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The Responsibility and Accountability of Governing Boards and Presidents: Recent Developments

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I. INTRODUCTION

Issues related to compliance among tax-exempt organizations remained on the forefront of political agendas in 2008. Despite concerns regarding the potential effects of the economic downturn on charitable organizations, both Congressional leaders and the Internal Revenue Service (the "IRS") continued to focus their efforts on ensuring that tax-exempt organizations employ best practices and operate in a transparent environment.

In many ways, 2008 was the "year of higher education" as Congress passed the long-awaited Higher Education Act of 2008, and both Congress and the IRS undertook compliance initiatives to better understand the practices employed by colleges and universities. In this regard, Douglas Shulman, who began his five-year tenure as Commissioner of the IRS in 2008, commented recently that one of the primary goals of the new IRS strategic plan is to concentrate on the tax-exempt sector and specifically to "focus on universities, hospitals and other major segments of the tax-exempt community."[1] Given the scrutiny that colleges and universities have experienced in the past year, and likely will continue to face, now is the time for the governing boards of colleges and universities to ensure that they are maintaining good governance and best practices. This paper discusses some of the more significant developments in the past year with respect to governance and best practices, how these developments should shape

[1] Remarks of Douglas Shulman, Commissioner of Internal Revenue, before Independent Sector (Nov. 10, 2008).

the policies and practices of college and university boards, and areas that boards should monitor for future developments.

II. REVISED 990

In connection with recent implementation of the Sarbanes-Oxley Act and the Pension Protection Act of 2006, and in keeping with IRS efforts to increase the transparency of tax-exempt organizations, the IRS recently undertook revisions to Form 990, Return of an Organization Exempt from Federal Income Tax. The IRS released the finalized draft of this return in December 2007, and the revised form must be used commencing in 2009 (reflecting the 2008 tax year). The IRS articulated three primary goals of the re-design process: "(i) enhancing transparency to provide the IRS and the public with a realistic picture of the organization; (ii) promoting compliance by accurately reflecting the organization's operations so the IRS may efficiently assess the risk of noncompliance; and (iii) minimizing the burden on filing organizations."[2] Among the most significant changes to the Form 990 were updates to reporting requirements with respect to (i) governance and (ii) compensation of officers, directors, trustees, key employees, and highest compensated employees.

A. Governance on the Revised Form 990

The revised Form 990 includes a new Part VI, Governance, Management, and Disclosure. Consistent with the IRS' belief that "the existence of an independent governing body and well-defined governance and management policies and practices" leads to tax compliance, this new part includes a series of questions addressing an organization's governance structure, its policies, and its disclosure practices.[3] Although most questions in this section can be addressed by someone familiar with the organization's practices and policies, the organization will be required to seek information from its officers, directors, trustees, and key employees with respect to certain family or business relationships. Notable new questions in this section include:

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[2] IR- 2007-117, IRS Releases Discussion Draft of Redesigned Form 990 for Tax-Exempt Organizations (June 14, 2007).

[3] IRS, Background Paper, Forms 990, Moving From the Old to the New (Aug. 19, 2008), *available at* www.irs.gov (*hereinafter* IRS, Background Paper).

- Line 1b asks the organization to provide the number of "independent" voting members of the organization's governing body.
- Line 3 inquires as to whether the organization delegated management responsibilities to an outside management company.
- Line 10 asks whether a copy of the Form 990 was provided to the organization's governing body before being filed and asks for an explanation of the process, if any, used by the organization to review the Form 990. This question may prompt organizations to develop new policies whereby the governing board, or a committee of the board, is required to review or approve the Form 990 prior to submission.
- Line 12 asks whether the organization has adopted a conflict of interest policy and, if so, the measures that the organization has taken to enforce the policy.
- Line 13 asks whether the organization has adopted a whistleblower policy.
- Line 14 asks whether the organization has adopted a written document retention and destruction policy.
- Line 15 asks the organization to describe the process used to establish compensation of the organization's management, officers, and key employees.
- Line 16 asks if the organization participated in a joint venture and, if so, if the organization has adopted a written policy requiring the organization to evaluate its participation in accordance with federal tax law and to protect it tax-exempt status.
- Section C of Part VI asks a series of questions about how the organization makes its application for exemption, annual returns, governing documents, conflict of interest policy, and financial statements available to the public.

The draft instructions that accompany the revised form are careful to state that most of these policies and procedures are not <u>required</u> by federal tax law. Nonetheless, the instructions also emphasize that such policies and procedures generally improve tax compliance.[4] In the wake of several high-profile improprieties involving charitable organizations, the entire tax-exempt community is now subject to more intense public scrutiny, and one form of protection against charges of wrongdoing is through the adoption of policies and procedures. If they have not already done so, all college and university boards should consider, at a minimum, the adoption and implementation of a conflict of interest policy, a whistleblower policy, and a document retention policy. Moreover, existing policies should be re-evaluated periodically by college and university

[4] *See* 2008 Instructions for Form 990, Part VI, *available at* www.irs.gov.

boards to ensure that the terms are current and that the practices of the institution are consistent with such terms. Below is a brief summary of the goals of such policies and information that should be contained in them:

1. Conflict of Interest Policy[5]

- The general purpose behind a conflict of interest policy is to ensure that the organization has a procedure to follow when actual or potential conflicts of interest arise, by which the affected individual at a minimum will notify the organization's governing body of all relevant facts concerning the conflict of interest.
- In drafting a conflict of interest policy, the organization will want to make sure that the policy complies with state laws that address conflict of interest situations. Other important elements of a conflict of interest policy include:
  - A definition of "conflict of interest";
  - The identities of those covered by the policy (e.g., trustees, officers, employees);
  - Limits on the extension of loans, or other forms of private benefit, to or for any officer, director, or employee of the organization;
  - A means for trustees, directors, and officers to disclose personal and professional relationships;
  - A means for the disclosure of information to help identify conflicts of interest; and
  - A procedure for how to manage conflict of interests as they surface.

2. Whistleblower Policy

- The Sarbanes Oxley Act legislated protections for whistle-blowers, making it illegal for an organization to retaliate against an employee who reports suspected illegal activity by her or his employer. An organization's whistleblower policy should describe the process by which an employee or volunteer may convey complaints or identify concerns regarding violations of legal and regulatory requirements governing the organization.
- Important elements of a whistleblower policy include:
  - Recognition of an employee's legal right to report actual or suspected unlawful activity to either the appropriate government agency or to the organization's management;

[5] The IRS has provided a sample conflict of interest policy with the instructions to the Form 1023, Application for Exemption. This can be found on the IRS web-site at www.irs.gov.

- o Acknowledgment that it is the organization's responsibility to ensure that employees feel comfortable reporting actual or suspected unlawful activity;
- o Provision of internal controls and procedures to facilitate the anonymous reporting of inadequate or unlawful activities; and
- o A statement that the organization will not retaliate against any individual who makes a report, even if it is later deemed to be unfounded.

3. <u>Document Retention Policy</u>

- Under the Sarbanes Oxley Act, a nonprofit corporation may commit a criminal offense if it alters or destroys records to avoid federal investigation or to obstruct a government function.[6] As a result, all organizations should adopt a document retention and destruction policy to prevent a dispute regarding whether documents were purged in the ordinary course of business or in an effort to impede a federal investigation. Key elements of a document retention policy include:
  - o Timelines for the retention of various types of documents based on applicable federal and state statutes of limitations and sound business practice;
  - o Procedures for retaining and discarding electronic files and voicemail; and
  - o Recognition that if an official investigation is underway or suspected, the organization must cease all document destruction regardless of established timelines.

B. <u>Compensation Reporting on the Revised Form 990</u>

Following the IRS' comprehensive investigation into the compensation practices of tax-exempt organizations in 2004, a continued commitment to monitor executive compensation is reflected in the new Part VII, <u>Compensation of Officers, Directors, Trustees, Key Employees, Highest Compensated Employees, and Independent Contractors</u>. Although information regarding compensation was collected on previous versions of the Form 990, the new form generally captures more information and requires more detailed information with respect to executive compensation. The IRS articulated two primary purposes behind the re-designed compensation section: "1) [to] simplify and obtain more uniform basic compensation reporting from all organizations, regardless of

[6] *See* section 802(a) of Sarbanes Oxley Act.

type or size . . . and 2) in some instances, [to] obtain additional detailed information regarding a listed person's compensation and the organization's compensation practices, particularly in those cases where the organization has compensated one or more persons above certain amounts."[7]

Part VII, Section A, requires the organization to provide information regarding: (i) the organization's current officers, directors, and trustees (regardless of compensation); (ii) the organization's twenty highest paid key employees who received compensation over $150,000; (iii) its five other highest compensated employees who received compensation over $100,000 (on previous versions of the 990, the threshold was $50,000); and (iv) information regarding individuals who served in the aforementioned roles in the previous five years.[8] The revised form provides new definitions of "officer" and "key employee." The revised form also contains a new Schedule J, Compensation Information, requiring organizations to provide more specific compensation information for those persons listed in Part VII who receive compensation in excess of certain thresholds.[9]

Part VII and Schedule J request information regarding two types of compensation: (i) "reportable compensation," which is determined by the reportable amounts provided on the individual's Form W-2 or Form 1099, and (ii) "other compensation," which includes compensation that is not reflected on such forms. The instructions provide more detail with respect to definitions and exclusions for these types of compensation. Part VII and Schedule J also require that compensation be reported on a calendar year basis. Accordingly, organizations operating on a fiscal year are no longer permitted to report compensation on that basis.[10]

Given the emphasis placed on executive compensation in the revised Form 990, the recent attention that colleges and universities have received for significant increases in presidential compensation from 2007 to 2008 (see discussion below), and the

[7] *See* IRS, Background Paper.

[8] *See Id.*

[9] *Id.*

[10] *Id.*

controversy surrounding endowment spending, college and university boards should carefully examine their compensation practices. Below is a brief overview of the characteristics of best practices with respect to executive compensation that will help protect college and university board members and other disqualified persons from tax liability.

1. Background. Section 4958 of the Internal Revenue Code of 1986, as amended (the "Code"), and the corresponding regulations impose penalty taxes on certain individuals within tax-exempt organizations who receive excess benefits from their organizations. An excess benefit transaction occurs when an economic benefit is provided by a public charity (e.g., most colleges and universities), directly or indirectly, to or for the use of any disqualified person where the value of the economic benefit provided by the public charity exceeds the value of the consideration received for providing such benefit. Excess benefit transactions include the payment of excessive compensation. Generally, a "disqualified person" will include any entity or individual with substantial control over the organization (e.g., the governing body, the President, or the Chief Executive Officer), family members of a disqualified person, and 35% controlled entities of a disqualified person.

2. Rebuttable Presumption. Although the regulations governing this area are complex, they do contain a relatively straightforward procedure for public charities to follow in order to demonstrate that a disqualified person's compensation is not excessive, thereby relieving officers, directors, and trustees of any potential tax liability -- the *"rebuttable presumption of reasonableness."*[11] If followed, then the organization is entitled to a rebuttable presumption that compensation paid by the organization to a disqualified person is reasonable. There are three basic requirements of the rebuttable presumption:

1. The compensation arrangement must be approved in advance by an *authorized body*.

[11] *See* Treas. Reg. section 53.4958-6.

- The organization's governing board, or other body authorized by the governing board to serve as the authorized body, must be involved in setting compensation.
- The authorized body may not have any personal interest in the compensation arrangement, and the authorized body must approve compensation without discussion or voting participation by the person whose compensation is at issue.

2. The authorized body must obtain and rely upon *appropriate data as to comparability* in making its determination.

    - Comparability data should include compensation levels at similar organizations for similar positions, the availability of similar services in the organization's geographic area, and any written offers from similar organizations competing for the disqualified person's services.

3. The authorized body must adequately *document* the basis for its determination.

    - Documentation must include the terms of the transaction and date approved, members of the authorized body present during discussion of the transaction and those who voted, the comparability data relied on by the authorized body and how it was obtained, and any actions by a member of the authorized body having a conflict of interest. The authorized body must approve the documentation within a reasonable time after preparation and the documentation must be prepared before the later of the next meeting of the authorized body or sixty days after the group's final actions.

III. COMPLIANCE INITIATIVES

In 2008, the spending practices of colleges and universities came under closer scrutiny by both congressional leaders and the IRS. In January 2008, the United States Senate Committee on Finance issued a press release announcing that Senator Baucus, then Chairman of the Senate Finance Committee, and Senator Grassley, then Ranking Member of the Senate Finance Committee, sent questionnaires to 136 colleges and endowments with assets greater than $500 million asking a series of questions regarding practices with respect to student financial aid and endowment growth.[12] The letter indicated that it was motivated by a desire to understand whether the tax-exempt

[12] United States Senate Committee on Finance, Press Release, *Baucus, Grassley Write to 136 Colleges, Seek Details of Endowment Pay-Outs, Student Aid* (Jan. 24, 2008)

status enjoyed by universities and their endowments is having a direct impact on the affordability of college for low and middle class students and their families. The letter also recognized the strong growth that many university endowments experienced in recent years, noting that the authors "hope that these strong returns will encourage you and your Board of Trustees to review your endowment payout policy and ensure that it reflects best practices."[13]

In the May 30, 2008, edition of the *Chronicle of Higher Education*, Senator Grassley drafted an editorial, Wealthy Colleges Must Make Themselves More Affordable. The editorial emphasized his concern that colleges and universities are not doing enough to make college affordable. Senator Grassley discussed the possibility of legislation to implement a five-percent payout requirement for university endowments, in addition to requirements regarding increased reporting with respect to endowment spending practices. In this regard, he addressed concerns from colleges and universities that a five-percent payout would be detrimental, noting that private foundations have thrived under the strict five-percent payout requirement. Later, in September 2008, Senator Grassley hosted a roundtable with Congressman Welch,[14] Maximizing the Use of Endowment Funds and Making Higher Education More Affordable. In his opening comments, Senator Grassley expressed similar concern regarding rapid endowment growth and simultaneous skyrocketing tuition. In closing, he asked the IRS to develop a separate schedule to Form 990 specifically for colleges and universities that would require information regarding student populations and costs.

The release of the annual *Chronicle of Higher Education* survey of executive salaries at colleges and universities in November 2008 prompted renewed interest by Senator Grassley in the spending practices of colleges and universities. The *Chronicle of Higher Education* reported that despite the economic downturn, public research universities in the survey increased their presidential pay 7.6% from 2007 to 2008, and similarly presidents at private institutions received a 6.5% increase in

[13] Letter of January 24, 2008 to 136 Colleges and Universities from Senators Baucus and Grassley.

[14] Congressman Welch originally introduced an amendment to the Higher Education Act of 2008 that would have required a five-percent payout for all college and university endowments. He later withdrew the amendment. NAICU Washington Update, *Endowments, College Costs Discussed at Grassley/ Welch Roundtable* (Sept. 16, 2008).

compensation from 2007 to 2008.[15] With respect to the survey, Grassley commented in a press release, "the executive suite seems insulated from budget crunches."[16] He expressed particular concern regarding the increased salaries at public universities, noting that these schools have argued against a mandatory five-percent endowment payout on the basis that state budget cuts have stretched their financial resources.

Coinciding with the Congressional review of college and university spending practices, in October 2008, the IRS sent its own compliance questionnaires to 400 colleges and universities that represent a broad spectrum of higher education, ranging from small to large schools and including both public and private institutions.[17] The IRS questionnaire focuses on obtaining information with respect to unrelated business income, endowments, and executive compensation practices. The deadline for submission of the thirty-three page questionnaire[18] to the IRS was extended to February 6, 2009, and the IRS plans to release the results of its survey in 2009. With respect to this initiative, Douglas Shulman, IRS Commissioner, stated that the "effort reflects our work to build a better understanding of the largest, most complex organizations in the tax-exempt sector."[19]

Although the implications of these questionnaires and compliance initiatives remain unknown, there is a possibility that legislation may be introduced that would mandate a set percentage of endowment spending, at least for larger colleges and universities. As a result of the recent attention directed at colleges and universities, issues relating to endowment spending, student aid, and executive pay will be addressed by nearly every college and university board in the coming months and years. All college and university boards should monitor developments in this area, carefully examine the spending practices of their respective institutions, and ensure that appropriate procedures are followed in establishing executive compensation (as described above).

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[15] *Presidential Pay and Benefits: By the Numbers*, CHRONICLE OF HIGHER EDUCATION (Nov. 21, 2008).

[16] Senator Charles Grassley, Press Release, *College Presidents' Salaries* (Nov. 17, 2008).

[17] IRS, *Colleges and University Compliance Project*, www.irs.gov.

[18] A copy of Form 14018, *Compliance Questionnaire, Colleges and Universities*, is available at www.irs.gov.

[19] IR-2008-112, IRS Sends Compliance Questionnaires to 400 Colleges and Universities (Oct. 1, 2008).

IV. OTHER DEVELOPMENTS

A. Higher Education Act of 2008

In August 2008, President Bush signed into law the Higher Education Act of 2008 (the "Act"), which "creates dozens of grant programs, and imposes hundreds of new reporting requirements," on colleges and universities.[20] One component of the Act requires the Secretary of Education to publish the names of colleges and universities with the highest and lowest tuition and fees, by sector, in addition to a separate list of the names of those institutions with the most significant percentage increases in tuition and fees over the previous three years.[21] Those colleges and universities appearing on the percentage-based lists are required to submit reports to the Secretary of Education explaining the reasons for increases in tuition, and how they plan to keep costs down in the future. Some have indicated that institutions appearing on the Secretary of Education's list will be "publicly named -- and shamed," a consequence that college and university boards may want to consider prior to implementing major tuition hikes.[22]

B. Diversity Legislation

In early 2008, one house of the California legislature adopted Assembly Bill 624, the Foundation Diversity and Transparency Act (the "Bill"). The Bill's principal author, Assembly Member Joe Coto, introduced the Bill in an effort to combat a purported lack of diversity in foundation grantmaking and governance. Coto later agreed to withdraw the proposal in June 2008. If the Bill had passed, it would have required each California-incorporated foundation with assets valued at over $250 million to collect and report extensive diversity information, including the racial and gender compositions of: (i) the foundation's board of directors; (ii) the foundation's staff; (iii) recipients of business contracts; (iv) the boards of directors of grant recipient organizations; and (v) the staff of grant recipient organizations. The Bill received significant opposition from

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[20] Paul Basken, *Hearings Set on Rules for Higher Education Act*, THE CHRONICLE OF HIGHER EDUCATION (Sept. 19, 2008).

[21] Kelly Field, *A Bill That Took Longer than a Bachelor's Degree*, THE CHRONICLE OF HIGHER EDUCATION (Aug. 8, 2008).

[22] Chronicle Reporting, *How 5 Key Issues Were Handled in the Higher Education Act*, THE CHRONICLE OF HIGHER EDUCATION (Aug. 8, 2008).

the charitable and grantmaking community, arguing that the reporting requirements were overly onerous, and ultimately the Bill was withdrawn following the commitment by ten California foundations to develop a program to encourage nonprofit organizations to address the needs of low-income and minority communities. Although the Bill's reach was limited to foundations incorporated in California, the media has reported that the Bill's sponsor, Greenlining Institute, Inc., and others may be considering similar initiatives in other states, particularly New York. Although there is no immediate concern for college and university boards, diversity and board composition is an area to watch for future developments.