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Independent Directors and Tax Exempt Organizations

In the wake of the corporate scandals and some highly-publicized controversies involving large nonprofits, there has been an increased focus on corporate governance in the nonprofit sector by regulators, the media, donors, and nonprofit leaders. The IRS and other watchdog agencies have put great importance on nonprofits adopting conflict of interest, and whistleblower policies. In addition, they have also placed a great emphasis on the independence of nonprofit directors. This is because the need for independent directors is much broader than dealing with conflicts of interest. It also touches on principles and practices involving accountability, fiduciary duties, and transparency.

Following the Enron scandal, Congress enacted the Sarbanes-Oxley Act ("SOX"). The purpose of the act was to improve corporate accountability and governance. While most of its provisions do not apply to tax-exempt organizations, SOX pays particular attention to the role of independent directors in the decision-making process of corporate organizations.

In addition, Section VI of the IRS Form 990, the annual return filed by each 501(c)(3) organization with annual gross receipts of $200,000 or more, asks the nonprofit to disclose the number of voting members in its governing body, and how many qualify as independent members.

This Alert offers some general guidance on what independent directors are and the role they can, and should, play within your nonprofit organization.

I. Applicability to Nonprofit Organizations

While the standards related to independent directors for tax-exempt organizations are constantly evolving, the key principles underlying the independence of board directors are applicable to good corporate governance. It is important to evaluate the unique characteristics of your organization to determine how your organization will be best served by the use of independent directors.

Most nonprofits should give serious consideration to having a majority of its Board comprised of independent directors. There are cases where a director who provides services to the organization may be overly deferential to management's actions for fear of losing an important customer. Similarly, directors related to employees of

the organization may be less critical of actions or recommendations made by such employees.

The idea is to always consider the best interests of the organization when creating an effective decision-making process.

II. What is an Independent Director?

In the instructions to the Form 990, the IRS defines an independent director as a person:

- Who is not compensated as an employee of the organization;
- Who does not receive compensation or other payments exceeding $10,000 from the organization as an independent contractor (other than reimbursement of expenses or reasonable compensation for services provided in the capacity of serving as a member of the governing body);
- Who does not receive, directly or indirectly, material financial benefits from the organization except, if applicable, as a member of the charitable class served by the organization; and
- Who is not a spouse, ancestor, brother or sister (whether whole or half-blood), child (whether natural or adopted), grandchildren, great-grandchildren, or in-law of someone who receives compensation or other material benefits from, the organization.

In short, "independence" under this definition requires that there are no financial or familial relationships between the director and the organization. At the very least, nonprofits should consider whether such relationships affect the ability of the director and the board to act in the best interests of the organization.[1]

III. How Many Independent Directors Should Our Board Have?

Many public companies are required to have at least a majority of the board to be independent directors. The national Independent Sector Non-Profit Panel suggested that a tax-exempt organization's board of directors consist of "a substantial majority" of independent directors. According to that guidance, this usually means at least two-thirds of the board's members. For small organizations, this may or may not be a difficult goal to reach. Nonetheless, such a policy can be phased in through the electoral process as board seats come open.

[1] The national Independent Sector Non-Profit Panel suggests the following definition:

Independent Directors should not:

- *Be compensated by the organization as employees or independent contractors;*
- *Have their compensation determined by individuals who are compensated by the organization;*
- *Receive, directly or indirectly, material financial benefits from the organization except as a member of the charitable class served by the organization; or*
- *Be related to anyone described above (as a spouse, sibling, parent or child), or reside with any person so described.*

IV. What Role Should Independent Directors Play on Our Board?

The specific roles independent directors can play on your board should, of course, be dictated by the size and needs of your organization. Even if there is not a majority of board directors who are independent, independent directors can play more specific roles. In order to comply with the IRS guidelines for conflicts of interest and determining executive compensation, the nonprofit should have only independent directors serving on the following committees:

- Audit Committee
- Compensation Committee

Additionally, all members of such committees should be independent of any outside consultants and advisors selected or recommended to the board.

It also makes sense to always include a majority of independent directors on the Governance or Nominating Committees and in any other Board decisions in which there may be the perception of undue influence on those directors with a financial or familial relationship—for example, decisions involving employee compensation.

Additionally, it may be worthwhile for the independent directors to meet periodically in executive session outside the presence of non-independent directors and senior management.

V. Additional Resources

You may find the following information helpful in determining the role of independent directors in your organization, and in general issues of non-profit governance:

- IRS, Form 990, Schedules and Instructions https://www.irs.gov/charities-non-profits/annual-reporting-and-filing

- Principles for Good Governance and Ethical Practice: A Guide for Charities and Foundations (2015) https://www.independentsector.org/wp-content/uploads/2016/11/Principles2015-Web-1.pdf

- The Nonprofit Quarterly, http://www.nonprofitquarterly.org/

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