A. PRINCIPLES FOR FACILITATING LEGAL COMPLIANCE AND PUBLIC DISCLOSURE

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

Background:
A charitable organization is generally organized as a corporation or a trust under the laws of the state in which it was created. Some organizations choose to operate as unincorporated associations, although that legal form leaves directors and members exposed to a higher degree of liability for financial and other legal responsibilities of the organization. Unincorporated associations are still subject to legal requirements for charitable organizations. A few charitable organizations have been chartered by Congress under federal statute because of the special nature of their programs.

In order to be exempt from paying federal income taxes and to be eligible to receive tax-deductible contributions from the public, organizations must apply for and be recognized by the IRS as tax-exempt under section 501(c)(3) of the tax code. To receive this classification, an organization (with certain exceptions[1]) must file a formal application (Form 1023) with the IRS that describes its current or planned financial and programmatic activities, organizational documents, and governance structure. Depending on the organization's sources of support and other key factors, the IRS will determine whether it is recognized as a public charity or a private foundation. There are specific rules and reporting requirements for organizations in each category, and there can be significant penalties—including possible loss of exempt status—for failure to comply with those regulations.

Charitable organizations are not permitted to support or oppose candidates for public office or intervene in political campaigns, but they may engage in lobbying and advocacy to influence the outcome of legislation subject to certain restrictions. All charitable organizations may lobby public officials regarding legislation that might affect a charity's existence, powers and duties, tax-exempt status, or the deductibility of contributions, what is often referred to as "self-defense lobbying."[2] Public charities may lobby or conduct advocacy efforts to influence the outcome of other legislation so long as such

[1] Houses of worship, specific related organizations, organizations (other than private foundations) whose annual gross receipts do not normally exceed $5,000, and organizations (other than private foundations) subordinate to another tax-exempt organization that are covered by a group exemption letter, are not required to seek formal recognition of 501(c)(3) status.
[2] Treas. Reg. §. 53.4945-2(d)(2)(ii).

efforts constitute an "insubstantial part" of the organization's overall activities.[3] Private foundations are subject to substantial penalties if they engage in lobbying activities, other than "self-defense" lobbying.

Organizations that solicit charitable contributions must be knowledgeable of and abide by charitable solicitation regulations and reporting requirements of the states and local jurisdictions in which they operate or raise funds. Thirty-nine states currently require charitable organizations (with some exceptions) to register before soliciting residents or conducting fundraising activities within their state. Organizations that hire third parties to raise funds on their behalf must also take steps to ensure that those third parties comply with state and local registration and reporting requirements.

Charitable organizations that conduct specific types of services, such as nursing homes and other types of residential facilities, providers of health care or day care for children or adults, educational facilities, etc., must also abide by other laws and regulations that apply to any business, for-profit or nonprofit, that operates in those service areas. Charitable organizations that employ staff must abide by federal, state and local labor laws and regulations, and applicable payroll and income tax provisions

Rationale:
Obedience to the law is fundamental to being a responsible and accountable nonprofit organization. The governing board is ultimately responsible for overseeing and ensuring that the organization complies with its legal obligations and to detect and remedy wrongdoing by management. While board members are not required to have specialized legal knowledge, they should be familiar with the basic rules and requirements with which their organization must comply and secure the necessary legal advice and assistance to structure appropriate monitoring and oversight mechanisms.

Charitable organizations can draw on a series of resources to understand the law. The Internal Revenue Service provides a free online workshop covering tax compliance issues confronted by small and mid-sized tax exempt organizations at www.stayexempt.org. Some state attorneys general or secretaries of state maintain online services to assist organizations in understanding their responsibilities under the laws and regulations of their states. Many national, state and regional associations of nonprofit organizations provide online tools and resources that provide guidance on the fiduciary and legal responsibilities of board members and legal guidance for charitable organizations. Organizations may also find it helpful to consult with local chapters of the American Bar Association for referrals to low cost or pro bono legal assistance.

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

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[3] Public charities may also specifically elect to spend limited amounts on lobbying activities under section 501(h) of the Internal Revenue Code.

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

The duties and requirements for directors of charitable organizations are generally determined by the laws of the state in which the organization was founded or incorporated. Some states also have established requirements for the board of directors of any organization that conducts activities, particularly fundraising, within its borders. The Revised Model Nonprofit Corporation Act, adopted in 1987 by the American Bar Association's Subcommittee on the Model Nonprofit Corporation Law of the Business Law Section, sets forth parameters for the structure and composition of boards. It also sets forth duties of loyalty and due care by requiring that: "a director shall discharge his or her duties as a director, including his or her duties as a member of a committee (1) in good faith; (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and (3) in a manner the director reasonably believes to be in the best interests of the corporation."[4]

The Revised Act has been adopted in whole or in modified form by 23 states[5] for regulation of nonprofit entities, including charitable organizations. The original Model Act (developed in 1952) has been adopted in whole or in modified form by six other states and the District of Columbia.[6] A state Nonprofit Corporation Act is generally enforced by the state attorney general, the secretary of state, or other state officials charged with oversight of charitable and exempt organizations. Where no specific nonprofit corporation rules have been established, the rules for business corporations generally apply to tax-exempt entities.

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

Background:
A conflict of interest arises when a board member or staff person's duty of loyalty to the charitable organization comes into conflict with a competing financial or personal interest that he or she may have in a proposed transaction. Some such transactions are illegal, some are unethical, but others may be in the best interest of the charitable organization as long as certain clear procedures are followed.

The Internal Revenue Service has taken a number of steps to address concerns about conflicts of interests. It now requires charitable organizations to disclose on their annual

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[4] Revised Model Nonprofit Corporation Act § 8.30.
[5] The Act has been adopted in whole or with modifications in Alaska, Arkansas, California, Colorado, Georgia, Hawaii, Idaho, Indiana, Maine, Minnesota, Mississippi, Missouri, Montana, Nebraska, North Carolina, Oregon, South Carolina, Tennessee, Utah, Vermont, Washington, West Virginia, and Wyoming.
[6] Alabama, New Jersey, North Dakota, Texas, Virginia, and Wisconsin have adopted the original Model Nonprofit Corporation Act as promulgated or modified.

information returns (Forms 990) if any officers, directors, trustees, key employees, highest compensated employees, or highest compensated profession or other independent contractors are related through family or business relationships.[7] Its Form 1023, which an organization must file to obtain a determination of federal tax-exemption under section 501(c)(3) of the Internal Revenue Code, now asks the organization to indicate whether it has adopted a conflict of interest policy and, if not, how it will handle conflicts of interest.

Violations of section 4941 of the Internal Revenue Code (self-dealing transactions for private foundations) and section 4958 (excess benefit transactions for public charities) often involve transactions between the organization and individuals who may have a conflict of interest. Under new laws enacted in August 2006, section 4967 of the IRC prohibits self-dealing transactions between donor-advised funds and their donors and parties related to those donors.

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

Rationale:
Establishing and enforcing a conflict of interest policy is an important part of protecting charitable organizations from unethical or illegal practices. The policy need not be complex, but it should be consistent with the laws of the state in which the nonprofit is organized and tailored to specific organizational needs and characteristics. The policy should require full disclosure of all potential conflicts of interest within the organization. The policy should apply to persons who have the ability to influence decisions of the organization, including board and staff members, and parties related to them. Some organizations may extend the policy to substantial contributors as well.

All board and senior staff members should be required to sign the policy and disclose any material conflicts of interest at the time they join the board and at the beginning of each new board year. They should be expected to refrain from attempting to influence other board members or staff decision-makers regarding matters in which they or their family members have a conflict of interest. The board should ensure that the practice of full disclosure is fostered at board meetings, particularly those involving discussions of items that could pose a conflict of interest for any board member, and should take steps to ensure that board members with conflicts recuse themselves from the board discussion.

[7] IRS 2006 Form 990, Part V-A, line 75b. Family relationships include "an individual's spouse, ancestors, children, grandchildren, great-grandchildren, siblings (whether by whole or half blood), and the spouses of children, grandchildren, great-grandchildren, and siblings. Business relationships are defined as "employment and contractual relationships, and common ownership of a business where any officers, directors, or trustees, individually or together, possess more than a 35% ownership interest in common."

4. A charitable organization should establish and implement policies and procedures that enable individuals to come forward with credible information on illegal practices or violations of organizational policies. This "whistleblower" policy must specify that the organization will not retaliate against individuals who make such reports.

Background

Existing legal provisions protect individuals working in charitable organizations from retaliation for engaging in whistle-blowing activities, and violation of these provisions will subject organizations and the individuals responsible to civil and criminal sanctions. Some states have enacted laws that provide protections for employees who report misconduct under specific conditions. Federal law prohibits employment-related retaliation by all entities—including charitable organizations—against whistleblowers who provide information on certain financial crimes delineated under federal law.[8]

Rationale:

Every charitable organization, regardless of size, should have clear policies and procedures that allow staff, volunteers, or clients of the organization to report suspected wrongdoing within the organization without fear of retribution. Information on these policies should be widely distributed to staff, volunteers, and clients, and incorporated both in new employee orientations and ongoing training programs for employees and volunteers. Such policies can help boards and senior managers become aware of and address problems before serious harm is done to the organization.

These policies—sometimes known as a "Whistleblower Protection Policy" or "Policy on Reporting of Malfeasance or Misconduct" —generally cover suspected incidents of theft; financial reporting that is intentionally misleading; improper or undocumented financial transactions; improper destruction of records; improper use of assets; violations of the organization's conflict-of-interest policy; and any other improper occurrences regarding cash, financial procedures, or reporting.

The policy should be tailored to the nonprofit's size, structure, and capacity, as well as the laws of the state in which it is organized or operates. All policies should specify the individuals within the organization (both board and staff) or outside parties to whom such information can be reported. Employees and volunteers should be encouraged and able to share their concerns with a supervisor, the president or executive director, and/or the chief financial officer of the organization, but there should also be a method of reporting anonymously and confidentially to either a board member or an external entity specified by the organization. Some organizations have set up a computerized system that allows for anonymous reports, and some private companies offer anonymous reporting services via a toll-free telephone number, email address, or intranet site.

It is equally important that the organization have clear procedures to investigate all reports and take appropriate action. The policy should stipulate that there will be no retaliation against any individual who in good faith reports a suspected violation, except

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[8] The Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 18 U.S.C. 1513(e).

in those instances where the organization determines that a false report was made with intent to harm the organization or an individual within the organization.

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

Background
Federal, state and local laws and regulations require both for-profit and nonprofit organizations to retain certain business records--such as applications for employment and payroll records, tax forms and contracts--for specified lengths of time. Failure to maintain such records may subject the organization and/or individuals to penalties and fines and may compromise the organization's position in litigation.

Charitable organizations are required to maintain permanently their organizational documents, board minutes and policies, and materials related to their state and federal tax-exempt status. Other documents related to the governance, administration, fundraising, and programs of the organization must be kept in paper or electronic form for specific periods.

The American Competitiveness and Corporate Accountability Act of 2002, (commonly known as the Sarbanes-Oxley Act) provides that it is a federal crime, punishable by a fine and up to twenty years in prison, for any corporate agent, whether of a for-profit or nonprofit corporation, knowingly to alter, destroy, mutilate, conceal, cover up, falsify, or make a false entry in any record with the intent to impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of a federal department or agency or any bankruptcy case.[9] The same penalty applies to anyone who alters, destroys, mutilates, or conceals a record, or attempts to do so, with the intent to impair the object's integrity or availability for use in an official proceeding, regardless of whether such proceeding is pending or about to be instituted at the time of the offense.[10]

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

Rationale:
A written document retention policy is essential to protect the organization's records of its governance and administration, as well as business records that are required to demonstrate legal compliance and to protect against allegations of wrongdoing by the organization or its directors and managers. A document retention policy should address the length of time specific types of documents must be retained, as well as when it is permissible or required to destroy specific types of documents. The policy should

[9] Id., § 802 and United States Code Title 18, § 1519.
[10] Id., § 1102 and United States Code Title 18, § 1512.

provide guidance to staff and volunteers for handling paper documents, as well as electronic files and email messages.

Document retention and destruction is a process that should be constantly monitored, justified, and carefully administered. The leaders of the organization must make the legal requirements for document retention clear to staff and volunteers and establish procedures to ensure that any document destruction is immediately halted if an official investigation of the organization is underway or anticipated.

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

Background:
Federal law requires many public charities[11] and all private foundations to file an annual information return (Form 990, 990-EZ, or 990-PF) with the Internal Revenue Service that provides accurate information about its finances and programs. The IRS may impose penalties on any organization that fails to file timely and accurate returns, and failure to file for three consecutive years will result in revocation of tax-exempt status.

For tax years beginning after August 17, 2006, each public charity[12] with annual revenues of $25,000 or less is required to file an annual notice electronically with the IRS that indicates its legal name; mailing address; web site address; taxpayer identification number; name and address of a principal officer; evidence of the continuing basis for the organization's exemption from filing Form 990; and, upon termination, notice of that termination. There are no monetary penalties for failure to file the notice, but failure to file the annual notice for three consecutive years will result in revocation of tax-exempt status.

Federal law also requires organizations recognized by the IRS as tax-exempt after 1987 to make their initial application for recognition of tax exemption, correspondence with the IRS in connection with the application, and its returns[13] to be made available for free inspection during regular business hours at its principal, regional, and district offices.[14] These documents must also be provided without charge, other than a reasonable fee for

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[11] Organizations other than private foundations with annual gross receipts of $25,000 or less, houses of worship and specific related institutions, specified governmental instrumentalities, and other organizations relieved of this requirement by authority of the IRS are excluded from this requirement. These public charities may choose to file a more detailed Form 990 or 990-EZ instead of the new electronic form.

[12] Other than houses of worship and specific related institutions, specified governmental instrumentalities, and other organizations relieved of this requirement by authority of the IRS.

[13] Each annual information return must be made available for a period of three years beginning on the date the return is required to be filed or is actually filed, whichever is later. For tax years beginning after August 17, 2006, the requirement that charitable organizations make their annual IRS returns available for public inspection also includes the requirement to disclose the Form 990-T (report of unrelated business income).

[14] IRC § 6104.

reproduction and postage costs, to any individual who submits such a request in person or in writing.

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

Rationale:
Donors, volunteers, and staff will have greater confidence in a charitable organization if they can learn easily about how the organization conducts its work and how its programs improve and enrich lives.

The annual information return a charitable organization files with the IRS serves as the primary document providing information about its finances, governance, operations, and programs for federal regulators, the public, and many state charity officials. While filing an accurate and complete return and making it available to the public is a legal requirement for private foundations and most public charities, the return can also be a valuable tool for communicating about a charitable organization's contributions to the community. For example, instructions for the Form 990 and 990-EZ ask each filing organization to describe its "exempt purpose achievements in a clear and concise manner" for each of its four largest program services (as measured by total expenses incurred).

Charitable organizations can demonstrate their commitment to accountability and transparency by not only providing the documents required by law, but also offering additional information about their operations, governance, and finances. They should provide an annual report that lists their board and staff members, describes their mission, shares information on program activities, and details financial information, including at a minimum their total income, expenses, and ending net assets. Such reports need not be elaborate and can direct the reader to other readily available documents (such as the Form 990 return or audited financial statements) for further information. If an organization chooses to produce such reports on a less frequent basis (such as every two or three years), it should ensure that any changes in its board and staff or programs and its current financial statements are provided as an attachment or are otherwise made known to readers of the report.

A charitable organization should consider maintaining a website, either independently or through another organization, as a key method for communicating about its work. A website should feature the same information recommended for annual reports. The site should also include links directly to or instructions on how to request its most recent IRS Form 990 return and other financial statements. Charitable organizations may also find it useful to post on their websites such information as their vision and mission statements; statement of values and code of ethics; and policies on conflicts of interest, whistleblower protection, and travel policy.

Larger charitable organizations should provide detailed information about their programs, including methods they use to evaluate the outcomes of programs and information on accreditations their organization holds or certifications/standards it may meet, to the public through its printed reports and website. A more detailed discussion of program evaluation is provided in principle #16.

B. PRINCIPLES FOR EFFECTIVE GOVERNANCE

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

   Background:
   The Revised Model Nonprofit Corporation Act and many state laws stipulate that the rules regarding meetings of the board, including their frequency, should be established in the bylaws of the organization. The bylaws should indicate how a meeting of the board should be called, quorum requirements for the meeting, and an indication as to whether board members must participate in person or may participate through electronic means. Most state laws allow a charitable organization to stipulate meeting quorum requirements, that is, the number of board members who must be present before the meeting begins, in its governing documents. In the absence of such a stipulation in the governing documents, many state laws require that a majority of current board members be present to constitute a quorum.

   Rationale:
   Regular meetings provide the chief venue for board members to review the organization's financial situation and program activities, establish and monitor compliance with key organizational policies and procedures, and address issues that affect the organization's ability to fulfill its charitable mission. While many charitable organizations find it prudent to meet at least three times a year to fulfill basic governance and oversight responsibilities, some with strong committee structures hold only one or two meetings of the full board each year. Each board should determine the appropriate number of meetings based on the nature of the organization and the number and structure of committees the board has created to assist it in overseeing the organization's business.

   Charitable organizations should ensure that their governing documents address legal stipulations about board meetings, such as quorum requirements and methods for notifying board members about meetings. The board should establish and enforce an attendance policy that requires board members to attend meetings on a regular basis to ensure that those quorum requirements will be met.

   Given the time and expense involved in travel to board meetings, some boards may choose to conduct their meetings through conference calls or online technologies that permit board members to hear and be heard by all other participants. In such cases, the organization's governing documents should specify that such alternative methods of holding meetings are permitted.

   Depending on the organization's governing documents, a board of directors may choose to create one or more committees to carry out specific duties for the board. In most states, the law prohibits boards from delegating certain responsibilities to committees, including authorizing distributions on behalf of the organization; approving the dissolution, merger, or sale of all or substantially all of the organization's assets; electing, appointing, or removing directors; and adopting, amending, or repealing the organization's governing documents. The board may appoint a committee to investigate and make recommendations on any of these issues, but the full board should consider and decide on any recommendations made by the committee.

8. The board of a charitable organization should establish and review periodically its size and structure to ensure effective governance and to meet the organization's goals and objectives. The board should have a minimum of five members.

Background:
Federal law currently permits organizations to qualify for tax-exempt status with a single director or trustee. The Revised Model Nonprofit Corporation Act stipulates that a board of directors must have a minimum of three members. It sets no maximum number and allows an organization to set and change the number of directors in its bylaws, so long as there are always at least three directors in place. In practice, some states require only one director for nonprofit corporations, and some also permit the formation of a corporation sole.[15] One state, New Hampshire, requires public charities to have a minimum of five directors who are not related family members.[16]

Rationale:
A board of directors should have a sufficient number of members to allow for full deliberation of governance matters and for diversity of thinking in areas such as conflicts of interest and self-dealing. The Panel on the Nonprofit Sector has recommended that Congress amend the federal tax code to require that each organization, with certain exclusions[17], have a minimum of three members on its governing board to be recognized as tax-exempt under section 501(c)(3) of the code. Most standards for nonprofit self-regulation state that in order to ensure that a board has the capacity to carry out its duties, it should include at least five members.[18]

Private foundations are subject to stringent laws regarding self-dealing, investment policies, and other governance matters, because of the assumption that their boards are not independent. It is not uncommon in the early years of a family foundation for the board to include only the primary donor and a few trusted family members or advisors. As the foundation matures and grows in size, it should consider expanding its board to include the broader range of knowledge and experience needed to inform governance and program decisions.

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

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

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

[18] Better Business Bureau Wise Giving Alliance, Iowa Principles and Practices for Charitable Nonprofit Excellence, Evangelical Council of Financial Accountability, and the Standards for Excellence Institute all require that an organization have at least five board members to meet their standards, and the Standards for Excellence Institute notes that at least seven board members is preferable.

Experts in nonprofit board governance are not of one mind as to the ideal maximum size of nonprofit boards. They note that size may depend upon such factors as the age of the organization, the nature and geographic scope of its mission and activities, and its funding needs. Some believe that a larger board may be necessary to ensure the range of perspectives and expertise some organizations need or to share fundraising responsibilities. Others argue that effective governance is best achieved by a smaller board, which then demands more active participation from each member. In the end, each organization should determine the most appropriate size for its board and the appropriate number and responsibilities of its committees to ensure that the board is able to fulfill its fiduciary and other governance duties responsibly and effectively.

9. **The board of a charitable organization should include members with the diverse skills, background, expertise, and experience necessary to advance the organization's ability to fulfill its mission. The board should include some individuals with financial literacy.**

Background:
There is no requirement in federal law or regulations regarding the composition of a charitable organization's board of directors, other than for an organization seeking exemption as a supporting organization. In reviewing applications for recognition as a public charity under federal tax law, IRS regulations stipulate that, where an organization's classification as a public charity hinges upon the facts and circumstances of its mission, operations, and structure, the agency will look at whether the organization's governing board reflects broad public interests, rather than simply the interests of a small group of donors and related parties. The agency will specifically look at whether the board includes public officials, individuals with expertise in the organization's areas of operation, leaders from the local community, representatives of the constituency the organization serves, and others who represent a broad cross-section of community interests.[19]

Rationale:
Boards of charitable organizations generally strive to include members with expertise in budget and financial management, investments, personnel, fund raising, public relations and marketing, governance, advocacy and leadership skills, as well as knowledge about and insights into the charitable organization's area of expertise or programs, or a special connection to the organization's constituency.

One of the primary duties of the board of directors of a charitable organization is to ensure that all financial matters of the organization are conducted legally, ethically, and in accordance with proper accounting rules. Charitable organizations should therefore make every effort to ensure that at least one member of the board has "financial literacy," that is, sufficient financial competency to understand financial statements, evaluate the bids of accounting firms that may undertake an audit or review, and assist the board in making sound financial decisions. An individual need not have advanced training in accounting or financial management in order to have "financial literacy." For

[19] Treas. Reg. § 1.170A-9(e)(3).

some charitable organizations, finding people with the necessary financial literacy skills to serve on the board may be challenging. If the board is unable to recruit such an individual to serve on the board, it should contract with or seek pro bono services of a qualified financial advisor, other than its auditor, to assist the board in its financial responsibilities.

The composition of the governing board may also be shaped by the requirements of public and private funding programs. For example, in order to be recognized as a Community Housing Development Organization, one-third of the board members must be representatives of the low-income community the organization serves.[20] In determining the appropriate size and composition of its board, a charitable organization should look carefully at the requirements of its current and prospective funding sources.

Many donors to private foundations wish to involve family members on the boards of their foundations to ensure that the donor's philanthropic tradition will continue through future generations. If family members do not have the expertise and experience necessary to provide appropriate governance and oversight, the board may wish to bring in advisors.

10. A substantial[21] majority of the board of a public charity should be independent--that is, they should be individuals (1) who are not compensated by the organization as an employee or independent contractor; (2) whose compensation is not determined by individuals who are compensated by the organization; (3) who do not receive, directly or indirectly, material financial benefits from the organization except as a member of the charitable class served by the organization; and (4) who are not related to (as a spouse, sibling, parent or child), or do not reside with, any individual described above.[22]

Background:
Five states have legislative mandates for the independence of nonprofit boards of directors. North Dakota,[23] Maine,[24] California,[25] and Vermont[26] require that no more

[20] Community Housing Development Organizations (CHDOs) must maintain at least one-third of the governing board's membership for residents of low-income neighborhoods, other low-income community residents, or elected representatives of low-income neighborhood organizations. 24 CFR Part 92.

[21] A substantial majority generally means at least two-thirds of the board members. The Report of the National Association of Corporate Directors Blue Ribbon Commission on Director Professionalism (2005) and The Business Roundtable, Statement on Corporate Governance (2002) both suggest that a "substantial majority"of the board of a for-profit corporation should be independent. The Council of Institutional Investors, Corporate Governance Policies, Policy 2 and explanatory note states: "At least two-thirds of the directors should be independent (i.e., their only non-trivial professional, familial or financial connection to the …corporation is their directorship."

[22] This principle does not apply to private foundations, supporting organizations or subsidiaries that are required by law or by their articles of incorporation to include representatives of the supported or sponsoring charities on their board of directors, public charities that are incorporated under the auspices of a religious organization and are required under their articles of incorporation to include clergy and others who are compensated by the parent religious organization, and public charities that are established as charitable trusts where the trust instrument specifies that trustees shall be institutions or professional advisors that are expected to provide services beyond general governance, including substantial asset and investment management activities.

[23] ND Cent. Code § 10-33-27.

than 49% of the board may be "interested" or "financially interested" persons. While the definitions vary slightly in each state, "financially interested" persons are generally those who have received or are entitled to receive compensation for personal services rendered to the organization (other than compensation for board service), and/or those who are related family members of compensated persons.[27] New Hampshire requires that at least five voting members of the board of a charitable corporation "are not of the same immediate family or related by blood or marriage."[28] The New Hampshire provision does not apply to private foundations, and certain religious organizations including churches and integrated auxiliaries of churches.

The Sarbanes-Oxley Act of 2002 sets forth standards for the independence of members of board audit committees of publicly traded corporations; companies registered with the New York Stock Exchange must have a majority of directors who meet the Exchange's definition of "independence."

Rationale:
All directors of nonprofit corporations have a "duty of loyalty" that requires them to put the interests of the organization above their personal interests and to make decisions they believe are in the best interest of the nonprofit. Nonetheless, individuals who have a personal financial interest in the affairs of a charitable organization may not be as likely to question the decisions of those who determine their compensation or fees or to consider changes in management or program activities that might advance the mission and improve the services of the organization.

When a majority of the board members are free of the conflicts of interest that can arise from having a personal interest in the financial transactions of the charity, the board as a whole may be more likely to exercise its responsibility to review and take action on materials and information independent of the staff management. The founders of a nonprofit corporation may initially turn to family members and business partners to serve on its board of directors, but interlocking financial relationships can increase the difficulty of exercising the level of independent judgment required of all board members in evaluating and questioning decisions that affect the organization's management and program directions. It is therefore important to the long-term success and accountability of the organization that a majority of the individuals on the board are free of financial conflicts of interest.

This standard is not intended for application to public charities established by a religious entity or a group of other tax-exempt entities if it is required by law or by its founding documents to reserve a majority of its board positions for representatives of the founding organizations. Similarly, it may be appropriate for the governing documents to

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[24] Maine Nonprofit Corporation Act, Title 13-B, § 713-A (2).
[25] Cal. Corp. Code § 5227 (a).
[26] 11B VT Stats § 8.
[27] Maine and Vermont define related parties as "spouse, brother, sister, parent or child," while California also includes ancestor, descendant, brother-in-law, sister-in-law, son-in-law, daughter-in-law, mother-in-law, or father-in-law.
[28] N.H. Rev. Stat. § 292:6-a.

specify that the board members of a supporting organization or a subsidiary to another tax-exempt entity be composed primarily of key staff managers of the organizations they support or the parent organization.

Because they derive their primary support from a single individual, family, or corporation, the governing documents of some private foundations, particularly family foundations, may specify that the boards be composed of individuals who are related by family or business. Many donors create private foundations as a mechanism to institutionalize a family tradition of giving and want to ensure that the board is made up of family members who will continue that tradition. Many corporations create and fund private foundations whose governing boards include only officers and employees of the corporation so that the foundation upholds the values and interests of the corporation.

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

11. **The board should hire, supervise, and annually evaluate the performance of the chief executive officer of the organization, as well as approve annually and in advance the compensation of the chief executive officer unless there is a multi-year contract in force or there is no change in the compensation except for an inflation or cost-of-living adjustment.**

Background:
Boards of directors have the authority to delegate responsibility for maintaining the daily operations of the organization to a chief staff officer. The board must then supervise that officer to ensure that the organization is managed appropriately and meets its obligations to donors, constituents, and legal authorities.

A charitable organization is permitted under current law to pay reasonable compensation for services provided by its board members, its chief executive officer, and other staff. Reasonable compensation is defined as the amount that would ordinarily be paid for like services by like enterprises (whether tax-exempt or taxable) under like circumstances.[29] Studies document that compensation for nonprofit workers and executives is on average substantially lower than their counterparts in the for-profit or government sectors.[30] Increasingly, in order to compete with other organizations, including for-profit and government employers, for qualified staff and managers, nonprofits are finding it necessary to provide comparable compensation packages.

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[29] Treas. Reg. § 53.4958-4(b)(1)(ii).
[30] Minnesota Council of Nonprofits, "Minnesota Nonprofit Economy Report" (2004), www.mncn.org; Congressional Budget Office, "Comparing the Pay of Federal and Nonprofit Executives: An Update" (July 2003), www.cbo.gov; Eric Twombly and Marie Gantz, Urban Institute, "Executive Compensation in the Nonprofit Sector: New Findings and Policy Implications" (2001), www.urban.org.

The Internal Revenue Code prohibits payment of excessive compensation and other transactions that provide excessive economic benefit to executives and other disqualified persons.[31] Charitable organizations are also prohibited from providing excessive compensation or benefits to family members of individuals who have substantial influence over the organization's affairs.[32] Private foundations are generally prohibited from engaging in any financial transactions, other than payment of reasonable compensation for services deemed necessary to the foundation's exempt purposes, with their disqualified persons.[33]

For public charities, the federal "intermediate sanctions" regulations encourage organizations to have executive compensation approved in advance by members of an "authorized body" of the organization (such as the board or a board-appointed committee), none of whom has a conflict of interest with respect to the transaction.[34] If the authorized body approves the compensation based on appropriate data that help determine comparability or fair market value and documents the basis for its determination at the time it makes its decision, the regulations confer a rebuttable presumption of the reasonableness of the compensation.[35] Although the IRS may not draw any negative inferences simply because an organization chooses not to follow these procedures,[36] an organization that does follow the procedures may be able to avoid penalties if compensation is later found to be excessive.

Federal tax regulations define comparable data needed to determine the reasonableness of compensation or other transactions with disqualified persons as including (1) compensation paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions; (2) the availability of similar services in the geographic area; (3) current compensation surveys compiled by independent firms; (4) actual written offers from similar organizations competing for the disqualified person; and, if the transaction involves the transfer of property, (5) independent appraisals of that property and (6) offers received as part of an open and competitive bidding process. Public charities with gross receipts (including contributions) of less than $1 million may rely on the compensation paid by three comparable organizations in the same or similar communities for similar services when approving compensation arrangements.[37]

A disqualified person of a public charity who is found to have received excessive compensation must repay the excess benefit to the charity, plus interest, and pay an initial tax of 25 percent of the excess benefit.[38] Abatement of this initial tax is available if the excess compensation was due to reasonable cause. If the approval process outlined above was followed in determining an executive's compensation, the compensation is presumed to be reasonable unless the IRS proves it to be excessive. If a public charity provides benefits to a disqualified person and does not provide contemporaneous

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31 IRC § 4941, § 4958.
32 IRC § 4941 and § 4946; § 4958(f).
33 IRC § 4941.
34 Treas. Reg. § 53.4958-6(a)(1).
35 Treas. Reg. § 53.4958-6.
36 Treas. Reg. § 53.4958-6(e).
37 Treas. Reg. § 53.4958-6(c)(2).
38 IRC § 4958(a)(1), (f)(6); Treas. Reg. §§ 53.4958-1(a), 53.4958-7(c).

written substantiation that the benefit is intended as compensation for that individual (i.e., it reports the benefit as compensation on a Form W-2 or a Form 1099 or on its Form 990, it includes the benefit in a written employment contract or in the minutes of the meeting approving the compensation, or the individual reports the benefit as compensation on his or her income tax return), the value of the benefit will be treated automatically as an "excess benefit."[39] If the disqualified person fails to repay the excess benefit within a certain time period, he or she is subject to an additional tax of 200 percent of the excess benefit.[40]

A disqualified person of a private foundation who receives excessive compensation is subject to an initial tax of 10 percent of the excess compensation and a requirement to repay the excess compensation to the foundation.[41] For private foundations, in contrast to public charities, there is no contemporaneous written substantiation requirement. There is also no possibility of abatement of this initial tax even when the prohibited transaction was due to reasonable cause and was beneficial to the foundation. If the executive fails to repay the excess compensation within a certain time period, the executive is subject to an additional tax of 200 percent of the excess compensation.[42]

Board members and other managers of charitable organizations who approve a transaction knowing it provides an excess benefit are generally jointly and severally liable for a tax of 5 percent of the transaction amount for private foundations or 10 percent of the excess benefit for public charities, both capped at $20,000 per transaction, unless their participation is not willful and due to reasonable cause.[43] For private foundations, an exception to the general rule provides that if the transaction involves compensation, the penalties are based on a percentage of the excess compensation (not the *total* compensation).[44]

To impose penalties on public charity or private foundation managers, the IRS must prove that the organization manager's actions in accepting or approving an excess benefit or self-dealing transaction were conscious, voluntary, and intentional, and that the manager had actual knowledge of sufficient facts to determine that the transaction would be an excess benefit or self-dealing transaction, was aware that such a transaction would violate federal excess benefit or self-dealing transaction laws, and negligently failed to make reasonable attempts to determine whether the transaction was an excess benefit or self-dealing transaction.[45] A board member or other manager who relies on the advice of legal counsel (or, in the case of public charity managers, certain other professionals[46]) is generally not held responsible for knowing that the transaction was

[39] Treas. Reg. § 53.4958-4(c)(3).
[40] IRC § 4958(b).
[41] IRC § 4941(a)(1), (e)(3); Treas. Reg. § 53.4941-1(b)(2)(i), (c)(6). These penalties reflect the Pension Protection Act of 2006, P.L. 109-280, which doubled the pre-existing penalties.
[42] IRC § 4941(b)(1).
[43] IRC § 4941; IRC 4958. These penalties reflect the Pension Protection Act of 2006, P.L. 109-280, which doubled the pre-existing penalties.
[44] IRC §4941(e)(2).
[45] Treas. Reg. §§ 53.4941(a)-1(b)(3), 53.4958-1(d)(4)(i).
[46] Public charity managers may also rely on the professional advice of certified public accountants or accounting firms with relevant tax law expertise, and independent appraisers or compensation consultants who

improper.[47] In addition, a board member or other manager of a public charity is generally not held responsible for knowing that a transaction conferred an excess benefit if an appropriate authorized body has met the requirements of the rebuttable presumption procedures with respect to the transaction.[48]

Federal laws do not subject managers of public charities to the excess benefit rules when they are setting the compensation for a new chief executive officer, chief financial officer, or a chief operating officer so long as the new employee was not a board member, key manager, or substantial contributor to the organization in the preceding five years and the compensation is based on a fixed amount or formula over single or multiple years.[49]

Charitable organizations, with some exceptions,[50] are required to report on their Form 990 or 990-PF the name, title, and average hours per week of every board member, officer, and key employee. In addition, the organizations must report the compensation, contributions to employee benefit plans and deferred compensation, expense account, and other allowances paid during the year covered by the report to any current or former board member, officer, and key employee. The instructions to the forms specify that all types of compensation must be reported, including both taxable and nontaxable fringe benefits except for de minimis fringe benefits (for example, property or services provided to the individual of such a small value as to make accounting for it impractical).[51] Organizations are also required to include the preferred address of each listed individual.

Rationale

For charitable organizations with paid staff, one of the most important responsibilities of the board of directors is to select, supervise, and determine a compensation package that will attract and retain a qualified chief executive. The organization's governing documents should require the full board to evaluate the chief executive's performance and approve the compensation of the CEO annually and in advance of payment of the new compensation level. The board may choose to approve a multi-year contract with the CEO that provides for increases in compensation periodically or when the CEO meets specific performance measures, but it is important that the board institute some regular basis for reviewing whether the terms of the contract have been met. If the board designates a separate committee to review the compensation and performance of the CEO, that committee should be required to report its findings and recommendations to

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perform such valuation services on a regular basis, are qualified to make valuations of the particular type of property or services involved, and provide certifications regarding those qualifications. Treas. Reg. § 4958-1(d)(4)(iii).

[47] Treas. Reg. § 53.4941(a)-1(b)(6).

[48] Treas. Reg. § 53.4958-1(d)(4)(iv).

[49] Treas. Reg. § 53.4958-3(a)(1).

[50] Excluded from this requirement are organizations, other than private foundations and supporting organizations, with annual gross receipts of $25,000 or less, houses of worship and specific related institutions, specified governmental instrumentalities, and other organizations relieved of this requirement by authority of the IRS. IRC § 6033(a)(2).

[51] IRC § 132(e).

the full board for approval and should provide any board member with details, upon request.

Charitable organizations increasingly find it necessary to compete with for-profit and government employers to attract and retain a range of qualified professionals. In establishing reasonable compensation, boards of directors should follow the procedures outlined in the "intermediate sanctions" regulations for public charities, which require that executive compensation be approved in advance by members of an "authorized body" of the organization (such as the board or a board-appointed committee), none of whom have a conflict of interest with respect to the transaction.[52] The authorized body should examine appropriate data to establish the "fair market value" of the compensation offered, including:

1) compensation paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions;
2) the availability of similar services in the geographic area; and
3) current compensation surveys compiled by independent firms or actual written offers from similar organizations competing for the disqualified person.[53]

Some organizations may find it difficult to locate salary surveys or other data to establish comparable values for executive compensation within their geographic area or field of operation, but the board should still seek objective external data to support its compensation decisions. The board should be prepared to answer questions about executive compensation and should document the basis for its determination of the executive's compensation at the time it makes its decision.

Where appropriate to the position, governing boards should be free to use comparable data from either government or the for-profit sector to develop a reasonable compensation package in order to attract appropriately qualified managers. Similarly, managers of charitable organizations should have the same latitude, since there are a number of staff positions requiring certain professional and technical qualifications that are not possible to fill unless market rates are paid.

The use of consultants to assist in determining the appropriate range of compensation within a given professional field of practice is still relatively new to the charitable sector. When governing boards use compensation consultants to help determine the appropriate salary for the chief executive, the consultant should report directly to the board or its compensation committee.

While governing boards are responsible for hiring and establishing the compensation of the CEO, it is the responsibility of the CEO to hire other staff to carry out the work of the organization. There may be cases where the CEO finds it necessary to offer compensation that equals or surpasses his or her own compensation in order to attract and retain certain highly qualified and experienced staff. In such cases, the compensation should be reviewed by the board of directors to ascertain that the compensation does not provide an excess economic benefit to the staff member.

[52] Treas. Reg. § 53.4958-6(a)(1).
[53] Treas. Reg. § 53.4958-6.

In order to ensure that the CEO is serving the organization well, boards or a designated compensation committee should also review the overall compensation program, including salary ranges and benefits provided for particular types of positions. Such a review will enable the board or its designated committee to assess whether the compensation program is fair and reasonable, and whether additional resources are needed to attract and retain staff.

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

Background:
Most state laws specify that a charitable corporation must have a president, a secretary, a treasurer, and such other officers as appointed by the board. Some permit the same individual to hold simultaneously more than one office in the corporation, while others have restrictions that specify that the offices of president and the treasurer cannot be held by the same individual.

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

When the board deems it is in the best interests of the charitable organization to have the chief executive officer/executive director serve as the board chair, the board should appoint another board member (sometimes referred to as the "lead director") to handle issues that require a separation of duties. For example, the lead director would serve as chair for deliberations involving the responsibilities, performance or compensation of the chief executive officer/executive director.

13. **The board should establish an effective, systematic process for educating and communicating with board members to ensure that the board carries out its oversight functions and that individual members are aware of their legal and ethical responsibilities and are familiar with the programs and activities of the organization.**

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

The federal Volunteer Protection Act and most state volunteer liability laws provide some safeguards for board members who are not compensated, other than reimbursement of expenses. However, the Act does not protect board members, even if they are not compensated, and other volunteers from liability for "willful or criminal misconduct, gross negligence, reckless misconduct, or a conscious, flagrant indifference to the rights or safety of the individual harmed by the volunteer action."[54]

The governing documents of a charitable organization may include "indemnification provisions" that allow the organization to pay the costs of defending or paying settlements or judgments board members might incur for actions related to their board service. In some cases, federal or state laws may prohibit the organization from indemnifying a board member for specific types of offenses.

Rationale:
A knowledgeable, committed board of directors is the strongest protector of a charitable organization's accountability to the law, its donors, consumers of its products and services, and the public. Most people volunteer for boards because of a commitment to the mission of the organization and the value of the organization's work to society. Too often, they do not have the training or information necessary to understand adequately their fiduciary responsibilities or common practices of boards of charitable organizations.

An effective board orientation process addresses the broad oversight responsibilities of the board and the specific legal and ethical responsibilities of individual board members. Board members should be aware of their personal liability for actions – or failure to take action – by the board, and the protections that are available to them.

All board members should receive oral and written instruction regarding the organization's governing documents, finances, program activities, and governing policies and practices. Even board members who have served on the board of other organizations can benefit from an orientation to the programs and activities, board policies and financial reports applicable to each organization for which they provide board service. Charitable organizations, if funds permit, should provide opportunities for board members to obtain special training or advice on legal and financial issues and responsibilities. It is also advisable to have an attorney or insurance agent who is knowledgeable about board liability explain the legal protections available to board members, as well as the options for insurance coverage.

Board education should be an ongoing process that includes ensuring that board members have received and reviewed sufficient information regarding the organization's finances, program operations, and administrative issues throughout the year to enable them to fulfill their oversight responsibilities. Meeting agendas and background materials on issues to be addressed should be distributed far enough in advance of all board meetings with the expectation that all board members will read and consider the issues prior to attending the meeting.

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[54] The Volunteer Protection Act of 1997, Pub. L. 105-19.

14. **Board members should evaluate their own performance as a group and as individuals no less frequently than every three years. The board should establish clear policies and procedures on the length of terms, the number of consecutive terms a board member may serve, and the removal of board members.**

Background:
There are no federal or state legal requirements that limit the length of time an individual may serve on the board of a charitable organization. Some state laws do establish the length of a board term of service, but they do not limit the number of terms an individual may serve. Trust laws in some states permit trustees to be appointed without any limitation on the term of service.

The Revised Model Nonprofit Corporation Act stipulates that the organization's bylaws or articles of incorporation must specify the terms of directors and that, except for designated or appointed directors, the terms of directors may not exceed five years. The Act and many state laws permit directors to be re-elected for successive terms.[55] The Act further stipulates that directors may be removed through judicial proceedings or by a vote of the board if "a director has engaged in fraudulent or dishonest conduct, or gross abuse of authority or discretion, with respect to the corporation … and removal is in the best interest of the corporation."[56] In judicial proceedings, a court may also stipulate that the director who is removed may be barred from serving on the board for a proscribed period of time.

Rationale:
Establishing a regular process of evaluating the board's performance is an essential component of ensuring it is able to fulfill its responsibilities to the organization, its funders, and the community it serves. Evaluation can help to identify strengths and weaknesses of the board's processes and procedures and provide insights for strengthening orientation and educational programs, the conduct of board and committee meetings, and its interactions with board and staff leadership. Most boards will find it necessary to conduct such a self-assessment on an annual basis to provide the most useful feedback to each member and to address any obstacles to effective performance before they become problems. A number of print and online tools, ranging from sample self-assessment questionnaires to more complex evaluation procedures, can help an organization design a board evaluation or self-assessment process that best meets its particular needs.

The board should establish clear guidelines for the duties and responsibilities of each board member, including meeting attendance, preparation, and participation; committee assignments; and other expertise board members should bring or develop in order to provide effective governance for the organization. Boards should establish the expectation that board members read the meeting materials in advance so they can participate productively in discussions and decisions. Many boards assign responsibility for oversight of the board evaluation and development function to their executive

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[55] Revised Model Nonprofit Corporation Act § 8.05.
[56] Id. § 8.10.

committees or to a separate board development committee. Board members with this responsibility should be empowered to discuss problems of attendance or other aspects of board performance with individual members to ascertain whether the problem can be corrected or the individual needs to resign or be removed from the board.

Removing a non-performing board member generally requires the action of the full board or, if the organization has members, the action of the membership. Some organizations establish limits on the number of successive terms a board member may serve, which provides an automatic basis for rotating board members. This process can provide an easier solution to removing non-performing members, but it also forces others to leave the board even though they are still providing valuable services.

Identification and cultivation of prospective board members and engagement of new members are equally important responsibilities of the board, and are key to effective leadership of the board both now and in the future. As part of that work, the board should carefully consider whether it is in the organization's best interests to limit the number of terms each member can serve. Limiting the terms requires an organization to invite new members to join its board on a regular basis, a process that many organizations have found provides a needed infusion of new energy, ideas, and expertise. However, other organizations find that limiting terms would deprive them of valuable experience, continuity, and, in some cases, needed support. Instead, they rely on rigorous board procedures for evaluating board members and removing those who are not able to fulfill their governance responsibilities effectively.

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

Background:
Each organization's articles of incorporation and governing instruments set forth the requirements for its conduct and that of its board of directors. Charitable organizations are required to submit these articles and instruments to the Internal Revenue Service when applying for recognition as a 501(c)(3) exempt organization. If an organization amends its governing instruments, it must provide the revised documents to the appropriate Exempt Organization area manager or attach them to the next annual information return (Form 990, 990-EZ, or 990-PF) it files with the IRS.[57] Most state laws permit the state attorney general or an organization's board members to file suit asking the court to hold the board accountable for failure to abide by the requirements set forth in those documents.

Rationale:
Boards of charitable organizations should regularly review their governing instruments, to ensure that the organization is abiding by the rules it set for itself or determine if changes need to be made to those instruments. Such reviews should be the ongoing work of a board of directors and a special effort should be made at least once every five years to conduct a thorough review of the organization's articles of incorporation, bylaws and other governing instruments, to ensure that they reflect its current practice. The

[57] IRS Publication 557, Tax-Exempt Status for Your Organization, page 16.

board may choose to delegate this responsibility to a committee, but the full board should consider and act upon the committee's recommendations.

16. The board should establish or review goals for implementing the organization's mission on an annual basis and evaluate no less frequently than every three years the organization's programs, goals, and activities to be sure they advance the mission and make prudent use of the organization's resources.

Background:
Some legal scholars argue that a board member's duty of loyalty to the beneficiaries of a charitable organization requires that he or she ensures that the organization's purposes are carried out effectively.[58] If it becomes impractical or no longer feasible to carry out the purposes of the organization as outlined in its articles of incorporation, the board should take appropriate action to amend the articles and to file the amended articles with state officials, as required. Changes in the articles of incorporation or other governing instruments must also be reported to the Internal Revenue Service. In some instances, a charitable organization may need court approval to amend its organizing documents.

Some types of charitable organizations, such as hospitals (and other health care providers) and educational institutions, are subject to accreditation programs that evaluate the quality of services. Others may be subject to evaluations of program service accomplishments required by public and private funding agencies or the federated giving programs in which they participate.

Some groups—from external "watchdog" agencies to membership associations of nonprofit organizations in particular service or geographic areas—employ specific standards to assess the performance of charitable organizations. Many self-regulation systems require that individual organizations have systems in place to establish goals for and to evaluate their own program performance.

Rationale:
As stewards of the public's trust and the resources invested in the organization, board members have an obligation to ensure that the organization uses its resources as effectively as possible to advance its charitable mission. Every board should review the strategic goals of the organization on an annual basis, generally as part of the annual budget review process. The annual review should address current needs and anticipated changes in the community or program area in which the organization operates that may affect future operations. It should also consider the financial and human resources that are needed to accomplish the organization's goals.

Discussions of program activities and accomplishments, primarily based on reports from the chief staff executive or program committees, are often a part of most, if not all, board meetings. While such discussions are valuable, they should not substitute for a more rigorous evaluation of the impact and effectiveness of the organization's programs in light of the goals and objectives the board has approved. This process of review and

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

evaluation is critical to the board's ability to determine whether programs should be altered, expanded, or dropped in order to produce the best results for the organization's mission.

Because of the diversity of the sector and the subjective nature of performance measures, it is incumbent on each organization to develop its own process for evaluating its program activities based on such factors as the nature of the services offered, the constituency served, the resources available to support the program, and both the short-term and long-range goals for the program. Most organizations should have at least an informal review of its progress on goals and objectives on an annual basis but, because of the time and cost involved, may choose to conduct a more rigorous evaluation less frequently. It may not be appropriate to evaluate on an annual basis the outcomes of some types of programs, such as scientific or medical research and after-school programs, where accomplishments may not be evident for a number of years. However, even in these instances, benchmarks can be identified to assess whether the work is moving in the right direction.

Some accreditation programs and standards of practice for charitable organizations require the board to prepare a written report of its annual program review and strategic plan for future operations. Such reports should not be treated as a final, static document, but rather as a valuable record and guide for both the board and the staff in their ongoing implementation of program activities.

17. **Board members are generally expected to serve without compensation, other than reimbursement for expenses incurred to fulfill their board duties. Charitable organizations that provide compensation to board members should have it reviewed by an independent, external source and should, upon request, make available to anyone relevant information that will assist in evaluating the reasonableness of such compensation.**

Background:
Charities and foundations are permitted under current law to pay reasonable compensation for services provided by board members. Reasonable compensation is defined as the amount that would ordinarily be paid for like services by like enterprises (whether tax-exempt or taxable) under like circumstances.[59] Federal tax laws prohibit excessive compensation and transactions that provide excessive economic benefit to board members and other disqualified persons.[60] The rules and penalties regarding excessive compensation of board members are the same as those applied to the compensation of the chief executive officer or other disqualified persons (see Principle #11).

[59] Treas. Reg. § 53.4958-4(b)(1)(ii).
[60] IRC §§ 4941, 4958.

Charitable organizations, with some exceptions,[61] are required to report on their Form 990 or 990-PF the name, title, and average hours of service per week of every board member, officer, and key employee. In addition, the organizations must report the compensation, contributions to employee benefit plans and deferred compensation, expense account, and other allowances paid to any board member. Public charities must also provide this information for former employees and board members who received any compensation or benefit during the reporting year. The instructions to the Forms specify that all types of compensation must be reported, including both taxable and nontaxable fringe benefits except for de minimis fringe benefits (for example, property or services provided to the individual of such a small value as to make accounting for it impractical).[62] Organizations are also required to include the preferred address of each board member.

Rationale
Millions of Americans serve each year on the boards of charitable organizations. Although some charitable organizations reimburse expenses related to board work, the vast majority of board members serve without compensation. In fact, board members of public charities often donate both time and funds to the organization, a practice that supports the sector's spirit of giving and volunteering.

When organizations find it appropriate to compensate board members due to the nature, time, or professional competencies involved in the work, they must be prepared to provide detailed documentation of the amount of and reasons for such compensation, including the services provided and the responsibilities of board members. Any compensation provided to board members must be reasonable and necessary to support the performance of the organization in its exempt function. Compensation paid to board members for services in the capacity of staff of the organization should be clearly differentiated from any compensation paid for board service.

Board members of charitable organizations are responsible for ascertaining that any compensation they receive does not exceed to a significant degree the compensation provided for positions in comparable organizations with similar responsibilities and qualifications. When they establish their own compensation, board members generally cannot avail themselves of the protections accorded by following rebuttable presumption procedures outlined in federal intermediate sanctions regulations, because they would not meet the criteria for an independent authorizing body.

[61] Excluded from this requirement are organizations, other than private foundations and supporting organizations, with annual gross receipts of $25,000 or less, houses of worship and specific related institutions, specified governmental instrumentalities and other organizations relieved of this requirement by authority of the IRS. IRC § 6033(a)(2).
[62] IRC § 132(e).

C. PRINCIPLES FOR STRONG FINANCIAL OVERSIGHT

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

Background:
Under all state laws, directors must exercise their "duty of care" by providing careful oversight of the organization's assets and financial transactions in order to protect the interests of the organization and its charitable purposes.

Federal law generally does not regulate the management of investment assets by public charities. Private foundations and their managers, however, are subject to penalties under federal tax law if the board approves investments "in such a manner as to jeopardize the carrying out of any of (the organization's) exempt purposes."[63] Treasury regulations state that board members must exercise ordinary business care and prudence in providing for the short- and long-term needs of the foundation in evaluating both the overall investment portfolio and individual investment decisions.

Many states have enacted legislation regulating the investment activities of trustees and directors of charitable organizations. The state standard of care applicable to most nonprofit corporations is the Uniform Management of Institutional Funds Act (UMIFA),[64] which has been adopted in some form by 47 states and the District of Columbia. This Act requires board members to exercise ordinary business care and prudence under the facts and circumstances prevailing at the time of an investment decision.

Charitable organizations established as trusts are typically subject to the Uniform Prudent Investor Act (UPIA), which has been adopted in more than 40 states and the District of Columbia.[65] Some states also apply UPIA to charitable corporations or specific types of funds within charitable corporations.

In July 2006, the National Conference of Commissioners on Uniform State Laws (NCCUSL) approved the Uniform Prudent Management of Institutional Funds Act (UPMIFA), which would supersede UMIFA and is widely expected to be adopted by many states in the near future. UPMIFA applies to both charitable corporations and

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[63] IRC § 4944.
[64] UMIFA was promulgated by the National Conference of Commissioners on Uniform State Laws (NCCUSL) in 1972. It liberalized prior rules that limited the ability of a charity to expend from its endowment funds anything other than the fund's income.
[65] UPIA was promulgated by NCCUSL in 1994 and is based on the General Standard of Prudent Investment set forth in the Restatement (Third) of Trusts, which was released in 1992. The Restatement reflects modern portfolio theory which has become universally accepted. The Uniform Trust Code promulgated by NCCUSL in 2000, and amended in 2001, 2003 and 2005, incorporates UPIA wholesale as the standard applicable to the investment of trust assets.

charitable trusts and provides more guidance for boards and others responsible for managing the investments of charitable organizations. It defines the following principles of prudence for those who manage and invest funds of charitable organizations:

1. Give primary consideration to donor intent as expressed in a trust instrument;
2. Act in good faith, with the care an ordinarily prudent person would exercise;
3. Incur only reasonable costs in investing and managing charitable funds;
4. Make a reasonable effort to verify relevant facts;
5. Make decisions about each asset in the context of the portfolio of investments, as part of an overall investment strategy;
6. Diversify investments unless, due to special circumstances, the purposes of the fund are better served without diversification;
7. Dispose of unsuitable assets; and
8. In general, develop an investment strategy appropriate for the fund and the charity.[66]

Under UPMIFA, a charity would also have the flexibility to spend or accumulate as much of an endowment fund as it deemed prudent.

Rationale:
Among the most important responsibilities of the board of directors is ensuring that the organization manages its financial resources effectively to further the charitable mission. The board must set the policies for financial management and review financial practices and reports to ensure that staff or designated volunteers are adhering to those policies. Day-to-day accounting and financial management should be the task of staff or, in the case of organizations with no or one staff member, designated volunteers with the necessary time and skills.

Despite the good intentions of most individuals involved in charitable organizations, there is the potential for the organization's funds to be embezzled or misused. The board must ensure that the organization has adequate internal controls so that no one person bears the sole responsibility for receiving, depositing, and spending those funds. To do so, it should establish clear procedures within the accounting operations such as separating of the custody of the organization's assets (including cash, checks, inventory and equipment) from the accounting process, preventing individuals who authorize transactions from handling payments for those transactions, and requiring the individuals who prepare and review financial records to be different from those who input or approve transactions. While thoroughly separating financial duties can be a challenge for smaller organizations, adequate separation is essential to protect the organization's assets and prevent human errors.

The organization's annual budget should provide a roadmap for determining the programs and activities the organization will undertake in the coming year and the resources it will need to raise or generate to support those activities. It is also a key tool to assist the board and the staff as they strive to ensure that the organization lives within its means. Careful review of regular financial reports showing both budgeted and actual expenditures and revenues will permit the board to determine whether adjustments must

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

be made in spending or program policies to accommodate positive or negative changes in revenues.

Prudent financial oversight requires that the board look beyond monthly or annual financial reports to consider how the organization's current financial performance compares with previous years and how its financial future appears. If the organization's net assets have been declining over a period of years, the board may wish to consider what actions should be taken to achieve stability or increase the organization's financial position. The board should also be aware of any anticipated changes in future funding streams or revenues and whether the organization will need to make changes in its fundraising, investment, earned income, or program activities to accommodate those changes.

Financial policies and procedures should also address the need to adhere to any restrictions placed on funds by donors or grant programs.

Whenever possible, an organization should generate income beyond its daily operational needs to provide cash reserves for its future. When an organization has built sufficient reserves to establish investment funds, the board is responsible for establishing policies to govern how the funds will be invested and what portion, if any, of the returns on investments can be used for immediate operational or program needs. These policies should take into account both the short- and long-term needs of the organization, expected total return on its investments, price-level trends, and general economic conditions. The boards of organizations with sizeable reserve funds or endowments generally select an independent investment management service to handle the organization's investments, but the board or a committee of the board must monitor that investment manager in a timely manner.

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

Background:
The Revised Model Nonprofit Corporation Act, which has been adopted in whole or in part by 23 states, requires that a nonprofit corporation with members (other than religious corporations) must furnish on request from a member its latest annual financial statements with a balance sheet and statement of operations. If the statements are prepared by a public accountant, they must include the accountant's report. Otherwise, the statements must include a statement from the organization's president or the individual responsible for the corporation's financial records stating whether the statements were prepared on the basis of generally accepted accounting principles or, if not, the basis of preparation.

Federal law requires many public charities[67] and all private foundations to file an annual information return (Form 990, 990-EZ, or 990-PF) with the Internal Revenue Service with accurate information on the organization's finances and programs. IRS regulations permit any authorized officer of the organization[68] to sign Form 990 returns certifying, under penalty of perjury, that the return and accompanying schedules and statements are true, correct, and complete.

The Internal Revenue Code provides for penalties if an organization fails to file a required return or to include required information on Form 990 series returns. These penalties may reach up to $10,000 or 5 percent of gross receipts per return for organizations with annual receipts of $1 million or less, and $50,000 per return for organizations with over $1 million in annual gross receipts.

The IRS instructs charitable organizations "generally [to] use the same accounting method on the return as it regularly uses to keep its books and records."[69] The returns therefore may be prepared using a different accounting method than is used to prepare the organization's audited financial statements. The Generally Accepted Accounting Principles (GAAP) used to prepare most audited financial statements apply specific rules for the treatment of fundraising expenses and contributions received by and pledged to the organization that may differ from the cash records maintained by the organization.

Some states also require public charities to file their IRS annual information returns with the state and may impose additional penalties for failure to meet their filing requirements.

There is currently no federal requirement for audits of charitable organizations (except under OMB Circular No. A-133 for organizations that receive $500,000 or more in federal grants). Organizations with annual revenues of $250,000 or more must submit an independent audit of financial statements to qualify for participation in the Combined Federal Campaign which allows government employees to make contributions through payroll deductions to participating charities.[70]

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[67] Organizations, other than private foundations and supporting organizations, with annual gross receipts of $25,000 or less, houses of worship and specific related institutions, specified governmental instrumentalities, and other organizations relieved of this requirement by authority of the IRS are excluded from this requirement.

[68] For a corporation or association, this officer may be the president, vice president, treasurer, assistant treasurer, chief accounting officer or other corporate or association officer, such as a tax officer. For a trust, the authorized trustee must sign.

[69] IRS 2005 Form 990 and 990-EZ Instructions, pages 5, 6.

[70] 5 CFR Part 950 (final rule effective November 21, 2006). Any organization seeking participation in the national/international parts of the Combined Federal Campaign (CFC) regardless of revenues, must certify that the organization is fiscally accountable and submit a copy of an audited financial statements conducted by an independent auditor. Organizations with revenues between $100,000 and $250,000 seeking local participation in the CFC are required to certify that they account for funds in accordance with generally accepted accounting principles and have an audit of their financial statements conducted by an independent certified public accountant in accordance with generally accepted accounting principles and auditing standards but will not be required to submit the audited financial statements with their application. Charities with revenues under $100,000 seeking local participation will be required to certify that they have adequate financial controls in place as specified by the Office of Personnel Management, but will not be required to submit these with their application.).

Eighteen states require a charitable organization that solicits contributions in the state to submit a copy of an independent audit report or a certified review of financial reports annually if it meets certain financial criteria. The budget thresholds for audit requirements vary substantially. California requires charitable organizations, other than educational organizations and hospitals, to file audited financial statements if their gross annual revenues are $2 million or more[71], whereas Maryland requires organizations soliciting contributions in its state to file audited financial statements if their annual revenues exceed $200,000.

The Panel on the Nonprofit Sector recommended that Congress revise federal laws to require that exempt organizations with total annual revenues of $1 million or more have their financial statements audited by an independent certified public accountant. The Panel also recommended that Congress revise federal laws to require that exempt organizations with revenues between $250,000 and $1 million have their financial statements reviewed by an independent public accountant.

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

Having financial statements prepared and audited in accordance with generally accepted accounting principles and auditing standards improves the quality of financial information available. Oversight of the audit function is a critical responsibility of the board of directors, and the board must have the independence to assess the most cost-effective methods for ensuring that the organization's financial resources are managed responsibly and effectively. Depending on the size, scale and complexity of the organization's operations, a financial audit can be a substantial expense.

Each organization must ensure that it has its annual financial statements audited or reviewed as required by law in the states in which it operates or raises funds. When an audit is not legally required, a financial review offers a less expensive option that still provides the board, regulators, and the public with some assurance of the accuracy of the organization's financial records. Many smaller organizations that have opted to work with an independent accountant have noted that the accountant provided invaluable assistance and guidance regarding the organization's financial records and have encouraged their counterparts to follow the same procedure.

Every charitable organization that has its financial statements independently audited, whether legally required or not, should consider establishing an audit committee of the board which should be separate from the finance committee and be composed of at least three members. Audit committee members must be independent: they cannot be

[71] CA Govt. Code § 12585.

members of the staff or receive any compensation from the organization aside from compensation for services as a board member, and cannot have a material financial interest in any entity doing business with the charitable organization. By reducing possible conflicts of interest between outside auditors and the paid staff of the organization, audit committees can help the board have greater assurance that audited financial statements are accurate and comprehensive.

It is important that the board or its audit committee, if the board chooses or is required by state law to establish one, include individuals with financial expertise. If state law permits, the board may appoint non-voting, non-staff advisors rather than board members to the audit committee.

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

The board is responsible for overseeing the audit process. If a committee of the board is used, the committee should make a recommendation to the full board regarding approval of the annual audit. Duties that the board should either perform itself, or delegate to an audit committee, include:

- Retaining and terminating the engagement of the independent auditor;
- Reviewing the terms of the auditor's engagement at least every five years;
- Overseeing the performance of the independent audit;
- Conferring with the auditor to ensure that the affairs of the organization are in order;
- Overseeing policies and procedures for encouraging whistleblowers to report questionable accounting or auditing matters;
- Approving any non-audit services performed by the auditing firm;
- Reviewing adoption and implementation of internal financial controls through the audit process; and
- Monitoring the organization's response to potentially illegal or unethical practices within the organization, including but not limited to fraudulent accounting.

20. A charitable organization should not provide loans (or the equivalent[72]) to directors, officers or trustees

Background:
Federal laws prohibit private foundations from making loans to board members. The Revised Model Nonprofit Corporation Act states that a nonprofit corporation "may not lend money to or guaranty the obligation of a director or officer of the corporation." [73] Some state laws expressly prohibit loans to directors and officers of nonprofit organizations.

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[72] An equivalent to a loan could be financial arrangements such as a guarantee on a loan from a financial institution or another party, purchasing and transferring ownership of a residence or office to an officer or director, and relieving an officer or director of a lease obligation for office or living space.
[73] The Revised Model Nonprofit Corporation Act § 8.32.

Loans to officers, directors, trustees, and key employees must be reported to the Internal Revenue Service on the organization's annual information return (Form 990). The IRS generally scrutinizes such loans to determine whether they qualify as a true loan or some other type of payment. In making its determination, the IRS examines information reported on the Form 990, including the maturity date of the loan, repayment terms, the interest rate charged, any security or collateral provided by the borrower, and the purpose of the loan. The IRS also expects that the organization maintain and be able to provide written documentation of the loan. The financial benefit of a loan that is provided at below-market interest rates must be added to the borrower's other compensation to determine if the total qualifies as an excess benefit transaction. Any payment that is not determined to be a loan may automatically be treated as an excess benefit transaction.[74]

Rationale:
The practice of providing loans to board members and executives, while infrequent, has created both real and perceived problems for public charities. While there may be circumstances in which a charitable organization finds it necessary to offer loans to staff members, there is no justification for making loans to board members.

When a charitable organization deems it necessary to provide loans to an employee, for example, to enable a new employee of a charity to purchase a residence near the offices of the charitable organization,[75] the terms of such loans should be clearly understood and approved by the board.

21. **A charitable organization should spend a significant percentage of its annual budget on programs in pursuance of its mission. An organization should also provide sufficient resources for effective administration of the organization, and, if the organization solicits contributions, for appropriate fundraising activities.**

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

Public charities that are required to file Form 990 must disclose their total expenditures for administration or what the instructions to the form calls "management and general" expenses. The IRS defines management and general expenses as the organization's expenses for overall function and management, rather than for its direct conduct of fundraising activities or program services. Overall management usually includes the

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[74] IRS Instructions to 2005 Form 990, page 12.

[75] California Corp Code § 5236 prohibits charitable corporations from making loans of money or property to any director or officer other than financing for the purchase of the principal residence of an officer if the board deems it is necessary to secure or retain the services of that officer and the loan is secured by real property; payments of premiums on a life insurance policy on the life of a director or officer if repayment is secured by the proceeds of the policy and its cash surrender value; advances for expenses that would normally be reimbursed by the corporation; or other loans that are approved by the attorney general.

salaries and expenses of the chief officer of the organization and that officer's staff. If part of a manager's time is spent directly supervising program services and fundraising activities, the appropriate portion of his or her salary and expenses should be allocated to those functions.[76]

The Form 990 instructions detail the following examples of management and general expenses:

- meetings of the board of directors or similar group, committee and staff meetings (unless held in connection with specific program services or fundraising activities);
- general legal services;
- accounting (including patient accounting and billing);
- general liability insurance;
- office management;
- auditing, personnel, and other centralized services;
- preparation, publication, and distribution of an annual report; and
- investment expenses.

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

There is no comparable definition of administrative expenses for private foundations in the instructions to the Form 990-PF. Private foundations are permitted to count all "reasonable and necessary" administrative expenses against their five percent payout requirement.[77] Current law does not permit expenses for ongoing investment management, such as investment consultant fees, custodial fees, attending investment conferences, etc., to be counted as qualifying distributions.

Rationale:

A charitable organization has an obligation to devote its resources to carrying out the charitable purposes for which it was granted tax exemption, and to spend donated funds on the programs and activities for which the funds were contributed. At the same time, the successful operation of any business or organization requires effective management and administration.

The American Institute of Certified Public Accountants defines administrative or "management and general activities" of charitable organizations as "those activities not associated with a single program, fund-raising activity, or membership development activity but that are indispensable to the conduct of those activities and to an organization's existence." Administrative activities include financial and investment management, personnel services, recordkeeping, soliciting and managing contracts, legal services, and supporting the governing body of the organization. These operations are essential to ensuring that the organization complies with all legal requirements and

[76] IRS 2005 Form 990 Instructions, pages 22-23.
[77] IRC § 4942(g)(1)(A).

provides complete, accurate, and timely information to donors, the public, and government regulators.

In addition to effective administrative operations, charitable organizations rely on other supporting services to carry out their missions. Most public charities must have fundraising operations to encourage potential donors to contribute money, materials, and other assets and to ensure that donors receive necessary reports about how their contributions were used. Some public charities also rely on membership development activities to solicit prospective members, collect membership dues, and ensure that members receive promised benefits. Private foundations and some public charities also have expenses associated with making grants and contributions to other organizations and individuals. Expenditures related to administrative activities and supporting services are also referred to as "overhead" or "indirect costs" which may be charged to some grant-funded activities.

Qualified personnel are crucial for providing programs, recruiting and managing volunteers, raising funds, and ensuring proper administration. The costs of compensating personnel, including salaries and benefits, must be allocated to the particular functions they perform for the organization based on time sheets or other appropriate records.

Some self-regulation systems and "watchdog" organizations recommend that public charities spend at least 65% of their total expenses on program activities. This standard is very reasonable for most charitable organizations, but there can be extenuating circumstances that require an organization to devote a higher percentage of its resources to administrative and fundraising expenditures. For example, a new organization must often devote the majority of its resources to the administrative functions needed to establish its operations and to raise sufficient funds to support the programs it intends to provide. Similarly, an organization that has determined it needs to acquire a new building or establish an endowment to support its ongoing programs may devote a larger percentage of its resources to fundraising activities over a period of years. Organizations whose primary purpose is to raise funds to support the activities of other public charities, such as federated fundraising organizations, may also find that a substantial majority of its expenses qualify as "fundraising expenses." As a result, when examining the percentage of funds devoted to program versus administrative and fundraising expenses, it is important to consider all relevant factors including the age, size, and nature of the organization's operations.

22. **A charitable organization should establish and implement policies that provide clear guidance on its rules for paying or reimbursing expenses incurred by anyone conducting business or traveling on behalf of the organization, including the types of expenses that can be paid for or reimbursed and the documentation required. Such policies should require that travel on behalf of the organization is to be undertaken in a cost-effective manner. Charitable organizations should not pay for nor reimburse travel expenditures (not including de minimis expenses of those attending an activity such as a meal function of the organization) for spouses, dependents, or others who are accompanying individuals conducting**

business for the organization unless they, too, are conducting business for the organization.

Background:
Public charities and private foundations, like taxable organizations, are permitted to pay for or reimburse ordinary and necessary expenses incurred in carrying out the organization's activities, including the costs of travel. Under federal tax regulations, expenses for transportation, lodging, and meals must be documented to establish that they were incurred in connection with the work of the organization and not the personal activities of the individual. Federal tax regulations also require that these expenses not be "lavish or extravagant under the circumstances," though "lavish" and "extravagant" remain undefined in the tax code or in regulations.[78] Current law generally requires that such payments of travel expenditures for spouses, family members, and others accompanying an individual traveling on behalf of the organization must be treated as taxable income to the individual who is traveling on behalf of the organization.

Special rules apply to many types of travel-related expenses and reimbursement methods, including per diem payments, car allowances, employer-provided vehicles, security expenses, and travel expenses of spouses or other family members.[79] Travel expenses also have specific documentation requirements; for example, proper receipts and an indication of the business purpose of the travel or expenditure must be provided.[80] Taxable organizations also have limitations on deductions for meals, entertainment expenses, and some travel expenses.[81]

Travel expenses that are paid or reimbursed but are not properly documented or are "lavish or extravagant" must be treated as additional taxable compensation to the individual benefiting from them. The law requires public charities intending to treat an expenditure as compensation to provide contemporaneous written substantiation by reporting the amounts on a Form W-2, a Form 1099, or a Form 990, or otherwise documenting such compensation in writing; otherwise, the compensation will be treated automatically as an "excess benefit."[82] Board members and executives of charitable organizations who approve or receive excessive travel benefits are subject to penalties under existing law.[83]

Rationale:
Charitable organizations should establish and implement clear travel policies that reflect the standards of the organization as to what it considers "reasonable" expenditures and that will guide individuals who may incur travel expenditures while conducting the business of the organization. These policies should include procedures for properly documenting expenses incurred and their organizational purpose.

[78] IRC § 162(a)(2); Treas. Reg. §§ 1.162-2, 1.162-17.
[79] Treas. Reg. §§ 1.162-2, 1.132-5.
[80] IRC § 274(d); Treas. Reg. §§ 1.274-5, 1.274-5T.
[81] IRC § 274 and the regulations thereunder.
[82] IRC § 4958(c)(1)(A); Treas. Reg. § 53.4958-4(c)(1).
[83] IRC §§ 4941, 4958.

Charitable organizations generally should not pay for or reimburse travel expenditures for spouses, dependents, or others who are accompanying individuals conducting business for the organization and who are not themselves conducting business for the organization. If such expenses are paid by the organization, they generally must, by law, be treated as compensation to the individual traveling on behalf of the organization.

While there are occasions on which travel may require the purchase of tickets and accommodations at the last moment and necessitate paying premium prices, as a matter of general practice travel policies should ensure that the business of the organization is carried out in a cost-effective and efficient manner. The same standards for reimbursement of travel expenditures should be applied to the organization's board members, officers, staff, consultants, volunteers, and others traveling on behalf of the organization. Decisions on travel expenditures should be based on how to best further the organization's charitable purposes, rather than on the title or position of the person traveling. As a general practice, charitable funds should not be used for premium[84] or first-class travel. However, boards should retain the flexibility to permit first-class or premium accommodations or travel when it is in the best interest of the organization. Such a policy should be consistently applied and transparent to board members and others associated with the organization. Many organizations have developed policies that allow for such travel if the flight is longer than six hours or if an overnight flight ("red-eye") enables the traveler to sleep during the flight and thereby save time and cost of an overnight stay.

An organization's travel policies should reflect the requirements and restrictions on travel expenditures imposed under current law. For example, policies should make clear that personal use of the organization's vehicles or accommodations is prohibited, unless the expenditure is treated as compensation. Public charities may permit individuals to reimburse the organization for the fair market value of the personal use of its property, though this option is not always available to private foundations because of restrictions on transactions with disqualified persons.

Federal per diem rates can be a useful guide for charitable organizations, but there are many circumstances in which it is not reasonable or even possible to reimburse at federal per diem rates while conducting the business of the organization. In addition, federal government employees are eligible for travel services and are able to secure special rates for travel and accommodations that are not currently available to charitable organizations.

The detailed guidance provided in IRS Publication 463: Travel, Entertainment, Gift and Car Expenses should serve as a guide for managers of charitable organizations in avoiding lavish, extravagant, or excessive expenditures.

[84] Federal travel regulations define premium class travel as "any class of accommodation above coach class, that is, first or business class." U.S. General Accounting Office, *Travel Cards: Internal Control Weaknesses at DOD Led to Improper Use of First and Business Class Travel*, October 2003 (GA)-04-88).

D. PRINCIPLES FOR RESPONSIBLE FUNDRAISING PRACTICES

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

Background:
Most public charities solicit funds from the public to support their programs. Fundraising techniques vary greatly from charity to charity, depending on the size and age of the organization, the needs and resources of its community, and the organization's judgment as to how best to fund its activities in the short- and long- term. While public charities conduct many of their own fundraising activities, they may also obtain assistance from for-profit fundraising professionals and from volunteers.

Overlapping federal, state, and local laws regulate charitable solicitations. States play the leading role, with 38 states and the District of Columbia currently regulating such practices. Most states can also prosecute fraudulent or misleading charitable solicitations under their anti-fraud and consumer protection statutes. Many cities and counties have enacted their own solicitation ordinances. The Federal Trade Commission has jurisdiction over fraudulent solicitations in interstate commerce by for-profit organizations, including those who solicit on behalf of charitable nonprofits, while the Postal Service can prosecute fraudulent or misleading solicitations conveyed via the U.S. mail.

Over the years, state and local governments have attempted to prevent fraudulent fundraising, as well as curb what they perceive to be a waste of charitable assets, by limiting the amount that could be paid for fundraising (including amounts paid to professional fundraisers) or by requiring point-of-solicitation disclosures about the proportion of the funds that the charity would receive. The U.S. Supreme Court struck down three of these efforts on the grounds that they infringed on charities' First Amendment free speech rights.[85] While the Court expressed sympathy for state regulators' desire to protect their citizens from deceptive practices, it noted that existing anti-fraud statutes were adequate and that there were much less restrictive tools for combating fraudulent solicitations than percentage caps and point-of-solicitation disclosures, which it found to be excessive burdens on or unlawful compulsion of speech and thus unconstitutional. However, when the Court affirmed these precedents in 2003, it also upheld the Illinois Attorney General's right to pursue an action for fraud against a professional fundraiser that made representations to donors that a "significant amount" of each dollar donated would be going to the charity, when only 15 percent actually did.[86]

Rationale:
Charitable solicitations – whether in print, via the Internet, over the phone, or in person – are often the only contact a donor has with a charitable organization. Clear and accurate solicitation materials are therefore important for helping potential contributors differentiate an organization with a solid reputation and history of service to the

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[85] See *Village of Schaumburg v. Citizens for a Better Environment*, 444 U.S. 620 (1980); *Secretary of State of Maryland v. Munson*, 467 U.S. 947 (1984); and *Riley v. National Federation of the Blind of North Carolina, Inc.*, 487 U.S. 781 (1988).
[86] *Illinois ex rel. Lisa Madigan v. Telemarketing Associates, Inc.,* 538 US 600 (2003).

community from deceptive fundraising efforts launched by individuals using organizations that use similar names and purposes.

A donor has the right to know the name of anyone soliciting contributions, the name and location of the organization that will receive the contribution, a clear description of its activities, the intended use of the funds to be raised, a contact for obtaining additional information, and whether the individual requesting the contribution is acting as a volunteer, employee of the organization, or hired solicitor.[87] Materials and any representations by those who solicit on behalf of a charitable organization should not include information, photographs, or other material that would create a false impression about the organization or how it will use the contributions. Descriptions of program activities and the financial condition of the organization must be current and accurate, and any references to past activities or events should be dated appropriately.

If an organization is not eligible to receive tax-deductible contributions, it must disclose this limitation at the time of solicitation. Similarly, a charitable organization that the IRS has recognized as eligible to receive tax-deductible contributions should clearly indicate in its solicitations how donors may obtain proof of that status. The charity may post a copy of its IRS letter of determination on its website or offer to provide a copy of the letter to donors who request it. If the solicitation promises any goods or services to the donor in exchange for contributions, the materials should also clearly indicate the portion of the contribution (that is, the value of any good or services provided) that is not tax-deductible.

24. Contributions must be used for the purposes described in the relevant solicitation materials, in the way specifically requested by the donor, or in a manner that reflects the donor's intent.

Background:
"Donor intent" has been the subject of a long-running debate. If a donor provides a clear, written directive about how funds are to be used at the time a gift is made, the donor (or his or her heirs) may have legal standing to ask a court to enforce those terms. This type of instruction would include a contract or grant agreement between a private or public funder and a charitable organization. An organization's communications while it is soliciting contributions may also create a legally binding restriction that can be enforced under state and federal fraudulent solicitation prohibitions.

When a donor's clear, written directive on how to use his or her contribution becomes impossible, impracticable, or illegal to carry out, a charitable organization may appeal to a court or state Attorney General (or other applicable charity official) for authority to deviate from the original purposes of the gift.[88] Courts have often turned to the doctrine

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[87] See The Donor Bill of Rights, created by the American Association of Fund Raising Counsel (AAFRC), Association for Healthcare Philanthropy (AHP), the Association of Fundraising Professionals (AFP), and the Council for Advancement and Support of Education (CASE). It has been endorsed by numerous organizations
[88] See Comment to § 413 of The Uniform Trust Code, promulgated by the National Conference of Commissioners on Uniform State Laws (NCCUSL) in 2000, and amended in 2001, 2003 and 2005, which provides in part: "if a particular charitable purpose becomes unlawful, impracticable, impossible to achieve, or wasteful ... the court may apply cy-pres to modify or terminate the trust ... in a manner consistent with the

of "cy pres," a common law doctrine that allows a court to amend the terms of a charitable trust in a manner that is close (cy pres) to the original intent of the donor, to resolve such requests.[89]

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

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

A charitable organization should carefully review the terms of any contract or grant agreement before accepting a donation. If it will be unable or unwilling to comply with any of the terms requested by a donor, the organization should negotiate any necessary changes prior to concluding the transaction. Particularly in the case of substantial contributions, an organization should develop an agreement that indicates its right to modify the terms of the gift if circumstances warrant. Some charitable organizations include provisions in their governing documents or board resolutions indicating that the organization retains the right to modify conditions on the use of assets, or "variance powers." Such powers should be clearly communicated to donors through a written agreement.[90]

25. Charitable organizations must provide donors, in accordance with IRS requirements, with clear, accurate acknowledgments of charitable contributions, and should provide donors with information to facilitate compliance with tax law requirements.

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settlor's charitable purposes." UPMIFA, as adopted July 2006, Comment to Section 6, similarly allows a release of restrictions with donor permission, and permits deviations to modify or release a restriction, through court order or upon notification to the State Attorney General (or other applicable charity official). Modifications from the original intent of the donor must be "in accordance with the donor's probable intention" for deviation, and "in a manner consistent with the charitable purposes expressed in the gift instrument" for cy pres.

[89] Fremont-Smith, *Governing Nonprofit Organizations*, pp. 173-186, provides a thorough discussion of the application of the cy pres doctrine.

[90] See also Treas. Reg. § 1.170A-9(e)(11)(V)(B),(C) and (D).

Background:
Federal law requires charitable organizations to provide a written acknowledgement to donors who contribute $75 or more if the organization has provided the donor with goods or services in exchange for the contribution.[91] The acknowledgment (also called a "disclosure statement") must include the name of the charitable organization; the date of the contribution; either the amount of cash or a description (but not the value) of any property contributed; a statement that the amount of the contribution that is deductible for federal income tax purposes is limited to the amount in excess of the value of any goods or services provided to the donor; and a good faith estimate of the fair market value of any goods or services received by the donor. The IRS indicates on its website that no disclosure statement is required if "the goods or services given to a donor have insubstantial value."[92]

A taxpayer who itemizes deductions on his or her annual income tax return is required to have written, contemporaneous acknowledgement from the charitable organization to substantiate deductions for contributions of $250 or more. Under new laws enacted in August 2006, taxpayers are required to have bank records or a written communication from the organization (indicating its name and the date and amount of the contribution) to substantiate a deduction for a charitable contribution of any amount for tax years beginning after August 17, 2006.[93] For most taxpayers, this requirement takes effect for the 2007 calendar year.

For non-cash contributions, the taxpayer is generally allowed to deduct the fair market value of property donated to an organization exempt from taxation under IRC section 501(c)(3) or to a federal, state, or local governmental entity. The amount that taxpayers may deduct varies depending on the type of property contributed, the type of organization to which the property was contributed, and the taxpayer's income. If the taxpayer is claiming a deduction of more than $500 for any single item other than publicly-traded stock, the taxpayer must submit Form 8283 (Noncash Charitable Contributions) with his or her tax return. If the deduction claimed for any single item (other than publicly traded stock) exceeds $5,000, the taxpayer must have the item appraised by a qualified appraiser, then attach to the tax return a copy of the appraisal, a signed declaration of the appraiser, and a signed acknowledgement from the charitable organization that received the donation. If the charity sells contributed property valued at $5,000 or more within three years of the property's receipt, the charity must file Form 8282 (Donee Information Return), which reports that sale to the IRS.[94]

Under a new law enacted in August 2006,[95] taxpayers who itemize deductions on their annual income tax can only claim deductions for clothing and household items donated to charity if the items are in good used condition or better. The Treasury Department is expected to issue further guidance in 2007 regarding the responsibilities, if any, of charitable organizations to affirm the condition of donated items.

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[91] IRC § 170(f)(8); Treas. Reg. § 1.170A-13(f).
[92] See IRS Publication 1771; www.irs.gov/pub/irs-pdf/p1771.pdf
[93] IRC § 170 as revised by the Pension Protection Act of 2006 § 1217.
[94] Pension Protection Act of 2006, Pub. Law 109-280.
[95] Id.

Rationale:
Providing appropriate acknowledgement and recognition to donors is an important step toward building a donor's confidence in and support for the charitable organization's activities. Organizations should establish procedures for acknowledging contributions in a timely manner and for providing appropriate receipts for cash contributions if requested. If the organization has provided goods or services to the donor in exchange for or recognition of the contribution, the acknowledgement must include a good faith estimate of the fair market value of those goods or services—that is, the amount the donor would have to pay to purchase those goods or services independently. The cost of the item to the charitable organization does not determine the fair market value of the item, although it may be an important factor. For example, a hotel may donate the food served at a banquet with no charge to the charitable organization, but the fair market value of the benefit provided to the individual donor would be the price he or she would have to pay for a similar meal at that hotel. The charitable organization does not have to include such information in donor acknowledgements if the fair market value of the benefit provided is not more than 2% of the contribution or $86, whichever is less.[96]

Charitable organizations can also build this trust by providing donors with regular updates about the activities and programs supported by contributions. When they acknowledge contributions, many organizations also include information about how the donor can—through a website, print publications, or visits to the organization's office—learn more about the organization, its governance and financial status, and its programs.

Charitable organizations are not required to and generally are not qualified to appraise the value of gifts of property for those taxpayers who want to take income tax deductions for their contributions. Charitable organizations should, however, alert donors to IRS rules for substantiating such claims and encourage donors to seek appropriate tax or legal counsel when they make significant non-cash gifts to the organization.

26. Charitable organizations should implement clear policies, based on the organization's exempt purpose, to determine whether accepting a gift would compromise the ethics, financial circumstances, program focus, or other interests of the organization.

Background:
Some charitable contributions have the potential to create significant problems for an organization or a donor. Contributors may ask a charity to disburse the funds for illegal or unethical purposes, whereas other gifts may subject the organization to liability under environmental protection laws or other rules. Some types of corporate sponsorships, interests in closely-held stock or oil, gas and mineral interests, may result in unrelated business income for a charitable organization. Donors may also face adverse tax consequences if a charity is unable to use a gift of property in fulfilling it mission and is

[96] This amount is determined by the Internal Revenue Service and may vary from year to year. For the latest figures, see Rev. Proc. 90-12, 1990-1 C.B. 471 and Rev. Proc. 92-49, 1992-1 C.B. 987 (as updated).

therefore required to sell or otherwise dispose of the property soon after the donation is received.

Federal law designates certain transactions as prohibited tax-shelter transactions and imposes excise taxes and disclosure rules on certain tax-exempt entities that are party to such transactions, regardless of whether the transaction was initiated by a charitable contribution.[97] Recent guidance provided by the Internal Revenue Service outlines the circumstances in which excise taxes may be imposed pursuant to Internal Revenue Code Section 4965 on charity managers and organizations on income received after August 15, 2006, resulting from a transaction in which the charitable organization is a party to a prohibited tax shelter transaction.[98]

Rationale:
Because of a continuing need for income to operate its programs, a charitable organization can be tempted to accept a generous donation before carefully considering any associated costs or other consequences. A gift acceptance policy provides some protection for the board and staff of the organization, and for potential donors, by outlining the rules and procedures by which an organization will evaluate whether it can accept a contribution even before an offer is actually made.

A gift acceptance policy should make clear that the organization will not accept any gifts that are counter to or outside the scope of its mission and purpose. The policy should list any funding sources, types of contributions, or conditions that would prevent the organization from accepting a gift. The organization should also consider establishing parameters for the types of gifts, including most types of non-cash contributions, that legal counsel must evaluate for potential consequences before the gift can be accepted.

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

Background:
A charitable organization may be legally responsible when those who solicit on its behalf engage in illegal or fraudulent practices. Most states require charitable organizations and professional fundraisers that solicit contributions in their jurisdiction to register and provide reports on their activities. Many states require a charitable organization that has paid solicitors or professional consultants working on its behalf to have a written contract with those fundraisers that delineates the specific purpose, time, and fees to be paid under the contract; the obligations of both the organization and the paid solicitor or consultant; whether the solicitor or consultant will have custody or control of contributions at any time and how such contributions will be transmitted to the

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[97] The Tax Increase Prevention and Reconciliation Act of 2005 P.L. 109-222.

[98] See IRS Notice 2007-18. The Service has indicated that further guidance on charitable abusive tax-shelters will be forthcoming.

organization; and how information about donors and potential donors will be treated by the solicitor during and following completion of the contract. Some states impose fines on charitable organizations that engage professional fundraisers to solicit contributions on their behalf if those fundraisers fail to register or provide reports as required.

Federal law requires for-profit firms soliciting for charitable nonprofits via telephone to follow specific rules that include (1) disclosing the purpose of the call and the name of the organization for whom the call is made promptly and "in a clear and conspicuous manner," and (2) honoring requests by the recipient of the call not to call again.[99] The law also prohibits professional solicitors from misrepresenting, directly or by implication, the nature or purpose of the charitable organization, the purpose for which the contribution will be used, the percentage of the contribution that will go to that purpose, and the organization's or the solicitor's affiliation with or sponsorship by a specific organization, business, individual or government entity.

Rationale:
Individuals who solicit funds on behalf of a charitable organization are often a potential donor's first, and sometimes only, direct contact with the organization. The organization should therefore ensure that its fundraisers are respectful of a donor's concerns and do not use coercive or abusive language or strategies to secure contributions, misuse personal information about potential donors, pursue personal relationships that are subject to misinterpretation by potential donors, or mislead potential donors in other ways. All those who solicit contributions on the organization's behalf, including volunteers, should be provided with clear materials and instructions on information they should provide to prospective donors, including the name and address of the charitable organization, how the donor can learn more about the organization, the purposes for which donations will be used, whether all or part of the donation may be tax-deductible, and who the donor can contact for further information.

If a charitable organization decides to use an outside professional fundraising firm or consultant, it should have a clear contract as required by law or as determined by good practice that outlines the responsibilities of the organization and of the firm or consultant. The fundraiser must agree to abide by any registration and reporting requirements of the jurisdictions in which fundraising will be conducted, as well as federal restrictions on telephone, email, or fax solicitations. The charitable organization should verify that the outside solicitor is registered as required in any state in which the solicitor will be seeking contributions.

In general, those soliciting funds on behalf of charities should refrain from giving specific legal, financial, and tax advice to individual donors and, when appropriate, should encourage donors to consult their own legal counsel or other professional advisors before finalizing a contribution.

28. Organizations should not compensate internal or external fundraisers based on a commission or a percentage of the amount raised.

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

Background:
Many professional associations of fundraisers (including the Association of Fundraising Professionals and the Giving Institute, formerly known as the American Association of Fund Raising Counsel) prohibit their members from accepting payment for fundraising activities based on a percentage or the amount of charitable income raised or expected to be raised. Federal tax law prohibits charitable organizations from providing "excessive compensation" to executives and other disqualified persons.[100]

Rationale:
Compensation for fundraising activities should reflect the skill, effort, and time expended by the individual or firm on behalf of the charitable organization. Basing compensation on a percentage of the money raised can encourage fundraisers to put their own interests ahead of those of the organization or the donor and may lead to inappropriate techniques that jeopardize the organization's values and reputation and the donor's trust in the organization. Percentage-based compensation may also lead to payments that could be regarded by legal authorities or perceived by the public as "excessive compensation" compared to the actual work conducted. Percentage-based compensation may also be skewed by unexpected or unsolicited gifts received by the charitable organization through no effort of the fundraiser. [101]

Some charitable organizations choose to provide bonuses to employees for exceptional work in fundraising, administrative, or program activities. Due to the factors outlined above, the criteria for such bonuses should be clearly delineated based on the work performed by the employee, rather than as a percentage of the funds raised.

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

Background:
A charitable organization is required to report on its annual IRS information return (Forms 990) the names and addresses of those who contributed the greater of $5,000 or 2% of the total contributions received by the organization in the tax year covered by the return. Federal tax laws specifically provides that tax-exempt organizations, other than private foundations or political organizations described in section 527 of the tax code, are not required to disclose the name and address of contributors to the public.[102] However, to the extent that donor information is included in a public charity's application for tax-exemption, or correspondence with the IRS during the application process, such information may be subject to public disclosure.

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[100] IRC § 4941, § 4958. See discussion of Principle 11 for more information about legal requirements regarding excessive compensation.
[101] The Association of Fundraising Professionals' position paper on "percentage-based compensation" provides a careful analysis of the potential pitfalls of such compensation and the rationale for the Association's prohibition on such compensation. www.afpnet.org
[102] IRC § 6104(d)(3)(A).

Some charitable organizations affiliated with governmental entities, such as supporting organizations affiliated with a public higher education institution, may be subject to state Open Public Records or Freedom of Information laws that require disclosure of records that include donor information. As a result of court decisions upholding such requirements, the state of Iowa recently passed legislation allowing state-affiliated university foundations to preserve the confidentiality of donors' personal financial information. The Iowa law also permits the state university foundation to uphold a donor's request to remain anonymous. Eight other states[103] have enacted laws protecting donor information from disclosure.

Rationale:
Preserving the trust and support of donors requires charitable organizations to handle donations and donor information with respect and confidentiality to the maximum extent permitted by law.[104] Charitable organizations should disclose to donors whether and how their names may be used, and provide all donors, at the time of making a contribution, an easy way to indicate that they do not wish their names or contact information to be shared outside the organization. In all solicitation and other promotional materials , organizations should also provide a means, such as a check-off box or other "opt-out" procedure, for donors and others who receive such materials to request that their names be deleted from similar mailings, faxes, or electronic communications in the future. The organization should ensure that all donors are contacted at least once a year with information about how they may request that their names and contact information not be shared outside the organization.

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

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[103] Arizona, Colorado, Georgia, Florida, Louisiana, Minnesota, Nevada and New Jersey.

[104] The Donor Bill of Rights, created by the American Association of Fund Raising Counsel, the Association for Healthcare Philanthropy, the Association of Fundraising Professionals, and the Council for Advancement and Support of Education, explicitly states the donor's right to confidentiality. The document has been endorsed by numerous charitable organizations.

E. Staff Drafts of Two Additional Principles

NOTE: These drafts have not yet been reviewed and approved by the Advisory Committee.

30. A charitable organization should have a formally adopted, written code of ethics with which all of their trustees, staff and volunteers are familiar and to which they adhere.

Background:
While adherence to the law provides a minimum standard for the behavior of a charitable organization, each organization should also have a code of ethics that outlines the practices and behaviors its staff, board, and volunteers agree to follow. The adoption of such a code, though not required by law, helps demonstrate the organization's commitment to carry out its responsibilities ethically and effectively.

Some accreditation programs require participating organizations to have a written code of ethics in order to receive and maintain their accreditation. Many professional societies and membership associations make complying with a specific code of ethics or code of conduct a condition of membership.

Rationale:
Developing and adopting a code of ethics is an important part of the process of being an ethical and accountable organization. The code should be built on the values that are embraced by the organization, such as a commitment to the public good, accountability to the public, transparency, integrity, honesty, responsible stewardship of resources, and a commitment to excellence. The code should describe the ethical principles that the organization's staff, board and volunteers agree to follow and highlight expectations of how those working with the organization will conduct themselves in a number of areas, such as the confidentiality and respect that should be accorded to clients, consumers, donors, and fellow volunteers and board and staff members.

The process by which a code of ethics is adopted and implemented can be just as important as the code itself. The board and staff should be engaged in developing, drafting, adopting, and implementing a code that fits the organization's characteristics. It must then be complemented by policies and procedures that describe how the principles in the code will be put into practice. Organizations should include a discussion of the code of ethics in orientation sessions for new board and staff members and volunteers, and should regularly address adherence to the code in their ongoing work.

The organization should also develop a process whereby individuals can report perceived problems with adherence to the code. In some cases, these violations may fall under the organization's "whistleblower" policy (see principle #4). In others, the organization may wish to develop a less formal mechanism for the discussion of concerns with appropriate groups of board, staff or volunteers.

The code of ethics can help build or reinforce positive perceptions of the organization and its work. Each organization should consider distributing its code more broadly through methods such as posting it on its website or incorporating it in reports on its work.

31. A charitable organization's board of directors should ensure that the organization adheres to a risk management plan that protects the organization's assets—its property, financial and human resources, and programmatic content and material. The board should review annually the organization's need for general liability and directors' and officers' liability insurance, as well as take other actions necessary to mitigate risks.

Background

The assets of charitable organizations can be at risk from a wide variety of external and internal factors, ranging from fires and natural disasters to actions – or the lack thereof – by the organization's board members, employees, volunteers, or clients. Board members may have personal liability for fines and other penalties as a result of certain legal violations, such as failure to pay required payroll and other taxes or approval of excess benefit or self-dealing transactions. Under most state laws, board members also bear a "duty of care" for protecting the organization's assets, which requires careful supervision of policies and practices.

The federal Volunteer Protection Act and most state volunteer liability laws provide some safeguards for board members who are not compensated, other than reimbursement of expenses. However, the Act does not protect board members, even if they are not compensated, and other volunteers from liability for "willful or criminal misconduct, gross negligence, reckless misconduct, or a conscious, flagrant indifference to the rights or safety of the individual harmed by the volunteer action."[105] The federal Act and most state laws do not prohibit lawsuits against board members and other volunteers, nor do they provide the charitable organization immunity from legal actions.

The governing documents of a charitable organization may include "indemnification provisions" that allow the organization to pay the costs of defending or paying settlements or judgments board members might incur for actions related to their board service. In some cases, federal or state laws may prohibit the organization from indemnifying a board member for specific types of offenses.

Rationale

The board of a charitable organization is responsible for understanding the major risks to which the organization is exposed, reviewing those risks on a periodic basis, and ensuring that systems have been established to manage those risks. The level of risk to which the organization is exposed and the extent of the review and risk management process will vary considerably based on the size, programmatic focus, geographic location, and complexity of the organization's operations.

[105] The Volunteer Protection Act of 1997, Pub. L. 105-19.

Risk management generally includes a review of the organization's key programs and activities and an assessment whether the organization should purchase insurance as a way to limit its financial exposure in the event of a loss. While it is rare for a charitable organization and its board to be the target of a lawsuit, each organization should still take steps to ensure that its board members and its assets are protected. The board of directors should consider the appropriateness of including indemnification provisions in the organization's governing documents, based on a review of the laws of the states in which it is based or operates. The board should also assess periodically the organization's need for insurance coverage based on its program activities and financial capacity. Insurance is only one risk management strategy, however. Other financial strategies should be considered to protect an organization's assets,[106] as well as policies and procedures designed to reduce the risk of various occurrences, or limit the exposure of the organization to certain identified risks.

Even the smallest organization should have procedures in place to back up and preserve electronic and print copies of documents and other information vital to its governance, financial, and programmatic operations. Larger organizations may require more extensive risk management programs, including emergency preparedness and disaster response plans in case of natural or man-made disasters or other crises that may disrupt significantly its programs and operations.

Charitable organizations that employ staff must ensure that they have and follow personnel policies in accord with federal and state laws and that appropriate procedures are in place to protect the health and safety of employees while they are at work. If the organization utilizes volunteers in the delivery of its programs and services, it should ensure that appropriate screening and training procedures are in place, particularly for personnel and volunteers dealing with vulnerable persons.

All organizations should carefully consider all of the principles for effective governance, strong financial oversight, and responsible fundraising practices as they develop appropriate policies and procedures to protect the organization's assets.

[106] Risk retention strategies include: drawing on your revenues to absorb minor losses, setting up reserves for losses, borrowing from lenders, and negotiating with third parties for them to assume certain losses.