IRS COMMENTS ON EXEMPT ORGANIZATION GOVERNANCE STUDY AND SIGNIFICANT DIVERSION OF ASSETS

In a speech delivered at an educational conference on April 19, Lois Lerner, Director of the Exempt Organizations Division at the Internal Revenue Service ("IRS"), reported the preliminary findings from an analysis of governance practices of exempt organizations and signaled that good governance will continue to be a focal point for the IRS. The findings represent the first measurable data from the IRS supporting the premise that good governance and tax compliance go hand in hand. In addition to her comments on the governance analysis, Ms. Lerner announced that the IRS will begin conducting examinations of organizations reporting "Significant Diversions of Assets" (such as embezzlement or theft) in the governance section of the Form 990. The goal of the IRS will be to use the examinations to pursue excess benefit transactions against persons engaged in such activities.

BACKGROUND

For several years, the IRS has stated publicly its belief that a well-governed exempt organization is more likely to be compliant with the tax law. In accordance with this belief, the IRS published on its website various educational pieces touting the importance of good governance to nonprofit managers and implemented Part VI, Governance, Management and Disclosure, of the revised Form 990, which solicits governance information from organizations filing the form. In addition, the IRS publicly released the training materials it used to train its staff on the governance issue and announced its intention to develop an examination check sheet regarding governance practices (see: http://www.hallrender.com/health_care_law/library/articles/498/RS%20RELEASES%20CPE%20TRAINING%20.pdf).

GOVERNANCE CHECK SHEET

In undertaking the governance check sheet initiative, which was the primary subject of Ms. Lerner's remarks, the IRS sought to provide statistical support for its proposition that good governance leads to tax compliance. The results of this check sheet initiative came from an analysis of organizations selected for IRS exam and not from a statistically representative survey of the exempt organization population. The IRS focused the check sheet on a few key questions related to governance, including whether an organization used comparability data in making compensation decisions, whether it had adopted a written conflicts of interest policy and whether the IRS Form 990 was reviewed by the organization's full board of directors or a designated committee of the board.

Overall, the preliminary results of the check sheet analysis support the IRS position that good governance enhances tax compliance. The IRS found a statistically significant correlation between tax compliance and the following familiar governance practices:

- An organization with a written mission statement is more likely to be compliant;
- An organization that always uses comparability data when making compensation decisions is more likely to be compliant;
- An organization that has its Form 990 reviewed by the organization's Board of Directors prior to filing is more likely to be compliant; and
- An organization effectively controlled by one individual or a small, select group of individuals is less likely to be compliant.

The IRS study did not support a correlation between tax compliance and the existence of conflict of interest policies or having one or more board members that were not independent. However, it should be noted that, despite these preliminary results, an organization must nevertheless disclose on its Form 990 whether it has a written conflict of interest policy and must disclose the number of independent board members. More importantly, perhaps, a strong conflict of interest policy and independent board support independent decision making and help fulfill the board members' fiduciary duties of care to make decisions in the best interest of the organization, rather than any one individual.

In general, the data supports the IRS' long-standing assertion that effective corporate governance practices enhance tax compliance. Based on these preliminary results, the IRS has decided to expand the check sheet initiative to a statistically representative sample of the general exempt organization population.

SIGNIFICANT DIVERSION OF ASSETS

Part VI of the redesigned Form 990 asks whether the organization became aware during the year of a "significant diversion of the organization's assets" (defined in the form instructions to include embezzlement or theft). In her recent remarks, Lerner explained that the IRS has reviewed the tax filings and other publicly available information on those organizations that reported significant diversions and now intends to conduct an examination program in the area. The goal of the program will be to pursue excess benefit transaction actions against the persons committing them.

RECOMMENDATIONS

It is apparent from these recent comments that the IRS continues to focus on issues of nonprofit governance and is motivated to demonstrate, with data, that those organizations that practice "good governance" will be more successful in their tax compliance efforts. We recommend that tax-exempt organizations continue to review their governance practices, paying particular attention to those elements identified by the IRS as having a direct relationship to tax law compliance. In addition, the preliminary results notwithstanding, we encourage the continued use of a strong conflict of interest policy and an emphasis on maintaining board independence to the extent possible.

A transcript of Ms. Lerner's remarks is available here: http://www.irs.gov/pub/irs-tege/georgetown_04192011.pdf.

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