

# EO Determinations CPE

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# GOVERNANCE

# Why We are Here and What We Hope to Accomplish

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- Provide context within which nonprofit governance has become an area of focus by IRS and others
- Describe ongoing discussion over the roles of the IRS, the states, and the sector in NP governance
- Explain how IRS Life Cycle governance document fits into this discussion
- Discuss your role in determinations
- Describe current IRS tools and other resources available
- Describe our next steps

# What this Session is Not

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- A course on nonprofit governance under state law
- An answer to all questions you might have about nonprofit governance
- A simple checklist of dos and don'ts
- The end of the governance discussion

# Most Important Take Aways

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- When it comes to nonprofit governance, one size does not fit all
  - Governance issues vary depending upon type, size, structure, and culture of the organization
- It is our responsibility to administer the tax laws uniformly and fairly
  - Everyone in EO must understand why we are focusing on governance, what we mean when we say we will emphasize governance, and how we intend to do that across all of EO
    - Determinations, education and outreach, rulings and agreements, examinations

# Most Important Take Aways (cont.)

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- Our job is to assess whether an organization has complied with tax laws
  - In some cases, this means looking at whether particular organization managers participated in decisions that resulted in excess benefits or other noncompliance (e.g., 4958 or PF excise taxes)
  - In other cases, it means looking at whether the organization took certain steps to assure the fairness of the arrangement to the exempt organization (e.g., taken steps to establish reasonableness of compensation)
  - It is not our job to determine the organization's governance structure, policies or practices, or to make decisions for them

# Background – Specific Actions by the Sector

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- Panel on the Nonprofit Sector convened in 2004 to consider proposals to improve effectiveness and accountability of NP orgs., with particular attention to self-governance
  - Issued reports in 2005, 2006 and 2007
- Council on Foundations issued stewardship principles for private foundations in 2005
- American Law Institute project begun in 2000 to develop Principles of the Law of Nonprofit Organizations – draft issued in 2007
- ABA Coordinating Committee on Nonprofit Governance issued its Guide to Nonprofit Corporate Governance in the Wake of Sarbanes Oxley in 2005

# Background – Recent Action by the Sector

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- Numerous governance education programs held for organization board members and officers, practitioners, policy makers
- Accrediting organizations that set and assess standards before giving stamp of approval
  - Organizations that rate charities based on standards for accountability or on public data or input
- Research, academic and public interest groups and centers who study governance and promote good governance principles and practices

# States' Role in Governance

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- Oversight by charity officials
  - Enforcement of state nonprofit corporation or trust statutes
  - Charitable trust principles
  - Charitable solicitation and fundraising registration and reporting
  - NASCO – National Association of State Charity Officials
- Audited financial statement requirements
- Examples of state statutes
  - Revised Model Nonprofit Corporation Act
  - California's Nonprofit Integrity Act of 2004, including governance provisions for charities



# Examples of Relevant State Law

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- Who governs the organization – members or directors, trustees, and allocation of duties across them
- Who are the required officers of a corporation
- Business judgment rule and the decisions made by a governing body
- Duty of loyalty to the organization and duty of care
- Certain procedures and policies, including amendments to governing instruments
- Requirements regarding certain minimum or maximum board sizes or qualifications of directors
- Requirements regarding term limits for board members

# Congress and Governance: Sarbanes-Oxley

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- Legislation responding to governance deficiencies in for profit world in last decade
- Generally not applicable to nonprofits, but does have limited application
- Imposes criminal liability on tax exempt and other organizations for:
  - Retaliation against whistleblowers that report federal offenses
  - Destruction of records with the intent to obstruct a federal investigation

# Recent IRS History

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- In early 2007 EO posted Preliminary Staff Discussion Draft on good governance practices
- Put together a draft governance section for the 990 which we released in June 2007
- Over course of second half of 2007, finalized 990 governance section – released in Dec. 2007
- Used that experience to design an educational tool on governance for charities – Life Cycle – which we released in Feb. 2008

# Recent IRS History (cont.)

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- April 2008 - released Form 990 draft instructions, including for governance questions
- April 2008 – TEGE Commissioner delivered speeches at Georgetown nonprofit conference addressing governance
- June 2008 – ACT issued its report on IRS role in nonprofit governance
- December 2008 – released official form and instructions for 2008 tax years (2009 filing season)
- December 2008 - EO Implementing Guidelines released, including governance project

# Stakeholder Feedback

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- ACT Report (June 2008) – The Appropriate Role of the IRS with Respect to Tax Exempt Organization Good Governance Issues
  - ACT - Advisory Committee on Tax Exempt and Government Entities
  - Comprised of experts in TEGE who volunteer to serve for specific terms – issue public reports
- Concern that we don't uniformly apply requirements within EO to all exempt organizations
  - Determination letters – sometimes insist on conflicts policies, on an independent board, or specific board size
  - Exam - practices may vary in terms of what we might require or accept as a corrective action plan to avoid revocation or other penalties (noted in ACT report)

# ACT Report – Methodology

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- Interviewed IRS and Treasury officials, state charity officials, and experts in the field
- Reviewed extensive set of general and specialized written materials and publications on the topic
- Reviewed for profit corporate governance materials, including Sarbanes Oxley
- Presented report to IRS Commissioner in June 2008
- Acknowledged IRS's longstanding stake and legitimate interest in governance issues as they related to compliance with federal tax laws
- Expressed concern IRS could drive behavior merely by asking about specific practices, causing organizations to adopt practices not suited to them

# ACT Report – Conclusions and Observations

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- IRS should continue to work with EO community
- Specific governance practices should be mandated only in rare circumstances
- Closer the nexus to tax compliance, the more appropriate the inquiry
- IRS should explain the specific relationship between tax compliance and each practice it is addressing
- Compliance Qs more appropriate than governance Qs or commentary
- Governance inquiries should be made in as neutral a manner as possible



# ACT Report – Conclusions and Observations (cont.)

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- Qs about practices and approaches are typically better than Qs about policies
- IRS should expressly acknowledge when practices are not required
- IRS should expressly acknowledge that practices may be more appropriate for some orgs than for others, and that it respects the role of the governing body in making decisions
- Taking into account the absence of certain practices in determining whether to exam an org may be appropriate in certain circumstances
- Consistency and fair treatment by IRS are critical
- Education, implemented thoughtfully, is more appropriate than pressuring change



# Nonprofit Governance Studies

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- Study of nonprofit governance practices and policies is increasing
- Too soon to tell whether there are trends or patterns, but these studies should help inform us and others about what is going on in the sector
- Two in particular we mention today to give you a flavor of what is being studied
  - 2005-2007 by Urban Institute
  - 2007 by BoardSource®

# 2005-2007 Urban Institute Center on Nonprofits and Philanthropy Study

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- Survey of over 5,100 nonprofits
  - Stratified random sample, self reported data
  - Covered 2005
  - UI described it as first-ever national representative study of nonprofit governance
- 70% have trouble recruiting board members (p.16)
- Having CEO serve on board results in less engaged board and may undermine stewardship role of the board (p.22)
- Large board size doesn't necessarily weaken board performance or detract from board engagement (p.17)

# Urban Institute (cont.)

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- Smaller nonprofits that engage in financial transactions need to have more formal policies in place (pp. 10 and 22)
- Larger organizations need to more often have other board members review transactions (pp. 10 and 22)
- Best practice guidelines or adopting new policies will not be sufficient to strengthen board performance and accountability (p.23)

# Urban Institute (cont.) – Some Statistics

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- 67% of nonprofits have audits (p.4)
- Half of nonprofits have a conflict of interest policy, 29% required disclosure of financial interests (p.9)
- Less than 1% of nonprofits made loans to board members (p.4), but many buy/rent goods or services from board members, which more often than not does not yield savings in the way of below market rates (p.22)
- 2% compensate board members (p.11)
- 75% of organizations did not require board members to disclose financial interests in entities doing business with the nonprofit (p.8)

# *Nonprofit Governance Index 2007, BoardSource® (2007)*

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- June 2007 survey of 2,152 nonprofit leaders on board composition, structures, oversight and performance
  - 1,126 chief executives; 1,026 board members
  - Not a statistical sample
- 37% under \$1M budget size; 37% \$1M to \$5M; 26% \$5M or over
- 80% public charities, 9% private foundations

# *Nonprofit Governance Index 2007,* **BoardSource® (2007)**

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- 99% of NPs have a written mission statement (p.5)
- 92% of NPs have an external financial audit (p.17)
  - 54% of NPs have an audit committee (p.17)
- Board size averages 16 voting members (p.10)
- 14% of chief executives are voting members of their boards; 4% are also board chair (p.10)
- Boards meet an average of 7 times a year (p.14)
- Boards meet an average of 16.5 hours a year (p.14)

# *Nonprofit Governance Index 2007,* **BoardSource® (2007)**

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- *Fundraising (p.6):*
  - 68% of charities require board members to contribute
  - 61% require them to identify donors for fundraising
- 3% of NPs pay board members a fee or honorarium, 29% reimburse for travel and meeting expenses (p.12)
- 67% of full boards approve chief executive's total compensation package, 65% consider salary at comparable organizations (p.18)
- 88% have a conflict of interest policy (p.16)



# Today's Focus is Public Charities

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- Governance structures vary based on size, type, structure, and culture of organization – one size does not fit all
- Not all 501(c)(3)s are alike
  - Public charities versus private foundations
- Member organizations such as trade associations and social clubs have special considerations
  - They are accountable to members as well as to the public
- Cannot apply what you hear or learn today equally to all types of exempt organizations
- Good governance is important to safeguarding assets and operating to further exempt purposes



# Background – Governance Life Cycle for Charities

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- The Life Cycle governance document is an educational tool aimed at helping organizations and their governing bodies consider certain governance practices and policies during both the formation and operation of the organization
  - Not recommended practices but encourage certain items
  - Generally applies to public charities
- Advises organizations what they will be required to report about on new 990
- Six topic areas – mission, organizational documents, governing body, policies, financial statements and 990 reporting, transparency, and accountability

# What is Governance?

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Remember, One Size Does  
Not Fit All!

# What is a Governing Body?

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## Form 990 Definition

# Governing Body Purposes

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- Stewardship
- Mission Focus
- Oversight

# Governing Body Purposes

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- Fulfillment of Obligations
- Asset Protection
- Vision & Strategic Direction
- Hiring a CEO

# IRS Areas of Interest

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- Active and engaged
- Appropriately sized
- Composed of primarily independent members
- Structure: who is governing the organization?
- Are the meetings documented?
- Policies and practices

# IRS Areas of Interest

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**Warning-these are  
areas of interest,  
NOT requirements  
for exemption**

# Form 1023 Part V

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- Part V of the Form 1023 details the compensation and other financial arrangements with the applicant's Officers, Directors, Trustees, Employees and Independent Contractors.
- Part V consists of 9 questions and is located on pages 2 thru 5 of the Form 1023.



# Organizing Document

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- The organizing document provides the framework for governance and management.

# Bylaws

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- The bylaws are the rules governing the internal affairs of an organization.

# Governing Body Items

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- Size of the Governing Body
- Term Limits of Board Members
- Diversity of the Governing Body

# Governing Body Items

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- Board Meetings
- Board Committees
- Board Independence
- Board Compensation

# Management Policy Items

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- Executive Compensation
- Conflicts of Interest
- Investments
- Fundraising

# Management Policy Items

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- Governing Body Minutes and Records
- Document Retention and Destruction
- Ethics and Whistleblower Policies

# Governance Related Citations

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- Regulations 1.170A-9 (f)(3)(v)
- Regulations 1.509(a)-3(d)(3)(i)
- IRM 7.20.4.6

# Governance Related Citations

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- Revenue Rulings
  - 55-656
  - 61-170
  - 69-383
  - 69-545



# Governance Related Citations

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- Court Cases
  - *Levy Family Tribe Foundation v. Commissioner*, 69 T.C. 615 (1978).
  - *Parker v. Commissioner*, 365 F.2d 792 (8th Cir. 1966), *cert. denied*, 385 U.S. 1026 (1967).
  - *United Libertarian Fellowship, Inc. v. Commissioner*, 65 T.C.M. (CCH) 2178 (1993).

# Governance Related Citations

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- Court Cases (continued)
  - *Wendy L. Parker Rehabilitation Foundation, Inc. v. Commissioner*, 52 T.C.M. (CCH) 51 (1986).
  - *Western Catholic Church v. Commissioner*, 631 F.2d 736 (7th Cir. 1980), *cert. denied*, 450 U.S. 981 (1981).
  - *Blake v. Commissioner*, 29 T.C.M. (CCH) 513 (1970).

# Miscellaneous Items

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- Private Foundations
- IRS.GOV
- Form 990

# Special Cases

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- Facts and Circumstances
- Supporting Organizations
- Credit Counseling

# Special Cases

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- Hospitals
- Partnership
- Unusual Grants

# Solutions to Problem Boards

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- Facts and Circumstances
- Board Expansion
- Conflict of Interest
- Audit Referral or other possible follow-up
- Contributing Factor to an Adverse Position

# Summary

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# GOVERNANCE

# Summary of Main Points

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- Each organization needs to decide for itself how best to govern – one size does not fit all
- Not our role to tell them how to govern
- All of EO must understand our role in the area and what we are trying to accomplish in the areas of education and outreach, rulings and agreements, and examinations
- We will keep you posted and seek your input along the way



# EO Next Steps

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- Develop examination checksheet regarding various governance topics to explore link between good or bad governance and compliance with tax laws
- Incorporate Form 990 questions and responses into compliance initiatives
- Continue training - what further training or emphasis is needed?

# Governance Project Objective

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- Long term study by IRS – this is not something we will do quickly
- Will include several segments along with different activities over the span of several years in order to accomplish the project objective.
  - Compliance Checks
  - Examinations

# Where do you go if you have questions about nonprofit governance in general?

- Outside sources – not authoritative in legal sense but excellent discussions of issues
  - ACT Report
  - Independent Sector/Nonprofit Panel Reports
- IRS sources
  - IRS Life Cycle governance document
  - Governance Project Team Members

# Governance Project

## Team Members

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# Discussion Questions (True/False)

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- The bylaws are the rules governing the internal affairs of an organization.
- To obtain exemption, the IRS mandates a board must be active and engaged, appropriately sized and composed of independent members.
- The I.R.M. does not address board expansion.
- The absence of a whistleblower policy precludes exempt status.

# Discussion Questions (True/False)

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- It is very important to ensure a private foundation has a “community board”.
- IRS.GOV is a good information source for both the specialist and applicant.
- If an organization refuses to expand their board, the case should be closed FTE.
- Board concerns never merit the consideration of an audit referral.