IRS Places New Emphasis on Nonprofit Corporate Governance Policies: Are You Ready for the New Form 990?

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The IRS recently released two documents that effectively encourage nonprofit organizations to adopt appropriate written policies related to corporate governance. In light of those new releases, nonprofit organization boards and their counsel should carefully consider whether the organization’s current corporate policies are sufficient or whether they may need to be supplemented and/or revised.

This article discusses the recent IRS documents and the corporate governance policies they reference. It also considers what the IRS may be looking for when it recommends adoption of a particular type of policy.

IRS Developments Related to Corporate Governance

The first IRS document is a draft paper titled “Good Governance Practices for 501(c)(3) Organizations” (IRS governance practices paper). It recommends that all charitable organizations adopt the following policies:

- a conflict of interest policy (for both directors and staff);
- a financial information disclosure policy;
- a charitable fundraising policy;
- a financial audit policy (including possible establishment of an audit committee);
- compensation and expense reimbursement policies; and
- a document retention policy.

The IRS governance practices paper was obtained by a member of the press. According to a February 2, 2007 article published in Tax Notes Today, “IRS Prepares Draft of Good Governance Practices for 501(c)(3) Organizations,” the proposed good governance practices are designed to ensure that nonprofit directors understand their roles and responsibilities as persons charged with guiding and overseeing a charity’s operations and finances.1

Good governance was the focus of Steven T. Miller’s recent speech at the 24th Annual Conference on Representing and Managing Tax-Exempt Organizations. Miller is the IRS commissioner of the Tax Exempt and Government Entities Division. In his speech at the Georgetown University Law Center, Miller commented that some of the problems facing the tax-exempt sector could be remedied by “full spectrum sunshine” and “enhanced transparency.” He concluded that the IRS should educate tax-exempt organizations “on basic standards and practices of good governance and accountability.” He believes that if the nonprofit sector is well governed, it is likely to be more compliant.2

Senate Finance Committee Chair Max Baucus, D-Mont., and ranking minority member Chuck Grassley, R-Iowa, joined the chorus on May 29, when they sent a letter urging the Treasury secretary to update the Form 990 to place more emphasis on corporate governance. The letter stated, “[T]ime and again we have seen poor governance at the core of problems at charities.” The senators concluded that the IRS tax form used by tax-exempt organizations “can serve a useful purpose of

bringing a focus on governance issues both for the board and management of the charity as well as the public.\(^3\)

On June 14 the IRS released a completely redesigned draft Form 990. The IRS has requested comments on this radically different and expanded form by September 14, 2007. (The short deadline is necessary to facilitate IRS plans to implement the new form for the 2008 filing year.) The redesigned Form 990 focuses much more heavily on corporate governance than the existing Form 990 does. It specifically asks each tax-exempt organization filing the redesigned Form 990 whether it has the following written policies in place:

- a conflict of interest policy;
- a whistle-blower policy;
- a document retention and destruction policy;
- policies to ensure consistency in the operation of chapters, affiliates, and branches;
- policies regarding affiliates and joint ventures;
- a policy regarding reimbursement of business, travel, and entertainment expenses;
- compensation policies (for both directors and key staff);
- a financial information/audit policy (including tax filings); and
- a financial information disclosure policy.

If the proposed changes contained in the redesigned Form 990 are adopted, all tax-exempt organizations (not just charitable or so-called 501(c)(3) organizations) filing the Form 990 will be required to state annually whether they have such policies in force in the tax year to which the filing relates. Also, Form 990 schedules applicable to specific types of nonprofits ask about specialized policies— for example, nonprofit hospitals are asked about charity care and billing and collection policies, schools are asked about racial discrimination policies, and conservation organizations are asked about conservation easement policies.

The following is a brief overview of good governance policies or related items that the IRS would like all tax-exempt organizations filing the Form 990 to adopt.

Mission Statement

Nonprofit organizations should adopt a well-written, focused mission statement that sets forth the organization’s purposes and objectives. As noted in the IRS governance practices paper, “a clearly articulated mission statement” will “popularize the charity’s purpose and serve as a guide to the organization’s work.” Further, an organization’s mission statement will serve as its introduction to the IRS.

Part I, line 1 of the redesigned Form 990 states, “[B]riefly describe the organization’s mission.” If the board of directors has not already honed a mission statement, it will be difficult, if not impossible, for any individual charged with completing the redesigned Form 990 to answer this question appropriately. Thus, it behooves nonprofit organizations to draft a well-articulated mission statement. The mission statement should address why the organization exists, what it hopes to accomplish, what activities it will undertake, where it will undertake them, and for whom.

Conflict of Interest Policy

Nonprofit organizations are increasingly subject to intense public scrutiny, especially when an officer, director, or other related party is perceived to benefit inappropriately. Thus, a conflict of interest policy should emphasize the nonprofit director’s duty of loyalty, which requires every director to act in the best interest of the nonprofit organization, rather than in the personal interest of the director or some other person or organization. The IRS governance practices paper specifies that a good conflict of interest policy should:

(1) require directors and staff to act solely in the interests of the nonprofit without regard to personal interests;
(2) include written procedures for determining whether a relationship, financial interest, or business affiliation results in a conflict of interest; and
(3) prescribe a course of action in the event a conflict is identified.

In addition to avoiding the appearance of impropriety or a fiduciary breach, a well-drafted conflict of interest policy helps nonprofit organizations safeguard their tax-exempt status, which can be jeopardized if they allow insiders to derive inappropriate benefits.

Whistle-Blower Policy

Since the corporate scandals earlier this decade, nonprofit organizations have been encouraged to adopt a whistle-blower policy. Whistle-blower policies establish a procedure for individuals to report, without fear of retaliation, complaints or unethical conduct occurring at an organization. A well-drafted policy allows the organization to investigate and remedy any potential issues before a situation has unintended consequences. When adopting a policy, nonprofits should consider the following questions:

- How broad should the policy be?
- Who is protected by the policy?
- How should complaints be reported?
- Who should resolve the complaints?
- What protection is the whistle-blower afforded?

A whistle-blower policy can be incorporated into the organization’s code of ethics.

Code of Ethics

The public expects those associated with nonprofit organizations to abide by ethical standards while promoting the public good. The board of directors is ultimately responsible for ensuring that ethical standards are maintained. One way to carry out this responsibility is to adopt a code of ethics that encourages good behavior while discouraging bad behavior. The board of directors should view the code of ethics as an opportunity to communicate a strong culture of legal compliance and ethical integrity. Two topics frequently addressed by

nonprofit organizations’ ethics codes are relationships with vendors and expense reimbursement.

Document Retention and Destruction Policy

Nonprofit organizations should adopt a written policy establishing standards for document integrity, retention, and destruction. The document retention policy should also include guidelines for handling electronic files and should cover backup procedures, archiving of documents, and regular system reliability checkups. IRS Publication 4221, Compliance Guide for 501(c)(3) Tax-Exempt Organizations, provides further details on document retention. The publication states that supporting documents such as contributions, purchases, sales, payroll, grant applications and awards, sales slips, paid bills, invoices, receipts, deposit slips, and canceled checks should be kept because they support organization transactions and accounting entries. The publication further explains how long records, such as employment tax records and nontax records, should be retained.

Policy on Affiliated Organizations (Including Joint Ventures)

A nonprofit organization may team with another organization, exempt or nonexempt, to carry out its mission. These partnerships, while valuable, carry significant risk for nonprofits. A joint venture may lead a nonprofit organization to stray from its charitable purpose, which can cost the organization its tax exemption. As a result, tax-exempt organizations should consider adopting a policy that safeguards the organization’s tax-exempt status when partnering with other entities. The policy should make clear that joint ventures must permit the tax-exempt partner to act exclusively in furtherance of its exempt purpose and only incidentally for the benefit of the for-profit partners. Such policies should also address the extent to which the nonprofit organization must retain effective governance control over the venture and sufficient authority over operations to further the organization’s charitable purposes.

Compensation Policy

Nonprofit organizations should adopt a compensation policy designed to ensure that no more than reasonable compensation is paid for services rendered. Nonprofits generally do not compensate board members for service, but they frequently reimburse for board-related expenses. At the same time, nonprofits almost always compensate officers and staff. A well-drafted compensation policy will ensure that the executives’ compensation is reasonable. In determining what is reasonable, the board — or the committee setting compensation, as the case may be — should review what persons performing similar tasks for similar organizations are receiving as compensation. Section 501(c) (3) and 501(c)(4) organizations may wish to include procedures for satisfying the rebuttable presumption of reasonableness under section 4958 of the code.

Expense Reimbursement Policy

Nonprofit organizations are permitted to pay for or reimburse ordinary and necessary expenses incurred while carrying out the organization’s activities, including the costs of travel. However, expense reimbursement policies should be consistent with recent IRS guidance on the required elements of an accountable plan expense reimbursement, which include the following:

1. There is a business connection or reason for the expense;
2. The officer or employee adequately accounts for such business expenses within a reasonable time; and
3. The officer or employee returns any amount of excess reimbursement within a reasonable time.

The IRS is now taking the position in audits of nonprofit organizations that expenses reimbursed outside of an accountable plan must be reported as taxable income to the individual receiving such reimbursements, which means additional taxes must be withheld. Nonprofit organizations may wish to reconsider whether they will continue to reimburse airline fares that exceed coach airfare. The re-designed Form 990 contains a new Schedule J, “Supplemental Compensation Information,” in which it asks whether the organization paid or reimbursed for “first-class travel, club dues or use of personal residence.” That is a question that must be answered yes or no with no opportunity for explanation.

Conclusion

While some may question the recent IRS assertion of authority over corporate governance (traditionally, a matter of state law), there is no question that well-governed nonprofit organizations tend to be more compliant taxpayers — particularly regarding critical issues such as private benefit and inurement. Simply adopting a policy supporting a particular aspect of good governance will not ensure compliance, but a concerted program of adoption and implementation of such policies will strongly indicate to the IRS that the organization has its house in order — or, at the very least, is taking steps in the right direction. Thus, if the policies reviewed in this article are unfamiliar territory to you or your organization, get ready — the IRS will be asking about them.

5Redlands Surgical Services, 113 T.C. 47, 92-93 (1999), aff’d 242 F.3d 904 (9th Cir. 2001).
6St. David’s Health Care System v. United States, 349 F.3d 232, 236-237 (9th Cir. 2003).
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