

**REMARKS OF STEVEN T. MILLER
COMMISSIONER, TAX EXEMPT AND GOVERNMENT ENTITIES
INTERNAL REVENUE SERVICE
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I am pleased to be here in Los Angeles at the Western Conference on Tax Exempt Organizations. I particularly want to thank Loyola for its collaboration with us in putting on this conference.

We meet at a time of difficulty and potential peril for the tax-exempt sector. The battering that donors and endowments have taken in the stock market in recent days, and the worrying prospects for the economy, pose a clear challenge. Many organizations are not only facing sharply declining resources, but are being asked at the same time to urgently expand their services to greater numbers of persons in need.

Our topic this morning is a dialogue about non-profit governance. It is a pertinent topic for this time. I think the current situation heightens – rather than diminishes – the importance of this subject. The proper stewardship of the tax subsidy that the tax-exempt community receives from the American public is always important, but especially so at a time of economic distress. At the same time, as we approach the topic of governance, we at the IRS need to be very mindful of the economic challenge the sector faces.

The first thing we recognize about governance is that there are gaps in our ability to regulate in this area. No section of the Internal Revenue Code establishes specific requirements for how a tax-exempt organization is to be governed. However, it seems somewhat obvious that, at a minimum, governance is relevant in some areas.

For example, section 501(c)(3) prohibits inurement, and one can see how a board of directors that is engaged and independent can help avoid problems. But the statutory prohibition contains little that would establish a specific practice by which inurement is to be avoided. Instead, protective measures are left to the board of directors and the leadership of the organization.

Indeed, the word “governance” does not appear in section 501 of the Code at all. Nevertheless, the IRS has been and will remain active in this area. It is too important to ignore.

In my time today, I would like to answer four questions:

- First, why does governance matter to the IRS?
- Second, what has the IRS done in the past year to encourage good governance?
- Third, where will the IRS go from here?
- Finally, what can you do, going forward, to help your clients and organizations strengthen their governance practices?

Why governance matters to the IRS

It is evident that we care about this area. We have been out front on the issue for some time.

When we first started to speak about governance, some agreed with our posture, but we also met with reluctance, indignation, and even anger. Some argued that we had no authority to involve ourselves in this area – that we could not tell you how to run your business. Some argued that we were infringing on the authority of the state attorneys general.

Let me respond plainly and directly to both these concerns. First, we have no interest in telling you how to run your organization. If you would like some reassurance that we mean this, let me read to you what my boss, Commissioner Shulman, said on this subject in a speech just 10 days ago:

“I admire the tax-exempt sector: its diversity, its creativity and its risk-taking. ... This diversity means many points of view are expressed, many problems are attacked in many ways, many solutions are found, and many benefits are created for the nation.

“I firmly believe that that the IRS must recognize and allow for this diversity – and not become a barrier to it. We shouldn’t supplant the business judgment of organizational leaders, and certainly shouldn’t determine how a nonprofit fulfills its individual mission. That’s not our role.”

So we are not about the business of second guessing how you run your organization.

At the same time, we recognize that good governance is important and that we have a legitimate interest in the issue. The Commissioner made this point as well in his speech. *“The tax-exempt sector,”* he said, *“tends to be guided by a high-minded, rule-abiding culture. At a time when the consequences of abandoned and debilitated standards lie in disarray all around [us], I respect the tax-exempt sector’s adherence to fundamental principles.”*

He added, however, the Service “*will continue to insist that the [tax-exempt] sector be squeaky-clean,*” and emphasized that our role is to work with you to promote good governance.

In a word, the Service is going to be involved with governance.

What then are our intentions with regard to this issue? First, we will contribute to the effort, undertaken by many, to explain the advantages of good governance, and the need for it in a healthy tax-exempt sector. Our hope here is to facilitate discussions within your organizations – for a board member to say to you, for example: “You know, I saw that the IRS is asking us whether we document the decisions we make at our board meetings. What’s that all about, and why do we need to do it?” Not a bad question.

Our second intention in this area is to let the sun shine on governance practices. Let the public see how your organization is run – what standard of conduct you desire and aspire to.

As to the second objection raised against our involvement – that we are infringing on the authority of the state attorneys general – I agree that the states have primary jurisdiction over many areas of governance. We will not interfere in the relationship of the state and the charity. Indeed, we continue to work well and closely with state charity officials.

But questions about authority and primary jurisdiction beg the important question of why we are becoming more active in this area. We care about governance because we believe, and I believe, that a well-governed organization is more likely to be compliant with the tax law, while poor governance can easily lead to trouble. Good governance also allows organizations to self-identify and self-resolve problems.

My view is clear. We are not interlopers trying to regulate an area that is beyond our sphere. Rather, the effects of good or bad nonprofit governance cut across virtually everything we see and do in our work. Governance practices influence whether an organization is operated to further exempt purposes, and whether the organization serves public, rather than private, interests.

Good or bad governance dictates whether the organization's executives are compensated fairly or excessively. It influences whether the organization makes informed and fair decisions regarding its investments or its fundraising practices, or whether it allows others to take unfair advantage.

The question is no longer whether the IRS has a role to play in this area, but rather, what that role will be.

What have we done in the area in the past year?

We have been active. We have pushed to educate and pushed to require reporting on how organizations are managed. The crown jewel of this effort is the governance section of the revised Form 990, effective for 2008.

This governance section asks about the composition and independence of the governing body, about governance policies and procedures, and about whether, and how, an organization makes governance and financial information available to the public.

As many of you know, the revised 990 instructions include new definitions of many terms relevant to this area: “officer,” “director,” “key employee,” and “independent voting member,” to name a few. Steve Clarke can walk you through those.

In addition, in February, we put an educational piece on our Web site. This encourages leaders of nonprofits to consider key governance issues, and it ties these issues into the governance section of Form 990. Our goal is to notify organizations about the questions they will be asked each year from now on when they file their 990s.

The purpose of the piece is to highlight governance matters that leaders of charities, of all sizes and types, should consider throughout the entire life cycle of their organizations, from cradle to grave.

Where do we go from here?

So what is in the works from the IRS in this area for the future? First, we have some work to do in-house. The American Bar Association and our own public advisory committee recommended that we exercise caution in our approach, and that we ensure that both our determination specialists and our exam agents have a clear and uniform understanding of what they are to do with governance issues when they encounter them. We cannot adopt a one-size-fits-all policy to resolve governance issues, and leave it at that. What is needed is a more nuanced view – one more appreciative of the unique facts and circumstances that a particular applicant or organization faces.

We therefore are going to provide training, this fiscal year, to our determination specialists and our examination agents on governance issues. We want them to understand the difference between requirements on one hand and policy preferences on the other. And we want them to realize that our concerns about governance may appropriately be scaled to the size and nature of the organization.

We will also emphasize to our specialists and agents that there can – indeed there should – be a dialogue about governance between them and the organizations they are working with.

For example, in an exam context, if an agent sees a clear connection between a missing good governance practice and improved tax compliance, we will encourage the agent to point that out to the organization, even when it has no direct tax consequence. In appropriate cases, agents may consider recommending good governance practices in a closing letter, an advisory, or a closing agreement.

Given the many best practices that a variety of commentators have recommended, what principles of good governance will we emphasize? To date, we have concentrated on the composition and independence of the organization's governing board, as well as on the compensation of the board members and conflicts of interest. All this remains vital.

What else? While the diversity of the sector may mean that one size does not fit all when it comes to how a particular organization should be governed, it is nonetheless true that there are some general principles to be considered when one sets up and operates a tax-exempt organization.

You cannot convince me that the gold standard should not be to have an active, independent and engaged board of directors overseeing the organization. Now there may be exceptions to the idea that there should be some independent members on the board – small family foundations come to mind – but generally an exempt organization's board or governing body must be accountable to the community it serves.

In some cases this community is the general public; in other cases it is the organization's membership; but in all cases the governing body is accountable to someone other than the officers and directors of the organization. This is how it should be when you remember that a tax-exempt organization exists to serve and be accountable to some segment of the public.

Independent board members are important because they increase the likelihood that decisions will be made in the best interests of the organization and the community it serves. The composition of the board will therefore remain a key focus of our efforts.

We will also continue to press forward on procedures that are designed to safeguard assets. Key among these is the presence and use of internal financial controls. Other procedures should exist that call for the board or one of its committees to review major decisions to make sure that the expenditure or activity is for an appropriate, tax-exempt purpose.

Now, will a properly composed board, the adoption of internal controls, and the like guarantee that no lapses or losses will occur? No, of course not.

But even if they fail to prevent all problems, such measures will prevent many problems, and will increase the probability that when they do occur they will be uncovered, addressed, and resolved before the IRS gets there. And doesn't everyone win when that happens?

This means that board composition, internal controls and governance structure will remain a large part of our focus going forward. But what actions will we be taking to sharpen this focus? First and foremost, we need to continue to educate the sector about the need for standards. We will do this through the excellent education and outreach programs that our Exempt Organization's office has put together and offers on-line and in-person.

Second, we need to try to educate new organizations about these best practices right from the outset – by which I mean during the determination letter process. Soon we will implement what we lovingly refer to as the Cyber Assistant. Cyber Assistant is a software system, similar to tax preparation software, that applicants for tax-exempt status will be able to use to fill out the Form 1023 application. As the Cyber Assistant helps the applicant work through the form, it will also provide – at the appropriate place – suggestions and educational material about relevant governance issues. We hope this will encourage the new organization to adopt a number of best practices right from the outset. We hope to roll out the Cyber Assistant this coming year.

So we will continue to educate and to communicate widely about governance during the determination process.

We will also continue to press for transparency in reporting as organizations begin to file the new Form 990. Timely, complete and accurate filing is the goal.

Part VI of the new Form 990 is the section that addresses governance issues most comprehensively, and its 28 questions are fairly comprehensive. Schedule O also calls for some relevant descriptions, and there are a few other governance issues – the gift acceptance policy and the grant making monitoring policy, to name two – sprinkled elsewhere on the 990.

One of the most often discussed questions on Part VI is whether an organization provides a copy of the 990 to all board members before it is filed and asks for a description of any internal process to review the 990 before it is filed. Let me say just a word about that. The purpose of this question is to encourage the organization to consider – I'll repeat that word – to consider the board's role in the 990 process. It gets back to having an interested and engaged board of directors. In asking this question, we know that one size does not fit all. We

expect that how an organization will review the 990, and how it will answer the question, will vary depending on the size, nature and culture of the organization.

One last word on the 990. We are encouraged by the dialog we have been having with the sector, and by the discussion now going on inside the sector. Lots of conferences and professional meetings have been scheduled to address the new 990. Many organizations, boards and practitioners have been working with the Part VI questions, preparing for the 2009 filing season. I appreciate all this hard work.

That's it for the 990.

Let's move to the examination process, and talk about governance from the perspective of the enforcement side of the Service.

We have been arguing that good governance is related to tax compliance, but others challenge us and question whether such a relationship exists. It seems like a logical inference to us, but some want proof. We are going to collect evidence on this question during the exam process.

One idea we are considering is to look, at the end of an exam, at how an organization's governance practices influenced its compliance. The idea is for agents to answer a set of questions. Did we uncover a problem that was caused by a weakness in governance? Alternatively, did we find a problem that the organization could have found and corrected if an appropriate best practice had been in place? Are there actions the organization can take going forward that will strengthen compliance? We already have been asking some of these questions informally.

Soon we will begin asking about certain governance and financial practices at the start of an examination. The answers to these preliminary questions will help determine what issues we pursue during the exam, and how deeply we delve into them.

But to understand the correlation between good governance and good compliance, some kind of new post-exam checklist seems useful. Once we have introduced such a checklist, and used it long enough to collect some good information, we plan to report publicly on what we find. We are not doing this yet, but it seems to be a natural extension of our work in the governance area. Other projects, based on our analysis of the data we will begin to receive from the new Form 990, are also likely.

Last question – What can you do?

All of us who are part of the exempt sector share an important common goal – helping assure that the sector as a whole, as well as each individual tax-exempt

organization, operates for the benefit of society. In a word, we need to make sure that the public is getting a fair return for the enormous tax subsidy it entrusts to the tax-exempt sector. We need to be sure the public is getting its money's worth.

When I'm talking about governance, I often conclude my remarks by doing something I like to do: ask a few questions. In the past, I have asked who should lead the sector on the nonprofit governance issue. That question remains relevant today.

The sector has been busy with this topic. It is a sign of the strength and health of the sector that these discussions are taking place.

One of the most important recent developments was the release in October 2007, of "Principles for Good Governance and Ethical Practice: A Guide for Charities and Foundations," by the Panel on the Nonprofit Sector. If you have not already done so, I urge you to review that document, and work within your own organization, or with your own clients, to adopt governance practices consistent with those the Guide recommends. I am happy to note that the sector is leading in the area of governance, and I think it is important that it continues to lead.

There is another valuable role that you in this room can play right now, and that is helping tax-exempt organizations prepare for filing their new Forms 990 for the first time for 2008. The new 990 is substantially different from the form filed in the past. You can help organizations consider now, before the end of the year, how they will answer many of the new questions, including the governance questions. This may save them from scrambling in the last moments of the 2008 tax year, to adopt a conflict of interest policy, or to establish a compensation committee. It may save them from regretting their delay and wishing, after the end of the tax year, that they had acted. This is work you can do now. Start the conversation!

What else? I think the next step for you is to help assure that these organizations go beyond the formal establishment of policies, procedures and committees. The mere adoption of written policies and procedures does not mean that they are being used. You can help organizations breathe life into their procedures so that meaningful self-regulation occurs in fact and not just on paper. You can make all the difference here.

Conclusion

Let me wind up.

I believe that poor governance within tax-exempt organizations inevitably leads to the waste or careless use of charitable assets; to a misuse of the tax expenditure

– the foregone taxes – the Congress entrusts, with high expectations, to the sector; and – most damagingly of all – to a loss of public confidence in the non-profit sector. We cannot ignore these dangers. The tax-exempt sector is too important, too valuable a resource to the country. We cannot shirk our responsibility to shape a vibrant and compliant tax-exempt sector, and governance is a part of that.

One may argue the states can address the issue of governance. Or that the sector can articulate and somehow ensure the application of principles of good governance and the adoption of best practices. It is clearly true that both the states and the sector can and must play important roles in promoting good governance. Indeed I think they have the principal role to play in keeping the tax-exempt sector strong and healthy. Now more than ever you have an important opportunity to lead in discussions about the future of governance in your organization.

But the Internal Revenue Service has a robust role as well. I believe that the need for good governance, and its magnifying glass, transparency, has actually increased in the wake of the economic downturn. There are always a few who use the worst of times, and others' desperate situations, to misuse exempt organizations and line their own pockets.

We also have to ask whether difficult times will prompt some entities to inch across permissible lines to make up budget shortfalls?

I hope not, and I know that most organizations will not. But this is a time for us to be vigilant, and to make sure the tax-exempt sector remains what it has always been, the envy of the world.

Thank you again for this opportunity to be with you this morning. Best of luck in the days ahead. I will be happy to take your questions after Doug makes his presentation.