



# REID AND RIEGE, P.C.

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## **The IRS is your Big Brother (and your Daddy too!)**

Much has been written about the IRS's governance initiative – its decision to force feed its view of best practices on nonprofits even though there is nothing in the law giving the IRS authority to do this.<sup>1</sup> While many have protested, the IRS's pace is accelerating, and its efforts have now transcended the frivolous and ventured into the absurd. If readers think we are getting carried away with our rhetoric, we note the definition of “absurd” in Merriam-Webster's online thesaurus: “conceived...without regard for reason or reality; showing or marked by a lack of good sense or judgment.” Our case for absurdity follows.

First, in December 2009 the IRS piggybacked its previous labors by publishing a “Governance Checksheet” (Form 14114) to be completed in *every* public charity audit, and a “Guidesheet” with instructions to help its auditors fill in the Checksheet. These documents are available on the Web. Readers should look them over – if for no reason other than the opportunity they present to stare into the mind of the IRS.<sup>2</sup>

Second, stated purely and simply, governance is a matter of state and *not* federal law. For example, in Connecticut we have the Nonstock Corporation Act. This body of law is reflected in the text of the certificate of incorporation and bylaws of Connecticut nonprofit corporations, and in the procedures followed by their boards of directors. The other 49 states have their own bodies of law; while there are similarities, the law is not the same in every state. For example, in Connecticut a nonprofit must have a minimum of three people on the board of directors; under Delaware law the minimum number is one. There are myriad other examples but the point should be obvious – a governance structure or practice that is legal in one state could very well be unlawful in another.

Third, the IRS has the authority to enforce the tax law (the Internal Revenue Code), and it and its agents have years of experience doing so. However, there is no body of federal law on nonprofit governance (for example, no federal statute establishing a minimum board size), and neither the IRS nor its agents have the experience to make judgment calls about the legality or advisability of governance practices under state law. These judgment calls are often nuanced and subjective – taxing the brains of even experienced lawyers trying to give the best advice to their clients. The IRS is walking this turf blindly and shooting from the hip.

Fourth, rumor has it that the governance initiative is based on the IRS's belief that there is a direct connection between good governance and tax law compliance. But this anecdotal and facile leap of faith is, in our experience (both advising and serving on boards), too slender a reed upon which to base so massive and intrusive an initiative. Members of voluntary boards rarely get involved in the nuances of IRS tax issues, and with good reason (and as *specifically authorized by state law*) rely on the advice of expert accountants and lawyers for tax advice and conclusions.<sup>3</sup> Moreover, if the IRS believes good governance leads to better tax compliance, then maybe it should follow the advice of Willy Sutton and launch a similar initiative on Wall Street – which, after all, is where the money is.<sup>4</sup>

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<sup>1</sup> See the Summer 2008 edition of this report entitled The Nonprofit Sector: RIP (the New Form 990 or “Sox Lite”), available at [www.rrlawpc.com/content/news](http://www.rrlawpc.com/content/news).

<sup>2</sup> [http://www.irs.gov/pub/irs-tege/governance\\_check\\_sheet.pdf](http://www.irs.gov/pub/irs-tege/governance_check_sheet.pdf)

<sup>3</sup> Indeed, it would be a violation of the fiduciary duty of care for a board to do otherwise.

<sup>4</sup> Willy Sutton is the infamous robber who, when asked why he robbed banks, replied “Because that is where the money is.”

Fifth, a look at even a few parts of the IRS's Checksheet pulls the above comments into focus and demonstrates how big of a mess the IRS is making.

**For example:** The IRS asks if copies of the bylaws have been provided to the general public either by request or online. There is no requirement (at least in Connecticut) to provide copies of bylaws to the public, and our advice to clients is that disclosing bylaws to the public is *not* a good practice.

**For example:** The IRS asks if the bylaws set forth the qualifications of the board members. Typically, the only state law qualification requirement for board service is being over the age of majority, and it is perfectly legal for bylaws to be entirely silent on this topic.

So what happens when, in the above two examples, the IRS auditor checks “no” on the Checksheet? Will it make your Executive Director nervous – causing her to scurry to the board and the lawyers to put the bylaws on the Website or to amend them to add “qualifications” for directors? The potential unintended and wasteful consequences (of resources better spent on the mission) leave one breathless.

**For example:** The Checksheet asks how often the “*full board*” met during the year, and the answer blocks available for the agent to check off are: once per year, twice per year, quarterly, once per month, twice per month and other. This question fails to take into account the myriad governance variations permissible under state law such as this one: many nonprofits have a large “*board of directors*” (i.e., the “full board”) that meets only once per year, but smaller “*executive committees*” (specifically authorized under state law) to conduct business at all other times. The point is that if, in a case like this, the agent checks “*once per year*” in the answer box a misleading inference of board inattentiveness is created – one with no connection to governance reality or compliance with the controlling state law.

**For example (and this one is a real beauty):** The Checksheet asks if “effective control” of the organization rests with a single or a select few individuals. Human nature and politics being what they are, it is common for certain board members or others (based on personality or experience) to be more influential than others – and this is typically a good thing. But having said that, think about the nonprofits you serve and ask how in God's name an IRS auditor is ever going to be able to answer so subjective and personal a question? Perhaps the IRS should add Rorschach inkblot tests to the Checksheet and hire a team of psychology professors to interpret them in Washington?

The IRS's misguided and “one size fits all” foray onto this turf is administrative malpractice. No one is saying that good governance isn't a desirable goal, but you don't go to a podiatrist when you need brain surgery. The IRS should keep its feet on the ground and do what it knows how to do. The nonprofit sector is not broken enough to need the kind of fixing that will scare away volunteers and increase administrative costs for no measurable benefit. Absurd? You bet it is! If an IRS agent knocks at your door with the Checksheet in hand, show him this Newsletter and ask him to give us a call. ☺

*The Reid and Riege Nonprofit Organization Report is a quarterly publication of Reid and Riege, P.C. It is designed to provide nonprofit clients and others with a summary of state and federal legal developments which may be of interest or helpful to them.*

*This issue of the Nonprofit Organization Report was written by John M. (Jack) Horak, Chair of the Nonprofit Organizations Practice Group at Reid and Riege, P.C., which handles tax, corporate, fiduciary, financial, employment, and regulatory issues for nonprofit organizations. While this report provides readers with information on recent developments which may affect them, they are urged not to act on this report without consultation with their counsel. For information or additional copies of this newsletter, or to be placed on our mailing list, please contact Carrie L. Samperi at (860) 240-1008 or [info@rrlawpc.com](mailto:info@rrlawpc.com), or members of Reid and Riege, P.C., One Financial Plaza, Hartford, CT 06103. For other information regarding Reid and Riege, P.C., please visit our website at [www.rrlawpc.com](http://www.rrlawpc.com).*