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IRS Issues Governance Examination Guidelines By Michael Peregrine and Elizabeth Mills*

On December 9, 2009, the Internal Revenue Service (IRS) released corporate governance information--gathering tools to be used by agents in their examination of tax-exempt hospitals and other public charities. The [new materials](#) include a "Governance Check Sheet," and a more detailed "Guide Sheet" to be used by agents in completing the Check Sheet. They incorporate--and significantly expand upon--the governance topics addressed in Part VI of the Form 990. Their release is consistent with the earlier pledge of IRS Commissioner Sarah Hall Ingram to share internal IRS governance-related training and examination material with the nonprofit sector, and follow up on the release in July 2009 of [training materials](#) on governance for IRS staff. Access the Tax and Finance Practice Group's July 30, 2009, [email alert on the training materials](#). The newly released documents serve to underscore the continuing IRS interest in the relationship between governance and tax compliance. They also provide a very specific checklist of items the IRS will consider in every examination of a tax-exempt public charity.

The Governance Check Sheet

The Governance Check Sheet is a two-page document (IRS Form 14114) that is to be used by IRS exempt organization Revenue Agents in their examination of hospitals and other public charities recognized as income tax exempt under Section 501(c)(3) of the Internal Revenue Code. The Check Sheet provides questions to be considered by the agent concerning six specific aspects of the organization's corporate governance structure: (a) "Governing Body and Governance Topics;" (b) "Compensation;" (c) "Organizational Control;" (d) "Conflict of Interest;" (e) "Financial Oversight;" and (f) "Document Retention." Not only are these issues addressed in Part VI of the Form 990, but also many health lawyers will recognize these as topics also addressed in the IRS' (2007) [summary of recommended governance practices for](#)

[nonprofits](#) ("Life Cycle Materials"). The Check Sheet is designed to be filled out online, with drop-down menus of possible responses and very little opportunity for narrative or description.

The Guide Sheet

Intended to be a supporting document for completing the Check Sheet, the Guide Sheet contains twenty-eight separate "prompts" to the Revenue Agent for use in completing the Check Sheet. The Guide Sheet does not contain specific headings, but its numbers correspond directly to the questions on the Check Sheet. In several instances, the Guide Sheet provides examples and other suggestions to the Revenue Agent which help narrow the focus of specific IRS interest.

What's New and Different

The particular value to the health lawyer of this new release is twofold. One is that it outlines very specifically what the IRS will surely look for on an examination and will enable organizations to prepare for good answers on the Check Sheet. The other is the extent to which the Check Sheet and Guide Sheet expand upon governance issues beyond the treatment provided in the Form 990 and the Life Cycle Materials. Specific governance new topics receiving new or enhanced IRS attention include the following:

- Certain organizational document issues (e.g., whether they include an articulation of a charitable purpose, and information about the composition, duties, qualifications, and voting rights of board members);
- Whether board members have received copies of the organization's articles and bylaws;
- Whether the organization's articles and bylaws are available to the public, and if so, whether they are generally available or only on request;
- The frequency of board meetings as compared to bylaw requirements;
- The frequency with which the board or compensation committee relied upon comparability data in making compensation decisions;
- The number of "horizontal board conflicts" (i.e., family and/or outside business relationships with any voting or non-voting board member, officer, director, or key employee);
- Whether there is a single individual or small group of individuals to whom the board typically defers;
- The frequency with which the conflict-of-interest policy is actually adhered to (e.g., how often have conflicted members actually recused themselves from the corresponding decision making process?);

- The extent to which board members are provided with information concerning the organization's financial condition and discusses those reports and related financial activities;
- Whether the Form 990 was reviewed (not merely received) by either the full board or a designated committee prior to filing;
- The extent to which the independent accountant's report and the related management letter was reviewed by either the full board or by a designated committee (and whether any action was taken in response to recommendations contained in the management letter);
- Whether there are systems or procedures in place to make sure assets are used properly and are consistent with the organization's mission;
- Whether the organization has a written policy for document retention and destruction, and whether it adheres to that policy; and
- Whether the Revenue Agent's examination was hindered by a lack of necessary documentation.

Many of these new questions reflect a significant level of understanding of board room practices; i.e., in several instances, the IRS is asking "the tough questions." In these ways, the Check Sheet suggests that the IRS is building on prior examinations of charities with problematic governance practices. Based on these new questions, health lawyers may wish to prompt their clients to consider more closely the sufficiency of existing practices with respect to board education and awareness of core governing documents, financial oversight practices, board size, meeting frequency and attendance history, interaction with and response to the independent auditor, and the sufficiency of conflict-of-interest practices.

What the IRS Will Do With the Data

Ultimately, the Check Sheet data will be included in a long-term study the IRS is undertaking to set forth a greater understanding of the connection between charities' tax compliance and corporate governance practices. At this point, the IRS is not expected to make poor governance practices alone an exemption-level issue, but it is conceivable that evidence of problematic governance may contribute to the consideration of penalties where evidence of more severe organizational abuse exists.

Furthermore, given the level of cooperation and referrals between the IRS and state charity officials on exempt organization/nonprofit issues, it is quite possible that these state officials will refer to this checklist to support their own state law-based reviews and investigations of nonprofit governance. In several respects, the Check Sheet questions resemble allegations made by the New Jersey attorney general in its

recent, seminal fiduciary duty litigation instituted against the officers and board of Stevens Institute. Particularly at issue in that situation is whether the board was controlled by a small group of individuals (e.g., the chief executive officer and board chair) and whether the board ignored the recommendations and other warnings of its independent auditor.

Bottom Line

From a practical perspective, the Check Sheet and Guide Sheet serve as a very useful tool from which the general counsel and governance committee leadership of charities can monitor the effectiveness of existing governance practices. This is particularly the case with respect to some of the more focused questions raised with respect to the sufficiency of board meeting protocols, the extent of financial oversight, interaction with the independent auditor, and the effectiveness of conflicts practices. A general counsel or board governance committee can use the Check Sheet to see how the organization stacks up in comparison to what the IRS wants to see.

**We would like to thank Michael W. Peregrine, Esquire (McDermott Will & Emery LLP, Chicago, IL), and Elizabeth M. Mills, Esquire (Proskauer Rose LLP, Chicago, IL), for co-authoring this alert and sharing their expertise with other colleagues.*

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