Charities and Governance: Is the IRS Subject to Challenge?

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The following discussion is intended to explore ramifications of the role the IRS is assuming regarding charities and governance. As such, it highlights the inherent tension between a system of rules drawn from, and limited by, the explicit terms of the authorizing statute, the Internal Revenue Code of 1986,[1] and an oversight system deriving its authority from equity and the common law. The intention is not to examine the desirability of "good governance" in a charity, or whether the IRS has identified appropriate indicators of that behavior, but rather to examine the nature of the Service's authority to demand, under the threat of civil and criminal sanctions,[2] information about a given charity's governance practices and whether the IRS assumption of that authority can be effectively challenged.

Background

On February 7, 2007, the IRS released a "preliminary staff discussion draft" of its principles of nonprofit governance. Described as a list of possible "good governance practices for 501(c)(3) organizations," the document's suggestions appear to have been drawn from several nongovernmental sources, including the Independent Sector and the Better Business Bureau Wise Giving Alliance, as well as materials distributed by state attorney general offices. The broad departure of the proposals from matters of traditional tax administration is reflected in the preamble to the principles, which initially echoes common management-consulting advice that boards should operate openly and be composed of active and informed members, but then opines that boards should neither be too large, as that would increase the risk that the board would be less attentive, nor too small, as smaller boards "generally do not represent a public interest." The discussion draft reviews the duties of care and of loyalty, recommends that charities adopt a mission statement, a code of ethics, and policies addressing whistle-blowers and conflicts of interest. In places, the draft's suggestions are quite explicit: For example, the document states that "directors and staff should also file annual written disclosure statements of interests they or family members may have in entities that transact business with the charity." Also, charities are encouraged to make annual reports and financial statements public.

The IRS does not appear to have been instructed to assemble the exposure draft by law or under any other form of formal congressional or Treasury Department direction. As a consequence, the legal import of the document is unclear; it does not fall into one of the traditional categories of Treasury or IRS guidance. However, the draft's recommendations are consonant with the public position of Senate Finance Committee ranking minority member Chuck Grassley, R-Iowa, a longtime proponent of charity governance issues. The apparent informal origins of the effort raise a question as to the intentions of the Service: Is it undertaking an extended public service announcement project (for example, the missing children notices that now accompany our tax return materials) or are we seeing the birth of an enforcement campaign? Public statements by IRS officials have not clarified the situation. Indeed, in one account of a speech announcing the discussion draft, Marvin Friedlander, an official in the IRS Exempt Organizations Division, acknowledged that the IRS has no enforcement authority regarding charity governance, yet asserted that the agency believed that good governance practices tended to reduce the incidence of tax problems.[3]

The IRS requested comments on the discussion draft, and some organizations responded. The IRS did not immediately and formally react to the comments or issue a revised discussion draft, but the agency's interest in nonprofit governance did not lapse. On June 14, 2007, the IRS released a draft Form 990 for the 2008 tax year in which the Service's continued interest was reflected in several new questions on the return, particularly a series of questions in the new Part VI. The Part VI questions, as with a number of aspects of the draft return, drew public comment. For example Philanthropic Research Inc., popularly known as GuideStar, noted that the form "goes beyond the information required by the Internal Revenue Code" and that what a given organization does regarding "best practices" is a matter for the business judgment of the organization.[4]

On December 20, 2007, the IRS released a revised draft Form 990, along with reactions and observations to the comments received on the first draft return. While no summary of the comments regarding Part VI was released, the IRS did state that many of the comments supported the new Part VI but that some challenged the authority of the IRS to request information about governance and management practices. The IRS also drew attention to comments that observed that section 6033 grants broad authority to request information deemed necessary for the administration of the federal tax laws. Apparently in reaction to the observations questioning the Service's authority to request the information, the December 2007 version of the draft Form 990 contains a parenthetical addition to the heading of Part VI: Governance, Management, and Disclosure (Sections A, B, and C request information about policies not required by the Internal Revenue Code).

On February 14, 2008, the IRS posted a statement on the charities home page on its Web site entitled "Governance of Charitable Organizations and Related Topics." The statement notes that the comments received in response to the February 2007 discussion draft informed the development of the governance section of the revised Form 990 and were also used to enhance the "Life Cycle" tool that has been available since 2004 on the IRS Web site. Draft instructions for the Form 990, released on April 7, 2008, contain the following statement on Part VI:

All organizations must answer each question in Part VI. Even though certain governance, management, and disclosure policies and procedures may not be required under the Internal Revenue Code, the IRS considers such policies and procedures to generally improve tax compliance. For example, although the governing body is not required by federal tax law to review the Form 990, line 10 asks certain questions about the organization's process, if any, it uses to review the Form 990.

Steven T. Miller, commissioner of the IRS Tax Exempt and Government Entities Division, in a speech on November 10, 2007,[5] summarized the emerging governance initiative when he described it as one of the new "pillars" of the Service's compliance program:

The second new pillar is to promote standards of good governance, management and accountability. I believe that the IRS contributes to a compliant, healthy charitable sector by expecting the tax-exempt community to adhere to commonly accepted standards of good governance. For many tax-exempt organizations, governance is already very good. But in too many instances, we have found governance to be wanting.

While a few continue to argue that governance is outside our jurisdiction, most now support an active IRS that is engaged in this area.

The concept of IRS involvement with good governance is not new. We have been quietly but steadily promoting good governance for a long time. Our determination agents ask governance-related questions. Further, our agents assess an organization's internal controls as the agents decide how to pursue an examination. And recently we took a deliberate step in support of principles of good governance and of an independent board of directors in our discussion draft of the new Form 990.

We are comfortable that we are well within our authority to act in these areas. To encourage transparency is not a stretch at all. We've been doing it for a long time, beginning with work with Guidestar and others to make 990s and 990PFs easily accessible.To more clearly put our weight behind good governance may represent a small step beyond our traditional sphere of influence, but we believe the subject is well within our core responsibilities.

Clearly, the IRS is assuming a new role in charity governance, and perhaps more broadly, with other types of tax-exempt organizations. In doing so, it has publicly acknowledged that it is moving beyond the requirements of the code; however, as Miller has noted, the Service believes that it has authority to take such a step and justifies it on the basis that "we've been doing it for a long time."

Scope of the IRS Authority

In one sense, the role and requisite authority of the IRS is simply stated: to enforce the federal tax laws. The Service's own chief counsel has explicitly said as much and has linked the Form 990 to that charge, noting in General Counsel Memorandum 36506[6] that:

The present information return requirements are essentially the same as those provided by the 1950 amendments to the charitable organization provisions of the code.The primary purpose of these requirements is to provide the Internal Revenue Service with the information necessary to enforce the tax laws.

For purposes of tax administration relating to tax-exempt organizations, the relevant code provisions direct the IRS to ascertain which organizations should be recognized as exempt from tax, to determine the extent to which contributions to them should be deductible by donors as charitable contributions, and to identify which transactions engaged in by those organizations should be subject to income or excise taxes. To facilitate making those decisions, section 7805(a) gives Treasury and the IRS authority to issue "all needful rules and regulations" for enforcement of the internal revenue laws. Correspondingly, section 6033(a) mandates the filing of returns and the maintenance of records, giving Treasury and the IRS broad authority to design returns to collect information for the "purpose of carrying out the internal revenue laws." Similarly, section 7402(b) sets forth the jurisdiction of the U.S. district courts regarding IRS summons matters, stating:

If any person is summoned under the internal revenue laws to appear, to testify, or to produce books, papers, or other data, the district court of the United States for the district in which such person resides or may be found shall have jurisdiction by appropriate process to compel such attendance, testimony, or production of

books, papers, or other data. [Emphasis added.]

Because the code, including the provision regarding summons enforcement jurisdiction (arguably, the place at which the enforcement power of the agency is starkest), links IRS authority to the need for enforcement of the internal revenue laws, the agency's authority regarding administration of the tax laws applicable to tax-exempt organizations is limited by the requirements of that very task, however it might be defined by particular provisions of the code and Treasury regulations.

Limits on the Ability to Demand

Historically, the IRS has been acutely aware of a limit at some point on its ability to compel information. Analysis of the limit has arisen in conjunction with at least two matters: summons enforcement and incomplete return penalties.

Section 7602(a) authorizes the Treasury secretary to examine the books and records as may be "relevant or material" to tax administration -- essentially the ability to review for accuracy the returns filed under section 6033(a). In United States v. Powell, the Supreme Court interpreted section 7602, together with section 7605(b) (which restrains unnecessary and repetitive examinations), to mean that an IRS summons must satisfy four specific requirements to be enforceable: it must be for a legitimate purpose; the information requested under the summons must be relevant to that purpose; the information must not yet be in the possession of the IRS; and the summons must be issued and served under proper procedures.[7] The second Powell requirement, relevance, has been interpreted to mean a demonstration that the information requested "may be relevant" or "may shed light upon" a potential tax liability,[8] provided there is "a reasonable expectation rather than an idle hope that something may be discovered."[9] While this relevance standard sets a relatively low bar for IRS examiners to meet, it does nevertheless set a bar, and courts have not infrequently refused to enforce summonses on the basis of irrelevance.[10] That a charity's governance policies and procedures, beyond those specified by the code, may reflect its institutional attitude toward general tax compliance would not appear to meet the Powell requirement of relevancy to a potential tax liability.

Regarding incomplete return penalties for tax-exempt organizations and related questions, such as whether a return is sufficiently complete to begin the statute of limitations running, the IRS Office of Chief Counsel has issued several GCMs over the years. [11] Without exception, the chief counsel's views are contingent on whether a given return omits information that is "material and thus necessary for the administration of the tax laws."[12] For example, in GCM 36506, the chief counsel considered the consequences of the omission, by filing organizations, of some information from the 990 series of information returns. In its analysis, the chief counsel observes "that if the material required and requested, but unsupplied, in those forms was material and thus necessary for the proper administration of the tax laws, then any failure to include such information on the forms, without reasonable cause, would subject the filing organization to penalties." [Emphasis added.]

The chief counsel also advised that:

It should be pointed out that if the materiality of these items is questioned by a taxpayer or subsequently made the subject of litigation, the Service should be prepared to substantiate why it considers such items to be material.

The most interesting discussion by the chief counsel, for purposes of the new Form 990 governance questions, is found in GCM 38382:[13]

In 1954, when section 6501(g)(2)[14] was enacted, section 6033(a) required an exempt organization to file with the Secretary "an annual return, stating specifically the items of gross income, receipts, and disbursements, and such other information for the purpose of carrying out provisions of subtitle A as the Secretary should prescribe." Subtitle A relates only to income tax. Therefore, when section 6501(g) was originally enacted, the Secretary had no authority to require returns filed under 6033 to include information needed to enforce provisions relating to taxes other than income tax.

GCM 38382 further states:

Section 6033(a) was amended by section 101(d)(1) of the Tax Reform Act of 1969, so that it authorized that returns filed under section 6033 could include information to carry out "the internal revenue laws," rather than just "the provisions of subtitle A." The legislative history indicates that the language in section 6033(a) was broadened for a specific and relatively narrow purpose -- to enable the Secretary to require that returns under section 6033 should include information needed to enforce the prohibitions against self-dealing and related activities, most of which were added by the Tax Reform Act of 1969. See H. Rep. No. 91-413, 91st Cong., 1st Sess. 36 (1969). The prohibitions against self-dealing and related activities are found in chapter 42 of subtitle D rather than in subtitle A.Thus, Congress never envisioned that returns filed under section 6033 as amended would be used to elicit from exempt organizations information that might relate to the wagering excise tax, and, accordingly, section 6501(g)(2) has never been expanded to apply to wagering excise tax liability.[15]

Clearly, an argument can be made that the IRS has exceeded its authority by incorporating questions on governance and other matters that, by its own admission, are not required by the code. The executive branch functions -- IRS Chief Counsel, the Treasury Department, and the Office of Management and Budget -- that would traditionally operate to prevent such overstepping by the tax administrator have not acted, whether merely out of inattention to or perhaps in complicity with the Service's unilateral expansion of its authority. It is possible that the expansion of the IRS authority might be reviewed as a function of congressional oversight; however, that seems unlikely in view of the tendency over the last few years of Senate Finance Committee and House Ways and Means Oversight Subcommittee hearings to focus on particular taxpayers or tax issues rather than the nature and quality of IRS tax administration in the exempt organizations area.

Possible Recourse for Form 990 Filers

If a particular charity is sufficiently concerned about the legal ability of the IRS to compel the governance information without clear legal authority to do so, the options for the organization are limited if it desires judicial review of the matter. It is possible that a charity could decline to answer the governance questions on the return, triggering the possible assessment and payment of an incomplete return penalty, followed by refund litigation. That approach requires that the IRS implement the new return and that the charity's 2008 tax year close, followed by the filing of the partially complete Form 990. The assessment of the penalty, followed by the filing of the refund claim and IRS consideration of the claim could easily consume the better part of a year. The IRS would have six months alone to evaluate whether to grant or deny the refund claim, and it is by no means certain that such an approach would end up in court. If the IRS gives any deference to the early

GCMs on incomplete returns, it is in fact quite possible that a return that is missing the governance information would nevertheless be accepted as complete.

A more timely option for contesting the IRS authority to compel the information would be to seek to enjoin the implementation of the new return. An action to enjoin the IRS must address section 7421, also known as the Anti-Injunction Act (AIA), which provides in relevant part that "no suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court by any person."[16] Whether the AIA applies in a particular situation is a jurisdictional question.[17]

The AIA should not be applicable in an action to enjoin the implementation of a revised tax return because the plaintiff would not be attempting to enjoin the assessment or collection of taxes, particularly in the circumstances when the face of the return asserts that the information is not required by federal tax law. Indeed, such a suit would not interfere with the collection of information that may be relevant for the administration of the tax laws, as the IRS would be free to continue to compel production of the information required on the Form 990 as it exists for the 2007 reporting year, and any other information that is material for determining compliance with the tax laws. Regardless, the courts have taken a narrow view of the circumstances in which an action to enjoin the IRS would be entertained.[18] It does not appear, however, that the IRS has ever publicly announced that the information it is compelling, under civil and criminal penalties, is "not required by the Internal Revenue Code."[19] Indeed, it appears that this situation is truly unprecedented and that a challenge under the AIA would potentially be successful.

This article is designed to give general information on the developments covered, not to serve as legal advice related to specific situations or as a legal opinion. Counsel should be consulted for legal advice.

FOOTNOTES:

1. All section references are to the Internal Revenue Code of 1986, as amended. All regulatory references are to the regulations promulgated under the code.

2. The threat of criminal sanctions is not theoretical. In United States v. Muhamed Mubayyid et al., Crim. No. 05-40026-FDS (D. Mass. 2007), officers of a tax-exempt charity were convicted of conspiracy to defraud the United States (18 U.S.C. section 371) and making false statements on tax returns (IRC section 7206(1)) when the facts that the charity published a fundraising newsletter and that the officers had formerly been volunteers for another organization were not disclosed on the charity's Form 1023 or Form 990.There were no allegations of a diversion of the charity's funds for improper purposes in that case.

3. Health Care Client Alert, Fulbright & Jaworski LLP, Feb. 12, 2007. The IRS conclusions about the impact of "good governance" on tax compliance are likely based on anecdotal IRS enforcement evidence or the opinions of nongovernmental experts, as the IRS has never undertaken a systematic and statistically valid assessment of charity governance and its relationship to tax compliance. Indeed, the idea that there is a link between a well-run charity and tax compliance presupposes that the tax rules are clear and that efficient and effective management incorporates tax compliance. While that may be the case with payment of some tax obligations,

such as withholding for employment taxes, it is not at all clear, for example, that a charity that exceeds its lobbying expenditure limit in a given year to affect the course of legislation that would have a dramatic and adverse impact on the charity's area of interest, thus subjecting it to the penalty excise tax in section 4911, is suffering from bad governance.

4. Letter from Robert Ottenhoff, president and CEO, GuideStar, to Lois Lerner, director, Exempt Organizations Division, Sept. 14, 2007.

5. "The IRS's Role in an Evolving Charitable Sector," remarks of Miller before the Philanthropy Roundtable, Nov. 10, 2007.

6. Incomplete Returns, GCM 36506 (Dec. 8, 1975).

7. *United States v. Powell, 379 U.S. 48,* 57-58 (1964).

8. See, e.g., United States v. Arthur Young & Co., 465 U.S. 805, 814-815 (1984).

9. *United States v. Harrington*, 388 F. 2d 520, 524 (2d Cir. 1968).

10. See, e.g., *David H. Tedder & Associates Inc. v. United States, 77* AFTR2d 96-1148 (9th Cir. 1996), *Doc 96-6561*, *96 TNT 45-20*; *United States v. Richards*, 631 F.2d 341 (4th Cir. 1980); *United States v. Coopers & Lybrand*, 550 F.2d 615 (10th Cir. 1977); *United States v. Matras*, 487 F.2d 1271 (8th Cir. 1973); *United States v. Union First Nat. Bk. of Washington*, 45 AFTR2d 80-1427 (D.D.C. 1980); *United States v. New England Co*., 45 AFTR2d 80-1178 (D.R.I. 1979).

11. See, e.g., Application of Section 6652(d) Penalty to Incomplete Forms 990-P & 4848, GCM 36372 (Aug. 11, 1975); Incomplete Returns, GCM 36506 (Dec. 8, 1975); Incomplete Returns Program Correspondence Examination Program, GCM 37785 (Dec. 12, 1978).

12. GCM 36372 (Aug. 11, 1975).

13. Control Number 7912056218, GCM 38382 (May 23, 1980).

14. Section 6501(g)(2) provides that if a taxpayer determines in good faith that it is a tax-exempt organization, and accordingly files a Form 990, and if it is ultimately determined to be a taxable organization for that year, the filing of the Form 990 started the running of the statute of limitations.

15. It is an interesting question how the analysis of GCM 38382 applies to the information on gaming activities that will be required by the draft 2008 Form 990, Part V and Schedule G and what effect the filing of that return will have on the statute of limitations for the wagering excise tax.

16. The statute includes several exceptions, none of which are at issue here.

17. See, e.g., Erwin v. United States, No. 05-1698 (CKK), 2006 WL 2660296, at 8-9 (D.D.C. 2006), noting that a court lacks subject matter jurisdiction when the suit falls into the scope of the AIA.

18. See, e.g., *Foodservice and Lodging Inst., Inc. v. Regan*, 809 F.2d 842 (D.C. Cir. 1987), holding that the plaintiff, a trade association, had an alternate remedy to challenge two regulations because a member of the association could contest the regulations if the IRS chose to assess penalties on the member for its refusal to comply.

19. Draft 2008 Form 990, Part VI.