Legal *counsel*

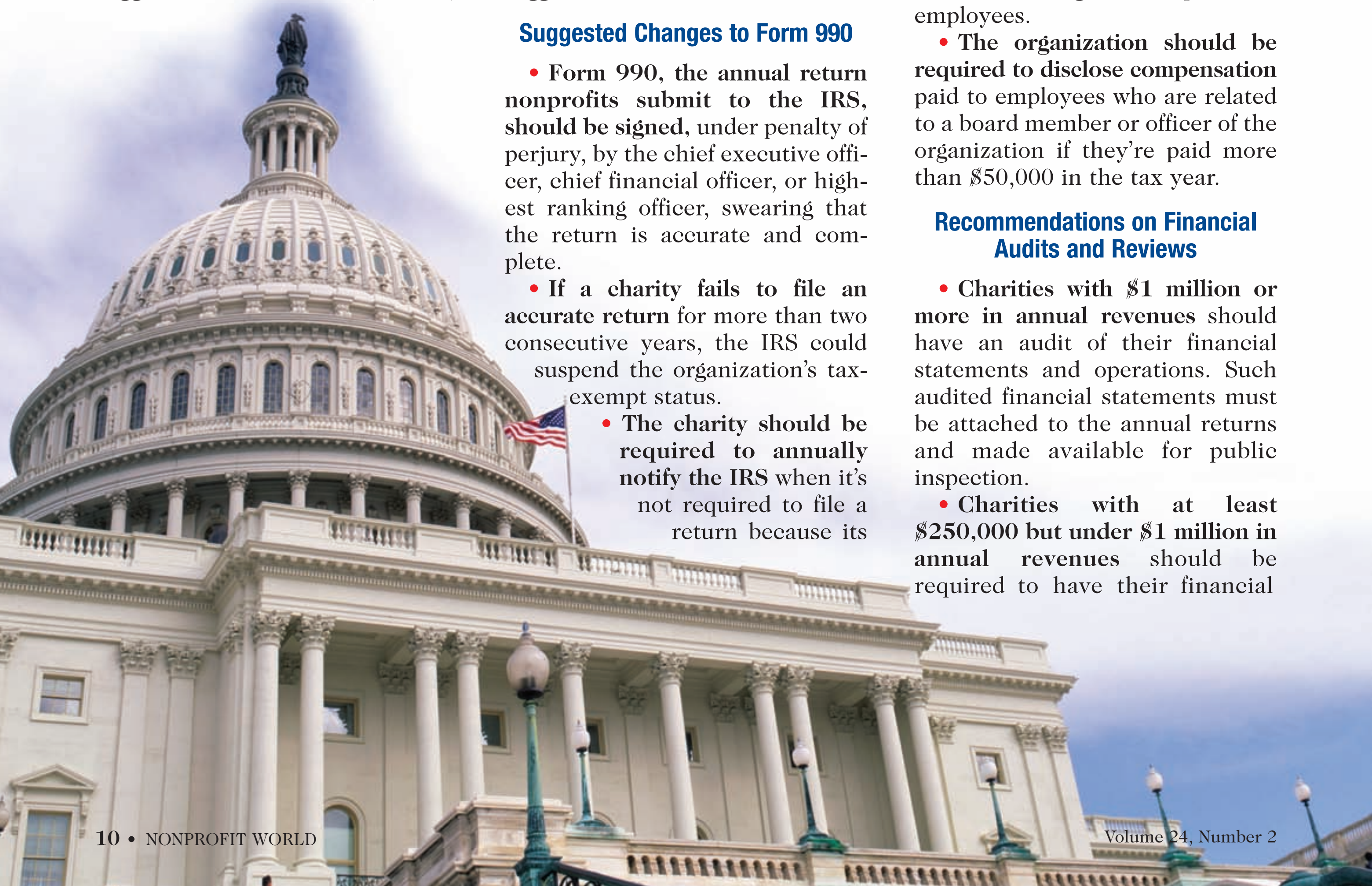
Government Crackdown on Nonprofits: What You Need to Know

Congress is considering proposals crucial to nonprofits. How should you respond?

By Maria Spindel, Ben Tesdahl, & Elinor Ramey

There's a growing perception in Congress and the IRS that nonprofits are abusing their tax-exempt status. To address these perceived abuses, the Senate Finance Committee has held several hearings and issued a draft of onerous recommendations to ensure nonprofit accountability.

The Committee also asked Independent Sector (the Washington, D.C., nonprofit coalition) for suggestions. In October, 2004, Independent Sector formed a group of nonprofit leaders, dubbed the Panel on the Nonprofit Sector, to make recommendations to the Committee. In June, 2005, the Panel issued a report recommending more than 120 separate actions by the charitable community, Congress, and the IRS to strengthen the accountability and governance of the nonprofit sector. Here are the Panel's most notable suggestions:



Suggested Changes to Form 990

- **Form 990, the annual return nonprofits submit to the IRS, should be signed,** under penalty of perjury, by the chief executive officer, chief financial officer, or highest ranking officer, swearing that the return is accurate and complete.
- **If a charity fails to file an accurate return** for more than two consecutive years, the IRS could suspend the organization's tax-exempt status.
- **The charity should be required to annually notify the IRS** when it's not required to file a return because its annual gross receipts fall below the specified minimum amount for filing (currently below $25,000). The IRS would be authorized to suspend the tax-exempt status of organizations that fail to file such notification for three consecutive years.
- **Form 990 should be revised to detail the compensation paid** by the organization to its chief executive officer, all its officers, and the five highest compensated employees.
- **The organization should be required to disclose compensation** paid to employees who are related to a board member or officer of the organization if they're paid more than $50,000 in the tax year.

Recommendations on Financial Audits and Reviews

- **Charities with $1 million or more in annual revenues** should have an audit of their financial statements and operations. Such audited financial statements must be attached to the annual returns and made available for public inspection.
- **Charities with at least $250,000 but under $1 million in annual revenues** should be required to have their financial

statements reviewed by an independent public accountant.

• **Nonprofit boards should include individuals** with some financial literacy.

• **Nonprofits that have their financial statements independently audited** should create a separate audit committee.

• **A charity's board should oversee** the audit process by: (1) retaining an independent auditor; (2) reviewing the terms of the auditor's engagement every five years; (3) supervising the auditor's performance; (4) overseeing policies and procedures for encouraging whistleblowers to report questionable accounting or auditing matters; (5) reviewing and approving internal auditing controls; and (6) monitoring the organization's response to potentially illegal or unethical practices within the organization, including fraudulent accounting.

Suggestions Regarding Compensation and Expenses

• **Form 990 should be revised to ensure clear reporting of the full compensation** of the CEO and other so-called "disqualified persons" (those in a position to exercise substantial influence over the organization's affairs).

• **The full board must approve** the CEO's compensation annually and in advance.

• **Form 990 should require the charity to report** whether it followed the "rebuttable presumption" procedures of the Intermediate Sanctions rules of Internal Revenue Code section 4958 when determining the reasonableness of compensation provided to key executives and other disqualified persons. Current IRS regulations provide for a "rebuttable presumption" that compensation is reasonable if the board adheres to the following procedures when making compensation decisions: (1) The transaction is approved in advance by an authorized body of the organization whose members don't have a conflict of interest in the transaction. (2) The authorized body relied on appropriate data as to comparability or fair market value of the compensation. (3) The authorized body documented the basis for its decision at the time it made the decision.

You need to be ready to respond to potential Congressional and IRS action.

• **If any officers or other disqualified persons** are paid an excess benefit (an economic benefit that exceeds the value received), the board members who approved such transactions will be subject to penalties if they knew or should have known the transactions were improper. The penalties imposed would be increased from current amounts specified in the Intermediate Sanctions law.

• **Compensation for board members** is discouraged. If board members are compensated, the charity should be required to disclose the services the board member provided and the method used to determine the reasonableness of compensation. The organization should also be required to disclose which of its board members are independent (that is, uncompensated). At least one-third of a charity's board members should be independent.

• **The organization should provide clear guidance** regarding the type of travel expenses that can be reimbursed and the documentation required. Its policies should make clear that individuals are expected to make their arrangements as far in advance as possible and obtain the most reasonable rate for transportation and accommodations. Travel policies should state that charitable funds won't, in general, be used to pay for premium or first-class travel. Payment of travel expenditures for spouses, dependents, or others accompanying individuals who are conducting the business of the organization should be prohibited,

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Nonprofit World • Volume 24, Number 2 March/April 2006
Published by the Society for Nonprofit Organizations
5820 Canton Center Road, Suite 165, Canton, Michigan 48187
734-451-3582 • www.snpo.org

unless such expenses are de minimus. Charities should disclose on their annual reports whether they have such travel policies.

Recommendations about Conflicts of Interest

- **Every charity, as a matter of best practice, should enforce a conflict-of-interest policy** consistent with state law. The policy should define conflict of interest, identify those covered by the policy, specify procedures to be followed in managing conflicts of interest, and facilitate disclosure of information that may lead to conflicts of interest.
- **Special attention should be paid** to any transactions between board members and the organization to assure there are no conflicts of interest.
- **Form 990 should be revised to require all charities to state** whether they have a conflict-of-interest policy.

Proposal for an In-Depth Five-Year Review

- **Every five years, every charity should conduct a full review** of its organization, key financial transactions, and compensation policies and practices. It should pay special attention to its articles of incorporation, bylaws, and governing instruments.

What Does This Mean for You?

The Panel's suggestions include proposals for legislation, regulations, and "best practices" that would require nonprofit organizations to enact reforms and increase their reporting of information. If enacted into law, these new changes will be costly, time-consuming, and in some cases extremely burdensome for nonprofits.

Significantly, in December, 2005, the Senate passed the Tax Relief Act of 2005, which adopted some of the Panel's 120 recommended reforms for the charitable sector. While the specific reforms described in this article were not part of that legislation, there is no question that Congress, the IRS, and the

Independent Sector Panel are still focused on continuing to improve charitable transparency and accountability, so these issues are bound to be revisited again in future sessions of Congress.

Because of the intense scrutiny being focused on nonprofit governance and accountability, it's important that you review your policies and procedures now to ensure that, at a minimum, you're keeping the records required by current law and using the "best practices" recommended by the Panel to operate your organization. In addition, you need to be ready to respond to upcoming Congressional and IRS action in this area.

How do you know whether your organization is complying with the law and able to handle the recordkeeping and reporting changes being considered by Congress and the IRS? Conducting a thorough "legal audit" of your organization is a good place to start. Legal counsel can inspect your documents and methods of operation. After that review, counsel can help you enact policies and procedures to address the issues raised by the Independent Sector Panel, such as conflicts of interest, travel reimbursement, compensation, and other legal requirements.

Equally important, legal counsel can advise you about the "best practices" that are being recommended. You can then decide which practices will make a meaningful difference in improving your organization's compliance with legal requirements, ethical guidelines, and efficient methods of operation. ■

Resources

For guidance on complying with the law and the suggested "best practices," see these *Nonprofit World* articles at www.snpo.org/members:

- **Executive Compensation: Rewarding Excellence and Ensuring Governance** (Vol. 23, No. 5)
- **Preparing for Today's Nonprofit Audit** (Vol. 13, No. 4)
- **New Regs Unravel Intermediate Sanctions Snares** (Vol. 19, No. 4)
- **Expectations for Board Members Are Changing** (Vol. 19, No. 3)
- **The Audit Committee: Why You Need One, How to Form One** (Vol. 6, No. 6)
- **Are You Fulfilling Your Financial Trust? The Three Key Financial Roles in Every Nonprofit** (Vol. 16, No. 4)
- **New Penalties Proposed for Nonprofits** (Vol. 14, No. 1)
- **Protecting Your Organization's Assets: A Primer on Internal Control** (Vol. 9, No. 2)
- **Setting Up a Control System for Your Organization** (Vol. 16, No. 3)
- **How to Be Sure Compensation Is Reasonable** (Vol. 17, No. 1)
- **Common-Sense Approaches to Fraud Awareness, Prevention, and Detection** (Vol. 15, No. 4)

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