NONPROFIT GUIDE:

Church Board Members

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Congratulations – you have just been elected and accepted a position to the board of directors of a church.

You want to do the job right. What do you need to do?

This eBook has been created to help directors, officers, and pastors think through governance and compliance issues when they are serving a nonprofit church entity. It is a tool for new board members to use as they think through all the basic issues that arise when sitting on a board.

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BASIC DUTIES OF DIRECTORS

While each state has its own specific statutes on the duties of directors, there are two basic duties that are consistent throughout the U.S. – the duty of care and the duty of loyalty.

The *duty of care* is fundamentally about acting prudently. The *duty of loyalty* is fundamentally about putting the interests of the corporation before the director's own interests. Directors of charities are required by law to carry out their responsibilities as directors "*in good faith, in a manner such director believes to be in the best interests of the corporation and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.*" This is known as the "business judgment" rule.

As a practical matter, a director cannot carry out his or her duty of care without minimally doing the following:

- A director must attend meetings and read materials provided at meetings and in advance of meetings. A director cannot exercise a duty of care if the director is absent.

- Directors must be familiar with the organization they represent, including the mission as set forth in the Articles of Incorporation and in mission statements, the activities of the organization, and the organizational structure and key staff positions.

- Directors should have a basic working knowledge of the main tax laws that affect the local Church.

Fortunately, the law permits directors to rely on experts. In performing their duties, directors are specifically allowed to rely on information and opinions prepared or presented by corporate officers or employees, other professionals including legal counsel, accountants, auditors, and board committees (on which the director does not serve), so long as:

- The director reasonably believes that the provider of the information or advice is competent and reliable as to the matter at hand, and
- The director "acts in good faith, after reasonable inquiry when the need therefor is indicated by the circumstances and without knowledge that would cause such reliance to be unwarranted."

The law sets forth a separate, but similar standard for directors in making investments on behalf of a nonprofit corporation. Charities are governed by the "prudent person" investment rule. However, an otherwise imprudent investment is allowed if it is either authorized or required by "an instrument or agreement pursuant to which the assets were contributed to the corporation."

CONFLICTS OF INTEREST

A conflict of interest is different than the duties of loyalty and care. A conflict of interest presents itself when a church needs to secure outside assistance and a director, or other interested party, provides the goods or services needed by the Church, or otherwise derives some benefit therefrom.

Each state is unique in outlining the contours of conflicts, but there is a general rule among all states that directors should not make decisions on behalf of a church if the director personally benefits from the from the decision.

Well run churches avoid conflicts of interest by adopting policies that prohibit certain types of conflicts and that require board members to disclose potential conflicts annually. A well-drafted conflicts of interest policy, containing a basic statement of policy and annual disclosure forms provide a significant benefit to a church. The depth and complexity of these forms will vary depending on the corporation, its activities, and its pre-existing relationship or affiliation with other for-profit or nonprofit entities.

The minutes of any meeting at which such a decision is made shall record the nature of the affiliation and the material facts disclosed by the affiliated person and reviewed by the Board of Directors or its Executive Committee.

Overall, except for potential self-dealing actions, a director who acts in accordance with the duty of care "shall have no liability based upon any alleged failure to discharge the person's obligations as a director. Similarly, a director involved in a potential self-dealing situation will not be liable if the Board follows the procedures as described above.

THE BASIC RULES OF INTERNAL REVENUE CODE SECTION 501(c)(3)

To qualify as a tax-exempt charitable organization, an entity must be organized and operated for one or more exempt purposes, and it must refrain from private inurement, electioneering, and substantial lobbying.

A. Governing Documents

The church's governing documents – whether articles of incorporation, articles of association, or a trust agreement – must meet certain requirements to satisfy the "organizational test," set forth in the Code. The documents must limit the Church's purposes to one or more of the purposes listed in IRC Section 501(c)(3).

Moreover, it must not "expressly empower the organization to engage, otherwise than as an insubstantial part of its activities, in activities which in themselves are not in furtherance of one or more exempt purposes." [1] In practice, the Church must also include an affirmation that it will not engage in prohibited political activities. Finally, it must make clear that its assets are irrevocably dedicated to one or more exempt purposes.

B. The Operational Test

Section 501(c)(3), taken literally, requires an organization to be operated exclusively for exempt purposes. However, there is a regulation, known as the Operational Test, that adds some flexibility to this requirement. It makes clear that a Church may qualify under Section 501(c)(3) if it is operated primarily for exempt purposes, even if an "insubstantial part" of the Church's activities may be devoted to non-exempt purposes.[2]

This means that a Church may operate a trade or business that is not related to the achievement of its exempt purposes without losing its charitable status under the tax law.[3] Private interests may also benefit from the Church's activities if that benefit is an unavoidable incident of the Church's otherwise proper activities. The Operational Test requires a Church to "establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family of the organization, or persons controlled, directly or indirectly, by such private interests." [4]

C. Private Inurement

IRC Section 501(c)(3) specifically requires that "no part of the net earnings of [the organization] inures to the benefit of any private shareholder or individual . . . ."The IRS Chief Counsel's office has written that "[i]nurement is likely to arise where the financial benefit represents a transfer of the organization's financial resources to an individual solely by virtue of the individual's relationship with the organization, and without regard to accomplishing exempt purposes." [5]

The IRS takes the position that "all persons performing services for an organization have a personal and private interest [in that organization] and therefore possess the requisite relationship necessary to find private benefit or inurement." [6]

The Tax Court has stated that an insider is a person who has a unique relationship with the organization by which they, by virtue of control or influence over the organization, can cause its funds or property to be applied for their own private purposes.[7]

IRC Section 4958 provides the IRS with the ability to impose intermediate sanctions, short of revocation of exempt status, on insiders who engage in excess benefit transactions. As the law under Section 4958 evolves, it is likely that the definition of insiders or "disqualified persons" will also be used to define insiders for purposes of the inurement prohibition. It is also likely that, given the right to impose intermediate sanctions on insiders who profit from a Church improperly, the IRS is less apt to pursue revocations on grounds of inurement.

D. Prohibition of Electioneering

A church may not support or oppose candidates for public office. The IRS considers this prohibition to be absolute. The Chief Counsel's office has stated that "an organization described in IRC Section 501(c)(3) is precluded from engaging in any political campaign activities." [8]

Some activities that initially appear overtly political may not, however, constitute prohibited electioneering. For example, students in a college political science course that were required to participate in political campaigns of their choosing as part of their course work, or in the case where a college provides faculty for a school newspaper that publishes student-written editorials on political matters, the IRS has ruled that the college was not itself breaking the rules against supporting or opposing candidates.[9] A church is also allowed to register voters, to urge registered voters to vote, and to educate voters, so long as its activities are nonpartisan.[10]

E. Prohibition of Substantial Lobbying

A church may not devote a substantial part of its activities to attempting to influence legislation. However, charities that are neither churches, nor private foundations may quite properly engage in legislative lobbying without risking their tax-exempt status, so long as lobbying remains an insubstantial part of their overall activities, by taking advantage of the provisions of IRC Sections 501(h) and 4911.

IRC Section 501(h) defines substantiality with reference to a Church's expenditures on lobbying, and Section 4911 defines precisely what is and is not lobbying.

Even under the "insubstantiality" test, much advocacy commonly conducted by charities does not rise to the level of lobbying. A Church can attempt to influence the actions of government officials aside from legislative decisions, advocate its views through public interest litigation, convene conferences on public policy issues even if those issues are controversial, and express its views on those issues through advertisements, all without engaging in lobbying as the IRS understands the term.

F. Unrelated Business Taxable Income (UBTI)

Churches, which are presumed to be tax-exempt under Section 501(c)(3) of the Internal Revenue Code, do not pay taxes on the income that they generate. There is an exception, however. Any Section 501(c) organization with unrelated business taxable income (UBTI) pays on that income at the regular corporate tax rates.

A Section 501(c) organization generates UBTI when it recognizes net income from a trade or business, which is regularly carried on, and which is not substantially related to the organization's exempt purpose. The regulations suggest that the term "trade or business" has the same meaning as it has under Section 162 in connection with analyzing the deductibility of business expenses.

Although there have been cases that analyze the "trade or business" element of the test, and although it is possible to have an income-generating activity that is not a "trade or business," as a practical matter, most potential UBTI matters that come to the attention of a practitioner are going to satisfy the "trade or business" element of the test. The stated purpose in Section 4958, "The Regulations", is "to place exempt organization business activities upon the same tax basis as the nonexempt business endeavors with which they compete."[11]

If an exempt activity is substantially related to the organization's exempt purpose, it does not generate UBTI. Section 4958 indicates that an activity is related to exempt purposes "only where the conduct of the business activity has a causal relationship to the achievement of exempt purposes," and the causal relationship must be substantial.[12]

In analyzing whether a particular activity is substantially related to an organization's exempt purpose, the organization must first examine the exempt purpose set forth in its own organizing documents and its own charitable purpose.

There are, of course, many other rulings and cases in this area. Some areas, such as the relatedness of associate member dues or insurance programs provided to members, have led to the development of significant bodies of law, while many issues that arise are supported by minimal precedential guidance.

G. Excess Benefits – Section 4958

Excess benefit transactions are transactions in which an excessive economic benefit is provided by a church to a disqualified person. A benefit is excessive if the value of the benefit exceeds the value of what the church received from the disqualified person. Typically, excess benefit transactions involve compensation of insiders, but they can also involve the sale or other transfer of a church's property, and they can involve the use by a disqualified person of a Church's property, including intellectual property.

"Disqualified persons" are persons who are, or in the previous five years have been, in a position to exercise substantial influence over the Church's affairs. The following persons are deemed to have substantial influence: members of the board of directors including the president, chief executive officer, chief operating officer, treasurer, and chief financial officer; their spouses, ancestors, children, grandchildren, great-grandchildren, brothers, and sisters; the spouses of the children, grandchildren, great-grandchildren, brothers, and sisters; and any entity in which such persons hold more than 35% of the control. In addition, the Board may determine that other persons exercise substantial influence over the Church's activities based on facts and circumstances. Such persons could include the founder of the Church, a substantial contributor to the Church, a person with managerial authority over the Church, or a person with control over a significant portion of the Church's budget.

Normally, when a Church engages in a transaction with a disqualified person (such as a major donor or a Board member), the Church must be prepared to demonstrate that it has taken appropriate steps to ensure that it is not providing an excess benefit to the insider.

Section 4958 describes the steps an organization may take to create a presumption that no excess benefit transaction occurs and to shift the burden of proof onto the IRS.

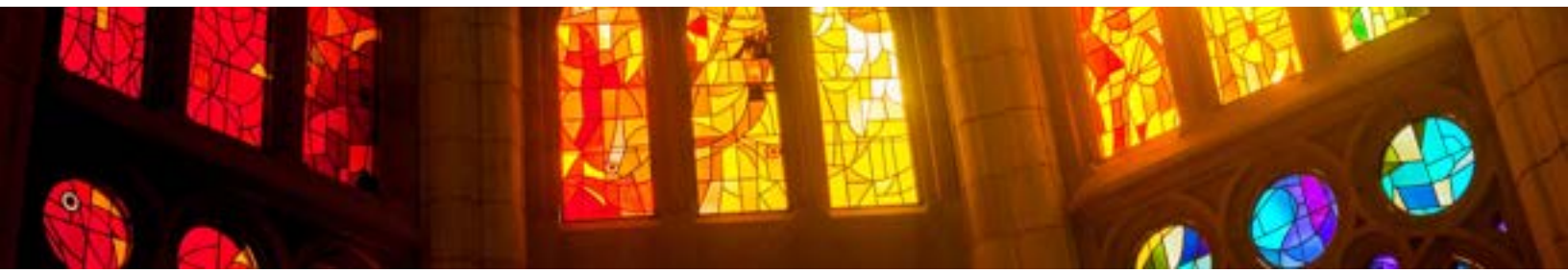
Under Section 53.4958-6 of the Regulations, payments under a compensation arrangement will be presumed to be reasonable, and a transfer of property or services between a Church and a disqualified person is presumed to be at fair market value, if the following conditions are satisfied:

- The compensation arrangement or terms of transfer are approved in advance by the Church's governing body, or by a committee of the governing body composed entirely of individuals who do not have a conflict of interest with respect to the arrangement or transaction; and

- The governing body or committee obtained and relied upon appropriate data as to comparability before making its decision; and

- The governing body or committee adequately documented the basis for its decision concurrently with making that decision.

To ensure that the board of directors is not inappropriately influenced by a director with a conflict of interest, the regulations provide that a director with a conflict of interest can meet with other members of the board only to answer questions. The director should otherwise recuse him- or herself from the meeting and should not be present during debate and voting on the transaction in question.



For the decision to be documented adequately, the written records of the governing body or committee must note:

(1) The terms of the transaction that was approved and the date it was approved;

(2) the members of the board or committee who were present during the debate on the transaction or arrangement that was approved and those who voted on it;

(3) the comparability data obtained and relied upon by the Board or committee and how the data was obtained; and

(4) the actions taken to appropriately exclude directors with a conflict of interest while the transaction was considered.

The records must be prepared by the next meeting of the Board or committee or 60 days after the final action regarding the transaction was taken and must be approved within a reasonable time after that.

AUDITS, INDEMNITY AND INSURANCE

i. Audits

The best practices of successful churches are to secure a yearly audit and financial statement from an independent certified public accountant in accordance with generally accepted accounting principles (GAAP).

If the audit firm also performs non-audit functions for the Church, the firm and its auditors must conform to the standards for auditor independence set forth in the Government Auditing Standards issued by the Comptroller General of the United. Audits give donors confidence in the donations provided and clarity for Directors and staff as to the income, expenses, and expenditures

ii. Director Liability and Protections

Individuals serve on church boards to provide a service. They exercise their fiduciary duties as directors because they want to be good, effective directors and because they care about the church they serve, and not principally because they want to avoid being sued.

Nonetheless, when lawyers talk about the duties and responsibilities of directors, we often think in terms of avoiding liability. The most effective way that a director can avoid liability is precisely to act diligently and with attention to the director's fiduciary duties.

Consider some of the possible claimants who might file suit or assert a claim against a nonprofit director:

- Members, fellow officers, or directors who believe that one or more of the directors acted without care or in bad faith.

- The Attorney General believes a director is responsible for causing the Church to squander charitable assets or has been involved in a self-dealing transaction.

- Employees who claim wrongful termination, harassment, or discrimination and who believe that the directors are responsible.

- "Outsiders" who believe that the Church has wronged them, and that the directors' actions or inactions caused the Church to act improperly, e.g., tort actions, breach of contract actions, libel and slander actions, and patent, trademark, and copyright infringement actions, to name a few.

- The Internal Revenue Service if it believes that a director has received an excess benefit, such as excess compensation, from the corporation.

iii. Director Indemnification

Sometimes even a director who acts correctly and in accordance with the director's statutory duty of care can be sued and might have to endure the hardship and expense of litigation (even if the director ultimately prevails). Indemnification refers to the payment by a corporation of, or an agreement by a corporation to pay, the legal expenses, judgments, fines, or settlement amounts that would otherwise have to be paid personally by an agent of the corporation. Some states provide for indemnification for directors. The best practice, however, is to include indemnification within the Articles of Incorporation and Bylaws.

Indemnification means one party agrees to pay for the losses of another to a third party. In most cases, indemnity protects the officer and director from paying legal fees, judgments and any other cost related to the service the director provided to the Church. It is good practice to include indemnity provisions within the Articles of Incorporation and Bylaws so that Directors need not worry about a personal loss for their service to the Church.

iv. Insurance

Both the corporation and directors will want to have adequate insurance to protect against different types of liability. The levels and types of coverage will depend on the size of the organization and the type of work it is doing. For example, a small church that makes grants may not need any insurance, while a larger organization that operates a program will need to think more carefully about its levels and types of coverage. The best way to assess an organization's insurance needs is to consult with a qualified insurance broker.

The *general commercial insurance* covers the corporation itself, rather than the individual directors and officers. It typically covers tort actions, such as slip and fall and other bodily injury. It may also cover contract damages. General liability insurance is either covered on a claim made or occurrence basis. For this type of insurance, occurrence basis coverage is usually preferable. Occurrence basis coverage means that the insurance in place at the time the act giving rise to liability occurred covers the claim. Claims made typically means that the insurance in place when the claim is made, rather than when the act occurred, covers.

There are a series of policies that protect an organization and its board and officers against claims that might be raised by employees.

Some key types of policies are:

- *Improper sexual conduct insurance coverage*. Board members should be particularly careful to understand what they are getting and not getting with this coverage. Frequently, insurers claim to offer this free "silent" coverage with the commercial general liability, because they do not specifically exclude improper sexual conduct. However, unless this coverage is purchased as a separate policy specifically providing coverage for improper sexual conduct, you likely will not have any coverage for your employees or volunteers. With the "silent" coverage, employees or volunteers who may be unfairly accused will receive no coverage at all under this insurance.

- *Employee Benefits.* This type of insurance covers damages from the negligent handling of the administration of your employee benefits program.

- *Employee Fidelity/Dishonesty Policy.* This type of policy can protect an organization from employee theft or embezzlement.

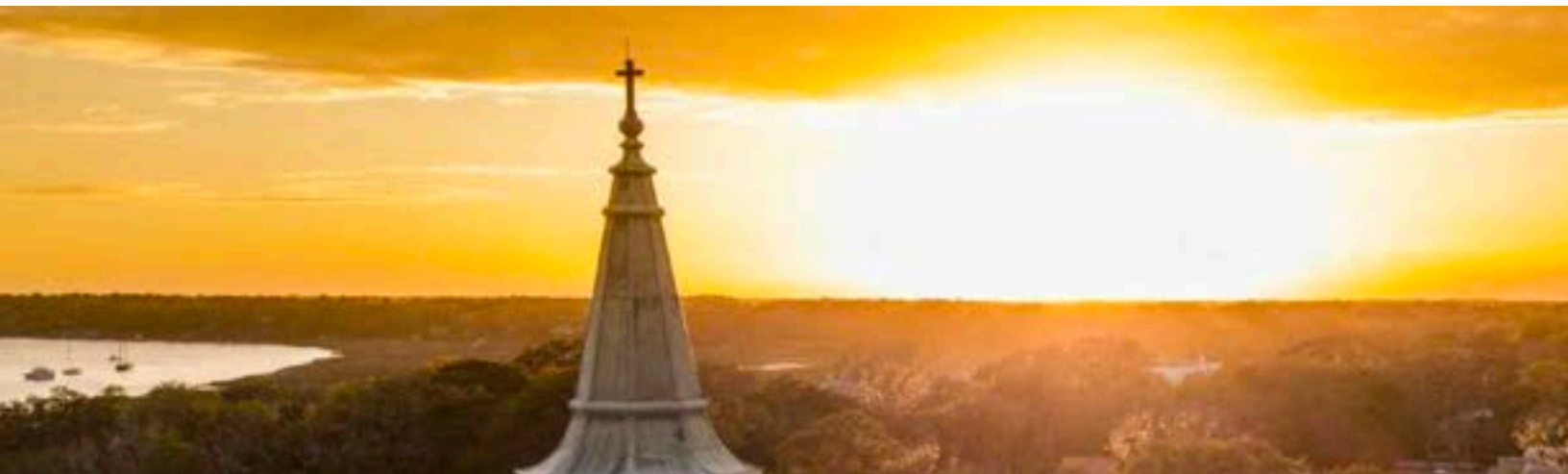
- *Employment Practices Insurance.* Some general liability policies simply do not cover actions by employees for wrongful termination or discrimination. Separate coverage may be available for these types of claims.

- *Director and Officer's Liability Coverage*. It is important to read the policy in conjunction with other policies to make sure that between all the policies of the organization, directors and officers are covered for all claims, including employment claims. The policy should ideally pay defense costs as they are incurred, not on a reimbursement basis. This can obviate the need for an advance from the corporation.

- *Umbrella coverage.* This coverage typically provides higher limits for a variety of coverages. For example, an umbrella policy may increase the limits of coverage on a commercial general liability policy, a business auto policy, and a director and officers' policy.

Conclusion

A well-run church is built on the foundation of solid governing documents, well crafted policies, and thoughtful measures drafted, designed, and implemented to ensure that the employees are protected, the donors are protected, and the directors and officers clearly know and understand their duties and obligations. Once the foundation is laid, the directors can move forward with the ministry of the Church. We hope that you found this eBook helpful, it is not designed to provide you with every answer to all your questions, nor is it a specific guide to your unique ministry. Rather, it is an overview of general duties of a board members and issues for directors to spot when they serve a church. You should work with a licensed and qualified attorney in your area to help guide you through this process.



References

[1] Reg. Sec. 1.501(c)(3)-1(b)(1)(i)(b)
[2] Reg. Sec. 1.501.(c)(3)-1(c)(1)
[3] IRC Sections 511-515, generally; Reg. Sec. 1.501(c)(3)-1(e)(2).
[4] Reg. Sec. 1.501(c)(3)-1(d)(1)(ii)
[5] Gen. Couns. Mem. 38,459 (July 31, 1980).
[6] Gen. Couns. Mem. 39,670 (June 17, 1987).
[7] *American Campaign Academy v. United States*, 92 T.C. 1053 (1989)
[8] Gen. Couns. Mem. 39,694 (Jan. 22, 1988)
[9] Rev. Rul. 72-512, 1972-2 C.B. 246; Rev. Rul. 72-513, 1972-2 C.B. 246
[10] IRC Section 4945(f); Reg. Sec. 53.4945-3(b); Rev. Rul. 78-248, 1978-1 C.B. 154.
[11] Reg. 1.513-1(c)(1).
[12] Reg. 1.513-1(d)(2).

About the Authors

Daniel P. Dalton is one of a handful of attorneys in the United States who specialize in religious land use matters. He is the author of the book Litigating Religious Land Use Cases, the sole authority on religious land use issues. Dan litigates these types of cases for most religious organizations throughout the United States.

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