

ARTS Law Memo

IRS Mandates Transparency

Among the best practices that emerged from the Sarbanes-Oxley Act of 2002 and other accountability standards promulgated by the Internal Revenue Service, Better Business Bureau, United Way and Independent Sector is adoption of a conflict of interest policy.

The new version of IRS Form 1023, the application organizations file to obtain tax-exempt status, asks whether or not the organization has adopted a conflict of interest policy. To further encourage organizations to say "yes," a sample policy is included in the application instructions.

How about established organizations? The same question appears on Form 990, the annual information return filed by large organizations. No doubt it will be included on Form 990-EZ, the "short form" for exempt nonprofits with incomes of less than \$100,000 and total assets of less than \$250,000, the next time that form is revised.

This issue of *Arts Law Memo* explains what constitutes a conflict of interest and provides guidance in adopting a policy. It also reviews the requirements for filing Form 990, highlights recent changes in the form and previews what may be coming soon. Finally, on page 4, you can read about our recent *Arts Law Memo* survey.

If your organization does not have a conflict of interest policy, please start the adoption process at your next board meeting.

THE BOARD'S LEGAL DUTIES

Legally, nonprofit directors have two duties: the duty of care, which requires the director to act as an ordinarily prudent person would under similar circumstances; and the duty of loyalty, which requires directors to act for the benefit of the

corporation, rather than for personal gain.

Duty of Care: A director is not required to possess specialized skills, but is expected to use practical judgment and common sense. The key to the duty of care is that decisions should be informed decisions.

Directors should attend regularly scheduled meetings, read minutes, approve an annual budget, understand financial statements and audits, and have a general understanding of how the organization is functioning.

When making decisions, board members should exercise independent judgment. Stewardship requires active participation. People who do not have the time to regularly participate should not agree to be on a board.

Duty of Loyalty: The duty of loyalty requires directors to act in good faith and in the best interest of the corporation. This duty requires directors to be aware of potential conflicts of interest and to disclose them with candor and refrain from voting on the transaction.

The duty of loyalty also requires directors to treat matters involving the nonprofit corporation confidentially, unless they are already common knowledge, and to support the majority decisions of the board.

CONFLICT OF INTEREST DEFINED

A conflict of interest occurs when a director has a material, financial or personal interest in the impending transaction with the corporation. A potential conflict of interest exists, for example, when an organization considers hiring a board member's relative or obtaining services from a board member's business.

In extreme cases, the Attorney General or Internal Revenue Service may challenge the board's actions, particularly when the conflict of interest is flagrant. The publicity associated with such actions will be destructive, perhaps fatal, to the suspect organization.

Recent decisions in Missouri and

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VLAA helps artists and arts organizations solve and avoid legal and accounting problems by:

- Making referrals to lawyers and accountants;
- Mediating arts-related disputes;
- Publishing *Arts Law Memo* and concise how-to guides;
- Sponsoring seminars and public forums;
- Arranging for guest speakers;
- Maintaining a reference library;
- Operating an arts space clearinghouse;
- Supplying model contracts and other arts law and business materials;
- Facilitating meetings;
- Conducting and disseminating research;
- Contributing articles to publications;
- Collaborating on arts advocacy initiatives; and
- Providing access to the national volunteer lawyers for the arts network.

This issue was written by VLAA Executive Director Sue Greenberg. It is based, in part, on VLAA's *Guide to Board Duties and Liabilities*, which was written by Peter H. Ruger.

This publication is distributed with the understanding that VLAA is not engaged in rendering legal or accounting counsel. We urge you to seek professional services to address your specific needs.

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Illinois provide examples of the bad publicity and financial liability that can occur when directors ignore their duty of loyalty and seek to profit to the detriment of their nonprofit.

A suit, *Nixon v. Lichtenstein*, brought by the Missouri Attorney General resulted in the removal of several board members and the reimbursement of funds spent for personal purchases.

A comparable Illinois decision handed down in *White Gates Skeet Club v. Lightfire*, castigated two directors on a nonprofit for their breach of their fiduciary responsibilities. The court prevented them from profiting from their wrongdoings.

More commonly, conflict of interest matters are handled internally. For example, S.I. Newhouse, owner of *Vogue*, *Vanity Fair* and *The New Yorker*, was forced to give up his coveted seat on the Museum of Modern Art board of directors after he bought Picasso's *Man with Guitar*, which the museum had decided to de-acquisition to fund new purchases.

The painting was sold to an unidentified art dealer who then sold it to Newhouse for \$10 million. Although Newhouse played no role in deciding that the painting should be sold, MoMA's conflict of interest policy prohibits trustees from buying works of art from the museum.

Arts organizations can operate in an atmosphere of fairness and integrity when board members serve the organization as a whole, not a particular constituency. They should avoid asking staff members for special favors, decline or return personal gifts of more than nominal value from those doing business with the organization and disclose potential conflicts of interest in a timely manner.

While conflict of interest concerns usually revolve around inappropriate behavior by board members, they also can involve paid staff. For example, the recent departure of the director of the San Francisco Museum of Modern Art was attributed, in part, to his business partnership with a commercial Web site that offers artwork for sale.

ADOPTING A POLICY

To ensure accountability, nonprofit arts organizations should establish a conflict of interest policy for both staff and the board of directors. The policy should cover all situations in which the organization's decisions could result in direct or indirect benefit to a member of the board or staff by setting out procedures to address actual or perceived conflicts of interest.

Disclosure is the essential first step in addressing a potential conflict of interest upon becoming aware that his or her personal or financial interest might be impacted by a potential board action, the director should disclose that interest to the board. Board minutes should reflect that disclosure.

The director also should refrain from voting on the transaction at issue and the minutes should reflect this action. While not required by Missouri or Illinois statute, a good practice is for the director involved in the transaction

to leave the meeting so that the rest of the board can freely discuss the issue. Following full disclosure, board members may approve the transaction, provided they find it to be in the corporation's best interest. Under these circumstances, the transaction would be legal.

Many boards find it desirable to go beyond these procedures to avoid the appearance of conflict of interest by soliciting requests for proposals or bids from potential service providers. This procedure allows the board to compare potential providers and choose one best suited to the board's needs. Other boards prohibit transactions with board members altogether, as many public bodies do.

Like other policies, your conflict of interest policy should be in writing, consistent with state law, tailored to your organization's specific needs and characteristics and adopted by the board of directors after thoughtful discussion.

Questions for Discussion

- What measures are needed to promote fairness and foster goodwill in the community?
- Are there special concerns related to your organization's mission, programming or aesthetic decision-making that should be addressed in the policy?
- What is the appropriate form of disclosure for board members to make known their connections with those doing business with your organization?
- How will the board elicit this information in a manner that is sensitive to the personal privacy of those who are involved? Do you need a mechanism for updating the needed information?
- How are staff members with actual or potential conflicts involved in your organization's transactions?
- Should your procedures go beyond what is required by law?

A sample conflict of interest policy is available on VLAA's Web site, www.vlaa.org.

Getting to Know IRS Form 990

The widely expected changes in IRS Form 990 appear to be arriving in incremental stages rather than as an extreme makeover. The forms, which already are the most commonly available source of financial information on the nonprofit sector because they are posted on the Web (www.guidestar.org), are taking on even more importance in the wake of executive compensation scandals, the Sarbanes-Oxley Act and Sen. Chuck Grassley's proposed nonprofit reform legislation.

Most of the 2005 revisions have to do with the disclosure of compensation and benefits for officers, directors, trustees and key employees. In addition, organizations completing Form 990 must disclose whether they have a written conflict of interest policy.

WHO NEEDS TO FILE?

Tax-exempt organizations with total income of \$25,000 or more are required to file Form 990, Return of Organization Exempt from Income Tax. Organizations with less than \$100,000 in income and less than \$250,000 in assets can file the 990-EZ Form, Short Form Return of Organization Exempt from Income Tax.

Schedule A includes compensation information on staff members who are paid more than \$50,000. In August, the IRS issued a revised Schedule A on which organizations will have to disclose the compensation provided to the five highest paid independent contractors for professional services and the compensation provided to the five highest paid independent contractors for all other services. This added and separate disclosure of professional service arrangements will help the IRS monitor potential conflicts of interest between professional service providers and leadership — both staff and board.

Schedule B, which lists contributors, must be attached to both the Form 990 and Form 990-EZ forms.

UNRELATED BUSINESS INCOME TAX

Even though your nonprofit arts organization is recognized as tax-exempt, it may still be liable for tax on the net income derived from commercial activities that are not substantially related to your tax-exempt purpose or functions. This tax, called the unrelated business income tax (UBIT), was enacted to prevent tax-exempt organizations from having an unfair advantage over for-profit enterprises that offer the same goods or services. Within reason, there is nothing illegal or unethical about having unrelated business income; your organization simply pays taxes at the corporate rate when the net income of those activities exceeds \$1,000. Unrelated business income is reported on Form 990-T.

FILING TIPS

Your organization's Form 990 is due 4.5 months after the close of your fiscal year. So if your fiscal year ended June 30, the form is due on November 15. An organization that fails to file a required return is subject to a penalty of \$20 a day for each day the failure continues. To obtain an automatic extension, use the new Form 8868, Application for Extension of Time to File an Exempt Organization Return. IRS forms and instructions can be downloaded from the Internet (www.irs.gov).

The Form 990 includes several sections. Donors and watchdog groups take special interest in Part II: Statement of

Functional Expenses. This section allocates expenses into three functions: program services, management and general, and fund-raising. If the percentage for programs appears too low, readers may question the cost effectiveness of your programs or overall operations. For example, the Better Business Bureau Standards for Charity Accountability say an organization should spend at least 65 percent of its total expenses on program activities.

Organizations also should take care in preparing the form's narrative sections. In Part III, the 990 asks for a statement of your organization's purpose and a list of program activities. The revised form allocates more space for these descriptions. Be sure your narrative tells your "story."

Organizations with total income of \$25,000 or more are required to file. Failure to file can result in substantial penalties and — heaven forbid — loss of tax-exempt status.

VIGILANCE NEEDED

How good is the quality of Form 990 reporting? Not as good as it should be. A recent study found that 30 percent of returns contained mathematical errors. An examination of required attachments found that a fourth of the organizations that were required to provide additional information failed to do so.

Clearly, more care is needed. The chief executive officer should review the Form 990 to ensure that it is accurate and complete. In addition, the BBB Standards for Charity Accountability say directors should see and understand the organization's Form 990. For a Web-based template that can be used to present highlights of the form to your board, visit the Minnesota Council of Nonprofits site (www.mncn.org).

PUBLIC DISCLOSURE REQUIREMENTS

Regulations that went into effect in 1999 require tax-exempt organizations to make their three most recent annual 990 returns and their applications for tax-exempt status available upon request. The names and addresses of contributors may be masked on copies made available to the public. Organizations are allowed to charge a small fee for reproduction and postage. Some organizations satisfy the "widely available" requirements by posting their forms on their Web sites or providing a link to Guidestar.

MORE CHANGES AHEAD

While the 2005 revisions do not constitute the major overhaul the IRS has been promising, more changes are anticipated in the coming years. They are expected to include mandatory electronic filing; requiring the highest-ranking executive to sign the forms; strengthened rules for granting extensions; penalties for errors; and a new short form for organizations not currently required to file. Stay tuned.

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Arts Law Memo Survey

Thanks again to everyone who completed our recent readership survey. We were pleased by the huge response rate – 26% – and can recommend SurveyMonkey.com with enthusiasm. Here are some of the findings that informed our decision to distribute *Arts Law Memo* electronically:

- 95% of the respondents have Internet access in their art organization office;
- Going electronic would increase circulation. Generally, one or two people per organization are reading the print version. However, 91% of respondents said they would be inclined to forward *Arts Law Memo* to board and staff members if it were in an electronic format.
- Readers seem just as likely to read and save issues electronically as they do to read and save the print version;
- Two-thirds of readers have visited recommended Web sites as a result of reading *Arts Law Memo*. This could be increased significantly by embedding links directly into an electronic version of the publication.

We will be making the transition from print to email distribution during the next few months. If you are unable to receive *Arts Law Memo* by email and would like to receive it by U.S. mail, please call us, 314/863-6930.

Finally, we will be incorporating your suggestions, especially regarding content, into our plans for upcoming issues.

Back issues of *Arts Law Memo* are available on
VLAA'S Web site, www.vlaa.org.