ADVISORY COMMITTEE ON TAX EXEMPT AND GOVERNMENT ENTITIES (ACT)

THE APPROPRIATE ROLE OF THE INTERNAL REVENUE SERVICE WITH RESPECT TO TAX-EXEMPT ORGANIZATION GOOD GOVERNANCE ISSUES

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I. EXECUTIVE SUMMARY

In recent years, the subject of "good governance" and its potential to prevent wrongdoing, ensure compliance with the law, and enhance the overall effectiveness of the nonprofit sector has been a topic of enormous interest. It has had the attention of the media, Congress, the public, and the nonprofit community. The Internal Revenue Service ("IRS") has significantly increased its own role with respect to promoting improved governance and has announced it plans to become even more active in the area. Under the circumstances, we thought this was an opportune time to consider what the appropriate role of the IRS is with respect to good governance practices by tax-exempt entities.

The IRS's view that "a well-governed charity is more likely to obey the tax laws, safeguard charitable assets, and serve charitable interests than one with poor or lax governance" seems self-evident. At the same time, efforts to promote good governance are fraught with complexity. There are over 1.2 million organizations described in section 501(c)(3) today. Effective governance practices among these organizations will vary depending on numerous factors, including size, sophistication, location, available resources, and activities. Moreover, while we may all agree that governance matters, it is not at all clear that requiring specific governance practices results in greater compliance with the tax laws. In fact, superior board governance may have much more to do with the values, active engagement, and accountability of those in charge than with the adoption of procedures and policies.

We acknowledge the IRS's longstanding stake and legitimate interest in governance issues as they relate directly to compliance with the laws under its jurisdiction. But, the IRS is a powerful force that can drive behavior merely by asking about specific governance practices. Charities can feel pressured to adopt the specified practices, even where it is inadvisable in their situation, because they believe the IRS or others will consider them poorly governed if they fail to do so. This then can effectively usurp the judgment of governing boards in determining what governance practices make sense in their specific context, place undue burdens on organizations, divert their attention to proxies for governance instead of actual governance, and adversely impact the unique, diverse, vibrant, and flexible charitable sector in this country. Accordingly, we believe the IRS should approach this area with caution. We provide a framework and 12 recommendations that are intended to assist the IRS as it seeks to balance the desirability of promoting good governance against the potential deleterious consequences to the sector.

Background. After first setting forth the scope of our report, we examine what is meant by good governance, and the extent to which there is empirical evidence to support specific governance practices. We conclude that while there is a growing list of "good governance" indicators that are organized roughly around the composition, structure, responsibilities, and operations of nonprofit boards and their committees, there is little or no empirical evidence to date that supports the efficacy of any specific governance practices by nonprofit organizations, much less compliance with the requirements for maintaining tax exemption. We do not mean to suggest that the adoption of specific

practices and policies are not useful for organizations in providing a structure that assists them in their decision-making and operational processes. Rather, we believe that respect for the diverse and evolving nature of the nonprofit sector requires that we continue to value flexibility in our expectations of the specific governance practices that may be essential to the health of the sector. Thus, we support the autonomy of an organization's governing body and its exercise of its business judgment as to what best reflects the needs of its organization.

Regulation and Self-Regulation of Nonprofit Governance Outside of the IRS. One of the issues that arises is whether there is a need for the IRS to be more involved in nonprofit governance beyond the specific statutory requirements in the tax laws. Nonprofit organizations can be regulated by many—and sometimes conflicting—authorities. Because nonprofit organizations are established under state law, states historically have had the principal responsibility and greatest authority to regulate in the area. Organizations with offices in more than one state or that solicit contributions in multiple jurisdictions may be subject to the laws of a number of states. There also are industry-specific accreditation agencies, standards relating to participation in particular membership groups, and innumerable voluntary standards and publications from leading organizations regarding nonprofit governance. Because large, sophisticated, and complex organizations are subject to regulation and/or are accredited and, in any event, have numerous governance resources available to them, it is less clear what the IRS adds to the governance discussion in their case. Conversely, while smaller and more rural organizations have less governance resources available to them, there is a greater need to tread lightly because of the burdens flowing from encouraging unnecessarily extensive governance reforms, the fact that the costs of adopting certain practices simply may not be worth the benefits, and the reality that the costs of governance will consume charitable assets that could otherwise be devoted to the organizations' programs. Finally, while disclosure and transparency, facilitated by the public availability of Forms 990 and 1023, undeniably play an influential role in encouraging appropriate nonprofit governance, they have limitations.

Role of IRS/Treasury in Governance Involving Tax-Exempt Organizations. The IRS has sought, to varying extents, to promote good governance practices in each of its five points of contact with tax-exempt organizations: in creating standards for exemption; on determination of exemption; on examination or in other compliance initiatives; in 990 reporting; and in education and outreach. Our report reviews each in turn to identify how governance is involved and to highlight some concerns.

Governance Issues on Standards for Exemption. While Congress has not required the adoption of specific governance practices as a condition for exemption under section 501(c)(3), there are a limited number of situations where the IRS has mandated specific governance practices as a condition for exemption in precedential (sometimes non-precedential) rulings and other documents. Most of these arise in the health care arena, although the IRS requires a conflict of interest policy in certain low-income housing joint ventures. We appreciate that in the quickly-changing field of health care it can, in some instances, be difficult to distinguish a health care organization that qualifies for exemption from one that is merely the for-profit practice of medicine or a health-related

business. In various contexts, as the IRS has labored to draw that line, it has created a *per se* requirement for exemption that requires the organization be governed by an independent body. The IRS's position, however, has not always been sustained by the courts and we are concerned about *per se* requirements.

Governance Issues Involving Determinations. Both stages of the determination process—the completion and submission of Form 1023; and the administrative process where the IRS determines whether exemption is merited—address governance matters. We were not able to find guidance as to how the IRS takes governance issues into account in the determination process, except in limited instances in the health care and low-income housing joint venture areas. We certainly appreciate that governance can bear on the operational test, among other issues. Our personal experience and research for this report suggest, however, that the IRS may require specific governance practices on an ad hoc and inconsistent basis. For example, determination specialists may require organizations seeking exemption to have independent boards or at least some independent board members. Similarly, despite the fact that the Form 1023 specifically states that a conflict of interest policy is recommended but not required, our experience and interviews suggest that determination specialists often require adoption of such a policy, and occasionally require adoption of the sample form of policy included with the Form 1023 instructions. We appreciate we have only anecdotal evidence regarding governance issues in the determination process. It is, however, our impression that the "when" and "what" are unclear and not uniformly applied. We are concerned about the IRS having this level of discretion in cajoling or requiring specific governance process, particularly in the determination phase, where there usually is no track record evidencing operational failures.

Governance Issues Involving Form 990 Disclosure. The addition of a number of governance-related questions to the recently redesigned Form 990 serves as further demonstration of the IRS's growing involvement in the area. The IRS's approach to the redesigned Form 990 for 2008 has been a model of inclusiveness and collaboration. We believe in large part the governance questions on the redesigned Form 990 for 2008 are appropriate and formulated in a relatively neutral manner, recognizing that true neutrality is an unattainable goal. The inclusion of the questions, however, inherently (and intentionally) suggests that the IRS supports adoption of specific governance policies and practices. The danger then is that organizations will take the path of least resistance and adopt the policies and practices whether or not they are appropriate for them, or effective in their context.

Governance Issues in the Examination or Other Compliance Initiative Context. As with determinations, the IRS considers an organization's governance in the context of an audit or other compliance initiative. However, the audit context differs significantly from determinations in that the organization has a track record and the IRS is, or should be, considering the organization's actual operations in ascertaining whether the organization qualifies for exemption. Thus, where there are violations of the standards for exemption, the IRS rightfully has a greater interest and duty and correspondingly increased latitude to address misbehavior. However, we were not able to find

significant guidance as to how the IRS takes governance issues into account in the examination process; and we find the absence of guidelines in this area to be troubling.

Governance Issues in Education and Outreach. In recent years, the IRS has been active in addressing governance issues as part of its education and outreach efforts. Although these initiatives do not have the force of law, the structure of these pronouncements can and does signal IRS's expectations regarding charitable organization governance. We believe the IRS has an important role to play in this area. We note, however, that efforts to promote good governance are fraught with complexity. While we may all agree that governance matters, there is little or no empirical support for the proposition that requiring specific governance practices results in greater compliance with the tax laws pertinent to exempt organizations. We are very mindful of the fact that even the most modest level of prescription from a regulatory body such as the IRS regarding what constitutes "good governance" can undermine the fundamental and wholly legitimate authority of the organization's governing board and can suggest a one-size-fits-all approach that can place undue burdens on an organization, divert the organization's attention from meaningful governance to polices and procedures, and do damage to the uniquely diverse and vibrant charitable sector in this country. Given the diversity of the sector and the varying, and often unpredictable, challenges facing an organization, the organization's governing board generally is in the best position to determine what the most appropriate practices are for its organization.

Why Treasury/IRS Should Proceed With Caution in Promoting Nonprofit Governance. The IRS should remain mindful of the following set of cautionary concerns:

- Beware the law of unintended consequences.
- The power to inquire is the power to punish.
- Governance is an unfunded mandate.
- One size does not fit all.
- Conventional wisdom is not empirical evidence.
- Good governance cannot be captured in a "punch list."
- Policies are not practices.
- Bad policies can lead to bad practices.
- The bully pulpit is a form of regulation.
- Exempt organizations are governed by boards, not by the IRS.

These concerns should be considered by the IRS in any instance in which the IRS inquiries or opines about matters of nonprofit governance. However, the inherent risks and the need for caution are not of equal sensitivity in all circumstances. Therefore, we offer a framework and recommendations that take these concerns into account in our consideration of the appropriate role of the IRS with respect to nonprofit governance.

Recommendations. We again acknowledge the IRS's longstanding stake and legitimate interest in governance issues as they relate directly to compliance with the laws under its jurisdiction. But because of the concerns expressed above and the dearth of empirical evidence supporting the effectiveness of specific nonprofit governance measures, we believe the IRS should approach the governance area with caution. We recommend that in each instance the IRS is considering involvement in a specific governance issue it should consider the importance of the specific governance practice to compliance with the laws under its jurisdiction and then balance that against potential countervailing considerations (*e.g.*, will it elicit or promote a meaningful response related to tax compliance and what harm might flow) in determining whether to proceed. We believe the context in which the IRS is operating—in creating standards for exemption; on determination of exemption; on examination or in other compliance initiatives; in 990 reporting; and in education and outreach—is relevant to this balancing. We conclude our report with 12 recommendations we hope the IRS will find useful as a framework in helping it navigate appropriately between its mandate to ensure compliance with the tax laws and the broader and more aspirational goal of promoting good governance in the sector. We recognize that in a number of instances the IRS already follows or substantially follows these recommendations, but we include all 12 to ensure a complete framework.

(1) The IRS Should Continue to Work Collaboratively With The Tax-Exempt Community In Connection With Its Governance Initiatives.

(2) Specific Governance Practices Should Be Mandated Only In Rare And Limited Circumstances.

(3) The Closer The Nexus To Tax Compliance, The More Appropriate The Governance Inquiry Or Recommendation.

(4) The IRS Should Explain The Specific Relationship Between Tax Compliance And Each Governance Practice About Which It Is Inquiring Or Which It Is Addressing.

(5) Compliance Questions Or Commentary Are More Appropriate Than Governance Questions Or Commentary.

(6) Governance Inquiries Should Be Made And Comments Addressed In As Neutral A Manner As Possible Under the Circumstances.

(7) Questions That Ask About Practices And Approaches Are Typically Better Than Questions That Ask About Policies.

(8) The IRS Should Expressly Acknowledge When Governance Practices About Which It Is Inquiring Or Which It Is Addressing Are Not Required.

(9) The IRS Should Expressly Acknowledge That Governance Practices About Which It Is Inquiring Or Which It Is Addressing May Be More Appropriate For Some Types Of Organizations Than For Others And Respect The Role Of The Governing Body In Making Those Decisions.

(10) Taking Into Account The Absence Of Certain Governance Practices In Determining Whether To Audit Or Take Other Compliance Actions May Be Appropriate in Certain Instances.

(11) Consistency and Fair Treatment are Critical.

(12) Education, Implemented Thoughtfully, Is More Appropriate Than Pressuring Change.

II. STATEMENT OF THE PROBLEM AND THE PROJECT OBJECTIVES

A. Problem

Recently, the IRS has become increasingly involved in seeking to promote "good governance" practices across the tax-exempt sector based on its belief that a well-governed organization is more likely to be compliant and that good governance also allows for self-identification and resolution of problems. We acknowledge the IRS's longstanding stake and legitimate interest in governance issues as they relate directly to compliance with the laws under its jurisdiction. However, the efficacy of specific governance practices is unproven; and the IRS merely asking about specific governance practices is a powerful force that can drive behavior. Charities can feel pressured to adopt the specified practices even where it is inadvisable in their situation because they believe the IRS or others will consider them poorly governed if they fail to do so. This then can effectively usurp the judgment of their governing boards in determining what governance practices make sense in their individual contexts, place undue burdens on organizations, divert their attention to proxies for governance instead of actual governance, and adversely impact the unique, diverse, vibrant, and flexible charitable sector in this country. Accordingly, we believe that caution is critical when seeking to promote specific governance practices.

B. Objective

The objective of this report is to provide a framework that will assist the IRS as it seeks to balance the desirability of promoting good governance against the potential deleterious consequences to the sector.

III. PROCESS

ACT members obtained information and perspectives about governance issues and practices through interviews with IRS and Treasury staff, charities' experts in state attorneys general offices, academics, and practitioners in the field (including exempt organization and other attorneys, accountants that work with nonprofit organizations, those involved with the promotion of voluntary standards in the nonprofit sector, and other experts and stakeholders). The interviews explored the history of the IRS's involvement in governance issues with respect to exempt organizations, any empirical evidence regarding the efficacy of specific governance practices, and the interviewees' perspectives on what is meant by good governance and the appropriate role of the IRS in this area.

ACT members also benefited from the perspectives of many more professionals and practitioners through their participation in two mini-conferences convened at the suggestion of the ACT: