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IRS Updates Position On Corporate Governance

Late last month, the Internal Revenue Service (the "IRS") posted on its website a revised and comprehensive update of its position concerning the governance of nonprofit tax-exempt organizations, including hospitals and health systems (the "Position Paper"). This updated position is consistent with the emphasis by the IRS on corporate governance as a significant aspect of its education and enforcement program for the tax-exempt sector.

- 1. Scope of Position Paper.** The Position Paper is basically structured as a discussion of six specific governance topics: (i) Mission; (ii) Organizational Documents; (iii) Governing Body; (iv) Governance and Management Policies; (v) Financial Statements and Form 990 Reporting; and (vi) Transparency. These six areas will be the key focus of the IRS in monitoring compliance. The Position Paper significantly updates and expands upon the IRS' February 2007 discussion draft of "Good Governance Practices" for charitable organizations, which has now been withdrawn from the IRS website.
- 2. Noteworthy Provisions.** The Position Paper is noteworthy for its many new or significantly revised IRS perspectives on exempt organization governance. Included among these perspectives are the following:

Duty of Care: The IRS places significant emphasis on the relationship of an "active and engaged board" to the success of a tax-exempt organization and to its legal compliance. This translates in part to increased attentiveness to proper board composition, selection of board members who are knowledgeable and engaged, and those who have special skills of potential value to the organization (e.g., accounting, finance, compensation, and ethics). The IRS expresses concern with respect to boards that tolerate "a climate of secrecy or neglect."

Board Size and Composition: The IRS expresses interest in the important topic of appropriate board size, commenting on the risks to effective governance arising from boards that are either very small, or very large. The IRS endorses a committee-centric approach to governance of organizations with very large boards. The IRS continues to place emphasis on the importance of assuring

that the governing board is controlled by a majority of independent directors and free of intra-board relationships that could result in misuse of charitable assets.

Governance Policies: The IRS does not require exempt organizations to maintain governance and management oversight policies and protocols, but supports them as indicating a well-governed charity. The IRS will review an organization's application for exemption and annual information returns to determine whether the organization has implemented policies relating to executive compensation, conflicts of interest, investments, fundraising, documenting governance decisions, document retention and destruction, and whistleblower claims.

Executive Compensation: The IRS' ongoing interest in board oversight of the executive compensation process is underscored by comments that emphasize (a) reliance on the Rebuttable Presumption of Reasonableness, (b) the importance of the independence of the compensation consultant, and (c) the value of appropriate compensation comparability data.

Investments: Particularly noteworthy is the new focus on the board's oversight of investments of the organization, including those in joint ventures, for-profit subsidiaries, and complicated and sophisticated financial products or investments that require financial and investment expertise and which may require the advice of outside investment advisors. The IRS recommends that the board adopt written policies and procedures relating to the supervision of such investments.

Fundraising: Another area of new focus is the board's oversight of the costs and methods associated with charitable solicitation activities. Charities are encouraged to keep their fundraising costs reasonable and to provide information about fundraising costs and practices to donors and the public.

Compliance Matters: The IRS also recommends as a matter of exemption compliance the adoption of document retention and destruction policies and procedures, as well as ethical standards and effective whistleblower procedures.

Form 990 Reporting: The IRS does not require, but clearly seems to encourage, a practice by which the organization provides copies of the Form 990 to the governing board or to other internal governance or management officials prior to or after it is filed with the IRS. No specific practice in this regard is recommended, although several are offered as examples.

Transparency: Boards are reminded of the transparency benefits of making principal organizational documents (e.g., Form 1023, Form

990, Form 990-T, governing documents, conflicts of interest policy, and financial statements) available to the public through the corporate website or similar means.

3. **Relevance.** The Position Paper is more than merely a compilation of existing IRS viewpoints on corporate governance of exempt organizations. It contains many new perspectives on governance practices. Further, it is a clear indication of the IRS' strong commitment to monitoring these practices by the tax-exempt community. It should be considered together with other recent developments in nonprofit corporate governance, such as the release of the Panel on the Nonprofit Sector's Principles for Good Governance and Ethical Practice released in October 2007. A copy of such principles can be viewed at [http://www.nonprofitpanel.org/report/principles/Principles Guide.pdf](http://www.nonprofitpanel.org/report/principles/Principles_Guide.pdf). The Position Paper is contained within the IRS publication, Life Cycle of an Exempt Organization – Public Charities and can be viewed at the following link: http://www.irs.gov/pub/irs-tege/governance_practices.pdf.

If you have any questions regarding the IRS' Position Paper or other key tax-exempt governance issues, please contact Michael J. Philbrick at (248) 740-7505 or mphilbrick@hallrender.com.

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