

When the Revenue Agent Comes Calling: Organizational Control

07.19.16 | Linda J. Rosenthal, JD



Since the early 2000s, federal and state charity regulators around the nation – spooked by the high-profile corporate scandals of Enron and Worldcom – have turned their attention more closely to the governance practices of tax-exempt organizations.

Although these spectacular corporate meltdowns involved for-profit conglomerates, the possibility that similar instances of corporate board negligence were also lurking in the nonprofit sector caused government officials in Washington, D.C. and around the nation to institute heightened audit and oversight programs.

While matters of governing are ordinarily in the jurisdictional purview of the states' attorneys general, the IRS has also stepped up its interest in these matters. The agency –

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“believes that a well-governed charity is more likely to obey the tax laws, safeguard charitable assets, and serve charitable interests more than one with poor or lax governance.... [W]hile the tax law generally does not mandate particular management structures, operational policies, or administrative practices, it is important that each charity be thoughtful . . . [about] governance practices....”

As part of this heightened scrutiny, the IRS “encourages a charity’s board of directors to adopt” specific written policies on matters including executive compensation, fundraising, and organizational structure and control. While they are not express requirements, this inquiry has become part of the newer versions of the tax-exemption application (Form 1023) and the annual information return (Form 990). “And just to make sure charities are paying attention, the agents on a field audit are asking some pointed questions.”

IRS Revenue Agent Audit Checklist

In 2009, the Internal Revenue Service issued Form 14114, a Governance Check Sheet, which is used by IRS field audit staff during examination of 501(c)(3) organizations. This two-page audit guide is divided into six separate sections, each focusing on a specific aspect of charity governance: namely, (1) Governing Body and Management; (2) Compensation; (3) Organizational Control; (4) Conflict of Interest; (5) Financial Oversight; and (6) Document Retention

In “When the Revenue Agent Comes Calling: Part 1,” we reviewed the specific matter of governing body and management policies and practices. In Part 2 of this series, we turned our attention to compensation protocols.

Organizational Control Questions

Here, we turn our attention to the focus of the next section of Form 14114, IRS Governance Audit Checksheet, “Organizational Control.”

Once again, there are multi-part questions, including drop-down menus for the agent to record detailed answers to these queries:

- Do any of the organization’s voting board members have a family relationship and/or outside business relationship with any other voting or nonvoting board member, officer, director, trustee, or key employee?;
- If there are any such relationships, how many are there – specifically – as to officers, directors, trustees, or key employees?;
- What are the total numbers of these key players in terms of: (1) family relationships; (2) business relationships; (3) both types of relationships?; and
- Does “effective control” of the organization rest with a single or select few individuals?

What is the reason for the Internal Revenue Service’s interest in this issue of relationships among key players in a 501(c)(3) organization?

Most significantly, there’s the overriding premise asserted by the IRS that a well-governed organization with an “active and engaged board” is more likely to properly follow the detailed rules and regulations that apply to section 501(c)(3) charities.

There is no optimal board size; it should be suitable in terms of that particular organization.

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“Small boards run the risk of not representing a sufficiently broad public interest and of lacking the required skills and other resources required to effectively govern the organization. On the other hand, very large boards may have a more difficult time getting down to business and making decisions.”

A key consideration, though – according to the IRS – is that “irrespective of size, a governing board should include independent members and should not be dominated by employees or others who are not, by their very nature, independent individuals because of family or business relationships.”

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The Internal Revenue Service reviews the board composition of charities to determine whether the board represents a broad public interest, and to identify the potential for insider transactions that could result in misuse of charitable assets. The Internal Revenue Service also reviews whether an organization has independent members, ... or other persons with the authority to elect members of the board or approve or reject board decisions, and whether the organization has delegated control or key management authority to a management company or other persons.

Conclusion

Form 14114, Governance Audit Checksheet is a useful tool not only for the revenue agent conducting an audit but also for the organization itself. “It is a ‘very specific roadmap for exempt organizations – well in advance of any potential audit – to compare their practices and policies with what the IRS wants to see and to make adjustments where necessary.’”