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IRS Releases Governance Red Flags

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Well, now we know what they're looking for.

On December 9, the IRS released an informative set of guidelines to be applied by its agents in the course of evaluating the governance of tax-exempt organizations under examination. The guidelines include both a ''Governance Check Sheet'' to be compiled by the agent and a supplementary ''Guide Sheet'' for the agent to use when completing the checksheet. The new examination guidelines provide an extrapolation of the governance topics addressed in Part VI of the Form 990, ''Return of Organization Exempt From Income Tax,'' by highlighting practices likely to be viewed with suspicion or concern by the IRS. As such, the guidelines should be closely considered by the governance committees of exempt organizations and their counsel.

The release of the new examination guidelines follows the July 23, 2009, release by the IRS of materials it uses to train its agents on exempt organizations governance issues. The training materials consisted of a combination of outlines and PowerPoint presentations intended to (a) provide context within which nonprofit governance has become such an important area of IRS focus; (b) describe the various governance-related roles of the IRS, state charity officials, and the nonprofit sector itself; (c) emphasize governance practices the IRS encourages organizations to adopt; and (d) discuss the role of individual IRS personnel as it relates to their review of governance issues. The materials for examinations and headquarters personnel focused on Form 990 questions addressing governance, while the materials for determination staff focused on questions involving governance found on Form 1023, ''Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code.''

Through these examination guidelines and training materials, the IRS continues its practice of cooperation and transparency with the exempt organizations sector. It also sends a clear message that the IRS will continue to monitor how nonprofit corporate governance relates to compliance by exempt organizations.

The following discussion will concentrate on the portions of the new examination guidelines of greatest significance to nonprofit boards, their governance committees, and general counsel.

The Governance Checksheet

The first, primary portion of the new examination guidelines is a governance checksheet (IRS Form 14114), to be used and completed by IRS agents in their examinations of section 501(c)(3) public charities. The checksheet and guide sheet are available at http://www.irs.gov/charities/article/0,,id=216068,00.html. The checksheet has 28 questions, broken down into seven sections, six of them substantive: ''Governing Body and Management,'' ''Compensation,'' Organizational Control,'' ''Conflict of Interest,'' ''Financial Oversight,'' and ''Document Retention.'' The sections track the principal governance issues contained in Part VI of the redesigned Form 990. They are also generally consistent with governance topics and practices recommended by the IRS within the ''Governance and Related Topics — 501(c)(3) Organizations'' document (available at http://www.irs.gov/pub/irs-tege/governance_practices.pdf). The checksheet is designed as an online application, incorporating drop-down menus of possible responses without much room to accommodate a narrative response or other description.

The Guide Sheet

The guide sheet is intended to be a reference to the IRS agent in completing the checksheet as it relates to the governance portion of the examination. It contains 28 supplemental ''prompts'' that correspond to the individual questions on the checksheet. The guide sheet is more descriptive than the checksheet, contains several specific examples to clarify the instructions, and in general is a more valuable resource for the IRS agent and the exempt organization's counsel.

What We Learn

The value to the EO counsel of the combined examination guidelines is threefold. First, they provide concrete evidence that can be used to convince an otherwise doubtful charity CEO that the IRS is indeed serious about taking its governance initiative to the examination level. Second, they specify the governance issues on which the IRS will focus in each examination it conducts of a public charity. Third, and perhaps most important, they highlight more than ever before specific governance practices that the IRS is likely to consider troubling or problematic. Such red flag practices include the following:

- the articles of incorporation and bylaws fail to contain any information about (a) the composition, duties, qualifications, and voting rights of board members, and (b) the organization's charitable purposes (questions 7, 8);
- board members are not provided with copies of the organization's most current articles of incorporation and bylaws (Question 9);
- the frequency of full board meetings is inadequate given the business of the organization, or the full board does not meet with the annual frequency prescribed in the bylaws (questions 11, 12);
- the rebuttable presumption of reasonableness safe harbor is not regularly applied in approving compensation arrangements for the organization's officers, directors, trustees, and key employees (Question 13);
- persons with conflicts of interest participate in executive compensation decisions (Question 13);
- the board or committee fails to rely on appropriate comparability data in making executive compensation decisions (Question 14);
- the board or committee fails to contemporaneously record (in meeting minutes or other written documents) the reasons underlying particular compensation decisions (Question 15);
- ''horizontal'' conflicts, or business and family relationships between voting board members, exist (Question 16);
- effective control of the organization rests with a single or select few individuals (Question 17);
- there is no annual conflict of interest questionnaire (Question 18);
- the board fails to adhere to the organizational conflict of interest policy (for example, a conflicted board member does not recuse himself or herself) (Question 18);
- there are no disclosed conflicts of interest by any board member (Question 18);
- organizational systems or procedures intended to ensure that assets are used properly and consistently with the organization's mission are absent (Question 19);
- the board is inattentive to organizational financial affairs (for example, failure to provide board members with written financial reports, or the failure of the board to discuss and consider those reports) (Question 20);
- the Form 990 is not reviewed by the full board or a designated committee before filing (Question 21);
- neither the full board nor a designated committee discussed an independent accountant's report (if one was prepared) and/or reviewed, discussed, or acted on the recommendations contained in any associated management letter (Question 23); and
- the organization's document retention and destruction policies are inadequate (questions 24, 25).

The Significance

The IRS has stated that it will use the checksheet information as part of a long-term study it has undertaken to gain a greater awareness of the relationship between charities' tax compliance and effective governance practices.

There is no indication the IRS intends to include improper governance practices as factors that in and of themselves raise exemption issues. Nevertheless, evidence of problematic governance practices, when added to other types of abuses by an exempt organization, could make the IRS more likely to consider penalties.

It is also conceivable that the new governance examination guidelines may be used by state charity officials to support their own evaluation of charity compliance with state nonprofit law principles, given the degree of cooperation between these officials and the IRS. This is especially true as state charity officials become more aggressive in their scrutiny of allegedly problematic governance practices (for example, the *Stevens Institute* litigation).[1]

Summary

The new governance examination guidelines provide a highly practical means by which exempt organization board leadership and counsel can monitor the effectiveness of their own governance practices. The guidelines also serve as a strong reminder of the IRS's continued interest in the effectiveness of charity governance and its relationship to tax compliance. Accordingly, the release of the examination guidelines should be brought to the attention of a charity's board, or at least its governance committee.

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[1]This case is based upon the New Jersey attorney general's 16 count civil complaint filed in September 2009 against Stevens Institute, its president, board chair, and some members of its board of trustees. The central claims involved allegations of financial mismanagement, misuse of endowment assets, and excess executive compensation. The specific nature of the executive compensation allegations related to the reasonableness of the president's compensation (salary and bonuses), the alleged lack of board involvement in approving such compensation, and large amounts of allegedly below market interest rate loans to the president, which allegedly were ultimately forgiven.