

NONPROFIT DIRECTORS: IRS RAISES THE GOVERNANCE BAR

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The IRS has raised the bar for directors of nonprofit organizations. Proceeding on the premise that good governance produces better tax compliance, it has issued a revised Form 990, the annual information return filed by most nonprofits. It includes an entirely new governance section which, in effect, seeks to assure that directors of nonprofit organizations fulfill their fiduciary duties of care and loyalty in matters related to tax law compliance.

The questions in the new governance section are strong encouragements for directors to govern their organizations to avoid conflicts of interest, to properly review and approve executive compensation, to foster transparency by disclosure of tax returns and other financial information, and to enact governing policies that will further these goals. Because the revised Form 990 will be effective for the tax years beginning after January 1, 2008, now is the time for directors to take the initiative to review their organization's policies so that they are fully prepared to demonstrate compliance with both tax laws and "best practices" of nonprofit governance.

IRS Form 990 Revision

In June 2007, the IRS proposed substantial changes to its Form 990. It explained that the existing form, last revised in 1979, "failed to keep pace with changes in the law and with the increasing size, diversity, and complexity of the exempt sector," and "fail[ed] to meet the Service's tax compliance interests or the transparency and accountability needs of the states, the public, and local communities served by the organization."

More than 700 public comments (3,000 pages) were filed in response to the proposed revisions, prompting the IRS to make additional changes. The final version was published in

December, 2007, and the draft instructions were published for comment in April, 2008. The IRS expects to finalize the instructions by the end of the year.

The revised Form 990 expands the "core" form from 9 to 11 pages, and increases the number of potential schedules to 15. Organizations will determine which schedules they need to file by completing a new, 37-question checklist. The revised "core" form, schedules, and IRS background explanations can be found [here](#) and the draft instructions may be found [here](#).

New Governance Section

An entirely new section entitled, "Governance, Management and Disclosure" is particularly important to nonprofit directors. It seeks information on governance and management, the process for determining executive compensation, policies regarding conflicts of interest, whistleblower encouragement and protection, and document retention, and public disclosure of tax returns and other governance and financial information. Opponents of this section had argued that the information it sought about nonprofit governance is not required by the Internal Revenue Code and that the inclusion of questions on such topics could make them a *de facto* legal requirement.

Although the IRS admitted that much of the requested information was not required, it replied that "the existence of an independent governing body and well-defined governance and management policies and practices increases the likelihood that an organization is operating in compliance with federal tax law." In other words, the IRS will use the responses to these governance questions to ferret out non-compliance with tax laws.

Besides the IRS, donors and grantors will likely be very interested in a nonprofit's responses to the new governance questions and may use the questions as additional criteria for their donations and grants. Negative or inadequate responses may reflect poorly on the grantee's ability to properly use the funds or their financial integrity.

For example, Line 10 asks whether a copy of the Form 990 was provided to directors *before* filing with the IRS. The form's follow-up question underscores the point: it requires a description of the process by which directors, officers or other management, if any, reviewed the Form 990, including by whom and when the review was conducted, and the extent of the review. Both the IRS and likely the nonprofit's funding sources are looking for assurances that the directors are properly supervising tax compliance.

Consequently, these new governance questions in the revised Form 990 are strong motivation for nonprofit organizations to review and update their policies and practices as needed. Given their potential to raise a "red flag" with the IRS or to undermine a nonprofit's relationships with its donors and grantors, careful attention to the revised Form 990's governance questions is important.

Key Governance Questions

The new Part VI, "Governance, Management and Disclosure," of the revised Form 990 is divided into three sections: (A) Governing Body and Management, (B) Policies, and (C) Disclosures. It contains a total of 28 questions, most of which are entirely new. The more significant questions are addressed below.

A. Governing Body and Management

Number of "Independent" Voting Directors. Line 1 asks for both the total number of voting members of the governing board and the number that are "independent." The IRS' draft definition of "independent" is less stringent than California's statutory definition.

Under the IRS definition contained in the draft instructions, a director is "independent" if, during the entire year, he or she did not receive

from the nonprofit or a related entity: (1) any compensation as officer or employee; (2) more than \$10,000 as an independent contractor; or (3) other "material financial benefits" (including prior year "excess benefit" transactions, loans from the nonprofit, non-arms' length loans to the nonprofit, grants or assistance, and business transactions with the nonprofit for more than \$10,000); *and* (4) the director was not related to any such person. Notably, a director does not lack independence if he or she is a major donor or a member of the class served by the exempt organization.

From a risk perspective, the IRS may use the response to this question regarding "independent" directors to indirectly discover potential "excess benefit" transactions subject to excise taxes. Also, a response which indicates that more than 49% of the directors of a California nonprofit public benefit corporation are "interested" highlight the nonprofit's noncompliance with California Corp. C. § 5227 which, reflecting a standard more stringent than the IRS, requires that no more than 49% of the directors of a nonprofit public benefit corporation be "interested persons."

This question may also increase pressure on California nonprofit mutual benefit and certain religious corporations to have more "independent" directors even though they are not subject to the "49% rule" applicable to nonprofit public benefit corporations.

Delegation of Director or Officer Responsibilities to Management Company. Line 3 asks whether the organization delegated to a management company or other person control over management duties customarily performed by or under the direct supervision of a director or officer. Such duties include hiring, firing, and supervising personnel, budget or financial planning and responsibility, supervising exempt operations or unrelated businesses. An affirmative response may raise a question whether such delegated responsibilities are adequately supervised consistent with a director's fiduciary obligations.

Embezzlement—"Material Diversion of Assets." Line 5 asks, "Did the organization become aware during the year of a material diver-

sion of the organization's assets?" "Material diversion of assets" is defined as any unauthorized conversion or use of the nonprofit's assets other than for its exempt purposes, including but not limited to embezzlement or theft, exceeding the lesser of \$250,000 or 5 percent of the nonprofit's gross receipts or assets. An affirmative response requires an explanation of the diversion, amount involved, and corrective actions taken (without identifying the person(s)). Such asset diversion may also constitute an "excess benefit" transaction with consequent excise taxes and penalties. The need for this public explanation of the material diversion of a nonprofit's assets could well cause boards to handle such situations more aggressively.

Minutes of Board Meetings. Line 8 asks if the organization contemporaneously documents board and board committee meetings or written actions. The instructions define "contemporaneous" to be the later of the next meeting of the board or board committee or 60 days after the meeting or written action.

On the surface, the question simply reflects good management practice to keep timely, accurate, records of actions taken by board and board committees. However, a negative response potentially precludes reliance upon the executive compensation "safe harbor" provisions of federal "excess benefit" prohibitions which require contemporaneous recording of the board's deliberations and decision. Treas. Reg. § 53.4958-6. In the broader context, the board's tolerance of tardily-prepared minutes may, if relevant to a dispute, cause them to be viewed as unreliable or, worse, fuel an assertion that they were fraudulently prepared long after the meeting.

B. Policies

Conflict of Interest Policy. Line 12 continues to ask, as does the existing version of the form, whether an organization has a written conflict of interest policy. If the answer is "yes," two new subparts (Lines 12a and 12b) ask whether officers, directors, trustees or key employees are required to make annual disclosures of potentially conflicting interests, and how the organization monitors and enforces compliance with the policy. However, even if the initial response is "no," it may be prudent to attach an

explanation how the nonprofit, in practice, assures that conflicts are disclosed and addressed.

Whistleblower and Document Retention Policies. Lines 13 and 14 ask whether the nonprofit has written whistleblower and document retention and destruction policies. Although federal tax law does not require such policies, there are several sections of the Sarbanes-Oxley Act of 2002, which apply to both for-profit and nonprofit entities and make it a crime to retaliate against a whistleblower or to destroy documents. 18 U.S.C. § 1513(e) (whistleblower); 18 U.S.C. § 1519 (document destruction). Because these sections relate to violations of federal law, implicitly including the federal tax law, the IRS hopes to encourage tax law compliance through the adoption of such policies by nonprofit organizations.

Executive Compensation. Lines 15, 15a and 15b collectively ask whether the process for determining the compensation of an organization's CEO, Executive Director, or top management official, or other officers or key employees included a review and approval by "independent persons," using "comparability data," and with "contemporaneous substantiation of the deliberation and decision." A description of the process is then requested. Persons familiar with prohibited "excess benefit" transactions and the resulting substantial "intermediate sanctions" will recognize that the three factors match those which, if they exist, provide a "safe harbor" from an "excess benefit" transaction under Treas. Reg. § 53.4958-6. Thus, a negative response likely eliminates the availability of a rebuttable presumption that the compensation is not an excess benefit transaction and may flag an organization's compensation decisions for possible examination.

A negative response may also raise a question concerning compliance with the California Nonprofit Integrity Act which requires board's to determine that the compensation for a nonprofit's President/CEO or Treasurer/CFO is "just and reasonable." Govt C. § 12586(g).

Joint Ventures. Line 16 addresses a nonprofit's joint venture investments or participation and, with little subtlety, raises the specter of loss of exemption, when it directly asks, "[H]as

the organization adopted a written policy or procedure requiring the organization to evaluate its participation in joint venture arrangements under applicable Federal tax law, and taken steps to safeguard the organization's exempt status with respect to such arrangements?" Some suggested safeguards identified in the instructions include control over the venture to ensure it furthers the exempt purpose of the organization and gives priority to the exempt purpose over profits for other participants.

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C. Disclosures

Public Disclosures. In addition to confirming that the nonprofit's Form 1023 (or Form 1024 if applicable) and Form 990 and 990-T are available for public inspection as required by IRC § 6104 (with names and addresses of contributors redacted), Line 18 asks how that disclosure occurs: on the nonprofit's website, another person's website, or upon request. If any of these documents are not made available upon request (as required by statute), the instructions request an explanation for the reason.

Line 19 asks whether the organization makes its governing documents (articles and bylaws), conflict of interest policy, and financial statements available to the public and, if so, how those disclosures are made. The instructions note that such disclosures are not required by law except as such information may be contained in publicly-available forms, *e.g.*, Form 990.

Conclusion

Nonprofit directors need to pay increasing attention to governance issues involving independence of board members, identification and resolution of conflicts of interest, determination of reasonable executive compensation, and means to improve financial transparency. If the increased demands of the revised Form 990 are addressed early, nonprofits can use the new governance section to demonstrate that they are well-managed. If not, the IRS, the Franchise Tax Board, their donors and grantors may give them more attention than they desire.

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