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IRS Efforts to Improve Nonprofit Governance

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In our March 2014 Professional Notes, we discussed the origins of the trend toward imposing increased requirements on nonprofit governance. This issue focuses on the IRS approach to governance—not requirements, exactly, so much as questions. But questions asked by the IRS are not ordinary questions, and the understandable desire of nonprofits to "give the right answer" inevitably drives behavior.

The IRS's foray into governance started in earnest in 2004, with the issuance of a substantially revised version of IRS Form 1023, the application for recognition of tax-exempt status. In February 2007, the IRS issued a discussion draft entitled *Good Governance Practices for 501(c)(3) Organizations*. A few months later came a proposal to revise IRS Form 990, the annual return for exempt organizations (other than private foundations). The proposed new 990 was vastly longer and more complex than the old form—and included a number of questions about governance. These questions went far beyond the still-new 1023. After a public comment period, a final Form 990 was released in time for the 2008 tax year.

The IRS acknowledges that "the tax law generally does not mandate particular management structures, operational policies, or administrative practices…"[1] Yet the questions now asked by the IRS can leave the impression that the agency has strong views on these topics—and that an application for exempt status could be rejected or the annual return audited if the IRS does not like the answers.

Professor James Fishman of Pace University has called IRS regulation of nonprofit governance "stealth preemption," with the effect of "eroding a traditional area of state interest, expertise, and control." He argues that the IRS has interpreted the scope of its own jurisdiction, expanding its authority at the expense of the states.[2]

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1. http://www.irs.gov/Charities-&-Non-Profits/Charitable-Organizations/Life-Cycle-of-a-Public-Charity
2. James J. Fishman, *Stealth Preemption: The I.R.S.'s Nonprofit Corporate Governance Initiative* (2009), http://ssm.com/abstract=1494932

Form 1023: Application for Recognition of Exemption

For charities other than certain religious organizations, filing for recognition of exemption has been a requirement since 1954. The current Form 1023, the application form, is 12 pages long, plus as many as eight schedules stretching for another 14 pages. More than two pages of the form are given over to questions about compensation of the organization's leaders and other topics related to governance.

Conflict of Interest Policy. Form 1023 asks whether the applicant organization has a conflict of interest policy consistent with an IRS sample and, if so, requests a copy. If not, the IRS asks a series of questions about the procedures followed with respect to situations involving conflicts of interest. Instructions for the 1023 state that adoption of a conflict of interest policy, though recommended, is not required, but then go on to say that "by adopting the sample policy or a similar policy, you will be choosing to put in place procedures that will help you avoid the possibility that those in positions of authority over you [the organization] may receive an inappropriate benefit." Although this is presented only as a recommendation, an organization that declines to adopt a conflict of interest policy does so in the face of an implied warning that it may be placing itself—and perhaps its application for recognition of exempt status—in jeopardy.

Compensation. The application asks about the compensation that is, or will be, paid to all officers and directors (including trustees), as well as the five highest compensated employees and five highest compensated independent contractors that receive, or will receive, annual compensation of more than $50,000, and it requires a list of their qualifications, average hours, and duties. It also requires disclosure of the practices the organization uses in setting compensation of directors, highest compensated employees and independent contractors, including whether the organization has a conflict of interest policy. A sample policy is provided and recommended by the IRS. In the absence of a policy, the organization must explain the procedures it uses to ensure that persons with a conflict of interest will not have "influence over you for setting their own compensation" or "influence over you regarding business deals with themselves."

The application requires information about any compensation arrangements involving bonuses or revenue-based payments as well as detailed information about relationships among officers and directors, highest compensated employees, and highest compensated independent contractors, and about goods or services provided to or by any of them or their family members. In addition, it asks about certain practices that it states are recommended but not required to obtain exemption, including whether there is a conflict of interest policy applicable to those who approve compensation arrangements. According to the instructions: "by adopting these recommended compensation-setting practices, such as by resolution of your governing board, you will be establishing procedures aimed at helping to prevent your top officials from receiving excess compensation."

In several rulings denying exemption, Professor Fishman notes in *Stealth Preemption,* the IRS has considered the lack of an independent board or a conflict of interest policy.[3] Bruce Hopkins makes a similar point, stating that the IRS rulings in the area of nonprofit governance have been "founded principally on an expansive (and incorrect) interpretation of the private benefit doctrine."[4] The IRS has no authority for its positions about board composition, conflict of interest policies and other policies, Hopkins adds. These rulings generally seem to involve fact patterns that support the decision to deny exemption in any event, and yet the references in the rulings to the lack of certain policies or of board independence seem to suggest that those factors were important to the decisions.

3. Fishman, supra, p. 18
4. Bruce R. Hopkins, *The Law of Tax-Exempt Organizations* (10th ed., 2011) and 2013 cumulative supplement

Form 990

A series of Form 990 questions addresses corporate governance. Some relate directly to provisions of the Internal Revenue Code, such as those about compensation and excess benefit transactions. But other questions have no obvious connection to enforcement of the Code, including questions about independence of directors and whether the organization has a written conflict of interest policy, a written whistleblower policy, or a written document retention and destruction policy.

In addition, Form 990 asks about other policies. For example:

- Organizations with chapters, affiliates, or branches must indicate whether they have policies and procedures governing the activities of those organizations to ensure consistency of operations.
- Organizations that have engaged in joint ventures with commercial entities are asked whether they have a written policy requiring evaluation in joint ventures under the tax law.
- Organizations that make foreign grants must indicate the procedures for monitoring use of the funds.

Form 990 asks whether and how the conflict of interest policy, governance documents, and financial statements were made available to the public during the tax year. From the question, a person filling out the 990 might infer that such disclosure is a legal mandate. One has to go the instructions, however, to read that public disclosure is not, in fact, required.

Form 990, like Form 1023, requires significant detail about relationships among directors, officers and key employees, and business transactions with interested persons. These questions might be read to imply that conflicts of interest are *per se* bad—without regard to other considerations, such as whether these transactions were, in fact, on terms that were highly favorable to the organization (e.g., discounted goods or services provided by a board member's company).

Form 990 also requires an organization to report the number of its directors who are independent. Independent directors are those who are not compensated by the organization or a related entity as an officer or employee, who did not receive directly or through certain indirect relationships compensation or other payments exceeding $10,000 (other than as compensation for serving as a board member or for reasonable reimbursement of expenses), and who are not involved in a transaction with the organization. A board member who owns more than 35 percent of a professional services firm (e.g., a law or accounting firm) that provides services to the organization is not independent—even if that $10,000 barely covers the cost of the services or is a trivial amount in the scheme of the organization's budget.

IRS Audits

Examination agents use the IRS governance check sheet to gather data about charities. It contains 26 questions about governance. The IRS says the check sheet (Form 14114) mimics Part VI of Form 990 and is used by agents at the end of every examination of a public charity. According to the IRS, the intent is to generate data to see if there is a correlation between the answers to questions and whether the organization was tax compliant.

Interestingly, the IRS has indicated that the data collected in connection with the check sheet showed no statistically significant correlation with tax compliance for organizations that have conflict-of-interest policies or those whose board members have business or family relationships with other board members or key employees.[5]

Conclusion

There are inconsistencies in the IRS approach to nonprofit governance. More than six years after rolling out the new Form 990, the IRS has not changed Form 990PF, the annual information return for private foundations. Will the 990PF be the next governance frontier for the IRS? Or is the IRS questioning whether the governance aspects of the modified Form 990 are really all that helpful? That possibility was raised recently when the IRS issued a discussion draft of a greatly simplified exemption application (Form 1023-EZ, for organizations that expect to have $200,000 or less in annual receipts); it has no governance questions at all.

5. www.irs.gov/Charities-&-Non-Profits/Governance-Issues

There are also sharp critics of what the IRS has done in this area. Professor Fishman states:

> [I]n a time when many charities are struggling to survive and maintain their level of activity, when there are pressures to reduce administrative expenses, the [IRS] corporate governance initiative is an unwelcome, unnecessary distraction. It increases administrative costs, diverts boards and staff from the focus on the charity's mission, and has no empirically verified relationship to tax compliance.[6]

Inconsistencies and critics aside, the core message from the IRS is unmistakable: Governance matters to us, and your organization could be jeopardizing its tax-exempt standing if your governance procedures do not conform to our expectations.

Some states are showing greater interest in nonprofit governance. Yet, ideas adopted in the states are not always congruent with those of the IRS. Charities in some places, particularly New York, may be faced with a bewildering mosaic of federal and state definitions that they have to master in order to answer the IRS's governance questions correctly, while ensuring compliance with complex governance requirements imposed at the state level. In our next issue, we will consider some of these state-law developments.

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6. Fishman, supra, p. 48

For further reference see:

James J. Fishman, *Stealth Preemption: The I.R.S.'s Nonprofit Corporate Governance Initiative* (2009), http://ssm.com/abstract=1494932

James J. Fishman, *Strange Silence: Attorneys General Reaction to The Internal Revenue Service's Corporate Governance Initiative*, presented at 2013 Columbia Law School Charities Regulation Policy Conference, http://web.law.columbia.edu/sites/default/files/microsites/attorneys-general/Fishman%20Paper%20Final.pdf

Bruce R. Hopkins, *The Law of Tax-Exempt Organizations* (10th ed., 2011) and 2013 cumulative supplement

T.D. 9423, IRB 2008-43 (eliminating requirement of filing at end of 5-year advance ruling period)

Tax Exempt Governance Proposals: Staff Discussion Draft, June 2004, Staff of the Senate Finance Committee, www.finance.senate.gov/imo/media/doc/062204stfdis.pdf

Options to Improve Tax Compliance and Reform Tax Expenditures, January 27, 2005, Staff of the Joint Committee on Taxation (JCS-02-05), www.jct.gov/s-2-05.pdf

IRS, Life Cycle of a Public Charity, www.irs.gov/Charities-&-Non-Profits/Charitable-Organizations/Life-Cycle-of-a-Public-Charity

PLR 200737044 (Exemption denied to organization with only two board members who were father and son; deemed private benefit to controlling founder)

PLR 200843032 (Exemption denied to purported church with no congregation and only two trustees who were husband and wife; absent evidence about how compensation was determined, IRS concluded earnings would inure to them)

PLR 201203025 (Exemption denied to organizations that referred participants in financial seminars to for-profit entities, one of which employed many of the organization's staff members, including founder. Founder had right to appoint or remove board members)

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