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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.

The Nonprofit Sector: RIP (the New Form 990 or “SOX Lite”)

The nonprofit sector has been a whipping boy for a few years, and if the new Form 990 (the annual information return) is any indication, the flogging is only going to get worse. The 990 brings to mind the ancient Chinese form of execution known as “slow slicing” or “death by a thousand cuts” in which flesh is peeled off the body incrementally. While any one cut may not be lethal in itself, at the end of the day the result is always fatal. The new 990 is the cut that ends the life of the sector as we have known it.

The new information return is not merely a more rigorous numbers reporting device. It is a major government policy initiative akin to an annual self-audit or self-disclosure certification – requiring nonprofits to disclose detailed facts about their finances, compliance, personnel, and governance – all of which will then be available to the IRS and the public. There is also a dollop of Big Brother intimidation built into the 990 in that it asks a few questions to which nonprofit organizations will not feel comfortable answering “no.” The price of being tax-exempt just got higher. Why and how did this happen?

To answer this question, we have to go back eight years to the Enron and WorldCom calamities, in which a combination of improper financial practices, inadequate disclosure, and appalling governance practices wreaked havoc in peoples’ lives and on the economy. The federal government’s reaction was the Sarbanes-Oxley law (or “SOX”) which force-fed accounting, financial reporting, and governance reforms to companies with publicly traded stock.

At the same time, running on a parallel track, policy makers in Washington tied together a few threads and had an epiphany of their own: (i) nonprofits are, in a unique way, also publicly owned and financed;¹ and (ii) the sector was ripe with scandals based, like Enron and WorldCom, on poor financial practices, inadequate disclosure, and poor governance. In 2004, testimony before the Senate Finance Committee, then IRS Commissioner Mark Everson stated:

In recent years there have been a number of very prominent and damaging scandals involving corporate governance of publicly traded organizations. The Sarbanes-Oxley Act has addressed major concerns about the interrelationships between a [for-profit public] corporation, its executives, its accountants and auditors, and its legal counsel. Although Sarbanes-Oxley was not enacted to address issues in tax-exempt organizations, these entities have not been immune from leadership failures. We need go no further than our daily newspapers to learn that some charities and private foundations have their own governance problems.

¹ Nonprofits are owned by the public in the sense that their *raison d’être* is to meet the needs of the community or a segment of the public. They are publicly financed in the sense that they pay no tax on their income and their donors are allowed a tax deduction for contributions.

Commissioner Everson made these remarks in support of a Finance Committee position paper which suggested draconian legislative changes for nonprofits. These included, as most relevant to the topic of this newsletter: (i) a requirement that nonprofit executive officers sign a declaration that they had put in place procedures to ensure that the 990 complies with the law; and (ii) a requirement that charities make their investments and financial statements (in addition to tax returns) available to the public.²

While this 2004 activity created anxiety attacks among sector leaders, and a couple of years of intense lobbying, at the end of the day not much happened. The government's lawmaking efforts were tractionless motion in that the final legislative product – the Pension Protection Act of 2006 – was a mouse's squeak compared to the Congressional roar of 2004. The 2006 legislation was a minor tune up – not the major overhaul that had been promised.³

The IRS is an administrative agency (a part of the Executive Branch). As such, it has the power to *administer and enforce* the law, but not to *make* the law. While the line between administering and making law is gray and subject to political pulls and pushes, it is clear that the design of tax returns is an administrative function. And in an effort that did not get the same degree of attention as the “law making” activity before Congress in the 2004-2006 period, the IRS used its administrative powers to begin making changes to the 990.⁴ While there were relatively minor adjustments for 2006 and 2007, the foot did not drop completely until now. The new 990 (with some parts phased in) is required for tax year 2008 and thereafter.

Some critics have suggested that the 990 reflects an IRS effort to push the envelope of its administrative powers in order to gain some of the ground that it did not get from Congress in the Pension Protection Act of 2006. It is not our intention to pass judgment on the IRS's motives. Nor will we attempt to summarize the scores of detailed questions on the 990. Instead, we will limit our remarks to an analysis of the whole – an attempt to give readers a sense of the cultural changes the 990 is foisting upon the sector.

Public access to your laundry and whistleblowers. The starting point is the 1,000-pound gorilla sitting in the corner – the fact that 990's are available to the public free of charge on the internet (as opposed to written requests by “snail mail”). The fact of internet access in itself is not the point (which is not new and is fairly well known by now anyway). The point is that the intense 990 disclosure requirements were designed with full knowledge of just how readily available the disclosed information will be, and with recognition that not everyone who accesses a tax-exempt organization's information will have benign motives or the interests of that organization in mind.

In other words, as you begin to complete the 990 for the first time, remember that what you say will be only a mouse click away from donors, plaintiffs' lawyers, vendors, competitors, clients, happy employees, disgruntled employees, labor unions, state attorneys general, newspaper reporters, governmental agencies, and anyone else with a computer. It's almost like the IRS has deputized the

² These proposed changes are discussed in the Summer 2004 edition of this report (“Interesting Times for the Tax-Exempt Sector”), available on the Web at <http://www.reidandriege.com/content/news>.

³ The disparity between the Congressional activity in 2004 and the final 2006 legislation is discussed in the Fall 2006 edition of this report (“Much Ado about Nothing”), available on the Web at <http://www.reidandriege.com/content/news>.

⁴ The Form 990 changes were presaged by 2005 Senate testimony by Commissioner Everson in which he noted that “abuse is increasingly present” in the sector, that the IRS had a new Financial Investigations Unit at the “tougher end of the compliance spectrum,” and that there would be increased transparency resulting from “e-filing initiatives, *planned changes to Form 990*, and enhanced case building ability through better access to researchable data.” This testimony is available at <http://www.senate.gov/~finance/hearings/testimony/2005test/metest040505.pdf>.

public – making its members *de facto* auditors – thereby increasing the pressure to keep nonprofits on their toes.

But the *coup de grâce* on the issue of public disclosure, at least for larger nonprofits, is a little-recognized whistleblower reward statute enacted in 2006. Under the statute, an individual who turns in a “tax cheat” can recover between 15% and 30% of what the government eventually recovers. The amount that can be recovered depends on the significance of the information and the role of the individual or his or her lawyer in contributing to the case. As readers might expect, with all this bait in the water, a cottage industry of whistleblower lawyers has suddenly evolved – as a Google search of the terms “whistleblower, IRS and lawyer” will demonstrate.⁵

Shine your spotlight on your problems: FIN 48 and 990 Schedule D. As noted above, in 2004 the Senate Finance Committee proposed a law requiring nonprofits to make their financial statements (in addition to tax returns) publicly available. This proposal was not adopted.

Tax returns and financial statements are different documents prepared for different purposes. In brief, financial statements are prepared by independent auditors who must render a professional opinion as to the accuracy of the information contained in the statements, and the statements must disclose known and in some cases contingent or potential liabilities (such as lawsuits, investigations or audits) to which the nonprofit is or may be subject. The accountants preparing the statements must follow strict protocols (Generally Accepted Accounting Principles or GAAP) to ensure accuracy and uniformity, and they can be personally liable for errors in the statements. Most importantly, financial statements and the auditor’s opinion as to their accuracy are relied upon by creditors, such as banks and bonding authorities, when evaluating creditworthiness and setting interest rates.

A recent amendment to GAAP (known as FIN 48) requires auditors to disclose in financial statements the risk of certain tax positions taken by the issuer of the statements not being sustained if challenged by the government. For example, if management of an organization decides not to treat certain income as Unrelated Business Taxable Income (UBTI), or not to file in certain states where it may or may not be required to file, and if its auditors believe that there is a less than 50% chance that its position will be upheld if challenged, the auditors must disclose this conclusion in the organization’s financial statements and book an appropriate liability. While this may seem like hyper-technical background noise to some readers, it is a very significant development in that it basically (as an auditor acquaintance put it to us recently) requires your accountants to provide a “road map of your vulnerabilities to your enemies.”

Interestingly, even though Congress did not make public financial statement disclosure a part of the law, the new 990 requires that you include in Schedule D to the 990 the text of the FIN 48 disclosure footnote included in your financial statements. It is not too hard to connect the dots to see the potential significance of this disclosure requirement for your organization. Not only is your laundry open to anyone passing by on the internet – the spotlight is focused on that piece that may be most in need of cleaning.

Governance and management questions. If we take a moment or two to think back to the civics classes we took in high school, we will recall the federalism question – the line of demarcation between the powers of the federal government and those reserved to the states. In this context, it is clear that matters of corporate governance, fiduciary duty, conflicts of interest, board and management authority, by-laws, charters, minutes and the like are matters of state law and not federal tax law. State law is enforced by the office of the Attorney General in the state in which an organization operates. Having said

⁵ The whistleblower statute in question has a high minimum recovery threshold (\$2,000,000) – which is not to say that anyone else unhappy with your organization won’t drop a dime on you anyway.

this, Part VI of the 990 is dedicated entirely to disclosure of governance and management (state law) practices.

There must have been some people at the IRS feeling a little sheepish about this. In written commentary the IRS noted that several comments challenged the IRS's authority to request information regarding "governance and management practices." But, relying on federal tax law language authorizing the IRS to "request information it deems necessary for the administration" of the tax law, the IRS charged ahead anyway. In doing this, the IRS acknowledged (in its written commentary) that there would be an appearance of wrongdoing in the "mind of the public" if certain questions are answered "no." For example, the mere fact that an organization answers "no" to a question asking if it has a conflicts of interest policy does not mean that board members are acting contrary to the interests of the organization. Yet what will the public infer if the answer is no?

There are many intrusive questions in Part VI. For example: (i) are there any family or business relationships among the officers, directors, trustees and key employees; and (ii) are all of the officers, directors, trustees and key employees reachable at the addresses of the organization, and if not, where is an address at which they can be reached?

The question we find most interesting, however, is this: "*Was a copy of the Form 990 provided to the organization's governing body before it was filed? All organizations must describe in Schedule O the process, if any, the organization uses to review the Form 990.*" This question should be juxtaposed with the Senate Finance Committee proposal of 2004 (which did not become law) which would have required nonprofit executive officers to sign a declaration that they had put in place procedures to ensure that the 990 complies with the law. The point of the comparison is obvious – if the IRS did not get all of the legal changes it wanted in 2004, it has nevertheless used its administrative powers to pressure nonprofits to do what it wants.

The Form 990 issues described above are just the tip of a gigantic new iceberg. It will take several years for nonprofits and their advisors to come to grips with the many detailed questions and their nuances, and with the collateral issues they will present. On the whole, the new 990 strikes us as overkill – another example of a few bad apples making everything worse for the vast majority of nonprofits which operate honestly and which wrestle every day with societal problems in need of the limited supply of available time and resources.

This issue of the Nonprofit Organization Report was written by John M. (Jack) Horak, Chairman of the Nonprofit Organization 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 Jack Horak (860-240-1077) (e-mail jhorak@reidandriege.com), or other members of the firm 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.reidandriege.com.