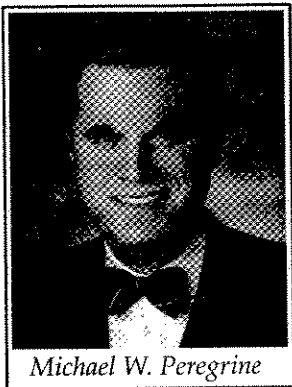


Emphasis on Corporate Governance in Final Form 990

by Michael W. Peregrine



Michael W. Peregrine

Michael W. Peregrine is a partner at McDermott Will & Emery LLP, Chicago.

Copyright 2007, American Health Lawyers Association, Washington, D.C. Reprint permission granted. Further reprint requests should be directed to American Health Lawyers Association, 1025 Connecticut Avenue, NW, Suite 600, Washington, DC 20036.

Corporate governance of tax-exempt organizations is a key factor addressed in the new Form 990, "Return of Organization Exempt From Income Tax," released by the IRS on December 20, 2007.¹ The governance provisions incorporated within the redesigned Form 990 include those relating to board size and structure, conflict-of-interest management, director independence, intraboard relationships, audit committee practice, written governance policies, and the role of governance in the preparation and review of the form. Corporate counsel may wish to consider a special briefing to corporate leadership on these new governance provisions and their policy implications.

I. The Backdrop: Increased IRS Focus on Governance

The redesigned Form 990 is a substantial byproduct of the IRS's increased focus on the corporate governance of charitable, tax-exempt organizations. IRS officials have repeatedly expressed their belief that the existence of an independent governing board, combined with well-designed governance and management policies and procedures, increases the likelihood that an organization will comply with the tax laws.² To that end, the promotion of good governance, management, and accountability has become a new pillar of the IRS's compliance program for

the tax-exempt sector.³ The IRS's view is that efforts to maintain a compliant, healthy charitable sector are supported by efforts to encourage the tax-exempt community to adhere to commonly accepted standards of good governance. The IRS has expressed concern about increasing evidence of abuse within the tax-exempt sector and about the failure of the sector to fully appreciate the extent to which abuse has emerged in recent years.⁴ Enhancing transparency and public disclosure is thus perceived as a means of supporting meaningful governance and accountability. Through the redesigned Form 990, the IRS seeks a vehicle that provides it and the public with a realistic picture of the filing organization (including its governance) while minimizing the burden on the organization.

II. Governance and the New Form

A. Overview

While governance-related provisions are presented throughout the new Form 990, most are concentrated in new Part VI (Governance, Management and Disclosure). Part VI requires each organization to provide information about the composition and independence of its board or governing body, its governance and management structure and policies, and whether (and if so, how) the organization promotes transparency and accountability to its constituents.⁵ Individual questions are separated into three categories: Section A, addressing the governing body and management; Section B, addressing governance policies; and Section C, addressing disclosure.

B. New Questions

The governance structure and management-related questions in Section A explore the following topics:

- the number of voting members of the governing body;
- the number of independent voting members;
- the presence of family or business relationships between board members, officers, and key employees. In this regard, reference should also be made to Part IV of Schedule L, "Business Transactions Involving Interested Persons," which has been recast (more narrowly than contemplated in the

¹Form 990 redesign and schedules, available at <http://www.irs.gov/pub/irs-tege/f990rcore.pdf>.

²Remarks of Steven T. Miller, commissioner, Tax Exempt and Government Entities Division, IRS, October 22, 2007, available at http://www.irs.gov/pub/irs-tege/stm_isector_10_22_07.pdf, and November 10, 2007, http://www.irs.gov/pub/irs-tege/stm_speech_-_philantoropy_roundtablestm1107.pdf.

³*Id.*

⁴*Id.*

⁵*Supra* note 1.

June draft) to incorporate descriptions of transactions involving officers, directors, trustees, and key employees, and the tax-exempt organization;

- the extent to which control over management duties has been delegated to a management company or person;
- whether the organization has adopted significant changes to its articles or bylaws;
- awareness of any "material diversion of organizational assets";
- a practice of contemporaneous documentation of board and key committee meetings;
- whether the governing board reviewed the Form 990 before filing; and
- the general process used by the organization to review the Form 990.⁶

Section B requests information about the use of governance-related policies and procedures, including the following:

- a written conflict-of-interest policy that requires regular disclosure by officers and directors and that is subject to regular and consistent monitoring and enforcement;
- a written whistle-blower policy;
- a written document retention and destruction policy;
- specific procedures for determining compensation of the CEO and other key employees, including a review and approval by independent persons, comparability data, and contemporaneous substantiation of the deliberation and decision; and
- a written policy requiring the organization to monitor its participation in joint ventures for compliance with federal tax law and to safeguard its tax exemption regarding such arrangements.⁷

C. Changes From June Draft

The final Form 990 includes several material changes to the governance-related provisions in the June 2007 draft. Those include the following:

1. *Authority to Request Governance Information.* Several statements were added to Parts V and VI to clarify that although some questions therein relate to items legally required by tax law, others relate to policies and practices that are not required by the code but that may indicate management practices relating to the adequacy of internal controls. Also, several questions addressing public disclosure of documents were separated so that those regarding public inspection requirements of the code are set forth in Question 18 and those for which public inspection requirements do not apply are listed in Question 19.

⁶IRS, "Form 990 Redesign for Tax Year 2008 Form 990 Core Form Highlights," December 20, 2007, available at http://www.irs.gov/pub/irs-tege/highlights_core_form.pdf.

⁷*Id.*

The changes were made in response to public comments concerning the IRS's authority to request information about an organization's governance and management practices.

2. *De Facto Requirements.* Questions regarding governance policies and procedures (Part B) were revised to allow the organization to explain each of its answers. This was in response to concerns that such policies could become de facto legal requirements by virtue of their inclusion in the Form 990, and thus could lead to a presumption of wrongdoing by the IRS and the public, depending on the answers.
3. *Conflicts of Interest.* An important clarification was made to the questions (Part B) regarding conflict-of-interest policy and process. Commenters expressed concern about the confusing nature of the question asking for the number of conflict transactions reviewed annually under the policy. The concern was that no conclusions regarding the adequacy of the policy could be drawn from the answer to the question (for example, a large number of reviews could mean either that the organization's process was working, or that the organization had encountered a large number of conflicts). Accordingly, that question was replaced with two other questions intended to address policy implementation and monitoring.
4. *Material Diversion.* In response to public comment, a new Part A, Question 5 was added regarding the organization's awareness of a material diversion of corporate assets. (The comments perhaps reflect the noticeable increase in embezzlement and financial impropriety in the nonprofit sector.) The new question is intended to collect information from organizations that become aware of a diversion and to allow them to describe the related circumstances and any corrective actions adopted in response.
5. *Additional Space.* The final Form 990 allows organizations to use Schedule O to supplement their Part VI governance responses. This change was made in response to concerns that a narrative answer (as opposed to a mere yes or no) was needed to properly respond to several of the questions. According to IRS Exempt Organizations Division Director Lois Lerner, organizations should utilize Schedule O to respond to specific governance-related questions regarding the recording of governance body meetings, and how the organization determines executive compensation amounts.⁸ Schedule O also may profitably be used to address the manner in which the organization effects its conflicts-of-interest policy, and by which the board reviews the entire Form 990 prior to filing.

⁸See "IRS Releases Redesigned Form 990," *The Exempt Organization Tax Review*, Jan. 2008, p. 9.

6. *Voting Members/Independence.* Governing body composition and independence questions now apply only to voting members of the board. The change was made to address concerns about the lack of legal authority of nonvoting members.
7. *Board Review.* A subtle change was made regarding review of the Form 990 by the governing board. Question A(1) was revised to (a) ask whether the governing board is provided with a copy of the Form 990 before it is filed with the IRS; and (b) direct the organization to describe who within the organization is provided the form, when it is provided, and the level of review that is undertaken. This change was made in response to concerns that a blanket requirement that the full board review the Form 990 before filing could prove burdensome to larger boards and that the concept of review was unclear.⁹
8. *Miscellaneous.* A variety of other, smaller changes were made to the governance questions in the new Form 990. Most notable among them were the following:
 - Question 8 from the June draft (“Does an officer, director, trustee, employee or volunteer prepare the financial statements?”) was deleted.
 - Revisions were made to each of the following questions from the June draft:
 - Question 4, narrowing the inquiry on the scope of significant changes in governing documents (to exclude policies outside articles or bylaws);
 - Question 7, regarding who elects directors and whether the board’s decision is subject to approval by members or others; and
 - Question 8, regarding documentation of board action.
 - Two new questions were added:
 - Question 3, regarding the delegation of key governance or management duties to a management committee or to others; and
 - Question 6, whether the organization has stockholders or members.
 - Three questions from other sections of the June draft were moved to Part VI:
 - Question 2, regarding family and business relationships with other board members (was 5a and 5b in Part 11, Compensation, in the draft);
 - Question 11, regarding address information of officers, directors, trustees, or key employees who cannot be reached at the organization’s address; and
 - Question 15, revising the three-part question that dealt with the process for establishing compensation for the highest corporate officers (by asking it separately

- regarding the senior executive and for other officers and key employees).
- Questions regarding the audit committee and audit/compilation/review were moved to Part XI (Financial Statements and Books and Records),¹⁰ in other words, whether the organization has “a committee that assumes responsibility for oversight of the audit, review, or compilation of its financial statements and selection of an independent accountant.”

III. Governance Themes Arising From Final Form

The following themes regarding the relationship between corporate governance and tax-exempt status can be gleaned from the new Form 990:

1. A well-governed organization is more likely to be tax compliant.
2. A formal internal process for the preparation and prefiling review of the Form 990 should exist and should involve the board or a committee thereof. The new Form 990 reflects an expectation of governance review of the form as an element of effective prefiling oversight.
3. Greater focus on intraboard relationships will help identify potential bias in decision-making.
4. The independence of a percentage of directors continues to be an important factor for tax-exempt status.
5. Director/former-director-as-vendor relationships are subject to scrutiny for potential inurement/excess benefit/self-dealing.
6. Adoption of basic governance policies is an indicator of effective governance (see, for example, Panel on the Nonprofit Sector, “Principles of Self-Governance”).¹¹
7. Transparency of governing documents and key policies is consistent with corporate responsibility.
8. A conflict-of-interest policy should be supported by an effective conflicts review and management process.
9. Contemporaneous written documentation of board and key committee meetings is an indicator of effective governance.
10. The board should ensure monitoring of the tax-exemption implications of organizational joint venture investments as part of its compliance oversight obligations.
11. A written process ensuring independent, impartial review of executive compensation (for example, satisfaction of rebuttable presumption criteria) is an important safeguard against excessive compensation arrangements.

¹⁰*Id.*

¹¹Michael W. Peregrine, “The Continuing Evolution of Non-profit Governance Best Practices,” *The Exempt Organization Tax Review*, Dec. 2007, p. 241.

⁹*Id.*

12. Sarbanes-like policies regarding whistle-blower reporting and prevention of retaliation, and document preservation and destruction, are consistent with corporate responsibility expectations.
13. The IRS remains concerned with the potential for abuse in the nonprofit, tax-exempt sector and is interested in organizational efforts to prevent, and if necessary respond to, instances of abuse.

IV. Recommendations

Corporate counsel can support the tax-exempt organization and its leadership in responding to the governance-related provisions of the Form 990 in the following ways:

First, by educating senior management and the governing board on the governance-related provisions of the new form, particularly the governance themes they reflect.

Second, by working with the interdisciplinary organizational team responsible for completing the form to help advise on how best to gather the information required by the governance provisions.

Third, by advising the board on an appropriate level of diligence to be applied in its review and approval of its information return.