Profitable Solutions *for* Nonprofits

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When does forming a subsidiary make sense?

More and more nonprofits are setting up for-profit subsidiary corporations to generate income. How do you know if you should follow suit? And if the move to a subsidiary is right, when should you take action?

Various factors may suggest that it's in your nonprofit's best interest to form a for-profit subsidiary. Here are examples of some of them.

APPLES, APPLES — AND A POMEGRANATE

Your nonprofit may benefit from the creation of a subsidiary if it runs a unique program with management requirements that are different from, or more extensive than, those of your normal operations. For example, let's say the (hypothetical) American Church of Providence comprises local churches across the country as well as a national and an international organization. The church creates a supporting program to generate current and deferred gift-giving and starts accepting donor-advised funds and other gifts requiring sophisticated investment strategies.

The church finds that greater financial and legal expertise is needed to manage the program than it has available. So it begins to add professional staff. It also engages outside experts: attorneys, accountants, estate planners and investment advisors. The program begins to operate with higher compensation levels than the rest of the organization and requires greater board and management oversight. Recordkeeping and reporting practices become extensive.

As its complexity grows, turning the program into a subsidiary makes financial and operational sense. Thus, the American Church of Providence *Foundation* is born.

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A GOLD MINE OF AN IDEA

You also might consider setting up a subsidiary if your organization has an operation that generates too much revenue that's unrelated to your primary mission. This *unrelated business income* (UBI) creates the potential for a future sale or passive operation or ownership.

Rainbow Valley, for example, is a fictional community service organization that acquires an older, and largely unused, shopping center. It develops the property for its own use as well as use by other nonprofits and commercial enterprises. The development requires taking out a substantial loan, leading to debt-financed income. And the nonprofit expects the shopping center's value to appreciate significantly. Before its opening, Rainbow Valley's executives and board decide to form a subsidiary, Joined Hands Village.

A HOT (OR WARM) POTATO

Wanting to reduce your nonprofit's liability also may warrant the creation of a subsidiary. Say a group of homeless shelters receive an estate gift of patents and copyrights for certain manufacturing processes involving some potentially hazardous materials used to make synthetics. The shelters decide to set up a plastics manufacturing and sales enterprise. This insulates the parent organization from liability (an accident at the plant, for example) and the plant's ownership remains confidential.

Placing certain assets or higher-risk activities under the umbrella of a corporate subsidiary should protect this nonprofit from the risk of lawsuits alleging negligence and similar claims.

THE NEED FOR GREEN

On the surface, the idea of starting a profit-making business may seem at odds with a nonprofit's exempt status. But you are allowed to generate surpluses (or net revenue) as long as you don't distribute them to board members or employees — a practice known as *private inurement*.

Just as individuals need a financial cushion as a safety net, nonprofits need surplus funds for emergencies and special expenditures, and to even out cash flows. Some of the most successful examples of for-profit ventures are those that enable an organization to further its mission while generating revenue to support it.

TAX-EXEMPT-STATUS PROTECTION

Creating a for-profit subsidiary also can enable a nonprofit to avoid jeopardizing its tax-exempt status. Although not-for-profits can engage in some degree of profit-making activities without losing their exempt status, they must pay unrelated business income tax (UBIT) on the profits from that activity. If the gross revenue, net income or staff time devoted to UBI becomes too substantial in the eyes of the IRS, an organization can potentially lose its exempt status. With a for-profit subsidiary, you don't have to worry about crossing the line and risking your exempt status or incurring UBIT. Although your for-profit subsidiary, either wholly or partly owned by your nonprofit, will owe corporate income tax on its net income, it can pass the after-tax profits on to you.

A possible side benefit of forming a subsidiary involves funding from untapped sources. Organizations sometimes find that setting up a for-profit business enhances their eligibility for funding from banks and private investors. Certain grants become available to nonprofits adopting more for-profit business models.

PRIORITIES, PRIORITIES, PRIORITIES

For-profit ventures are becoming more common with organizations seeking to establish steady revenue streams, improve their financial position and satisfy other needs. Yet they aren't without risks. If you do create a subsidiary, don't allow it to consume too great a share of resources. Otherwise, it may undermine your ability to carry out your primary mission. ✻

Your records retention policy

Be e-there or be square

To assess the effectiveness of your organization's records retention policy, ask yourself:

1. Does your policy spell out how long you must keep different types of records?
2. Is it geared only toward paper-based records?
3. Is it passed on only via word of mouth and not written down?

If you answered "yes" to the first question, good for you. If you answered "yes" to the second or third question, it's time to take action.

WHY DO YOU NEED ONE?

For a wide variety of reasons, your nonprofit needs to have a written records retention policy in place. And it needs to target the hundreds, or thousands, of electronic files that pass through your nonprofit's computers each year, as well as any records you still keep in paper form.

Federal law, including the Sarbanes-Oxley Act of 2002 (which regulates nonprofits in the areas of document retention and whistle-blowing) and 2006 amendments to the Federal Rules of Civil Procedure (FRCP), makes it essential that your nonprofit have an electronic and paper trail. Legally, an organization is required to preserve all documents and data that it "knows, or reasonably should know, will likely be requested" in pending or reasonably foreseeable litigation matters.

But the laws are moderate in requiring nonprofits, as well as businesses in general, to produce documents when asked to do so by an attorney or the courts. For example, an e-discovery amendment to FRCP, Rule 37, establishes a *safe harbor* protecting parties against sanctions for failing to provide electronically stored information (ESI) "lost as a result of the routine, good-faith operation of an electronic information system."

This safe harbor recognizes that ESI may be deleted due to an organization's routine document retention and backup procedures. So you need to have written records retention policies in place to support what's "routine" in your office.

In addition to these reasons, having an adequate records retention policy — and following it — can protect you in the event of a natural (fire, tornado or flood, for example) or man-made (computer virus, theft or hackers) disaster that disrupts your computer system and causes a significant loss of data.

If a disaster occurs, only the records that are archived on removable media or those stored off-site (either online or in a safe location) can be restored and the information contained in them retrieved. Although, in some disasters, recovery of data in the computer might be possible, the data might be unreliable and the process quite expensive.

WHAT KIND DO YOU NEED?

Your records retention policy should address both electronic and paper documents, and specify the length of time they should be retained. And this should be based on their content, not their format. For example, a policy of deleting all e-mails after 60 days (which would include those from co-workers, volunteers, donors and funding sources) is likely to violate your records retention obligations if those e-mails are relevant to a federal investigation or pending or threatened litigation.

Some nonprofits just keep everything forever. That way, there's no risk of deleting something important. But this "pack rat" approach is a poor solution. As your servers (and file cabinets and off-site storage) become cluttered with unneeded documents, it's more difficult, time-consuming and expensive to store, locate and retrieve the records you need. The better approach is to delete irrelevant records right away and to purge other records, according to the retention schedule in your policy.

WHAT ELECTRONIC TOOLS ARE APROPOS?

In the recent past, the mere management of paper-based documents was a major concern for most not-for-profits. Paper file folders were used for organizing documents onsite. Cardboard boxes and file cabinets were

WHAT RECORDS SHOULD YOU KEEP?

An important part of your records retention policy will be a schedule that shows how long different kinds of documents need to be stored. Retention laws vary from state to state and your professional advisors, including your CPA and attorney, should review them. The following guidelines can serve as a starting point as you sort out what to keep and for how long. The suggestions apply also to electronic files (including e-mail) and voicemail records.

PERMANENTLY:

- Articles of incorporation, charter, bylaws, minutes and other incorporation records
- Documents relating to exempt status, including original application 1023 or 1024, any follow-up documents before status was issued, determination letter, advance ruling, Form 8734 (filed five years later) and final determination letter
- Audit reports, annual financial statements, journals, chart of accounts
- Contracts still in effect
- Legal and other important correspondence
- Deeds, mortgages and bills of sale
- Insurance records, accident reports
- Loan documents
- Retirement and pension records, including summary plan descriptions
- Files of terminated employees
- Tax returns and worksheets

10 YEARS:

- Workers' compensation documentation

7 YEARS:

- Accounts receivable and payable ledgers
- Expired contracts, mortgages, notes, leases
- Expense analyses
- Donations and funded grants
- Personnel files (from termination date)
- Invoices and purchase orders
- Payroll records, timesheets and garnishments
- Withholding tax statements

5 YEARS:

- OSHA logs
- Insurance claims for loss/damage, accident reports, appraisals

3 YEARS:

- Bank records
- General correspondence
- Employee demographic info and applications
- I-9s – Compliance (from date of hire)
- Annual plans and budgets

1 YEAR:

- I-9s – Compliance (from date of termination)
- Internal audit reports
- Expired insurance policies

for temporary storage. Off-site facilities and warehouses archived documents on a longer-term basis.

Now, with electronic records being the norm, document management has evolved into the use of computer-based files and folders to keep your data organized; electronic databases for temporary storage; and removable media (for example, backup tapes and CD-ROMs) for longer-term archival storage. There are now even providers of archival storage using "hardware-free" online backup systems. An electronic records retention policy should cover all three purposes — on-site organization, temporary storage and off-site archival needs.

WHERE SHOULD YOU BEGIN?

A good starting point for developing a new — or revising an old — records retention policy is to review what you currently do. What records do you keep in storage and where are they stored?

Next, assess what you need to include in your new or revised policy. Start with the most critical records, namely those that could be subject to an audit or legal investigation, such as accounting, corporate, tax and legal/insurance records, and regulatory licenses and accreditations. Also include the files of current and terminated employees. As part of the process, interview your managers about the records created and received in

their departments. It's important to know where records are generated to determine if documents are original or copies. Naturally, you should know the record's purpose.

Weighing this information, decide what value the record is to your organization and how long it needs to be retained. For example, annual and quarterly reports, financial statements, articles of incorporation and bylaws, and board and staff meeting minutes, expense reports, inventories and invoices are vital in the event of an IRS or state agency regulatory audit of the nonprofit's activities and status.

The retention of grant-related documents usually is governed by the grantor agency and is spelled out in the grant documents. If it isn't, you should treat the documents as contracts, either still in effect or expired. (See "What records should you keep?" on page 5.)

WHO PROVIDES INPUT?

Before writing — or revising — your records retention policy, seek input from experts in a variety of areas, including information technology, tax, legal and insurance. This multidisciplinary approach helps ensure the policy addresses a wide range of issues such as the durability of the medium and applicable state and federal requirements. The final draft of your records retention policy must be approved by your board of directors.

Then distribute copies to your senior management, department managers and those responsible for managing records. Remember that any of the documents at your nonprofit may go through many hands. Make sure your staff, board and anyone who might come into contact with records understand your rules. Also consider the policy a living document — review and update it regularly.

ARE YOU PREPARED FOR THE FUTURE?

As your nonprofit ages, you'll have to manage a burgeoning amount of records. A solid records retention policy goes a long way toward ensuring that crucial records are safely stored and can easily be retrieved when needed. ❃

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3 TYPES OF INFORMATION YOUR BOARD MUST HAVE

How much — and what kind of — information do you need to give board members? That's a question often weighed by a nonprofit's staff, especially new managers and directors.

It's a tricky question, too, because you don't want to overload the board with unnecessary details — or information you're not ready to give them. On the other hand, you want to make sure you're supplying board members with the data they need to fulfill their responsibilities.

In a nutshell, there are three types of information that you should share with your board:

1. Financial. To fulfill their fiduciary duties, the board should review and approve Form 990 before it's filed. The board also must be provided with the results of any audits that have been conducted, salary information for key staff, and monthly and quarterly financial reports on income and expenses. What's more, they should receive proof of directors and officers insurance, if your organization provides it.

2. Strategic. This includes reports on your organization's work: how programs are being carried out, program usage statistics, progress on event planning and membership statistics. If your organization collects information from the audience it serves, through formal or informal means, provide at least an executive summary of your findings. It also may be useful to occasionally share with the board members internal reports and news articles that relate to your organization's mission, locations or audiences.

3. Board member related. To help foster teamwork and commitment, ask that members and key staff share brief bios and other relevant background information. Also publicly share thank-yous when board members make special efforts — whether those efforts are individual (such as securing an event sponsor) or group (performing due diligence on a new executive director).

Newsbits

PUTTING A PRICE ON VOLUNTEERS

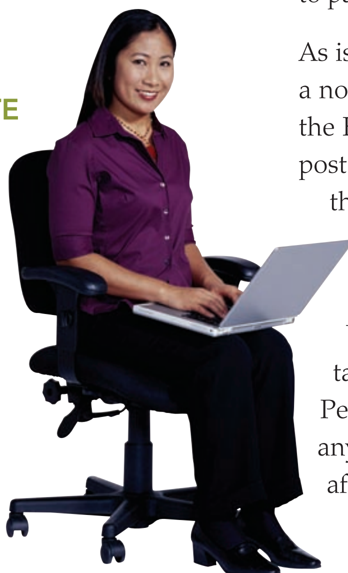
You surely appreciate your volunteers, but did you know that their time is worth about three times the minimum wage? Just as for paid workers, the value of a volunteer hour keeps going up, according to Independent Sector (IS), a nonprofit coalition representing about 600 charitable groups.

IS has reported that the value of a volunteer hour reached $19.51 in 2007, increasing from $18.77 per hour in 2006. Washington, D.C., had the highest hourly value ($30.10) in the nation. The top states were all found in the Northeast: New York ($26.18), Connecticut ($25.75), Massachusetts ($24.29) and New Jersey ($23.62).

The bottom six were West Virginia ($14.70), Arkansas ($14.63), North Dakota ($14.27), Mississippi ($14.08), South Dakota ($13.72) and Montana ($13.51).

IS calculates the hourly value of volunteer time based on the average hourly wage for all nonmanagement, nonagricultural workers as determined by the Bureau of Labor Statistics. A 12% increase is added to the estimate to account for fringe benefits. ❃

RESEARCH, APPLY FOR GRANTS ON BANK OF AMERICA WEB SITE



Capabilities recently added to the Bank of America's (BofA's) Philanthropic Management Web site now make it possible for nonprofits to investigate and apply for grants from almost 70 foundations the bank serves. The division distributes more than $350 million annually to charities on behalf of the foundations for which it serves as trustee or as a grant-making agent, according to BofA. ❃

FORM 990-T GOES PUBLIC

Your nonprofit must now make public the federal form that reports and calculates income tax on its unrelated business income (UBI), according to IRS interim guidance issued in May. As defined by the IRS, UBI is "income from a regularly carried on trade or business that is not substantially related to the organization's exempt purpose."

IRS Form 990-T is now subject to the same disclosure requirements as other annual information returns (Forms 990, 990-EZ and 990-PF) and applications for exemption (Forms 1023 and 1024). It must be made available for inspection by any individual during regular business hours at your main office and at any regional or district office with three or more employees. You must respond to in-person requests immediately and to written requests within 30 days. The public inspection rule does not apply when Form 990-T is filed solely to request a refund of telephone excise tax.

The form must be made available at no cost to the requestor. But organizations are allowed to charge a "reasonable fee" (currently 20 cents per page) for copying the document and to pass on mailing costs to send it.

As is true with Form 990 and applications for exemption, a nonprofit can comply with these requirements by posting the Form 990-T on its Web site. But the return must be posted "in a format that exactly reproduces the image of the return as it was originally filed with the IRS … including all schedules, attachments and supporting documents."

Until last summer, Form 990-T was considered a tax return and wasn't open to public inspection. The Pension Protection Act of 2006, however, mandates that any IRS Form 990-T filed by a 501(c)(3) organization after Aug. 17, 2006, is a public document. ❃

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