THE NEW YORK COMMUNITY TRUST

90 YEARS OF GIVING

PROFESSIONAL TAX & ESTATE PLANNING NOTES

MARCH 2014

1 From Self-Regulation to Government Regulation

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It is widely agreed that charities should be publicly accountable. While private corporations have shareholders, a charity has stakeholders, broadly defined as the public at large. But what information is useful to these stakeholders? Is there a limit to the value of public accountability? Does better governance really lead to greater accountability or better performance?

The Internal Revenue Service certainly thinks better governance equals greater accountability. In its own words, "a well governed charity is more likely to obey the tax laws, safeguard charitable assets, and serve charitable interests than one with poor or lax governance."[1]

This year's Professional Notes series explores the trend toward imposing more—and more specific—requirements on nonprofit governance. First, we will look at the origins and development of this trend. In the next two issues, we'll consider its practical results, including the revised annual information return for charities (IRS Form 990) and the recently enacted New York Nonprofit Revitalization Act, a law that may have national reverberations.

The IRS determines whether an organization's purposes, operations and structure qualify it for exemption from federal income taxes and for classification as a charitable organization—that is, one whose purposes and activities enable it to receive contributions that are deductible. Federal tax laws governing exempt status and deductibility say virtually nothing about governance, and regulation of this issue generally occurs at the state level. Historically, the determination of how a particular charity should conduct itself has generally been left to its board of directors. In some fields, such as higher education and health care, self-regulation is supplemented by an

1. Internal Revenue Service, February 4, 2008. www.irs.gov/pub/irs-tege/governance_practices.pdf.

outside accreditation process or through membership in an association that imposes standards on members.

At their best, boards enhance the work of the staff, infuse ideas from the outside world, bring in expertise, provide checks and balances that protect an organization from mismanagement and mission drift, and advise the CEO on leadership issues. Boards also ensure continuity and a strategic orientation to the future.

Early governance guidelines

Code Section 501(c)(3)[2] exempts from federal income tax only those organizations that are organized and operated exclusively for exempt purposes, "no part of the net earnings of which inures to the benefit of any private shareholder or individual." This statutory language is the source of the proscriptions against private inurement and excessive private benefit—the former situated in the requirement that net earnings may not inure to the benefit of any private shareholder or individual, and the latter embedded in the requirement that an organization be operated *exclusively* for exempt (e.g., charitable or educational) purposes. Private inurement is ordinarily the result of improperly managed conflicts of interest, usually in the form of excessive compensation or "sweetheart" transactions involving insiders. Private benefit is typically the result of an organization's drift away from its charitable mission.

The penalty for private inurement or excessive private benefit is harsh: loss of tax-exempt status. Of course, the flaw in revoking an organization's exempt status is that the very people who benefit from the charity's work may be the ones who are punished most harshly when it closes its doors. Since 1996, an excise tax has provided the IRS with an "intermediate sanction" to address cases of private inurement. Under those rules, onerous penalty taxes may be imposed on any "disqualified person" (e.g., a director or officer) who receives a benefit that exceeds the value of what he or she provided in return and on those organization managers who knowingly and without reasonable cause approved such an arrangement. The tax is structured to give an incentive to repayment to make the organization whole.

State laws generally impose three duties on nonprofit board members, without detailing how to meet these requirements:

- Duty of loyalty (obligation to act solely in the organization's best interests);
- Duty of care (obligation to act in good faith using the degree of care and diligence that an ordinarily prudent person would exercise in a like position and under similar circumstances); and
- Duty of obedience (obligation to act in a manner that is faithful to the organization's mission and applicable law).

Beyond these broad expressions of board members' fiduciary duties, and a handful of specific statutory prohibitions (e.g., a prohibition on loans to directors and officers) and procedural requirements (e.g., super-majority voting requirements for certain categories of decision-making and limitations on the kinds of decisions that may be delegated to committees), expectations for board governance generally have been only that: expectations, not legal requirements.

For many years, the National Charities Information Bureau (NCIB) evaluated national organizations against its guidelines about governance, fundraising, and operations. In 1991, these guidelines included an independent, volunteer board with a minimum of five members; in-person board meetings at least twice a year with a majority of voting members in attendance; no more than one paid staff person on the board (not serving as either chair or treasurer); and a conflict of interest policy. In 2001, NCIB merged with the Council of Better Business Bureaus Foundation, creating the BBB Wise Giving Alliance. The standards evolved into the voluntary Standards for Charity Accountability, which still guide many organizations today.

2. All "Code" references are to the Internal Revenue Code of 1986, as amended, and all "Treas. Reg." references are to regulations promulgated thereunder.

Sarbanes-Oxley

In response to failed oversight by some corporate boards, the Sarbanes-Oxley Act of 2002 imposed new governance standards on boards and officers. Although generally applicable only to publicly-traded companies, its prohibition of employment-related retaliation against whistleblowers and destruction of evidence in connection with an investigation applied to charities as well. Sarbanes-Oxley increased awareness in the nonprofit sector of the importance of good governance. Some have looked to it as a resource in seeking to help define "best practices" for charities.

Later that year, the IRS requested comments on proposed changes to the Form 990 (the information return filed annually by charities) that would have modified it to provide measures similar to Sarbanes-Oxley "to increase public confidence in the integrity of the disclosures by exempt organizations." The IRS expressed particular interest in comments about requiring organizations to disclose whether they had adopted conflict of interest policies or had independent audit committees, and about relationships or transactions with directors, officers, and substantial contributors.

Proposals of the Senate Finance Committee and the Joint Committee on Taxation

In 2003, media articles about fraud and abuse at private foundations and other charities led Senators Charles Grassley (R-Iowa), then Chairman of the U.S. Senate Finance Committee, and Max Baucus (D-Montana), then its ranking minority member, to begin an examination of the entire nonprofit sector.

In June 2004, Senate Finance Committee staff (Finance) released a discussion draft of legislative proposals designed to tackle a number of alleged abuses.[3] Six months later, the Joint Committee on Taxation staff (JCT) released its own tax reform recommendations, including some targeting nonprofit organizations.[4]

Senate Finance Proposals

Compensation and related party transactions: The Senate Finance Committee proposed extending the private foundation "self-dealing" rules to public charities, effectively forbidding any sale, exchange or lease of property between a charity and a disqualified person (e.g., a director, officer or substantial contributor), including a loan to the charity, even if on terms advantageous to the charity. The proposals also would have expanded the definition of a "disqualified person" for public charities to include a corporation or partnership with respect to which a disqualified person exercises substantial influence.

Governance standards: Finance proposed rules dictating board size, giving the IRS authority to remove board members under certain circumstances, and prohibiting or limiting compensation to board members of private foundations. The proposal called for federal law standards for fiduciary conduct, including a federal prudent investor standard for public charities and for holding directors with special expertise to a higher duty of care. It also would have dictated board responsibility for approval of significant transactions; review and approval of audit and accounting practices; approval of the budget and significant investments; adoption of a conflicts-of interest-policy; and establishment of procedures for whistleblower protection.

Form 990 Changes: Citing a 2002 GAO Government Accountability Office report, the Finance discussion draft asserted that there were "significant problems in the accuracy and completeness of Form 990." It proposed reforms that included requiring the Form 990 be signed by the CEO under penalties of perjury; increased penalties for failure to file and loss of exemption for failure to file for two consecutive years; and requiring an independent auditor to review a charity's Form 990 and prepare a report that would become a public document. Moreover, all exempt organizations with over $250,000 of gross receipts would have been required to obtain audited financial statements and to change auditors every five years. Finance also proposed greater disclosure requirements for certain types of transactions.

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

4. 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.

Unlike earlier standards, which had been voluntary, Finance and JCT were endorsing out-and-out legal requirements. These detailed proposals addressed compensation, related party transactions, governance, and standards of fiduciary behavior, as well as revisions to the Form 990 (*see box on page 3*).

Some of the proposals went beyond existing requirements or added a substantially similar federal requirement on top of an existing state requirement. It was unclear to many what would have been gained by the imposition of a federal standard. Commenters raised concerns that imposing a higher standard of care on board members with special skills—such as legal, investment, or accounting expertise—could have the effect of driving out such board members. Even though the proposals did not become law, the concept of requiring those with special investment skills to use them has since found its way into *state* law through the near-nationwide adoption of the Uniform Prudent Management of Institutional Funds Act, or UPMIFA.

One reaction to a number of the proposals was doubt about the IRS's ability to enforce them. A common misconception among the public is that the IRS has extensive powers if it finds malfeasance in a tax-exempt organization. In reality, the principal remedy of the IRS against a charity is a blunt instrument: revocation of its tax exemption. The IRS does not have authority to remove officers and directors. Generally, conflict of interest rules do not give rise to federal penalties unless the violation results in either a "self-dealing transaction" under Code Section 4941 (private foundations) or an "excess benefit transaction" under Code Section 4958 (charities and social welfare organizations). Even then, the penalty is in the form of an excise tax.

All these proposals were aimed at increasing transparency in the nonprofit sector, and, as will be discussed in greater detail in the June issue of Professional Notes, many of the proposals were adopted by the IRS in later revisions of the Form 990.

The Finance discussion draft included an interesting proposal that the IRS should accredit charities that meet best practices. While laudable in theory, "best" practices are not the "only" practices, and traditionally are voluntary efforts. A host of questions arose: Who would determine best practices? Would standards be national, or would they vary by state? Would different standards apply to different charitable sectors?

Reacting to the draft, the ABA commented: "the charitable sector is far more varied in size, resources, operational characteristics, and mission, making it virtually impossible to have 'one size fits all' rules."[5] Other commenters were more critical, questioning the ability of the IRS to administer the governance and best practices recommendations.

2005 Recommendations of the Panel on the Nonprofit Sector

At the encouragement of Senators Grassley and Baucus, the nonprofit umbrella group Independent Sector convened the Panel on the Nonprofit Sector in 2005 to respond to the various proposals. Lorie Slutsky, President of The New York Community Trust, co-chaired the Panel. "For several years, Washington had been hearing a great deal about fraud and abuse in public companies and in charities," Slutsky recalls. "This was an opportunity for the charitable sector to articulate practical, constructive ideas to improve transparency and address perceived shortcomings in governance."

The Panel's final report[6] included detailed recommendations that provided for, among other things, significantly increased disclosure of compensation arrangements and requirements about board size and independence. It also recommended that individuals barred from service on corporate boards or convicted of crimes related to breach of fiduciary duty be prohibited from serving on charity boards for five years.

5. ABA Section of Taxation letter to Senate Finance Committee dated July 19, 2004, www.americanbar.org/content/dam/aba/migrated/tax/pubpolicy/2004/040719ba.authcheckdam.pdf.

6. Panel on the Nonprofit Sector, *Strengthening Transparency Governance Accountability of Charitable Organizations, Final Report to Congress and the Nonprofit Sector* (June 2005), www.independentsector.org/uploads/Accountability_Documents/Panel_Final_Report.pdf.

While concluding that audit committees should not be mandated by federal law, the Panel recommended that any charity with independently audited financial statements (whether legally required or not) consider establishing an audit committee of the board that does not include staff. The Panel noted that, if state law permits, the board should be able to delegate the audit oversight to an audit committee of experienced non-board members.

The Panel recommended that charities adopt and enforce conflict of interest policies and the IRS require disclosure on the Form 990 of whether or not the organization has such a policy. Even so, the Panel stopped short of recommending that conflict of interest policies be legally mandated.

The Panel also recommended that charities have whistleblower policies to encourage individuals with information on violations of law or the organization's own policies to come forward, with a way to report information anonymously.

Although these proposals influenced state rules, generally speaking, they were not included in federal legislation. The Pension Protection Act of 2006 included a number of provisions affecting tax-exempt organizations and charitable giving, but generally did not address the proposals concerning governance and transparency.

Subsequent developments

In February 2007, the IRS issued a discussion draft of good governance practices.[7] Several months later, it released a proposed revision of Form 990 that included a section on governance. After a public comment period, the IRS released a redesigned Form 990 in December 2007; stating that the IRS positions on governance are best reflected in the revised Form 990, the discussion draft on good governance was withdrawn. Our June issue of Professional Notes will discuss the IRS approach to governance as reflected in the revised Form 990.

A number of the Finance and JCT proposals ended up getting traction at the state level. In our October issue, the third and final in this series, we will examine accountability and governance under New York law, including the new requirements imposed by the Non-Profit Revitalization Act of 2013.

Conclusion

Like other grantmaking organizations, The New York Community Trust considers many characteristics of good governance in evaluating a potential grant to an organization. Our 90 years of experience helping nonprofits has taught us that a board that is too small or compensation practices that seem unduly opaque can be signs that an organization is not a suitable grantee. A board that is not independent of paid staff may not be able to exercise proper oversight. But we know, too, that every situation is unique, and an important or innovative program is not always found in an organization with unassailable governance practices. So The Trust sometimes serves as catalyst for an organization to operate on two parallel tracks: maintaining and expanding an excellent program *and* improving the way it governs itself. "Our role is to help organizations be better and more effective at what they do, and we are candid with an organization when we have concerns about its governance," Slutsky observes. "There are no 'one-size-fits-all' solutions, and the community of funders and regulators has to be careful to demand accountability without stifling innovation or discouraging volunteer engagement."

In the end, reams of rules and regulations can accomplish only so much. Probably the most significant change in the last few decades has been the emphasis on transparency—the sense that charitable groups are opening their doors and windows to the outside world.

7. Internal Revenue Service, *Good Governance Practices for 501(c)(3) Organizations* (Feb. 2, 2007), previously published at www.irs.gov/pub/irs-tege/good_governance_practices.pdf.

NOTES

The push for transparency comes from new technology and a culture of openness as much as from any regulatory agency. It assumes that when given adequate information, the public—generally donors—can make appropriate decisions about whether to support a charity.

For further reference, see:

Bruce R. Hopkins, *Nonprofit Counsel*, Vol. 25 No. 5 (May 2008).

BBB Wise Giving Alliance Standards for Charity Accountability, www.bbb.org/us/charity-evaluation.

P.L.107-204, Sarbanes-Oxley Act of 2002, www.gpo.gov/fdsys/pkg/PLAW-107publ204/content-detail.html.

Announcement 2002-87, 2002-39 I.R.B. 624, www.irs.gov/pub/irs-drop/a-02-87.pdf (IRS request for comments on proposed changes to IRS Form 990).

Panel on the Nonprofit Sector, *Strengthening Transparency Governance Accountability of Charitable Organizations, Final Report to Congress and the Nonprofit Sector* (June 2005), www.independentsector.org/uploads/Accountability_Documents/Panel_Final_Report.pdf.

About The Trust

Since 1924, The New York Community Trust has served the needs of donors and nonprofits in the New York area. One of the oldest and largest community foundations, The Trust is an aggregate of funds created by individuals, families, and businesses to support the voluntary organizations that are crucial to this community's vitality.

Grants made from these funds—which now number more than 2,000—meet the needs of children, youth, and families; support community development; improve the environment; promote health; assist people with special needs; and bolster education, arts, and human justice.

In addition to reviewing proposals from nonprofit agencies and responding to the grant suggestions of donors, The Trust is alert to emerging issues and develops strategies to deal with them, works collaboratively with other funders and with government, and gets information to the public. Recent initiatives have included programs that address youth violence, managed health care, immigration, child abuse, and public school reform.

The Trust is governed by a 12-member Distribution Committee composed of respected community leaders. Its staff is recognized for its expertise in grantmaking, financial administration, and donor services. Local divisions are located on Long Island and in Westchester. In 2013, The Trust made grants of $141 million from $2.4 billion in assets (unaudited).

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