



## Summary of IRS Requirements for 501(c)(3) Organizations *from the IRS*

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The Internal Revenue Service believes that a well-governed charity is more likely to obey the tax laws, safeguard charitable assets, and serve charitable interests than one with poor or lax governance.

A charity that has clearly articulated purposes that describe its mission, a knowledgeable and committed governing body and management team, and sound management practices is more likely to operate effectively and consistent with tax law requirements.

And while the tax law generally does not mandate particular management structures, operational policies, or administrative practices, it is important that each charity be thoughtful about the governance practices that are most appropriate for that charity in assuring sound operations and compliance with the tax law.

As a measure of our interest in this area, we ask about an organization's governance, *both when it applies for tax-exempt status and then annually as part of the information return that many charities are required to file with the Internal Revenue Service (the Form 990).*

Some of the policies and practices we commend for your consideration are divided into the topics below. The discussion that follows is generally directed to public charities:

### 1. Mission

The Internal Revenue Service encourages charities to establish and review regularly the organization's mission. A clearly articulated mission, adopted by the board of directors, serves to explain and popularize the charity's purpose and guide its work. It also addresses why the charity exists, what it hopes to accomplish, and what activities it will undertake, where, and for whom.

### 2. Organizational Documents

Regardless of whether a charity is a trust, corporation, unincorporated association, or other type of organization, it must have organizational documents that provide the framework for its governance and management.

State law often prescribes the type of organizational document and its content. The organizational document of a trust is usually the trust agreement or declaration of trust, and of a corporation, its articles of incorporation. State law may also require corporations to adopt bylaws.

The Internal Revenue Service requires the submission of organizational documents and bylaws, if adopted, with an application for exemption under section 501(c)(3), and will review these documents to ensure that the applicant is organized exclusively for exempt purposes and that the applicant's proposed or actual activities are consistent with those documents.

### 3. Governing Body

The Internal Revenue Service encourages an active and engaged board believing that it is important to the success

of a charity and to its compliance with applicable tax law requirements.

Governing boards should be composed of persons who are informed and active in overseeing a charity's operations and finances. If a governing board tolerates a climate of secrecy or neglect, we are concerned that charitable assets are more likely to be diverted to benefit the private interests of insiders at the expense of public and charitable interests. Successful governing boards include individuals who not only are knowledgeable and engaged, but selected with the organization's needs in mind (e.g. accounting, finance, compensation, and ethics).

Attention should also be paid to the size of the board ensuring that it is the appropriate size to effectively make sure that the organization obeys tax laws, safeguards its charitable assets, and furthers its charitable purposes. Very small or very large governing boards may not adequately serve the needs of the organization.

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. If an organization's governing board is large, the organization may want to establish an executive committee with delegated responsibilities or advisory committees.

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. 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, stockholders, 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.

If an organization has local chapters, branches, or affiliates, the Internal Revenue Service encourages it to have procedures and policies in place to ensure that the activities and operations of such subordinates are consistent with those of the parent organization.

#### 4. Governance and Management Policies

Although the Internal Revenue Code does not require charities to have governance and management policies, the Internal Revenue Service will review an organization's application for exemption and annual information returns to determine whether *the organization has implemented policies relating to executive compensation, conflicts of interest, investments, fundraising, documenting governance decisions, document retention and destruction, and whistleblower claims.*

##### A. Executive compensation.

A charity may not pay more than reasonable compensation for services rendered. Although the Internal Revenue Code does not require charities to follow a particular process in determining the amount of compensation to pay, the compensation of officers, directors, trustees, key employees, and others in a position to exercise substantial influence over the affairs of the charity should be determined by persons who are knowledgeable in compensation matters and who have no financial interest in the determination.

The Internal Revenue Service encourages a charity to rely on the rebuttable presumption test of section 4958 of the Internal Revenue Code and Treasury Regulation section 53.4958-6 when determining compensation of its executives. Under this test, compensation payments are presumed to be reasonable if the compensation arrangement is approved in advance by an authorized body composed entirely of individuals who do not have a conflict of interest with respect to the arrangement, the

authorized body obtained and relied upon appropriate data as to comparability prior to making its determination, and the authorized body adequately documented the basis for its determination concurrently with making the determination.

Comparability data generally involves looking to compensation levels paid by similarly situated organizations for functionally comparable positions.

The Internal Revenue Service has observed significant errors or omissions in the reporting of executive compensation on the IRS Form 990 and other information returns (e.g., Form W-2 and employment tax returns). Organizations should take steps to ensure accurate and complete compensation reporting on these forms, and to also ensure that appropriate income and employment taxes are withheld and deposited with the Internal Revenue Service. Executive compensation continues to be a focus point in our examination program.

#### B. *Conflicts of interest.*

The directors of a charity owe it a duty of loyalty. The duty of loyalty requires a director to act in the interest of the charity rather than in the personal interest of

the director or some other person or organization. In particular, the duty of loyalty requires a director to avoid conflicts of interest that are detrimental to the charity. Many charities have adopted a written conflict of interest policy to address potential conflicts of interest involving their directors, trustees, officers, and other employees.

The Internal Revenue Service encourages a charity's board of directors to adopt and regularly evaluate a written conflict of interest policy that requires directors and staff to act solely in the interests of the charity without regard for personal interests; includes written procedures for determining whether a relationship, financial interest, or business affiliation results in a conflict of interest; and prescribes a course of action in the event a conflict of interest is identified.

The Internal Revenue Service encourages organizations to require its directors, trustees, officers and others covered by the policy to disclose, in writing, on a periodic basis any known financial interest that the individual, or a member of the individual's family, has in any business entity that transacts business with the charity.

The organization should regularly and consistently monitor and enforce compliance with the conflict of interest policy.

#### C. *Investments.*

The governing body or certain other persons may be required either by state law or by the organizational documents to oversee or approve major investments made by the organization. Increasingly, charities are investing in joint ventures, for-profit entities, and complicated and sophisticated financial products or investments that require financial and investment expertise and, in some cases, the advice of outside investment advisors.

The Internal Revenue Service encourages charities that make such investments to adopt written policies and procedures requiring the charity to evaluate its participation in these investments and to take steps to safeguard the organization's assets and exempt status if they could be affected by the investment arrangement.

#### D. *Fundraising.*

Charitable fundraising is an important source of financial support for many charities. The Internal Revenue Service encourages charities to adopt and monitor policies to ensure that fundraising solicitations meet federal and state law requirements and solicitation materials are accurate, truthful, and candid. Charities are encouraged to keep their fundraising costs reasonable and to provide information about

fundraising costs and practices to donors and the public.

*E. Governing body minutes and records.*

The Internal Revenue Service encourages the governing bodies and authorized sub-committees to take steps to ensure that minutes of their meetings, and actions taken by written action or outside of meetings, are contemporaneously documented.

*F. Document retention and destruction.*

The Internal Revenue Service encourages charities to adopt a written policy establishing standards for document integrity, retention, and destruction. The document retention policy should include guidelines for handling electronic files.

The policy should cover backup procedures, archiving of documents, and regular check-ups of the reliability of the system.

*G. Ethics and whistleblower policy.*

The public expects a charity to abide by ethical standards that promote the public good. The organization's governing body bears the ultimate responsibility for setting ethical standards and ensuring they permeate the organization and inform its practices.

The Internal Revenue Service encourages a charity's board or trustees to consider adopting and regularly evaluating a code of ethics that describes behavior it wants to encourage and behavior it wants to discourage.

A code of ethics will serve to communicate and further a strong culture of legal compliance and ethical integrity to all persons associated with the organization.

The Internal Revenue Service encourages the board of directors to adopt an effective policy for handling employee complaints and to establish procedures for employees to report in confidence any suspected financial impropriety or misuse of the charity's resources. Such policies are sometimes referred to as *whistleblower* policies.

## 5. Financial Statements and Form 990 Reporting

Members and officers of the organization's Board of Directors are stewards of a charity's financial and other resources.

The Internal Revenue Service encourages the board, either directly or through a board-authorized committee, to ensure that financial resources are used to further charitable purposes and that the organization's funds are appropriately accounted for by regularly receiving and reviewing up-to-date financial statements and any auditor's letters or finance and audit committee reports.

*A. Financial Statements.*

Some organizations prepare financial statements without any involvement of outside accountants or auditors. Others use outside accountants to prepare compiled or reviewed financial statements, while others obtain audited financial statements. State law may impose audit requirements on certain charities, and a charity must ensure that it abides by the requirements of state law.

Many organizations that receive substantial federal funds are required to undergo one or more audits as set forth in the Single Audit Act and OMB Circular A-133. However, even if an audit is not required, a charity with substantial assets or revenue should consider obtaining an audit of its financial statements by an independent auditor.

The board may establish an independent audit committee to select and oversee an independent auditor. An audit committee generally is responsible for selecting the independent auditor and reviewing its performance, with a focus on whether the auditor has the competence and independence necessary to conduct the audit engagement, the overall quality of the audit, and, in particular, the independence and competence of the key personnel on the audit engagement teams.

The Internal Revenue Service encourages all charities to take steps to ensure the continuing independence of any auditor that conducts an audit of the organization.

*B. Form 990.*

Although not required to do so by the Internal Revenue Code, some organizations provide copies of the IRS Form 990 to its governing body and other internal governance or management officials, either prior to or after it is filed with the Internal Revenue Service.

Practices differ widely as to who sees the form, when they see it, and the extent of their input, review, or approval. Some, especially smaller organizations, may provide a copy of the Form 990 to the full board for review or approval before it is filed. Others provide a copy of the form to a portion of the governing body, or to a committee or top management officials, before it is filed. Still others provide a copy to the board, a committee or top management officials, but not until after it is filed.

**6. Transparency and Accountability**

By making full and accurate information about its mission, activities, finance, and governance publicly available, a charity encourages transparency and accountability to its constituents. The Internal Revenue Code requires a charity to make its Form 1023 exemption application, and the appropriate version of its Form 990 available for public inspection.

The Internal Revenue Service encourages every charity to adopt and monitor procedures to ensure that its Form 1023, Form 990, Form 990-T, annual reports, and financial statements, are complete and accurate, are posted on its public website, and are made available to the public upon request.