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Fiduciary Obligations of CFOs and Finance Committees

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THE EXPERTS IN MISSION-DRIVEN NONPROFIT FINANCE

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Fiduciary Obligations of CFOs and Finance Committees

Focus over the next 60 minutes:

I. Core fiduciary duties: duty of care, loyalty, and obedience

II. Best practices for financial oversight and internal controls
   - Internal Controls and Financial Policies
   - Executive Compensation

III. Investment management responsibilities and endowment stewardship
   - Supporting Organizations
   - Emerging Revenue Challenges – Alternative Streams

I. Core Fiduciary Duties: Duty of Care, Loyalty, and Obedience

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Origin of Fiduciary Duties

- “Fiduciary” Latin origin for “Trust.”
- *Charitable Corp. v. Sutton*, 18th century English case - a nonprofit made unsecured loans to members of the board, and due to lax procedures, some of these loans were never repaid. The court found the entire board responsible, holding: “By accepting a trust of this sort, a person is obliged to execute it with fidelity and reasonable diligence.”

To Whom Is the Duty Owed?

- The Nonprofit

I. Core Fiduciary Duties: Duty of Care, Loyalty, and Obedience (cont.)

Source of Duties

1. Federal tax law

2. State law

I. Core Fiduciary Duties: Duty of Care, Loyalty, and Obedience (cont.)

T.C.A. § 48-58-403. Standards of conduct for officers.

(a) An officer with discretionary authority shall discharge all duties under that authority:

(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 officer reasonably believes to be in the **best interests** of the corporation.

T.C.A. § 48-58-301. General standards for directors.

(a) A director shall discharge all duties as a director, including 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.

I. Duty of Care

Duty of Care - The duty to oversee the organization's operations and well-being in a diligent manner.

- **Process** - The duty of care relates to the process by which a board of directors makes a decision.
  - Where judgment is inescapably required, all that the law may sensibly ask of corporate directors is that they exercise independent, good faith and attentive judgment, both with respect to the **quantum of information** necessary or appropriate in the circumstances and with respect to the **substantive decision** to be made." *In re NCS Healthcare, Inc.* (Del Ch.2002).

I. Duty of Care (cont.)

The process consists of several key components

- Being Informed
  - Mission/purpose in general
  - Finances
  - Major transactions
- Attendance
- Information Flow
- Informed Decisions
  - Reliance on Others
- Reliance on Others
  - Officers

I. Duty of Care (cont.)

Benefit of following process

- Business Judgment Rule:
  - A fundamental doctrine of corporate law applicable to both for-profit and nonprofit corporations is the so-called “business judgment rule.” This rule provides that, generally speaking, a court will respect the business decisions of a board of directors, even if those decisions turn out to have been in error and will not substitute the court's judgment for that of the board.

I. Duty of Loyalty

Duty of Loyalty

Requires directors to exercise their powers with undivided allegiance to the organization.

- Interested director transactions
- Corporate opportunities

I. Duty of Obedience

Duty of Obedience

Two parts:

1. Requires that nonprofit's activities are in furtherance of its mission
    1. Fidelity to Mission

2. Requires compliance with organizational documents
    1. Charter
    2. Bylaws
    3. Adopted Policies – Conflicts of Interest, etc.

II. Best Practices for Financial Oversight and Internal Controls

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II. What Are Internal Controls?

Internal controls are policies and procedures to protect the assets of an organization, create reliable financial reporting, promote compliance with laws and regulations and achieve effective and efficient operations.

Internal controls should address accounting and reporting policies, the nonprofit's internal and external communication processes. It should include procedures for:

- Caring for funds received and expended
- Preparing financial reporting to the Board and Officers
- Conducting the annual audit
- Evaluating staff and programs
- Implementing personnel, conflicts of interest and whistleblower policies.

II. Implementing Internal Controls

Procedures for Monitoring Funds:

- Nonprofits need written procedures for monitoring its assets received, held and expended. The procedures should be reviewed by Board and Officers at least annually.

Various Roles in the Organization:

- Nonprofits should have written job descriptions for its directors, officers, employees and volunteers.
  - Executive Director/CEO and CFO’s descriptions should make clear that person’s responsibilities in the day-to-day activities of the organization and set forth information is expected by the Board and timing of providing.
    - For example, set clear expectations of frequency that Board expects financial reports and activity reports
      - Clear expectations will avoid ambiguity as to ED/CFO’s responsibility for accountability to the Board.

II. Implementing Internal Controls (cont.)

Personnel Policies

- Personnel policies, including vacation and sick leave, health insurance and other benefits, evaluations, ordinary and overtime compensation, conflicts of interest and code of ethics, and grievance procedures (including protections for “whistle blowers”) should be in writing and given to all employees prior to hiring, with changes in policies communicated on a regular basis.

Training

- Appropriate training should be arranged for all involved.

II. Implementing Internal Controls (cont.)

Conflicts of Interest Policies and Code of Ethics:

- State statutes set forth the procedures to be followed if a Board member's personal or financial interests may be advanced by an action of the board.

- The conflicts of interest policy must require an individual to disclose any interest the individual and/or the individual's family has in any entity that does business with the organization.

    - Any change concerning potential conflict should be provided to the Board immediately.

II. Implementing Internal Controls (cont.)

Audits

- Board should:
  - Constitute an audit committee
    - Independent directors
  - Engage Independent CPA

Review of the Organization’s Governance Structure, Procedures and Programs

- Periodic review of structure, procedures and programs will assist the Board in determining what is working well and what practices require further review and change in order to be more efficient, effective or responsible.
  - Business judgment rule!

II. Executive Compensation Considerations for Tax-Exempt Organizations

- Constraints on Executive Compensation
  - Prohibition on Private Inurement
  - Intermediate Sanctions/Excess Benefit Transactions under Code Sections 4958
  - Tax on Excess Executive Compensation under Code Section 4960
  - Compensation Disclosure on Form 990 Schedule J
- Design Considerations for Executive Compensation Arrangements
  - Code Section 457
  - Code Section 409A
  - Split-Dollar Arrangements

II. Constraints on Executive Compensation
Private Inurement

- An organization's tax-exemption is conditioned on no part of the organization's net earnings inuring to the benefit of any private shareholder or individual.
- The purpose of the private inurement rule is to ensure that the tax-exempt organization serves exempt, rather than private, interests. An organization that violates this rule will not qualify (or will cease to qualify) for tax exemption, regardless of whether it meets the other statutory requirements for exemption.
- The payment of reasonable compensation for services rendered does not constitute private inurement; however, excessive compensation might be treated as an impermissible private inurement.
- Whether a compensation agreement is excessive and violates the prohibition against private inurement depends on the particular facts and circumstances.

II. Constraints on Executive Compensation
Private Inurement (cont.)

- Criteria to ascertain the reasonableness of the compensation include:
  - Whether the compensation arrangement was negotiated at arm's length.
  - Whether the compensation determination was made by an independent compensation committee, exercising its fiduciary responsibility to the organization.
  - Whether the compensation is comparable to compensation paid to other persons working in a similar capacity at similar organizations (which may include for-profit organizations).
  - Whether the compensation is reasonable based on the benefit conferred on the tax-exempt organization.
  - The nature of the executive's duties and responsibilities.
  - The correlation between the services provided and the compensation paid.
  - Whether there are adequate upper limits on compensation.

II. Constraints on Executive Compensation
Code Section 4958 Intermediate Sanctions (cont.)

- Applies only for organizations that are exempt under Code Section 501(c)(3), (4), or (29).
- A disqualified person is subject to an excise tax of 25% of the excess benefit on any excess benefit transaction. Further, an excise tax of 200% of the excess benefit may be levied against the disqualified person if the transaction is not corrected before the IRS either (i) sends a notice of deficiency or (ii) assesses the excise tax.
- In addition to the tax on a disqualified person, an excise tax may be imposed on organization managers who knowingly and willfully approved the excessive transaction. This additional excise tax is 10% of the excess benefit, up to a $20,000 maximum. For this purpose, organization managers include officers, directors and trustees, among others.

II. Constraints on Executive Compensation
Code Section 4958 Intermediate Sanctions (cont.)

- The regulations under Code Section 4958 provide for a rebuttable presumption that compensation is reasonable if:
  - The compensation arrangement is approved by an authorized body of the tax-exempt organization, composed of individuals who do not have any conflict of interest. In most cases, this would be an independent committee of the board, such as a compensation committee.
  - The authorized body has obtained and relied on comparative data from similarly situated organizations, which may include both taxable and tax-exempt organizations, regarding reasonableness before entering into a compensation arrangement. Compensation committees often engage consultants to collect and to help evaluate comparative data.
  - The authorized body has adequately documented the basis for the determination that the compensation was reasonable. The regulations specify details to include in the documentation.
- If these three requirements are satisfied, the IRS may rebut the presumption of reasonableness only if it develops sufficient evidence to rebut the probative value of the comparative data relied on by the authorized body.

II. Constraints on Executive Compensation
Code Section 4960 Excise Tax

- Code Section 4960 of the Code requires "applicable tax-exempt organizations" (ATEOs) to pay an excise tax on compensation over $1 million and on excess parachute payments to covered employees of the ATEO, effective for taxable years commencing after December 31, 2017.
- The rate of the excise tax equals the federal income tax rate for corporations (21% for 2025).
- Under Code Section 4960, an ATEO is any organization that is any of the following for the taxable year:
  - Is exempt from taxation under Code Section 501(a).
  - Is a farmers' cooperative organization described in Code Section 521(b)(1).
  - Has income excluded from taxation under Code Section 115(1).
  - Is a political organization described in Code Section 527(e).

II. Constraints on Executive Compensation Code Section 4960 Excise Tax (cont.)

- An ATEO is subject to the Code Section 4960 excise tax on either of the following:
  - Compensation that exceeds $1 million paid to any of its covered employees for a taxable year.
  - Certain separation payments made to its covered employees (referred to as excess parachute payments, but unlike Code Section 280G, no change in control is required).
- For purposes of Code Section 4960, a covered employee is an employee of a tax-exempt organization who either:
  - Is one of the 5 most highly compensated common-law employees of the organization for the taxable year.
  - Was a covered employee of the organization (or any predecessor) for any of the organization's preceding taxable years beginning after December 31, 2016. Once an individual is a covered employee for purposes of Code Section 4960, they continue to be a covered employee for all subsequent taxable years.

II. Constraints on Executive Compensation Code Section 4960 Excise Tax (cont.)

- Code Section 4960 contains an exception for compensation paid to a licensed medical professional (including a veterinarian) for the performance of medical or veterinary services.
- Compensation paid to a covered employee by an ATEO includes compensation payable with respect to the employee's employment by a related organization (including for-profit organizations
- The excise tax is also imposed on excess parachute (severance) payments. For purposes of Code Section 4960, parachute payments are amounts that both:
  - Are contingent on the employee's separation from employment.
  - Have an aggregate present value that equals or exceeds three times the employee's base amount.
- The base amount for this purpose is generally the employee's average annualized compensation includible in the employee's gross income for the five taxable years before the employee's separation from employment (or, if shorter, the employee's period of employment).

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II. Design Considerations for Executive Compensation Code Section 457(f)

- Proposed Regulations under Code Section 457(f) permit elective deferrals of current compensation and extensions of the substantial risk of forfeiture, subject to the following conditions:
  - The present value of the deferred amount must be increased to at least 125% of the amount that would have been paid if not for the deferral.
  - The full amount deferred (including the portion that would have been paid sooner if not for the deferral) must be conditioned on a requirement to provide substantial services, or to adhere to a qualifying agreement not to compete, for at least two additional years.
  - The arrangement must be made in writing (and irrevocable):
    - for initial deferrals, in the year before services giving rise to the compensation are performed; or
    - for extensions, at least 90 days before the substantial risk of forfeiture would have otherwise lapsed.

II. Design Considerations for Executive Compensation Code Section 409A

- Code Section 409A applies broadly to nonqualified deferred compensation arrangements of for-profit and tax-exempt organizations.
- Code Section 409A imposes a number of strict requirements on nonqualified deferred compensation, including restrictions on timing of deferral elections, distribution events, and ability to accelerate or further delay distribution of deferred amounts.
- Code Section 457(f) plans must either qualify for an exemption from Code Section 409A or comply with its requirements.
- Code Section 457(f) plans are often designed to be exempt from Code Section 409A as short-term deferrals.
- For arrangements subject to Code Section 409A, failure to comply causes deferred amounts to be includible in income and subject to an additional tax of 20% plus interest.

II. Design Considerations for Executive Compensation Split-Dollar Arrangements

- Tax-exempt employers may consider use of a split-dollar arrangement.
- One common form is a collateral assignment split dollar arrangement under which the organization pays premiums on a life insurance policy that is owned by the executive and collaterally assigned to the employer.
  - Premium payments are structured as loans from the employer to the executive that are generally repaid upon death.
  - Intended to avoid application of Code Sections 457(f), 409A, and 4960 as well as disclosure on Form 990 Schedule J.
- Very complex and long-term arrangements. Due diligence is key!
- Many states prohibit non-profits from making loans to directors and officers.

III. Investment Management Responsibilities and Endowment Stewardship

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III. What is a Supporting Organization

- A Supporting Organization ("SO") is a **509(a)(3) public charity**
- Exists to **support one or more public charities**.
- Typical roles include:
  - Grantmaking (common in colleges/universities).
  - Operating functions such as **managing endowments/investments**.

III. Forming a Supporting Organization

Objective: The Nonprofit may form a SO to manage investments.

Reasons for Forming an SO

- Create a more efficient investment platform
- Improve fiscal management by separating excess funds from the annual budget
- Enhance asset protection from legal claims

III. Asset Protection

- A SO is a **separate legal entity**, helping protect assets from the organization’s liabilities.

- However, risks exist:
  - **Creditor challenges** could claim the SO assets still belong to the nonprofit.
  - Control over the SO by the nonprofit could trigger “alter ego” claims.

- Best Practices for Asset Protection:
  1. Appoint **outside directors** with financial expertise to SO Board.
  2. Avoid **regular cash transfers** between the nonprofit and SO.
  3. Ensure **donor contributions** go directly to the SO.
  4. Maintain **adequate reserves** in the nonprofit to avoid undercapitalization claims.

III. Supporting Organization Types & Considerations

SO Relationship Types:

- SOs must meet **organizational, operational, and relationship** tests.

Type I SO (Parent-Subsidiary) – The Nonprofit appoints majority of SO's board.

Type II SO (Brother-Sister) – Same people manage/control both organizations.

Type III – *Not recommended.*

III. Emerging Revenue Challenges

- **Unrelated Business Taxable Income (UBTI)**
  - Definition – Income derived from any **trade or business** that is **regularly carried on** and **not substantially related** to the organization's exempt purpose.
  - The following three elements are required:
    - Trade or Business
    - Regularly Carried on
    - Not Substantially Related

III. Emerging Revenue Challenges

- **Unrelated Business Taxable Income (UBTI)**
  - Trade or Business – Any activity for the production of income from selling goods or providing services.
  - Regularly Carried On – Frequency and continuity similar to for-profit entities.
  - Not Substantially Related - Activity does not contribute meaningfully to the exempt purpose.

III. Emerging Revenue Challenges

- **Unrelated Business Taxable Income (UBTI)**
  - Exclusions from UBTI
    - Interest
    - Dividends
    - Annuities
    - Royalties
    - Rental income from real property

III. Emerging Revenue Challenges

- **Alternative Income Sources**
  - Joint Ventures
  - Mission Related Investments
  - Recoverable Grants
  - Examples

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Thank You

Questions?

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