

501 (c)(3)s: Prepare for More Governance Scrutiny



Q: I've heard the IRS is stepping up its scrutiny of not-for-profit organizations. Can you tell me more?

A: For charitable organizations undergoing examination (audit), the IRS plans to deeply delve into their governance policies and practices. Last year, the IRS rolled out the revised Form 990, which requires comprehensive financial, activity and policy information from all types of tax-exempt 501(c) organizations. Now, the IRS has adopted a new “governance check sheet” for IRS agents examining tax-exempt 501(c)(3) organizations. The check sheet will be used to capture data about governance practices and the related internal controls of public charities being examined.

The IRS's authority to expand its inquiries in this way is unclear. Nonetheless, the check sheet indicates the IRS's continuing interest in monitoring organizational governance. The IRS plans to use the data in a long-term study to gain a better understanding of the intersection between governance practices and tax compliance. It remains to be seen whether the IRS also will use the information to target other organizations for audit, or extend use of the check sheet to other types of tax-exempt organizations.

For now, the questions delve deeper into the financial, activity and policy information requested of 501(c)(3) organizations on the Form 990. Some of the most significant questions relate to the governing body and organizational control. IRS agents are being directed to review and

report on the number of board members with voting rights; whether the bylaws outline the board's composition, duties, qualifications, and voting rights; and whether the board actually met as often as required in the bylaws.

The check sheet — along with organizational questions concerning family and outside business relationships among board members and key employees — asks whether a single individual or select few individuals effectively control the organization. Such subjective analysis seems designed to unearth whether any individual has undue influence over the board in setting his or her compensation or in other decisions.

Not surprisingly, compensation is a major focus. The compensation section mirrors the intermediate sanctions “safe harbor” provisions for creating a rebuttable presumption of reasonableness in compensation. The primary question is whether compensation arrangements for all officers, directors, trustees and key employees are approved in advance by an authorized body of the organization composed of individuals with no conflict of interest. The IRS agent must indicate if even one person participating in the approval of the arrangement had a conflict.

The check sheet devotes significant attention to the data used for compensation decisions, including whether that comparability data came from other exempt organizations, non-tax-exempt not-for-profit organizations, government entities or for-profit entities. While the IRS does not prohibit using for-profit salary data, it has raised concerns about using such data in the tax-exempt context. The check sheet also asks whether the organization has contemporaneously documented all compensation decisions.

Regarding conflicts of interest, the IRS agent must indicate whether there is a written conflict of interest policy, whether the policy was adhered to and whether the policy addresses recusals and requires annual written disclosures.

Questions on financial oversight range from whether the organization has systems in place to ensure assets are used consistent with the organization's mission to how frequently board members received and discussed reports of the organization's financial condition. A special set of questions centers on independent auditor's reports, including whether the organization received a management letter identifying problems in its accounting system and whether it adopted all, some or none of the recommendations in the management letter. The check sheet also asks whether the board in fact *reviewed* the Form 990 prior to filing, which differs from the question on the Form 990 asking only whether the board *received* the Form 990 prior to filing.

Other questions include whether the organization has a *written* mission statement that reflects its *current* 501(c)(3) purposes and activities; whether there is a written document retention policy to which the organization adheres all, some or none of the time; and whether the board maintains contemporaneous minutes of its meetings. Finally, the IRS agent must indicate whether his or her examination was hindered by a lack of necessary documentation or cooperation.

The message is clear that organizations must do what they say they're going to do in their policies, bylaws and the information reported on the Form 990. Organizations should become familiar with the questions posed by the check sheet and be prepared if the IRS selects their return for closer examination. Remember, however, that a “no” or “negative” answer on the check sheet does not mean the organization has violated the law. Rather, the IRS has singled out specific policies and practices for closer scrutiny based on its belief that it will, thereby, encourage good governance practices and greater overall tax compliance. ■

The answers provided here should not be construed as legal advice or a legal opinion. Consult a lawyer concerning your specific situation or legal questions.