


PART ONE

Analysis

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Organizational Structure: Programs and Corporations

The nonprofit industry is enormous. Tens of thousands of such organizations are created every year. Exhibit 1.1 shows the growth curve for the last several years. Nonprofit organizations in the United States spend over \$340 billion each year. They employ nearly 7 percent of the total workforce and are responsible for 6 percent of the Gross Domestic Product. Universities, research centers, religious institutions, and museums produce priceless accomplishments. Nonprofit hospitals are major elements of our health care system and in many communities are the largest employer. Social service agencies provide a wide variety of services to those less fortunate citizens. Other nonprofits educate people of all ages and at all levels. Still others develop communities and support our social lives.

There are many ways to categorize this industry. The IRS's way is discussed later in this chapter. The traditional way is by the service provided and, to a lesser extent, the size of the nonprofit organization. This approach may not be particularly useful from a financial management perspective since services and even size alone do not necessarily say much about the nature of the financial management challenge, so we suggest a different way of thinking about the financial management challenge.

TYPES OF NONPROFIT ORGANIZATIONS

For financial purposes, a better way of looking at this industry is to sort it into categories according to the primary economic function the

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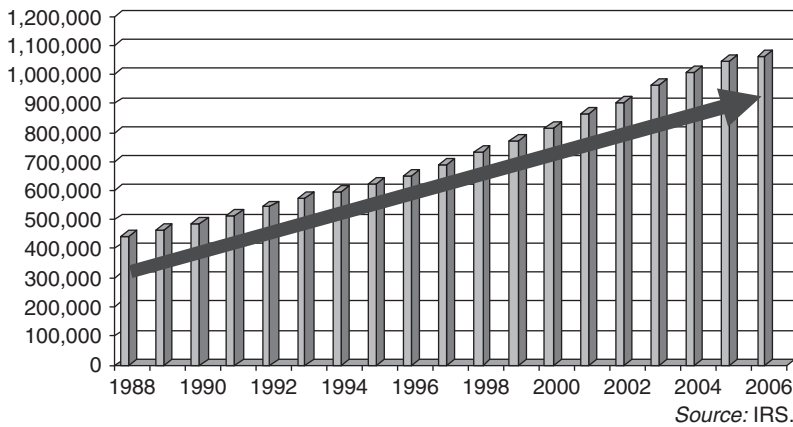


EXHIBIT I.1 Numbers of Nonprofit Public Charities 1988–2006

organizations perform. We suggest that there are six distinct types of non-profit corporations:

1. Direct service providers
2. Information managers
3. Resource distributors
4. Support and development providers
5. Grant makers or funders
6. Social organizations

Note that these groupings are chiefly for analytical purposes, and that the activities of many organizations can span several categories.

Direct Service Providers

These organizations are the classic nonprofits. Usually public charities, they are the hospitals, clinics, social service providers, and the like that provide some sort of direct and recognizable service to some or all of the public at large. Often major employers of professionals, these corporations provide a “hands-on” service.

Financial issues in direct service providers vary according to size and funding source. One characteristic that many share is the need to assemble

a workable mix of funders, and to be careful about managing the relationships between funders' requirements. Complexities abound in their financial management profile because governmental and quasi-governmental entities are often major funding sources. More on that subject later. Due to the limitations of government funding, philanthropy must also often play a role in direct service providers' management, and the stakes are high if money is accounted for inaccurately.

Payment in this field has moved from the traditional reimbursement for costs incurred to a defined price for a defined service such as one often finds in the health care field now. Level funding and cutbacks for many years has been the norm.

Information Managers

Another large category of nonprofits are the information managers—universities, museums, advocacy groups, trade associations, and a variety of similar organizations. Their role is to accumulate information of a predefined sort and share it with selected users, often in the role of broker. A university, for example, can be viewed as a broker between professors and students, or between researchers and consumers of research. Information management agencies range widely in size from the very smallest advocacy group to multibillion-dollar universities with international branches.

Consumers of information management services are multiple and naturally quite independent of each other; their financial systems must be capable of handling unusually massive quantities of information. These types of organizations tend to have memberships; therefore, the financial systems must store information about the same people for retrieval and usage over a period of years. In effect, membership records are the financial data.

In practice this scenario dictates a financial system, especially the revenue tracking component, that is capable of handling large numbers of small or large transactions. Frequently, the financial task is paralleled by the program manager's need to communicate with hundreds or even thousands of people, members and nonmembers. Fast and effective data management often becomes the only thing distinguishing one information manager from another, laying a heavy burden on the administrative infrastructure of each organization.

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Resource Distributors

Resource distribution agencies reached their zenith during the Great Society days of the 1960s. For a variety of political, psychological, and logistical reasons, the federal government did a lot of business directly with local nonprofit agencies, positioning them as the last stop before direct contact with eligible clients.

No doubt it was politically useful for these local players to wield ultimate distribution responsibility, thereby shielding the federal government from criticism. It was also smart to graft onto the organizations' existing formal or informal support systems rather than re-creating them from scratch. Community action organizations from the 1960s such as antipoverty programs and heating oil assistance services are good examples of resource distribution nonprofits.

The premiere financial demand of resource distribution nonprofits is strict accountability. In many ways, they serve as the social equivalent of general contractors, assembling a team of benefit or service providers in order to accomplish a coordinated job. In other cases, they act mainly as a final distribution point for transfer payments, usually as part of an entitlement program. Their work typically involves outreach, evaluation, and servicing of eligible clients. From the funders' perspective, however, their real value comes after the client transaction has occurred and they make their reports to the payments' source.

Owing to the demand for accountability, resource distribution nonprofits' financial systems will tend to be shaped by individual transactions and the funding source's rules. Most programs of this sort are expected to track the flow of money, not the effectiveness of the programs. Accountability in this context means careful accounting, not managerial success. Perhaps not surprisingly given their role as intelligent conduits, many resource distribution nonprofits end up looking a lot like the governmental unit that funds them.

Support and Development Providers

The fourth category of nonprofit corporations refers to support and development groups. These organizations are limited in number but play a major role in areas of the health and social welfare sector. In size and focus

they are not unlike resource distribution nonprofits, except that they concentrate on leveraging resources rather than simply marshaling them.

Financial management for support and development groups will be unremarkable except when ownership or financing of capital projects is involved. The task in these cases often relates to properly valuing assets, estimating the percentage of a project completed, and properly accounting for and reporting on funds received. The difficult aspect of financial management in the property acquisition or rehabilitation environment is dealing with irregular flows of cash in and out of the corporation and keeping track of which expenses are of the current period and which expenses should be considered part of the capital project.

Grant Makers or Funders

One of the most common of all types of nonprofits, grant makers or funders can range from the very smallest fund-raising agencies to massive private foundations. Their task is to raise money and decide who should get it, and, in the case of private foundations, raising the money may consist chiefly of effectively managing a portfolio of equities.

One of the things that makes the funder's financial management job at least theoretically easier than many in the nonprofit field—foundation CFOs, block your ears—is that things like revenue management may have to be done by outsiders such as investment managers. No financial officer can be expected to have the skills to manage a major chunk of investments, nor would the responsible board expect it. Moreover, there are arguments for accountability that favor separating investment management from operational tasks.

On a broader level, to do the grant-making job correctly, the funder needs to operate in a planned, disciplined fashion. Happily, good financial management can thrive under the same conditions. In effect, a funder is engaged in the business of shaping and directing streams of money over a period of years. This is a profoundly different dynamic than most other nonprofit categories, and it should not be underestimated in the context of designing a financial management system.

For all practical purposes, funders are accountable to no one. While the technical aspects of fund-raising and grant-making must be handled properly, it is relatively easy to hire skilled staff to see to that. Beyond the

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minimal level of legal compliance in both the public charity and the private foundation worlds, no significant person or authority is in a position to routinely challenge the workings of a funder. Ironically, this can be as much a hindrance to good financial management as anything else, since there is the possibility that complacency will crowd out effectiveness.

Social Organizations

The final entry in the list of major nonprofit types is social clubs and organizations. Whether fraternities, lodges, sporting clubs, quilting associations, or any of a vast array of other entities, they share the common theme that they exist in order to further the social interests of their members. Funding comes almost entirely from members' dues and from business transacted with members (such as restaurant and bar sales at clubs), and occasionally from rents or investments.

Typically, the financial stakes are low in a social club. Members usually have little interest in the details of financial management beyond seeing that the dues are collected and the bills paid on time. As a result, two of the greatest threats to a club's financial health are sloppy record keeping and fraud. The need for fiscal accountability is just as strong as in other categories, but much of the focus is likely to be on cash. One thing that tends to be true for social clubs is that their financial prowess is never any greater than what the membership demands.

STRUCTURE OF NONPROFIT ORGANIZATIONS

Programs

Programs are the most visible and best understood aspect of the nonprofit form of business organization, and its chief means of carrying out its mission. Also called services, projects, clinics, divisions, departments, floors, or any one of a thousand other names, programs are the activities of the nonprofit organization.

Coming up with a fair and workable definition of a program is difficult. Here's an attempt: A program is a coherently packaged group of activities, usually associated with one or more specific physical locations, designed to accomplish a stated result.

Nonprofit organizations run all kinds of programs, and often more than one. Day care centers offer infant care programs, environmental groups operate recycling systems, museums run art appreciation courses, and so forth. The two keys to understanding programs are that they generally have some coherent internal structure, and they appear as distinct choices to potential users.

In most nonprofit organizations, programs are like little businesses, with a structure reinforced by nonprofit accounting rules and one that has immense if largely unnoticed consequences for everything from compensation to organizational effectiveness. They represent a delegation of responsibility from the chief executive officer, and so they are the engines of mission. It is at the program level where the organization's goals are accomplished or not, and therefore those in charge of programs carry heavy moral pressure to get the job done.

Notice the use of the word "moral" in the preceding sentence. Typically, the motivations of those who run nonprofit organizations are different from those who do the same thing in the for-profit world, and the motivations of program managers everywhere are often different still from their bosses. We'll explore some of those differing interests later. For the moment, we'll use the program as the smallest management unit of the nonprofit corporation.

Corporations

The next major level of nonprofit management is the corporation that "owns" or runs the programs. The corporation is a statutory entity established by the legally sanctioned actions of one or more individuals. As a legally approved entity separate from its constituent individuals, the corporation has its own continuing existence. In legal theory, corporations are treated as distinct entities just like individual people, and corporations have their own collection of responsibilities, liabilities, and powers.

Why a corporation? The answer is disarmingly simple: because it's easier for the rest of us. Corporations can be mentioned in the same legal breath as the individuals who use their services, work in them, or simply exist in the same state with them. All are on the same legal footing, in that respect. The complicated and narrower answer to the question has to do with such practical considerations as revenue sources and liabilities.

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Revenue source regulations and political realities often nudge nonprofits in the direction of a specific type of organizational structure. Programs such as battered women's shelters almost of necessity start out as single-service corporations, while older and more established groups may have developed a multi-corporate structure.

There are also liability laws to consider when operating different types of businesses. Nonprofit public charities traditionally have been granted generous protection from state liability laws, although that tendency is beginning to change. It's a tradition growing out of English Common Law that

DROPPING OUT OF SCHOOL

The community center prided itself on being able to identify community needs and respond to them effectively over time. Unfortunately, their grand old 175,000-square-foot building had already chewed up substantial funding just to keep it running. They achieved their first operating surplus in years, but it was a tissue-thin \$7,900 on a budget of \$10,000,000. Projections for next year contemplated more red ink.

The most prominent program in their building was their Montessori school, which occupied only about 7% of their total space but represented half of their total employees. Moreover, it was running a regular six-figure deficit. As part of a strategic positioning process, the question arose: why are we doing this?

There was not an obvious answer. When a financial commitment of this size does not have a ready answer to this simple question, it is usually time for some re-thinking. Which the center did. As a result, the school was spun off as its own nonprofit public charity, with parents and teachers taking over the management. The happy ending is that the school now rents its space from the community center and is a steady source of earned income.

Ultimately, corporate structures are simply a way to organize programs and services in logical ways to achieve maximum results. What the community center realized was that a Montessori school, while obviously important to the community, was too much of a mission stretch for them. Re-casting the legal structures allowed the center to focus on the programs and services it was good at, while turning a management diversion into a source of revenue.

has been codified in many places around the country. Often there will be either an explicit limitation on suits or a prohibition altogether on the grounds that agencies funded by the public at large ought not to be siphoning resources into private hands via lawsuits. Liability considerations alone are not normally strong enough to determine a corporate structure, but the more favorable liability climate for public charities is clear.

The Role of the Internal Revenue Service

If programs sometimes seem fuzzily defined, there is no such problem with corporate structure. Unlike other forms of business organization, a corporation does not exist until certain governmental authorities say it exists. For nonprofit corporations, the lead voice in the chorus is the Internal Revenue Service (IRS). In matters having to do with nonprofit corporations, it is the IRS that giveth and the IRS that taketh away.

Corporations are organized according to the laws of individual states. Ordinarily, starting a corporation is as easy as filing the required paperwork and paying the necessary fees; in fact that is how all corporations must start. But government at all levels reserves the right to tax the profits of a business. In order to get the government to waive its right to tax—to allow a corporation to be *tax exempt*—a would-be nonprofit corporation must show that it has been created and will be operated with certain purposes in mind. It must do so according to preestablished guidelines spelled out in the code. Then it must wait for the IRS's decision on the application.

IRS acceptance of exempt status is the turning point. After this step, state government often must have its say about the organization's acceptability as a tax-exempt entity. Normally, state government is willing to follow the IRS's lead, so once the IRS has weighed in, it's usually pro forma thereafter.

In effect, the IRS considers all nonprofits to be taxable entities until they prove otherwise. The major thing that distinguishes a nonprofit from a for-profit corporation is that most nonprofits (including all charities) are not allowed to have shareholders with whom to share profits. Note that this is not a prohibition against profits, just against having shareholders with whom to share them. This is the reason why it is often said that the profits of a nonprofit are kept within the corporation—salaries, benefits, and perks notwithstanding.

The first permanent federal income tax was enacted in 1913, but affected less than one half of 1 percent of the population. Congress expanded the tax base in 1917, when it also initiated a deduction for charitable contributions.

Hybrid Corporations

In recent years there has been growing interest in what are sometimes known as “hybrid” corporations. These entities, approximations of which as of this writing exist in one state but not as a nationwide class of corporate entity, would combine the explicit profit-making and ease of capital formation characteristic of for-profit corporations with the social responsibility of nonprofits. Social enterprise practitioners are particularly interested in hybrid corporations because they often must create a basis for social responsibility in a for-profit, or manufacture ways to raise private equity (not donations) through a nonprofit. The compromises they must reach are unsatisfying or impractical, and that is what drives the search for a new form.

There is some precedent for these hybrid corporations, such as in England where the Community Interest Company form was approved in 2004, or in the United State where well-known groups such as Newman’s Own or Ben and Jerry’s Ice Cream have molded traditional for-profits into social enterprises. Even many nonprofits have experimented with for-profit-like structures and cultures. The difficulty is that these are one-of-a-kind ventures. Creative legal and financial advisors can often find ways to jerry-rig a structure that mimics a hybrid corporation, but until such options are well-defined, well-understood, and enshrined in law in all states, hybrid corporations will never really become widely accepted. This is the significance of the L3C form that first gained legal acceptance in 2008. This variation on the traditional LLC is specifically intended to support social enterprise and could become the first genuine prototype in hybrid structure.

An IRS Question: Private Foundation or Not?

Historically, Congress has disliked private foundations, which are a form of charitable organization, probably because of the abuses that occurred when they were first “created.” In 1969, the U.S. Congress laid the groundwork

for what we now call private foundations. In the process of paying attention to private foundations, however, a curious thing happened. The IRS actually developed a much clearer and better developed sense of what a private foundation is than what a public charity is. Consequently, it essentially regards public charities as nonprofit corporations that are *not* private foundations. This is why the IRS letter granting tax-exempt public charity status says that the applicant is a tax-exempt corporation that is not a private foundation.

The driving force around which the determination of private foundation or public charity status revolves has nothing to do with public mission but rather is usually a product of that old-fashioned determinant, money and its control. Whereas a private foundation derives its initial or ongoing funding from limited private sources, regulators expect the charitable organization to get its funding from the public at large. For many public charities, that hurdle is set at one-third of total revenue, although in a few obscure legal cases that percentage could be lower.

It is not hard to infer the authorities' motivation here. Private foundations' sole source of revenue being a single individual or family gives the founders tremendous control over determining who gets the benefits of the tax-exempt activity. It could also lead to a temptation to abuse that power if not kept in check. By obliging public charities to derive a substantial chunk of their revenue from the public at large, the Congress has virtually guaranteed that a public charity's management could never exercise the same degree of control.

Another IRS Question: What Type of Nonprofit?

So far it may seem like the nonprofit organization's only choice about tax-exempt status is between private foundation and not a private foundation, but the range of choices is much broader than that. In fact, the familiar nonprofit public charity is only one of several possible options under which a nonprofit corporation can operate. In official IRS parlance, nonprofits are organized under Section 501(c) of the code. What all of these types of corporations have in common is that (1) they are exempt from federal and usually state corporate taxes and, in the case of public charities, (2) they are not private foundations. Significantly, only 501(c)(3) corporations—and a few others, under certain circumstances—can offer donors the right to deduct contributions from taxable income. (See Exhibit 1.2.)

EXHIBIT I.2 TAX-EXEMPT ORGANIZATIONS AND OTHER ENTITIES LISTED ON THE EXEMPT ORGANIZATION BUSINESS MASTER FILE, BY TYPE OF ORGANIZATION AND INTERNAL REVENUE CODE SECTION, FISCAL YEARS 2003-2006

Type of Organization, Internal Revenue Code Section	2003 (1)	2004 (2)	2005 (3)	2006 (4)
Tax-exempt organizations and other entities, total	1,640,949	1,680,061	1,709,205	1,726,491
Section 501(c) by subsection, total	1,504,772	1,540,554	1,570,023	1,585,479
(1) Corporations organized under act of Congress	103	116	123	126
(2) Title-holding corporations	7,078	7,144	7,116	7,120
(3) Religious, charitable, and similar organizations [1]	964,418	1,010,365	1,045,979	1,064,191
(4) Social welfare organizations	137,831	138,193	136,060	135,155
(5) Labor and agriculture organizations	62,641	62,561	61,075	60,932
(6) Business leagues	84,838	86,054	86,485	86,563
(7) Social and recreation clubs	69,522	70,422	70,399	70,569
(8) Fraternal beneficiary societies	73,390	69,798	67,391	65,752
(9) Voluntary employees' beneficiary associations	13,366	12,866	12,567	12,206
(10) Domestic fraternal beneficiary societies	22,576	21,328	21,091	21,385
(12) Benevolent life insurance associations	6,662	6,716	6,718	6,738
(13) Cemetery companies	10,585	10,728	10,819	10,879
(14) State-chartered credit unions	4,338	4,289	4,083	3,976
(15) Mutual insurance companies	1,777	1,988	2,127	2,126
(17) Supplemental unemployment benefit trusts	468	462	448	438
(19) War veterans' organizations	35,132	36,141	36,166	35,982

(25) Holding companies for pensions and other entities	1,259	1,285	1,274	1,238
Other 501(c) subsections [2]	88	98	102	103
Section 501(d) Religious and apostolic associations	138	141	146	162
Section 501(e) Cooperative hospital service organizations	39	38	37	37
Section 501(f) Cooperative service organizations of operating educational organizations	1	1	1	1
Section 501(k) Child care organizations	0	3	2	6
Section 501(n) Charitable risk pools	0	1	2	2
Nonexempt charitable trusts	138,999	139,323	138,994	140,804

[1] Includes private foundations. Not all Internal Revenue Code section 501(c)(3) organizations are required to apply for recognition of tax exemption, including churches, integrated auxiliaries, subordinate units, and conventions or associations of churches.

[2] Includes teachers' retirement funds [section 501(c)(11)]; corporations to finance crop operations [section 501(c)(16)]; employee-funded pension trusts [section 501(c)(18)]; black lung trusts [section 501(c)(41)]; multiemployer pension plans [section 501(c)(22)]; veteran's associations founded prior to 1880 [section 501(c)(23)]; trusts described in section 4049 of the Employee Security Act of 1974 (ERISA) [section 501(c)(24)]; State-sponsored high-risk health insurance organizations [section 501(c)(26)]; and State-sponsored workers' compensation reinsurance organizations [section 501(c)(27)].

Source: *Internal Revenue Service Data Book, 2006*. Tax Exempt and Government Entities SE:T: BSP

LOSS OF TAX-EXEMPT STATUS—THE MONSTER WITHIN

There is a monster loose in nonprofit land. It is a monster few have seen but many can describe, summoned up from nightmares to give body to commonly held, nameless fears. It has the power to terrorize whole boards of directors, senior staffs, attorneys, accountants, managers, and donors. It is the monster called “Loss of Tax-Exempt Status.”

Like most monsters, this one’s power comes not from what it does directly but from its ability to govern our thoughts and shape our actions in anticipation of encountering it. And it is in the latter dynamic that the uncritical mind is most vulnerable to the advice of those who would pretend to have glimpsed the beast.

Let us make the monster slink away into the night, discouraged by reality. According to the IRS, in many years the total number of those organizations that lost their tax-exempt status is around 100. In 2007 the IRS revoked 116 tax exempt statuses (although the pace increased in the first half of 2008, with 98).

If this surprises you, it might be well to remember that the business of managing the tax responsibilities of tax-exempt organizations is, at least at their initialization, largely a matter of trust. The IRS trusts that organizations that say they are organized to benefit the public good will do just that, and since the only return that they file (Form 990) doesn’t determine the amount of money the government gets paid in taxes, there is little reason to systematically review it the way personal and for-profit corporate returns are handled. To put it another way, there’s little payoff for the IRS to go looking for trouble in this sector.

Revocation Not Typical of Public Charities

When trouble finds the IRS and results in these yearly 100 or so tax-exempt status revocations, it tends to fall disproportionately on groups that are not public charities. These organizations are social clubs, trade associations, fraternal organizations, and the like that enjoy tax-exempt status but are not considered public charities in the same mode as the more familiar hospitals and universities.

By far the biggest reason for exempt status revocation is that the corporations violated the prohibition against private inurement, meaning that

they used their tax-exempt status to illegally enrich individuals connected with the organization in some way. Public charities also tend to lose their tax-exempt status for political work on behalf of individual candidates, a strictly prohibited activity. Another major reason for loss of tax-exempt status in all types of tax-exempt organizations is a group's receipt of an excessive amount of income from an unrelated trade or business.

CHANGING TAX STATUS: A CASE HISTORY

The designations of tax-exempt entity are categories in the tax code for which each corporation must apply. The IRS has the final word on whether a corporation fits any given category. Organizations can change their selection of code if their mission or activities change. One organization, an association of nonprofit service providers, started life as a 501(c)(3). Why? The founder was candid, "We knew the options, but foundation grants were going to be critical."

Over time the organization changed its identity from that of charity to one involving considerable lobbying on behalf of its member corporations and others like them. Nonprofit charities that begin to do substantial lobbying, in addition to having to pay a tax on lobbying above the allowable limits, must rethink their tax code election. The clock was ticking, because the IRS has the right to examine the organization's performance over a four-year period and revoke its public charity status if they determine that the corporation never operated in a proper fashion.

Eventually, the association chose to change its status from a 501(c)(3) public charity to a 501(c)(4) social welfare organization. The tradeoff was explicit. In return for the opportunity to carry out considerable lobbying activity, the group gave up its right to receive tax deductible contributions. In this case, there was no real problem because they had long ago ceased seeking foundation grants and because increased lobbying was clearly in support of its evolving mission.

Here's the twist. That same organization realized that some of its activities such as running educational programs fit more comfortably in a public charity context. So, after changing their tax exempt status, they immediately created a *second* corporation, wholly controlled by the newly re-christened social welfare organization, for the sole purpose of running educational programs. This was a classic case of lodging the correct activities in the correct corporate structure.

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Why should nonprofit board members care about IRS policy on tax-exempt status termination when so few organizations actually lose their privileged tax status? The answer to this question is rooted in the same reservoir of public trust and social spiritedness that gives rise to the privilege of tax-exemption in the first place. All of these are ways in which a tax-exempt organization behaves like something it is not, particularly when it acts as a vehicle for private enrichment.

The vast majority of nonprofit leaders are ethical, committed individuals who need not worry about their actions even remotely endangering the organization's tax-exempt status. This is the greatest counterbalance to the tiny fraction who would exploit the public trust.

But a more compelling and far more subtle reason for understanding the real risks regarding loss of tax-exempt status is to be in control of one's own organization. Citing a danger that doesn't exist, presumed experts can exercise undue sway over the actions of a board or management team, insidiously discouraging the assumption of prudent risk or the exploration of innovative financial directions. Well-meaning advisors can work in monstrous ways.