

## **Corporate Governance Update**

### **Governance Provisions of Proposed Form 990 Instructions**

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On April 7, the IRS released for public comment draft Instructions for the comprehensive new Form 990, to be filed for the 2008 tax year (returns filed in 2009). Consistent with the significant emphasis on corporate governance in the new Form 990, the proposed Instructions contain valuable insight on responding to Part VI of the Form, and more broadly on the IRS' perspectives on exempt organization governance. Highlights of likely interest to the general counsel and executive leadership include the following:

1. **Independent Voting Members:** A definition of "independent voting member" of the board is provided. The definition contains four specific criteria, all of which must be satisfied at all times during the organization's tax year. Note that this definition, for purposes of answering the question at Line 1b, may not necessarily be consistent with independence/"disinterested director" definitions already established under state law, nonprofit sector governance best practices, or previously existing protocols of the exempt organization. Accordingly, in some circumstances the organization may be required to apply a different definition of independence to its board, for purposes of completing Line 1b.
2. **Relationships Among Officers, Directors, etc.:** One of the most controversial governance questions on the Form 990 in recent years is that which inquires about horizontal business and financial relationships among officers, directors, and key employees. The goal is to identify relationships that could create bias in the decision-making process. Proposed definitions of "family relationship" and "business relationship" are provided. Note that the definition of "business relationship" includes types of employment relationships, business arrangements, common ownership of business entities, and board service on the same business entity.
3. **Material Diversion of Assets:** This question reflects the IRS concern with the increasing incidence of financial fraud committed against exempt organizations, including but not limited to embezzlement. The question does not inquire as to board action taken to prevent such fraud (*e.g.*, enhanced audit committee oversight). Furthermore, the materiality threshold is set sufficiently high as to exclude some common types of cash misappropriation, and non-extraordinary expense account abuse.
4. **Documentation of Meetings and Actions:** The proposed definitions of "documentation" (*i.e.*, approved minutes, email strings, similar writings) and "contemporaneous" (*i.e.*, by the later of the next board or committee meeting or 60 days after the date of the meeting) are provided. These proposals are reasonably consistent with similar definitions as applicable to the satisfaction of the rebuttable presumption of reasonableness under the intermediate sanctions regulations. However, the examples of permissible documentation in the proposed instructions are more expansive than those contained in the regulations.
5. **Governing Body Review:** Another area of controversy with the development of the Form 990 is whether the exempt organization's governing board is required to review the Form 990 before filing (Line 10). The proposed instructions make it clear that the IRS' principal interest is whether such a review took place, and if so, how (although the inference is that such a review is preferred practice). Details concerning the review (who conducted it, whether it was conducted before or after filing, the extent of the review) are to be described on Schedule O.

6. **Conflicts of Interest Policy:** The proposed instructions provide substantial guidance on the Line 12 questions regarding the exempt organization's conflict of interest policy. For example, a definition of "conflict of interest," is provided (note: the IRS template conflicts policy does not contain any such definition). In addition, "dualities of interest" are not considered conflicts unless they involve material financial interest or benefit to the person. A description is provided of the types of conflicts disclosures to be made on the annual questionnaire (*e.g.*, list of family members, substantial business or investment holdings, and other transactions or affiliations with businesses and other organizations). Also significant is the detail sought (for Schedule O) on conflicts enforcement practices, whether discovered before or after the transaction has occurred. This includes a description of the types of persons covered by the policy, the level at which the conflicts determination is made, and at which actual conflicts are reviewed, as well as any restrictions imposed upon persons determined to have a conflict with respect to a particular transaction.
7. **Executive Compensation:** The proposed instructions confirm that the IRS is interested in Line 15 in determining whether the organization satisfied the rebuttable presumption of reasonableness for purposes of particular compensation decisions. The Line 15b question appears particularly designed to inquire as to the basis by which comparability determinations were made.
8. **Joint Ventures:** Additional clarity is provided with respect to the types of joint venture information sought for purposes of Line 16. For example, the term "joint ventures" includes not only those formed as partnerships but also associations taxable as corporations. Information as to the purpose of the venture (*e.g.*, conduct an exempt purpose, an investment activity, or an unrelated trade or business) is to be provided. Certain types of joint ventures (*e.g.*, those with primarily passive investments) can be disregarded for purposes of Line 16. The "policy or procedure" referenced in Line 16b is described as one which requires the organization to actually negotiate into its joint venture agreements exempt purposes safeguards, primarily from Rev. Rul. 98-15. Several examples of exempt purposes safeguards are also provided.
9. **Interested Party Transactions:** The proposed Instructions also contain a "large board exception" with respect to reporting business transactions involving interested persons, as otherwise required under Part IV of Schedule L of the Form 990. The exception provides that in reporting transactions under Part IV, an organization with more than 20 voting directors or trustees in its governing body and with an executive committee that possesses delegated powers to act on behalf of the entire governing body may disregard all current or former directors or trustees that are not current (a) members of the executive committee, or (b) officer, key employees, or highest compensated employees of the organization.

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In these and other respects, the proposed Instructions, while confusing in some respects, provide useful and specific guidance on completion of the Governance-related questions of Part VI. Furthermore, they provide noteworthy inferences concerning certain IRS-preferred governance practices by exempt organizations.

The comment period with respect to the proposed Instructions is open only until June 1, 2008, as the IRS seeks to expedite publication of the Instructions in final form.