Nonprofit Risk Management Center

The Taxman Cometh

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What's on the agenda for the IRS this year? Lois Lerner, the Director of Exempt Organizations, Internal Revenue Service, addressed a gathering of lawyers and accountants in Washington, D.C. last week to share how the IRS views the impact of the economy on the charitable sector and how the IRS hopes to use its enforcement powers to protect taxpayers as well as the sector. The focus of the IRS, she explained, will be to enhance the public's trust in charities by protecting the sector from "predatory abuse," such as tax avoidance schemes. Accordingly, Ms. Lerner described the IRS priorities as:

- enforcing the IRS rules on "reasonable" compensation and income tax withholdings for employees
- investigating sham mortgage assistance and credit counseling organizations
- cracking down on overly aggressive fundraising tactics, and
- investigating and correcting the mis-classification of employees as independent contractors.

The message was clear: The IRS is poised to pounce on organizations that play fast and loose with the regulations. Here are some of the things you need to do to stay clear of unwelcome visits from the IRS.

1. **Adopt a policy addressing compensation practices.** Your policy should follow the "rebuttable presumption" procedures set forth in IRS regulations and described in detail on the instructions to the new 990. See page 66 of the new 990 instructions. Ms Lerner emphasized that the IRS is interested in *the process* of how compensation is determined and will look for evidence that charitable organizations follow a 'thoughtful process' of setting compensation levels, versus glancing mechanically at comparability data of salaries and compensation in the sector. To demonstrate due diligence in this area the Center suggests that organizations implement a policy for compensation approval, and pay close attention to drafting minutes that describe how the board or a compensation committee reached its decision about staff salaries and benefits.
2. **Adhere, without exception, to withholding requirements.** When financial times are tough, it is human nature to look for ways to cut corners. But playing fast and loose with IRS regulations is a risky and unwise savings strategy. Board members can be personally liable for failure to withhold income taxes from employee wages. In a recent decision in the Fifth Circuit, the volunteer chair of a nonprofit board was held personally liable for penalties when a hospital failed to withhold income taxes from employees' paychecks. The IRS successfully argued that the chairperson was the "responsible person" under Internal Revenue Code Section 6672 because he acted willfully when he had "reason to know that the taxes were not being paid," and "failed to exercise his authority to ensure their payment." The court found that even though the primary responsibility for paying taxes rested with someone else in the organization that fact did not excuse the board chair from the oversight. *Verret v. USA, 542 F Supp 2nd 526 (E.D. Tex. 2008)*.
3. **Use the 990 to your organization's advantage.** Many organizations will soon be filing their 990 for fiscal year 2008. Watchdog groups and stakeholders including the IRS and donors may review these filings to examine how organizations respond to the new questions addressing governance, accountability and transparency issues. Lerner reminded her audience that now is the perfect time, 'before the ink is dry' to become familiar with the questions on the 990 and the nonprofit's answers. In particular, nonprofit leaders should review the description of the organization's purpose and activities, making sure that the mission statement is clear and consistent with current realities. Over time organizations often add or discontinue programs and activities, but the individual who prepares your 990 may simply insert the language from prior years unless directed to include new information. It is in every nonprofit's best interests to put its best foot forward in documents available for public consumption. That means

presenting an accurate, up to date description of the mission and mission-related activities, as well as an accurate reporting of finances and governance practices.

4. **Be wary when classifying workers as independent contractors.** As its enforcement capacity allows, the IRS will be cracking down on the mis-classification by nonprofits of workers as independent contractors. Stay tuned for a future *eNews* from the Nonprofit Risk Management Center that offers a checklist for nonprofits to use to help them properly classify workers as either employees or as consultants and independent contractors. Meanwhile, if you have any questions about whether a worker is properly classified, the IRS website offers helpful guidance. The IRS also offers a lengthy packet of “training materials” on the topic at www.irs.gov/pub/irs-utl/emporind.pdf. Careful review of these resources can help your nonprofit navigate the gray areas.

Have a question about any of the issues raised in this eNews? Contact us at info@nonprofitrisk.org.