Legal Guide for Arkansas Nonprofit and Volunteer Organizations

By

Bonnie Johnson, M.P.A., J.D.

Williams & Anderson PLC

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STATE OF ARKANSAS
MIKE BEEBE
GOVERNOR

From the days of the earliest settlers in the territory that was to become the State of Arkansas, neighbors have helped neighbors during good times and bad. Again and again, people banded together to raise barns, fight wildfires, and harvest crops.

In modern times, this same spirit is seen in volunteer service so evident across Arkansas. Adults tutor and mentor children in schools and after-school programs; police, volunteer firefighters, medical personnel, emergency coordinators, and members of faith-based groups respond when disaster strikes. Volunteers help to keep our highways free of litter, make our neighborhoods safer, mentor children from disadvantaged backgrounds, feed the hungry, and comfort the dying. Volunteers, who work through faith-based organizations, state or local agencies, private or nonprofit foundations, make life better for all of us.

I am proud to introduce this new publication, "*Legal Guide for Arkansas Nonprofit and Volunteer Organizations*", a resource and guide for nonprofit and volunteer management organizations. It is the result of a collaborative effort between the UALR Bowen School of Law, the Department of Human Services Division of Volunteerism, the Arkansas Service Commission, and Williams & Anderson PLC. Together, their efforts are a model for public-private partnerships. I am confident that this manual will become an indispensable tool for nonprofit and volunteer organizations as they work to improve the quality of life for all Arkansans.

Sincerely,

Mike Beebe

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Introduction

Glance at the news, whether you prefer to read it electronically or in print, and you soon realize that we are once again becoming a nation of service-minded individuals. Arkansans are ahead of this curve and in a position to demonstrate leadership in this era of renewed interest in service and in the non-profit sector. This book was written as a guide to help those individuals achieve their goals and see their projects come to fruition.

As Dean of the Bowen School of Law and as an inaugural faculty member of the University of Arkansas Clinton School for Public Service, I have a unique perspective on how people become interested in public service and volunteerism. Law degrees are often associated with high-powered individuals working in tall buildings and commanding large salaries. While some do use their education to pursue that type of career, many more end up pursuing service related careers, especially in the non-profit sector. The mission statement of the Bowen School of Law states that one of our five main objectives is "To serve public interest through a wide range of public service activities for the State of Arkansas…" By exposing our students to volunteerism during law school, Bowen Law School is fulfilling its mission and is itself providing a service to the community.

The "service connection" with the UA Clinton School for Public Service is much more apparent (the name of the school gives it away). The concurrent JD/MPS degree, a one-of-a-kind program, produces individuals who not only use their education to serve local communities but also the global community. Think of it – these students who have a connection to Arkansas are affecting change through service world-wide. That is exciting stuff.

I hope this guide is used often; by those whom I have had the privilege to teach and by those I'll never meet. I hope all of you experience the joy of seeing your ideas come to life, the reward of seeing your projects help those in need, and the satisfaction of serving instead of being served.

John M. A. DiPippa
Dean and Distinguished Professor of Law and Public Policy,
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CHAPTER I

The Birth of a Nonprofit

Big News in Little Dipper

Obesity and poor nutrition are major problems among children in communities across America. Claire Morgan's hometown of Little Dipper, Arkansas, is no exception. In fact, the Arkansas Department of Education had just published a study listing the children of Little Dipper Elementary School as among the heaviest in the state.

The report was front-page news in the Little Dipper Gazette and caused a tremendous stir among Little Dipperans. Mayor Janet Hightower called an emergency town-hall meeting. Because Claire is Mayor Hightower's personal trainer and a local physical fitness guru, the Mayor asked her to attend. Everyone at the meeting agreed that a comprehensive community initiative was needed. They even came up with a clever name for the program: K-Child, which stands for "Keeping Children Healthy In Little Dipper."

It seemed like the whole town had promised its support. Local car dealer "Big Bill" Robbins was so inspired that he immediately wrote a check for $10,000 and pledged his fleet of minivans to the program. Reverend Marcus Bailey said the program could use a spare office in his church's gymnasium. Principal Cynthia Roosevelt promised her cooperation and support in working with the children at the elementary school. Several people signed a mailing list to volunteer their skills and time to the effort. Claire volunteered to organize the entire initiative.

When she got home from the meeting, Claire was excited about all of the good things she planned to do to help the children of Little Dipper lead healthier, more active lives. At the same time, she began to wonder if she had taken on too much responsibility. Questions and doubts started to fill her mind: Did she need to have a meeting? Who was responsible for making sure everything worked out? What was she going to do with the check for $10,000? What if someone got hurt at an activity? Did she need insurance?

Introduction

Most of us have been like Claire at some point in our lives, facing a new challenge and not sure what to do next. This can be especially true when the law is involved—even a lawyer may need some time to figure out one's rights, or the legal implications of one's actions and decisions. The purpose of this book is to explain many of the legal issues that commonly face individuals in the field of volunteer program management. Recognizing that most of this book's readers will not have formal legal training, the authors seek to describe legal issues from the point of view of volunteer managers, in terms of situations they commonly face.

Each chapter of this book begins by describing a situation confronting the fictional Claire Morgan and her organization, K-Child, in the imaginary town of Little Dipper, Arkansas. From there, the authors discuss the legal issues that Claire may face, and what steps she can take to ensure that the interests of her organization, K-Child, are achieved. It is our hope that, after reading this book, volunteer managers will be more comfortable with relevant legal issues and will have a better idea of when it is time to contact an attorney.

Returning to Claire, it seems like she is off to a great start. She has an office, volunteers, money, and community support. So, why is she still worried? It turns out that there are good reasons for Claire's concerns, and a few things she needs to do before K-Child begins full-scale operations.

The Nature Of Nonprofits

Arkansas law recognizes three basic categories of organizations: governments, for-profit businesses, and nonprofits. Each category has distinct legal structures and the differences are significant under the law. The most notable characteristic of a nonprofit organization is that it cannot distribute its earnings to the individuals who control it.[1] Unlike a for-profit entity, a nonprofit does not have private owners or shareholders who benefit personally from the activities of the organization. In its definition of a corporation exempt from taxation, section 501(c)(3) of the Internal Revenue Code states that "no part of the net earnings . . . inures to the benefit of any

private shareholder or individual." This means that no part of the net earnings of the organization may be used to benefit a private shareholder or individual. A nonprofit may earn a profit and may even engage in commercial activities. (See discussion of unrelated business income tax, below.) For example, the Girl Scouts may sell cookies and the Red Cross may buy, sell, and hold real estate. Profits or earnings from these endeavors must be used in a way that furthers the nonprofit purpose of the organization. Nonprofit status is conferred by the State, but to be recognized as exempt from income tax, an organization must apply to the Internal Revenue Service (the "IRS").

This manual is written primarily for the incorporated nonprofit charitable organization that qualifies for tax-exempt status under Internal Revenue Code section 501(c)(3). Like most charitable groups that intend to solicit donations from the general public, K-Child will probably choose to incorporate and apply for IRS recognition of its 501(c)(3) status. It is possible, however, to operate as a nonprofit under a less formal structure.

Creating an Unincorporated Nonprofit Association

Under Arkansas law, K-Child could become an unincorporated nonprofit association without taking any formal steps. A group of at least two people agreeing to act for a common, nonprofit purpose is considered an unincorporated nonprofit association.[2] Although it has not filed any formal documents with the state, a nonprofit association is a legal "person," that is, it can own property and sue (or be sued) separate from its members.[3] This means that, if K-Child was a nonprofit association, Claire could open a checking account and enter into contracts in K-Child's name instead of her own. Even better for someone like Claire, K-Child's status as a nonprofit association would limit some of her liability for the organization's obligations.[4]

A person is liable (or has liability) if she may be held legally responsible to another person or to society.[5] Liability is an important idea in the law. If there is a lawsuit and a jury finds that a person is liable, the court can order that person to pay money to another person. As long as Claire tells the people she deals with that she is acting on behalf of K-Child, and not herself individually, she should not be liable for its debts.[6]

While several people have volunteered to help K-Child achieve its goals, it is not clear that anyone other than Claire can be considered a member of the organization.[7] For this reason, it is a good idea for Claire to undertake some formal steps so that everyone can be sure that K-Child is clearly a nonprofit association under Arkansas law. First, she should contact the other potential members and discuss the overall purpose of the

organization. Then, they should put their understanding in writing, stating the organization's name, describing its purpose, listing its members, and stating what property belongs to the association. This organizing document does not need to have any particular name, but it may be called the "Articles of Association," or "Constitution."[8] It should be signed and dated by at least two members.[9] Because Claire's organization already has significant funding and numerous volunteers, she may want to seek the help of an attorney to help K-Child come up with a more detailed organizing document. While state and Federal laws allow K-Child to operate as an unincorporated nonprofit association, most nonprofit associations choose to incorporate. The incorporation process is described below.

Incorporating as a Nonprofit

Although K-Child could continue to operate as an unincorporated nonprofit association, it will probably decide to become a corporation, a more formal structure that adds stability and credibility to the organization. The primary advantage of incorporation is that it limits the liability of board members and managers of the organization. Another benefit is that the law of corporations is better developed than the law of unincorporated nonprofit associations. Consequently, an incorporated nonprofit has a clearer legal position and its directors, officers and members are more likely to be insulated from liability. Foundations, for-profit corporations, and other donors may be unfamiliar with unincorporated nonprofit associations and, therefore, more comfortable giving to organizations that have incorporated. Similarly, banks and other businesses may be disinclined to deal with unincorporated groups. For these reasons, an organization like K-Child that intends to seek funding and expand its services will usually incorporate.

This is the point at which many groups like K-Child begin to wonder whether they need the services of an attorney. While it is certainly possible to establish a tax-exempt nonprofit corporation without legal assistance, an attorney who is knowledgeable about nonprofit issues can be a big help. Incorporating as a nonprofit is a fairly simple matter of drafting adequate articles of incorporation and filing with the Arkansas Secretary of State. After incorporating, most nonprofits seek recognition of their tax-exempt status from the IRS, a process that is considerably more complicated than incorporation. Legal representation, while not strictly necessary, can ease the burden of dealing with the IRS and free the group to attend to the many tasks inherent in getting a new nonprofit off to a good start.

Drafting and filing articles of incorporation

To incorporate as a nonprofit, K-Child will need to draft articles of incorporation and file them with the Arkansas Secretary of State. Under Arkansas law, the articles of incorporation must include:

- the name of the organization;
- the name and address of the corporation's incorporators;
- a statement as to whether the organization will have members (see discussion of membership below);
- an explanation of how the organization's assets will be distributed if it shuts down; [10] and
- the name and address of the corporation's first registered agent.[11]

The Articles may also include:

- a statement of the organization's purpose,
- the names and addresses of the initial directors, and
- provisions related to the management and governance of the organization.[12]

The Articles must declare whether the organization is a public benefit, mutual benefit, or religious corporation.[13] Usually a nonprofit that intends to seek recognition of 501(c)(3) tax status will be either a public benefit or religious corporation. A mutual benefit corporation is an organization such as a trade association or chamber of commerce that exists primarily to advantage its members. Since K-Child's purpose is to serve the children of Little Dipper and it is not a religious organization, it will be a public benefit corporation.

The office of the Arkansas Secretary of State is a useful resource for developing nonprofits. Its website, at *www.sos.arkansas.gov*, offers general information about nonprofit corporations and accommodates on-line filing of articles of incorporation. Articles of incorporation also may be filed at the Secretary of State's office in the Arkansas State Capital building, room 256. The filing fee is $50.[14]

Holding an organizational meeting

Once the articles of incorporation are filed, the incorporators or initial directors of the newly formed corporation should hold an organizational meeting.[15] The purpose of this meeting is to elect officers, adopt bylaws and conduct any other necessary business. The directors need to choose an "accounting year" and

authorize bank accounts and signatories, the filing of documents necessary to obtain tax-exempt status, and other actions necessary to begin operations. An organization's "accounting year" is the annual period that the organization uses for computing its income and keeping its books. Thus, the organization should choose an accounting year that corresponds with its natural cycle of financial activity. The organization can choose the normal calendar year, which would mean an accounting year that begins January 1 and ends December 31, or it can choose another 12-month period that ends on the last day of any month other than December. If initial directors are not named in the articles of incorporation, then the incorporators should elect a board of directors, which will then proceed to conduct the necessary business.

Arkansas reporting requirements

A new law passed by the 2007 General Assembly requires nonprofit organizations to make an annual disclosure to the Secretary of State.[16] By August 1 of each year, K-Child must file a statement with the Arkansas Secretary of State that provides the following information:

- The name of the corporation;
- The corporation's place of incorporation;
- The name and address of the corporation's registered agent for service of process;

- The address of the corporation's principal office;
- The names of the corporation's principal officers; and
- The names and addresses of the corporation's directors.[17]

If K-Child fails to file this statement within sixty (60) days after it is due, the Secretary of State is authorized to commence a proceeding to dissolve the corporation.[18]

Deciding Whether to Have Members

Some nonprofits choose to have members; others do not. The primary reason for members is to allow a large number of people to be involved in the governance of the organization by electing the board of directors and deciding other major issues. Members of a nonprofit organization may be compared to shareholders in a for-profit, but they do not hold stock and they do not really own the organization. If anybody can be said to "own" a nonprofit, it is the public served by the organization. Members and directors represent the interests of that public.

Membership can be a good way to build support for the mission of the organization, but only if members are motivated to stay informed and play a meaningful role. Recruiting members and keeping them informed and involved can be time-

consuming and expensive. A membership organization should have a good plan for keeping up with members and ensuring that they are involved enough to take their role, including election of the board of directors, seriously. The Arkansas Nonprofit Corporation Act of 1993 requires a nonprofit corporation to maintain a membership list, including an address for each member and the number of votes to which each member is entitled.[19]

Some organizations have "members" who are actually donors or participants with no power to elect the board of directors or otherwise participate in governance. For example, a nonprofit athletic club may charge "membership" dues to use its facilities, but not afford such members a vote. For the sake of clarity, it is better to find a term other than "member" to describe such persons. At a minimum, the organization should make it clear that these are non-voting memberships.

In most nonprofits without members, the board of directors is self-perpetuating, meaning that the board members themselves elect the board. For this system to work well, most boards will need to make an ongoing effort to recruit new members and otherwise provide for a turnover of power.

Tax-Exempt Status

As it now stands, K-Child may have to pay income taxes on money that the organization receives. In addition, anybody who makes a gift to K-Child will not be able to deduct the donation from his or her federal or state income taxes. Of course, both of these issues could make it much harder for the organization to raise money, do its work, and achieve its goals. For these reasons, K-Child should seek IRS recognition of its tax-exempt status immediately.

Attaining tax-exempt status

An organization may be exempt from state and federal taxation if it is organized and operated "exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international sports competition…or for the prevention of cruelty to . . . animals."[20] These organizations are commonly called "501(c)(3) organizations" because of the section of the U.S. tax code where the exemption is found. Because it is organized for the purpose of educating children about good nutrition and physical activity, K-Child will probably qualify under section 501(c)(3). Both unincorporated associations and incorporated nonprofits may seek recognition of 501(c)(3) status from the IRS.

K-Child will apply for tax-exempt status by using IRS Form 1023. Before K-Child may complete Form 1023, though, it must obtain an Employer Identification Number (EIN) from the Internal Revenue Service.[21] An Employer Identification Number is an organization's account number with the IRS, similar to an individual's Social Security Number. It is needed even if K-Child does not plan to have any employees.[22] K-Child can apply for an EIN by calling 1-800-829-4933, submitting Form SS-4, or visiting the IRS website at *www.irs.gov*.[23]

At twenty-eight pages long, Form 1023 is rather complicated, seeking information regarding the nonprofit's structure, operations, finances, fundraising activities, and membership.[24] It also requires that an organization's organizing document contain a "Purpose Clause" and a "Dissolution Clause."[25] Many nonprofits seek an attorney to help them obtain tax-exempt status, often the same attorney who helped to draft the organizing documents. Once the IRS issues a Tax Determination Letter, the nonprofit may also apply for an exemption from Arkansas income taxes using Form AR1023CT, a form much shorter than the federal version.[26]

Keeping tax-exempt status

After attaining tax-exempt status, K-Child will be subject to certain federal requirements and restrictions with which it must comply in order to maintain its tax-exempt status. These requirements and restrictions have similar objectives. They are designed to ensure that K-Child is conducting its affairs in a manner that furthers the purpose for which it was organized, educating children about good nutrition and physical activity. They are also designed to discourage K-Child from engaging in activities that cause K-Child to look more like a for-profit company than an organization with a charitable purpose.

IRS Form 990; Annual notice required under the Pension Protection Act of 2006

Each year most tax-exempt organizations must file a Form 990. Form 990 is often called an "informational return," as it requires the organization to provide the IRS with information about its receipts, disbursements, expenses, and all other information required under section 6033 of the Internal Revenue Code. Form 990 is not a typical tax return, in that it is not used by the IRS to determine the amount of tax owed. Rather, it is a mechanism by which the IRS is reassured that K-Child deserves to keep the tax-exempt status that it has been granted.

The following tax-exempt organizations do not have to file a Form 990: (1) "churches, their integrated auxiliaries, and conventions or associations of churches;" (2) certain

organizations that are not private foundations and whose yearly gross receipts normally do not exceed $5,000; and (3) "the exclusively religious activities of any religious order."[27] The IRS also has the discretion to exempt other organizations from this filing requirement, and it has done so by increasing the $5,000 yearly gross receipts limit to $25,000 for many tax-exempt organizations that are not private foundations.[28]

Even though there are several organizations that do not have to file a Form 990, the Pension Protection Act of 2006 (the "PPA") created new notification requirements for organizations whose yearly gross receipts normally do not exceed $25,000.[29] Under section 1223 of the PPA these organizations must provide, in electronic form, the following information: (1) the legal name of the organization; (2) any name under which the organization operates or does business; (3) the organization's mailing address and website address (if it has one); (4) the organization's taxpayer identification number; (5) the name and address of a principal officer; and (6) evidence of the continuing basis for the organization's exemption from the Form 990 filing requirement in section 6033 of the Internal Revenue Code.[30]

The Act also describes the penalty for an organization's failure to file a Form 990 or failure to comply with the Act's notification requirements. If an organization does not comply with the Form 990 or notification requirement for three consecutive years, the organization's tax-exempt status will be revoked.[31] An organization whose status is revoked must re-apply if it wants to have its tax-exempt status reinstated.[32]

Section 4958 intermediate sanctions

As mentioned above, Internal Revenue Code section 501(c)(3) states that "no part of the net earnings of [a tax-exempt organization may inure] to the benefit of any private shareholder or individual." This restriction is often referred to as the inurement limitation. The inurement limitation addresses transactions between an organization and "insiders," such as founders, directors, and officers. Inurement occurs when the insider receives a disproportionate benefit as a result of his or her control over the organization. Examples of a disproportionate benefit are paying excessive compensation to one of K-Child's officers or making a below-market rate loan to one of K-Child's board members. Under the inurement limitation, if an insider receives a disproportionate benefit, the only sanction is a severe one, revocation of the organization's tax-exempt status.

Because of the severity of the sanction, the IRS historically did not enforce the inurement limitation very often. There was a concern that an organization would have to suffer a

disproportionately severe punishment for a small inurement violation. Things changed in 1996 when section 4958 was added to the Internal Revenue Code. Section 4958 is known as "intermediate sanctions" legislation because it creates a middle ground between no sanction and the ultimate sanction (revocation of tax-exempt status) for violation of the inurement limitation. Rather than revoking an organization's tax-exempt status for engaging in an inurement transaction, section 4958 imposes a lighter penalty, an excise tax. This excise tax is imposed on the individual who benefited from the transaction, and the tax is twenty-five percent (25%) of the amount of the excess benefit that the individual received.[33] A lesser excise tax penalty may be imposed on any officer, director, or trustee of the organization if she knowingly allowed the organization to engage in the transaction; however, she will not be subject to the penalty if she can show that her involvement in the transaction was "not willful and [was] due to reasonable cause."[34]

A significant aspect of the section 4958 intermediate sanctions is that they apply to anyone considered a "disqualified person." An individual with a formal title, such as chairman of the board of directors, is a disqualified person. But, additionally, someone without a formal title, yet still in a position to exert substantial control over the organization, is also treated as a disqualified person.[35] Furthermore, the family member of a disqualified person is treated as a disqualified person for purposes of imposing the penalty, as well as certain entities in which a disqualified person owns more than a thirty-five (35%) interest.[36]

While the section 4958 intermediate sanctions appear daunting and penalty-oriented, most tax-exempt organizations appreciate section 4958 and its regulations. Before section 4958, an organization had no way to know whether a particular compensation package would be considered excessive compensation, in violation of the inurement limitation. The section 4958 Treasury Regulations describe a process that, if followed, will assure the organization that the payments it makes to a disqualified person, if such payments are part of a compensation package, will be presumed not to be an excess benefit transaction.[37] As a result of these regulations, organizations have been more inclined to pay higher salaries to their officers and directors, since now they know how to determine whether compensation is reasonable or excessive.

Unrelated business income tax

Despite the misleading label "nonprofit," nonprofits are permitted to earn a profit without automatically losing their tax-exempt status. The profit, however, must be used to further the organization's tax-exempt purpose. Despite the misleading label

"tax-exempt," tax-exempt organizations often are subject to taxation, such as the excise tax under section 4958 or the unrelated business income tax.

The unrelated business income tax is imposed when an organization engages in commercial activities that are unrelated to the organization's tax-exempt purpose. This means that if K-Child were to sell mouse pads and paper weights decorated with the K-Child logo, K-Child probably would have to pay income tax on the revenues derived from the sale of those items. On the other hand, if K-Child were to open a store that sold health foods and snacks along with books and magazines about nutrition, the revenues from the store probably would not be subject to the unrelated business income tax, as the sale of those items would be substantially related to the performance of K-Child's educational purpose.[38] In either of the situations described above, K-Child would not lose its tax-exempt status simply because it engaged in commercial activities. However, if K-Child was to expand its sale of mouse pads and paper weights into a large scale operation of an office-supplies store, at some point its commercial activities could jeopardize K-Child's tax-exempt status. A nonprofit that engages in commercial activities not substantially related to its charitable purpose should seek guidance from a tax professional in order to safeguard its exempt status.

Endnotes

[1] *See* Henry B. Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. Pa. L. Rev. 497, 501 (1981).
[2] Ark. Code Ann. § 4-28-501(2) (Repl. 2001).
[3] Ark. Code Ann. §§ 4-28-504, 506 (Repl. 2001).
[4] Ark. Code Ann. § 4-28-506 (Repl. 2001).
[5] Black's Law Dictionary 932 (8th ed. 2004).
[6] Mary Beth Matthews, *A Review of Arkansas Statutes Affecting Business and Other Organizations Enacted Since 1990*, 1998 Ark. L. Notes 65, 67 (1998) (citing Restatement (Second) of Agency § 320).
[7] A "member" is any person who, "under the rules or practices of a nonprofit association, may participate in the selection of persons authorized to manage the affairs or in the development of policy of the nonprofit association." Ark. Code Ann. § 4-28-501(1) (Repl. 2001).
[8] *See* I.R.S. Instructions for Form 1023 at 35 (June 2006).
[9] *Id.* at 7; Ark. Code Ann. § 4-28-501(2) (Repl. 2001).
[10] Ark. Code Ann. § 4-33-202(a) (Supp. 2007).
[11] Ark. Code Ann. § 4-20-105(a) (Supp. 2007).
[12] Ark. Code Ann. § 4-33-202(b).
[13] Ark. Code Ann. § 4-33-202(a)(2).
[14] Ark. Code Ann. § 4-33-122(a) (Supp. 2007).
[15] Ark. Code Ann. § 4-33-205 (Repl. 2001).
[16] Ark. Code Ann. § 4-33-131 (Supp. 2007).
[17] Ark. Code Ann. § 4-33-131(6).
[18] Ark. Code Ann. § 4-33-1420 (Supp. 2007).
[19] Ark. Code Ann. § 4-33-720 (Repl. 2001).
[20] 26 U.S.C. § 501(c)(3) (2006) (Supp. 2008); Ark. Code Ann. § 26-51-303(a)(9) (Repl. 1997).
[21] I.R.S. Instructions for Form 1023 at 6 (2006).
[22] *Id.*
[23] *Id.*
[24] *See generally* I.R.S. Form 1023 (2006).
[25] I.R.S. Instructions for Form 1023 at 7 (2006).
[26] *See* Ark. Dept. of Finance & Admin. Form AR1023CT (2007).
[27] 26 U.S.C. § 6033(a)(3)(A) (Supp. 2008).
[28] Rev. Proc. 83-23, 1983-1 C.B. 687; Rev. Proc. 94-17, 1994-1 C.B. 579; Rev. Proc. 2003-21, 2003-1 C.B. 448.
[29] Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat. 1090 (2006).
[30] *Id.* at § 1223(a)(i).
[31] *Id.* at § 1223(b)(1).
[32] *Id.* at § 1223(b)(2).
[33] 26 U.S.C. § 4958(a)(1) (Supp. 2008).
[34] 26 U.S.C. § 4958(a)(2).
[35] 26 U.S.C. § 4958(f)(1).
[36] *Id.*
[37] *See generally* Treas. Reg. § 53.4958-6.
[38] Treas. Reg. § 1.513-1(b).

CHAPTER II

The Nonprofit Board of Directors

K-Child, Inc., is Born

Mayor Hightower suggested that Claire talk to an attorney about the advantages of incorporating and getting tax exempt status from the IRS. Claire asked around and got the name of Sandy Stone, a local attorney who was familiar with legal issues related to nonprofit organizations. A few days later, Claire and Sandy met for breakfast at Dipper Diner on the Little Dipper town square. The two hit it off and Sandy was able to answer Claire's questions and explain the process of establishing a nonprofit corporation with tax exempt status.

Claire decided to invite people interested in the project to meet and talk about whether they should incorporate K-Child and apply for tax exempt status. On the appointed date, the group gathered in the spare office offered by Reverend Bailey. Claire reviewed what she had learned from Sandy about the advantages of incorporation and the importance of being tax exempt. The group decided K-Child should pursue both.

Luckily, Little Dipper is blessed with numerous active, community-minded citizens. One of them is Tim McSwain, the town's fire chief who also runs the little league (the "Little Dipper League," to be exact). Another is Zoey Wright, a retired school teacher and the owner of the Little Dipper Doggy Daycare. Tim and Zoey together volunteered to help Claire draft the Articles of Incorporation. They also agreed to serve as incorporators and initial directors.

Meeting the following week, Claire, Tim, and Zoey had to make some initial decisions in order to draft the Articles. They all liked the name K-Child and came up with the following statement of purpose: to improve nutrition, fitness, and general health among the students at Little Dipper Elementary School. They agreed that K-Child would not have members. When the Articles were completed, Claire filed them with the Arkansas Secretary of State and paid the required filing fee. K-Child, Inc., was born.

After incorporating, Claire invited Tim and Zoey to join her for an organizational meeting. Reviewing a proposal from Sandy, they decided to hire her to help them get tax-exempt status from the IRS. Tim volunteered to work with Sandy during that process. The three incorporators agreed that they needed to expand the board of directors in order to provide for effective governance of K-Child. Claire, Tim and Zoey decided that twelve directors, including themselves, would be a good start. Tim and Claire volunteered to interview community members and propose a slate of candidates. Zoey, who liked to write and had served on other nonprofit boards, promised to draft some bylaws for the others to consider. The three arranged to meet again in two weeks.

In the meantime, Tim and Claire talked to prospective board members. Some had never served on a nonprofit board and asked lots of questions. What was the purpose of the K-Child board? What were directors expected to do? Would they have legal responsibilities and liabilities? Sandy provided Tim and Claire with some basic information on the role and responsibilities of the nonprofit board to support their recruitment efforts.

Introduction

If K-Child is to prosper, Tim and Claire will need to take their recruitment duties seriously. Nothing is more important to the success of a nonprofit organization than a highly motivated, well-informed, active board of directors. The first step to having a great board is thoughtful recruiting. That means the organization will determine what skills and attributes it needs on the board and then look for people who match those requirements. Prospective directors should be informed about the responsibilities of board membership, the programs of the organization, and what will be expected of them if they are selected to serve.

Role of the Nonprofit Board

The role of a nonprofit board of directors is to safeguard the public trust by providing effective governance for the organization. Nonprofits occupy a privileged position in our society. Generally, they are exempt from income tax and enjoy other significant benefits. The tradeoff is that nonprofits exist to serve the public, not to generate profits for individuals. A nonprofit organization should hold itself to the highest standards of legal and ethical behavior. While everybody concerned – board, staff and volunteers – carries this responsibility, the board of directors sets the standard and oversees compliance with it.