discussed in Chapter 8 apply *only to certain groups exempt from federal income taxation*. They cover political activities and lobbying at the federal, state and local levels. Groups exempt from federal taxation whose political activities or lobbying are regulated as described in Chapter 8 must follow the rules in Chapter 8 *and* the rules in this chapter. Non-exempt nonprofits and exempt corporations that are not subject to regulation in Chapter 8 follow only the rules in this chapter.

• *Groups exempt under §501(c)(3)* cannot engage in any activities to influence the election of candidates and are restricted in how much lobbying they can do. The meaning and limitations of the campaigning and lobbying restrictions are described in Chapter 8. If your organization is exempt under §501(c)(3), you cannot engage in any campaigning in connection with federal, state or local elections nor can you contribute to PACs that support or oppose candidates or parties. The only political activities described in this chapter in which you can engage are to sponsor candidate debates (subject to the rules in Chapter 8 and to the rules in this chapter), to support or oppose nominations for *appointed*, not elected, positions and to support or oppose state ballot measures (but not recall petitions). Keep these limitations in mind as you read the federal and state rules on political activities in this chapter.

• Any group *exempt under any subsection of §501(c)* that tries to influence elections or appointed positions at the federal, state or local level should read the section on the political expenditure tax on page 614-616. You may be required to pay this tax. If you are registered as a PAC (see page 601), you can skip this section.

• The *federal* regulations discussed in this chapter apply only to political activity and lobbying *at the federal level.* If you do not try to influence federal elective or appointed positions or to lobby at the federal level, you can skip that material.

• *State* regulations on political activity apply to *federal, state and local* activity, so you will need to read that section if you support

or oppose a candidate, political party or ballot measure at any governmental level.

• *State* lobbying rules apply only to lobbying done *in connection with state government*. If you don't lobby the state legislature, these rules do not apply to you.

• Any nonprofit *that receives federal funds* should read the section on federal funds on page 613. Your funding may contain restrictions on your political or lobbying activities at the federal, state or local levels.

Not all political activity and lobbying is regulated. You may engage in an activity that you think of as a political activity or lobbying that is not regulated. For example, the state of Oregon does not regulate get-out-the vote efforts for ballot measure campaigns and federal law does not apply to state ballot measures. If you do not get federal funds, you can engage in this activity without any regulation under these laws. As long as you are not violating some other law, you can engage in political and lobbying activities that are unregulated.

You're probably getting the inkling that the rules governing federal and state electioneering and lobbying are quite complex. We give you an overview here so that you can determine if you need to be concerned about these rules. All of these rules have penalties if you fail to follow them that we don't try to cover here. If you are engaging in political campaigning or lobbying that may be covered by these rules, get legal advice.

FEDERAL ELECTION RULES

Federal election rules are campaign finance reform laws designed to regulate how money is spent to influence federal elections. The laws attempt to do this by controlling the source and amount of contributions to federal candidates, by limiting electioneering by corporations and unions and by requiring public disclosure of contributions and electioneering. Nonprofit organizations may become involved in electioneering in several ways. A nonprofit may want:

• to *contribute* to a candidate, political party or political committee,

• to *explicitly endorse or oppose a candidate or political party*,

• to *implicitly endorse or oppose a candidate or political party* by communicating its position on issues to the public in a way that encourages voters to vote for or against a candidate,

- to *act as a political committee*, or
- to *engage in voter registration and education activities*.

Each of these activities is subject to regulation.

The federal laws do not restrict nonprofit involvement in state or local races. State laws may. (See pages 606-612.) In addition, you have to file all reports required under the federal election laws with the Oregon Secretary of State. If you are exempt under §501(c)(3), you are prohibited from all electioneering (see Chapter 8). You cannot engage in any of the activities in this section nor contribute to PACs except to support or oppose nominees for appointed positions and to sponsor candidate debates subject to the strict limitations described on page 604.

If you are exempt under §501(c)(3), you cannot engage in any of the activities in this section nor contribute to PACs except to support or oppose nominees for appointed positions and to sponsor candidate debates subject to strict limitations.

Contributions to Candidates and Political Committees

Federal candidates raise and spend money through candidate or party political committees. Federal candidates cannot receive money or in-kind contributions from nonprofit (and business) corporations or unions and therefore you cannot give directly to them. Your nonprofit corporation or union can set up or contribute to a separate segregated fund which you will almost always be required to register as a political action committee (PAC) as discussed below. The PAC can then contribute to your candidate. The ban on contributions includes in-kind contributions and anything of value, not just cash contributions. For example, you cannot offer your mailing list, the use of your staff to canvas or your phones for phone-banking to federal candidates. You may sell your mailing list or rent your phones as long as you get a fair price paid *in advance* for the sale or rental.

Express Advocacy

Unless you are exempt under §501(c)(3), your nonprofit corporation can endorse or oppose a candidate for federal office. If you do this, you will probably want to influence others to adopt your position. However, federal election law puts restraints on how you communicate your position by regulating your expenditures. Virtually any effort on your part to communicate your position will involve an expenditure because it will involve advertising costs, paper, use of your computer or phones, staff time, etc. Generally, the law says that a corpora-

tion or union cannot make an expenditure from its general funds to expressly advocate for or against a candidate for most federal offices. What constitutes express advocacy is currently being debated, but at a minimum it means that your message cannot use explicit words like "vote for," "elect," "support," "defeat," or "reject."

Federal candidates cannot receive money or in-kind contributions from nonprofit corporations or unions.

Although you generally cannot expressly advocate for or against a candidate, there are some exceptions for internal communications with certain members and employees. These people are called your *restricted class*. If you are a nonprofit corporation, you may communicate with your executive or administrative personnel and your members and with their families. To be classified as a member for purposes of your communications about your endorsements, each member must have consented to be a member and must have some significant financial or organizational attachment to your corporation, such as the payment of annual dues or the right to vote. Oregon law requires that all members must consent to be a member but there are a few nonprofits that attempt to define their membership in a way that does not require consent. (See page 317.) If you are a union, you can communicate with your members (without worrying about a significant connection), executive and administrative personnel and their families. Whether you are a nonprofit corporation or a union, you may place your endorsement on your website only if access to your website is limited to your restricted class.

> *Example*: The Madison Main Street Consortium is a nonprofit neighborhood association (not exempt under §501(c)(3)) that wants to endorse a candidate running for the House of Representatives. Your bylaws describe your members as "all residents and business owners on the Main Street of Madison." Not every resident and business owner has joined. Those who do pay dues and elect the board of directors. You want to communicate your endorsement to your members and encourage them to support your candidate. Your members for this purpose are those who have joined and shown their attachment by paying dues and voting. Other residents and business owners in the district have not consented to be members and are therefore not part of the Consortium's restricted class.

Both nonprofit corporations and unions can spend as much of their own money as they wish on internal communications with their restricted class and these communications can expressly advocate for or against a candidate. You

can coordinate these activities with a candidate (coordination is discussed below) but you cannot simply reproduce campaign materials and distribute them. You need to generate materials that express your own views. You can allow a candidate or party representative to address your restricted class and you may bar other candidates. Your corporation or union can suggest that those in the restricted class contribute to the campaign or party but only the candidate or party representative (and not your corporation) can collect contributions. You can operate a phone bank to urge your restricted class to vote for a particular candidate or to support a political party. You can conduct registration and get-out-the vote drives aimed at your restricted class that urge them to register with a particular party or to support your candidate. Generally, you will have to report your expenditures for express advocacy to the Federal Election Commission if they exceed $2,000 for any primary, general or special election.

Both nonprofit corporations other than §501(c)(3) organizations and unions can establish PACs and your PAC can endorse or oppose a candidate.

You also can engage in certain measures to reach a broader audience with your message of express advocacy for or against a candidate. Your nonprofit corporation or union may announce your endorsement to your usual press list as long as you do not coordinate your announcement with a candidate. More significantly, both nonprofit corporations other than §501(c)(3) organizations and unions can establish PACs and your PAC can endorse or oppose a candidate as discussed below. Your corporation or union can solicit funds for your PAC from your restricted class as long as you don't pressure your salaried employees or members to contribute. There are special rules for corporations that want to communicate with employees who are not administrative or executive personnel. These rules are protective of those employees and ensure equal access to candidates.

Issue Advocacy

Many corporations and unions have gotten around the express advocacy limits described above by crafting messages that implicitly endorse or oppose a candidate for federal office without telling the voter to vote for or against the candidate. These messages are called issue advocacy because they take usually a position on a controversial issue or issues related to the organization's exempt purpose and then praise or castigate a candidate for their position. The ad is nonpartisan and does not tell the voter to vote for or against a candidate but the endorsement or condemnation is strongly implied. The corporation or union generating the ad cannot *coordinate* the ad with a candidate or party (see below for a discussion of coordination). Because the organization spending money on the advertisement cannot coordinate with the candidate, its expenditures are

called *independent expenditures*. There is considerable pressure to close this loophole by defining many types of issue advocacy ads as express advocacy. This issue is currently being debated so you should get up-to-date advice if you are considering an issue advocacy message. §501(c)(3) organizations cannot fund these types of ads because they violate the neutrality rules described in Chapter 8.

Many corporations and unions have gotten around the express advocacy limits by crafting messages that implicitly endorse or oppose a candidate without telling the voter to vote for or against the candidate.

> *Example*: Your nonprofit low-income housing advocacy group is exempt under §501(c)(4). You primarily assist low-income people to find housing and also lobby for housing issues. You have decided to oppose a candidate for the U.S. Senate because she supports gentrification over low-income housing. You run an ad in the Sunday paper pointing out the plight of low-income and homeless people. You name the candidate and explain how her record shows that she ignores the needs of the homeless and low-income community. Your ad does not tell people to vote against her. Your ad is probably an issue advocacy message and not an express advocacy message.

Broadcast Communications

There is one type of issue advocacy that is clearly banned for almost all corporations and unions. Your nonprofit is restricted from paying for certain broadcast communications (also called electioneering communications) that identify a candidate for federal office, even though you do not endorse or oppose the candidate. You cannot communicate your issue advocacy message via a broadcast, satellite or cable ad that can be received by 50,000 or more people in the candidate's jurisdiction within 30 days before a primary or 60 days before a general election. You can place your ad in newspapers and on the Internet and you can broadcast it before the restricted period. If your nonprofit is exempt under §501(c)(4) and does not receive money from for-profits, unions or foreigners, you can air these electioneering communications subject to certain restrictions on targeting voters. You have to file a disclosure statement with the Federal Elections Commission if you spend more than $10,000 in a calendar year on electioneering communications.

There are a couple of exceptions to these rules. Free ads, such as public service announcements, are not subject to the broadcast communications restriction. §501(c)(3) organizations are also exempted from the broadcast

electioneering rules but the IRS restrictions against political activity described in Chapter 8 will preclude (c)(3)s from doing most broadcast electioneering communications. If you are a (c)(3) that wants to run an ad that identifies a candidate during an election cycle for non-political purposes, be sure to get good legal advice in advance or you may lose your exemption.

Coordination

If you engage in certain activities or in issue advocacy, your expenditures must be independent expenditures – that is, you cannot coordinate your activities or your communications with a federal candidate or party. For your communication to remain uncoordinated, neither the candidate nor the candidate's campaign staff or party can share financial responsibility for your activity or communication nor be involved in decisions about your activity or communication, including what you say in your message, when you publicize it, which media you use or who you try to reach. If you do coordinate with a candidate, your expenditure will be considered a contribution to the candidate, which you cannot do.

The (c)(4) Ideological Nonprofit Exception

Some organizations exempt under §501(c)(4) were formed in order to promote a particular political ideal. These organizations are commonly called ideological nonprofits. Examples include right-to-life organizations, pro-choice organizations, death-with-dignity groups and organizations that support or oppose gun control. The U.S. Supreme Court has held that election laws must provide protection to the free speech rights of ideological nonprofits. To comply with the court's ruling, election laws now allow ideological nonprofits to make *unlimited independent* (that is, uncoordinated) expenditures on express advocacy by explicitly endorsing or opposing federal candidates as well as *unlimited uncoordinated* expenditures on issue advocacy. Your (c)(4) qualifies for this favorable treatment if:

- Your only express purpose is to promote political *ideas*, which may include issue advocacy, election-influencing activity, and research, training or educational activity that is expressly tied to your political goals;

- You do not engage in business activities;

- You do not coordinate expenditures with a candidate;

- You were not established by, nor do you receive funds from, a business corporation or union; and

- You do not have members that receive benefits that would discourage them from leaving your corporation because of your political position.

The first criterion that requires the (c)(4) to exist solely to promote political ideas is a bit tricky. To be recognized as exempt under §501(c)(4), you can engage in limited political *activity* but political activity cannot be your primary purpose. (See page 111.) To qualify for the ideological nonprofit exception, your only purpose must be to promote political *ideas*, which you may do by engaging in various political activities. In order to comply with both sets of rules, your ideological nonprofit would have to have as your only express purpose the promotion of a political *idea*. In promoting your idea, you would need to primarily rely on education, litigation or other nonpolitical activities (that is to say, nonpolitical activities as the IRS defines these activities, discussed in Chapter 8). You can also engage in limited political activities, including uncoordinated express and issue advocacy and broadcast communications, in order to promote your idea.

The second criteria restricts ideological nonprofits that want expanded free speech rights from engaging in business activities. This means that you cannot generate any income from the sale of goods or services, such as from the sale of your publications or from conference fees. Since you also cannot receive funds from businesses or unions, generally your sole source of support must be contributions from individuals and from other nonprofits. The idea here is that you have the right to special protection of your free speech, but only if you are supported by funds from non-union and non-business contributors who give specifically to support your ideas.

If you meet the criteria for ideological nonprofits, you may spend as much money as you like (taking care that your expenditures do not jeopardize your (c)(4) exemption) on express and issue advocacy and broadcast (or electioneering) communications. Your solicitations for donations *of any kind* must state that the donations may be used for political purposes, including supporting and opposing candidates. You can spend the money from your general funds without setting up a separate PAC. Like other corporations, you cannot make contributions to federal candidates or political committees. You must report any expenditure over $250 to the Federal Elections Commission and show that you are eligible for this (c)(4) exemption. You may also be liable for the political expenditure tax on your political expenditures discussed on page 614.

Federal Political Committees

At the federal level, nonprofits that are organized and operated primarily to influence the selection of candidates to federal, state and local elected or ap-

pointed office or to an office in a political party are commonly called political committees. Their activities to influence these elections or appointments are called their exempt functions. There are several types of political committees. The most common are political parties, candidate committees and political action committees (PACs). Political committees are exempt from federal income taxation except taxation on their investment income under §527 of the Internal Revenue Code. (See Appendix 8 for a discussion of the IRS tax exemption rules applicable to political committees.) To take advantage of the exemption, almost all of them register with the IRS.

Political committees are also subject to the federal election rules, except for four types of political committees:

- Those that focus only on state or local elections.

- Those that operate only to influence appointed positions and not elected positions — for example, Cabinet positions or federal judgeships.

- Those that receive and spend no more than $1,000 per year in federal electioneering and are not segregated funds of nonprofit corporations or unions.

- Those that only sponsor uncoordinated communications or engage in partisan voter registration drives. This exception is currently in dispute.

We discuss PACs that are formed by nonprofit corporations or unions and PACs that are set up independently. Political committees set up by candidates or political parties have different rules than the ones we describe in this book.

Political Action Committees (PACs)

For purposes of federal election rules, PACs are formed in one of two ways:

- Corporations, including nonprofit corporations, and unions can set up *separate segregated funds, or connected PACs,* to advance their political views in federal contests. Corporations and unions behind connected PACs can use their general funds to set up and administer these PACS and to solicit for money.

- *Independent PACs* are those that are set up by founders not connected with a corporation or union. They must pay the fees for

setting up, administering and soliciting funds from the funds that they solicit.

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§501(c)(3) organizations cannot form or contribute to PACs, except those whose sole activity is to support or oppose a candidate for appointed, not elected, office.

If your PAC is subject to federal election rules, you must have a treasurer who keeps track of the contributions and expenditures and complies with the disclosure regulations. Your PAC must file a statement of organization with the Federal Election Commission (FEC) within ten days after becoming a political committee. This filing is in addition to the notice of status that §527 PACs file with the IRS described in Appendix 8.

§501(c)(3) organizations cannot form or contribute to federal PACs, except those whose sole activity is to support or oppose a candidate for appointed, not elected, office. §501(c)(3)s can set up a §501(c)(4) organization and the (c)(4) can set up a PAC that supports or opposes a candidate for elected office, but the (c)(3) money and resources cannot be used for the PAC unless the PAC's sole function and the sole use of its funds are to promote a nominee for an appointed office.

Contributions to Your PAC

The federal PAC rules are designed in part to prevent corporations and unions from using their funds to influence elections. If you are a connected PAC, you can only raise money from your members, executive and administrative employees and their families that are connected with your corporation or union. (See page 596 for a discussion of this restricted class.) There are rules governing how you conduct your solicitations. If you are an independent PAC, you can solicit contributions from anyone except unions or profit or nonprofit corporations. All PACs subject to federal election rules may only accept contributions from individuals or other political committees of up to $5,000 each year.

Expenditures by Your PAC

Your PAC may spend money by contributing directly to a candidate or political committee or you may engage in express or issue advocacy. If you contribute directly to a candidate, political party or other PAC, the amount that you can contribute depends on whether you are a multi-candidate PAC. You are a multi-candidate PAC if you have been registered with the FEC for at least six months, have contributed to at least five federal candidates and have at least 50 contributors. As a multi-candidate political committee, you can contribute

up to $5,000 per year to each federal candidate and to other PACs and $15,000 to a national party. If you are not a multi-candidate PAC, you can contribute up to $2,000 to each federal candidate, $5,000 to other PACs and $25,000 to a national political party.

Your PAC may spend money by contributing directly to a candidate or political committee or you may engage in express or issue advocacy.

If your PAC wants to engage in express advocacy (see page 595) or issue advocacy, including broadcast communications (see page 597), there are no limits on how much you can spend *as long as you do not coordinate your activities with a candidate*. (See page 599 for a discussion of coordination.) This means that you can spend as much as you want on independent ads supporting or attacking federal candidates. If you coordinate your communications with a candidate, your expenditure is a contribution to the candidate and is subject to the contribution limits described above.

Disclosure Requirements

If your political committee is covered by federal electioneering rules, you must report all contributions and disbursements over $200 to the Federal Elections Commission. If your PAC is exempt under §527, you also have to comply with the IRS reporting requirements described in Appendix 8.

Voter Activities

Your nonprofit corporation or union can spend your general funds on certain types of voter activities that are directed to the general public rather than to your restricted class. However, you must conduct these activities in a neutral manner and you cannot expressly advocate for a candidate for federal office or for a party. You can engage in voter registration and get-out-the-vote programs aimed at the general public but you cannot advocate for or against a candidate or party and you cannot coordinate your project with a candidate or party. (Coordination is discussed above.) You cannot conduct your registration and get-out-the-vote drives by directing them primarily to individuals previously registered with or intending to register with the party you favor. Any services, including rides to the polls, that you offer must be made available to all regardless of party affiliation. As long as you observe these rules, you can conduct your drives among populations of unregistered voters that you generally believe will support your candidate or party. §501(c)(3) organizations must also comply with the stricter get-out-the-vote rules described in Chapter 8.

In addition to getting citizens to vote, you can educate voters. You can distribute voting records of the federal candidates but you cannot advocate in favor of or against a candidate or party, nor can you coordinate the production or distribution of the candidate's records with a candidate or party. You can also distribute voter guides that explain the candidates' positions on the issues as long as you don't coordinate with a candidate or party. In the case of voter guides, you must either avoid express advocacy or meet a more detailed list of criteria designed to ensure fairness. §501(c)(3) organizations must also comply with the more stringent voter education rules described in Chapter 8.

Nonprofit corporations exempt under §501(c)(3) may host federal candidate debates. §501(c)(4) organizations that do not support or oppose a candidate for federal office or a party can also host candidate debates. Other nonprofit corporations cannot to sponsor federal candidate debates. These (c)(3) and (c)(4) nonprofits may use their own funds and may accept funds donated by corporations and unions to cover the costs of the debate. The debate must include at least two candidates and cannot be structured to promote one candidate over the other. Your nonprofit must use preestablished criteria to determine whether to include a candidate. For example, you may require that candidates have at least 10% of the vote in independent polls in order to be included. For debates before a primary, you can restrict the candidates to those from one party but you may not use party as the sole criteria to determine who is in a debate before the general election. If your organization is exempt under §501(c)(3), you must follow the somewhat more detailed criteria on page 177-178 as well as the rules here if you sponsor candidate debates.

FEDERAL LOBBYING RULES

The federal Lobbying Disclosure Act requires some organizations to disclose how much federal lobbying that they do. Most churches and religious orders are exempt from the law. The law accomplishes disclosure by requiring registration and reporting of lobbying. It does not limit *how much* lobbying that you do. This is a complicated area. In our brief description here, we will alert you about whether you need to get professional advice about registering and reporting.

The federal Lobbying Disclosure Act requires some organizations to disclose how much federal lobbying that they do.

The Lobbying Disclosure Act defines lobbying as written and oral communications directed to certain legislative and executive branch officials in the federal government. The law covers communications made in regard to federal

legislation, rules, regulations, Executive Orders, the administration of a federal program or policy, or the nomination or confirmation of a person whose position is subject to confirmation by the Senate. There are numerous exceptions to the definition of a lobbying contact, including the provision of information in response to a request from an executive or legislative branch employee, responses to notices in the Federal Register for public comment and testimony before Congress and congressional committees.

The lobbying law divides the year into two semi-annual periods – one running from January through June and the second from July through December. Your organization is required to register and file reports if you meet two requirements:

- You must have at least one lobbyist who is your employee, who makes more than one lobbying contact and who spends 20% or more of his or her time engaged in lobbying over a semi-annual period. You do not have to comply with the lobbying law if you hire only outside lobbyists, if your lobbyist is a volunteer who receives no compensation, if your lobbying employee only makes one lobbying contact or if your lobbying employee spends less than 20% of his or her time lobbying during a semi-annual period.

- Your total lobbying expenses must exceed, or be expected to exceed, $24,500 in a semi-annual period. (This sum is adjusted each year, so get updated information from *http://clerk.house.gov*.)

If your organization is required to register under the federal lobbying law, you must register within 45 days of making your first lobbying contact. You can obtain the form to register as a Senate lobbyist by going to the Senate website at *www.senate.gov* and following the links for "Legislation and Records" and "Lobbying Disclosure." House lobbyists should go to *http://clerk.house.gov* and follow the link to "Lobbying Registration." You must file semi-annual reports on your lobbying contacts that are due by August 14 and February 14 each year. In these reports, you must list the issues, bills and executive actions targeted by your lobbying, the houses of Congress and executive agencies that you lobbied and your lobbying expenses.

(c)(3) Organizations

The definition of lobbying under the federal lobbying law is quite different than the definition of lobbying used by the IRS for tax exempt purposes that we discussed in Chapter 8. The Lobbying Disclosure Act's definition is broader in that it includes lobbying of administrative agencies. It is narrower in that it

includes only lobbying of the federal government and does not include any grassroots lobbying. Organizations exempt under §501(c)(3) can face complex bookkeeping requirements to meet both the IRS and Lobbying Disclosure Act lobbying rules. To alleviate this burden, the Lobbying Disclosure Act allows (c)(3)s that have made the lobbying election under subsection (h) (see pages 181-184) to choose to use the definition of lobbying under the subsection (h) rules rather than the definition under the federal lobbying law to determine if they meet the threshold for registration and to report lobbying expenses if they are required to register. Subsection (h) organizations use the Lobbying Disclosure Act's definition of *legislative lobbying* to report their legislative lobbying contacts and the subsection (h) definition of *administrative lobbying* to report their administrative lobbying contacts. This allows these (c)(3)s to avoid keeping two sets of books on lobbying while requiring them to disclose as much as other organizations about who they are lobbying in Congress. If you chose to make this election, you have to notify Congress.

> *Example*: Preserve Our Fisheries is exempt under §501(c)(3) and has made the subsection (h) lobbying election. The organization brings numerous stakeholders together to create workable programs to protect the supply of fish. POF has an employee who spends 20% of her time from January through June lobbying Congress and the Environmental Protection Agency. The organization pays $25,000 for the lobbying portion of her salary and other lobbying expenses. One-half of the employee's time and the expenses are for Congressional lobbying and the other half for lobbying the EPA. POF can chose to use the (h) election definition of lobbying that excludes administrative agencies from the definition of lobbying. If it does, POF has only spent $12,500 and 10% of its employee time on lobbying (as subsection (h) defines it) and so does not need to register.

OREGON RULES GOVERNING POLITICAL CAMPAIGNS

Oregon laws that govern political involvement have several distinct features. They cover federal, state and local political candidates. The laws also apply both to candidate races and to ballot measures. State law regulates both electioneering and ballot measures under political campaign regulations by establishing registration and reporting requirements. Your nonprofit may be covered by these regulations:

- if you make *independent expenditures* for political purposes,

- if you are *classified as a political committee by the state,* or

- if you *form a separate political committee*.

Oregon also regulates election conduct. Nonprofits that are involved in political campaigns and in ballot measure advocacy need to familiarize themselves with all of these rules. The Oregon Secretary of State publishes an excellent and readable book, the *Campaign Finance Manual*, that explains Oregon's rules and electioneering and contains the forms required by the state. You can obtain this from the Secretary of State at the address or on the website listed in Appendix 2.

Independent Expenditures

Oregon law regulates nonprofits (and others) that support or oppose a candidate, party or ballot measure by recognizing two levels of involvement. On one level are nonprofits that use their own funds to make a very few expenditures in a campaign. If you engage in very limited campaigning and do not make your expenditure with the cooperation of the candidate or political committee, you may be making an *independent expenditure*. An independent expenditure is an expenditure for a communication that expressly advocates the election or defeat of a clearly identified candidate or ballot measure and that was not made with the consent of, in consultation with or at the request or suggestion of a candidate, agent or political committee of the candidate or measure. For example, you may make an independent expenditure by paying for a voter pamphlet argument or for an advertisement without the knowledge of a candidate or committee connected with a ballot measure.

If you make an independent expenditure of more than $50 to support or oppose a candidate, political committee or ballot measure, you must file a Statement of Independent Expenditures (PC 10) with the appropriate elections office.

The state does not regulate independent expenditures as heavily as it does those made by political committees. If you make an independent expenditure of more than $50 to support or oppose a candidate, political committee or ballot measure, you must file a Statement of Independent Expenditures (PC 10) with the appropriate elections office. If you report your expenditure as a contribution to a political committee and your contribution is reported by the committee, you do not have to report it again.

If you make an expenditure that you coordinate with a candidate or a political committee, your expenditure is not longer independent and will be treated as a *contribution* to that candidate or political committee. If you engage in more

than a few independent expenditures that support or oppose one candidate, party or ballot measure so that you have "taken up the cause," you may also move outside the classification of independent expenditure and may be classified as a political committee.

Political Committees

Nonprofits that solicit funds for political campaigns or that make more than a few expenditures for a campaign have a greater level of involvement in the political process and are subject to more state regulation. The law defines those groups with this greater level of involvement as political committees. Political committees consist of several types. Political party committees are committees for political parties. Measure committees are those that operate solely to support or oppose a single ballot measure. Most political committees are miscellaneous committees that support or oppose candidates, parties, recalls or multiple candidates and measures. Most measure committees and miscellaneous committees advance an advocacy agenda of a group and are known as political action committees (PACs). Our discussion here will focus on what nonprofit PACs need to know about Oregon's political campaign rules. Candidates and political party committees are subject to different rules and should consult the Secretary of State's *Campaign Finance Manual*. Your nonprofit may be classified as a political committee without your consent or by your choice.

Your nonprofit may be classified as a political committee even though you did not intend this result.

Involuntary Classification as a Political Committee

Your nonprofit may be classified as a political committee even though you did not intend this result. You will become a political committee under Oregon law if:

- you receive contributions or make expenditures (other than independent expenditures described above) for the purpose of supporting or opposing a ballot measure, candidate or political party; or

- you send out a mass mailing that supports or opposes a total of three or more candidates or ballot measures (these are called slate mailings).

In order to determine if you are a political committee, you need to know if your activities "support or oppose" candidates, parties or ballot measures. Ex-

plicit language that urges a voter to elect or vote against a candidate or measure clearly supports or opposes that candidate or ballot measure. However, your activities may support or oppose a candidate or ballot measure even if you do not use explicit language of support or opposition. You have engaged in express advocacy under Oregon law (unlike current federal law) if your message, taken in context, clearly urges the election or defeat of a candidate and seeks action rather than simply gives information. You should get legal advice if you are drafting messages that you don't want to be interpreted as an endorsement or opposition to a candidate or measure.

> *Example*: Clean Government runs an ad just before the election complaining about the corruption of union bosses with the words UNION BOSSES appearing in large print. CG runs the pictures of a dozen candidates with the words PUBLIC EMPLOYEE FINANCED stamped on each photo. CG doesn't explicitly urge its readers to vote against these candidates. It has nonetheless engaged in explicit advocacy, since the context of its message implies more than an argument on the issues about union corruption. By presenting candidate photos as it did, it has exhorted its readers to vote against them.

If you engage in any of these activities, your nonprofit becomes a political committee and will have to comply with the registration and reporting requirements of political committees described below. One significant consequence of being a political committee is that your complete list of contributors who gave more than $50 becomes a public record whether or not each donor's contribution was used for your political purposes. Other nonprofits can generally keep their list of contributors private.

Choosing to Form a Separate Political Committee

Many nonprofits that engage in electioneering do not want to be classified as a political committee because they do not want to disclose their donors and do not want to meet the reporting requirements for all of their operations. If your nonprofit wants to engage in supporting or opposing a ballot measure, candidate or party but does not want to be classified as a political committee, you can set up a separate political committee to handle your political activities. You organize a political committee by naming a treasurer and your directors and by registering with the state. All your contributions and expenditures to the committee go through your treasurer. Treasurers are personally liable if they fail to carry out the duties required by the law. The state can assess fines up to $10,0000 for each late or insufficient filing of contribution and expenditure reports, so you should exercise care in naming a treasurer. Anyone who directly and substantially participates in the decision-making concerning the

solicitation or expenditure of funds and the support or opposition to a candidate or ballot measure is a director and should be named. You must have at least one other director in addition to your treasurer.

> *Example*: Coalition for Responsible Taxation is a §501(c)(3) organization that seeks to educate the public about the Oregon tax system. The Coalition decides to support a ballot measure to improve Oregon's tax structure. Some of its contributors do not want the Coalition to set up a separate political committee to receive contributions and to make expenditures because the contributors wish to remain anonymous. In spite of their wishes, CRT must establish a separate political committee or the (c)(3) becomes a political committee, requiring disclosure of all its contributors over $50.

You must register your political committee within three business days of receiving your first contribution or making your first expenditure. The location for registration varies:

- If your political committee supports or opposes a candidate for *federal* office, check with the Secretary of State to see when you must register in Oregon. You must also file your campaign finance information with the Federal Elections Commission and follow the rules described above for federal electioneering.

- Political committees supporting or opposing candidates for *state* offices or statewide ballot measures register with the Secretary of State.

- If you are supporting or opposing *county or city* candidates or measures, you register with the county or city elections office.

In most cases, you must file periodic reports of your contributions and expenditures. In these reports, you must list the name, address and occupation of your donors who contribute more than $50. If you expect that neither your contributions nor expenditures will exceed $2,000, you can file a certificate to this effect instead of filing the periodic reports. You do need to keep track of your receipts and expenses and must report them if you exceed the $2,000 figure. You cannot receive contributions from anonymous donors or from foreign nationals nor can you accept contributions that you know to be in a false name.

The Oregon Secretary of State's *Campaign Finance Manual* (see page 608) explains the rules for and contains the forms to be filed by political committees.

Contributions to Political Committees

Federal campaign laws described above contain complex regulations to limit the size and source of contributions to the political committees of federal candidates and parties. Oregon law does not limit the amount of money that an individual, corporation, union or other entity can contribute to political committees, except that a political committee cannot accept anonymous contributions, contributions in a false name or contributions from foreign nationals. Oregon also does not restrict contributions by corporations or unions. Oregon does regulate the timing of contributions to election campaigns. You cannot make or promise to make a contribution to a legislative or statewide official or candidate, to a gubernatorial candidate or to the principal political committee of any of these persons from January 1 until adjournment during the year that the biennial legislative session meets nor during the period of any special session.

If you are exempt under §501(c)(3), you cannot engage in any of the activities described in this section and cannot contribute to PACs. The exception is for ballot measures, other than recall petitions.

Electioneering Conduct

In addition to registration and reporting requirements, Oregon law also restricts certain conduct related to elections and ballot measures. You cannot write, publish or place an advertisement that contains false statements relating to a candidate, political committee or ballot measure. If you assist in circulating petitions for a ballot measure, you cannot obtain signatures by lying about the contents or the effect of the petition. You also cannot knowingly accept false or unqualified signatures and you cannot of course pay people to sign a petition or threaten them to get them to sign.

(c)(3) Organizations

Generally, if you are exempt under §501(c)(3), you cannot engage in any of the activities described in this section and cannot contribute to PACs. The exception is for ballot measures, other than recall petitions. Oregon's use of political campaign laws to cover ballot measures creates an exception to these rules because ballot measures are legislative in nature and are therefore treated by the IRS as lobbying, not political activity. (See Chapter 8.) One important consequence of the inclusion of ballot measures as part of Oregon's political campaign laws is that organizations exempt under §501(c)(3) may be involved in supporting or opposing a ballot measure. (c)(3)s may contribute to political committees whose only function is to support or oppose ballot measures and whose funds can never be used for other purposes as long as the (c)(3) does not

exceed its lobbying limits described in Chapter 8. (c)(3)s cannot contribute to political committees that support or oppose candidates or parties. (See Chapter 8.) Oregon's definition of political activity is different than the definition under federal election laws in this chapter, since we don't have federal ballot measures.

OREGON LOBBYING RULES

The Oregon lobbying law is a *disclosure* statute with registration and reporting requirements and a *regulatory* law restraining the conduct of lobbyists. The definition of who is a lobbyist and the registration and reporting requirements in Oregon are different from the federal lobbying rules. Under Oregon law, a lobbyist is a person who, for compensation or as a representative of a group, attempts to influence legislative action by communicating with a legislator, by encouraging others to communicate with a legislator or by attempting to obtain the good will of a legislator. Unlike the federal lobbying law, lobbyists can be volunteers who lobby as a representative of your group as well as your paid employees.

Under Oregon law, a lobbyist is a person who, for compensation or as a representative of a group, attempts to influence legislative action by communicating with a legislator, by encouraging others to communicate with a legislator or by attempting to obtain the good will of a legislator.

The Oregon definition of lobbying is quite broad. Lobbying covers direct and indirect contacts with legislators as well as attempts to obtain good will. Unlike the federal lobbying law, Oregon's lobbying statute applies only to lobbying the legislature and does not include lobbying administrative agencies. Unlike IRS law for (c)(3) organizations (discussed in Chapter 8), ballot measures are not considered legislative action. However, advocating for ballot measures may subject you to Oregon's political campaign rules discussed above.

The law requires most lobbyists to register with the Oregon Government Standards and Practices Commission. Your lobbyist is not required to register if he or she:

- receives no compensation or reimbursement of expenses for lobbying, limits her or his lobbying activities to testifying before public committee sessions in the legislature or public hearings of state agencies, *and* registers in the records of those committees or agencies;

• does not spend more than 24 hours nor more than $100 lobbying during the calendar quarter, *or*

• is already registered as a lobbyist and engages in lobbying for your organization without compensation and without spending more than 24 hours nor more than $100 lobbying during the calendar quarter.

Lobbyists can be volunteers who lobby as a representative of your group as well as your paid employees.

If your lobbyist must register, she or he must do so within three days after spending more than 24 hours or more than $100 lobbying during any calendar quarter. All lobbyists who must register must report on their lobbying expenditures to the Oregon Government Standards and Practices Commission. You can obtain registration and reporting forms from the Commission at the address in Appendix 2. Your statement will be a public record.

In addition to registration and disclosure regulations, the Oregon lobbying law prohibits certain lobbying conduct. Your lobbyist cannot attempt to influence a legislator's vote by promising financial support for the legislator's candidacy or by threatening to finance the legislator's opponent. You cannot pay your lobbyist based on whether or not the lobbyist is successful. Your lobbyist cannot make false statements to legislative or executive officials or supply them with documents that the lobbyist knows are false.

USE OF FEDERAL FUNDS FOR POLITICAL AND LOBBYING ACTIVITIES

The federal government has put several restrictions on the use of federal funds for lobbying and political activities at the federal, state and local levels. The restrictions vary, depending on what kinds of funds you receive, what activities you pursue and whether you are exempt under §501(c)(4). If you receive any monies from the federal government pursuant to a federal *contract, grant, loan or cooperative agreement*, you cannot use those funds to lobby *federal* legislative or administrative officials covered by the Lobbying Disclosure Act. (See pages 604-605 for more discussion of this Act.)

Most nonprofits, except for colleges and universities, also cannot use federal funds from *grants, cooperative agreements and certain cost contracts* to lobby *federal or state* legislators either directly or by urging the public to get involved (including organizing demonstrations, marches and rallies). You are also re-

stricted from using these monies for certain kinds of legislative liaison efforts. You can lobby *local* officials without restrictions. These nonprofits are also prohibited from using these federal monies to attempt to influence *federal, state and local elections* or to contribute to political committees. You may use most federal *awards* and other non-federal monies to engage in your lobbying and political activities.

Most nonprofits, except for colleges and universities, cannot use federal funds from grants, cooperative agreements and certain cost contracts to lobby federal or state legislators either directly or by urging the public to get involved (including by organizing demonstrations, marches and rallies).

If you are tax-exempt under §501(c)(4), you are subject to the above restrictions as well as some additional ones. If you receive *awards, grants or loans* from the federal government, you cannot do any *federal* lobbying as that term is defined in the Lobbying Disclosure Act with *any* of your funds, *even those you obtained from other sources*. This prohibition for (c)(4)s does not apply if the money you received from the federal government was part of a federal *contract*. If your (c)(4) received an *award or loan*, you can use this money for *state and local* lobbying if this activity is otherwise permissible under the terms of your award or loan. *Grants* are subject to the restrictions described above that forbid lobbying *state* legislators either directly or by urging public involvement and forbid engaging in legislative liaison efforts. You can use grants for local lobbying.

Although the government's rules distinguish between the types of funding you receive and what activities you can pursue, the federal government in practice sometimes fails to make the distinctions and enforces the lobbying bans more broadly than its rules require. If you receive federal monies and plan to engage in lobbying or political activities, get legal advice.

POLITICAL EXPENDITURE TAX

The IRS grants tax exemption under §527 of the Internal Revenue Code to political committees (political parties and PACs) that are organized primarily for the purpose of collecting contributions and making expenditures to influence the election or appointment of individuals for federal, state or local public office. These purposes are called their exempt function. Groups exempt under §527 are subject to considerable public disclosure about their contributors and finances. (See Appendix 8 for a discussion of §527 groups.) Some organizations that are exempt under §501(c) may also attempt to influence the election or appointment of individuals to federal, state or local office. These organizations are not §527 organization because their political activities are not their primary

purpose. But they are engaging in a function (political activity) that is the same as the exempt function for §527 groups.

The IRS imposes a tax (called a political expenditure tax or exempt functions expenditure tax) on groups that engage in §527-type political activity. The tax is an effort to discourage an end-run around the §527 disclosure rules. §501(c) organizations can make a choice about how they handle their political activities. The §501(c) organization can use its own general funds for its §527 political activities or it can establish a separate, segregated fund under §527. If it uses its funds from its general account, the §501(c) group does not have to comply with the notice and reporting requirements of §527 but it has to pay a tax on the lesser of its investment income or the amount of the exempt function expenditure. If it establishes a separate segregated fund, that fund in most cases must give notice and report on its contributions and expenditures but avoids the tax. Although it is rare that organizations exempt under §501(c)(3) would be concerned with this tax (because they should not be electioneering at all), you do need to be concerned with this tax if your (c)(3) attempts to influence the *appointment* of individuals to a public office.

When is an expenditure for a political activity by a §501(c) organization subject to the political expenditure tax? The only activity that counts as political activity is an attempt to influence the election or appointment of individuals to public office. The obvious case is when you *expressly advocate* for or against the election or appointment of an individual to public office. The IRS lists other factors that may show that an advocacy communication is for a taxable political activity even though you do not explicitly endorse or oppose a candidate. These factors include the identification of a candidate for public office, publication during an electoral campaign, targeting voters in a particular district, identification of the candidate's position on a policy issue, distinguishing the candidate's position from that of other candidates and the lack of an ongoing series of such communications by the organization.

> *Example*: Tobacco Free America, a (c)(4) organization, advocates for smoke-free workplaces. A month before the Senate elections, TFA published a full page ad in the largest newspaper in Senator Jones' district stating the Senator Jones, up for reelection, had voted consistently in favor of tobacco interests and had opposed efforts to create smoke-free workplaces. The ad ended with the statement "Let Senator Jones know how you feel about smoke-free workplaces." This was the first time that TFA had run an ad. TFA's ad is probably for taxable political activity and TFA will have to pay the political expenditure tax even though TFA did not expressly urge voters to vote against Senator Jones.

It is easy to confuse the rules that trigger the political expenditure tax with federal and state rules about express and issue advocacy under the election laws. Express and issue advocacy rules arise under the federal election laws and are enforced by the Federal Election Commission for federal candidates. Express advocacy rules that are more broadly defined also arise under Oregon election law and are enforced by the Elections Division of the Secretary of State's office for federal, state and local candidates. The political expenditure tax is part of the Internal Revenue Code and is enforced by the Internal Revenue Service for federal, state and local candidates. All three agencies have rules that apply if you *expressly endorse or oppose* a candidate (and you fall within their jurisdiction). But the rules about less clearcut advocacy are different for each agency. You need to carefully think through which agencies are regulating you and how your expenditures will be classified under their rules.

Consult Appendix 1 if you would like information about source material related to this Chapter. Appendix 1 has references of interest to all readers, not just professionals.

Chapter 27 describes other record-keeping, reporting and legal requirements applicable to all nonprofit corporations.

27 RECORDKEEPING, REGISTRATION, AND RULES

Books and records of various kinds are the backbone of nonprofit corporations. A nonprofit corporation is itself a legal entity. It is created by means of a record called "Articles of Incorporation." It is run in accordance with rules set out in a record called "Bylaws." Its financial life occurs largely on paper in the form of books: checkbooks, ledgers, journals, etc. In spite of the obvious importance of books and records to an artificial entity like a nonprofit corporation, there is very little material that guides a nonprofit corporation about how to handle some basic questions about recordkeeping. What books and records must your nonprofit corporation keep? How long do you need to keep them? Who can see them?

Your existence as a corporation and sometimes the activities that you engage in require that you comply with various registration laws and other rules. The consequences of failing to do so range from the annoying to the disastrous: you may have to pay a fine, you may lose your corporate or even your tax-exempt status, or you may end up in jail.

THIS CHAPTER COVERS

- **Books and Records**
- **Reports and Registrations**
- **Notices**
- **Releases**
- **Terrorism Laws**
- **Tax-Exempt Groups: Operational Rules**

BOOKS AND RECORDS

What Books and Records Should You Keep?

You need to keep those books and records that will facilitate your operations and allow you to comply with a variety of laws. This will vary from organization to organization. We list the books and records most nonprofits will need. Some of these may not apply to your group.

Books: Financial Records

- Board-approved annual budget
- Financial statements
- If you have audited financial statements, keep all of them
- Bank statements for all accounts
- Chart of Accounts
- Cash Receipts and Disbursements Journal
- General Ledger
- Payroll timecards, record and reports
- Forms 990 and CT-12
- Personnel records
- Account payable invoices and cash payment vouchers
- Inventory schedules
- Accounts receivable detailed records
- Restricted donations and endowment use (sufficient information to determine historic dollar value)

Records

- Articles of Incorporation and amendments
- Bylaws and amendments
- Department of Justice registration
- IRS exemption application, attachments, and all correspondence with the IRS about the application
- IRS exemption letter
- Resolutions of Board
- Minutes of Board, committee, and membership meetings
- Other records of Board, committee, and membership actions
- Written communications required to be made by Oregon law and those regarding general membership matters made to members

- List of the names and business or home addresses of your Directors and officers
- Annual reports delivered to Secretary of State
- Membership list with name, address, and membership date of each member in alphabetical order by class showing the number of votes each member has
- All documentation showing proper handling of conflicts of interest
- All documentation showing proper handling of suspicious circumstances
- All documentation on any matter that may become a subject of a lawsuit or claim
- Employee related matters – payroll records discussed in Chapter 24 and employee tax records
- Contracts, leases, property, insurance documentation
- All significant operational policies – e.g., personnel policies
- Client files

How Long Should You Keep Them?

Your attorney, accountant, and archivist would probably be happiest if you simply kept all your books and records forever. However, most groups don't have the space for this. We have compiled this list to help you keep documents for as long as they are reasonably likely to be needed.

Permanently

- Articles of Incorporation and Amendments and Bylaws
- IRS exemption documents
- Resolutions of Board
- Minutes of Board, committee, and membership meetings
- Other records of Board, committee, and membership actions
- Financial statements and general ledgers
- Real estate documents
- Audited financial statements

At Least Ten Years

- All documentation showing proper handling of conflicts of interest
- All documentation showing proper handling of suspicious circumstances
- Insurance information

- All documentation on any matter that may become a subject of a lawsuit or claim (including contracts, leases, etc.)
- Cancelled checks
- Client files (you should check with any applicable governmental agencies on these)

At Least Seven Years

- Bank statements and canceled checks
- Chart of Accounts
- Cash Receipts and Disbursements Journal
- Payroll timecards, records, and reports and personnel records
- Forms 990 and CT 12 and all tax records
- Accounts payable invoices and cash payment vouchers
- Inventory schedules
- Accounts receivables detailed records
- Government reports

At Least Three Years

- Written communications required to be made by Oregon law and those regarding general membership matters made to members within the past three years

Other Periods

For books and records not mentioned above, consider carefully the purpose of the book or record and how it might be useful to you in the future. Such future uses might include financial documentation, evidence in a lawsuit, archives about your organization, etc. You are balancing possible future need against the expense and inefficiency of maintaining records you don't need. It is generally wise to err on the side of keeping rather than throwing away.

Who Can See or Copy Your Books and Records

Oregon law is not entirely clear on who can inspect and copy your records and books.

Members

Oregon has extensive rules about records that must be made available for inspection and copying by members. See pages 331-333.

Nonmembers' Rights to Inspect and Copy Books and Records

Directors

Directors should have access to all records necessary to carry out their Board functions. Probably the only circumstance in which a Director could be denied access to records would be if the Director wanted them for an improper purpose.

Staff members

Staff members should have access to all records necessary to carry out their jobs. As employees, staff members are entitled to see their personnel records (see page 351).

General public

The Oregon statute is somewhat unclear as to what access the general public has to the records of an Oregon nonprofit corporation. It is quite likely that there is no right to access, except for the tax-exempt and public benefit corporations described below. If your organization has sufficient government connections, it is possible you may be subject to the federal Freedom of Information Act or public records laws of the state of Oregon. See Appendix 4 for information about nonprofits that may be subject to Oregon's public records laws.

Tax-Exempt Organizations

If your nonprofit is a tax-exempt organization, the public can inspect your tax-exempt application, its supporting documentation (which includes your Articles and Bylaws, at least as of the time of filing) and your correspondence with the IRS about your application. The public can also inspect documents or letters issued by the IRS relating to your approved application. Your annual return (usually, Form 990) is also subject to public inspection. However, the following information can be withheld: the names and addresses of contributors to tax-exempts, other than private foundations, and the amount of that contributor's contribution, if it could reasonably be expected to identify the contributor; and the names, addresses, and amounts of contributions from persons who are not U.S. citizens made to a foreign organization. This is discussed in more detail on pages 630-632.

Public Benefit Corporations

If your nonprofit is a public benefit corporation, you are required to register with the state Attorney General. That registration includes some information

about what you do, a financial statement if one is available, and a copy of your Articles and Bylaws. (See page 44). That information is a public record.

Open Records Laws

Public bodies in Oregon must make their public records open for inspection by everyone, with certain exceptions. The issue for Oregon nonprofit corporations is "Are nonprofit corporations public bodies?" In most cases, the answer is "no." However, if your group exercises significant governmental functions, you may be subject to the Open Records Law (Public Records Law). We have included a more detailed discussion of this in Appendix 4.

What Records Can and Must Be Protected

It is beyond the scope of this book to describe all the rules concerning confidentiality and recordkeeping. To a large degree, this will vary from organization to organization. If you have the following kinds of records, your organization should become familiar with all applicable rules about confidentiality and disclosure and take steps to safeguard the confidentiality of the records:

- Personnel and employee medical records (see page 351);
- Confidential client records, such as medical, mental health, or legal files;
- Records pertaining to HIV status;
- Criminal records;
- Trade secrets.

REPORTS AND REGISTRATIONS

Your nonprofit is responsible for submitting certain reports and registration renewals on an annual basis in addition to the tax reporting discussed in Chapter 12. In many cases the agency to which you submit the report will send you an annual notice. However, you must submit the reports or registrations even if you do not receive a notice.

Secretary of State (Corporation Commissioner)

Every year your corporation must submit an annual report to the Secretary of State (Corporation Commissioner's office). The Secretary of State will mail a form to the address that they have for the corporation. You need to fill out the form and mail it back along with a fee. If they fail to send it to you, it is your obligation to obtain a copy and deliver it to them in a timely fashion. If the

annual report is not completely and properly filled out, the Secretary of State will notify you in writing and return the report for correction. You have 45 days to correct the errors.

If the corporation fails to file the annual report or fails to make the necessary corrections within 45 days, the Secretary of State will administratively dissolve the corporation. This has serious repercussions for your organization and potentially for the Board members. (See Chapter 30 for what this means and what you must do if this happens to you.) Because your failure to file an annual report can trigger the dissolution of your corporation, it is extremely important that you check to ensure that your annual report is filed each year. Consider linking this task with another annual event, such as the filing of your tax forms. You can check whether the report was filed by going to the Secretary of State's website at *www.egov.sos.state.or.us/br/pkg_web_name_srch_inq.login*. If your Entity Status is "ACT," then your corporation is current in its filings. If it is "INA," then you need to check the detailed listing on the website to see why you are listed as "inactive."

Because your failure to file an annual report can trigger the dissolution of your corporation, it is extremely important that you check to ensure that your annual report is filed each year.

If information provided in the annual report changes before you file your next annual report and the change does not require an amendment to the Articles of Incorporation, you are required to file an amendment to the annual report with the Secretary of State. The amendment must state the name of the corporation and the information that is changed. An example of such a change would be a change in the President or Secretary of the corporation or a change in your federal employer ID number.

Department of Justice (Attorney General)

If you are a Public Benefit Corporation and incorporated after October 3, 1989, you should have registered with the Attorney General at the Department of Justice (see page 44). If you were incorporated before that date and meet the definition of Public Benefit Corporation (see Chapter 2), you should register with the Department of Justice. You may already have done so. If you have registered the Department will send you an annual reporting form. If they fail to send it, you must contact them to get it and file it. They do charge a fairly small fee each year, based on the amount of your receipts. You may also need to register with the Department of Justice if you conduct charitable solicitations.

Other State and Local Licenses and Filings

If your nonprofit engages in activities in another state, you will probably need to register to do business in that state. You will need to consult the laws of that state to see what the threshold is for registration. You should check with the local governments in Oregon (or elsewhere) where you are located to see if there are any additional licenses that you need. If you operate any type of business, it is likely that you will need a business license. (See Chapter 11 for a discussion of exemptions from licensing for nonprofits.) If your operations invoke any sort of state licensing requirements – for example, nursing homes, child care centers, adoption agencies – you will need to comply with those as well.

NOTICES

In a variety of circumstances, your corporation must give or be given notices. The following (admittedly boring) rules apply to notices that the Oregon law requires that you give or be given.

Oregon law is unclear about whether you may use email, list-serves, websites or other electronic methods to give notice.

Notice may be verbal or written (unless otherwise specified for a particular kind of notice). Notice may be communicated in person, by telephone, telegraph, teletype or other form of wire or wireless communication, or by mail or private carrier, including publication in a newspaper or similar document mailed to a member's or Director's address. If these forms of personal notice are impractical, notice may be communicated by a newspaper of general circulation in the area where the meeting is to be held or by radio, television or other form of public broadcast communication.

Oregon law is unclear about whether you may use email, list-serves, websites or other electronic methods to give notice. Until the law is clarified, you take a risk that you have not provided proper notice if you use these venues for notice. If you use an electronic method, you can eliminate your risk if you have *everyone who is entitled to notice* sign a waiver of notice whether or not they attend the meeting for which the notice is issued. The Forms section in the back of the book includes sample forms entitled Waiver of Notice of Meeting of Directors and Waiver of Notice of Meeting of Members. Obviously, in many cases, especially with respect to membership meetings, this will not be practical. If you cannot get signed Waivers from everyone, you can further minimize your risk if you have everyone who is notified by electronic means sign a con-

sent to this method of notice. The individual should include their e-mail address in the consent and agree to notify you if their address changes. You should send your notice in a manner that does not inhibit the ability of the recipient to print or to store it. If you get a notice that an e-mail is undeliverable, you should send notice to that individual using one of the clearly permissible methods.

Verbal notice is effective when it is communicated if it is communicated in a comprehensible manner. Written notice given by a corporation *to its members*, if comprehensible, is effective when it is mailed, if it is mailed postage paid and it is correctly addressed to the member's address shown in the corporation's current records. Other personal written notice, if comprehensible, is effective at the earliest of the following:

- When received;

- Five days after its postmark, if mailed by the United States mail, if correctly addressed and with first class postage affixed;

- On the date shown on the return receipt, if sent by registered or certified mail, return receipt requested, and the receipt is signed by or on behalf of the addressee;

- Thirty days after its deposit in the United States mail if mailed correctly addressed and with other than first class, registered, or certified postage affixed; or

- The date specified by the Articles or Bylaws with respect to notice to Directors.

Written notice is correctly addressed to a member of your corporation if addressed to the member's address shown in the corporation's current list of members. A written notice or report delivered as part of a newsletter, magazine or other publication sent to members will constitute a written notice or report if addressed or delivered to the member's address shown in the corporation's current list of members, (or in the case of members who are residents of the same household and who have the same address in the corporation's current list of members, if addressed or delivered to one of them, at the address appearing on the current list of members). Written notice is correctly addressed to another corporation (other than in its capacity as a member of your corporation) if addressed to its registered agent or, if it has none, to its principal office shown in its most recent annual report or, if none, in the Articles of Incorporation or its application for authority to do business.

In some cases (such as in giving notice of meetings to members – see page 321), the law provides different notice requirements than above.

RELEASES

Your organization can get written releases from the people you serve or deal with in which those people agree not to sue you or your agents, employees, and volunteers in the event that an injury occurs. These releases are often not upheld by the courts, particularly if the activity involved is an essential service or a dangerous activity or it the release is signed by someone who is a member of a vulnerable population. However, in some cases, they are upheld.

> *Example*: Your nonprofit community center operates a program that teaches adults how to swim. You require each adult to sign a release in which she or he releases you from all liability for injuries to her or him that occur in connection with the swimming lessons. One of the adults drowns during a lesson and his family sues your nonprofit for damages. In a very similar case, the Oregon appellate court upheld the release.

In the Forms section, you will find a very simple "Complete Release" that you might include as part of an application for services or other document. The Forms section also includes a much more thorough "Complete Release and Hold Harmless Agreement by Client" that is drafted for the situation in which you provide services for a reduced fee to your client. There are many possibilities in between. Your choices about whether to have a release and how thorough you should make it will be governed by many other considerations in addition to legal ones: you will want to assess how much risk you have, whether you are covered by insurance, how offensive the release will be to your clients or those you serve, how likely it is that the release will be enforced, etc. You should have any release you draft checked by an attorney.

TERRORISM LAWS

After the September 11, 2001 terrorist attacks, the federal government responded with new laws and amendments to existing laws designed to prevent terrorism. These laws apply to nonprofits as well as to individuals and businesses. Although nonprofits who are grant-makers or who work internationally are most affected by these laws, many of them apply to other nonprofits as well. You may be aiding a suspected domestic or international terrorist if you supply financial assistance, technical assistance, in-kind support, or humanitarian aid. The laws apply to domestic nonprofits as well as those who make grants or provide aid abroad. Perhaps most difficult to swallow is

that, in some cases, the government can apply sanctions to your nonprofit even though you did not realize you were assisting suspected terrorists.

In many cases, the laws are very vague and open to numerous interpretations. The various laws are worded somewhat differently and so may not impact all nonprofits in the same way. Although you may feel sure that you don't deal with terrorists, your conviction (even if correct) does not shield you from paying attention to this area of law. The terrorism laws are quite complex and are just beginning to be interpreted by the courts. We can't give you a detailed picture here but we alert you to what kinds of actions constitute aid to suspected terrorists and to the major consequences of aiding a suspected terrorist or terrorist organization. We discuss your alternatives and direct you to some of the government websites that list suspected terrorists. If you need help in this area, you should consult a knowledgable attorney.

Actions that Aid Suspected Terrorists

Your nonprofit does not have to supply guns or money in order to aid suspected terrorists under current law. Although each law is different, generally if you offer grants, financial assistance, technical assistance, in-kind support, or humanitarian aid to suspected terrorists or terrorist organizations, you have aided terrorists. More troubling, some of the laws are written broadly enough to include an American organization that gives money to a foreign non-governmental organization that then provides humanitarian aid to a suspected terrorist.

Sanctions for Aiding Suspected Terrorists

Your nonprofit faces four major types of penalties if you aid suspected terrorists: the federal government can freeze your assets without a hearing, the government can impose criminal penalties (fines and imprisonment) on your organization and its responsible individuals, private parties may bring a civil suit against those who support terrorism and the IRS may revoke your tax-exempt status.

Freezing Your Assets

Executive Order 13224 issued by President Bush shortly after the September 11 attacks prohibits all U.S. persons, including nonprofits, from engaging in transactions with individuals and organizations suspected of being terrorists. The Order is so broad in scope that it can cover people and groups not on any government list. If the government believes that your organization has violated this Order, *whether or not you know it*, it can freeze your assets even as it investi-

gates. The government has frozen the assets of at least four U.S. charities, including one in Ashland, Oregon.

You have to make your own assessment of how vulnerable you might be to aiding terrorists, how risk averse you are, how extensive an investigation will be required for your group and how much money and resources you can devote to this issue. Organizations that conduct foreign operations, particularly grant-making, are at the greatest risk.

Criminal Penalties

The Patriot Act and subsequent legislation contains criminal sanctions against any entity that provides material support, resources or financing knowing or intending that this support will be used in terrorist acts or by foreign terrorist organizations. Since suspected terrorists may live in the United States, the Act applies to domestic nonprofits although nonprofits engaged in international work have the greatest potential liability.

The law has long contained a variety of trade sanctions and embargoes that restrict activities by nonprofits with particular foreign countries. The Treasury Department and the Commerce Department administer these embargoes. The restrictions usually apply to nonprofits, even to those providing humanitarian aid. Violators are subject to criminal and civil penalties.

Civil Lawsuits

The Patriot Act authorizes private parties to bring civil lawsuits against those who materially support terrorism. Since September 11, victims of terrorist attacks have brought civil suits against a variety of foundations and nonprofits linked to Al Qaeda, including at least two United States foundations.

Revocation of Tax-Exempt Status

The Internal Revenue Code has always provided for revocation of tax-exempt status for an organization that failed to operate for exempt purposes. Using assets to support terrorism will obviously subject an exempt organization to revocation. In 2003, Congress amended the Code to suspend the tax-exempt status of an organization that is designated by other governmental agencies as a terrorist organization. The suspension occurs automatically and, most troubling for innocent donors, is retroactive to the date that the government first published the name of the organization on one of its lists of suspected terrorists.

Treasury Department's Voluntary Guidelines

The Treasury Department in 2002 issued voluntary guidelines to assist nonprofits to comply with Executive Order 13224 and the Patriot Act. These are truly guidelines. They are not required by law and compliance with them does not assure your nonprofit that you have not violated the law. The guidelines suggest that nonprofits with international operations exercise extensive efforts to check out not only individuals and nongovernmental organizations to whom they make grants and with whom they partner but also that they investigate foreign financial institutions and vendors with whom they deal. Many in the nonprofit sector are concerned by these expensive and difficult procedures.

What Should You Do?

You have to make your own assessment of how vulnerable you might be to aiding terrorists, how risk averse you are, how extensive an investigation will be required for your group and how much money and resources you can devote to this issue. Organizations that conduct foreign operations, particularly grant-making, are at the greatest risk. The larger the number of gifts you make, the greater your risk and the greater your expense in investigating the risk. You should consider several strategies to reduce your risk:

- Investigate your grantees. Make regular visits to their programs and make efforts to obtain information about them from reliable local sources, including churches, business connections, nongovernmental organizations and governmental officials.

- Consult the various government-generated lists of suspected terrorists listed below. As you will see when you view the lists, the search can be quite daunting, particularly using the OFAC list. Because the government can place individuals on the lists without any kind of hearing, it is quite likely that there are innocent people on the lists. In addition, many individuals have the same name and organizations using the lists obtain a significant number of false positives. These lists change frequently and may contain names spelled differently than those being checked by your nonprofit. The lists also contain names that are very difficult to eliminate. For example, if you want to search for someone named Ahmed, you will encounter listings for Ahmed the Egyptian and Ahmed the Tall, among others. Some commercial firms have established list-check businesses.

• Include anti-terrorism language in your grant agreements. If you are particularly vulnerable to aiding terrorists, you might include anti-terrorism language in your bylaws.

• Require, where feasible, a translated copy of the governing documents of your foreign grantee organizations and a translated copy of their foreign charity status. Review them to see if they raise any red flags.

• Direct your giving through another (c)(3) public charity that does extensive due diligence compliance.

• Document carefully all the efforts you make to comply with the Terrorism Laws. Include in your documentation the list searches that you do and other background checks you conduct, even if they are informal inquiries.

Government Lists of Suspected Terrorists

Here are the major lists of terrorists available as we go to press:

• Treasury Department's Office of Foreign Assets Control (OFAC) maintains the Specially Designated Nationals (SDN) list at *http://www.ustreas.gov/offices/enforcement/ofac/sdn/t11sdn.pdf*, or go to the Treasury Department's website and search for "Specially Designated Nationals."

• Department of Justice provides a Fact Sheet with links to the latest version of the State Department's Terrorist Exclusion List and Foreign Terrorist Organizations at *http://www.state.gov/s/ct/rls/fs/* or go to the State Department's website and search for "Terrorist Exclusion List" and "Foreign Terrorist Organizations."

• United Nations list at *http://www.un.org/Docs/sc/committees/1267/pdflist.pdf*, or go to the United Nations website.

TAX-EXEMPT GROUPS: OPERATIONAL RULES

If you have been recognized as tax-exempt under §501(c), you must also comply with certain federal requirements concerning your records and your procedures in addition to the on-going legal requirements described above that you must meet as a nonprofit corporation.

Public Inspection and Copying of Papers

You must make certain of your public records available for inspection and copying.

What Can be Inspected and Copied

Application

You must make available for public inspection a copy of your application for exemption (Form 1023), all papers submitted in support of the application and any determination letter or other document the IRS issued on the application. These requirements apply to organizations whose applications were submitted to the IRS after July 15, 1987 or before that date if the organization had a copy of the application on July 15, 1987. If your application contains trade secrets or other apparatus you want withheld from the public, you can request written permission from the IRS to withhold it. You can withhold the names and addresses of your contributors unless you are a private foundation or a political action committee. Failure to comply with these requirements will subject you to penalties, unless you can show reasonable cause for noncompliance.

Annual Information Return

You must make available for public inspection a copy of each annual information return (Form 990 for most groups and certain additional forms for trusts and pooled-income funds), for the most recent annual returns. You do not have to disclose the names or addresses of contributors unless you are a private foundation or political action committee. You do not have to allow inspection of Form 990-T (Exempt Organization Business Income Tax Return), relating to unrelated business income, Form 1120-POL (the U.S. Income Tax Return for Certain Political Organizations), Schedule A of Form 990-BL or Schedule K-1 of Form 1065. If you are a subordinate organization that receives a request for inspection, you must acquire a copy of the material from your parent organization and make it available within a reasonable time.

To avoid disclosing the names of your contributors and your 990-T, set up a special disclosure file that contains only the forms that you must disclose. Be sure your staff is instructed to respond to disclosure requests using this file and not the corporate master file. You can avoid this problem by using a website posting as described below.

Inspection Rules

You may have an employee present during inspection. The requestor can take notes or can request copies. These documents must be available for inspection during regular business hours at your principal office. If you maintain regional or district offices with paid employees who work an aggregate of 120 hours per week, these documents must also be available at those offices. However, if the only services provided at your regional or district offices are those that further your exempt purposes and you do not have management staff at those offices, other than managers involved in managing your exempt activities, you do not have to make documents available at those offices. Although you may post your documents on a website, this does not satisfy the requirement that you make them available for inspection. If someone wants to personally inspect them, you must do so as described above.

Copying Rules

You must also provide copies of the documents that are available for inspection upon request. If someone makes the request for copies in person, you must supply them that day. If the request places an unreasonable burden on your organization, provide them as soon as you can but no later than five business days after the request is made. If you receive a request in writing, by fax, by private delivery or by email for copies, you have 30 days from the date received to fill it. If you require payment in advance for the copies, you have 30 days from the time you received payment. Contact the IRS for the current fee list for what you can charge for copies.

In lieu of providing copies, you can make your documents widely available by posting them on your own website or as part of a database that provides the required information for a number of tax-exempt organizations. The IRS currently supplies Form 990 information for public inspection at *www.guidestar.org*. The Internet posting must allow the user to download your information at no cost and to view and print it in a manner which exactly reproduces the IRS document. Your Internet posting can't require the use of special hardware or software unless the software is readily available to the public free of charge. One format that meets this criteria is Portable Document Format (.pdf). And if you choose the Internet approach, you must tell those who request your information where it can be found on the Internet.

Rules on Solicitations and Dues

Some groups who are exempt under any section other than §501 (c)(3) must include certain language when they solicit charitable contributions. See pages 496-497. Some groups exempt under §501(c)(4), (5) and (6) that

engage in lobbying must either notify their members about what portion of their dues are deductible or pay a tax. This is discussed on page 200.

Donee Information Returns

If your organization receives donations or sells goods or services in which part of the payment the donor pays more than the product or service is worth as a partial contribution, see page 512. If your group receives property (other than cash or checks) that is donated to you and the donor is eligible to take a charitable deduction on it, there are special rules you must follow. You should talk to your accountant or attorney, particularly if you are dealing with items like donated cars or art.

Changes in Activities

Tax-exempt organizations are required to notify the IRS if they change their purposes or activities in ways that might affect their tax exempt status. If you contact the IRS *before* you make the change in order to get assurances from the IRS that the change is acceptable, the IRS will require that you request a private letter ruling. This is an expensive process and you will need professional help. If you make the change and then contact the IRS to notify them of the change, the IRS may respond with questions but does not assess a new fee. Be sure if you take this route that your change does not affect your tax exemption. If there is some doubt, notify the IRS immediately after the change and be prepared to make adjustments if the IRS insists. You can reach the IRS at the address for this purpose listed in Appendix 2. Another option is to notify the IRS about the change in response to a question about this on your Form 990, if you file one. (See Chapter 12.)

Group Exemptions

If you are a central organization that has a group exemption for your subordinates (see page 118), you must file the following information 90 days before the close of your annual accounting period:

1. List any changes by your subordinates that affect their purpose, character, or methods of operation.

2. Lists subordinates that have changed their names or addresses during the year, that no longer should be included in the group exemption or that should be added to the group exemption. You must submit a separate list for each of these categories. Each list must include the name, mailing and actual address of the new subordinate and the employer identification number for the subordinate. If

you did not add subordinates, you must make a statement to that effect.

3. For subordinates that are being added, you must include the information that was required when you submitted your original application. If the information in the original application describes the new subordinates in all important ways, you can make a statement to that effect instead of repeating the information.

Special Requirements for Schools

If you received recognition under §501(c)(3) as a school, you must do the following to keep your status:

• Your authorized official must certify annually that you are following racially nondiscriminatory policies.

• You must publish an annual notice in the newspaper advertising your non-discriminatory policy during the period in which you solicit for students or, if the school does not solicit, during registration. Check the IRS Publication 557 for details.

• You must keep records for three years after getting your exemption showing the racial composition of your student body, faculty, and staff, of the financial assistance awarded to students, of all published materials relating to students admissions, programs, and scholarships, and of all materials used to solicit contributions on behalf of the school.

Excess Benefits Transactions

If you are exempt as a public charity under §501(c)(3) or you are exempt under §501(c)(4), the IRS scrutinizes transactions with your insiders (called "disqualified persons") to make sure that your corporation is not providing unfair benefits to these people. Much of the scrutiny is around salaries but the regulations also include any property transaction with a disqualified person. If you engage in an excess benefits transaction, your organization is not fined although the IRS could revoke the tax exemption of a group that seriously violated the law. Instead, the statute imposes a heavy tax on the disqualified persons and on any organization manager (including Board members) who participated in the excess benefit transaction, knowing that it was such a transaction. The IRS currently places a priority on monitoring these transactions.

Many exempt organizations have overlooked these regulations, believing that they do not pay anyone enough money to fall under the regulations or that the use of comparability studies for their top executives satisfies the requirements of the regulations. Both assumptions are false. The sanctions for engaging in excess benefits transactions may be assessed on Board members and insiders in smaller organizations and in organizations that perform comparability studies. In order to protect your personnel against excess benefit sanctions (sometimes called intermediate sanctions), you should identify disqualified persons. You next need to identify what transactions are subject to the rules. Your goal is to act *in advance* of a transaction with a disqualified person to take advantage of IRS rules that create an assumption that your transaction is reasonable.

Your goal is to act ***in advance*** *of a transaction with a disqualified person to take advantage of IRS rules that create an assumption that your transaction is reasonable.*

Identify Disqualified Persons

Every organization has disqualified persons. Your board needs to identify disqualified persons so that it can act properly in relationship to them and, if the board plans to engage in a transaction with a disqualified person, to notify that person so that that person can take action on their own behalf to avoid sanctions. An individual may be a disqualified person by virtue of their position in your organization, their influence on your organization or their relationship with a disqualified person. Voting members of your Board and any person who has ultimate responsibility for implementing the decisions of your Board or for supervising the management of your organization are disqualified persons. The latter category will commonly include the President, chief executive officer, chief operating officer, chief financial officer and Treasurer. Any other individual who exerts substantial influence on the organization is also a disqualified person. This is a deliberately vague category and generally includes the founders, substantial contributors, those compensated by revenue from organizational activities that they control, persons controlling capital expenditures or employee compensation, and those who manage large programs for the organization. The law further provides that disqualified persons remain disqualified for five years after their influence in your organization ends. This means that if you engage in a transaction with someone who, within the last five years, was a disqualified person, you have to follow the excess benefit rules. For example, if you hire the person who was your Executive Director four years ago to do some contract work for your organization, this transaction is a transaction subject to the excess benefits rules.

Family members of disqualified persons are disqualified. These include the spouse, children, grandchildren, great grandchildren, whole and half-blooded brothers and sisters, and the spouses of any of these people, and any ancestors (parents, grandparents, etc). Corporations in which a disqualified person owns more than 35% of the voting power, partnerships in which the disqualified person owns more than 35% of the profits interest, and trusts or estates in which the disqualified person owns more than 35 %of the beneficial interest are also disqualified persons.

Identify Transactions Subject to the IRS Rules

Generally all transactions between your group and a disqualified person in which you provide the disqualified person with an economic benefit are subject to the excess benefits transactions rules. There are a few important exceptions.

One significant exception to the excess benefits law exempts most newly-hired employees from its provisions. The law does not apply to a person you hire from outside the organization for a position that would otherwise make them a disqualified person (for example, Executive Director, CFO, COO, etc.) unless they were already a disqualified person. The logic behind this exception is that the organization is contracting with an unrelated individual in a marketplace setting and the competition of the marketplace should ensure that the organization does not pay excess compensation. In order to qualify for this exception, you must hire your new employee under a binding written contract and the new employee must substantially perform his or her obligations under the contract. Your compensation arrangements with your employee must be in the form of a fixed payment. A fixed payment is an amount of cash or other property that is specified in the contract or is determined by a fixed formula in the contract that is paid in exchange for your employee's services. A fixed formula may incorporate amounts dependent on future contingencies as long as no person exercises discretion about the amount of the payment or whether to make it. The IRS considers qualified pension, profit-sharing, and stock bonus plans to be fixed payments. If you are considering compensation that is not clearly a fixed payment, you should get professional advice.

> *Example*: A written agreement to employ a person who is not a disqualified person prior to the employment contract as Executive Director of an arts organization for $200,000 per year is not subject to the excess benefit sanctions. This is a fixed payment. The same result applies if the organization also offers the Executive Director the $200,000 salary plus a bonus equal to 2% of the total season subscription sales that exceed $100,000. The bonus is a fixed payment pursuant to an initial contract, because the salary

is fixed and the bonus is fixed according to a formula over which no one has discretion.

When your new hire into an insider position is promoted or when you change the terms of the employment contract in more than insignificant ways (such as by raising the salary), that person is now an insider and will be subject to the disqualified person rules.

The IRS also allows your organization to provide economic benefits to disqualified persons in the following circumstances without complying with the excess benefit rules:

• You can reimburse disqualified persons for their reasonable expenses incurred on behalf of your organization pursuant to an expense reimbursement plan that meets the IRS requirements for such plans. You probably already have an expense reimbursement plan. Check with your accountant to be sure it complies with the IRS rules.

• You can give the same economic benefits to your members and donors who are disqualified persons as those you give to non-disqualified members and donors. You must have a significant number of such non-disqualified members and donors.

• You can give economic benefits to a disqualified person because that person is a charitable beneficiary and the gift carries out your mission. For example, Mental Health Consumers seeks to empower individuals with mental health needs and includes several such people on its board. This exception means that these board members of Mental Health Consumers can use its services without triggering a requirement that Mental Health Consumers follow the excess benefits transactions rules before it provides these services.

• You can give disqualified persons who volunteer for your organization the same economic benefits you give to members of the general public in exchange for a membership fee or contributions of less than $75 per year. This provision allows disqualified persons who volunteer to get the kind of small gratuities that others get for minimal contributions to your organization.

• You can give disqualified persons who are employees non-taxable fringe benefits.

- You can give economic benefits to governmental units as long as they are for public purposes. A governmental unit is most likely to become a disqualified person because it appoints a representative to your board. This exception allows your group to make gifts to the government for public purposes. This is clearly not the kind of transaction that the excess benefit rules are trying to discourage.

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*The IRS assumes that your compensation arrangements for a disqualified person are **not** reasonable and that any transfer of property to a disqualified person is **not** at fair market value **unless** you meet a reasonableness test.*

Create a Rebuttable Presumption of Reasonableness

The IRS may scrutinize any transaction other than those listed above between your corporation and your disqualified persons. The IRS assumes that your compensation arrangements for a disqualified person are *not* reasonable and that any transfer of property to a disqualified person is *not* at fair market value *unless* you meet a reasonableness test. To meet this test, you must properly document that your Board or an authorized committee used appropriate data in your transaction with a disqualified person. If you meet the reasonableness test, the IRS assumes that your transaction is reasonable unless there is strong evidence to persuade them otherwise. We have included a Form entitled "Excess Benefits Transactions Policy" in the Forms section that will help your organization comply with these rules. You should consider adopting this or a similar policy to protect your board members and disqualified persons.

1. The Decision-Making Body

An authorized body of your exempt organization must approve the arrangement with your disqualified person before it is finalized. The authorized body may be your Board or a Board committee given the power to engage in the transaction. Your authorized body must be composed entirely of individuals who do not have a conflict of interest when it is considering the transaction. In other words, if the Board is considering hiring or buying property from one of its Directors, that disqualified person cannot sit on the committee that is empowered to approve the transaction. A Director has a conflict of interest if he or she has a material financial interest affected by the transaction, is in an employment relationship subject to the direction or control of such a disqualified person or receives compensation or other payments subject to their approval, has a family relationship with the disqualified person, or agrees with a disqualified person to approve a transaction providing economic benefits in exchange for the approval by the disqualified person of a transaction providing benefits to

the member. The Director with a conflict of interest can meet with the body only to answer questions and must not be present for the debate and voting on the compensation arrangement or property transfer. Note that these conflict of interest rules disqualify more people than the rules under Oregon law and that the Director with a conflict has more restrictions on participation in the meeting than under Oregon law. See pages 302-305 for Oregon's rules.

Appropriate Data

The approval by your Board or committee must be based on appropriate compensation data. Your Board or committee has appropriate data if, given the knowledge and expertise of your Directors, your Board or committee has sufficient information to determine that compensation is reasonable or that the property transfer is at fair market value. Relevant information for compensation includes compensation levels maintained by similarly situated organizations for comparable positions, current compensation surveys by independent firms, and actual written offers from similar institutions competing for the services of the disqualified person. If your organization has gross annual receipts of less than one million dollars, appropriate data can be data on compensation paid by three comparable organizations in the same or similar communities for similar services. Such smaller organizations may also meet the requirement of appropriate data in other ways. You can obtain information about nonprofit salaries at *www.guidestar.org* or, if you are a private foundation, at the Council on Foundations' website at *www.cof.org*. You should get professional advice if you need help determining what is appropriate data.

If the written substantiation requirement is not satisfied, the IRS will treat the economic benefit as an **automatic** *excess benefit transaction without regard to whether the economic benefit was reasonable.*

Documentation

Your authorized body must document its decision contemporaneously with the transaction. To do this, you must keep written or electronic records that state the terms of the transaction and the date it is approved, the members present and who voted on it, the comparability data and how the data was obtained, and any actions taken with respect to any member of the authorizing body who had a conflict of interest. If you determine that the financial arrangement of the transaction was higher or lower than the range of comparability data, you must record the basis for your determination.

The IRS has instructed its agents to place great emphasis on contemporaneous written substantiation. Although the exempt organization may have treated

an economic benefit as compensation for income tax purposes and as wages for employment tax purposes, the Service will treat it as reasonable compensation and not an excess benefit *only if the organization clearly indicated its intent to treat the benefit as compensation at the time it was paid*. This requires written contemporaneous substantiation. If the written substantiation requirement is not satisfied, the IRS will treat the economic benefit as an *automatic* excess benefit transaction without regard to whether the economic benefit was reasonable. The individual receiving the compensation is subject to the penalties described below.

For your decision to be contemporaneous, your records must be prepared before the later of the next meeting or 60 days after the final action is taken. One method of providing written contemporaneous substantiation is by timely reporting the benefits as compensation on an original Form 990, W-2, or 1099 or on the Form 1040. Your organization can also use an approved written employment contract executed on or before the transfer of the benefit, appropriate documentation in your minutes showing timely approval of the transfer as compensation by your authorized body, and certain other written evidence. The records must be reviewed and approved by your Board or authorized committee within a reasonable time.

Intermediate Sanction Penalties

The Internal Revenue Code imposes substantial penalties on both the disqualified person and on any organization manager who participates in the excess benefit transaction, knowing it is such a transaction. The Code taxes the disqualified person who participates in an excess benefit transaction an initial tax equal to 25% of the excess benefit. If the disqualified person does not correct the transaction within the taxable period, the Code imposes a tax on the noncompliant party of 200% of the excess benefit involved. This tax cannot be paid by the exempt organization.

The statute imposes on any organization manager that participated in the excess benefit transaction, knowing that it was such a transaction, a tax equal to 10% of the excess benefit to a maximum of $10,000. An organization manager is any officer, director or trustee of the tax-exempt organization or any individual having powers similar to those of the officers, directors or trustees of the organization. Consequently, your Directors and officers that participated in the transaction will also personally pay taxes.

Consult Appendix 1 if you would like information about source material related to this Chapter. Appendix 1 has references of interest to all readers, not just professionals.

Part V is concerned with situations in which your corporation has changed or is changing in significant ways. Chapter 28 discusses when and how to review and amend your Articles and Bylaws. This chapter should be reviewed by everyone. Chapter 29 focuses on the situations in which you sell virtually all of your assets or plan to merge with another corporation, and Chapter 30 covers dissolutions.

Part V

CHANGING YOUR CORPORATION

28 REVIEWING AND CHANGING YOUR ARTICLES AND BYLAWS

Every Oregon nonprofit corporation should review its Articles and Bylaws every few years to be sure that these documents comply with Oregon law and conform to the procedures you are actually using. This chapter describes in detail how to review your Articles and Bylaws and how to amend your Articles and Bylaws if they need changing for any reason.

THIS CHAPTER COVERS

- **Reviewing Your Articles of Incorporation**
- **Changing Your Registered Agent or Registered Office**
- **Amending Your Articles of Incorporation**
- **Restating Your Articles of Incorporation**
- **Reviewing Your Bylaws**
- **Amending Your Bylaws**

REVIEWING YOUR ARTICLES OF INCORPORATION

Many organizations never look at their Articles of Incorporation after they are filed. In fact, some don't know where they are. You should keep your Articles of Incorporation with your important corporate documents. If you can't find them, get a copy from the Secretary of State. (See Appendix 2 for contact information.) It is a good idea to review your Articles of Incorporation periodically. You want to be sure that the Articles correctly reflect your Registered Agent's name and address and your mailing address and that the provisions about how your corporation is run are still accurate. You do not need to notify the Secretary of State when your Board of Directors changes.

You should keep your Articles of Incorporation with your important corporate documents.

CHANGING YOUR REGISTERED AGENT OR REGISTERED OFFICE

At the time you filed your Articles, you listed a registered agent and an address for your registered agent. It is very important for you to keep the state notified of any changes in either. You may change your registered agent or registered office by sending to the Office of the Secretary of State a statement that gives the name of the corporation and, if the current registered office is to be changed, the address, including the street and number, of the new registered office, or, if the current registered agent is to be changed, the name of the new registered agent along with:

- A statement that the new agent has consented to the appointment; and

- A statement that after the change or changes are made, the street addresses of the registered office and the office or residence address of the registered agent will be identical.

The Secretary of State has a form that you can use for this purpose on their website. See Appendix 2.

If your registered agent changes the street address of the agent's designated office or residence, she or he must notify the corporation in writing of the

change and also send to the Office of the Secretary of State a statement as described above. That statement must recite that the corporation has been notified of the change.

Your registered agent may resign upon delivering a signed statement to the Office of Secretary of State. The statement may include a statement that the registered office is also discontinued. After this statement is filed, the Secretary of State will immediately mail a copy to your corporation at its principal office (at the address shown in the most recent annual report or, if none, the address noted in the Articles of Incorporation). The authority of the registered agent is terminated and the registered office is discontinued, on the 31st day after the date on which the statement was filed by the Secretary of State, unless the corporation sooner appoints a successor registered agent. You do need to appoint another registered agent.

AMENDING YOUR ARTICLES OF INCORPORATION

If information in your Articles (other than a change in the Board, the registered agent, or your address) has been changed, you need to amend your Articles. Your corporation may make lawful amendments to your Articles at any time.

The procedure you follow to amend your Articles differs depending on whether or not you have members who are entitled to vote on the amendment and whether or not anyone else's consent is required to amend your Articles. In order to determine this, you need to read your Articles and any Restatement or Amendments to the Articles and review your Bylaws. If you are a membership corporation, determine if your members have the right to vote on this particular matter. You must also check to see if anyone else must approve. If you cannot easily determine these things, you need to have an attorney answer these questions for you.

Amendment by Corporations with No Members or No Members with Voting Rights on Amendments

If your corporation has no members entitled to vote on Articles, the incorporators, until Directors have been chosen, and after that, the Directors, may adopt amendments to the corporation's Articles. If the Articles require that an amendment to the Articles must be approved in writing by a specified person other than the Board, then that approval must be obtained.

The corporation must give notice as discussed on page 649 (for special meetings) of any meeting at which an amendment is to be voted upon. The notice must also state that the purpose (or one of the purposes) of the meeting is to consider the proposed amendment to the Articles and it must contain a copy of it or state its general nature. The amendment must be approved by a majority of the Directors *in office* (and not just a majority present at the meeting) when the amendment is adopted unless the Articles or Bylaws or the Board requires a greater vote.

Corporations With Voting Members

If your corporation has members entitled to vote on the Articles, the procedure for amending your Articles varies depending on the nature of the amendment. Some amendments can be adopted by the Board without member approval. Most amendments will require the approval of both the Board and the members.

By the Board Without Member Approval

If your corporation has members with voting rights and unless the Articles provide otherwise, your Board of Directors has the authority to adopt certain types of amendments without the members' approval:

- To delete the names and addresses of the initial Directors and incorporators;
- To delete the name and address of the initial registered agent or registered office, if a statement of change is on file with the Secretary of State;
- To delete the mailing address if an annual report has been filed with the Secretary of State;
- To change the corporate name by adding, changing, or deleting the word "incorporated," "company," "corporation," "limited," or abbreviations for these words;
- To change the corporate name by adding, deleting, or changing a geographical attribution to the name; and
- To include a statement of whether the corporation is a Public Benefit, Mutual Benefit, or Religious Corporation.

By the Board, Members, and Others

If your corporation has members with rights to vote on the Articles, amendments to the Articles must be approved by the Board (in some cases), by the members (in some cases), and by anyone whose approval is required in writing by your Articles.

• *By the Board* – If your corporation is a Public Benefit or Religious Corporation and the amendment does not relate to the number of Directors, the composition of the Board, the term of office of Directors or the way in which Directors are selected, then Board approval is required. Member approval may also be required (see below).

• *By the Members* – Except for those matters which can be decided by the Board without member approval (described above on page 648), voting members must authorize changes in the Articles by at least two-thirds of the votes cast or a majority of the voting power, whichever is less. This means that if you have 100 voting members (so that 51 is a majority) and 60 cast votes (two-thirds of which is 40), then 40 votes are needed to amend the Articles.

• *By Designated Individuals* – If your corporation is one whose Articles require that specific people must give approval in order to amend the Articles, that approval must be given in writing. This provision of the Articles may not be amended without the approval in writing of the designated individual.

In some circumstances, the Board or members may increase the number of votes that is needed for approval of an amendment to the Articles. If the Board initiates an amendment to the Articles or the corporation is a Public Benefit or Religious Corporation and the amendment does not relate to the number of Directors, the composition of the Board, the term of office of Directors, or the method or way in which Directors are selected, the Board may increase the number of votes or percentage of votes that are required to adopt the amendment. Where the Board initiates the amendment, the Board must adopt a resolution stating the proposed amendment and directing that it be submitted to a vote at a meeting of members (which may be either an annual or special meeting).

Members entitled to vote on the amendments may also increase the percentage or number of votes that are required to adopt the amendment.

Your corporation must give the voting members notice of the meeting at which the amendments to the Articles are to be adopted in the same manner in which the members receive notice of membership meetings (see pages 320-324). The notice must also state that the purpose or one of the purposes of the meeting is to consider the proposed amendment and must contain a copy or summary of the amendment. If the vote is to be done by written consent or written ballot, the material soliciting the approval of the amendment must be accompanied by a copy or summary of the amendment.

Class Voting by Members on Amendments

Some nonprofit corporations have different classes of members with each class having different rights or privileges. For example, a mutual benefit social club may have one class of members who pay dues at the highest level and receive invitations to the club's most exclusive functions and several classes paying lower dues with correspondingly decreasing privileges. The law requires a vote by class in certain circumstances for these corporations. These rules are generally aimed at protecting the voting rights of the class.

Religious Corporations

If your organization has members who vote as a class and is a Religious Corporation, the members of the class entitled to vote on the Articles are entitled to vote as a class on a proposed amendment to the Articles only if the class vote is provided for in the Articles or Bylaws. Your Religious Corporation may also provide in its Articles or Bylaws for the number of votes necessary to pass amendments to the Articles; if your do not do so, the amendment must be approved by a $^2/_3$ vote of the votes cast by the class or a majority of the voting power of the class, whichever is less.

Public Benefit Corporations

In a Public Benefit Corporation, the members of a class entitled to vote on the Articles are entitled to vote as a class on a proposed amendment to the Articles if the amendment would affect the rights of that class as to voting in a manner different than how the amendment would affect another class or members of another class.

Mutual Benefit Corporations

In a Mutual benefit Corporation, the members of a class entitled to vote on the Articles are entitled to vote as a class on a proposed amendment to the articles if the amendment would:

- Affect the rights, privileges, preferences, restrictions or conditions of that class as to voting, dissolution, redemption or transfer of memberships in a manner different than such amendment would affect another class;

- Change the rights, privileges, preferences, restrictions or conditions of that class as to voting, dissolution, redemption, or transfer by changing the rights, privileges, preferences, restrictions or conditions of another class;

- Increase or decrease the number of memberships authorized for that class;

- Increase the number of memberships authorized for another class;

- Effect an exchange, reclassification or termination of the memberships of that class; or

- Authorize a new class of memberships.

In a Public Benefit or Mutual Benefit Corporation, if a class is to be divided into two or more classes as a result of an amendment to the Articles, the amendment must be approved by the members of each class entitled to vote on Articles that would be created by the amendment. In a Public Benefit or Mutual Benefit Corporation, a class of members is entitled to the voting rights specified here, even though the Articles and Bylaws provide that the class may not vote on the proposed amendment.

Filing of Amendment

Once you have adopted an amendment, you need to prepare "Articles of Amendment." (See the Forms section). One copy of the Articles of Amendment to which you attach a copy of the actual amendment must be signed by your President or one of your officers. The original must be delivered to the office of the Secretary of State for filing along with a filing fee. For a small additional fee, the state will send one copy back to you with the date filed stamped on it. The amendments are effective on that date unless your document specifies a *later* effective date. The delayed effective date must be within ninety days of the filing date. The unchanged part of the original Articles (and other amendments to them) are still effective; the new amendments simply change some part of them or add to them.

If you are a Public Benefit or Religious Corporation, you may amend your Articles to become a Mutual Benefit Corporation only if notice, including a copy of the proposed amendment, has been delivered to the Attorney General at least 20 days before you complete the amendment.

Tax-Exempt Organizations

If you are tax-exempt and the amendments to your Articles substantially change the purpose, character, name, method of operation, or kind of activities of your corporation, you must notify the IRS of the change and send a copy of

your amended Articles to the IRS. If you file the Form 990 (see Chapter 12), you can accomplish this when you file your Form 990.

RESTATING YOUR ARTICLES OF INCORPORATION

Your corporation may choose to restate your Articles rather than to amend them. Your restated Articles replace the original Articles of Incorporation and any amendments to them and your original Articles and amendments are no longer valid. Contrast this with amendments to Articles which are used together with the original Articles as the organizational documents for a nonprofit corporation. The restated Articles must include all statements required to be in the original articles, except that you do not need to restate the names and addresses of the incorporators, the initial or present registered office or agent, or the mailing address of the corporation if an annual report has been filed with the Secretary of State.

Your Board can restate your Articles at any time with or without approval of members or any other person. If the restatement includes any amendments that would otherwise require approval by the members entitled to vote, it must be adopted using the same procedure as an amendment. The same notice must also be given and the voting requirements are the same. See the "Restated Articles of Incorporation" in the Forms section for an example of the form that your corporation must file to restate its Articles. Note that if you use that form you must attach to it a copy of your restated Articles; the form is a kind of cover sheet.

If your corporation is a Public Benefit or Religious Corporation, and you are restating your Articles so that you can become a Mutual Benefit Corporation, you must give notice, including a copy of the proposed restatement, to the Attorney General at least twenty days before you finalize the restatement.

REVIEWING YOUR BYLAWS

Your Bylaws provide the rules for how your nonprofit corporation is governed. It is critical that your corporation have a set of Bylaws that is current and that complies with the law. Unfortunately, many Oregon nonprofit corporations do not have a current and accurate set of Bylaws. This has come about because of two factors. Oregon nonprofit law is quite detailed and contains some pitfalls that most nonprofits would not expect in terms of how nonprofit corporations are to be governed.

The second factor that contributes to inaccurate Bylaws is the way that many corporations assemble their Bylaws. Many groups that do not get legal help put together their Bylaws by the cut-and-paste method. The group assembles the Bylaws by getting sample copies of Bylaws from several different groups and picking and choosing the provisions that it wants in its own Bylaws. These provisions are then cut and pasted into a new set of Bylaws.

Unfortunately, many, perhaps most, Oregon nonprofit corporations do not have a current and accurate set of Bylaws.

This method is probably a good way to get an idea of what items you might consider putting into your Bylaws but is a terrible way to assemble a final product. There are several reasons for this. Often, you have no way of knowing whether the Bylaws you are using comply with Oregon law. They may have come from another state (and no state has a law exactly like Oregon's); they may have been written before 1989 under Oregon's old statute; or they may have been drafted by someone who did not know what they were doing. Even if the samples you are using are completely in compliance with Oregon law, in the process of cutting and pasting you may build in inconsistencies and ambiguities without realizing it.

Consequently, unless you have had your Bylaws reviewed by someone who is familiar with Oregon law, you should review them now. The process of reviewing Bylaws is somewhat different from drafting them when you start a new corporation, because you have existing Articles and Bylaws with which you must work. If at all possible, you should have an attorney review your Bylaws for you after you have followed the suggestions of this chapter and come up with your best product.

Understanding the Hierarchy

The legal workings of your nonprofit corporation are governed by a variety of sources: the law, your Articles of Incorporation, your Bylaws, and resolutions (decisions) of your Board. These sources exist as a hierarchy: those above in the hierarchy control those below. In this hierarchy, the law controls all of your organizational documents and actions (Articles, Bylaws, resolutions). In many situations, state law allows your Articles and Bylaws to control the governance of your corporation and only steps in if you do not provide differently in your Articles or Bylaws. Your Articles then control your Bylaws and your Bylaws control any resolutions of your Board.

Articles of Incorporation

The most important corporate document you have is your Articles of Incorporation (and amendments to it). Your Articles are typically very short and establish basic items like your name, offices, whether you have members, and distribution of assets upon dissolution and may include other provisions you add. Your Articles and its amendments are like your corporation's constitution. If your other organizational documents conflict with your Articles, your Articles prevail. This means that you must read your Articles and amendments along with your Bylaws when you review your Bylaws because your Bylaws cannot contradict your Articles.

Many groups that do not get legal help put together their Bylaws by the "cut-and-paste" method. This method is a terrible way to assemble a final product.

Bylaws

Your next most important corporate document is your Bylaws. The purpose of Bylaws is to provide for how your organization is run. The Bylaws should contain provisions about your Board, members, officers, and committees and should include a provision for amending the Bylaws.

Board Resolutions

The Board may make decisions (resolutions) from time to time governing corporate matters as long as the resolutions do not conflict with the Articles or Bylaws. These resolutions are ways of handling corporate business. For example, the Board may want to approve personnel policies or authorize the establishment of a bank account. Typically, these resolutions will not cover matters concerning how the corporation is run because those matters are handled in the Bylaws (or Articles).

Tips for Reviewing Bylaws

As you review your Bylaws, keep these guidelines in mind:

Consistent with Laws

Your Bylaws must be consistent with the law. The discussion beginning below will cover some of the most common pitfalls in the law.

Consistent with Your Articles

Your Bylaws must be consistent with your Articles. Begin your review of your Bylaws by reading your Articles of Incorporation and all of its amendments. If your Bylaws conflict with any of these documents, your Articles prevail. For example, if your Articles say that your Board is composed of 7 people and your Bylaws say your Board has 9 members, then your Board can only be composed of 7 members. If you need to change your Articles, see page 647.

Begin your review of your Bylaws by reading your Articles of Incorporation and all of its amendments.

There are a few matters that the law requires that you place in your Articles. These provisions are not valid if you put them only in your Bylaws. See pages 37-39. For example, if some group other than your Board of Directors or a committee composed only of Directors makes Board level decisions for your corporation, you must include this in your Articles. If you have these provisions in your Bylaws and not in your Articles, these provisions are very likely not valid.

Internally Consistent

Each provision in your Bylaws must be consistent with the other provisions in your Bylaws. Read your Bylaws carefully to see if there are inconsistencies. For example, if your Bylaws provide in one section that your officers are a President and Secretary and in another provide duties for a Treasurer, you need to harmonize these sections.

Readability and Utility

Your Bylaws should be written so they are easily understandable. They should strike a balance between being detailed enough so that your organization knows how you are run but not so detailed that they stifle whatever flexibility you need. Your Bylaws should not contain references to other documents like *Robert's Rules of Order* unless you are prepared to become familiar with these documents and use their procedures.

Completeness

Be sure in reviewing your Bylaws that you notice what is not in them as well as what is there. Have you covered items about voting, quorums, meetings, and notice? Compare your Bylaws to the Bylaws in the Forms section of this book for Nonmembership Corporations or Membership Corporations to be sure

everything that should be covered is covered. For example, it is not uncommon for Bylaws to fail to provide for how they are to be amended.

Common Pitfalls in Bylaws

After you have completed your review of your Bylaws to be sure they comply with the basic rules described above, you need to determine if your Bylaws comply with Oregon law. The most thorough way to do this would be to review Chapter 4 with your Bylaws in hand, section by section, to see if your Bylaws satisfy the legal requirements. If your organization is a homeowners' association formed on or after July 1, 1982, you should review Appendix 6 rather than the materials below for the rules that apply to you.

There are some common traps and pitfalls in the law that the Bylaws of many groups inadvertently violate. At a minimum, you should look at your Bylaws to see if they have avoided these traps. If you find that your Bylaws have not avoided all of these traps, this should be a signal to you that you should do the more thorough review recommended above.

The common traps and pitfalls are listed below, divided into three categories. The first category includes pitfalls that apply to all Oregon nonprofit corporations; the second refers to pitfalls for membership corporations only; and the third category applies to nonmembership corporations only.

All Oregon Nonprofit Corporations

Who Runs the Corporation

The Board manages the business affairs of the corporation. If done properly, the Board can delegate some of its decision-making to a committee (see below). Your Bylaws can let someone else manage your business affairs only if your Articles permit this. For example, if your Bylaws provide that your members (or some other group) hire your Executive Director or adopt the budge, this is illegal if the provision is not also in the Articles.

If your Bylaws provide that your members (or some other group) hire your Executive Director or adopt the budget, this is illegal if the provision is not also in the Articles.

Term of Directors

The term for each elected director cannot exceed 5 years (but they can be reelected without limit). This may be violated if your Bylaws say that an elected Director serves until replaced.

Quorum

The quorum needed for a Board meeting must be at least ⅓ of the number of Directors fixed by your Bylaws. If you have a variable-sized Board, the quorum must be at least ⅓ of the number of Directors set by the Board or, if the Board has not set a number, ⅓ of the number of Directors in office immediately before the meeting began. (See pages 53 or 74 for a discussion about fixed and variable sized Boards.)

One pitfall here is in Bylaws that have a fixed number of directors and that say "A quorum is a majority of Directors in office." If the organization has allowed the number of Directors to fall below the number fixed in the Bylaws, as frequently happens, this can lead to invalid meetings and decisions.

> *Example*: The Bylaws of the Latino Federation fix the number of directors at 16 and provide that a quorum is a majority of directors in office. For the last year, there have only been 9 directors. A majority of 9 is 5. However, at least ⅓ of 16 is 6. If the organization has Board meetings attended by only 5 directors, it does not have a quorum. Any business transacted is invalid even though it is complying with the language of its Bylaws.

Majority Vote

The Board can take action only if the action taken gets at least a majority vote of the Directors present (and not of Directors voting). This can create a problem if Directors abstain from voting. For example, if 7 Directors are present and 5 vote, the majority needed to decide the issue is 4 Directors and not 3. Bylaws that provide for a majority vote for Board action without specifying that it is a majority of Directors present should be amended to make this clarification.

Bylaws that provide for a majority vote for Board action without specifying that it is a majority of Directors present should be amended to make this clarification.

Committees

If you have committees that can make Board-level decisions, each such committee must have at least two Directors on it. The statute is somewhat ambiguous but it appears that all of the members of the Committee must be on the Board. Many Bylaws place the Executive Director or some other non-Director as a voting member on the Executive Committee that has the power to make Board-level decisions. This is probably improper.

The creation of a Board-level committee and the appointment of Directors to the committee (or the designation of the method of selecting committee members) must be approved by the greater of:

- a majority of all the Directors in office when the action is taken; or
- the number of Directors required by the Articles or Bylaws to take action in voting matters.

Usually this means that your Board appoints committee members by a majority vote of all Directors in office, and not by a majority of Directors present at the meeting. Your Bylaws should have some provision that ensures that the Board understands how many votes are needed in this situation. (See the language on this point on pages 60 or 78.)

Officers

Your Bylaws should provide for at least two officers: President and Secretary. You can call these officers by other names and one person can hold both offices.

Supermajority Vote

Certain actions that substantially affect the structure or functioning of the corporation – such as certain amendments to your Articles of Incorporation, the sale of your assets other than in the regular course of business, mergers, and dissolution – cannot be taken by a majority vote of the Directors at the meeting. These actions require at least a vote of the majority of Directors in office. Your Bylaws cannot permit a lesser vote. If your Bylaws simply provide that action is taken by a majority of Directors present at the meeting and do not provide for a greater vote in the above circumstances, your Board may be misled in the future. See the language on this point on pages 56 or 74.

Membership Corporations

The common understanding about membership corporations is that they are corporations that have members who support the corporation's goals and pay dues. However, the law does not define membership corporations in this way. Membership corporations are those in which the members elect at least one member of the Board of Directors. If your members do not elect at least part of your Board, you are not a membership corporation as that term is defined by Oregon law. Review the discussion on pages 23-25 and in Chapter 14.

If you are not a membership corporation as the law defines it, you should review your Articles to see if you have filed as a membership corporation. If so,

you need to amend your Articles and file as a nonmembership corporation. You should also review your Bylaws to see if you refer to your corporation as a membership corporation. If you do, you also need to amend your Bylaws. See page 52 for suggestions on how to handle this if you have supporters that you have been referring to as members. Since you are not a membership corporation, you do not have to comply with the remaining items in this section that pertain to membership corporations.

If your members do not elect your Board, you are not a membership corporation as that term is defined by Oregon law.

If you truly are a membership corporation with members who elect your Board, you should review this next section carefully. Oregon law contains a number of provisions governing membership corporations that you might not expect.

Consent of Members

Members must consent to be members. Your Bylaws cannot make someone a member without their consent. This is often violated by incorporated neighborhood associations that provide that everyone within a given geographical boundary is a member. Page 317 discusses this along with some suggestions for how to handle this situation if it is a problem for you.

Annual Meetings

You have to hold at least an annual meeting of the members. You must give notice to all your members of the meeting. The notice has to be given in a "fair and reasonable" manner. Notice is fair and reasonable if you notify your members of the place, date, and time of the meeting by first class mail at least 7 days before the meeting or by other than first class mail from 30-60 days before the meeting. See pages 320-323. Although you don't have to put these provisions in your Bylaws, it is a good idea to do this so that future Boards and officers are reminded of these requirements.

Voting by Proxy

Your members are entitled to vote by proxy; that is, to give someone else the right to vote for them. Page 327 describes proxy voting. If you don't want your members to be able to do this, your Bylaws (or Articles) must forbid it. If it is not in one of these documents, you must add it, or allow proxy voting. See page 69 for suggested language to ban proxy voting.

Expulsion of Members

You may not expel, terminate or suspend a member of a public benefit or mutual benefit corporation unless you do so by a fair and reasonable procedure carried out in good faith. It is a good idea to put this procedure in your Bylaws. The law considers the following to be a fair and reasonable procedure:

You may not expel, terminate, or suspend a member of a public benefit or mutual benefit corporation unless you do so by a fair and reasonable procedure.

> *Membership may be terminated by the Board of Directors after giving the member at least 15 days written notice by first class or certified mail of the termination and the reasons for the termination, and an opportunity for the member to be heard by the Board, orally or in writing, not less than five days before the effective date of the termination.*

See pages 334-335 for more discussion about this.

Removal of Board of Directors

Some or all of the Board must be elected by the members. Those Directors elected by members can only be removed in one of two ways:

- By the members, if the number of votes to remove would be sufficient to elect the director at a meeting to elect directors; or

- By the Board, if the Articles or Bylaws provide reasons for removal and the director is removed by a majority of directors then in office. (See pages 72-73 for a fuller discussion.)

A common pitfall in membership organizations is a Bylaws provision that directors are elected by the members but can be removed by the Board without specifying reasons for removal.

Inspection of Membership List and Corporate Records

Your corporation must make available many of its corporate records and its membership list for inspection by its members, if the inspection if in good faith for a proper purpose. Some corporations want to limit the members' rights to inspect. If you are a Religious Corporation, your Articles or Bylaws can limit or abolish your members rights to inspect. If you are a Public Benefit Corporation organized primarily for political or social action, your Articles may limit or abolish the right of your members to inspect the membership list and to obtain

information about your contributors. If your Public Benefit Corporation tries to restrict access to its records through your Bylaws (without having this provision in your Articles), it is not effective. See pages 331-333 for more information about inspection of records.

A Director elected by the Board in a nonmembership corporation can only be removed by a vote of 2/3 of the directors then in office (or a greater number set by the Articles or Bylaws). You cannot remove a Director with a lesser vote.

Nonmembership Corporations

Removal of Board

A Director elected by the Board in a nonmembership corporation can only be removed by a vote of 2/3 of the directors then in office (or a greater number set by the Articles or Bylaws). You cannot remove a Director with a lesser vote. Many Bylaws provide for removal by a majority vote. Some provide for removal without discussing the vote needed, which frequently leaves the impression that a majority vote is sufficient. Your Bylaws should establish the 2/3 vote and should also say "of the directors then in office."

AMENDING YOUR BYLAWS

Consult your Bylaws (and Articles) to see if they contain a procedure for amending your Bylaws. If they do have a procedure, check the procedure against the law as described below. If it is legal, follow the procedure in your Bylaws. If it is not, you need to amend your Bylaws as described here.

Amendment by Corporations with No Members or No Members with Voting Rights on Amendments

If your Articles or Bylaws do not provide for how to amend your Bylaws, you need to determine if you are a nonmembership or membership corporation. If you are a membership corporation, you need to find out if your members have the right to vote on the Bylaws. You should check the provisions in your Bylaws that describe what your members can do to see if they can vote on the Bylaws. Many Bylaws provide that members have the right to vote on all matters for which a membership vote is permitted by law. If your Bylaws have this provision, your members do vote on amendments to the Bylaws. If your Bylaws do not address the question of whether members vote on Bylaws, then you need legal help.

Corporations With No Members Who Vote on the Bylaws

If you conclude that you are a nonmembership corporation or you are a membership corporation in which the members do not vote on amending the Bylaws, then your Board has the sole power to amend the Bylaws.

Corporations With Voting Members on the Bylaws

If your Bylaws give members the right to vote on Bylaws, then members may amend the Bylaws even though the Board may also do so. The Board has the right to amend the Bylaws for most matters unless the *Articles* reserve the power to amend exclusively to the members. Note that this provision must be in the Articles; putting it in the Bylaws alone is not enough. However, the Board cannot amend the Bylaws to increase the quorum required for any member action or to add to, change or delete the vote required for any member action that must be approved by the members. If your members entitled to vote on Bylaws amend or repeal a particular Bylaw, the members can expressly provide that the Board may not amend or repeal that Bylaw. The members' action is then final.

If your Articles require written approval by a third person, that provision may not be amended without the approval in writing by that person.

Your corporation must provide notice (see pages 320-323 for special meetings) of any meeting of Directors at which an amendment of the Bylaws is to be approved. That notice must also state that one of the purposes of the meeting is to consider a proposed amendment of the Bylaws and must contain a copy or summary of the proposed amendment. If your members have the right to amend the Bylaws, you must also provide notice of the members' meeting to the members. Follow the provisions for notice for a special or annual meeting, depending on which type of meeting the members will vote on the amendment. That notice must state that one of the purposes of the meeting is to consider a proposed amendment of the Bylaws and must contain a copy or summary of the proposed amendment.

Tax-Exempt Organizations

If you are tax-exempt and the amendments to your Bylaws substantially change the purpose, character, name, method of operation, or kind of activities of your corporation, you must notify the IRS of the change and send a copy of your new Bylaws to the IRS. If you file the Form 990 (see Chapter 12), you can accomplish this when you file your Form 990.

Consult Appendix 1 if you would like information about source material related to this Chapter.

29 MERGING WITH ANOTHER CORPORATION OR SELLING YOUR ASSETS

A merger occurs when one or more corporations combine with another corporation. This chapter discusses the unique set of issues that the merging corporations must solve. We also discuss the procedure that you follow to move from being two or more corporations into becoming one.

For a variety of reasons, your corporation may decide to sell, lease, exchange or otherwise dispose of all, or substantially all, of your assets. If you decide to do this, you must follow certain legal rules described in this chapter.

THIS CHAPTER COVERS

- **Mergers**
- **Sale of Your Corporation**

MERGERS

A merger occurs when two or more corporations decide to become one corporation. A merger is a complicated process that includes legal, financial, managerial and psychological components. Mergers commonly bring up many feelings in both organizations. Each group is looking at some significant changes and some personnel may be displaced by the merger. It is critical that the groups recognize and plan for this in advance. In virtually every merger, you will need to involve an attorney and an accountant. Some nonprofits retain other consultants to assist them in negotiating the emotional terrain of restructuring missions, jobs and organizational cultures. If you decide that you are serious about the merger, you should retain professionals early to assist you in the process. This chapter will prepare you for some of the common issues you will need to consider.

Mergers commonly bring up many feelings in both organizations. Each group is looking at some significant changes and some personnel may be displaced by the merger. It is critical that the groups recognize and plan for this in advance.

Why Nonprofits Decide to Merge

Nonprofits decide to merge for several reasons. Often the merging organizations are providing similar services and believe that they can provide those services more efficiently if they do so as one organization. Sometimes a funder requires the two organizations to merge so that the funder does not duplicate funding efforts. Nonprofits may merge because they are providing different but related services and believe that their merger will allow the delivery of those services in a package that is more beneficial to the clients. Sometimes nonprofits merge because each group has a strength that the other needs: for example, one group may have a strong fundraiser and the other may have an established reputation in the community.

Some Merger Terminology

Mergers are a legal mirror trick in which two or more corporations become one. The new corporation that will continue after the merger is referred to as the *surviving corporation*. The other corporation is called the *disappearing corporation*. Don't be too disturbed by the legal terminology. The fact that one survives and one disappears is a result of the legal recognition that there will only be one corporation where before there were two (or more). In fact, the new corporation is the result of discussions and agreements by both corporations. The one that is chosen as the surviving corporation is often chosen for practical reasons and not necessarily because it was the stronger or better of the two. The surviving corporation is in reality the new, merged corporation.

Limitations on Mergers by Public Benefit or Religious Corporations

A nonprofit corporation may merge with another nonprofit corporation or with a business corporation. Oregon law places some restrictions on the mergers of Public Benefit and Religious Corporations, because both are formed for a public purpose and often attract donations, grants and volunteer services because they have held themselves out as serving the public. The legislature wants to ensure that the merger does not result in a misuse of the assets of these corporations.

A Public Benefit or Religious Corporation can merge with the following:

- Another Public Benefit or Religious Corporation;
- A corporation from another state which, in Oregon, would qualify as a Public Benefit or Religious Corporation;
- A wholly-owned business or Mutual Benefit corporation, provided the Public Benefit or Religious Corporation is the surviving corporation and continues to be a Public Benefit or Religious Corporation after the merger;
- A business or Mutual Benefit corporation, provided that certain conditions are met; *or*
- Any other corporation (including business corporations), as long as the Public Benefit or Religious Corporation has received prior written consent of the Attorney General or prior approval by the court in a proceeding in which the Attorney General has been given written notice. The Attorney General will closely scrutinize these mergers. You should consult an attorney *before* you enter into serious negotiations for this type of merger.

Unless there has been prior written consent by the Attorney General or prior approval by the court, no *member* of a Public Benefit or Religious Corporation may receive or keep anything as a result of the merger other than a membership in the surviving Public Benefit or Religious Corporation.

An Overview of the Merger Process

The merger process begins when a nonprofit considers the possibility of aligning with another corporation. Usually the suggestion originates with the Executive Director or a board member, often because it has been suggested by a funder. Once the corporation decides on a merger partner, the parties form a planning committee to work through the numerous issues raised by the merger. At the same time, they begin a due diligence search in which each party dis-

closes extensive information to the other so that each party can determine whether it wants to finalize the merger. Once the parties settle the issues and decide to merge, they then agree upon the plan for merger. The plan formalizes the decisions that the parties made in a binding agreement. Each organization must then take the plan to their board and to their members eligible to vote on mergers, if any. When the plan is approved, the surviving corporation files Articles of Merger with the Secretary of State's office to notify the state about the merger. The surviving corporation will also notify other appropriate officials. It will handle practical matters that arise after the merger: for example, ensuring that all property is transferred from the disappearing to the surviving corporation, complying with the terms of the plan of merger, and notifying outside parties about the finalization of the merger.

The Steps of the Merger

Formation of a Planning Committee

When your nonprofit has located a likely merger partner, the two corporations start discussions with each other about the possibility of merger. At this stage the parties are considering the advantages and disadvantages of the merger. Generally, the organizations appoint about a half dozen leaders from each group to form a planning committee. In smaller and midsize nonprofits, this committee considers all the details of the merger. The planning committee in larger nonprofits may delegate much of their work to subcommittees that deal with specific issues, like the selection of the Executive Director or the kinds of financial systems to be used by the surviving organization. Regardless of the size of your organization, you should develop a timeline for the merger and keep each other apprised as to what progress is made toward the merger. Keep in mind that the timeline is very flexible. Each merger is unique and you will almost certainly find yourself revising your timeline on numerous occasions.

Letter of Understanding

With the formation of a planning committee, the parties will often sign a letter of intent that fleshes out the parties' decision to explore the possibility of merger. Generally, the letter is not a binding commitment to finalize the merger but a good faith statement to proceed with the process. It may contain some binding promises. For example, the parties may agree to hold in confidence information each gets from the other. Each nonprofit may promise that it won't exploit donors or funders of the other side that it discovers in the process. The letter may contain agreed-upon damages that a party that breaks the contract must pay. An attorney should draft this letter.

The Due Diligence Investigation

Each corporation needs to become thoroughly informed about the other corporation in order to make a reasonable decision about whether to approve the merger and to avoid unwelcome surprises after the merger is complete. The process by which this occurs is often referred to as the *due diligence* process and involves a very extensive exchange of documents and information. Among other items, each organization should review the legal status of the other by examining the other organization's Articles of Incorporation and amendments, bylaws, policies, and Board, committee and member minutes. Each party should give its most serious attention to the other party's financial information. You need to obtain documentation like the audits and management letters, the unaudited financial statements, budgets, insurance, fundraising material and any information on taxes. You should verify the ownership and value of the major assets. You must pay particular attention to the liabilities of the other corporation because these liabilities will become the liabilities of the merged organization. You need to exercise particular care to investigate potential liabilities that may not be apparent on financial statements. These include potential claims by employees, deferred maintenance on facilities and potential lawsuits against the other corporation. Much of the information you need to gather will be specific to the type and size of nonprofits that are involved. Your own attorney and accountant can advise you more specifically.

Each corporation should understand the potential consequences of this exchange of information. In the process of the due diligence search, the parties often disclose sensitive and confidential financial and managerial information to each other. Each nonprofit may be revealing the names of donors or trade secrets that the other could use to their benefit if merger talks fail. Key personnel in one corporation will interact with decision-makers in the other and may be approached to switch ships if the merger does not succeed. Each party will learn important details about how the other runs its programs. You need to be willing to live with this possibility.

At the same time that the parties pursue their due diligence search, they discuss in detail and reach resolutions about a variety of issues that must be resolved in order for the merger to occur.

Issues to Deal With in a Merger

Regardless of the reasons for the merger, all nonprofits need to deal with some common issues raised by the merger. Here are some of the most important.

Purpose and Structure of the Surviving Organization

The organizations will commonly develop a mission statement or a philosophical direction for the surviving organization. You will need to decide on the name for the surviving corporation – it may keep its own name, it may take the name of the disappearing corporation or it may take a new name. You should agree on the governance and structure for the new organization and you should draft the Articles and Bylaws for the surviving corporation. You will need to determine who will be on the Board of Directors and who the Executive Director of the surviving corporation will be.

Assets and Liabilities

Each organization will want full disclosure about the other's assets, liabilities, and other items pertinent to making an informed decision about the merger. You will exchange this kind of information in the due diligence process described above. The organizations should consider how to handle the transition of assets from the disappearing corporation to the surviving corporation. Is there property that needs to be deeded? Are there stocks or investment portfolios that will be transferred? How should you handle the timing on this? How do you arrange for the transfer of bank accounts?

The organizations will need to consider how to handle their indebtedness. You need to determine whether the consent of any creditors of either corporation is needed to the merger. You also need to explore whether either corporation has potential liabilities that do not appear on the balance sheet and how to handle them.

If either of the organizations is a membership organization, the organizations will have to deal with how to handle membership issues. Will the new organization have members and, if so, who are they? If the merger involves a Mutual Benefit Corporation or a business corporation, the organizations may need to convert the memberships or stock into cash or other property.

Employee Issues

As part of your merger planning you will determine the terms of employment that will be offered by the surviving corporation, including the compensation and benefits the surviving corporation will provide. You will need to determine whether you will transfer all of the accrued vacation and sick leave of employees moving from the disappearing corporation to the surviving corporation or make some other provision such as cashing them out or requiring them to "use it or lose it." This may be a particularly challenging question if the two merging corporations have very different approaches to providing ben-

efits. If the surviving corporation plans to change any of its benefits or personnel practices immediately upon merger, it should provide notice to the current employees and make transition plans. Consult an attorney familiar with employment issues to ensure that your plans are legal.

The surviving corporation will also need to discuss the merger plan with its fringe benefit providers to assure smooth transition for the employees moving from the disappearing corporation into the coverage of the surviving corporation.

Leases and Contracts

Both corporations need to review their lease and contracts to be sure that they will remain in compliance with them after the merger. Many leases require renegotiation in the event of a significant change in corporate status, such as a merger.

Audits

You will want to discuss your plans to merge with the auditor of both the surviving and disappearing corporations. There are several options for completing the audits and presenting the financial statements of both corporations. Your auditor can explain the options and make recommendations. You will want to take particular care in planning to meet audit requirements for government funds.

Funders

You will need to inform your funders of your merger plans and get their consent if it is needed. You may need to make some adjustments to your grants if the merger is occurring mid-cycle. Many organizations attempt to time their mergers to avoid mid-cycle mergers if possible.

You should ask your funders to prepare any contract amendments or new contracts which will be required to maintain the funder's relationship with the surviving corporation. While many funders encourage mergers, you cannot assume that they have an understanding of the legal issues involved and will take care of contracts on their own. You will also want to seek whatever assurances you can get that your funder will continue to provide the combined amounts of funds currently available to the two corporations rather than reducing the amount once there is only one corporation.

Remedies If the Surviving Corporation Violates the Merger Agreement

One issue of concern for some disappearing nonprofits is what they can do if the surviving corporation does not honor the merger plan. The problem with enforcing the plan of merger is that the disappearing corporation has, well, disappeared. Although Board members associated with the merger survive, the legal entity that was the corporation did not. The surest way to achieve compliance is to ensure that the disappearing corporation has a controlling voice on the new Board but this rarely happens. If this is an important issue for you, you need to talk to your attorney.

Creating the Plan of Merger

Once the due diligence search is complete and the details of the merger have been agreed upon the organizations are then ready to initiate the legal steps to effect the merger. The next step from the legal point of view is to create a legal plan of merger. The plan must state:

- the name of each business or nonprofit corporation planning to merge and the name of the surviving corporation into which each of the others plans to merge;

- the terms and conditions of the merger, including the agreements that the two corporation worked out in response to the issues raised above and details about how and when the merger will occur;

- the manner and basis of converting memberships of each Public Benefit or Religious Corporation into memberships of the surviving corporation; and

- if the merger involves a Mutual Benefit or business corporation, the manner and basis of converting the memberships or shares of each merging corporation into memberships, obligations, shares or other securities of the surviving corporation (or any other corporation) or into cash or other property.

The plan of merger may contain amendments to the Articles of Incorporation and Bylaws of the surviving corporation and other provisions relating to the merger.

Adopting the Plan of Merger

Unless the Articles, Bylaws, Board of Directors or members provide differently, the plan of merger must be adopted:

- by the Board; and
- by the members entitled to vote on the merger ; and
- in writing by anyone whose approval is required for an amendment to the Articles or Bylaws.

You must decide whether you have members entitled to vote on the merger and whether anyone else's approval is required for the merger. In order to determine this, you need to read your Articles and any Restatement or Amendments and Bylaws. If you are a membership corporation, you need to determine if your members have the right to vote on this particular matter. You must also check to see if anyone else must approve. Your attorney can help you determine whose approval is required.

Adoption by the Board

If your corporation does not have members entitled to vote on the merger, the merger must be approved by a majority of Directors *in office* at the time the merger is approved. In addition, the corporation must provide notice of any Directors' meeting at which such approval is to be obtained (as explained on page 287). The notice needs to state that the purpose (or one of the purposes) of the meeting is to consider the proposed merger.

Adoption by the Members

If your corporation has members entitled to vote on the merger, your Board first agrees to submit the plan to the members. The law is not clear about what vote is required but this can probably be done by whatever vote you require for Board actions. If the Board seeks to have the plan approved by the members *at a membership meeting*, the corporation must give notice as described on pages 320-324. The notice must state that the purpose (or one of the purposes) of the meeting is to consider the plan of merger, and must provide a copy or summary of the plan which includes:

- for members of the *surviving* corporation, any provision that, if contained in a proposed amendment to the Articles of Incorporation or Bylaws, would entitle members to vote for the provision; and

- for members of the *disappearing* corporation, a copy or summary of the Articles and Bylaws which will be in effect immediately after the merger takes place.

Unless your Articles, Bylaws, Board, or members require a greater vote, the members at the meeting must approve the merger by at least $^2/_3$ of the votes cast or a majority of the voting power, whichever is less.

> *Example*: A corporation has 100 members entitled to vote on the merger and 60 actually vote. 45 vote in favor of the merger. The merger is approved by the lesser of 51 votes (the majority of 100) or 40 votes ($^2/_3$ of 60). In this case, 40 votes is the minimum required and the merger is approved.

If the Board wants to have the plan approved by the members *by written consent or written ballot*, the material soliciting the approval needs to include the same information required to be sent out with the notice to members as described above.

As discussed on page 319, some membership corporations have more than one class of member. If one of the merging corporations has classes of members, the members must vote by class if the plan contains a provision that, if contained in a proposed amendment to the Articles, would entitle the class of members to vote as a class. The plan is approved by each class if it receives $^2/_3$ of the votes cast by the class or a majority of the voting power of the class, whichever is less.

Abandonment

After the merger is adopted, and at any time before Articles of Merger are filed, the plan of merger may be abandoned in accordance with the procedure given in the plan or, if none is given, in a manner determined by the Board.

Filing the Articles of Merger

After a plan of merger is approved by the Board and, if required, by the members and any others, the surviving corporation must deliver to the Secretary of State for filing an original copy of the Articles of Merger and a filing fee. (See the "Articles of Merger" in the Forms section). The merger takes effect when the Articles of Merger are filed, unless the plan names a delayed date. The delayed date must be within ninety days of the filing date. You cannot name a merger date *before* the plan is filed. If a particular merger date is important to you, be sure to plan so that the Articles are filed by that date.

The Effect of a Merger

The effect of the merger is that the corporations that participate merge into the surviving corporation and the disappearing corporations cease to exist. Title to all property owned by each corporation is vested in the surviving corporation. If the disappearing corporation owned real property or held other property, it should transfer these properties to the surviving corporation. You may need to involve an attorney to prepare new deeds or other evidence of title. The surviving corporation also has all the liabilities and obligations of each disappearing corporation. The Articles and Bylaws of the surviving corporation are amended as provided by the plan of merger. If the plan called for memberships or shares of the disappearing corporations to be converted into memberships, obligations, shares or other securities of the surviving corporation (or any other corporation) or into cash or other property, the surviving corporation must do this, and the former holders of the memberships or shares are entitled only to the rights provided in the Articles of Merger. The surviving corporation typically handles these details.

The effect of the merger is that the corporations that participate merge into the surviving corporation and the disappearing corporations cease to exist.

Special Note for Tax-Exempt Corporations

If you have a §501(c) tax exemption, you must notify the IRS on your annual information return about your merger. Be sure to follow the instructions on the return.

SALE OF YOUR CORPORATION

Your organization may find itself in the position of selling or disposing of all or substantially all of your property, even though you are not dissolving. If your organization decides to sell, lease, exchange, or otherwise dispose of all, or substantially all, of your property and assets, you may do so with the following restrictions.

In the Usual Course of Your Activities

If the sale or other disposal of all or substantially all of your properties is in the usual or regular course of your activities, you may do so without approval of members or any other person, unless your Articles provide differently. You may mortgage and incur indebtedness whether or not it is in the usual or regu-

lar course of your activities without the approval of members or any other person, unless the Articles provide differently.

Not in the Usual Course of Your Activities

If you want to sell or otherwise dispose of all or substantially all of your corporation's property *other* than in the usual or regular course of your activities, the corporation must obtain approval for the transaction by the Board, by the members entitled to vote on the transaction and in writing by anyone whose approval is required for an amendment of Articles or Bylaws. The Articles, Bylaws, Board or members may require a greater vote or voting by class in order to approve the transaction.

You must decide whether you have members entitled to vote on this transaction and whether anyone else's approval is required for this transaction. In order to determine this, you need to read your Articles and any Restatement or Amendments and Bylaws. If you are a membership corporation, you need to determine if your members have the right to vote on this particular matter. You must also check to see if anyone else must approve. If you cannot easily determine these things, you need to have consult with an attorney.

Adoption by the Board

If the corporation does not have members entitled to vote on the transaction, it must be approved by a majority of the Directors in office at the time the transaction is approved. Notice of the Directors' meeting must be given as provided on page 287 for special meetings, and the notice must state that one of the purposes of the meeting is to consider the sale or other disposition of all or substantially all of the property of the corporation, and must contain a description of the transaction.

Adoption by the Members

If your corporation has members entitled to vote on the sale, your Board (after approving the sale) must submit the issue to the members for a vote. If the Board seeks to have the transaction approved by the members *at a membership meeting*, the corporation must give notice as explained on pages 320-324. The notice must also state that one of the purposes of the meeting is to consider the sale or the disposition of all or substantially all of the property of the corporation and include a description of the transaction. If the Board wants to have the transaction approved by the members *by written consent or written ballot*, the material soliciting the approval has to contain a description of the transaction.

The Board may condition its submission of the proposed transaction to a vote of the members, and the members entitled to vote on the transaction may condition their approval on a receipt of a higher percentage of affirmative votes or any other basis. Unless your Articles, Bylaws, Board, or members require a greater vote, the members must approve the merger by at least $^{2}/_{3}$ of the votes cast or a majority of the voting power, whichever is less.

Finalizing the Sale

A Public Benefit or Religious Corporation must give written notice to the Attorney General twenty days before it sells or otherwise disposes of all or substantially all of its property, unless the transaction is in the usual or regular course of its activities or the Attorney General has given the corporation a written waiver of this notice requirement. After the sale or other disposition of property is authorized, the transaction may be abandoned without further action by the members or any other person in accordance with a procedure stated in the resolution proposing the transaction or, if none is stated, in the manner determined by the Board.

§501(c)(3) Groups

If your group has a §501(c)(3) tax exemption, you must notify the IRS on your annual information return if there is a full or partial liquidation or a major disposition of your assets. A major disposition occurs if you dispose of at least 25% of the fair market value of your assets. However, if you sell your assets for a fair price you do not need to report this separately on the return. You do need to report the income from the sale of your assets on Form 990. Follow the instructions on your return.

Creditors

Your creditors may have rights that are impacted by your decision to dispose of your property. You should get some legal advice for your own particular situation.

Consult Appendix 1 if you would like information about source material related to this Chapter. Appendix 1 has references of interest to all readers, not just professionals.

30 DISSOLVING YOUR OREGON NONPROFIT CORPORATION

"Dissolution" is the legal term for what happens when a corporation ends its existence. A dissolution of your corporation may be either voluntary (of your own choice) or involuntary (when you are forced to do so by others).

THIS CHAPTER COVERS

- **Voluntary Dissolution**
- **Involuntary Dissolution**
- **Activities After Dissolution**
- **Special Note for Tax-Exempt Corporations that are Voluntarily or Involuntarily Dissolved**

VOLUNTARY DISSOLUTION

A nonprofit corporation may choose to dissolve for several reasons. There may not be enough people with the energy to continue its work. The group may not be able to attract sufficient funding to survive. Occasionally, the corporation may feel it has fulfilled its mission or there are other groups working to accomplish the same purposes. Sometimes divisions in the group make it impossible to continue. Sometimes a corporation dissolves because it has acquired more debt than it can pay and prefers this alternative to bankruptcy.

Issues to Consider

If your corporation has decided on dissolution, you need to consider a number of issues concerning how the dissolution will occur. We list here some of the most common:

- You should develop a plan to liquidate or dispose of your assets.

- You will need to determine if you have sufficient assets to pay all your creditors, any claims against the corporation and the expenses of closing down. Pages 682-685 discuss how to identify and pay claims in more detail.

- You will need to consider whether you have leases, contracts, grants or other legal relationships that will be impacted by your dissolution and deal with them. If you are vacating property before a lease has expired, for example, the lessor becomes a claimant and will need to be dealt with as such.

- If you have employees, you will need to consult your personnel manual and should also consider talking to an attorney about employment law, in order to determine what your duties and potential liabilities are. You may need to set aside a reserve for potential claims by your employees.

- Be sure that any tax issues have been taken care of before you distribute your assets.

- You need to review all current contracts with funders to determine whether they include audit and record inspection require-

ments. Make plans to comply with these requirements or get legal advice about the consequences of violating the agreements.

• If you are going to have assets remaining after all creditors, claims and expenses are paid, you must determine what happens to these assets. You should consult your Articles of Incorporation and possibly your Bylaws to see what these documents state should happen to your assets on dissolution. If the documents provide that the Board is to decide, your Board needs to make this determination.

• If your corporation is a Public Benefit or Religious Corporation and no provision has been made in the Articles or Bylaws for distribution of assets on dissolution, you must transfer your assets after payment of your debts to an organization organized for a public or charitable purpose, a religious corporation, the United States, a state, a person, or an entity that is exempt under §501 (c)(3) of the Internal Revenue Code.

• If your corporation is a Mutual Benefit corporation and no provision has been made in the Articles or Bylaws for distribution of assets on dissolution, you must transfer your assets after payment of your debts to your members or, if you have no members, to those people whom you holds yourself out as benefiting or serving.

• You should develop a timeline for the dissolution.

After you make decisions about these and other issues, you should formulate them into a written plan of dissolution.

If the corporation dissolves and there is a dissatisfied creditor or if you give assets to someone who should not be receiving them and the Attorney General's office investigates, the Board may be held personally accountable.

If your organization has assets of any substantial value or any potential claim that you cannot pay or make provision for, you should seriously consider getting some legal advice. If the corporation dissolves and there is a dissatisfied creditor or if you give assets to someone who should not be receiving them and the Attorney General's office investigates, the Board may be held personally accountable.

Overview of the Dissolution Procedure

Voluntary dissolution is legally accomplished when dissolution is voted on by the corporation, the Attorney General is notified in certain cases, Articles of Dissolution are prepared and the Articles of Dissolution are filed with the State.

Dissolution by Incorporators

If a corporation has no members and does not yet have an initial Board of Directors, the incorporators may dissolve the corporation by delivering Articles of Dissolution to the Secretary of State for filing. This happens very rarely. The incorporators have to get any approvals for dissolution required by the Articles or Bylaws. The corporation must give the incorporators notice equivalent to that required for special meetings of the Board discussed on page 287, of any meeting at which dissolution will be considered. The notice must also state that one of the purposes of the meeting is to consider dissolution. In approving the dissolution, the incorporators will need to adopt a plan of dissolution indicating who will get the assets owned or held by the corporation after all creditors have been paid.

Dissolution by Directors, Members and Third Parties

Once the corporation has a Board or has members who have voting rights on dissolution, the incorporator is no longer empowered to dissolve the corporation. Unless your Articles, Bylaws, Board, or members provide differently, your corporation is dissolved:

- by the Board
- by the members entitled to vote on dissolution, and
- in writing by anyone whose approval is required for an amendment to the Articles or Bylaws.

You must decide whether you have members entitled to vote on dissolution and whether anyone else's approval is required for dissolution. In order to determine this, you need to read your Articles and any Amendments and Bylaws. If you are a membership corporation, you need to determine if your members have the right to vote on this particular matter. You must also check to see if anyone else must approve. If you cannot easily determine these things, you need to have an attorney answer these questions for you.

Adoption by the Board

If the corporation does not have members entitled to vote on dissolution, dissolution must be approved by a vote of the majority of Directors *in office* at the time the transaction is approved. The corporation must provide notice of the meeting at which the dissolution is to be considered, equivalent to that required for special meetings of the Board discussed on page 287. The notice must state that one of the purposes of the meeting is to consider dissolution of the corporation and must include a copy or summary of the plan of dissolution.

Adoption by the Members

If your corporation has members entitled to vote on the dissolution, your Board (after adopting the plan) must submit the plan of dissolution to your members for approval. If the Board wants to have the dissolution approved by the members at a membership meeting, the corporation has to give the members notice as discussed on pages 320-324 which states that one of the purposes of the meeting is to consider dissolving the corporation. It must include a copy or summary of the plan of dissolution. Unless the Articles, Bylaws, Board of Directors or members require a greater vote, or voting is by class, dissolution is authorized if it is approved by the members entitled to vote on dissolution by at least ⅔ of the votes cast, or a majority of the voting power, whichever is less.

If the Board wants to have dissolution approved by the members *by written consent or written ballot*, the material soliciting the approval must include a copy or summary of the plan of dissolution.

The Board may condition its submission of the proposed dissolution to a vote of members or the members may condition their approval of the dissolution on receipt of a higher percentage of votes or on any other basis.

Notice to the Attorney General

Your Public Benefit or Religious Corporation must give the Attorney General written notice that it intends to dissolve at or before it delivers its Articles of Dissolution to the Secretary of State. The notice has to include a copy or a summary of the plan of dissolution. Your corporation cannot transfer assets as part of the dissolution process until twenty days after it has given a written notice to the Attorney General or until the Attorney General has consented in writing or indicated in writing that the state will take no action with respect to the transfer or conveyance, whichever is earlier.

When all or substantially all of the assets of the Public Benefit Corporation have been transferred or conveyed following approval of dissolution, the Board needs to deliver to the Attorney General a list showing those, other than creditors, to whom the assets were transferred or conveyed. The list must indicate the address of each person, other than creditors, who received assets and indicate what assets each received.

A Public Benefit or Religious Corporation must give the Attorney General written notice that it intends to dissolve at or before it delivers its Articles of Dissolution to the Secretary of State.

Articles of Dissolution

After the dissolution is authorized, the corporation completes the dissolution by delivering to the Secretary of State for filing an original copy of the Articles of Dissolution along with a filing fee. (See the Forms section for a sample "Articles of Dissolution.") The dissolution is effective on the date it is filed by the Secretary of State unless the document specifies a delayed effective date. However, the delayed effective date may not be later than ninety days after the document is filed.

Revocation of Dissolution

A corporation may revoke its dissolution within 120 days of its effective date. The revocation must be authorized in the same manner as the dissolution was authorized unless the authorization of dissolution permitted revocation by the Board of Directors alone. After the revocation of dissolution is authorized, the corporation revokes the dissolution by delivering to the Secretary of State for filing, Articles of Revocation of Dissolution. You can get these forms from the Secretary of State. Unless a delayed effective date is specified, the revocation of dissolution is effective when the Articles of Revocation of Dissolution are filed. When the revocation of dissolution is effective, it takes effect as of the effective date of dissolution and the corporation resumes carrying on its activities as if a dissolution had never occurred.

Claims Against a Dissolved Corporation

If your corporation is dissolving, it is very important for you to establish who your creditors are. These people must be paid before your remaining assets are distributed. Although it is not mandatory, Oregon law provides a procedure by which you can determine who your creditors are. It is a very good idea to follow this procedure because, if you do not, and a creditor does not get paid, it is possible that the individual Directors may be liable for the claim.

You should begin by identifying those claims that you know about. Obvious claims would be suppliers and those who have loaned you money or extended credit. However, consider also:

- employees who may have claims for unpaid benefits, unemployment claims, or other claims;
- your landlord, if you lease space;
- funders who have restricted the use of assets purchased with funds provided by the funder;
- any taxing authorities; and
- whoever holds your mortgage, if you own your building.

In the case of claims that are known to you, you should notify those claimants in writing about the dissolution at any time after its effective date. The purpose of your notice is to give your potential creditors the opportunity to notify you that they have a claim and how much they believe that you owe them. Your written notice to the claimants must describe the information you want the claimant to include in the claim, provide a mailing address where the claim can be sent, state a deadline (which may not be fewer than 120 days from the effective date of the written notice) by which the dissolved corporation must receive the claim, and state that the claim will be barred if not received by that deadline. It is a good idea to send your notices by certified mail, return receipt requested, so that you can prove that your claimants received their notices. For purposes of this procedure, a claim does not include a contingent liability (one which is not now fixed but will become definite in the future) nor does it include a claim based on an event that occurred after the effective date of dissolution.

If your corporation is dissolving, it is very important for you to establish who your creditors are. These people must be paid before your remaining assets are distributed.

If you follow the above procedure, claimants who you wrote to and who do not deliver a claim to you by the deadline cannot bring a claim against your corporation. If a claimant submits a claim and you dispute its validity or the amount of the claim, you can respond with a written rejection of the claim in full or a partial rejection that states what you believe you owe and rejects the remainder of the claim. Claimants who do file a claim with you within the deadline but whose claims you reject have ninety days from the date of the rejection

notice to file a proceeding to enforce the claim; otherwise, they also lose their claim.

It is possible that, at the time of dissolution, there may be potential claims against the corporation that are not known to you. In order to protect against these claims, you may publish notice of your dissolution and request that people with claims against the corporation present them in accordance with the notice. The notice must be published at least one time in a newspaper of general circulation in the county where your principal office is located. It must describe the information to be included in the claim, provide a mailing address where the claim can be sent and state that the claim against the corporation will be barred unless the proceeding to enforce the claim is begun within five years after publication of the notice.

If the dissolved corporation publishes this notice, the following claims are barred unless the claimant begins a proceeding to enforce the claim within five years after the publication:

- A claimant who did not receive written notice that was directed to the known claimants;

- A claimant whose claim was sent in a timely manner to the dissolved corporation but was not acted on; *and*

- A claimant whose claim is contingent or based on an event occurring after the effective date of dissolution.

If someone has a claim against your corporation, it may be enforced against the dissolved corporation to the extent of its undistributed assets or against any person (other than the creditor) to whom the corporation distributed its property upon liquidation. If the distributee received a *pro rata* share of a distribution, the distributee's liability will not exceed the same *pro rata* share of the claim. The distributee's total liability for all claims may not exceed the total amount of assets distributed to that person, less any liability of the corporation paid on behalf of the corporation by that distributee after the date of distribution.

If the corporation is required to transfer assets to a creditor, claimant or member who cannot be found or who is not competent to receive them, the corporation must sell the assets for cash (unless the asset is subject to a trust restriction) and deposit this with the Division of State Lands. The corporation's agent handling this must prepare under oath duplicate copies of a statement containing the names and last-known addresses of the people entitled to the

funds. One of the statements must be delivered to the Secretary of State and the other to the Division of State Lands.

Effect of a Dissolution

A dissolved corporation continues its corporate existence but may not carry on activities except those necessary to wind up its affairs. Such activities include:

- Protecting its assets and minimizing its liabilities;
- Paying its indebtedness;
- Liquidating its properties that will not be distributed as they are;
- Returning assets held by the corporation upon conditions requiring a return;
- Transferring its assets as provided in the Articles or Bylaws or by law;
- Sending the Attorney General the list showing who received its assets as described on page 681; *and*
- Doing other necessary acts to wind up its affairs.

See page 687 for a discussion of the consequences if you continue to operate your corporation after it has dissolved.

INVOLUNTARY DISSOLUTION

In some cases, your corporation may be dissolved by someone other than you.

Administrative Dissolution

The Secretary of State may administratively dissolve a corporation if:

- The corporation fails to pay when due any fees owed by it;
- The corporation fails to deliver its annual report to the Secretary of State when due;

- The corporation fails to have a registered agent or registered office in Oregon;

- The corporation fails to notify the Secretary of State that its registered agent has resigned or been changed or that its registered office has been discontinued or changed; or

- If the period of duration stated in the Articles of Incorporation expires.

The most common cause of administrative dissolution is when a corporation fails to pay its annual fee to the Secretary of State (see page 622).

The most common cause of administrative dissolution is when a corporation fails to pay its annual fee to the Secretary of State.

If the Secretary of State decides to dissolve your corporation, the Secretary's office will give your corporation written notice that grounds exist to dissolve the corporation. If you do not correct each problem or demonstrate to their reasonable satisfaction within 45 days after notice is given that the grounds for dissolution do not exist, the Secretary of State will administratively dissolve your corporation and give the corporation notice of dissolution. If the corporation is a Public Benefit Corporation, the Secretary of State will notify the Attorney General in writing.

Reinstatement

A corporation that has been administratively dissolved may apply to the Secretary of State for reinstatement. The application must state the name of the corporation and the effective date of its administrative dissolution and state that the grounds for dissolution either did not exist or have been eliminated. If the Secretary of State determines that the application contains the necessary information, that the information is correct and that the corporation's name is still available, the Secretary of State will reinstate the corporation. The reinstatement takes effect as of the effective date of the administrative dissolution and the corporation resumes carrying on its activities as if the dissolution had never occurred. If the Secretary of State denies a corporation's application for reinstatement, the Secretary of State must give written notice to the corporation explaining the reasons.

Judicial Dissolution

In a variety of circumstances, the courts may act to dissolve the corporation. In cases where the Attorney General suspects fraud or other types of mismanagement, the Attorney General can apply for a judicial dissolution. In other circumstances, members, a Director, or people specified in the Articles may apply for dissolution. Creditors in some cases also have the right to apply for dissolution, as does the corporation itself. You should see an attorney if a judicial dissolution is involved.

ACTIVITIES AFTER DISSOLUTION

A corporation that has been voluntariy or involuntarily dissolved continues its corporate existence but may not carry on any activities except those necessary to wind up its affairs and notify its claimants. There can be quite serious consequences if your corporation continues to carry on activities after dissolution other than winding up. *You carry on these activities not as a corporation but as an unincorporated association even if you are unaware that your corporation was dissolved.* If you acquire or dispose of property in the name of the corporation, the purchases or sales may not be valid. It is likely that the Board and possibly the managers will be personally liable for any debts and liabilities that your group incurs that it cannot pay. If your corporation was tax-exempt under §501(c)(3), that status does not apply to the unincorporated association. Donors who give you money believing that you are tax-exempt probably cannot take a charitable deduction. Funders who give you grants relying on your (c)(3) status may also encounter problems.

SPECIAL NOTE FOR TAX-EXEMPT CORPORATIONS THAT ARE VOLUNTARILY OR INVOLUNTARILY DISSOLVED

If you have a §501(c) tax exemption, you must notify the IRS on your annual information return about your dissolution, whether it was voluntary or involuntary. See the instructions for the return for more information.

Consult Appendix 1 if you would like information about source material related to this Chapter.

APPENDICES

Appendices

Appendix 1

SOURCE MATERIAL

We have designed this Appendix primarily for attorneys, accountants and similar professionals who want to pursue the issues raised in this book in more depth. We also include some materials written for professionals within nonprofit organizations and for a wider audience. We've labelled these materials "Non-technical materials," and we list them at the beginning of each Chapter or section heading below so that they are easy for non-specialists to locate. Attorneys and accountants may also want to consult these sources. Because this Appendix is designed primarily for attorneys and accountants, we use citation shorthand familiar to them. We don't attempt to explain this to other readers because this kind of research really requires a certain kind of expertise. Please be aware that this Appendix does not attempt to provide a complete listing of legal or accounting sources pertaining to each topic. Obviously, such a project would be its own volume. We point you to a starting place and to sources that support the material in the chapters to which they refer.

General works on nonprofit organizations: MARILYN E. PHELAN, NONPROFIT ENTERPRISES: CORPORATIONS, TRUSTS AND ASSOCIATIONS (1997-2000) and Supplements. **General works on tax exempt organizations**: FRANCES R. HILL AND DOUGLAS M. MANCINO, TAXATION OF EXEMPT ORGANIZATIONS (2002), with Supplements.

Chapter 1
Should Your Organization Be a Nonprofit Corporation?

For a more detailed discussion of most of the legal structures discussed in this chapter, see ADVISING OREGON BUSINESSES Chapters 1-4, 7, 9 (Oregon State Bar: Rev. 2001). ORS Chapter 62 governs cooperatives. For a discussion of associations and charitable trusts, see MARILYN E. PHELAN, NONPROFIT ENTERPRISES: CORPORATIONS, TRUSTS AND ASSOCIATIONS §1.04-1.09 (1997-2000) and Supplements; Leslie v. Bendl, 92 Or App 519, 759 P2d 301 (1988), rev den 307 Or 245 (officers and directors of political committee have common law personal liability for acts that they authorize).

Chapter 2
The Structure and Types of Oregon Nonprofit Corporations

General: *Official Commentary to the Revised Oregon Nonprofit Corporation Act*, Special Issue OR L REV (1992).

Statutes: See ORS Chapter 65, especially:
65.301-.369—Board of Directors
65.371-.384—Officers
65.001(28) and (29)—Definitions of member and membership
65.131-.254—Members
65.774-.784—Inspection of records and reports to members
65.001(30), (37), and (39)—Types of nonprofit corporations.

Quasi-governmental nonprofits: Cynthia Cumfer, *Quasi-Governmental Nonprofit Organizations*, in ADVISING NONPROFIT ORGANIZATIONS, Chapter 6B (Oregon State Bar: 2002).

Chapter 3
Setting Up Your Oregon Nonprofit Corporation

General: David E. Atkin, *Setting Up a Nonprofit Organization and Getting the Tax Exemption*, in ADVISING NONPROFIT ORGANIZATIONS, Chapter 1 (Oregon State Bar, 2001); Cynthia Cumfer, *Governance and Maintenance of Oregon Nonprofit Organizations*, in ADVISING NONPROFIT ORGANIZATIONS, *id*, Chapter 2; Ross L. Laybourn, Jr., *The Oregon Attorney General's Role*, in NONPROFITS IN THE HEADLINES, Chapter 3 (Oregon State Bar, 2004).

Name: ORS 65.094 (choosing name); ORS 65.097 (reserving name).

Trademarks: Stuart E. Foster and Timothy L. Jackle, *Sole Proprietors*, ADVISING OREGON BUSINESSES §1.25-1.31 (Oregon State Bar: Rev. 2001).

Articles: ORS 65.047 (provisions); ORS 65.051 (filing); ORS 65.111 (registered office and agent); ORS 65.044 (incorporators); ORS 65.301(3) (limitations of Board powers); ORS 65.241 (quorum), 65.244 (voting), 65.464 (amendments to Bylaws in membership corporations); ORS 65.307(2) (size of Board in membership corporations); ORS 65.324 (removal of Directors for cause in membership corporations); ORS 65.774(5)(b) (members' rights to records).

Bylaws: ORS 65.061.

Organizational meeting: ORS 65.057.

Department of Justice: ORS 128.650-.660; OAR 137-010-0005 through 0055 (regulation of public benefit corporations).

Doing business in another name: ORS Chapter 648.

Postal benefits: United States Postal Service Publication 417 and Quick Service Guide 670 (available on the USPS website at *www.usps.com/businessmail101/rates/nonprofit.htm*).

Chapter 4
Writing Bylaws

Members: ORS 65.001(28) and (29); ORS 65.131-.254.

Board of Directors: ORS 65.301-.369.

Committees: ORS 65.354.

Officers: ORS 65.371-.384.

Indemnity: ORS 65.387-.414.

Amendments to Bylaws: ORS 65.461-.467.

Discrimination: We are not aware of cases that consider the issue of discrimination in choosing Board members. Courts have considered the issue of discrimination in admitting members in cases brought under the public accommodations laws. Roberts v. U.S. Jaycees, 468 US 609 (1984) (Jaycees violated Minnesota's public accommodations laws by refusing to admit women); New York State Club Assn v. City of New York, 487 US 1 (1988) (club violated city's public accommodation ordinance by refusing to admit women); Boy Scouts of America v. Dale, 530 US 640 (2000) (Boy Scouts did not violate New Jersey's public accommodation law by refusing to allow gay man to be scoutmaster).

E-mail: The federal Electronic Signatures in Global and National Commerce Act (E-SIGN) provides that records relating to any transaction that affects interstate or foreign commerce may be in electronic form. 15 USC §7001. The law allows a state to supercede §7001 by adopting the Uniform Electronic Transactions Act. Oregon has done this in ORS Chapter 84. ORS 84.061 states that Chapter 84 supersedes E-SIGN. ORS 84.004(16) defines a transaction as an action to conduct business, commerce or governmental affairs. If a law requires a person (which includes a legal entity) to send information in writing, the sender may satisfy the law by using an electronic means if both parties have consented and the sender does not inhibit the ability of the recipient to print or store the electronic record. ORS 84.022(1). The issue is whether nonprofits are conducting "business, commercial or governmental affairs" in their transactions. The Oregon law provides no additional guidance nor does the Uniform Laws Annotated. The commentary to the Uniform Laws describes transactions but does not provide any nonprofit examples. Uniform Laws Annotated, Vol. 7A Pt. I,

213-14, 231 (West: 2002). If your nonprofit engages in commercial operations, those operations are almost certainly covered. However, Oregon law is much less clear about whether a nonprofit's use of e-mail to deliver notice of meetings, for example, is a transaction that is covered. The cautious approach is to use the statutory methods of delivery. If a nonprofit uses e-mail, it must comply with ORS 84.022(1) above.

Chapter 5
Federal Tax-Exempt Status

Non-technical materials: The IRS has some materials that you may want to consult: Publication 557, *Tax Exempt Status for Your Organization;* Publication 4220, *Applying for 501(c)(3) Tax-Exempt Status,* and Publication 4221, *Compliance Guide for 501(c)(3) Tax-Exempt Organizations*. All are available free on the IRS website at *www.irs.gov*. You may also want to consult the IRS article, *The Life Cycle of Public Charities*, at *http://www.irs.gov/charities/charitable/article/0,,id=122670,00.html*. Private foundations may want to consult IRS Publication 578, *Tax Information for Private Foundations and Foundation Managers*.

General: Frances R. Hill and Douglas M. Mancino, Taxation of Exempt Organizations, Chapters 2, 3, 4, 7, 32 (2002), with Supplements.

Who Qualifies for (c)(3) Status

General: William S. Manne, *Private Inurement*, in Advising Nonprofit Organizations, Chapter 6C (Oregon State Bar, 2001).

Statutes: 26 USC §§501(c)(3); 26 USC §504 (excess lobbying by (c)(3) results in denial of (c)(4) status).

Regulations: 26 CFR §1.501(c)(3)-1; §1.504-1 and 504-2.

Cases: Church of Scientology of California v. Commissioner, 823 F2d 1310 (9th cir 1987) (private inurement to founder); United Cancer Council, Inc. v. Commissioner, 165 F3d 1173 (7th cir 1999) (professional fundraising firm was not insider to whom inurement rules apply).

Private Foundations and Public Charities

General: William S. Manne, *Private Foundations,* in Advanced Nonprofit Law: Beyond the Basics, Chapter 2 (Oregon State Bar, 2002).

Statutes: 26 USC §507 (termination of private foundation status); §508 (private foundation rules); §509 (private foundation defined); §§4940-4948 (private foundation taxes); §§4958, 4961-4963 (excess benefits taxes).

Regulations: 26 CFR §§1.507-1 through 1.507-8; §§1.508-1 through 1.508-4; §§1.509(a)-1 through 1.509(e)-1, especially §1.509(a)-3 (what this book calls PSOs and FASOs); 26 CFR §1.509(a)-4 (supporting organizations); §§53.4940-1 through 4948-1; §§53.4958-0 through 4958-8; §§53.4961-1 through 4963-1.

Procedures

General: HILL AND MANCINO, TAXATION OF EXEMPT ORGANIZATIONS, ¶8.05[6][g] (advance rulings); ¶32.01-32.03 (general).

Statutes: 26 USC §508 (who must file Form 1023 and presumption about private foundation status).

Regulations: 26 CFR §1.508-1 (15 month and retroactivity rules); Rev Rul 67-390, 1967-2 CB 179; Gen Couns Mem 38740 (June 3, 1981) (incorporation of (c)(3) unincorporated association creates a new entity that must file a new Form 1023 for exemption); Rev Proc 92-85, 1992-2 CB 490 (extensions of time for filing Form 1023 to 27 months), modified by Rev Proc 93-28, 1993-2 CB 344.

(c)(4) Social Welfare Organizations

General: HILL AND MANCINO, TAXATION OF EXEMPT ORGANIZATIONS, Chapter 13.

Statutes: 26 USC §501(c)(4).

Regulations: 26 CFR §1.501(c)(4)-1.

(c)(5) Labor and Agricultural Organizations

Statute: 26 USC §501(c)(5)-1.

Regulations: 26 CFR §1.501(c)(5)-1.

(c)(6) Business Leagues

General: HILL AND MANCINO, TAXATION OF EXEMPT ORGANIZATIONS, Chapter 14.

Statute: 26 USC §501(c)(6)

Regulations: 26 CFR §1.501(c)(6)-1.

Cases: Guide International Corporation v. United States, 948 F2d 360 (7th cir 1991) (line of business requirement for business leagues); Associated Master Barbers & Beauticians of America v. Commissioner, 69 TC 53 (1977) (insurance is a profit-making business that cannot be conducted as a substantial activity by (c)(6) organizations).

(c)(7), (8) and (10) Social Clubs and Fraternities

General: HILL AND MANCINO, TAXATION OF EXEMPT ORGANIZATIONS, Chapter 16.

Statutes: 26 USC §§501(c)(7), (8), and (10); 26 USC §501(i).

Regulations: 26 CFR §1.501(c)(7)-1 (social clubs); Rev Rul 69-635, 1969-2 CB 126 (members in social club must commingle); Rev Rul 74-30, 1974-1 CB 137 (members of social club must have identity of purpose); 26 CFR §1.501(c)(8)-1 and (c)(10)-1 (fraternities)

Cases: Zeta Beta Tau Fraternity, Inc. v. Commissioner, 87 TC 421 (1986) (college fraternity exempt under (c)(7) is not entitled to more favorable tax treatment granted to fraternal organizations under (c)(10)).

(c)(19) Veterans Organizations

Statutes: 26 USC §501(c)(19)

Regulations: 26 CFR §1.501(c)(19)-1.

General Information for Tax-Exempt Groups:

Group Exemption

General: HILL AND MANCINO, TAXATION OF EXEMPT ORGANIZATIONS, §32.04.

Regulations: 26 CFR §601.201(n)(8); Rev Proc 80-27, 1980-1 CB 677, modified by Rev Proc 96-40, 1996-32 IRB 8.

User Fees

General: HILL AND MANCINO, TAXATION OF EXEMPT ORGANIZATIONS, §32.06.

Regulations: Rev Proc 2004-8, 2004-1 IRB 240.

Chapter 6
Filling Out the Tax-Exempt Applications

Special Topics

Below cost rules: Rev Rul 71-529, 1071-2 CB 234 (substantially below cost); Rev Rul 72-369, 1972-2 CB 245 (donative element); *IRC 501(c)(3)-Substantially Below Cost* (IRS CPE for FY 1986); Airlie Foundation v. Internal Revenue Service, 283 F Supp2d 58 (DDC 2003) (court denied exemption to educational conference center because it operated center in commercial manner and did not provide enough services at substantially below cost).

Fundraising: Hill and Mancino, Taxation of Exempt Organizations, ¶34.04.

Gaming: Hill and Mancino, Taxation of Exempt Organizations, ¶22.11[3]; OAR 137-025-0030 (Oregon nonprofit must have its tax-exempt status for at least one year to get bingo license).

Economic Development: An economic development program may be charitable under several rationales. It may lessen the burden of government. Monterey Public Parking Corp. v. US, 321 F Supp 972 (ND Cal 1970), *aff'd on other grounds*, 481 F2d 175 (9th cir 1973) (construction of public parking facility lessened burden of government); PLR 199932052 (May 14, 1999) ((c)(3) that promoted model Maglev transportation project that included the construction and operation of a parking garage lessened the burden of government). Economic development may also combat community deterioration. 26 CFR §1.501(c)(3)-1(d)(2) (combatting community deterioration is charitable); Rev Rul 74-587, 1974-2 CB 162 (organization designed to stimulate economic development in low income areas is exempt); Rev Rul 76-147, 1976-1 CB 151 (community improvement organization in high income community combats community deterioration and is exempt). The IRS will challenge economic development programs that permit inurement or improper private benefit. Rev Rul 78-86, 1978-1 CB 151 (IRS refused to follow holding of Monterey Public Parking Corp. *supra*, because of private benefit), *distinguished by* Rev Rul 81-116, 1981-1 CB 333.

Development and Management of Facilities: Hill and Mancino, Taxation of Exempt Organizations, Chapter 4 (private benefit).

Joint Ventures: Hill and Mancino, Taxation of Exempt Organizations, Chapter 29.

Childcare: Hill and Mancino, Taxation of Exempt Organizations, ¶3.03[5].

Intellectual Property: HILL AND MANCINO, TAXATION OF EXEMPT ORGANIZATIONS, ¶3.04 (scientific research).

Contributions: JOSEPH P. TOCE, JR. ET. AL., TAX ECONOMICS OF CHARITABLE GIVING, Chapter 25 (2003).

International Nonprofits: FRANCES R. HILL AND DOUGLAS M. MANCINO, TAXATION OF EXEMPT ORGANIZATIONS, Chapter 36 (2002), with Supplements.

Grants and Loans to Other Organizations: Rev Rul 68-489, 1968-2 CB 210 (accountability regulations).

Linked Organizations: HILL AND MANCINO, TAXATION OF EXEMPT ORGANIZATIONS, Chapter 27, ¶5.05.

Schedules

Schedule A (Churches): HILL AND MANCINO, TAXATION OF EXEMPT ORGANIZATIONS, ¶8.05[1].

Schedule B (Schools): HILL AND MANCINO, TAXATION OF EXEMPT ORGANIZATIONS, ¶8.05[2].

Schedule C (Hospitals): HILL AND MANCINO, TAXATION OF EXEMPT ORGANIZATIONS, ¶8.05[3] and [4].

Schedule D (Supporting Organizations): HILL AND MANCINO, TAXATION OF EXEMPT ORGANIZATIONS, ¶8.07.

Schedule E (Retroactivity): HILL AND MANCINO, TAXATION OF EXEMPT ORGANIZATIONS, ¶32.02[1][b]-[d].

Schedule F (Homes for Elderly and Low Income): Rev Rul 72-124, 1972-1 CB 145 (elderly); PLR 9438039 (June 29, 1994) (elderly); Elizabeth C. Kastenberg and Joseph Chasin, *Elderly Housing* (IRS CPE for FY 2004); Rev Proc 96-32, 1996-20 IRB 14 (safe harbor guidelines for low income housing).

Schedule G (Successors): HILL AND MANCINO, TAXATION OF EXEMPT ORGANIZATIONS, Rev Rul 67-390, 1967-2 CB 179.

Schedule H (Scholarships): HILL AND MANCINO, TAXATION OF EXEMPT ORGANIZATIONS, ¶¶7.04[5], 9.02[2][a], 10.09[3][b], 11.03[4].

Chapter 7
Publicly Supported Organizations and Fee/Activity Supported Organizations

General: David Ross Gray, Nonprofit Foundations: A Tax Guide for Charitable Organizations (1978) and Supplements; Frances R. Hill and Douglas M. Mancino, Taxation of Exempt Organizations, Chapter 8 (2002), with Supplements.

Statutes: 26 USC §509(a) (listing (c)(3)s that are not private foundations); 26 USC §170(b) (referred to in §509(a)).

Regulations: 26 CFR §1.509(a)-2 (general); 26 CFR §1.170A-9 (on publicly-supported organizations); 26 CFR §1.509(a)-3 (on what this book calls fee-activity supported organizations); 26 CFR §1.509(a)-6 (status assigned to organizations that are both PSO and FASO); 26 CFR §1.509(d) (definition of support); 26 CFR §1.509(e) (definition of gross investment income); 26 CFR §1.507-6 (substantial contributors); 26 CFR §53.4946-1(f) (foundation managers); (26 CFR §1.509(a)-7 (reliance by contributors on definitive rulings on public charity status).

Chapter 8
Political Activity and Lobbying by Tax-Exempt Organization

Non-technical materials: The Alliance for Justice has some excellent materials available at a very low cost on political activities and lobbying. Their easy-to-read publications cover the IRS lobbying rules, federal tax and election laws, ballot measures, linked organizations, use of the Internet for lobbying and political activities and foundations that want to support advocacy. Some of the publications are older, so be sure that you update any information you rely on. You can reach them at Alliance for Justice, 11 Dupont Circle, NW, 2d floor, Washington, D.C. 20036; telephone 202.822.6070, or go to their website at *www.allianceforjustice.org* and follow the link to Publications.

You can also consult Terry Miller, Managing for Change: A Common Sense Guide to Evaluating Financial Management Health for Grassroots Organizations, $22.50, contact by telephone 415.824.4705, email: TBearSFO@compuserve.com.

General: Frances R. Hill and Douglas M. Mancino, Taxation of Exempt Organizations, Chapters 5, 6 (2002), with Supplements; David E. Atkin, *State and Federal Law*, in Nonprofits in the Headlines, Chapter 4 (Oregon State Bar, 2004).

Political Activity

General: HILL AND MANCINO, TAXATION OF EXEMPT ORGANIZATIONS, Chapter 6.

Statutes: 26 USC §501(c)(3); §4955 (political expenditures tax).

(c)(3) Regulations: 26 CFR §1.501(c)(3)-1(c)(3) (on political activity); 26 CFR §53.4955-1 (tax penalties); Rev Rul 78-248, 1978-1 CB 154 (candidate questionnaires, voting records and scorecards), *amplified by* Rev Rul 80-282, 1980-2 CB 178 (voting records and scorecards); Rev Rul 86-95, 1986-2 CB 73 (candidate forums and debates); TAM 91-17-001 (Sept. 5, 1990) (issue advocacy); TAM 1999-07-021 (May 20, 1998) (issue advocacy).

Cases: Branch Ministries, Inc. v. Rossotti, 40 F Supp2d 15 (DDC 1999) (IRS revoked exemption of church that opposed candidacy of Bill Clinton in 1992).

(c)(4), (5) and (6) Regulations: HILL AND MANCINO, TAXATION OF EXEMPT ORGANIZATIONS, ¶¶13.04, 14.04[2], 15.04, 16.02[7], 16.03[6]; 26 CFR §1.501(c)(4)-1(a)(2)(ii); Rev Rul 81-95, 1981-1 CB 332 ((c)(4)'s primary activities promote social welfare and its less than primary participation in political campaigns does not make it non-exempt); GCM 34233 (Dec. 30, 1969) (involvement in political campaigns is not an exempt purpose of (c)(5) and (6) groups).

Internet

Exempt Organization Tax Review Weekly, Vol. 16, No. 9, at 50 (11/29/99) (IRS responded favorably to FEC rule about web forums found in A.O. 1999-25 (FEC 1999).

Lobbying

General: HILL AND MANCINO, TAXATION OF EXEMPT ORGANIZATIONS, Chapter 5.

Statute: 26 USC §501(c)(3); §4911 and 4912 (lobbying taxes).

Substantial Parts Test

Statutes: 26 USC §501(c)(3); 26 USC §504; 26 USC §4912.

Regulations: 26 CFR §1.501(c)(3)-1(b)(3)(i) (insubstantial parts test); 26 CFR 1.501(c)(3)-1(c)(3)(ii); Rev Rul 70-449, 1970-2 CB 111 (testimony before Congressional committee at committee's request is not lobbying).

Cases: Seasongood v. Commissioner, 227 F 2d 907 (6th cir 1955) (less than 5% of time and efforts is insubstantial); Haswell v. United States, 500 F 2d 1133 (Ct.Cl. 1974), cert den. 419 US 1107, 95 SCt 779 (1975) (subjective balancing test of all facts and circumstances); Christian Echoes National Ministry, Inc. v. United States, 470 F2d 849 (10th cir 1972) (upheld IRS revocation of exemption of religious organization that engaged in substantial lobbying and intervened in political campaigns).

Lobbying Election

Statutes: 26 USC §501(h) (subsection h election).

(c)(3) Regulations: 26 CFR §1.501(c)(3)-1(c)(3)(ii); 26 CFR §1.501(h)-1 to 3; 26 CFR §56.4911-0 through 10 (lobbying election and computation rules).

(c)(4) and Affiliated Groups

General: Hill and Mancino, Taxation of Exempt Organizations, ¶¶13.03, 14.04[1], 15.04, 16.03[6].

Statutes: 2 USC §1611 (Lobbying Disclosure Act provision that (c)(4)s that lobby cannot get federal grants or loans); 31 USC §1352 (prohibits all recipients of federal grants, loans and contracts from using those funds to lobbying federal legislative and executive officials).

(c)(4), (5) and (6) Regulations: Rev Rul 61-177, 1961-2 CB 117 ((c)(6) (business league can have lobbying as sole activity); Rev Rul 71-530, 1971-2 CB 237 (organization whose only activity is lobbying can qualify as exempt under (c)(4)).

Deductibility of Dues/Lobbying Tax

General: Hill and Mancino, Taxation of Exempt Organizations, ¶14.05.

Statutes: 26 USC §6033(e).

Regulations: 26 CFR §1.162-20; Rev Proc 98-19, 1998-1 CB 547 (deductibility rules); Rev Proc 2004-71 (November 19, 2004) (cost of living adjustments for 2005).

Chapter 9
Business Activities by Tax-Exempt Organizations

General: FRANCES R. HILL AND DOUGLAS M. MANCINO, TAXATION OF EXEMPT ORGANIZATIONS, Chapters 21-22 (2002), with Supplements; Sean Barnett, Shed Jessup and Charles Barrett, *UBIT: Current Developments* (IRS CPE for FY 2002) (covers variety of UBIT topics).

Statutes: 26 USC §§511 (unrelated business income tax), 512 (unrelated business income and exceptions), 513 (unrelated trade or business) and 514 (debt-financed property).

Regulations: 26 CFR §1.511-1 to 1.514(g), especially §1.513-1 (definition of UBI). On web links and other UBI issues: PLR 200303062 (October 2, 2002). When an exempt organization carries on a business, this activity can implicate IRS positions on commerciality and partnerships with business: Rul 67-4, 1967-1 CB 121 (commerciality doctrine); Rev Rul 98-15, 1998-12 IRB 6 ((c)(3) hospital can form LLC with for-profit hospital management company); Rev Rul 2004-51, 2004-22 IRB 974 (joint ventures).

Cases: Goldsboro Art League v. Commissioner, 75 TC 337 (1980) (commerciality doctrine); Presbyterian and Reformed Publishing Co. v. Commissioner, 743 F2d 148 (3rd cir 1984) (commerciality doctrine); Plumstead Theatre Society, Inc. v. Commissioner, 74 TC 1324 (1980) (joint venture with business); St. David's Health Care System v. U.S., 349 F3d 232 (5th cir 2003).

Trade or Business

Regulations: 26 CFR §1.513-1(b)

Regularly Carried On

Regulations: 26 CFR §1.513-1(c)

Cases: National Collegiate Athletic Ass'n v. Commissioner, 914 F2d 1417 (10th cir 1990) (revenue received by NCAA, an exempt organization, from program advertising in men's championship tournament is not revenue from an activity that is regularly carried on and is therefore not taxable).

Substantially Related To

Regulations: 26 CFR §1.513-1(d)(4)(iv) (when ads are unrelated business income); 26 CFR §1.512(a)-1(f)(2) (computation of advertising income); 26 CFR

§1.513-1(d) (substantially related); 26 CFR §1.513-3 (conventions and trade shows); 26 CFR §1.513-4 (corporate sponsorship); 26 CFR §1.513-4(f), Examples 11 and 12 (corporate sponsorship and websites); 26 CFR §1.513-7 (travel and tours); Rev Rul 73-105, 1973-1 CB 264 (sales of merchandise in folk art museum related to its exempt purpose are not taxable but sales from scientific books and souvenir items unrelated to its exempt purpose are taxable); Rev Rul 80-296, 1980-2 CB 195 (sale of broadcast rights to college game is related to educational purpose of college and does not produce taxable income).

Cases: United States v. American College of Physicians, 475 US 834 (1986) (ads in AMA Journal are not substantially related to AMA's exempt purpose and are taxable).

Calculations

General: Hill and Mancino, Taxation of Exempt Organizations, Chapter 25.

Regulations: 26 CFR §1.513-1(d)(4)(iii) (dual use of facilities or personnel); 26 CFR §1.513-1(d)(4)(iv) (allocation rules for UBI activity that "exploits" exempt activity.

Exceptions

General: Hill and Mancino, Taxation of Exempt Organizations, Chapters 23, 24 and 26.

Statutes: 26 USC §§512, 513, 514.

Regulations: 26 CFR §1.512(b)-1 (special rules and exclusions); 26 CFR §1.514(a)-(1) (unrelated debt-financed income); §1.513-5 (bingo); 26 CFR §1.514(a)-(g) (exclusions from unrelated business income). The adjustments for inflation for low cost items are provided each year by the Treasury Department in Revenue Procedures. See Rev Proc 2004-71 (November 19, 2004) for 2005, setting the low cost article limit at $8.30.

Royalty Cases: Sierra Club, Inc. v. Commissioner, 86 F3d 1526 (9th cir 1996) (sale of mailing list yields passive royalty income that is not taxable); Oregon State University Alumni Ass'n v. Commissioner, 193 F3d 1098 (9th cir 1999) (affinity card income is royalty income); Arkansas State Police Assn v. Commissioner, 282 F3d 556 (8th cir 2002) (money paid by publisher to (c)(5) labor union to publish union's official publication is not royalty because union maintained control over publication).

Protecting Your Exempt Status

General: BRUCE HOPKINS, THE LAW OF TAX-EXEMPT ORGANIZATIONS, Chapters 28 and 31 and Supplement (8th ed., 2003) (on structures to avoid loss of exemption for excess unrelated business income).

Chapter 10
Fiscal Sponsorship

Non-technical materials: *Fiscal Sponsorship: 6 Ways to Do It Right* (Study Center Press: 1993), by Gregory L. Colvin. This book can be obtained from Study Center Press, 1095 Market St., Suite 602, San Francisco, CA 94103, 1.800.484.4173 x1073.

Regulations: Rev-Rul 67-149, 1967-1 CB 133 ((c)(3) providing financial assistance to other (c)(3)s is exempt); Rev Rul 68-489, 1968-2 CB 210 (accountability requirements for grants made by (c)(3)s to non-(c)(3) groups).

Chapter 11
State, Regional and County Tax Exemptions

State and District

State Income Tax: ORS 317.080(1) (§501(c) and (d) organizations are exempt); ORS 317.080(9) (certain old age homes are exempt).

Tri-Met and Lane Transit: ORS 267.380(2)(a) ((c)(3)s except hospitals excluded from Mass Transit District taxation).

County Property Tax:

Statutes: General charitable exemptions are found at ORS 307.130-.150.

Other nonprofit exemptions:

ORS 307.166--leasing by one exempt organization to another.
ORS 307.115--nonprofit holding property for park or public recreation.
ORS 307.157--nonprofit cemeteries.
ORS 307.160--public libraries.
ORS 307.195--nonprofit student housing.
ORS 307.210--nonprofit water associations.
ORS 307.220--nonprofit telephone associations.
ORS 307.241-.245, .370-.385--nonprofit housing for elderly.

ORS 307.460--school-rented student housing.
ORS 307.515-.548--low income housing.

Procedures for Most Nonprofits: ORS 307.162.

Leased Property by Exempt Organizations: ORS 307.166.

Personal Property: ORS 307.162.

Regulations: OAR 150-307, especially 150-307.130 and 150-307.162.

Cases: Theatre West of Lincoln City v. Dept. of Revenue, 319 Or 114, 873 P2d 1083 (1994) ("literary" includes theatres); YMCA v. Dept. of Revenue, 308 Or 644, 784 P2d 1086 (1989) (YWCA's gym is not used exclusively for charity since charity requires an element of giving); Southwest Oregon Public Defender Services, Inc. v. Dept. of Revenue, 312 Or 82, 817 P2d 1292 (1991) (public defender services funded by the state are charitable, since the organization has charity as its primary object; its services further its charitable object; and the performance of its service includes an element of giving when evaluated from perspective of recipient).

Chapter 12
Tax Returns for Tax-Exempt Organizations

Federal

General: Frances R. Hill and Douglas M. Mancino, Taxation of Exempt Organizations, ¶33.03 (2002), with Supplements

State

Regulations: OAR l37-10-0015 and 10-0020 (form and contents of this annual report); OAR 137-10-0030 (payment of the required filing fees).

Chapter 13
Board of Directors

Non-technical materials: Oregon Department of Justice, Guide to Non-Profit Board Service (available at *www.doj.state.or.us/ChariGroup/Tipsbrd.htm* or by telephone listed in Appendix 2).

Duties and Responsibilities of Board

General: MARILYN E. PHELAN, NONPROFIT ENTERPRISES: CORPORATIONS, TRUSTS AND ASSOCIATIONS, Chapter 4 (1997-2000) and Supplements.

Statutes: ORS 65.301 and 65.357 (duties and standards)

Cases: Stern v. Lucy Webb Hayes National Training School for Deaconesses, 381 F Supp 1003 (DDC 1974) (rejects older standard that directors act as trustees and establishes a corporate standard); American Baptist Churches of Metropolitan New York v. Galloway, 710 NYS 2d 12 (2000) (employee and consultant of Baptist Church who set up "rival" nonprofit and used connections made while employed by Baptist Church to secure funding breached their duty of loyalty to Baptist Church); Northeast Harbor Golf Club v. Harris, 725 A 2d 1018 (Me 1999) (director of golf club usurped corporate opportunity when she used information acquired as director to engage in private speculative opportunities rather than promote those opportunities on behalf of the golf club).

Board Committees

Statute: ORS 65.354.

Officers

Statute: ORS 65.371-.384.

Personal Liability of Directors and Officers

General: Debra Kawecki and Leonard Henzke, *Employment Tax Update--Review of Current Litigation*, D-26 (IRS CPE for FY 2003) (IRS authors reminded exempt organizations examiners that they should assess §6672 penalties against the responsible parties in an exempt organization that wilfully fail to collect and pay employee withholding taxes).

Statute: 26 USC §6672 (liability for failure to withhold federal taxes).

Cases: Hirsovescu v. Shangri-La Corp., 113 Or App 145, 831 P2d 73 (1992) (nonprofit directors were not shielded from personal liability under ORS 65.369(1) for wrongful discharge, since it is an intentional tort).

Protection of Board and Officers

Statutes: ORS 65.369 (limited liability); ORS 65.407 (indemnification).

Replacing Directors and Officers

Statute: ORS 65.321 (resignation), .324-.331 (removal of directors), .334 (vacancies on board), .381 (resignation and removal of officers).

Chapter 14
Members and Membership Corporations

Statutes: ORS 65.131-.134 (admission of members); ORS 65.144 and ORS 65.151-.154 (rights and obligations); ORS 65.177 (delegates); ORS 65.214-.221 (notice of meetings); ORS 65.201-.204 (meetings); ORS 65.211 (action without meeting); ORS 65.222 (ballots); ORS 65.227-.254 (voting); ORS 65.437 and .464 (amendments of Articles and Bylaws); ORS 65.224 (members list and inspection by members); ORS 65.771-.782 (records and inspection by members); ORS 65.164-.167 (resignation and termination).

Cases: The rights of members and of membership corporations are a fairly fertile ground of litigation although Oregon appellate courts have not addressed these issues under the current statutes. Courts give considerable deference to the right of private associations to handle membership matters. Even so, holdings on when a nonprofit can expel its members vary depending on the property interest implicated in the membership and the type of nonprofit: Bernstein v. Alameda-Costra Medical Assn, 139 Cal App 2d 241, 293 P2d 862 (1956) (standard is whether medical association acts in good faith in expelling member); Bernstein v. The Players, 120 Misc 2d 998, 466 NYS 2d 897 (1983) (court upheld expulsion of member of social club who questioned financial transactions of the club); Guinn v. Church of Christ of Collinsville, 775 P2d 766 (Okla 1989) (court limits church's ability to discipline member after member left). Courts have considered whether the admission of members to nonprofit organizations falls under the public accommodations laws with uneven results: Roberts v. U.S. Jaycees, 468 US 609 (1984) (Jaycees violated Minnesota's public accommodations laws by refusing to admit women); New York State Club Assn v. City of New York, 487 US 1 (1988) (club violated city's public accommodation ordinance by refusing to admit women); Boy Scouts of America v. Dale, 530 US 640 (2000) (Boy Scouts had constitutionally protected freedom of association that permitted them to discriminate based on sexual orientation in spite of New Jersey public accommodation statute that forbade it).

Chapter 15
Employees

Wage and Hour Laws

General: Ed Reeves and Alison Whitney Daugherty, *Wages, Hours, and Fringe Benefits,* LABOR AND EMPLOYMENT LAW: PRIVATE SECTOR Chapter 3 (Oregon State Bar: 2002)

Statutes: 29 USC §201, *et. seq.*; ORS Chapters 652 and 653.

Regulations: 29 CFR §778 (overtime); 29 CFR §785 (hours worked); OAR 839-020-0030 to 0050 (wage and hour).

Discrimination Issues

Statute: ORS 659A.309 (illegal to refuse to hire family members in some circumstances)

Personnel Policies

General: Sharon Toncray and Donald B. Potter, *Employment Actions in Contract*, LABOR AND EMPLOYMENT LAW: PRIVATE SECTOR §§2.8, 2.13, 2.15, 2.18 (Oregon State Bar: 2002).

Statutes: ORS 652.750 (employee has right to inspect and obtain copy of personnel records); ORS 659A.315 (restrictions on employer's right to restrict off-duty use of tobacco).

Family Leave

General: Eve L. Logsdon and Dan Grinfas, *Family Leave Law*, LABOR AND EMPLOYMENT LAW: PRIVATE SECTOR Chapter 20 (Oregon State Bar: 2002).

Statutes: 29 USC §2601, *et. seq.*; ORS 659A.150-.186.

Regulations: 29 CFR §825.100-.800; OAR 839-009-0200 *et. seq.*

Chapter 16
Independent Contractors

Federal Income Tax Withholding

General: Judy L. Johnson, Alison Whitney Daugherty, and Nichol Starr, *Independent Contractors*, in LABOR AND EMPLOYMENT LAW: PRIVATE SECTOR §15.2 and §15.9 (Oregon State Bar: Rev. 2002) and cases cited therein; Debra Kawecki and Leonard Henzke, *Employment Tax Update—Review of Current Litigation*, IRS Technical Instruction Program for FY 2003, D-1 to 21; IRS Publication 1779, *Independent Contractor or Employee*; IRS *Independent Contractor or Employee Training Materials*. The IRS material is available on the IRS website at *www.irs.gov*.

Regulations: Rev Rul 87-41, 1987-1 CB 296 (20 factor test).

Cases: Michael D. Webster v. CIR, 60 F3d 1104 (4th cir 1995) (minister is an employee because of control by United Methodist Church).

Oregon Income Tax Withholding

General: Johnson, *Independent Contractors*, in LABOR AND EMPLOYMENT LAW: PRIVATE SECTOR, §15.10.

Statutes: ORS 316.162(2)(j) (withholding for independent contractors as defined in ORS 670.600); ORS 670.600 (definition of independent contractor); Laws 2003, c. 704, §4 (new definition for independent contractor for purposes of ORS Ch. 316 as of January 1, 2006), §6 (corrects wording in ORS 670.600 as of January 1, 2006).

Worker Compensation

General: Johnson, *Independent Contractors*, in LABOR AND EMPLOYMENT LAW: PRIVATE SECTOR, §15.20.

Statutes: ORS 656.005(13) defines employer and 656.005(30) defines worker. ORS 656.027 provides that all workers are exempt with exceptions.

Cases: S.W. Floor Cover Shop v. National Council on Comp. Ins., 318 Or 614, 872 P2d 1 (1994) (reconciled statutory definition of worker with statutory definition of independent contractor in work compensation cases); Rubalcaba v. Nagaki Farms, Inc., 333 Or 614, 43 P2d 1106 (2002) (clarified S.W. Floor Cover Shop's holding).

Four factor right to control test: Woody v. Waibel, 276 Or 189, 554 P2d 492 (1976) (recognizes importance of control test); Castle Home, Inc. v. Whaite, 95 Or App 269, 769 P2d 215 (1989) (states four factors); Cy Investment, Inc. v. National Council on Comp. Ins., 128 Or App 579, 876 P2d 805 (1994); Trabosh v. Washington Co., 140 Or App 159, 915 P2d 1011 (1996); Stamp v. DCBS, 169 Or App 354, 9 P3d 729 (2000).

Two elements of relative nature of work test: Woody v. Waibel, *supra* (defines test); Cy Investment, Inc. v. National Council on Comp. Ins., *supra*; Trabosh v. Washington Co., *supra*; Stamp v. DCBS, *supra*.

State Unemployment

General: Johnson, *Independent Contractors*, in LABOR AND EMPLOYMENT LAW: PRIVATE SECTOR, §15.19.

Statutes: ORS 657.015 (definition of employee); ORS 657.025 (definition of employer); ORS 657.030 (exclusions from coverage); ORS 657.040(1) (independent contractor exceptions); ORS 657.072 (exclusions for certain religious organizations).

Regulations: OAR 471-031-0090 (notwithstanding ORS 657.072, employment includes services performed for churches and religious organizations).

Cases: Petersen v. Employment Division, 135 Or App 344, 898 P2d 210 (1995) (interprets independent contractor and independently established business tests of ORS 657.040(1)); Employment Division v. Surata Soy Foods, Inc., 63 Or App 221, 662 P2d 810 (1983) (cooperative members who receive patronage dividends for their work are employees subject to unemployment tax withholding).

On churches: ORS 657.072(1) purports to distinguish between churches and other religious organizations for purposes of unemployment taxation. The statute exempts ministers of churches from unemployment coverage. Oregon cases have held that both ORS 657.072(1)(a) and (1)(b) unconstitutionally favor churches over other religious organizations. In both situations, Oregon courts have required unemployment coverage by all religious organizations, including churches, in order to comply with the federal unemployment insurance law so that Oregon can retain federal dollars. Salem College and Academy v. Employment Division, 298 Or 471, 695 P2d 25 (1985) (ORS 657.072(1)(a) is unconstitutional); Employment Division v. Rogue Valley Youth for Christ, 307 Or 490, 770 P2d 588 (1989) (same); Newport Church of Nazarene v. Hensley, 335 Or 1, 56 P2d 386 (2002) (ORS 657.072(1)(b) is unconstitutional). The Court of Appeals has rejected a Free Exercise challenge to the unemployment tax stat-

ute. Church at 295 S. 18th St., St. Helens v. Employment Division, 175 Or App 114, 28 P3d 1185 (2001), rev den 333 Or 73, 36 P3d 974 (requiring church to acknowledge that it, not God, was evangelist's employer did not violate church's free exercise rights and evangelist was subject to tax, even though he was paid by tithe, not wage or salary).

Federal Wage and Hour

General: Johnson, *Independent Contractors*, in LABOR AND EMPLOYMENT LAW: PRIVATE SECTOR, §§15.3 and 15.21.

Cases: Brock v. Superior Care, Inc., 840 F2d 1054 (2d cir 1988) (five factors of independent contractor economic realities test under Fair Labor Standards Act); Martin v. Selker Bros., Inc., 949 F2d 1286 (3rd cir 1991) (six factor economic realities test); Mathis v. Housing Authority of Umatilla County, 242 F Supp2d 777 (D Or 2002) (court uses Martin's six factor economic realities test to determine that Section 8 Coordinator of nonprofit organization was not independent contractor in overtime wage case).

State Wage and Hour

General: Johnson, *Independent Contractors*, in LABOR AND EMPLOYMENT LAW: PRIVATE SECTOR, §15.22.

Wage and hour statutes: ORS 653.010(3) (defines employee but excludes certain services performed for nonprofits); ORS 653.010(4) (defines employer).

Other types of wage claims: ORS 652.310(1) (defines employer); ORS 652.310(2) (defines employee).

Cases: State ex rel Roberts v. Bomareto Ent., 153 Or App 183, 956 P2d 254 (1998) (definition of employee in ORS 652.310 does not apply to ORS 653.010 which has a very expansive definition of employee); Northwest Advancement v. BOL, 96 Or App 133, 772 P2d 943 (1989), rev den 308 Or 315, U.S. cert den 495 US 932 (1990) (court used federal law and common law control test to find that door-to-door sales people were employees).

Chapter 17
Volunteers

Volunteers as Employees

Non-technical materials: Check the websites for SOLV (*www.solv.org*), Hands on Portland (*www.handsonportland.org*), Craig's List (*http://portland.craigslist.org*) and Community Nonprofit Resource Group (*www.cnrg.org*).

Federal Law

Statutes: 29 USC §201 *et. seq.* (Federal Labor Standards Act). 29 USC §203(s)(1)(A)(ii) establishes that FLSA applies to employers that gross at least $500,000 annually and (B) describes organizations subject to coverage although they gross less than $500,000.

Regulations: 29 CFR §778.316 (parties cannot agree not to pay for overtime).

Cases: The cases considering when volunteers become employees are not entirely reconcilable. Some courts look at the economic realities and classify volunteers as workers if the nonprofit receives commercial benefits from their services. Tony and Susan Alamo Foundation v. Secretary of Labor, 471 US 290 (1985) (court used economic realities test to hold that former drug addicts, derelicts and criminals who staffed commercial operations for long periods and expected in-kind benefits were workers for purposes of FLSA because they were not working solely for personal purposes); Archie v. Grand Central Partnership, 997 F Supp 504 (SDNY 1998) (former homeless and jobless who worked at various jobs in clerical, food-service and similar positions were workers since the nonprofit received direct economic benefit from their services). Other cases take the position that the volunteers are not workers if the volunteer is the main beneficiary of a job program, even if the nonprofit also benefits. Isaacson v. Penn Community Services, 450 F2d 1306 (4th cir 1971) (volunteers for nonprofit that developed positions to help conscientious objectors satisfy the national service requirement were not workers); Williams v. Strickland, 87 F3d 1064 (9th cir 1996) (participants in Salvation Army's work therapy programs served their own interests and were not employees where the rehabilitation program included counseling, church services and work therapy on a fulltime basis, including refinishing furniture and sorting donations for the thrift shop).

State Law

Statutes: ORS Chapters 652 and 653 (wage and hours laws).

Regulations: OAR 839-020-0030(2)(a) (each work week stands alone for purposes of overtime); OAR 839-020-0046(3) (time spent in work for charitable purposes at employer's request or under its direction or control is work time but time spent voluntarily outside of normal work hours is not work time); OAR 839-020-0115(3) (if FLSA and state standards are different, employers must comply with those most favorable to worker). Oregon has special wage and hour regulations for certain types of nonprofits. OAR 839-020-0125(2)(e) (hospitals and institutions for care of aged, sick or mentally ill, and (2)(f) (nonprofit amusement or recreational establishments); OAR 839-020-0150(1) (adult foster care) and (3) (soccer referees).

Worker Compensation

Statutes: ORS 656.018(1)(a) (liability of employer for worker comp benefits is exclusive remedy for all injuries by subject workers); ORS 656.027 (subject workers and exceptions). ORS 656.039(1) allows employers to elect to cover nonsubject workers and make them subject workers. Various subsections of ORS 656.027 describe many nonprofit volunteers as nonsubject workers. See ORS 656.027(11), (14), (17) and (20). Read together, ORS 656.018, 656.027 and 656.039 seem to provide that volunteers listed in ORS 656.027 that become covered workers must use worker compensation as their exclusive remedy. However, ORS 656.005(30) defines "worker" as a person who engages to furnish services for remuneration. It is difficult to reconcile this definition with volunteers who receive nothing for their services.

Cases: Smith v. State Accident Industrial Commission, 144 Or 480, 23 P2d 904, 25 P2d 1119 (1933) (Grange member who donated labor was not a worker); Oregon Country Fair v. National Council on Compensation Insurance, 129 Or App 73, 877 P2d 1207 (1989) (Fair had to provide worker compensation coverage to individuals who were paid per diem for one month to prepare fair site because they were workers but volunteers at fair who worked 3 days for vouchers were not workers under ORS 656.027(10) exemption for those who provided services for room and board); Hopkins v. Kobos Co., 186 Or App 273, 62 P3d 870 (2003) (resident of religious recovery home donated his labor to a private business that made a donation to the charity and was not a worker entitled to worker compensation coverage from the business because the resident did not expect to be paid).

Volunteer Liability

Cases: Dunn v. Garcia, 95 Or App 150, 768 P2d 419 (1989), rev den 307 Or 719 (abused boy scout did not have cause of action under *respondeat superior* against scoutmaster whose wife abused him for failure to counsel him, since scoutmaster's acts toward him were not motivated, even in part, by a purpose

to serve the Scouts); Erickson v. Christenson, 99 Or App 104, 781 P2d 383 (1989), *appeal dism'd*, 311 Or 266, 817 P2d 758 (1991) (court reversed the trial court that dismissed *respondeat superior* claim by women who sued pastor and church for pastor's sexual relationship with her, since paster established a confidential relationship with her that was within the scope of the pastor's employment); Lourim v. Swenson, 328 Or 380, 997 P2d 1157 (1999) (Boy Scouts may be liable under *respondeat superior* for sexual abuse by volunteer scout leader if part of leader's job was to gain trust of boys).

Protection for Volunteers

Statutes: 42 USC §14,501 *et. seq.* (Volunteer Protection Act).

Cases: Armendarez v. Glendate Youth Center, 265 F Supp 2d 1136 (D Ariz 2003) (volunteer director of nonprofit could not be personally sued under FLSA for unpaid wages because Volunteer Protection Act applied against any claims for harm).

Chapter 20
Making a Budget

Regulations: OMB Circulars A-110, A-122 and A-133, available from *www.whitehouse.gov/omb/circulars*.

Chapter 21
Fundraising: Obtaining Resources for Your Organization

Non-technical materials: Craig McPherson, Oregon Foundation DataBook, $100, available from C&D Publishing at *www.foundationdatabook.com/ororder.html*; Rebecca Peatow, ed., Guide to Oregon Foundations, 12th edition. $46, available from 211 info, 621 SW Alder, #810, Portland, OR 97205, 503.226.3099. The IRS explanation of its rules about acknowledging donations can be found at *http://www.irs.gov/charities/article/0,,id=96102,00.html*. For information on social enterprise, go to *http://www.redf.org/publications-intro.htm*. The address for the Oregon Community Foundation for management of endowment funds is 1221 SW Yamhill, #100, Portland, OR 97205, 503.227.6846. Contact information for organizations of fundraising professionals:

Willamette Valley Development Officers
619 SW 11th Ave., Suite 121
Portland, OR 97205
503.274.1977

are

Association of Fund Raising Professionals of Oregon
P.O. Box 55512
Portland, OR 97238
503.715.3100
http://www.afporegon.org/contact.aspx
email: *afp-oregon@comcast.net*

Emerald Valley Development Officers
2852 Willamette Street
PMB OR #157
Eugene, OR 97405-8200
541.607.4062 (voicemail)
email: Laura Purkey at *lpurkey@comcast.net*

Solicitations

General: Cheryl Chasin, Susan Ruth and Robert Harper, *Tax Exempt Organizations and World Wide Web Fundraising and Advertising on the Internet* (IRS CPE for FY 2000) (available at IRS website at *www.irs.gov)*; Ross Laybourn, Jr. *The Attorney General's Office: Internet Solicitation, Gaming, and Fundraising Issues*, in ADVISING NONPROFIT ORGANIZATIONS, Chapter 3 (Oregon State Bar, 2001).

Statutes: 18 USC §1037 (CAN-SPAM Act of 2003); 26 USC §6113 (solicitation disclosures by non (c)(3) organizations); ORS 128.801-.995 (Charitable Solicitation Act, including professional and commercial fundraisers).

Regulations: Notice 88-120, 1988-2 CB 454 (safe harbors for non-(c)(3) solicitations); OAR 137-010-0045 through 0055 (charitable solicitations act, including professional and commercial fundraisers, and charitable trust act).

Cases: For some important cases on the First Amendment restrictions on governmental regulation of charitable solicitations, see Riley v. National Federation of the Blind of North Carolina, Inc., 487 US 781 (1988); American Charities v. Pinellas County, 189 F Supp 2d 1319 (MD Fla 2001); Public Citizens, Inc. v. Pinellas County, 321 F Supp 2d 1275 (MD Fla 2004).

Bingo and Gambling

Statutes: ORS 167.108-.166 (criminal gambling offenses); ORS Chapter 464 (state administrative regulation of legalized gambling).

Regulations: OAR 137-25-030-0020 through 0530.

Cases: Evans v. Attorney General, 148 Or App 133, 939 P2d 111 (1997) (state fined independent contractor who managed bingo for nonprofits and who was paid in excess of state administrative rules).

Chapter 22
Basic Steps for Handling Your Funds

Acknowledging Donations: 26 USC§170(f)(8) (substantiation of gift over $250), §6115 (disclosure of quid pro quo contributions over $75); 26 CFR 1.170A-13(f), 1.6115-1; Rev Pro 66-49, 1966-2 CB 1257 (donations); Rev Rul 67-246, 1967-2 CB 104 (*quid pro quo* rules), *amplified by* Rev Proc 90-12, 1990-1 CB 471 (*quid pro quo* rules). The IRS explanation of its rules about acknowledging donations can be found at *http://www.irs.gov/charities/article/0,,id=96102,00.html*.

Chapter 23
Keeping Books and Preparing Financial Reports

Non-technical material: Christine Manor, QuickBooks for Not-for-profits (look for the latest version published by Sleeter Store and available at *http://sleeter.store.yahoo.com* by following the links for "Not-for-Profit"). For assistance in choosing accounting software, go to *http://www.aicpa.org/pubs/jofa/sep2003/johnston.htm*.

Regulations: OMB Circular A-122, available at *http://www.whitehouse.gov/omb/circulars/a122*.

Accounting Standards: Financial Accounting Standards Board, Statement of Accounting Standards 116, 117, 124, 136; American Institute of Certified Public Accountants, SOP 98-2.

Chapter 26
Electioneering and Lobbying Rules for All Nonprofit Corporations

Federal Campaign Rules

Non-technical material: The Campaign Finance Guide (2004), published by the Campaign Legal Center (available free online at *www.campaignlegalcenter.org*). This is an excellent and readable guide to a very complicated area of law. It is an overview and is not written from the perspective of nonprofit organizations.

Statutes: 2 USC §§431-455 (Federal Election Campaign Act); 116 Stat 81 (Bipartisan Campaign Reform Act of 2002, aka McCain-Feingold Law). BCRA defines independent expenditures as uncoordinated expenditures for express advocacy communications. 2 USC §431(17). However, commentators use the term "independent expenditures" in connection with issue advocacy and broadcast electioneering as well as express advocacy. We use this more imprecise use of the term in this chapter.

Regulations: 11 CFR Parts 100, 102, 104-106, 108-111, 114; Rev Rul 2004-6, 2004-4 IRB 328 (describes when public advocacy expenditures by §501(c) organizations may be expenditures for an exempt function subjecting the organization to tax under §527(f)).

Cases: FEC v. Massachusetts Citizens for Life, Inc., 479 US 238 (1986) (case that caused the FEC to generate rules pertaining to ideological (c)(4) exception to express advocacy restrictions).

Federal Lobbying Rules

Statutes: 2 USC §1601-1612 (Federal Lobbying Disclosure Act).

Cases: Federal Election Commission v. Massachusetts Citizens for Life, 479 US 238 (1986) (unconstitutional to restrict electioneering activities of (c)(4) advocacy group); Austin v. Michigan Chamber of Commerce, 494 US 652 (1990) (state restrictions on political expenditures of chamber of commerce are constitutional, since business association is not organized to promote political ideas).

State Campaign Rules

Non-technical material: ELECTIONS DIVISION, CAMPAIGN FINANCE MANUAL (Oregon Secretary of State, 2004) (available free online at *www.sos.state.or.us/elections/manuals/c&e.pdf)*.

Statutes: ORS Chapter 260. ORS 260.005(8) defines an independent expenditure as one made in connection with a candidate. The definition does not include expenditures for ballot measures. However, the Secretary of State applies this definition to expenditures for ballot measures. CAMPAIGN FINANCE MANUAL, 86.

Regulations: OAR 165-012, especially 165-0120-005 (the provisions of the CAMPAIGN FINANCE MANUAL are part of the administrative regulations for ORS Chapter 260).

Cases: State ex rel Crumpton v. Keisling, 160 Or App 406, 982 P2d 3 (1999), rev den, 329 Or 650 (2000) (definition of express advocacy for expenditures in support of or opposition to candidate involving usage of "union bosses").

State Lobbying Rules

Statutes: ORS 171.725-.785.

Regulations: OAR 199-010-0005 through 199-010-0150.

Federal Funds for Lobbying

Statutes: 2 USC §1611 ((c)(4)s that lobby cannot get federal grants or loans); 31 USC §1352 (restrictions on using federal funds to lobby federal officials).

Regulations: OMB Circular A-122, Cost Principles for Nonprofit Organizations, May 10, 2004 (restrictions on using federal funds for lobbying and political activities).

Chapter 27
Recordkeeping, Registration and Rules

Access to Books and Records

Statutes: ORS 65.224 (membership list and inspection); ORS 65.771-.782 (recordkeeping requirements and inspection by members)

Reports and Registrations

Statutes: ORS 65.647-.657, 65.787 (administrative dissolution and annual report); ORS 128.650-.660 (Attorney General requirements).

Regulations: OAR 137-010-005 through 0055.

Notices

For a discussion of using electronic means for notice, see the discussion under Chapter 4 in this Appendix.

Releases

Cases: Mann v. Wetter, 100 Or App 184, 785 P2d 1064 (1990), rev den 309 Or 645, 789 P2d 1387 (agreement releasing scuba diving school from liability up-

held); Harmon v. Mt. Hood Meadows, Inc., 146 Or App 215, 932 P2d 92 (1997) (agreement that ski lift company was not liable for injuries upheld).

Terrorism

Non-technical material: *Handbook on Counter-Terrorism Measures: What U.S. Nonprofits and Grantmakers Need to Know* (Council on Foundations and others, 2004) (an excellent and very readable summary that is available for free at *www.cof.org*).

Statutes and Executive Orders: USA Patriot Act of 2001, Pub L No. 107-56, 115 Stat 272 (2001); 26 USC §501(p) (authorizes IRS to suspend exemption of organization listed as terrorist); Exec Order No. 13,224, 66 Fed Reg 49,079 (September 25, 2001), amended by Exec Order No. 13,258, 67 Fed Reg 44,751 (July 3, 2002) and Exec Order No. 13, 284, 68 Fed Reg 4,075 (January 28, 2003).

Cases: Boim v. Quranic Literacy Inst., 291 F3d 1000 (7th cir 2002) (charitable foundations that fund terrorists are civilly liable for terrorist acts that they abet); Benevolence Int'l Found., Inc. v. Ashcroft, 200 F Supp 2d 935 (ND Ill 2002) (court stayed civil case by BIF challenging constitutionality of FBI search until criminal case resolved); Global Relief Foundation, Inc. v O'Neill, 315 F3d 748 (7th cir), cert den, 540 US 1003 (2003) (court denied GRF's injunction and upheld freezing of assets); Holy Land Foundation for Relief & Dev. v. Ashcroft, 333 F3d 156 (DC cir 2003), cert den 540 US 1218 (2004) (court upheld government designation of HLF as a terrorist organization).

Guidelines: U.S. Department of the Treasury, *Anti-Terrorist Financing Guidelines: Voluntary Best Practices for U.S.-Based Charities* 6 (2002).

Special Rules for Tax-Exempt Groups

General: Hill and Mancino, Taxation of Exempt Organizations, Chapter 33.

Inspection and Copying

Statutes: 26 USC §6104.

Regulations: 26 CFR §301.6104 (public inspection and web rules); T.D. 8818, 1999-17 IRB 3 (April 26, 1999) (inspection and copying rules).

Change in Activities

General: Hill and Mancino, Taxation of Exempt Organizations, ¶32.07.

Group Exemptions

Regulations: Rev Proc 80-27, 1980-1 CB 490, §6 (annual information); 26 CFR §601.201(n)(8)(iv) (annual information).

Schools

Regulations: Rev Proc 75-50, 1975-2 CB 587 (racial nondiscrimination rules).

Excess Benefits Transactions

General: Cynthia Cumfer, *Structure and Governance*, NONPROFITS IN THE HEADLINES Chapter 1 (Oregon State Bar, 2004); Laura Kalick, *The IRS Focuses on Automatic Excess Benefit Transactions and Compensation,* TAXATION OF EXEMPTS 3 (July/August 2004); FRANCES R. HILL AND DOUGLAS M. MANCINO, TAXATION OF EXEMPT ORGANIZATIONS ¶4.04 (2002); Nancy Murphy, Greg D. Goller and Harvey Berger, *You vs. the IRS: The Best Defense is a Good Offense,* NONPROFIT TIMES, 20 (November 1, 2003) and *Rebuttable Presumption: Complying with IRS Regulations,* NONPROFIT TIMES, 24 (December 1, 2003); Lawrence M. Brauer and Leonard J. Henzke, Jr., *'Automatic' Excess Benefit Transactions Under IRC 4958* (IRS CPE for FY 2004), at *http:www.irs.gov/charities/article/0,,id=119768,00.html*; Steven T. Miller, *Rebuttable Presumption Procedure is Key to Easy Intermediate Sanctions Compliance*, at *www.IRS.gov/pub/irs-tege/m4958a2.pdf*. Miller is the Director of Exempt Organizations for the IRS.

Statutes: 26 USC §4958.

Regulations: 26 CFR §53.4958-0 through 53.4958-8.

Chapter 28
Reviewing and Changing Your Articles and Bylaws

Statutes: ORS 65.431-.467.

Chapter 29
Merging With Another Corporation and Selling Your Assets

General non-technical: THOMAS A. MCLAUGHLIN, NONPROFIT MERGERS AND ALLIANCES: A STRATEGIC PLANNING GUIDE (1998) (a very readable book with good information).

Statutes: ORS 65.481-.534.

Chapter 30
Dissolving the Oregon Nonprofit Corporation

Statutes: ORS 65.621-.674.

Appendix 2

LIST OF TAX AND REGULATORY AGENCIES

State

Attorney General/Oregon Department of Justice
Charitable Activities Section
1515 SW 5th, #410
Portland, OR 97201
www.doj.state.or.us
503.229.5725
503.229.5120 — fax
503.378-5938 — TDD
This is the place to file your registration with the Attorney General is you incorporate as a public benefit nonprofit and to file the Form CT-12. For gaming rules, go to *www.doj.state.or.us/ChariGroup/Howtoraffle.htm*.

Bureau of Labor and Industry (BOLI)
Technical Assistance for Employers
800 NE Oregon, Suite 1045
Portland, OR 97232
www.boli.state.or.us
503.731.4200
503.731.4103 — fax
BOLI is the source for information about state employment laws, regulations and seminars for employers.

Oregon Department of Revenue
PO Box 14800
Salem, Oregon 97309-0920
www.dor.state.or.us
503.378.4988
503.356-4222
503.945.8618 — Spanish language
503.945.8738 — TDD
This is the address for estimated tax payments. Check website for addresses for other payments.

Oregon Government Standards and Practices Commission
100 High Street SE, Suite 220
Salem, OR 97301-3607
www.gspc.state.or.us
503.378.5105

503.373.1456 — fax
This agency regulates state legislative lobbying.

Secretary of State
Corporations Division (and Elections Division)
255 Capitol Street NE, #151
Salem, OR 97310-1327
www.sos.state.or.us
503.986.2200
503.378.4381 — fax
The Secretary of State's office is where you file your incorporation papers as a nonprofit corporation and your annual report. The Elections Division regulates political activity. For the state *Campaign Finance Manual*, go to *www.sos.state.or.us/elections/manuals.htm*.

State of Oregon Employment Department
875 Union Street NE
Salem, Oregon 97311
www.emp.state.or.us
503.947.1847
503.947.1668 — fax
The Employment Department offers job fairs and recruitment and handles the unemployment tax and benefit audits.

Federal

Federal Election Commission
999 E Street NW
Washington, D.C. 20463
www.fec.gov
800.424.9530
202.219.3336 — TTY
The FEC regulates broadcast communications in political campaigns.

The Internal Revenue Service is online at *www.irs.gov.* To get IRS Publications online, go to *www.irs.gov* and type in "Publication" and its number in the Search box. The IRS has different offices for different purposes. For those most likely to be of interest to users of this book:

Internal Revenue Service
TE/GE Determination
P. O. Box 192
Covington, KY 41012-0192
1.877.829.5500 for filing assistance

This is the office where you file the Form 1023 and Form 1024, the Applications for Tax-exempt Status.

Internal Revenue Service
Ogden, Utah 84201-005
This is where you file Form 1099 and Transmittal Form 1096 and Form 941, the Quarterly Tax Report when no payment is made.

Internal Revenue Service
P.O. Box 660264
Dallas, TX 75266-0264
Here you file Form 941, the Quarterly Tax Report when you are making a payment.

Internal Revenue Service
Attn: EIN Operation
Philadelphia, PA 19255
This is where you file Form SS-4 — Application for Employer ID Number (EIN).
To get your EIN by fax, fax Form SS-4 to 215.516.3990
To get your EIN by phone, call 800.829.4933
To get your EIN online, go to *www.irs.gov/businesses/* and click on Employer ID Number under Topics.

Internal Revenue Service
TE/GE Customer Account Services
P.O. Box 2508
Cincinnati, OH 45201
To notify the IRS of changes in your purpose or activities.

Internal Revenue Service
Ogden, UT 84201-0027
This is the address to file Form 990, the Annual Tax Return, and Form 2758, the Extension of Time to File Annual Return.

Social Security Administration
Data Operations Center
Wilkes-Barre, Pennsylvania 18769
www.ssa.gov
File Forms W-2 and W-3 here.

U.S. Department of Labor
Frances Perkins Bldg.
200 Constitution Avenue NW
Washington, D.C. 20210
www.dol.gov

1.866.487.2365
TTY: 1.877.889.5627
For information on wage and hour and employment law.

U.S. Equal Employment Opportunity Commission
1801 L Street NW
Washington, D.C. 20507
www.eeoc.gov
202.663.4900
TTY: 202.663.4494
For information on civil rights laws.

U.S. Senate
Office of Public Records
232 Hart Senate Office Building
Washington, D.C. 20510-7116
www.senate.gov
202.224.0758
For registration for federal lobbyists, go to *www.senate.gov* and follow links to Legislation and Records and Lobbying Disclosure.

Appendix 3

TYPES OF OREGON NONPROFIT CORPORATIONS

Here is some additional information on Public Benefit, Religious, and Mutual Benefit Corporations that you may find useful.

Public Benefit Corporations

Board of Directors

The Board of Directors must be three or more individuals. (Mutual Benefit Corporations need only one Director, and Religious Corporations may be organized without Directors.) Public Benefit Corporations may not lend money to or guarantee the obligations of a Director or officer of the corporation (except for certain recruitment packages). Mutual Benefit Corporations can permit this to happen with some restrictions.

Members

Members of Public Benefit Corporations may not transfer for value a membership or any right arising from the membership, unless the transferring member is also a Public Benefit or a Religious Corporation. (Mutual Benefit Corporations do not have this restriction.)

A Public Benefit Corporation that is organized primarily for political or social action may, in its Articles, eliminate or abolish the right of a member (or the member's agent or attorney) to inspect or copy its membership list if the corporation provides a reasonable means to mail communication to the other members through the corporation at the expense of the member making the request. (Mutual benefit Corporations do not have this right.)

Dissolution

A Public Benefit Corporation that is dissolving must give notice to the Attorney General, unlike a Mutual Benefit Corporation. Assets cannot be transferred until the Attorney General consents in writing or indicates that it will take no action with respect to the transfer. After the assets have been conveyed, the Public Benefit Corporation, unlike Mutual Benefit and Religious Corporations, must provide the Attorney General with a list showing who, other than creditors, received the assets.

If the Articles or Bylaws of the Public Benefit Corporation do not provide for what happens to its assets on dissolution, its assets (after payment of liabilities and other commitments) are transferred to an organization organized for a public charitable purpose, a Religious corporation, the United States, a state, or an entity exempt from taxation under §501(c)(3). (Mutual Benefit Corporations are entitled under those circumstances to transfer assets to its members or, if it has no members, to those persons whom the corporation holds itself out as benefiting or serving.)

Other considerations

Public Benefit Corporations can get §501(c)(3) and (c)(4) tax-exempt status. Mutual Benefit Corporations can get other types of exemption but not §501(c)(3) exemption and would get (c)(4) status in rare cases.

Public Benefit Corporations (with a few exceptions) must register with the state Department of Justice. Mutual Benefit Corporations and Religious Corporations do not.

Religious Corporations

Formation

A Religious Corporation may be formed with a Board of Directors and officers similar to any other corporation. Alternatively, any individual may, in conformity with the constitution, canons, rules, regulations and disciplines of any church or religion, form a corporation to be a Corporation Sole. This is a form of a Religious Corporation—it is different in that it has no Board of Directors and does not need to have officers. It is managed by a single Director who is the individual constituting the corporation and its incorporator (or the successor of the incorporator). If the corporation has no officers, the Director may perform the duties of the officers. The name of the corporation is the same as the office within the religious denomination (e.g. "Reverend," "Deacon") held by the incorporator and must be followed by the words "and successors, a corporation sole." (For example, "Reverend Maria Martinez and her successors, a corporation sole.")

Board of Directors

Religious Corporations have more flexibility in their Articles and Bylaws to provide for removal of Directors than do Mutual Benefit or Public Benefit Corporations.

Members

The Articles or Bylaws of a Religious Corporation may limit or abolish the rights of a member to inspect or copy corporate records. (Public Benefit Corporations in some cases can provide some restrictions on such rights and Mutual Benefit Corporations may not.)

Dissolution

When a Religious Corporation dissolves, it must give notice to the Attorney General and must get the Attorney General's consent to transfer assets, or at least an indication from the Attorney General that it will take no action with respect to the transfer. (Mutual Benefit Corporations are not subject to this requirement.) Religious Corporations are limited to distributing those assets to the same groups as are Public Benefit Corporations. (Mutual Benefit Corporations can distribute assets to its members or to those persons whom the corporation holds itself out as serving.)

Mutual Benefit Corporations

Board of Directors

Mutual Benefit Corporations, like Religious Corporations, may be set up with one Director. (Public Benefit Corporations require three.)

A transaction in which a Director of a Mutual Benefit Corporation has a conflict of interest may be more easily approved within the corporation than one in which a Director in a Public Benefit or Religious Corporation has a conflict of interest.

Mutual Benefit Corporations may, with certain restrictions, make loans or guarantee obligations of their Directors, an action cannot be taken by Public Benefit or Religious Corporations.

Members

Members of a Mutual Benefit Corporation, like a Public Benefit Corporation, may not be expelled or suspended nor have their membership terminated or suspended, except pursuant to a fair and reasonable procedure carried out in good faith. (Religious Corporations do not have this restriction.)

Dissolution

On dissolution, Mutual Benefit Corporations may dispose of assets not provided for by its Articles or Bylaws by giving those assets to its members or, if it has no members, to those persons whom the corporation holds itself out as benefiting or serving. (Public Benefit and Religious Corporations may not do this.)

Sources

This Appendix draws on provisions throughout ORS Chapter 65, particularly ORS 65.001(30), (37) and (39) (definitions); ORS 65.042 (constitutional protections for religious corporations); ORS 65.067 (religious corporation sole); ORS 65.147, .167, .171, .224 (membership rules); ORS 65.307, .324, .357, .361, .364 (Board of Directors); ORS 65.377 (officers); ORS 65.627, .631 (dissolution); ORS 65.774 (records).

Appendix 4

OPEN RECORDS AND OPEN MEETINGS LAWS

Oregon has both an open records law, giving the public access to certain records of public (governmental) bodies, and an open meetings law, giving the public access to the decision-making process of public bodies. In some cases, nonprofits are considered to be public bodies.

Open Records Laws

The Open Records Law (Public Records Law) requires that all records of governing bodies of a *public body* shall be open to the public with certain exceptions. The issue for nonprofits is "Are nonprofit corporations 'public bodies?'" The answer in most cases is "no." However, if your nonprofit exercises sufficient governmental functions, the Open Meeting Law may apply to you.

Oregon has three types of nonprofit organizations that might be affected by the Open Records Law:

1. Public Corporations

Public corporations are created by a specific statute to perform public functions and are subject to government control. Examples include utility districts, water districts, etc. These corporations are subject to the Open Records Law.

2. Mixed Corporations

What we are calling mixed corporations are corporations created by or in response to a statute but which are not subject to government control. For example, the Oregon Medical Insurance Pool was created by the 1989 legislature to provide health insurance for those who cannot otherwise get it but is run by its member insurance companies. The Attorney General (the attorney for the state of Oregon) has indicated he does not believe this corporation is subject to the Open Records Law. The Attorney General's opinions are influential but are not binding law. Recent court cases suggest that in some cases these corporations will be subject to the Open Records Law (see below).

3. Private Nonprofit Corporations and Associations

Private nonprofit corporations are nonprofit corporations that were not established by a special statute but were incorporated under the general incorporation statute (the one we've been discussing in this book). Most Oregon

nonprofit corporation fall in this category. The Attorney General in 1984 stated that private nonprofit corporations are not public bodies for purposes of the Open Records Law, even if the private nonprofit corporation contracts to perform government functions and receives some or all its money from the government.

However, the Oregon Supreme Court changed this in 1994. The court stated that it will use a functional approach to see if the nonprofit functions as the government. No one criteria is decisive, but the court has said it will consider a number of criteria, including the entity's origin, the nature of the function assigned to and performed by it, the scope of authority granted to and exercised by it, the nature and level of government financial involvement, the nature and scope of government control over it, and the status of the entity's officers and employees.

> *Example*: The local school board has had complaints about a teacher. It requests your nonprofit corporation to conduct an investigation about the matter and report your findings and recommendations to the school board. The teacher requests a copy of your records in connection with the investigation under the Public Records Law. Under the court's opinions, since you are exercising a governmental function in conducting this investigation, you must turn the records over.

It is not entirely clear how this test will be applied in the future. Most nonprofit corporations do not function as the government but many nonprofits would meet at least some of the criteria discussed by the court. This would include those who provide goods or services that might also be provided by the government (such as low-income housing, treatment for mental disease, firefighting in some small communities); those that are accountable to the government because of government grants; those that are controlled to some extent by the government because of government grants; and those whose officers and employees are required to be government employees.

Open Meeting Law

The Open Meeting Law (Public Meeting Law) requires that all meetings of governing bodies of a *public body* shall be open to the public with certain exceptions. In most cases, decisions must be made at the meeting open to the public and cannot be made behind closed doors. The law also requires that certain public notice be given and that minutes be kept and made available to the public. Smoking is not allowed at public meetings.

Again, the issue for nonprofits is "Are nonprofits 'public bodies?'" The answer in most cases is "no." However, if your nonprofit exercises sufficient governmental functions, the Open Meeting Law may apply to you.

In connection with the three types of corporations described in the section above, the following is what the law appears to say at this time:

Public Corporations

Public corporations are subject to the Open Meetings Law.

Mixed Corporations

The Attorney General has indicated that it believes that local alcoholism planning committees created by statute that exercise functions assigned to them by law are subject to the Open Meetings Law. However, it does not believe that the Oregon Insurance Pool is a public body and so it is not subject to the Open Meetings Law. We don't have very clear guidelines for other types of nonprofits. If your mixed corporation exercises government functions, you may be subject to the law.

Private Nonprofit Organizations

The Attorney General stated in its 1984 manual that a private nonprofit corporation is not subject to the Open Meetings Law even if it contracts with a governmental agency to carry out public purposes, receives all of its money from the government and has public officers on the Board. Examples include the mental health clinics and the Oregon Parks Foundation.

The courts have not defined criteria for private nonprofits, but it is likely they will follow what was set down by the Oregon Supreme Court in the Open Records Law case and examine what you do to see if you are performing governmental functions. See the discussion about the Open Records Law above.

If you believe your organization may be a public body, you should talk to an attorney for a professional opinion. You will need to know and follow your obligations under these laws, which could include giving public notice of your meetings, enforcing a nonsmoking environment and ensuring that your decisions are made in a public meeting and not outside the meeting.

Implications

If you are subject to the Open Meetings or Open Records laws, you need to get legal advice. You need to be sure that you are conforming with the notice,

decision-making and other requirements of the Open Meeting Law. You also must understand the exceptions to the Open Meetings and Records Laws that are designed to protect the privacy of certain individuals and to accomplish other important purposes.

Sources

Statutes: ORS 192.410-.505 (public records inspection); ORS 192.610-.710 (public meetings law).

Case law: Prior to 1994, most nonprofits were guided by an Attorney General opinion that stated that "public bodies" subject to the public records and meeting laws did not include private nonprofits and cooperatives, including those set up to carry out public purposes. "Attorney General's Public Records and Meetings Manual," 44 AG 239 (September 1984). The Manual did indicate that the public meeting law applied to private groups that furnished advice to public bodies and to nonprofits that the state set up and controlled (for example, local alcoholism planning commissions). The Attorney General has since suggested that a public charter school may be subject to the public records law, depending on the scope of its contract. Opinion #8273, 49 AG 254 (September 13, 2000).

The Oregon Supreme Court characterized the Oregon State Bar, a private nonprofit corporation, as a public body subject to the public records law. State ex rel Frohnmayer v. Oregon State Bar, 307 Or 304, 767 P2d 893 (1989). Five years later, the court held that a private nonprofit organization that was engaged to handle a school district personnel matter carried out sufficient governmental functions to be classified as a public body. The court articulated criteria for determining when a private nonprofit became a public body. Marks v. McKenzie High School Fact-Finding Team, 319 Or 451, 878 P2d 417 (1994). A year later the Court of Appeals found that the Rockaway Beach fire department, formerly an agency of the city that became a nonprofit in 1991 and contracted with the city to provide fire services, was a public body. Laine v. City of Rockaway Beach, Oregon, 134 Or App 655, 896 P2d 1219 (1995).

Appendix 5

ADDITIONAL PROVISIONS FOR YOUR ARTICLES OF INCORPORATION

Chapter 3 describes how to draft your Articles of Incorporation. There are some provisions that you must put in your Articles if you want them to apply to your corporation; putting them in your Bylaws is not enough. Chapter 3 discussed those provisions that are of interest to most nonprofits. There are additional provisions that may be of interest to a smaller number of nonprofit corporations. We include these below in case these provisions are of interest to your group.

Duration—If you do not want your corporation to last indefinitely, you need to provide for the duration of the corporation in the Articles.

Emergency Bylaws—Unless your Articles provide otherwise, your Board may adopt, amend, or repeal emergency Bylaws. Emergency Bylaws are effective only if an emergency exists. An emergency exists if a quorum of your directors cannot be readily assembled because of some present or imminent catastrophe. The emergency Bylaws can provide special procedures for governing the corporation during the emergency, including procedures for calling meetings of the Board, quorum requirements, and designation of additional or substitute directors. The emergency Bylaws are not effective after the emergency ends. All procedures of your regular Bylaws that are not inconsistent with the emergency Bylaws remain in effect. Your members can amend or repeal the emergency Bylaws.

Indemnification—The law provides that your corporation must indemnify Directors who are successful in the defense of a proceeding to which they were a party because of being a Director, unless this indemnification is limited by your Articles. A Director who is a party to a proceeding is given the right by law to apply to the Court to get the corporation to indemnify him or her. If you want to modify or restrict this right, you must do so in your Articles. Officers of your corporation are also entitled to mandatory or court-ordered indemnification and can make other requests of the corporation to indemnify them, unless your Articles provide differently. If your corporation desires to provide other limitations on indemnification or advances of expenses to Directors who are being sued, you can do so in your Articles. Most nonprofits are hesitant to impose these kinds of limitations on indemnification because these restrictions discourage people from serving on the Board.

Amendments to Articles—In membership corporations, the Board of Directors has the right to adopt certain amendments to the corporation's Articles without member approval. These include amendments:

- to extend the duration of the corporation if it was incorporated at a time when limited duration was required by law;
- to delete the names and addresses of the initial Directors and incorporators;
- to delete the name and address of the initial registered agent or registered office;
- to delete the mailing address if an annual report has been filed;
- to change the corporate name in certain respects;
- to include a statement of whether the corporation is a Public Benefit, Mutual Benefit or Religious Corporation; and
- to make certain other changes.

If you do not want your Board to be able to make these amendments without member approval, your Articles must say so. Most nonprofits are satisfied to leave these mostly housekeeping matters to the Directors to change, thus avoiding the hassle of a membership meeting.

Amendments to Articles and Bylaws by Designated Persons—If your corporation wants to require that an amendment to the Articles or Bylaws be approved in writing by a specific person (or persons) other than the Board, you can do so in your Articles. If you make this provision, that individual must also approve (in writing) any plan of merger or sale of assets (other than in the regular course of activities) and dissolution.

Property Transfers—If the corporation decides to sell, lease, exchange, or otherwise dispose of all or substantially all of its property *in the usual or regular course of its activities* or to mortgage or otherwise encumber any or all of its property whether or not in the usual regular course of its activities, it does not ordinarily need the approval of the members or any other person. If you wish to require approval of the members or some other person, you must say so in the Articles. If you are concerned about restraining the Board's authority to mortgage your property without the member's consent, you need to consider this provision. If a normal part of your corporate activities is to sell or give away property and you want to place limits on how much the Board can sell or give away, you'll need a provision imposing these limits in your Articles.

Sources

ORS 65.077 (duration); ORS 65.081 (emergency bylaws); ORS 65.394, .401, .407, and .414 (indemnification); ORS 65.434 and .437 (amendments to Articles); ORS

65.437(1)(c), .467, .487(1)(c), .534(2)(c), and .624(1)(c) (amendments by designated persons); ORS 65.531 (property transfers).

Appendix 6

HOMEOWNERS ASSOCIATIONS

Homeowners associations are a form of planned community in which ownership of a single home automatically makes the homeowner a member of the homeowners association. The homeowners association has responsibilities for management and maintenance of the community. Traditionally, these associations could be profit or nonprofit, incorporated or unincorporated.

In the last several years, the Oregon legislature has passed laws dramatically revising how homeowners associations are created and governed. The new laws contain some very complicated provisions about whether and when the they apply to homeowner associations created before January 1, 2002. If your homeowners association was established before that date, you will need to consult an attorney to determine how much, if any, of the new laws apply to you. In some cases, you may be subject to the laws described in this Appendix. You will need legal advice to determine this.

If you are a homeowners association that was created after January 1, 2002, you must follow the rules set out in this Appendix rather than anything that contradicts them that is in this book. This Appendix is not a complete discussion of these very complicated statutes. That would probably be another book. We will discuss some of the major provisions of the new laws so that you know at what points the governance of your nonprofit corporation is most likely to vary from that of other Oregon nonprofit corporations that are discussed in this book. When the homeowner association's statute is silent, you will be governed by the same rules as other nonprofit corporations. If you have questions, you should get legal advice. We hope here to offer a picture of the lay of the land and to alert you to some important areas where you need further advice.

Overview of Creation of a Planned Community

Generally, when a planned community is set up, the developer (often a corporation or other legal entity) that created the planned community plats and sets it up by means of a recorded declaration that includes general information about the community and a provision for allocating votes to each lot, among many other items. The developer is called a declarant. A majority of the Board of Directors or at lest 30% of the owners in the community can propose amendments to the declaration unless the declaration provides otherwise. The declaration can be amended by the approval of owners with at least 75% of the total votes in the planned community unless the declaration requires a higher percentage of votes or interferes with certain rights reserved by the developer. Amendments cannot change the boundaries of lots or restrictions on the uses of

lots or change the method of determining the right to common profits or voting rights unless the owners of the affected lots unanimously agree. During the period of developer control, the developer can reserve the right to require its consent to any amendment to the declaration. The developer cannot amend the declaration to increase its rights after the first lot is sold unless owners representing 75% of the total vote, other than developer, agree.

The developer can reserve the right to control the homeowners association for as long as it wants. Generally a developer will relinquish control after it begins selling lots. Regardless of when the developer relinquishes control, the developer must organize a homeowners association as a nonprofit corporation under Oregon law and must adopt initial bylaws on or before the time that the first lot is sold. When the developer does turn over control, it must call a meeting to transfer administrative responsibility for the planned community to the homeowners association. At that turnover meeting, the developer delivers a variety of important documents to the association. The law provides for a three-month transition period during which the developer works with the board to facilitate the transition. After that time, the homeowners association governs the community. If the developer has not completed the development of lots or common property, it may continue to hold special rights but does not control the association.

Bylaws

The Oregon statute sets out the types of provisions about what must be in your Bylaws. We will not repeat all of these here, since virtually all homeowner's associations were initially set up with legal help and should contain these matters. We note a few specific requirements in the statute that conflict with the requirements for nonprofit corporations discussed elsewhere in this book.

Board Meetings. Your Bylaws must include a statement that all Board meetings are open to owners.

Officers. Your Bylaws must provide for at least a President, Secretary and Treasurer.

Amendment. Your Bylaws must provide for amendment. They may require *no greater than* a majority of votes to amend any provision. If the Bylaws contain a provision that is required by law to be in your declaration, then the vote required to amend your declaration is the vote needed to amend your Bylaws for that provision.

Board of Directors and Officers

Powers and Duties. The Board governs the corporation unless the declaration or Bylaws provide differently. The Directors and the officers are subject to the same standards of conduct as are Directors and officers of other Oregon non-profit corporations (see pages 264-277). They are also subject to the same rules on conflicts of interest (see pages 302-305), and liability for unlawful distributions (see page 265). Your Directors, if unpaid, are entitled to the same protection from liability as other qualified directors (see pages 305-306).

By statute, the Board has some duties that are specific to homeowners associations. We list some of the most important ones here:

- The Board must adopt a proposed annual budget and submit it to the members for review within 30 days.
- The Board must review the insurance coverage at least once a year. The requirements for insurance are somewhat detailed and you should get legal advise on this issue.
- The Board must be sure that the necessary tax returns are filed every year.
- The Board must maintain a current mailing address for the association.
- The Board must conduct an annual study of the reserve account.
- The Board must maintain certain information about assessments on the properties in the community.

The law also creates some special rules about how the Board operates in homeowners associations.

Vacancies. The board may fill vacancies in its membership unless otherwise provided by the bylaws.

Removal of Director. The owners may remove any Director other than Directors appointed by the developer or ex officio directors, with or without cause, at a membership meeting with a quorum, by a majority of all owners present and entitled to vote. The matter of removal must have been an agenda item and proper notice given.

Meetings. All meetings of the Board are open to owners, except that the Board may meet in executive session when dealing with personnel matters, negotiations of contracts with third parties, collection of unpaid assessments and consultation with attorneys about litigation or criminal matters. Except in emergencies, the Board authorizes an executive session by a vote in an open meeting. When the Board authorizes the executive session, the President must

state the general nature of the action and when and how the deliberations will be disclosed to the owners. A contract or action considered in executive session must be voted on in an open meeting.

If the majority of lots in your community are the principal residences of the occupants, your Board must post the notice of Board meetings at least three days prior to the meeting at a place that will reasonably inform everyone of the meeting. Your Board can hold emergency meetings without doing this if it states the reason for the emergency in the minutes. Your Board cannot hold telephonic meetings or other forms of communication that allow all members of the Board to hear each other, except in emergencies.

Rules of Order. The Board must use the latest edition of Robert's Rules of Order as the ground rules for its procedure unless the declaration or Bylaws or a resolution of the Board or members provide otherwise.

Members and Membership Meetings

Powers. Owners, who are the members in homeowner's associations, have more power than members in other nonprofit membership corporations (for example, the members must vote to transfer common property). Your Bylaws may grant members additional powers.

Meetings. Your corporation must hold at least one membership meeting each year. In addition, special meetings may be called by the President of the Board, a majority of the Board or a percentage of members specified in the Bylaws. The Bylaws cannot require a percentage greater than 50% or less than 10% of the votes of the planned community to call a meeting. If your Bylaws don't specify a percentage, 30% or more of the owners can call a special meeting.

Between 10 and 50 days before any membership meeting, your Secretary or other officer specified in the Bylaws must see that notice is hand delivered or mailed to the members and to all mortgagees that have requested notice. The notice shall state the time and place of the meeting and the items on the agenda.

Action by Written Ballot. Unless your declaration or Bylaws provide otherwise, any action that may be taken at an owners' meeting can be taken without a meeting if the association delivers a written ballot to every member entitled to vote. But you may not use action by written ballot in place of the turnover meeting or the annual meeting if more than a majority of the lots are the principal residences of the occupants. If you decide to use written ballots, you should get legal advice since the rules are fairly complex.

Quorum. A quorum for the meeting is 20% of the votes unless your Bylaws provide otherwise. In determining whether you have a quorum, you can count members who are present in person and those represented by proxy.

Rules of Order. Members shall use the latest edition of Robert's Rules of Order as the ground rules for running membership meetings unless the declaration or Bylaws or a resolution of the Board or members provides otherwise.

Voting. Unless the declaration provides otherwise, each lot is entitled to one vote. One co-owner can vote for the absent co-owner. If co-owners of a lot can't agree, their vote is disregarded. Unless the Bylaws provide otherwise, votes may be cast by absentee ballot or by proxy. A proxy terminates one year after it is given unless the proxy spells out a shorter term. The proxy must be dated and cannot provide that it is revocable without notice. Members can also vote by absentee ballot.

Actions are generally taken by majority vote. However, if the association wants to take actions that significantly affect the common property of the association, a supermajority vote is required. Unless the declaration provides otherwise, the members may sell or convey the common property of the association or subject it to a security interest only if 80% or more of the votes in the association, including 80% of the votes of lots not owned by a developer at the time of the vote, vote in favor of the action.

Inspection of Records

Your association must keep:

- the records turned over to it by the developer;
- proxies and ballots;
- all assessments;
- all financial records needed for accounting purposes;
- all records kept by other nonprofit corporation described on pages 618-619.

Within 90 days after the end of the fiscal year, the Board shall distribute to each owner and, upon request, to each mortgagee, a copy of the annual financial statement. Associations of planned communities whose annual assessments exceed $75,000 must have a CPA review the statements in accordance with the Statements on Standards for Accounting and Review Services issued by the American Society of Certified Public Accountants. If 60% of your owners, not including the developer, vote to waive the CPA review, you can avoid it. If your association has annual assessments of $75,000 or less, you must have a

CPA review your financial statements if a majority of owners petition for a review.

Any member or mortgagee can inspect and copy any record of the corporation if the request is made in good faith and for a proper purpose. There are a number of exceptions, including personnel and medical records, business records for matters under negotiation, some communications with your attorney, some records related to executive sessions, files of individual owners, and records made confidential by law. A prospective purchaser can inspect and copy the Declaration, Bylaws and any amendments or supplements to them; association rules and regulations; the plat; the most recent financial statement; the current operating budget; architectural standards and guidelines, if any, and the reserve study. You must provide the records within 10 days after receiving a written request. Your association can charge reasonable copying fees when copies are requested.

Federal Tax Exemption

Because homeowners associations are formed primarily to benefit the homeowners in the community, they are not exempt from taxation under §501(c)(3). (See Chapter 5 for a discussion of exempt organizations.) A homeowners association may be exempt under §501(c)(4) or (c)(7) or under §528. Your association is exempt under §501(c)(4) if you qualify as a social welfare organization. Your association must operate for the benefit of the general public, you cannot provide direct services to individual members and you cannot restrict access by the general public to your streets, sidewalks and green areas. If your primary function is to operate recreational club or facilities, you may be exempt under §501(c)(7). (See page 114.) §528 exempts certain nonprofit homeowners associations that manage association property. At least 60% of your gross income must come from dues, fees or assessments and at least 90% of your expenditures must be for the association's property. The tax exemption for associations under this exemption is more limited than the exemptions under §501(c).

Sources

Statutes: ORS 94.550-.785; *Homeowners' Associations Under IRS 501(c)(4), 501(c)(7) and 528*, IRS CPE for FY 1982.

Appendix 7

FORM 1024

This Appendix contains the information about how to fill out Form 1024 in its revised September 1998 version.

Filling Out the Form

You should use Form 1024 to apply for tax exemption for most of the Code sections other than §501(c)(3). See page 143 for a discussion about this form. You should read the information in IRS Publication 557 about your group before you fill out this form. If you have questions or find that your group does not fit precisely into one of the categories discussed in Publication 557, you should talk to an attorney or accountant before filing this Form.

Part I

Line 1 - Identification

Check the appropriate box.

Line 1a-d

Fill in your organization's name as it appears in your Articles of Incorporation. Lines 1b, 1c, 1d and 1e are self-explanatory.

Line 2 - Employer Identification Number

Every exempt organization is required to have an employer ID number whether you have employees or not. You may have applied for and received this number when you opened a bank account. If so, put your number in this blank. If you do not have such a number, obtain one as described on pages 44-45.

Line 3 - Contact Person

Be sure to fill in Line 3 with the name of someone in your group that IRS can contact during normal business hours for more information. Be sure this person has a copy of the application, is knowledgeable about it and can talk to IRS competently. If this person is not an officer, your organization will need to file Form 2848 (an IRS power of attorney form) to permit the IRS to talk to your contact person.

Line 4 - Annual Accounting Period

This line calls for the month your annual accounting period ends. The annual accounting period you choose should be the one you actually intend to use for maintaining financial records. See page 43 for a discussion about accounting periods (also called fiscal years). Whatever month is stated here will be considered binding for future tax requirements. If you are granted exemption status, your annual report on Form 990 must be filed by the l5th day of the 5th month after the close of your annual accounting period. Your annual accounting period may be changed only by following specific IRS procedures.

Line 5 - Incorporation Date

This asks for the date incorporated. Put in the date stamped on the Articles of Incorporation that the Corporation Commissioner returned to your organization. If you are not incorporated, fill in the date your Articles of Association or your Constitution was adopted.

Line 6 - Previous Application

You must declare whether or not your organization has ever applied for any type of tax-exempt status. Note that the question asks about your organization not about whether you personally have applied on behalf of another organization.

Line 7 - Previous Returns

This asks whether your group has filed federal income tax returns or exempt organization informational returns. The federal income tax return is Form 1120 used by tax-paying corporations, including nonprofit corporations that are not tax-exempt. The exempt organization informational returns is Form 990.

Line 8 - Corporate Status

Indicate whether you are a corporation, trust or association. Trusts and associations should submit the documents indicated.

Groups that are incorporated as nonprofit corporations should check the box that says “corporation”. You must enclose a conformed copy of your Articles of Incorporation that includes the stamp from the Corporation Commissioner showing the date filed, a conformed copy of any amendments or restatements of the Articles, and a conformed copy of your Bylaws. You only need to send a current set of your Bylaws; you do not have to send prior

versions. Do not send the original of any of these documents; they will not be returned.

A conformed copy is one that agrees with the original and all the amendments to it, including signatures. At either the beginning or the end of both your Articles, amendments, restatements and Bylaws, you should write onto the copy:

> *This is to certify that this is a true and correct copy of the Articles of Incorporation (or the amendment or restatement to the Articles, or Bylaws) of (name of corporation).*

*BY:*_____
(NAME)
Agent for (Name of Corporation)

This should be signed by someone authorized by your Board to sign these papers for your group.

Signature Requirement

Form 1024 must be signed by an officer authorized to sign by the corporation. It may also be signed by any person who the corporation authorizes by a power of attorney to sign. Your group must use IRS Form 2848 (Power of Attorney and Declaration of Representative) or Form 8821 (Tax Information Authorization) to grant a power of attorney. The signer should review the application carefully. The signature attests that the application and accompanying schedules and attachments are true, correct and complete.

Part II

Line 1 - Narrative Description

This requests a narrative description of your group's past, present and planned activities. Question 1 is the heart of the application. Your answer should be geared toward emphasizing those features of your group that make it exempt. You should carefully review all of your activities and projects and make sure that those that help your application are listed. In determining how much time you devote or plan to devote to each activity, take into account volunteer as well as paid staff time. In most cases, these estimates will be rough. The IRS is trying to get a sense of what are your most important activities. If part of your group's activities might disqualify you, your answer to Question 1 should either point out the insignificance of these activities to your overall ac-

tivities or should explain what facts exist that prevent these activities from disqualifying you.

Line 2 - Sources of Financial Support

List your sources of financial support, beginning with the largest source first. Some categories of exempt groups (for example, social clubs) have restrictions on the sources of support that must be met before the group is exempt. Read Publication 557 to see if your group has restrictions. If you do, your answer to this question should show that you meet the IRS guidelines. Your sources of financial support shown here should also be consistent with the budget attachments projecting support and revenue for your organization that are included later in the application.

Line 3a - Board of Directors

Your group should answer this question by giving the names and addresses of your Board of Directors and officers. You should also include any titles, particularly if they pertain to Board service. For example, a Chamber of Commerce may have the mayor on the Board.

Line 3b

"Annual compensation" refers to salary, bonus and other payments to the Board Member for services performed for the organization. This would include payments to Board Members for their services as employees or as independent contractors.

Line 4 - Predecessor

The IRS wants to know whether the activities of your group were formerly performed under another name or if your organization was a part of another organization, whether tax-exempt or not. For example, you may have begun as a project of a §501(c)(3) charitable organization and "spun off" from that group in order to do lobbying. If you are the outgrowth of another organization, you must submit the information requested.

Line 5 - Connection with Another Organization

Here the IRS wants to know about any connections you have with another organization, whether tax-exempt or not. For example, a §501(c)(4) lobbying group may have common Directors with and share space with the §501(c)(3) charity that spun it off. You have to disclose this. If you do have these connections, you need to keep separate organizational records and to divide the costs

in a way that is sound from an accounting perspective. The IRS will want to be assured that §501(c)(3) money is not being improperly mixed with other money, and that no private individual or profit-making entity is benefiting from its connection with a tax-exempt organization.

Line 6 - Stock

All Oregon nonprofits can answer this question "Does Not Apply." The Oregon nonprofit law (unlike that of some other states) does not allow the issuance of capital stock by nonprofits.

Line 7 - Membership

If your organization has members, you must supply the information and materials requested. The implication for your exemption varies depending on the category of exemption for which you are applying. Generally, if you are applying as a §501(c)(4) organization and have members, your members should not be benefiting from their membership in excess of what they pay in dues or otherwise contribute to the organization. This is because §501(c)(4) groups are operated to provide a public benefit and not primarily a benefit to its members. Most of the other groups filing the Form 1024 are organizations that are organized to benefit members in some way. The particular relationship between these organizations and their members varies depending on what IRS category is involved. Read Publication 557 and get additional professional advice if this question concerns you.

Line 8 - Distribution on Dissolution

Your Articles of Incorporation (and possibly your Bylaws) will have the details about how your assets are to be distributed on dissolution. Refer to these in answering this question. You should also read IRS Publication 557 to see if the IRS has restrictions on this. It does for some groups. Be sure your Articles and Bylaws conform to the IRS rules before you send in the application.

Line 9 - Distributions

In most cases, the answer to this question should be "no." Oregon nonprofit law does not allow nonprofits to make distributions to members and we do not have shareholders in Oregon nonprofit corporations.

Line 10 - Payments for Services

The IRS wants to know if you charge a fee for services. If so, you need to provide the details requested. Charging a fee for services will not necessarily

disqualify you from exemption. The IRS will use this to determine if you are in fact operating a business for a commercial purpose as opposed to operating a nonprofit to serve your members or the public. Consult Chapter 9 for a further discussion of this. If the fees you receive are a significant part of your receipts, you may want to get some professional advice before you send in the application.

Line 11 - Payments to Members

The Oregon nonprofit corporation does not have shareholders. You do not need to report normal salaries of officers or employees who are also members. You do have to report other payments to members for services. This would include payments to members who provide services as independent contractors.

Line 12 - Insurance

Some organizations provide insurance to their members and dependents. If you do, read Publication 557 carefully. In some exempt categories, this is fine. In others, this can disqualify you.

Line 13 - Supervisory Jurisdiction of Public Agency

If your organization is subject to the supervision of a government regulatory body, such as HUD, the Public Utilities Commission, the Insurance Commissioner or the Department of Human Services, you must provide the information requested.

Line 14 - Lease

Answer this question if you lease or plan to lease property.

Line 15 - Political Campaigns

§501(c)(3) organizations cannot engage in any political campaign activity but other types of exempt organizations can. §501(c)(4) groups can engage in some political campaigning but you must do this on a very limited basis since the promotion of social welfare does not include intervention in political campaigns. Other groups, such as unions and business leagues, are typically more involved in political campaigns and this is permitted. See Chapter 8 for a discussion of what constitutes political campaigning.

Line 16 - Publications

This question is self-explanatory.

Part III - Financial Data

If you have been in existence for more than one year, you must supply financial data for the current year and previous years, up to three previous years. If you are not seeking to backdate your exemption to the date you were formed but want it only for the current year and future years, you should give financial data for the current year and a proposed budget for the next two years. You might choose to do this if something in your past would keep you from getting the exemption but it is an activity that is no longer a part of your operations. If you have been in existence for less than one year, you must provide data for the current year and proposed budgets for the two years following the current year.

Your information for the current year should be for a period that ends within 60 days of the date you file the application. If your current year is less than 60 days old at that point, you do not have to file information for the current year. You can then end the previous year's financial information on any day that is within 60 days of the date of filing. You should use the method of accounting that you use in keeping your books. (See Chapter 23). If you do not use the cash receipts and disbursement method, attach a statement explaining your method.

Read the information that the IRS includes in Packet 1024 for help in filling out the Financial Data. The IRS uses the Revenue information to look at a number of things: whether your organization is exempt under the section for which you are applying; whether you have excessive unrelated business income; and whether anyone is privately benefiting from the organization. The expense information is used to determine whether there are unreasonable expenses; whether the organization is making disbursements to individuals or groups it should not be making; whether the members are receiving improper benefits; and whether you are paying excessive compensation.

Other Schedules

You need to look through Packet 1024 to find the other schedule or schedules that your organization needs to fill out. Follow the IRS instructions and get help if there is anything unusual about your situation. It is better to have the application reviewed and corrected before you send it in than to let the IRS catch a mistake.

Attachments to the 1024

To be complete, your 1024 must include these attachments:

- Form 8718: User Fee for Determination of Tax-Exempt Status: Organizations anticipating annual gross receipts of $10,000 or more must pay a $500 fee. Those anticipating less than $10,000 in annual gross receipts pay $150. Attach your check made out to the Internal Revenue Service to the 8718. Put your organization's employer identification number on the check.
- Form SS-4: If you do not already have an employer identification number, you must attach this form to apply for one.
- Conformed copies of the Articles of Incorporation and Bylaws (see the IRS instructions).
- Representative samples of brochures, newsletters or other written materials describing your organization.
- Copies of leases you have entered into.
- Attachments called for by the Financial Data section.
- All other attachments called for by the application.

Every attachment (other than the IRS forms) should show your organization's name and address, your employer identification number, and an identifiable heading and should be labelled that it is an attachment to the Form 1024 application form.

Questions Back From the IRS

It is common for the IRS to respond to your application by sending you a list of questions to answer. At this point, you should seriously consider getting professional help.

Appendix 8

POLITICAL ORGANIZATIONS UNDER §527

The Internal Revenue Code provides an exemption from federal income tax for certain types of political organizations. Political organizations exempt under §527 are those organized primarily for the purpose of collecting contributions and making expenditures to influence the election or appointment of individuals for federal, state or local public office. These purposes are called their exempt function. These political organizations are exempt from federal income tax, except on their investment income.

Political organizations may be political party committees, such as the Democratic or Republican National Committee, candidate committees or political action committees (PACs) of individuals or organizations that want to advance their own political agenda. This Appendix will focus on the PACs. There are generally two types of PACs. PACs may be formed as the separate segregated fund of an existing business or nonprofit organization or of a labor union. This type of PAC is sometimes called a connected PAC. PACs may also be formed as an independent political committee consisting of individuals who have come together to advance their common political ends.

§527 organizations do not have to be incorporated. Most PACs are unincorporated but some incorporate, primarily for protection from personal liability. Some PACs are organized with a board, officers or employees. On the other extreme, a political committee that is the separate segregated fund of another organization may consist simply of a separate bank account. Political organizations must comply with three types of reporting and disclosure requirements – notice of status, periodic reports of contributions and expenditures, and annual returns.

Notice of Status

A political organization must give notice that it is a §527 organization to the IRS within 24 hours after it is formed. You file this notice on Form 8871, *Political Organization Notice of Section 527 Status*. The form must be filed electronically at *www.irs.gov/polorgs* (IRS Keyword: political orgs). In order to file the form, you must first obtain a separate employer identification number for the political organization. You are not required to file this form if:

- you are required to report as a political committee under the federal campaign laws (see pages 600-603);

- you are a political committee of a state or local candidate or state or local political party; or

- your gross receipts will always be less than $25,000 for your first six taxable years.

If you are required to file Form 8871 and you fail to do so, you are subject to a tax. Your Form 8871 is a public document available for inspection on the IRS web site. You are required to make a copy available for public inspection at your offices in the same manner as organizations exempt under §501(c). (See page 631).

Periodic Reporting Requirements

Your §527 organization is required to report its contributions and expenditures on Form 8872, *Political Organization Report of Contributions and Expenditures*. Organizations that did not have to file Form 8871 do not have to file Form 8872. Certain state and local political organizations also do not have to file. Generally, these are organizations whose activities are limited to state and local races and who do not have federal candidates or office holders participating in, soliciting contributions for or directing disbursements of the political committee. Political committees should consult the instructions for Form 8872 to determine when your reports are due. Your form is available for public inspection.

Annual Returns

Tax-exempt political organizations must file the Form 990 (or the Form 990-EZ) if the organization has $25,000 or more of annual gross receipts. Certain state and local political organizations that did not have to file the Form 8872 must only file the Form 990 if they have annual gross receipts in excess of $100,000. Organizations that did not have to file the Form 8871 do not have to file Form 990. Form 990 is due on the 15th day of the fifth month after the close of your taxable year. See Chapter 12 for more information on filing the Form 990.

All political organizations, *whether or not tax-exempt*, must file Form 1120-POL, *U.S. Income Tax Return for Certain Political Organizations*. The only exception is if you do not have taxable income in excess of $100. The form is due by the 15th day of the third month after the close of your taxable year. This is two months *earlier* than the Form 990 is due. Form 1120-POL is not made available for public inspection.

Federal and State Election Laws

The IRS is not the only agency governing political committees. Most political committees are subject to federal and state election laws and in some cases may have to comply with federal and state lobbying laws. See Chapter 26 for more information.

Sources

Statutes: 26 USC §527.

Regulations: 26 CFR §1.527-1 through 1.527-9; Rev Rul 2003-49, 2003-20 IRB 903 (question and answer format on how to comply with the notice and reporting requirements for §527 organizations).

Appendix 9

SUBSTANTIATION AND DISCLOSURE STATEMENT

Dear Donor:

We want to thank you for your [PICK ONE: cash contribution of $___ OR contribution of property of _____, received by us on _____, 20___. This contribution will be very helpful to us in carrying out our mission.

You need certain information in connection with this contribution in order to maximize your tax deductions. [PICK ONE: No goods or services were provided in exchange for your contribution OR In exchange for your contribution, we gave you _____, valued at $___.] Your charitable tax deduction is limited to the excess of the value of your contribution over the value of the goods and services you received in connection with the contribution. Consult your own tax adviser for any other limits on the deductibility of your contribution.

It is through the generosity of people like you that we can carry out our work.

Very truly yours,

SIGNATURE

Appendix 10

LETTER TO DONORS

(Letterhead)
(Date)

TO: Grantors
ATTN:
RE: Classification of Donor Entity Status

Dear _____:

I am pleased to acknowledge receipt of your grant in the amount of $_____. Our organization is most grateful to be a recipient of these funds. We hope that our purposes, activities, programs and operations will continue to merit your further consideration and support.

As you may know, we are required by the Internal Revenue Service to classify our donors according to the tax status of the donor entity. Consequently, we have to confirm whether you are one of the types of tax entities listed on the next page. We request that you sign and complete the statement on the attached copy of this letter and return this signed copy in the enclosed stamped self-addressed envelope.

Again, we thank you for your generous support and for your consideration and cooperation in this process.

Very truly yours,

SIGNATURE

In connection with the above request, please be advised that our entity tax status would be (check appropriate box):

❑ A Publicly Supported Organization pursuant to §170 (b)(1)(A)(vi) (i.e., §509(a)(1) non-private foundation.)

❑ A Government Unit or subdivision (domestic).

❑ A Private Foundation pursuant to §170(b)(1)(A)(vii).

❑ A Fee/Activity (or Broadly Publicly) Supported Organization, pursuant to §509(a)(2) or Supporting Nonprivate Foundation pursuant to §509(a)(3).

I trust you will find this information helpful.

Organization: _____

By:_____

Date:_____

Appendix 11

DISQUALIFIED PERSON INQUIRY LETTER

(Letterhead)
(Date)

_____
_____
_____

Attn:

Dear _____:

In connection with your relationship to our organization as a _____, our tax accountant has indicated that membership fees and/or contributions by you, your spouse, ancestors, and lineal descendants (including spouses) must be considered as amounts received from "Disqualified Person" for purposes of our receipts classification system and our tax status. Accordingly, it is requested that you name on the attached sheets any of your family members in the specified relationships whom you believe have, or might have joined or contributed to our organization. We will be pleased to be of assistance in this regard by making our membership fee/contribution listing and/or permanent record cards available at your convenience. Further, we must be concerned with your ownership, either directly or in combination with your family members, etc., of entities which have contributed or provided revenue to our organization. Thus, there is also a disclosure question on the attachment in this regard. We must also determine whether you meet IRS definitions as a Foundation Manager for any foundations which have contributed to our organization. Please respond to this letter by completing and signing the attachment to this letter and returning said attachment in the enclosed self-addressed envelope.

Again, thank you for your generous support. We appreciate your effort and cooperation in completing our records for tax purposes.

Very truly yours,

SIGNATURE

In connection with the attached request, please be advised that to the best of my knowledge none of my family members have joined or contributed to your organization during the subject tax year(s) except as follows:

Amount	Disqualified Person
_____	Spouse: Name: _____
_____	Ancestor: Name _____
_____	Lineal Descendants: Name _____
_____	Spouses of Lineal Descendants: Name: _____

Listed below is, by name only, my ownership, including that by way of attribution or constructive ownership of my family members, of more than 35% of:

(a) total combined voting power of any corporation
(b) profits interest of any partnership
(c) beneficial interest of any trust or estate

Organization(s) more than 35% owned: _____
_____

Listed below are any foundation(s) for which I meet the IRS definition of Foundation Manager which have contributed to your organization during the subject tax year:

Foundation Name	Date of Contribution	Amount
_____	_____	_____
_____	_____	_____

I trust you will find this information helpful.

Signed: _____
Dated: _____

MEMBERSHIP CONTRIBUTOR PERMANENT RECORD CARD (M/CPRC)

NAME: _____ TEL. NO. _____ NO. ___

Appendix 12

FORMS FOR TAX-EXEMPT ORGANIZATIONS

990EZ - Annual return for organization with gross receipts more than $25,000 but less than $100,000, if assets less than $250,000.

990 - Annual return for organizations with gross receipts more than $25,000 and not eligible to file 990EZ.

990 Schedule A (990A) - Annual return for all 501(c)(3) organizations with gross receipts more than $25,000 (except Private Foundations) and organizations exempt under 501(e), 501(f), 501(k), or Section 4947. The 990A is required for these organizations whether they file Form 990 or Form 990EZ.

990T - Exempt Organization Business Income Tax Return for organizations with gross income of $1,000 or more from business activity unrelated to organization's exempt purpose (see Publication 598). The 990T may be required of filers of the 990, 990EZ or 990PF.

990PF - Annual return for 501(c)(3) organizations which are Private Foundations. The 990PF is filed instead of the 990 or 990EZ. Filers of the 990PF do not file the 990A.

2758 - Application for Extension of Time to File the 990EZ, 990, 990A, or 990T.

4720 - Return of Certain Excise Taxes on Charities and Other Persons. Used by organizations making the lobbying election and/or making political expenditures. *Note: "political" is not synonymous with "lobbying."*

8282 - Donee Information Return. Required of the donee (recipient) of "charitable deduction property" who sells, exchanges, or otherwise disposes of the property within two years after the date the property is received. Successor donees may also be affected.

8283 - Non-cash Charitable Contribution: partially completed by donor of items with Fair Market Value in excess of $5,000. Completed by charity and returned to donor.

1120POL - Filed by 501(c) organizations if their political expenditures and net investment income both exceed $100 for the year.

Appendix 13

TAX FORMS REQUIRED OF BOTH EXEMPT AND NONEXEMPT ORGANIZATIONS

W-2 & W-3: Wage and Tax Statement and transmittal for employers.

940: Annual Federal Unemployment Tax Return (not required of 501(c)(3)'s).

941: Employers quarterly Federal Tax Return (required of all employers).

1096 & 1099 Series: Information returns and transmittal for reporting payments made by the organization such as non-employee compensation (contract services, etc.).

1128: Application for Change in Accounting Period.

5500 Series: For employers maintaining pension, profit-sharing, or deferred compensation plans.

4506-A: Form to request copy of a previously filed return.

8300: Report of cash payments over $10,000 received in a trade or business.

Appendix 14

LETTER OF AGREEMENT FOR REGULAR EMPLOYMENT

Date _____

Dear _____:

This is to inform you that you have been employed by *[corporation's name]* as a *{position title]*. Your beginning date of employment is _____, 20__. You will work a _____ hour week. Your work schedule is _____ _____
(or: Your work schedule will be given to you by your supervisor). Your supervisor is _____.

Attached is your job description, which gives your duties and job responsibilities, and your copy of the Employee Handbook. Please read the Employee Handbook. It contains important information about our organization and your job.

We welcome you to our organization and hope that this new relationship will be a satisfying one. If you have any questions about the material enclosed with this letter please contact _____.

Please be advised that the purpose of this letter is to provide you with information and to welcome you. It does not constitute a contract or create any contractual rights or obligations.

Sincerely,

Name
Position

Appendix 15

LETTER OF AGREEMENT FOR TEMPORARY EMPLOYMENT

Date _____

Dear _____:

This is to inform you that you have been employed by *[organization's name]* as a *[position title]* at a salary of _____ *[per hour/per month]*. Your beginning date of employment is _____, 20__. You will work a _____ hour week. Your work schedule is _____ (or: Your work schedule will be given to you by your supervisor). Your supervisor is _____.

Attached is your job description, which gives your duties and job responsibilities, and your copy of the Employee Handbook. Please read the Employee Handbook. It contains important information about our nonprofit and your job.

Because funding for your position is temporary, your employment will not continue after *[date]*.

We welcome you to our organization and hope that this new relationship will be a satisfying one. If you have any questions about the material enclosed with this letter please contact _____.

Please be advised that the purpose of this letter is to provide you with information and to welcome you. It does not constitute a contract or create any contractual rights or obligations.

Sincerely,

Name
Position

Appendix 16

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Appendix 17

BUDGETS FOR ADMINISTRATIVE AND INDIRECT COSTS

Exhibit 1

Organization A - Indirect cost rate of 6.6%

		Total expenses					
		Programs					
		A	B	C	Admin	Indirect	Total
Expenses:							
Salaries and wages	$	18,613	19,500	23,347	18,557	5,150	85,167
Employee benefits		2,792	2,925	3,502	2,784	772	12,775
Materials and supplies		5,200	8,900	3,581	1,124	–	18,805
Postage and shipping		605	987	4,251	895	2,088	8,826
Printing and publications		1,000	1,355	756	201	50	3,362
Telephone		756	1,222	1,336	2,285	2,263	7,862
Occupancy		2,219	4,590	9,675	11,116	–	27,600
Depreciation		684	758	95	151	–	1,688
Total direct expenses		31,869	40,237	46,543	37,113	10,323	
Allocation of indirect costs		2,112	2,667	3,084	2,460	(10,323)	
	$	33,981		49,627			166,085

1. The effective indirect cost rate = 6.6% [$10,323/($166,085 - $10,323)].
2. The administrative rate = 23.8% [$39,573/$166,085].
3. Indirect costs are allocated by applying the indirect cost rate (6.6%) to each cost center's total direct expenses [e.g., Program A: 6.6% x $31,869 = $2,112].

We gratefully acknowledge Gary McGee, CPA, for permission to use his charts in this Appendix.

Exhibit 2

Organization B - Indirect cost rate of 65.8%

	Total expenses					
	Programs					
	A	B	C	Admin.	Indirect	Total
Expenses:						
Salaries and wages	$ 12,500	14,950	19,635	15,400	22,682	85,167
Employee benefits	1,875	2,243	2,945	2,310	3,402	12,775
Materials and supplies	3,300	6,000	895	1,400	7,210	18,805
Postage and shipping	500	1,035	3,675	1,682	1,934	8,826
Printing and publications	950	1,184	642	120	466	3,362
Telephone	1,672	1,724	1,126	2,418	922	7,862
Occupancy	–	–	–	–	27,600	27,600
Depreciation	–	–	–	–	1,688	1,688
Total direct expenses	20,797	27,136	28,918	23,330	65,904	166,085
Allocation of indirect costs	13,184	15,768	20,709	16,243	(65,904)	
	$ 33,981	42,904	49,627	39,573	–	166,085

1. The effective indirect cost rate = 65.8% [$65,904/($166,085 - $65,904)].
2. The administrative rate = 23.8% [$39,573/$166,085].
3. Indirect costs are allocated based on each cost center's direct salaries & wages as a percentage of total direct salaries & wages [e.g., Program A: $65,904 x ($12,500/($85,167 - $22,682)) = $13,184].

Exhibit 3

Organization C - Indirect cost rate of 0%

		Total expenses					
		Programs					
		A	B	C	Admin.	Indirect	Total
Expenses:							
Salaries and wages	$	19,255	21,621	25,388	18,903	–	85,167
Employee benefits		2,881	3,050	3,727	3,117	–	12,775
Materials and supplies		5,200	8,900	3,581	1,124	–	18,805
Postage and shipping		923	1,612	4,541	1,750	–	8,826
Printing and publications		1,025	1,380	800	157	–	3,362
Telephone		1,290	1,417	2,244	2,911	–	7,862
Occupancy		3,219	4,590	8,675	11,116	–	27,600
Depreciation		188	334	671	495	–	1,688
Total direct expenses		33,981	42,904	49,627	39,573		166,085
Allocation of indirect costs							
	$	33,981	42,904	49,627	39,573		166,085

1. The indirect cost rate = 0%. No indirect allocation mechanism is used; all expenses are charged directly.
2. The administrative rate = 23.8% [$39,573/$166,085].

Exhibit 4

Organization A - Indirect cost rate of 6.6%; administrative and indirect costs combined

	Total expenses				
	Direct Programs			Indirect	
	A	B	C	Admin.	Total
Expenses:					
Salaries and wages	$ 18,613	19,500	23,347	23,707	
Employee benefits	2,792	2,925	3,502	3,556	
Materials and supplies	5,200	8,900	3,581	1,124	
Postage and shipping	605	987	4,251	2,983	
Printing and publications	1,000	1,355	756	251	
Telephone	756	1,222	1,336	4,548	
Occupancy	2,219	4,590	9,675	11,116	
Depreciation	684	758	95	151	
Total direct expenses		40,237	46,543		166,085
Allocation of indirect costs					
	$ 33,981	42,904	49,627	39,573	166,085

1. The effective indirect cost rate = 6.6% [$10,323/($166,085 - $10,323)].
2. The administrative rate = 23.8% [$39,573/$166,085].
3. Indirect costs are allocated by applying the indirect cost rate (6.6%) to each cost center's total direct expenses [e.g., Program A: 6.6% x $31,869 = $2,112].

Exhibit 5

Organization A - "Fully loaded" cost model

		Total expenses					
		Programs					
		A	B	C	Admin.	Indirect	Total
Expenses:							
Salaries and wages	$	18,613	19,500	23,347	18,557	5,150	85,167
Employee benefits		2,792	2,925	3,502	2,784	772	12,775
Materials and supplies		5,200	8,900	3,581	1,124	–	18,805
Postage and shipping		605	987	4,251	895	2,088	8,826
Printing and publications		1,000	1,355	756	201	50	3,362
Telephone		756	1,222	1,336	2,285	2,263	7,862
Occupancy		2,219	4,590	9,675	11,116	–	27,600
Depreciation		684	758	95	151	–	1,688
Total direct expenses		31,869	40,237	46,543	37,113	10,323	166,085
Allocation of indirect costs		2,112	2,667	3,084	2,460	(10,323)	
Total direct and indirect costs		33,981	42,904	49,627	39,573	–	166,085
Allocation of admin. costs		10,629	13,420	15,524	(39,573)		
	$	44,610	56,324	65,151	–	–	166,085

1. The effective indirect cost rate = 6.6% [$10,323/($166,085 - $10,323)].
2. The administrative rate = 23.8% [$39,573/$166,085].
3. Indirect costs are allocated by applying the rate (6.6%) to each cost center's total direct expenses [e.g., Program A: 6.6% x $31,869 = $2,112].
4. Administrative costs are allocated based on the pro rata distribution of total direct and indirect costs of each program [e.g., Program A: $33,981 x ($39,573/($166,085 - $39,573)) = $10,629].

Exhibit 6

Organization A - Adjustment of fully loaded model for GAAP purposes

		Total expenses					
		Programs					
		A	B	C	Admin.	Indirect	Total
Expenses:							
Salaries and wages	$	18,613	19,500	23,347	18,557	5,150	
Employee benefits		2,792	2,925	3,502	2,784	772	
Materials and supplies		5,200	8,900	3,581	1,124	–	
Postage and shipping		605	987	4,251	895	2,088	
Printing and publications		1,000	1,355	756	201	50	
Telephone		756	1,222	1,336	2,285	2,263	
Occupancy		2,219	4,590	9,675	11,116	–	
Depreciation		684	758	95	151	–	
Total direct expenses		31,869	40,237	46,543	37,113	10,323	166,085
Allocation of certain administrative costs							
		35,092	44,307	51,250	25,113	10,323	166,085
Allocation of indirect costs		2,326	2,936	3,397	1,664	(10,323)	
	$	37,418	47,243	54,647	26,777	–	166,085

1. The effective indirect cost rate = 6.6% [$10,323/($166,085 - $10,323)].
2. $12,000 of administrative costs are allocated to programs based on total direct expenses. [e.g., $31,869 x ($12,000/($31,869+$40,237+$46,543)) = $3,223].
3. Indirect costs are allocated by applying the indirect cost rate (6.6%) to each cost center's total direct expenses after the allocation of selected administrative costs [e.g., Program A: 6.6% x $35,092 = $2,326].

Exhibit 7

Organization A - 5% cap on indirect costs that can be charged to Program A

		Total expenses					
		Programs					
		A	B	C	Admin	Indirect	Total
Expenses:							
Salaries and wages	$	18,613	19,500	23,347	18,557	5,150	
Employee benefits		2,792	2,925	3,502	2,784	772	
Materials and supplies		5,200	8,900	3,581	1,124	–	
Postage and shipping		605	987	4,251	895	2,088	
Printing and publications		1,000	1,355	756	201	50	
Telephone		756	1,222	1,336	2,285	2,263	
Occupancy		2,219	4,590	9,675	11,116	–	
Depreciation		684	758	95	151	–	
Total direct expenses		31,869	40,237	46,543	37,113	10,323	166,085
Allocation of 5% approved indirect cost cap		1,593				(1,593)	
Total expenses of Program A reportable to contractor		33,462					
Allocation of Program A's 1.6% excess		519				(519)	
Allocation of remaining indirect costs				3,084	2,460	(8,211)	
	$	33,981	42,904	49,627	39,573	–	166,085

1. $31,869 x 5% = $1,593 = maximum indirect costs chargeable to Program A.
2. Total indirect cost rate remains 6.6% [$10,323/($166,085 - $10,323)].

Exhibit 8

Organization B - Multiple cost pools

	Total expenses							
	Programs				Indirect cost pools			
	A	B	C	Admin.	1	2	3	Total
Expenses:								
Salaries and wages	$ 12,500	14,950	19,635	15,400	22,682	–		
Employee benefits	1,875	2,243	2,945	2,310	3,402	–		
Materials and supplies	3,300	6,000	895	1,400	7,210	–		
Postage and shipping	500	1,035	3,675	1,682	–	1,934		
Printing and publications	950	1,184	642	120	466	–		
Telephone	1,672	1,724	1,126	2,418	–	922		
Occupancy	–	–	–	–	12,589	15,011		
Depreciation	–	–	–	–	–	–		
Total direct expenses	20,797	27,136	28,918	23,330	46,349	17,867	1,688	166,085
Allocation of indirect costs 1	9,272	11,089	14,565	11,423	(46,349)	–	–	–
Allocation of indirect costs 2	6,497	3,249	4,872	3,249	–	(17,867)	–	–
Allocation of indirect costs 3	359	467	718	144	–	–	(1,688)	–
	$ 36,925	41,941	49,073					166,085
FTEs	2.0	1.0	1.5	1.0	–	–	–	5.5
Square footage utilized	500	650	1000	200				2350

1. Indirect cost pool 1: costs allocated to programs based on direct salaries and wages.
2. Indirect cost pool 2: costs allocated to programs based on FTE.
3. Indirect cost pool 3: costs allocated to programs based on square footage.

Exhibit 9

Organization A - Federal indirect cost proposal format - simplified allocation method

	Total expenses					
	Programs				Indirect	
	A	B	C	Fund-raising	Admin.	Total
Expenses:						
Salaries and wages	$ 18,613	19,500	23,347	–	23,707	85,167
Employee benefits	2,792	2,925	3,502	–	3,556	12,775
Materials and supplies	5,200	8,900	3,581	–	1,124	18,805
Postage and shipping	605	987	4,251	–	2,983	8,826
Printing and publications	1,000	1,355	756	–	251	3,362
Telephone	756	1,222	1,336	–	4,548	7,862
Occupancy	2,219	4,590	9,675	–	11,116	27,600
Depreciation	684	758	95	–	151	1,688
Total expenses	31,869	40,237	46,543		47,436	166,085
Less Direct Cost Adjustments:						
Materials and supplies		(2,499)	(866)		–	(5,010)
Alterations and improvements		(1,210)	–		–	(2,190)
Depreciation		(758)	(95)		–	(1,537)
	(2,625)	(3,709)	(866)	–	–	(7,200)
Less Indirect Cost Adjustments:						
Occupancy (interest)			–			
Depreciation			–			
					(913)	(913)
Reclassifications:						
Fund-raising	–	–				–
Public relations	–	–				–
Membership administration	–	–				–
				8,007		
	$ 29,244	36,528	45,677	8,007	38,516	157,972

1. Indirect cost rate = $38,516/($157,972-$38,516) = 32.2%.

Exhibit 10

Organization A - Federal indirect cost proposal format - direct allocation method

		Total expenses					
		Programs				Indirect	
		A	B	C	Fund-raising	Admin.	Total
Expenses:							
Salaries and wages	$	18,613	19,500	23,347	4,390	19,317	85,167
Employee benefits		2,792	2,925	3,502	790	2,766	12,775
Materials and supplies		5,200	8,900	3,581	-	1,124	18,805
Postage and shipping		605	987	4,251	-	2,983	8,826
Printing and publications		1,000	1,355	756		251	3,362
Telephone		756	1,222	1,336	861	3,687	7,862
Occupancy		2,219	4,590	9,675	1,966	9,150	27,600
Depreciation		684	758	95	-	151	1,688
Total expenses		31,869	40,237	46,543	8,007	39,429	166,085
Less Direct Cost Adjustments:							
Materials and supplies					–	–	(5,010)
Alterations and improvements					–	–	(2,190)
Depreciation					–	–	(1,537)
		(2,625)	(3,709)	(866)			(7,200)
Less Indirect Cost Adjustments							
Occupancy (interest)		–	–	–			
Depreciation		–	–	–			
	$	29,244	36,528	45,677	8,007	38,516	157,972

1. Indirect cost rate = $38,516/($157,972-$38,516) = 32.2%.

Exhibit 1

Organization A - Program A by funding source with multiple caps and limitations

		Program A			
		Gov't. grant	Private grant	General ops.	Total
Expenses:					
Salaries and wages	$	5,000	–	13,613	18,613
Employee benefits		–	–	2,792	2,792
Materials and supplies		2,600	–	2,600	5,200
Postage and shipping		–	605	–	605
Printing and publications		–	1,000	–	1,000
Telephone		115	–	641	756
Occupancy		400	–	1,819	2,219
Depreciation		–	–	684	684
Total direct expenses		8,115	1,605		31,869
Allocation of indirect costs		243	106		2,112
	$	8,358	1,711	23,912	33,981

1. Government grant caps salaries at $5,000, benefits and depreciation at 0, and indirect costs at 3%.
2. Private grant pays only postage and shipping, and printing and publications, but accepts the 6.6% indirect cost rate.

Exhibit 12

Organization A - Illustration of capital expenditures charged to a government grant

	Program A				
	Gov't. grant	Private grant	General ops.	Fixed asset elimin.	Total
Expenses:					
Salaries and wages	$ 5,000	–	13,613	–	18,613
Employee benefits	–	–	2,792	–	2,792
Materials and supplies	2,600	–	2,600	–	5,200
Postage and shipping	–	605	–	–	605
Printing and publications	–	1,000	–	–	1,000
Telephone	115	–	641	–	756
Occupancy	400	–	1,819	–	2,219
Depreciation	–	–	684	–	684
Capital expenditures	10,000	–	–	(10,000)	–
Total direct expenses	$ 18,115	1,605	22,149	(10,000)	31,869

Appendix 18

CASH FLOW PROJECTION

Cash Flow Projection						
July - December 2005						
	July	**August**	**Sept.**	**Oct.**	**Nov.**	**December**
Projected beginning Cash	**10000**	**8500**	**300**	**-13150**	**8700**	**1550**
Anticipated Cash Receipts						
Individual donations	1500	500	200	5000	1000	2000
Contract A	0	6000	6000	6000	6000	6000
Contract B	0	4000	3000	5000	5000	4000
Foundation X	0	0	0	0	0	30000
Foundation Y	15000	0	0	0	0	0
Special event	0	0	0	30000	2000	0
Program fees	5000	4000	6000	6000	6000	5000
Other	100	100	100	100	100	100
Sub-total Cash Receipts	**21600**	**14600**	**15300**	**52100**	**20100**	**47100**
Borrowed funds						
Total Cash Available						
Anticipated Cash Disbursements						
Net payroll	14000	14000	14000	16000	16000	16000
Fed and state tax deposit	4200	4200	4200	4800	4800	4800
Quarterly unemployment and WC	2200	0	0	2200	0	0
Professional services	500	1500	0	0	800	500
Rent	1000	1000	1000	1000	1000	1000
Utilities	200	200	200	250	300	350
Facilities maintenance	500	500	500	500	500	500
Telephone/internet	250	250	250	250	250	250
Postage	50	50	500	50	500	50
Printing	100	1000	3000	100	2000	100
Special event costs	0	0	5000	5000	1000	0
Debt service payments	0	0	0	0	0	0
Other	100	100	100	100	100	100
Sub-total Cash Disbursements	**23100**	**22800**	**28750**	**30250**	**27250**	**23650**
Projected Ending Cash	**8500**	**300**	**-13150**	**8700**	**1550**	**25000**

Appendix 19

CHART OF ACCOUNTS

Assets

1010 Cash -checking
1040 Petty Cash
1070 Cash-savings

1110 Accounts receivable
1190 Allowance for doubtful accounts

1210 Pledges receivable
1220 Allowance for doubtful pledges
1240 Grants receivable
1250 Discounts for long term pledges

1270 Other receivables
1290 Allowance for doubtful receivables

1310 Inventories for sale
1320 Inventories for use
1350 Prepaid expenses
1360 Refundable deposits

1410 Marketable securities for operations
1420 Marketable securities held in perpetuity

1510 Land
1520 Buildings
1530 Accumulated depreciation on acct 1520
1540 Leasehold improvements
1550 Accumulated amortization
1560 Furniture, fixtures, and equipment
1570 Accumulated depreciation on acct 1560

Liabilities

2010 Accounts payable
2110 Accrued expenses - payroll
2120 Accrued expenses-vacation leave
2150 Other accrued expenses
2200 Grants payable

2350 Unearned or deferred revenue

2550 Loans payable
2730 Mortgages payable

2900 Funds held on behalf of others

Net Assets

3000 Unrestricted net assets

3300 Temporarily restricted net assets

3900 Permanently restricted net assets

Support and Revenue

4010 Contributions - individual
4050 Gift portion of event income
4070 Legacies/bequests

4110 In-kind contribution- services
4130 In-kind contribution- other

4210 Corporate gifts
4230 Foundation grants

4420 Federated fund raising orgs.
4510 Government grants
5010 Government contracts

5110 Program related sales
5210 Program service fees

5310 Membership dues

5410 Interest and dividend income
5610 Other investment income
5810 Unrealized gains and losses

6310 Unrelated sales income
6320 Cost of goods sold

Expenses

7210 Salaries of officers
7220 Other salaries
7310 Pension contributions
7320 Other fringe benefits
7410 Employer payroll taxes

7510 Prof fund raising fees
7520 Professional services
7580 In kind - donated services
7710 Supplies

Expenses - continued:

7720 In-kind -other expenses
7810 Telephone
7910 Postage and shipping
8010 Rent
8020 Utilities
8030 Real estate taxes
8050 Interest on mortgage
8110 Equipment rental and maintenance
8210 Printing
8220 Publications
8310 Travel
8510 Conferences
8610 Interest - general
8710 Insurance
8810 Membership dues
8820 Staff development
9100 Bad debt expense
9250 Advertising
9300 Other expenses

9910 Payments to affiliates

7020 Grants to other orgs
7030 Allocations to affiliated orgs
7040 Awards to individuals
7050 Specific assistance to individuals

Notes: A more complete chart of accounts is available in
Unified Financial Reporting System for Not-for-Profit Organizations, www.Jossey-Bass.com

Appendix 20

STATEMENT OF FUNCTIONAL EXPENSES

Statement of Functional Expenses
for the period
July1, 2005 -September 30, 2005

	Prog A	Prog B	Prog C	Total Program	Admin	Fund Raising	Total
Salaries	300000	120000	83200	503200	91800	30000	625000
Taxes and benefits	75950	30000	21000	126950	22100	7200	156250
Professional services	5000	8000	3000	16000	5000	4000	25000
Rent	15000	7000	2000	24000	4500	1500	30000
Utilities	5000	3000	1600	9600	1800	600	12000
Facilities maintenance	2000	800	400	3200	600	200	4000
Telephone/internet	1400	700	300	2400	450	150	3000
Postage	100	300	100	500	500	2500	3500
Printing	1000	2000	1400	4400	500	3100	8000
Insurance	1800	400	300	2500	2000	500	5000
Travel	3000	1400	1000	5400	500	100	6000
Depreciation	700	50	50	800	150	50	1000
Miscellaneous	700	250	100	1050	100	100	1250
	411650	**173900**	**114450**	**700000**	**130000**	**50000**	**880000**

Appendix 21

FUNCTIONAL REVENUE AND EXPENSE STATEMENT

Functional Revenue and Expense Statement
7 Months Ending 1/31/03

	Progam 1	Program 2	Program 3	Program 4	Program 5	Program 6	Program 7	Fund Ra s ng	Adm n	Tota
Revenue										
PARENT FEES	60,073 00	74,411 00	9,981 00	50,188 10	33,891 00	0 00	0 00	0 00	0 00	228,544 10
SUBS D ZED FEES	81,557 40	47,652 26	10,257 50	21,660 50	10,375 00	0 00	0 00	0 00	0 00	171,502 66
Tota fees	141,630 40	122,063 26	20,238 50	71,848 60	44,266 00	0 00	0 00	0 00	0 00	400,046 76
UN TED WAY ALLOCAT ON	29,032 00	10,792 36	3,851 00	1,428 00	946 00	0 00	0 00	0 00	0 00	46,049 36
UN TED WAY DONOR OPT ON	1,469 68	1,741 47	351 00	797 00	541 58	0 00	0 00	0 00	0 00	4,900 73
USDA FOOD PROGRAM	12,236 60	15,552 12	716 22	2,641 62	2,743 46	0 00	0 00	0 00	0 00	33,890 02
COUNTY PROGRAM	0 00	0 00	0 00	0 00	0 00	25,166 17	0 00	0 00	0 00	25,166 17
C TY PROGRAM	0 00	0 00	0 00	0 00	0 00	0 00	30,059 10	0 00	0 00	30,059 10
COLLABORAT ON PROJECT	0 00	0 00	0 00	0 00	0 00	0 00	0 00	0 00	1,000 00	1,000 00
SCHOLARSH P FUND NCOME	932 00	835 00	0 00	95 00	0 00	0 00	0 00	0 00	88 00	1,950 00
DONAT ONS	0 00	0 00	0 00	0 00	0 00	0 00	0 00	55,580 00	0 00	55,580 00
DONAT ONS- NK ND	0 00	0 00	0 00	0 00	0 00	0 00	0 00	75 00	0 00	75 00
DONAT ONS-L TERACY PROJECT	0 00	0 00	0 00	0 00	0 00	0 00	0 00	0 00	1,779 73	1,779 73
FOUNDAT ON GRANT	0 00	0 00	0 00	0 00	0 00	0 00	0 00	14,581 00	18,669 00	33,250 00
NVESTMENT NCOME & GA NS	0 00	0 00	0 00	0 00	0 00	0 00	0 00	0 00	(3,558 44)	(3,558 44)
RENTAL NCOME	0 00	0 00	0 00	0 00	0 00	0 00	0 00	0 00	10,135 36	10,135 36
M SCELLANEOUS NCOME	0 00	0 00	0 00	0 00	0 00	0 00	0 00	0 00	175 00	175 00
Gross Revenue	185,300 68	150,984 21	25,156 72	76,810 22	48,497 04	25,166 17	30,059 10	70,236 00	28,288 65	640,498 79
Expenses										
SALAR ES (NCLUDES TAXES & BENEF TS)	141,977 73	103,289 79	19,279 97	48,290 42	38,163 75	5,275 69	2,100 00	22,933 65	89,818 64	471,129 64
PROFESS ONAL FEES	0 00	25 00	0 00	0 00	0 00	217 50	0 00	0 00	21,865 86	22,108 36
DEVELOPMENT COSTS	0 00	0 00	0 00	0 00	0 00	0 00	0 00	47 66	0 00	47 66
L TERACY PROJECT COSTS	0 00	0 00	0 00	0 00	0 00	0 00	0 00	0 00	1,779 73	1,779 73
NETWORK GRANTS & SUBS D ES	0 00	0 00	0 00	0 00	0 00	12,140 00	19,631 29	0 00	0 00	31,771 29
CONFERENCES & TRA N NGS	1,500 00	659 00	225 00	270 00	325 00	0 00	0 00	40 00	228 50	3,247 50
PROGRAM COSTS	2,379 38	1,161 25	183 35	2,499 20	1,334 42	0 00	333 00	0 00	0 00	7,890 60
N/NE NETWORK REALLOCAT ONS	(1,950 40)	(987 15)	(225 00)	(477 45)	(300 00)	3,998 00	0 00	0 00	(58 00)	0 00
FOOD & BEVERAGE	7,333 52	14,169 20	926 01	2,043 68	2,031 59	0 00	0 00	0 00	0 00	26,504 00
OCCUPANCY (NCLUDES NSURANCE & RENT)	16,545 05	20,786 02	1,304 33	3,224 82	2,322 60	0 00	0 00	0 00	5,293 81	49,476 63
RENT EXPENSE	0 00	0 00	0 00	0 00	0 00	0 00	0 00	0 00	9,413 32	9,413 32
VEH CLES (NCLUDES NSURANCE)	0 00	947 28	708 32	4,682 26	611 63	0 00	0 00	0 00	1,005 28	7,954 77
OTHER NSURANCE	89 46	123 83	27 51	91 70	66 50	0 00	0 00	0 00	2,581 81	2,980 81
OFF CE EXPENSE & SUPPL ES	13 50	22 50	2 50	16 95	5 50	0 00	0 00	0 00	1,811 96	1,872 91
DUES & MEMBERSH PS	50 95	6 00	0 00	0 00	0 00	0 00	0 00	45 00	61 00	162 95
PR NT NG & PUBL CAT ONS	269 82	167 97	39 60	51 43	51 40	0 00	0 00	5,547 80	1,210 06	7,338 08
FEES & L CENSES	361 50	318 50	122 50	225 50	122 00	0 00	0 00	0 00	436 95	1,586 95
MEET NG EXPENSES	250 04	142 43	4 00	17 00	12 80	34 98	1,117 70	17 50	544 33	2,140 78
POSTAGE & SH PP NG	0 00	0 00	0 00	0 00	0 00	0 00	0 00	1,036 00	379 57	1,415 57
ENROLLMENT COSTS	57 30	57 30	48 87	857 30	187 30	0 00	460 42	0 00	0 00	1,668 49
STAFF RECRU TMENT	207 81	144 00	0 00	0 00	6 00	0 00	0 00	0 00	0 00	357 81
M SCELLANEOUS EXPENSE	0 00	0 00	0 00	150 00	0 00	0 00	0 00	0 00	(15 83)	134 17
BAD DEBT EXPENSE	2,257 21	2,082 88	430 93	1,444 93	962 83	0 00	0 00	0 00	0 00	7,178 78
SCHOLARSH PS & ASS STANCE	932 00	835 00	0 00	95 00	0 00	0 00	0 00	0 00	0 00	1,862 00
DEPREC AT ON & AMORT ZAT ON	7,350 00	14,000 00	875 00	2,800 00	875 00	0 00	0 00	0 00	7,700 00	33,600 00
CAP TAL ACQU S T ONS	0 00	0 00	0 00	0 00	0 00	0 00	0 00	0 00	660 00	660 00
Tota Expenses	179,624 87	157,950 80	23,952 89	66,282 74	46,778 32	21,666 17	23,642 41	29,667 61	144,716 99	694,282 80
Earn ngs (Loss) for Per od	5,675 81	(6,966 59)	1,203 83	10,527 48	1,718 72	3,500 00	6,416 69	40,568 39	(116,428 34)	(53,784 01)
ADM N STRAT VE COST ALLOCAT ON	45,776 93	27,465 03	5,886 11	12,514 76	10,299 83	3,500 00	6,416 69	4,568 99	(116,428 34)	0 00
Earn ngs (Loss) for Per od	(40,101 12)	(34,431 62)	(4,682 28)	(1,987 28)	(8,581 11)	0 00	0 00	35,999 40	0 00	(53,784 01)

FORMS

Forms

Ballot for Election of Directors

Ballot for Proposed Action

Bylaws of a Membership Corporation

Bylaws of a Nonmembership Corporation

Complete Release

Complete Release and Hold Harmless Agreement by Client

Complete Release and Hold Harmless Agreement by Volunteers

Conflicts of Interest Policy

Consent to Corporate Action Without a Meeting by the Board of Directors

Consent to Corporate Action Without a Meeting by the Members

Depreciable Property

Excess Benefits Transactions Policy

In-Kind Contribution Record

Minutes of First Meeting of Board of Directors

Minutes of Meeting of the Board of Directors

Minutes of Meeting of the Members

Promissory Note

Proxy Vote

Waiver of Notice of Meeting of Directors

Waiver of Notice of Meeting of Members

BALLOT FOR ELECTION OF DIRECTORS

NAME OF CORPORATION: _____

This written ballot is a ballot for you to vote for your choices for the Board of Directors. Vote for no more than ___ of the choices below by placing an "X" or check mark on the line to the left of your choices or by filling in a blank space. Blank spaces are for other nominees.

Nominees:

_____ _____

_____ _____

_____ _____

_____ _____

_____ _____

_____ _____

In order to meet quorum requirements, the corporation must receive _____ valid ballots.

Place this ballot in the small envelope and sign and date the small envelope on the outside of the line indicated. Place the small envelope in the return envelope and mail or deliver it to the corporation. Your ballot must be received by 5:00 p.m. on _____, 20___, in order to be counted.

BALLOT FOR PROPOSED ACTION

NAME OF CORPORATION: _____

This written ballot is a ballot for you to vote for or against the proposed action below. In order to meet quorum requirements, the corporation must receive _____valid ballots. ____ % of these ballots are necessary in order to approve this proposed action.

PROPOSED ACTION:

I vote _____ FOR this action.

_____ AGAINST this action.

Please place an "X" or check mark by the choice above that reflects your vote. Place this ballot in the small envelope and sign and date the small envelope on the outside on the line indicated. Place the small envelope in the return envelope and mail or deliver it to the corporation. Your ballot must be received by 5:00 p.m. on _____, 20___ in order to be counted.

BYLAWS OF A MEMBERSHIP CORPORATION

NAME OF CORPORATION: _____

ARTICLE I: PURPOSE

This corporation shall be organized and operated exclusively for charitable, scientific, literary, religious, and educational purposes. Subject to the limitations stated in the Articles of Incorporation, the purposes of this corporation shall be to engage in any lawful activities, none of which are for profit, for which corporations may be organized under Chapter 65 of the Oregon Revised Statutes (or its corresponding future provisions) and Section 501(c)(3) of the Internal Revenue Code (or its corresponding future provisions).

This corporation's primary purpose shall be _____
_____
_____.

ARTICLE II: MEMBERS

Section 1. *Classes and Voting*. There shall be one class of members of this corporation. Each member shall be entitled to one vote on all matters for which a membership vote is permitted by law, the Articles of Incorporation, or the bylaws of this corporation.

Section 2. *Qualifications*. A person shall become a member of the corporation by _____
_____
_____.

Section 3. *Termination of Membership*. Membership may be terminated by the Board of Directors after giving the member at least 15 days written notice by first class or certified mail of the termination and the reasons for the termination, and an opportunity for the member to be heard by the Board, orally or in writing, not less than five days before the effective date of the termination. The decision of the Board shall be final and shall not be reviewable by any court.

Section 4. *Annual Meeting*. The annual meeting of the members shall be held on _____.

Section 5. *Special Meetings*. Special meetings of the members shall be held at the call of the Board of Directors, or by the call of the holders of at least five percent of the voting power of the corporation by a demand signed, dated, and delivered to the corporation's Secretary. Such demand by the members shall describe the purpose for the meeting.

Section 6. *Notice of Meeting*. Notice of all meetings of the members shall be given to each member at the last address of record, by first class mail at least 7 days before the meeting, or by means other than first class mail at least 30 but not more than 60 days before the meeting. The notice shall include the date, time, place, and purposes of the meeting.

Section 7. *Quorum and Voting*. Those votes represented at a meeting of members shall constitute a quorum. A majority vote of the members voting is the act of the members, unless these bylaws or the law provide differently.

Section 8. *Proxy Voting*. There shall be no voting by proxy.

Section 9. *Action by Consent*. Any action required by law to be taken at a meeting of the members, or any action which may be taken at a members' meeting, may be taken without a meeting if a consent in writing, setting forth the action to be taken or so taken, shall be signed by all the members.

ARTICLE III: BOARD OF DIRECTORS

Section 1. *Duties*. The affairs of the corporation shall be managed by the Board of Directors.

Section 2. *Number*. The number of Directors may vary between a minimum of three and a maximum of fifteen.

Section 3. *Term and Election*. The term of office for Directors shall be two years. A Director may be reelected without limitation on the number of terms she or he may serve. The Board shall be elected by the members at the annual meeting of the members by a majority vote of the members represented and voting.

Section 4. *Removal*. Any Director may be removed, with or without cause, at a meeting called for that purpose, by a vote of a majority of the members entitled to vote at an election of Directors.

Section 5. *Vacancies*. Vacancies on the Board of Directors and newly created board positions shall be filled by a majority vote of the Directors then on the Board of Directors.

Section 6. *Quorum and Action*. A quorum at a board meeting shall be a majority of the number of Directors prescribed by the Board, or if no number is prescribed, by a majority of all Directors in office immediately before the meeting begins. If a quorum is present, action is taken by a majority vote of directors present. Where the law requires a majority vote of directors in office to establish committees that exercise Board functions, to amend the Articles of Incorporation, to sell assets not in the regular course of business, to merge, to dissolve, or for other matters, such action is taken by that majority as required by law.

Section 7. *Regular Meetings*. Regular meetings of the Board of Directors shall be held at the time and place to be determined by the Board of Directors. No other notice of the date, time, place, or purpose of these meetings is required.

Section 8. *Special Meetings*. Special meetings of the Board of Directors shall be held at the time and place to be determined by the Board of Directors. Notice of such meetings, describing the date, time, place, and purpose of the meeting, shall be delivered to each Director personally or by telephone or by mail not less than two days prior to the special meeting.

Section 9. *Alternative Meeting Venue*. Any regular or special meeting of the Board of Directors may be conducted through use of any means of communication by which all Directors participating may simultaneously hear each other during the meeting.

Section 10. *No Salary*. Directors shall not receive salaries for their Board services but may be reimbursed for expenses related to Board service.

Section 11. *Action by Consent*. Any action required by law to be taken at a meeting of the board, or any action which may be taken at a board meeting, may be taken without a meeting if a consent in writing, setting forth the action to be taken or so taken, shall be signed by all the Directors.

ARTICLE IV: COMMITTEES

Section 1. *Executive Committee*. The Board of Directors may elect an Executive Committee. The Executive Committee shall have the authority to make ongoing decisions between Board meetings and shall have the authority to make financial and budgetary decisions.

Section 2. *Other Committees*. The Board of Directors may establish such other committees as it deems necessary and desirable. Such committees may exercise the authority of the Board of Directors or may be advisory committees.

Section 3. *Composition of Committees Exercising Board Authority*. Any committee that exercises any authority of the Board of Directors shall be composed of two or more Directors, elected by the Board of Directors by a majority vote of the number of Directors prescribed by the Board, or if no number is prescribed, of all Directors in office at that time.

Section 4. *Quorum and Action*. A quorum at a Committee meeting exercising Board authority shall be a majority of all Committee members in office immediately before the meeting begins. If a quorum is present, action is taken by a majority vote of Directors present.

Section 5. *Limitations on the Powers of Committees*. No committee may authorize payment of a dividend or any part of the income or profit of the corporation to its directors or officers; may approve dissolution, merger, or the sale, pledge, or transfer of all or substantially all of the corporation's assets; may elect, appoint, or remove directors or fill vacancies on the board or on any of its committees; nor may adopt, amend, or repeal the Articles, bylaws, or any resolution by the Board of Directors.

ARTICLE V: OFFICERS

Section 1. *Titles*. The officers of this corporation shall be the President and Secretary.

Section 2. *Election*. The Board of Directors shall elect the President and Secretary to serve one year terms. An officer may be reelected without limitation on the number of terms the officer may serve.

Section 3. *Vacancy*. A vacancy of the office of President or Secretary shall be filled not later than the first regular meeting of the Board of Directors following the vacancy.

Section 4. *Other Officers*. The Board of Directors may elect or appoint other officers, agents and employees as it shall deem necessary and desirable. They shall hold their offices for such terms and have such authority and perform such duties as shall be determined by the Board of Directors.

Section 5. *President*. The President shall be the chief officer of the corporation and shall act as the Chair of the Board. The President shall have any other powers and duties as may be prescribed by the Board of Directors.

Section 6. *Secretary*. The Secretary shall have overall responsibility for all recordkeeping and all corporate funds. The Secretary shall perform, or cause to be performed, the following duties: (a) official recording of the minutes of all proceedings of the Board of Directors and members' meetings and actions; (b) provision for notice of all meetings of the Board of Directors and members; (c) authentication of the records of the corporation; (d) keeping of full and accurate accounts of all financial records of the corporation; (e) deposit of all monies and other valuable effects in the name and to the credit of the corporation in such depositories as may be designated by the Board of Directors; (f) disbursement of all funds when proper to do so; (g) making financial reports as to the financial condition of the corporation to the Board of Directors; (h) maintaining current and accurate membership lists; and (i) and any other duties as may be prescribed by the Board of Directors.

ARTICLE VI: CORPORATE INDEMNITY

This corporation will indemnify to the fullest extent not prohibited by law any person who is made or threatened to be made a party to an action, suit, or other proceeding, by reason of the fact that the person is or was a director or officer of the corporation or a fiduciary within the meaning of the Employee Retirement Income Security Act (or its corresponding future provisions) with respect to any employee benefit plan of the corporation. No amendment to this Article that limits the corporation's obligation to indemnify any person shall have any effect on such obligation for any act or omission that occurs prior to the later of the effective date of the amendment or the date notice of the amendment is given to the person. The corporation shall interpret this indemnification provision to extend to all persons covered by its provisions the most liberal possible indemnification--substantively, procedurally, and otherwise.

ARTICLE VII: AMENDMENTS TO BYLAWS

Both the Board of Directors and the members must vote to amend or repeal these Bylaws or to adopt new ones. The Board of Directors must vote to amend or repeal these Bylaws or to adopt new ones by a majority vote of directors present, if a quorum is present. Prior to the adoption of the amendment, each Director shall be given at least two days notice of the date, time, and place of the meeting at which the proposed amendment is to be considered, and the notice shall state that one of the purposes of the meeting is to consider a proposed amendment to the Bylaws and shall contain a copy of the proposed amendment. The members must vote to amend or repeal these Bylaws or to adopt new ones by a majority vote of the members represented and voting. Prior to the adoption of the amendment, each member shall be given the notice

of meeting required by these Bylaws and the notice shall state that one of the purposes of the meeting is to consider a proposed amendment to the Bylaws and shall contain a copy of the proposed amendment.

ADOPTED: _____

SIGNATURE BY CORPORATE OFFICER: _____

BYLAWS OF A NONMEMBERSHIP CORPORATION

NAME OF CORPORATION: _____

ARTICLE I: PURPOSE

This corporation shall be organized and operated exclusively for charitable, scientific, literary, religious, and educational purposes. Subject to the limitations stated in the Articles of Incorporation, the purposes of this corporation shall be to engage in any lawful activities, none of which are for profit, for which corporations may be organized under Chapter 65 of the Oregon Revised Statutes (or its corresponding future provisions) and Section 501(c)(3) of the Internal Revenue Code (or its corresponding future provisions).

This corporation's primary purpose shall be _____
_____.

ARTICLE II: NONMEMBERSHIP

This corporation shall have no members.

ARTICLE III: BOARD OF DIRECTORS

Section 1. *Duties*. The affairs of the corporation shall be managed by the Board of Directors.

Section 2. *Number*. The number of Directors may vary between a minimum of three and a maximum of fifteen.

Section 3. *Term and Election*. The term of office for Directors shall be two years. A Director may be reelected without limitation on the number of terms she or he may serve. The board shall elect its own members, except that a Director shall not vote on that member's own position.

Section 4. *Removal*. Any Director may be removed, with or without cause, by a vote of two-thirds of the Directors then in office.

Section 5. *Vacancies*. Vacancies on the Board of Directors and newly created board positions shall be filled by a majority vote of the Directors then on the Board of Directors.

Section 6. *Quorum and Action*. A quorum at a board meeting shall be a majority of the number of Directors prescribed by the Board, or if no number is prescribed, a majority of the number in office immediately before the meeting begins. If a quorum is present, action is taken by a majority vote of the directors present, except as provided otherwise by these bylaws. Where the law requires a majority vote of the directors in office to establish committees to exercise Board functions, to amend the Articles of Incorporation, to sell assets not in the regular course of business, to merge, or to dissolve, or for other matters, such action is taken by that majority as required by law.

Section 7. *Regular Meetings*. Regular meetings of the Board of Directors shall be held at the time and place to be determined by the Board of Directors. No other notice of the date, time, place, or purpose of these meetings is required.

Section 8. *Special Meetings*. Special meetings of the Board of Directors shall be held at the time and place to be determined by the Board of Directors. Notice of such meetings, describing the date, time, place, and purpose of the meeting, shall be delivered to each Director personally or by telephone or by mail not less than two days prior to the special meeting.

Section 9. *Alternative Meeting Venue*. Any regular or special meeting of the Board of Directors may be conducted through use of any means of communication by which all Directors participating may simultaneously hear each other during the meeting.

Section 10. *No Salary*. Directors shall not receive salaries for their Board services but may be reimbursed for expenses related to Board service.

Section 11. *Action by Consent*. Any action required by law to be taken at a meeting of the board, or any action which may be taken at a board meeting, may be taken without a meeting if a consent in writing, setting forth the action to be taken or so taken, shall be signed by all the Directors.

ARTICLE IV: COMMITTEES

Section 1. *Executive Committee*. The Board of Directors may elect an Executive Committee. The Executive Committee shall have the authority to make ongoing decisions between Board meetings and shall have the authority to make financial and budgetary decisions.

Section 2. *Other Committees*. The Board of Directors may establish such other committees as it deems necessary and desirable. Such committees may exercise the authority of the Board of Directors or may be advisory committees.

Section 3. *Composition of Committees Exercising Board Authority*. Any committee that exercises any authority of the Board of Directors shall be composed of two or more Directors, elected by the Board of Directors by a majority vote of the number of Directors prescribed by the Board, or if no number is prescribed, of all Directors in office at that time.

Section 4. *Quorum and Action*. A quorum at a Committee meeting exercising Board authority shall be a majority of all Committee members in office immediately before the meeting begins. If a quorum is present, action is taken by a majority vote of Directors present.

Section 5. *Limitations on the Powers of Committees*. No committee may authorize payment of a dividend or any part of the income or profit of the corporation to its directors or officers; may approve dissolution, merger, or the sale, pledge, or transfer of all or substantially all of the corporation's assets; may elect, appoint, or remove directors or fill vacancies on the board or on any of its committees; nor may adopt, amend, or repeal the Articles, bylaws, or any resolution by the Board of Directors.

ARTICLE V: OFFICERS

Section 1. *Titles*. The officers of this corporation shall be the President and Secretary.

Section 2. *Election*. The Board of Directors shall elect the President and Secretary to serve one year terms. An officer may be reelected without limitation on the number of terms the officer may serve.

Section 3. *Vacancy*. A vacancy of the office of President or Secretary shall be filled not later than the first regular meeting of the Board of Directors following the vacancy.

Section 4. *Other Officers*. The Board of Directors may elect or appoint other officers, agents and employees as it shall deem necessary and desirable. They shall hold their offices for such terms and have such authority and perform such duties as shall be determined by the Board of Directors.

Section 5. *President*. The President shall be the chief officer of the corporation and shall act as the Chair of the Board. The President shall have any other powers and duties as may be prescribed by the Board of Directors.

Section 6. *Secretary*. The Secretary shall have overall responsibility for all recordkeeping and all corporate funds. The Secretary shall perform, or cause to

be performed, the following duties: (a) official recording of the minutes of all proceedings of the Board of Directors meetings and actions; (b) provision for notice of all meetings of the Board of Directors; (c) authentication of the records of the corporation; (d) keeping of full and accurate accounts of all financial records of the corporation; (e) deposit of all monies and other valuable effects in the name and to the credit of the corporation in such depositories as may be designated by the Board of Directors; (f) disbursement of all funds when proper to do so; (g) making financial reports as to the financial condition of the corporation to the Board of Directors; and (h) any other duties as may be prescribed by the Board of Directors.

ARTICLE VI: CORPORATE INDEMNITY

This corporation will indemnify to the fullest extent not prohibited by law any person who is made or threatened to be made a party to an action, suit, or other proceeding, by reason of the fact that the person is or was a director or officer of the corporation or a fiduciary within the meaning of the Employee Retirement Income Security Act (or its corresponding future provisions) with respect to any employee benefit plan of the corporation. No amendment to this Article that limits the corporation's obligation to indemnify any person shall have any effect on such obligation for any act or omission that occurs prior to the later of the effective date of the amendment or the date notice of the amendment is given to the person. The corporation shall interpret this indemnification provision to extend to all persons covered by its provisions the most liberal possible indemnification--substantively, procedurally, and otherwise.

ARTICLE VII: AMENDMENTS TO BYLAWS

These bylaws may be amended or repealed, and new bylaws adopted, by the Board of Directors by a majority vote of directors present, if a quorum is present. Prior to the adoption of the amendment, each Director shall be given at least two days notice of the date, time, and place of the meeting at which the proposed amendment is to be considered, and the notice shall state that one of the purposes of the meeting is to consider a proposed amendment to the bylaws and shall contain a copy of the proposed amendment.

Date Adopted: _____

Signature by Corporate Officer: _____

COMPLETE RELEASE

I assume all liability from any cause whatsoever in connection with _____ [hereinafter called "this nonprofit organization"], and I release this nonprofit organization, and its directors, officers, employees, agents, and volunteers from all liability from any cause whatsoever in connection with this nonprofit organization.

DATED: _____

_____
Signature

COMPLETE RELEASE AND HOLD HARMLESS AGREEMENT BY CLIENT

By my signature on this document, I assume all liability from any cause whatsoever that may arise out of or in connection with _____ _____ [hereinafter called "this nonprofit organization"], including but not limited to all liability from any cause whatsoever for personal injury or property damage; all liability from any cause whatsoever for contribution or indemnification; and all liability from any cause whatsoever that may arise out of, in connection with, or during the time of my presence at any businesses or other activities of this nonprofit organization.

I release and hold harmless this nonprofit organization and its directors, officers, employees, agents, volunteers, assigns, and successors [hereinafter, "the protected parties"] from all liability from any cause whatsoever as described above.

By this document, I assume all liability as described above that existed at the time of the execution of this document and all liability from that time forward into the future until such time as this nonprofit organization shall execute in writing a document revoking this document.

By this document, I release and hold harmless the protected parties from all liability from any cause whatsoever as described above that existed at the time of the execution of this document and all liability from that time forward into the future until such time as this nonprofit organization shall execute in writing a document revoking this document.

The consideration for this document is the services that this nonprofit organization is providing to me at a reduced cost.

This document shall be given a liberal construction, with all ambiguities resolved in favor of the protected parties. If any provision of this document is deemed to be partially void, invalid, or unenforceable, that provision shall continue in full force and effect to the maximum extent permitted by law and all remaining provisions of this document shall continue in full force and effect. To the extent that any provision of this document is deemed to be completely void, invalid or unenforceable, that provision shall be severed from the remainder of this document and all remaining provisions of this document shall continue in full force and effect.

DATED: _____

_____

Signature

COMPLETE RELEASE AND HOLD HARMLESS AGREEMENT BY VOLUNTEERS

By my signature on this document, I assume all liability from any cause whatsoever that may arise out of or in connection with _____ _____ [hereinafter called "this nonprofit organization"], including but not limited to all liability from any cause whatsoever for personal injury or property damage; all liability from any cause whatsoever for contribution or indemnification; and all liability from any cause whatsoever that may arise out of, in connection with, or during the time of my volunteering to provide services for this nonprofit organization; except that I shall be entitled to any and all worker compensation benefits that are available to me as a volunteer under the coverage of the worker compensation policy held by this nonprofit organization.

I release and hold harmless this nonprofit organization, its directors, officers, employees, agents, volunteers, assigns, and successors [hereinafter, "the protected parties"] from all liability from any cause whatsoever as described above.

By this document, I assume all liability as described above that existed at the time of the execution of this document and all liability from that time forward into the future until such time as this nonprofit organization shall execute in writing a document revoking this document.

By this document, I release and hold harmless the protected parties from all liability from any cause whatsoever as described above that existed at the time of the execution of this document and all liability from that time forward into the future until such time as this nonprofit organization shall execute in writing a document revoking this document.

The consideration for this document is the provision by this nonprofit organization of worker compensation insurance coverage to me as a volunteer.

This document shall be given a liberal construction, with all ambiguities resolved in favor of the protected parties. If any provision of this document is deemed to be partially void, invalid, or unenforceable, that provision shall continue in full force and effect to the maximum extent permitted by law and all remaining provisions of this document shall continue in full force and effect. To the extent that any provision of this document is deemed to be completely void, invalid or unenforceable, that provision shall be severed from the remainder of this document and all remaining provisions of this document shall continue in full force and effect.

DATED: _____

_____
Signature

CONFLICTS OF INTEREST POLICY

Definitions

A conflict of interest transaction or arrangement is a transaction or arrangement with this corporation in which a director or officer has a direct or indirect interest.

1. A director or officer has a direct interest in any transaction or arrangement if the director or officer or a member of the director's or officer's family has a financial interest in the transaction or arrangement.

2. A director or officer has an indirect interest in any transaction or arrangement if the director or officer or a family member:

a. has a financial interest or potential financial interest in any entity or individual involved in the transaction or arrangement;

b. has a compensation arrangement with any entity or individual with which this corporation has a transaction or arrangement; or

c. is a director, officer, or trustee of a profit or nonprofit entity involved in the transaction or arrangement and the transaction or arrangement is of such importance that it is or should be considered by the board of that nonprofit entity.

Procedures

Any director or officer with knowledge of an actual or potential conflict of interest on the part of that director or officer or any other director or officer of this corporation shall inform the entire board of the conflict. The board shall obtain disclosure of the financial interest and all material facts. After any discussion with the interested person, the interested person shall leave the meeting while the board determines whether a conflict of interest exists. If the board determines that a conflict exists, the board shall follow these procedures to address the conflict of interest:

a. The interested person may make a presentation to the board but after the presentation shall leave the meeting during the discussion of and the vote on the transaction or arrangement involving the conflict of interest.

b. The board shall investigate alternatives to the proposed transaction or arrangement. After exercising due diligence, the board shall determine whether

the transaction or arrangement is fair to the corporation. The transaction must be approved by a majority of all the members of the board who have no direct or indirect interest in the transaction. If a majority of the directors vote to approve the transaction or arrangement, a quorum is present for the purpose of taking action, except that such transaction or arrangement cannot be approved by a single director.

Records of the Proceedings

The board minutes shall contain the names of the persons who had a conflict of interest, the nature of the financial interest, a summary of the discussion to determine whether a conflict was present and the vote as to whether a conflict was present, the names of the directors and officers present for the discussion and vote related to the transaction or arrangement, a summary of the discussion, and a record of the vote taken.

ADOPTED: _____.

CONSENT TO CORPORATE ACTION WITHOUT A MEETING BY THE BOARD OF DIRECTORS

NAME OF CORPORATION: _____

We, the undersigned, being all the Directors of this corporation, an Oregon nonprofit corporation, do consent to the following corporate action as if such action had been taken at a duly held meeting of the Board of Directors of the corporation:

ACTION:

This action is to be effective as of this _____ day of _____, 20___.

_____ Date Signed: _____
Signature

_____ Date Signed: _____
Signature

_____ Date Signed: _____
Signature

_____ Date Signed: _____
Signature

_____ Date Signed: _____
Signature

CONSENT TO CORPORATE ACTION WITHOUT A MEETING BY THE MEMBERS

NAME OF CORPORATION: _____

We, the undersigned, being all the members of this corporation, an Oregon corporation, do consent to the following corporate action as if such action had been taken at a duly held meeting of the members of the corporation:

ACTION:

This action is to be effective as of this _____ day of _____, 20___.

_____ Date Signed: _____
Signature

_____ Date Signed: _____
Signature

_____ Date Signed: _____
Signature

_____ Date Signed: _____
Signature

_____ Date Signed: _____
Signature

DEPRECIABLE PROPERTY

Description of the property: _____

Date Acquired: _____

Method of Depreciation: _____

Cost (or other basis): _____

Percent of business usage: _____

Useful life: _____

Salvage value: _____

Additional first year depreciation taken: _____

*Adjusted basis here would be: Cost minus accumulated depreciation.

EXCESS BENEFITS TRANSACTIONS POLICY

The Board of Directors shall monitor the transactions between the corporation and any disqualified persons as required by the Internal Revenue Service in its excess benefits transactions rules to ensure that the corporation complies with these rules. This policy supersedes any conflicts of interest policy of the corporation to the extent that this policy is more stringent than the conflicts of interest policy.

In order to comply with these rules, the board shall act as follows:

1. The board shall develop and maintain a list of disqualified persons.

2. The board shall ascertain that no member of the board is a disqualified person with respect to any transaction that it considers. If a board member is a disqualified person with respect to a transaction, the board shall appoint a committee consisting of all board members who are not disqualified to consider the transaction.

3. The board shall notify each disqualified person who is employed by the corporation or with whom the board anticipates that the corporation may engage in a transaction that that person is a disqualified person.

4. The board shall convey the list of disqualified persons to the Executive Director and shall instruct the Executive Director to notify the board if the Executive Director or any employee plans to engage in any transaction with a disqualified person, including payment or reimbursement for business or travel expenses of the disqualified person and/or any members of the disqualified person's family. If so, the board shall monitor the transaction to ensure that it complies with the procedure in #6 below.

5. When employee compensation packages are established each year, the board shall identify those employees who are disqualified persons. The board shall monitor the compensation packages of disqualified persons in accordance with the procedure in #6 below .

6. When the corporation engages in a transaction with a disqualified person, the board shall monitor the transaction as follows:

(a) The board shall ensure that the corporation has a written agreement governing the transaction with each such disqualified person.

(b) The board shall gather appropriate data to ensure that the transaction with each disqualified person is reasonable.

(c) The board shall document its decision by keeping written records that state the terms of the transaction and date approved, the members present and who voted on it, and the comparability data and how the data was obtained. The records must be prepared before the later of the next board meeting or 60 days after the final action is taken. Once prepared, the records must be reviewed and approved by the board within a reasonable time.

The board may delegate its responsibilities under this policy to a committee of the board. If the board does so delegate its responsibilities, the committee shall alert the board if the committee ascertains that the board is considering a transaction with a disqualified person. The committee shall report to the board in a timely fashion the results of all monitoring of disqualified persons that the committee is required to do under this policy.

ADOPTED: _____

IN-KIND CONTRIBUTION RECORD

Organization's Name: _____ Fiscal Year: _____

Name of Contributor: _____

Address of Contributor: _____

_____

Phone # of Contributor: _____

Date of Contribution: _____

Description of contributed materials: _____

_____

_____

Value of contributed materials: _____

Description of services contributed: _____

_____

_____

Number of hours of service contributed: _____

Rate contributor is generally paid for similar services: _____

Other method of valuation of services contributed: _____

_____

SUMMARY

Value of materials: _____

Value of services: _____

Total: _____

Signature of Contributor: _____

Signature of staff receiving contribution: _____

MINUTES OF FIRST MEETING OF BOARD OF DIRECTORS

NAME OF CORPORATION: _____

The initial meeting of the Board of Directors of the above corporation, an Oregon corporation, was held at Portland, Oregon, on _____, 20___, at ___ .m., pursuant to a call for such meeting by _____ _____, the incorporator.

Present were the Directors listed on Attachment A, who constitute a quorum.

By unanimous vote of the Board of Directors, _____ _____ was chosen chairperson of the meeting and _____ was chosen to serve as Secretary of the meeting.

The Secretary presented to the meeting a Waiver of Notice of this meeting, signed by the initial Board of Directors of the corporation, and the Chairperson directed that such Waiver be attached to the minutes of the meeting.

The incorporator reported that the Articles of Incorporation have been filed in the appropriate state office for the state of Oregon, and were stamped on _____, 20___.

The incorporator then submitted to the meeting a form of Bylaws for the regulation of the affairs of the corporation. These Bylaws were read, and after discussion, it was unanimously

DECIDED: that the Bylaws presented to this meeting are adopted as the Bylaws of this corporation, and that a copy of these Bylaws be placed in the records of the corporation.

The Board of Directors then proceeded to the election of officers. Nominations were made, and the following persons were duly elected to the following offices:

President -

Secretary -

The chairperson then stated that it was desirable to designate a depository for the funds of the corporation. It was unanimously

DECIDED: that _____ is selected as a depository for the funds of this corporation. The President of the Corporation is authorized to

establish these accounts. Funds shall be withdrawn from this depository on checks of this corporation signed by both of the following:

Signer-

Signer-

and may be payable to bearer, or to the order of, and for the use and benefit of, the signers of the checks.

The Chairperson stated that the next order of business would be to discuss the necessity of the corporation borrowing funds from time to time for business purposes. After deliberation and discussion, it was unanimously

DECIDED: that the corporation is authorized to borrow such sums of money not to exceed a total amount of $_____ at any one time without further authorization; and

DECIDED: that the officers of the corporation are authorized to negotiate the terms of such borrowing on behalf of the corporation and to execute on behalf of the corporation any promissory notes, instruments, and other documents necessary or reasonable to evidence such borrowing from banks, institutions or other third persons.

It was then suggested that the Secretary of the corporation be authorized to pay all expenses and to reimburse any persons for expenses made in connection with the organization of the corporation. It was unanimously

DECIDED: that the Secretary of this corporation is authorized to pay all charges and expenses incident to or arising out of the organization of this corporation and to reimburse any person that has made any disbursements for this corporation.

It was then suggested that the officers of the corporation be paid a monthly salary as follows:

President – $

Secretary – $

Furthermore, the corporation should pay all expenses incurred by the officers in the performance of their duties. It was unanimously

DECIDED: that the monthly salaries be set as follows:

President –

Secretary –

and that the corporation is to reimburse each officer for business expenses.

The Chairperson then stated that any acts of the incorporators, performed so far on behalf of this corporation, should be ratified and confirmed as the duly authorized acts of the corporation. The unanimous decision was as follows:

DECIDED: that any and all acts of the incorporators of this corporation are hereby ratified and approved as duly authorized acts of this corporation in all respects as if they had been done pursuant to specific authority granted by this corporation.

The Chairperson next proposed that the fiscal year of the corporation begin on the first day of _____ and end on the last day of _____. The Board unanimously

DECIDED: that the fiscal year of the corporation shall be as proposed above.

READ AND APPROVED:

_____
Chairperson

ATTACHMENT A
DIRECTORS PRESENT AT FIRST MEETING OF BOARD

OPTIONAL ITEMS

It was proposed that the corporation apply for tax exemption under Section 501(c)(3) of the Internal Revenue Code and for all other applicable federal, state, regional and local tax exemptions and benefits. The unanimous decision was as follows:

DECIDED: that the President shall have the authority to apply on behalf of the corporation for tax exemption under Section 501(c)(3) of the Internal Revenue Code and for all other applicable federal, state, regional, and local tax exemptions and benefits.

It was suggested that the criteria for members be established. The Board unanimously

DECIDED: that the criteria for membership in this corporation shall be:

_____

_____

_____

MINUTES OF MEETING OF THE BOARD OF DIRECTORS

NAME OF CORPORATION: _____

Date:

Time:

Place:

Directors Attending:

Notice Given (if any): Attached

A sufficient number of Directors were present to constitute a quorum.

The minutes from the last meeting of the Board of Directors were presented by the Secretary. The minutes were adopted by a vote of _____ to _____.

Committee Reports:

Agenda Item:

Discussion:

Decision:

Agenda Item:

Discussion:

Decision:

Agenda Item:

Discussion:

Decision:

Agenda Item:

Discussion:

Decision:

There being no further business, the meeting was adjourned.

_____

Secretary

MINUTES OF MEETING OF THE MEMBERS

NAME OF CORPORATION: _____

Date:

Time:

Place:

Number of Votes Represented at the Meeting:

Notice Given: Attached

A sufficient number of votes were present to constitute a quorum.

Agenda Item:

Discussion:

Decision:

Agenda Item:

Discussion:

Decision:

Agenda Item:

Discussion:

Decision:

Agenda Item:

Discussion:

Decision:

Agenda Item:

Discussion:

Decision:

There being no further business, the meeting was adjourned.

Nonprofit Financial Management
Self Assessment Tool

I. FINANCIAL PLANNING/BUDGET SYSTEMS

	Don't Know	Inadequately Achieved	Partially Achieved	Fully Achieved
1. Organization has a comprehensive annual budget which includes all sources and uses of funds for all aspects of operations.				
2. All grant or contract budget agreements with funders are incorporated into the comprehensive annual budget.				
3. All grant or contract budget proposals are reviewed by fiscal staff before submission to funders.				
4. Program managers play an active role in the development of budgets for programs under their direction.				
5. A board committee has a detailed understanding of the annual budget and plays a significant role in directing the use of unrestricted funds.				
6. The full board formally authorizes the annual budget and revisions to the budget.				

	Don't Know	Inadequately Achieved	Partially Achieved	Fully Achieved
8. The organization has integrated meaningful consideration of financial issues into any strategic planning processes it undertakes.				
9. The organization has a capital budget and multi-year plans for major maintenance and replacement of facilities and equipment.				
10. The fiscal planning process includes continuous assessment of risks and identification of insurance coverage needs and appropriate risk management procedures.				
11. Risk assessment includes: general liability, professional liability, product liability, fire, theft, casualty, workers compensation/occupational safety, board and officer liability, vehicle operation, fraud and dishonest acts.				

II. EXECUTION

	Don't Know	Inadequately Achieved	Partially Achieved	Fully Achieved
1. The organization has written policies and procedures for fiscal operations including procedures for processing payroll, purchases, accounts payable, accounts receivable, etc.				
2. Written policies and procedures are reviewed and revised regularly.				
3. Actual processing activities are consistent with written policies and procedures.				
4. The concept of separation of duties is implemented to the greatest extent feasible within the limitations of the size of the organization staff.				

	Don't Know	Inadequately Achieved	Partially Achieved	Fully Achieved
a. Authorization functions for purchasing, signing checks, adjusting accounts, and extending credit are not performed by individuals who also perform recording functions such as disbursements and/or receipts, maintaining accounts receivable records, or cash handling functions such as receiving and depositing funds or preparing checks.				
b. Review and verification functions such as reconciliation of the bank statement to the record of cash receipts and disbursements are not performed by individuals who also prepare checks, record checks, receive funds and prepare bank deposits, and/or record receipts.				
5. Payroll policies and procedures are clearly documented and consistently followed.				
a. Written authorization is required for all new hires and pay rate changes.				
b. Written timesheets are prepared by all employees, signed by the employee, and approved in writing by the employee's direct supervisor.				

	Don't Know	Inadequately Achieved	Partially Achieved	Fully Achieved
c. Forms W 4 and I 9 are obtained and retained for each employee.				
d. Policies regarding overtime, vacation time, sick leave, holiday pay, and other leaves with or without pay are written clearly, and reviewed regularly for compliance with state and federal law.				
e. All fringe benefit plans are documented and in compliance with IRS and Department of Labor requirements. The proper tax treatment for all benefits and compensation arrangements has been determined and documented.				
f. Responsibility for maintaining fringe benefit records in accord with governmental requirements has been clearly assigned and records are reviewed regularly.				
6. Written purchasing policies clearly identify the purchasing authority of each staff position, and establish appropriate dollar limits for purchasing authority at each level.				

	Don't Know	Inadequately Achieved	Partially Achieved	Fully Achieved
7. There are clear procedures for review of and authorization to pay all vendor invoices.				
8. Written policies and procedures for charging and collecting fees are followed consistently and reviewed regularly.				
9. Cash handling policies and procedures are well-documented and are tested periodically.				
a. All checks are restrictively endorsed upon receipt.				
b. Receipts are given for all cash transactions and donors/clients are informed that they should receive a receipt for all cash payments. Pre-numbered, multi-copy, customized receipts are used.				
c. A receipts log is maintained by the person responsible for opening the mail.				

	Don't Know	Inadequately Achieved	Partially Achieved	Fully Achieved
d. Cash reconciliation sheets are maintained by all individuals responsible for accepting cash. All cash counts are initialled by the individual preparing the initial count and the individual receiving the cash for further processing.				
e. Post dated checks are not generally accepted, and if accepted, are secured carefully.				
f. All disbursements are made by check except for small purchases made through a Petty Cash fund.				
g. All unused check stock is carefully secured.				
h. Bank reconciliation is performed by someone who neither makes bank deposits nor prepares checks.				

III. RECORDING

	Don't Know	Inadequately Achieved	Partially Achieved	Fully Achieved
1. A complete written chart of accounts provides appropriate account titles and numbers for Assets, Liabilities, Net Assets, Revenues, and Expenses.				
2. The Chart of Accounts clearly establishes the programs or functions which will be distinguished and the funding sources and/or distinct funds which will be tracked.				
3. The Chart of Accounts utilizes the same line item categories and the same program or function distinctions which are utilized in the comprehensive annual budget and the budgets for individual contracts or grants.				
4. Accounting policies and recording procedures are clearly documented in the written fiscal policies and procedures.				
5. Appropriate computer software and hardware is utilized to perform recording functions.				
6. Appropriate electronic and physical security procedures are utilized to protect the integrity of computerized accounting records.				

	Don't Know	Inadequately Achieved	Partially Achieved	Fully Achieved
7. All accounting records are backed up daily. Back up media are stored in a secure area away from computer equipment.				
8. Back ups of accounting data are stored off site at least monthly.				
9. Detailed records of client fees and/or grants and contracts receivable are maintained and reconciled to the general ledger receivables balances.				
10. All contributions are recorded in the accounting records. If more detailed records are maintained by staff responsible for fund development, the fund development and accounting records of contributions are reconciled monthly.				
11. All general ledger balance sheet accounts are reconciled at least quarterly. All cash, payroll liabilities, and accounts receivable control accounts are reconciled monthly.				

IV. REPORTING

	Don't Know	Inadequately Achieved	Partially Achieved	Fully Achieved
1. Monthly financial statements are available no later than the end of the following month (i.e. April 30th statements are available no later than May 31st).				
2. Monthly financial statements include a Balance Sheet as well as a Statement of Activities and Changes in Net Assets.				
3. In organizations with multiple programs, statements of the expenses of each distinct program are prepared monthly.				
4. In organizations which receive restricted funds, separate statements of revenue and expenses are prepared for each funding source.				
5. All revenue and expense statements (for the whole organization, for specific programs, and for specific funding sources) include the current month's activity, the fiscal year to date activity, and a comparison to the year to date or annual budget by line item.				

	Don't Know	Inadequately Achieved	Partially Achieved	Fully Achieved
6. The excess (deficit) of support and revenue over expenses (net income) is reconciled to the change in fund balance between the beginning and ending of the accounting period.				

V. MONITORING

	Don't Know	Inadequately Achieved	Partially Achieved	Fully Achieved
1. The executive director and the program managers review the monthly financial statements carefully.				
2. The fiscal manager highlights unusual items and identifies potential problems in notes to the financial statements shared with the executive director and board committee or full board.				
3. A board committee or the full board reviews the monthly financial statements carefully.				

	Don't Know	Inadequately Achieved	Partially Achieved	Fully Achieved
4. The board or a board committee selects an independent CPA to conduct an annual audit or review. The board determines whether the organization should have an audit or a review, and whether or not the audit must conducted within the guidelines of OMB A 133, as required for organizations receiving over $300,000 in federal funds or recommended for organizations receiving more than $100,000 each from more than one federal source.				
5. The board or a board committee reviews the auditor's report, including any management letters, and reports on internal controls and compliance with governmental law and regulation.				
7. The board and executive director continually review the organization's financial statements to determine whether:				
a. The use of the organization's resources is consistent with the organization's mission and priorities.				
b. The organization is solvent, i.e. has assets in excess of its liabilities.				

	Don't Know	Inadequately Achieved	Partially Achieved	Fully Achieved
c. The organization has adequate cash and other liquid assets to meet its current obligations and assure its continuing ability to pay its employees, taxing authorities, and vendors on time.				
d. The organization is observing and documenting its observance of all restrictions imposed by funders and donors.				
8. The board and executive director are aware of the IRS requirements for maintaining tax exempt status and continually evaluate the organization's activities, use of funds, record keeping, and reporting to the IRS to assure compliance with all requirements.				

PROMISSORY NOTE

Date: _____

Place: _____

For value received, _____ promises to pay to the order of _____, at _____, the sum of _____ ($_____), in monthly payments of $_____, with the first payment due on _____, 20___ and a like payment due on the _____ day of each month thereafter and continuing until paid in full, with interest thereon at the rate of _____ percent (____ %) per annum from the date of this note until paid, interest to be paid annually and being included in the minimum regular payments above required. If any of the above-described payments are not so paid, all principal and interest becomes immediately due and collectible at the option of the holder of this note. If this note is placed in the hands of an attorney for collection, I promise and agree to pay the holder's reasonable attorneys fees and collection costs, whether or not a suit or action is filed, and including any attorneys fees and costs incurred on appeal.

_____

Signature

Agent for _____

PROXY VOTE

I, the undersigned, a member of _____, do hereby appoint _____ as attorney and agent for me, and in my name, place, and stead, to vote as my proxy, at any regular or special membership meeting of the above-named corporation to be held between the date of this proxy and _____, 20___, unless sooner revoked, with full power to cast all votes that my membership in the above-named corporation entitles me to cast including but not limited to votes at meetings, votes by written ballot, consents to actions without meetings, and waivers of notices of meetings, as if I were personally present or otherwise voting.

I hereby revoke all proxies made before this by me.

IN WITNESS WHEREOF, I have executed this proxy on _____, 20___.

_____

Signature

WAIVER OF NOTICE OF MEETING OF DIRECTORS

NAME OF CORPORATION: _____

We, the undersigned, the directors of this corporation, having been duly called for a meeting of directors on _____, 20___, at _____ __.m., at _____ each waive notice of the date, time, place, and purposes of this meeting and consent to the transaction of any business which may properly come before this meeting.

DATED this _____ day of _____, 20___.

_____ _____

_____ _____

_____ _____

WAIVER OF NOTICE OF MEETING OF MEMBERS

NAME OF CORPORATION:

We, the undersigned, the members of this corporation, having been duly called for a meeting of members on _____, 20___, at _____ __.m., at _____ each waive notice of the date, time, place, and purposes of this meeting and consent to the transaction of any business which may properly come before this meeting.

DATED this _____ day of _____, 20___.

_____ _____

_____ _____

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