Determining Board Structure of the New Wellness Foundation

Presented to Foundation Task Force

February 8, 2018

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Directors Only or Directors and Members

- Members typically are a larger group than Directors and are those individuals who meet some criteria.  
  - Examples: Paying members of a museum

- Members typically (but not always) elect at least some of the Directors of the organization and may have reserved powers to make some major decisions regarding the organization.

- Ohio law does not require an organization to have members; an organization can have only directors.

- An organization will only have members if there is a reason to have more individuals other than the directors involved in the organization. Reasons include:
  - Dues revenue
  - Encouraging support for the organization; developing volunteer base
Requirements for Foundation

- Between 5 and 21 Directors
- Two Board members must be appointed by the Cleveland Clinic
- Mission must be for health and wellness in the City of Lakewood
Models of Board Organization

- Self–Perpetuating Board of Directors
- Representative Boards
- Members/Directors are different. Members select some Directors.
Self- Perpetuating Board

- Each Board of Directors selects its successors.

- Board members may be required to have certain qualifications:
  - e.g. all live in a community. (Board may set guidelines for nomination to the Board, such as diversity).

- Ultimately the Directors just select new Board members, and can change the qualifications and guidelines.

**Advantages**: Simple structure; Board members selected for their expertise and commitment to the organization.

**Disadvantages**: Board may become less diverse as each Board may elect future Board members who they know and tend to think like they do. (This can be minimized by a robust nominating process).

**Ability to Change Direction of the Organization**: Very easy. Except for the requirements under the Master Agreement, each Board can change anything else. For example, a future board could change the nominating process, change the mission and vision etc. This can be mitigated by requiring supermajority votes to change certain things.
Representative Board

- Some or all of the Board members are selected from outside sources. The Foundation must be in part a representative board, because two members must be appointed by the Cleveland Clinic.

- The Foundation could be created to have representation from other sources.

**Advantages:** Broader based community involvement than with the Self-Perpetuating Board. A greater degree of accountability as representatives on the Board will report back to their appointing authorities.

**Disadvantages:** Conflicts of interest if Board members are appointed from organizations that will receive money from the Foundation. Greater board turnover because appointing authorities may change their representatives. Overtime the Board may want to change what entities may appoint board members and this could become acrimonious.

**Ability to Change Direction of the Organization:** As with the Self-Perpetuating Board, change is very easy. This can be mitigated by requiring supermajority votes to change certain things. Change may be a little more difficult than with the Self-Perpetuating Board because Board members may feel accountable to their appointing authorities.
Member and Director Structure

- Foundation established as a Member organization. (who would members be? Community members who want to join? Representatives from health and wellness organizations within Lakewood?).

- Members elect some number of the Directors.

- Members retain reserved powers to approve change of certain provisions of the Code of Regulations such as how Board members are selected; mission etc.

**Advantages:** Broad based community involvement; process for getting continued input from the community.

**Disadvantages:** Very cumbersome; must develop a method for keeping track of members; members may elect Board members with agendas counter to the best interest of the Foundation (this can be mitigated in part by a nominating process).

**Ability to Change Organization:** Difficult. If Members are given the right to approve major changes, it will be difficult to obtain the approval of a large, diverse group of individuals who are not significantly involved with the organization.
TAX STRUCTURE

- **Choices:**
  - Public Charity–509 (a)(1)–broad based community support (no tax on income)
  - Public Charity– Supporting Organization (no tax on income)
  - Private Foundation (tax on income)
Public Charity—Broad Based Public Support

- Mathematical tests must be met. At least 1/3 of organizations revenue (not including revenue in furtherance of its tax-exempt purpose) must come from public sources or government. Contributions from any one source can only be counted to the extent that it doesn’t exceed 2% of the organization’s total support; except contributions from the Cleveland Clinic are not subject to the 2% limitation and can be counted in full.

- This means the Foundation is likely to qualify as a 509 (a)(1) organization for about 15 years, after which it may need to change to a private foundation.
Public Charity—Supporting Organization

- The Foundation could be set up to support another 501(c)(3) organization. The supported organization must be given the right to appoint (or approve) a majority of the board members of the Foundation.

- No mathematical tests to meet.

- This could work well unless the supported organization refused to appoint the board members suggested by the Foundation. If that were to happen, the Foundation could change to be a 509(a)(1) public charity (if it qualified) or a private foundation.
Private Foundation

- Foundation would be autonomous, not subject to any other organization approving its Board members; and it would not be subject to any mathematical tests.

- 1% tax on net investment income

- Must expend 5% of its assets in furtherance of its tax-exempt purpose
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TO: Foundation Planning Task Force

VIA: email; handout

FROM: Susan Scheutzow; Kevin O’Connor

DATE: February 4, 2018

RE: Selection of Tax Exempt Structure for Lakewood Wellness Foundation

The selection of the tax-structure for the new Lakewood Wellness Foundation (“Foundation”) is one of the major decisions to be made by the Lakewood Wellness Foundation Task Force (the “Task Force”). The choices are to organize as a 501(c)(3) public charity or a 501(c)(3) private foundation.

Before that decision can be made, the various types of public charities and the restrictions upon them must be analyzed and then compared with the private foundation restrictions.

**Public Charities**

There are two types of public charities for the Task Force purposes: 509(a)(1), 170(b)(1)(a)(vi) and 509(a)(3) supporting organizations. (There is also a classification of 509(a)(2) but this is usually used by organizations that receive considerable revenue from offering services in furtherance of their exempt mission, for instance nonprofit nursing homes.)

1. **Characteristics of a 509(a)(1), 170(b)(1)(a)(vi) organization.** This type of organization is a stand-alone organization, meaning it is not created to support another organization. This organization must meet the following strict financial tests in order to maintain its public charity status:

   At least 1/3 of the organization’s total “support” must be public support.

   Total support = gifts, grants, membership fees, gross investment income, tax revenue levied for the organization; unrelated business revenue.

   Public support = contributions from the general public only to the extent contributions from any one source do not exceed 2% of the organization’s total support; all contributions from governmental entities and all contributions from other 509(a)(1) 170(b)(1)(a)(vi) organizations.

(There is also a facts and circumstances exception where the IRS may determine that only 10% of the organization’s revenue must be public support.)
Of significance to the Foundation, is that *all* the money from the Cleveland Clinic will be considered in total as public support because the Cleveland Clinic is also a 170(b)(1)(a)(vi) organization.¹

If the only funds the Foundation is to receive over the years are the contractually obligated funds from the Cleveland Clinic, and as long as investment income does not exceed 2/3rds of the total of the funds from the Cleveland Clinic plus the investment income, the Foundation should continue to qualify as a public charity.

Looking at the payment schedule from the Cleveland Clinic, it is likely that the Foundation would continue to qualify as a public charity under this section of the Tax Code until at least year 16 when the Cleveland Clinic contributions cease.

(This should, however, be modeled out using various assumptions regarding investment income and use of funds in furtherance of the Foundation’s tax-exempt purpose. For instance, if the Foundation made no expenditures for 16 years, and simply invested its funds, and investment income was high, the time at which the investment income exceeded two-thirds of total of the funds coming from the Cleveland Clinic plus the investment income, could come at a point prior to 16 years.)

**Advantages of proceeding under 509(a)(1);170(b)(1)(a)(vi):** The Foundation does not need to be organized to support another organization; there is no tax on the Foundation’s investment income; there is no mandatory amount of expenditures in any one year.

**Disadvantages of proceeding under 509(a)(1);170(b)(1)(a)(vi):** If the Foundation remains a grant-making organization and there are no new sources of contributions developed, the Foundation will probably need to convert to a private foundation within about 15 years of its operation.

2. **Characteristics of a Supporting Organization.** The other alternative available to the Foundation would be to become a public charity which qualifies for supporting organization status under Section 509(a)(3). The benefit of being a supporting organization is that there are no numerical tests to be met to show public support. However, in order to avoid such tests but to nonetheless show broad based public support, a supporting organization must be organized to

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¹ Many of the readings which have been presented to the Task Force are considering conversion foundations which receive initial funding from a for-profit entity, which would be capped out at the 2% limitation. The Foundation is different because its funding is coming from another public charity. Therefore, the consideration that the Foundation may qualify as a 509(a)(1); 170(b)(1)(a)(vi) organization has not significantly discussed in some publications.
support another 501(c)(3) organization or governmental entity and that entity must be able to exercise significant control over the supporting organization.

Supporting organizations are usually created specifically to support another 501(c)(3) organization (hospital foundations, foundations supporting public or private schools etc.) In this instance the Foundation is really not being created to support another organization but is being created to support wellness in the City of Lakewood, and it may do this through making grants to other 501(c)(3) organizations.

It would be possible for the Foundation to be created to support a class of organizations such as “all 501(c)(3) organizations providing wellness services in the City of Lakewood and the City of Lakewood”. In order for the Foundation to have such a broad class of supported organizations, the Foundation would either need to allow these organizations, in some manner, to select many of the directors of the Foundation, or allow those directors to provide meaningful input into the operations of the Foundation. Since the Foundation will be making decisions about funding from amongst the class of supported organizations (all supported organizations can’t be supported all the time), such a structure could create untenable contradictory input from all of these organizations.

Concurrently with the decision about tax-status, the Task Force is also making a decision about the selection of directors for the Foundation. If the decision is to provide broad based representation from various community organizations on the board of directors (see concurrent memorandum on board structure), a certain number of board members could be chosen from some of the donee (supported) organizations. (This does not mean that all funding must go to those supported organizations.) We recommend, however, that the decision regarding appropriate board representation be made on the basis of what makes sense in furtherance of the mission of the Foundation and that decision not be made based on the potential preferential tax treatment of being a supporting organization.

**Advantages of proceeding under 509(a)(3), supporting organization.** There is no tax on the Foundation’s investment income; there is no mandatory amount of expenditures in any one year; there are no numerical tests to be met.

**Disadvantages of proceeding under 509(a)(3).** The Foundation must be created to support another organizations or a class of organizations, giving up some control to these organizations.
**Private Foundations.**

Private foundations are subject to a number of restrictions not applicable to public charities. The two most relevant to the Foundation are:

1. The organization must expend at least 5% of its assets in furtherance of its charitable purpose each year;

2. The organization is subject to either 1 or 2% tax on its net investment income (including capital gains). The Internal Revenue Code reduces the excise tax on net investment income of a private foundation from 2% to 1% if the foundation makes sufficient qualified distributions during the tax year. The organization may not provide gifts or grants to any person significantly controlling the organization.

Private foundations, however, are totally independent and do not need to be created to support another organization.

The requirement that the Foundation expend at least 5% of its net assets each year should not pose a problem for the Foundation, as it is intending to make grants and/or be involved in programming; therefore the Foundation should qualify for the 1% reduced tax. To the extent that the Foundation generates over 6% in investment revenue on an annual basis (5% expenditures and 1% tax), the Foundation should be able to continue for long time if it determines that it wants to remain a Foundation in perpetuity.

The Internal Revenue Code attempts to prohibit, through penalty excise taxes, certain types of behavior ("prohibited transactions") between private foundations and persons who stand in special relationships to the foundation ("disqualified persons"). Disqualified persons include substantial contributors to the foundation, officers and trustees of the foundation and corporations which are, in one or more ways, affiliated or related to the foundation itself or to contributors to or officers or trustees of the foundation. A “substantial contributor” is any person who contributes an aggregate amount of more than $5,000 to the foundation if such amount is more than 2% of the foundation’s total contributions in the taxable year.

Prohibited transactions generally involve transfers of value between disqualified persons and the foundation. For example, sales, exchanges or leasing of property between a private foundation and disqualified persons, the lending of money or other extensions of credit between private foundations and disqualified persons, the furnishing of goods or services between a private foundation and disqualified person, payment of compensation by a private foundation to a disqualified person (other than reasonable compensation for personal services necessary to carrying out the foundation’s exempt purposes) and transfers to, for use by or for the benefit of, a disqualified person of the income or assets of a private foundation are all prohibited transactions.
Advantages of proceeding as a private foundation: The Foundation is not accountable to any other organizations, does not need to show broad based public support.

Disadvantages of proceeding under 509(a)(3). One percent tax on investment income; required to make annual expenditures in furtherance of its tax exempt purpose.
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One of the most important decisions for the Foundation Planning Task Force (the “Task Force”) is to determine the governance structure of the new Lakewood Wellness Foundation (the “Foundation”). The only restrictions provided by the Master Agreement appear to be that the Board of Directors\(^1\) be composed of between five (5) and twenty-one individual (21) members, at least two of whom shall be appointed by the Cleveland Clinic Foundation.

1. Members vs. Directors

A nonprofit corporation under Ohio law is to have members and directors. The members of an organization generally elect all, or at least some, of the directors and may reserve the power to make certain major decisions regarding the organization such as changing sections of the Code of Regulations (also called Bylaws) and making decisions such as dissolution of the organization. The members typically meet only on an annual basis to elect directors. The directors are responsible for operating the organization and meet more frequently.

Ohio law does not require different individuals serve as members and directors. If the members and directors are the same, the directors simply elect their successor directors.

The decision whether to have separate members and directors rests on whether the organization creates separate roles and powers for the members and directors (discussed more fully below).

\(^1\) Historically, the members of the governing body of a nonprofit corporation in Ohio were called “trustees”. Ohio law was changed to refer to the members of the governing body as “directors.” Many nonprofit corporations continue to use the term “trustees” and the Foundation may choose whichever name it wishes to use.

While there may be an infinite number of variations on governance structures, there are three basic models to consider: A) the self-perpetuating board with little or no representation from different sources; B) a structure where the board of directors has representation from different sources; and c) a structure with a membership that has representation from different sources and those members elect some or all of the board of directors. Once a basic structure is selected, that structure is further tailored to meet the specific needs of the organization.

A. Self-perpetuating board with little or no representation. The simplest way of organizing a board of directors is for the initial board to be appointed and that board simply elects future boards (“Self-Perpetuating Board”). Qualifications for directors may be provided in the Code of Regulations, such as requiring that each director live in the City of Lakewood or be a principal in a business operating in Lakewood. Among other items, the board itself may also set guidelines such as requiring diversity on the board; but these are usually not contained in the Code of Regulations but are guidelines provided to the nominating committee.

With this model, there is no reason to have members separate from directors. The Foundation may adopt this structure with the requirement that two of the board members must be appointed by the Cleveland Clinic.

**Advantages of this model:** simplicity in organization; current board selects board members it believes are the best to fulfill the mission and vision of the organization.

**Disadvantages of this model:** The board may become insular as future board members are most often people with whom the current board members have existing relationships. This can be minimized by having a robust nominating process including a mechanism whereby input is received from a variety of sources.

**Ability to change the direction of the organization:** The board of directors may vote at any time to change the vision and mission of the organization, change how the board is selected and make major decisions regarding the organization without oversight. Fundamental change is quite easily accomplished. Given the Master Agreement, the board would need to keep its size between 5 and 21 members, its mission would need to remain within the broad scope of “addressing community health and wellness needs in the City of Lakewood”, and there would need to be
two board seats reserved for appointment by the Cleveland Clinic, but everything within those parameters could be changed quite easily. This ease of change could be mitigated by providing a super-majority vote in order for the board to make major changes such as changes to the mission and vision of the organization and certain changes to the Code of Regulations.

B. Board of directors with representation from outside sources. Another model for board structure would require the board of directors be comprised, at least in part, of representatives selected by various constituent groups ("Representative Board"). The Task Force could provide that a certain number of directors be appointed by outside entities. An example of this might be an organization that provides scholarships within a school district which is comprised of board members appointed by parent-teacher associations, booster organizations, the school board, and other constituent groups. With this model there is no reason to have members separate from the directors.

With this model, in addition to having those individuals representing various constituent groups, there are often “at large” seats elected by the full board. This allows the board to bring in individuals with expertise, or diversity, which might be lacking in those individuals selected by the appointing organizations.

**Advantages of this model:** Broad based representation with direct input from the community the organization serves. A degree of accountability to the community. Heightened profile in the community through seeking representation from other organizations.

**Disadvantages of this model:** Greater board turnover because the organizations appointing board members might change their appointees to the board of the Foundation. Board members may be more concerned about the organization that appointed them than the Foundation, resulting in potential conflicts of interest. More attention to governance as the board may need to address, from time to time, whether there should be a change in the constituencies eligible to appoint board representative. Limitations on the number of organizations which can appoint board members; difficulty in choosing which organizations can participate.

**Ability to change the direction of the organization:** As with the Self-perpetuating board, a Representative Board may, at any time, change the vision and mission, change how the board is selected and make major decisions regarding the organization. Change would be slightly more difficult than with model A. above,
because the board members are likely to feel more accountable to their appointing organizations, but change is still quite easy. As with the Self-Perpetuating Board, this can be mitigated in part by providing for super-majority votes for making major changes.

C. Organizations with representation at the member level. With this model ("Membership Model") the organization has members separate from the directors and the members elect some or all of the directors of the organization. The membership is made up of a class of individuals (for example: representatives from all health and wellness organizations in the City of Lakewood, or individuals who sign up as members and pay nominal dues). With this model, in addition to having those individuals elected by the members, there are often “at large” seats elected by the full board. This allows the board to bring in individuals with expertise, and diversity, which might be lacking in those individuals elected by the members.

With this model, there may also be certain “reserved powers” in the members, such as the ability to approve any change in the mission or vision the organization and the ability to approve any changes to how board members are selected.

Advantages of this model: Broad based representation with input from the community the organization serves, but less direct input from such organizations and less conflicts of interest than model B. Annual meeting of the members provides a mechanism for reporting the work of the Foundation back to the community and an opportunity to receive community input.

Disadvantages of this model: Very cumbersome; a mechanism must be developed for membership and those membership records must be maintained. Board members may be elected who have interests counter to the best interests of the Foundation. This may be mitigated by having a nomination process that does not permit floor nominations and involves the Board of Directors making nominations and requiring additional nominations be made through a process of nomination prior to the meeting at which directors will be elected.

Ability to change the direction of the organization: This model is the most likely to maintain the original mission and vision and organizational structure. If approval rights are vested in the member group for certain major decisions, there can only be change if the board of directors determines to change and the members approve the change. Given that the members are a large diverse group, there is less potential
for them to agree to changes proposed by the board of directors. There is also substantial public accountability for any suggested changes.