

**EMPHASIS ON CORPORATE GOVERNANCE  
IN FINAL FORM 990**

**Michael W. Peregrine, Esquire**  
McDermott Will & Emery LLP, Chicago, IL

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 Internal Revenue Service on December 20, 2008.<sup>1</sup> The governance-related provisions incorporated within the redesigned Form 990 include those relating to board size and structure, conflicts of interest management, director independence, intra-board relationships, audit committee practice, written governance policies, and the role of governance in the preparation and review of the Form. As a result, corporate counsel may wish to consider a special briefing to corporate leadership on these new governance provisions and the policy implications they suggest.

**I. The Backdrop: Increased IRS Focus on Governance**

The redesigned Form 990 is a substantial byproduct of the IRS' dramatically 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

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<sup>1</sup> Form 990 Redesign and Schedules, [www.irs.gov/pub/irs-tege/f990rcore.pdf](http://www.irs.gov/pub/irs-tege/f990rcore.pdf).

board, combined with well-crafted governance and management policies and procedures, increases the likelihood that the organization will act in a tax-compliant manner.<sup>2</sup> To that end, the promotion of good governance, management and accountability has become a new “pillar” of the IRS’ compliance program for the tax-exempt sector.<sup>3</sup> The IRS’ 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 with increasing evidence of abuse within the tax-exempt sector and by the failure of the sector to fully appreciate the extent to which such abuse has emerged in recent years.<sup>4</sup> Enhancing transparency and public disclosure is thus perceived a means for supporting both meaningful governance and accountability. By the new, redesigned Form 990, the IRS seeks a vehicle that provides both the public and the IRS with a realistic picture of the organization (including its governance) while minimizing the burden on the filing organization.

## **II. Governance and The New Form**

### **A. Overview.**

While governance-related provisions are presented throughout the new Form 990, the majority are concentrated in new Part VI (“Governance, Management and Disclosure”). Part VI requires each organization to provide certain information regarding the

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<sup>2</sup> Remarks of Steven T. Miller, Commissioner, Tax Exempt and Government Entities, Internal Revenue Service, October 22, 2007, [www.irs.gov/pub/irs-tege/stm\\_isector\\_10\\_22\\_07.pdf](http://www.irs.gov/pub/irs-tege/stm_isector_10_22_07.pdf) and November 10, 2007, [www.irs.gov/pub/irs-tege/stm\\_speech\\_-\\_philantoropy\\_roundtablestm1107.pdf](http://www.irs.gov/pub/irs-tege/stm_speech_-_philantoropy_roundtablestm1107.pdf), collectively, “Miller Remarks.”

<sup>3</sup> *Id.*

<sup>4</sup> *Id.*

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.<sup>5</sup> Individual questions are separated into three specific 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, among others:

- 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/or key employees;
- The extent to which control over management duties has been delegated to a management company/person;
- Whether the organization has adopted significant changes to its articles or bylaws;
- Awareness of any “material diversion of organizational assets”;

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<sup>5</sup> Form 990 Redesign and Schedules, [www.irs.gov/pub/irs-tege/f990rcore.pdf](http://www.irs.gov/pub/irs-tege/f990rcore.pdf).

- 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.<sup>6</sup>

Notably, Section B requests information regarding the use of *governance related policies and procedures*, including the following:

- A written conflicts of interest policy that requires regular disclosure by officers and directors and which is subject to regular and consistent monitoring and enforcement;
- A written whistleblower policy;
- A written document retention and destruction policy;
- Specific procedures for determining compensation of the CEO and other key employees, which includes 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 with respect to such arrangements.<sup>7</sup>

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<sup>6</sup> Internal Revenue Service, "Form 990 Redesign for Tax Year 2008 Form 990 Core Form Highlights," December 20, 2007 ("Core Highlights"), [www.irs.gov/pub/irs-tege/highlights\\_core\\_form.pdf](http://www.irs.gov/pub/irs-tege/highlights_core_form.pdf).

C. Changes from June Draft.

The final Form 990 includes several material changes to the governance-related provisions contained in the June, 2007 Draft. These include the following:

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

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

2. De Facto Requirements. Questions relating to governance policies and procedures (Part B) were revised to provide the organization with an opportunity 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

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<sup>7</sup> *Id.*

thus could lead to a presumption of wrongdoing by the IRS and the public depending upon the scope of the answers.

3. Conflicts of Interest. An important clarification was made to the questions (Part B) relating to Conflict of Interest policy and process. Concern was expressed regarding the confusing nature of the question asking for the number of conflict transactions reviewed annually under the policy. The public concern was that no conclusions regarding the adequacy of the policy could be drawn from the answer to the question (e.g., 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, the "offending" 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 with respect to the organization's awareness of a material diversion of corporate assets. (The comments perhaps reflect the noticeable increase in instances of embezzlement and financial impropriety in the nonprofit sector.) The new question is intended to collect information from organizations that become aware of such a diversion and to allow them to describe the related circumstances and any corrective actions adopted in response to the diversion.

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.
6. Voting Members/Independence. Governing body composition and independence questions now apply only to voting members of the board. This was done to address concerns with respect to the lack of legal authority of non-voting members.
7. Board Review. A subtle change related to 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 the process (if any) as to who within the organization is provided the Form, when it is provided and the level of related 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.<sup>8</sup>
8. Miscellaneous. A variety of other, smaller changes were made to the governance questions in the new Form 990. Most notable among these were the following:

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<sup>8</sup> *Id.*

- Question No. 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 scope of significant changes in governing documents (to exclude policies outside of articles or bylaws);
  - Question 7 regarding who elects directors and whether the board’s decision is subject to membership or other approval; 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);
  - Question 11, regarding address information of officers, directors, trustees or key employees who can not be reached at the organization's address; and
  - Question 15, revising the three part question that dealt with the process to establish compensation for the highest corporate officers (by asking it separately with respect to the senior executive and for other officers and key employees).
- Questions relating to the audit committee, and to audit/ compilation/review were moved to Part XI ("Financial Statements and Books and Records").<sup>9</sup>

### **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 pre-filing review of the Form 990 should exist and should involve the board or a

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<sup>9</sup> *Id.*

committee thereof. The new Form 990 reflects an expectation of governance review of the Form as an element of effective pre-filing oversight.

3. Greater focus on intra-board relationships will help identify potential bias in decision-making.
4. The independence of a certain 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, e.g., Panel on Nonprofit Sector “Principles of Self Governance”).<sup>10</sup>
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.

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<sup>10</sup> Michael W. Peregrine, “The Continuing Evolution of Nonprofit Governance Best Practices,” Exempt Organization Tax Review, Vol. 58, No. 3 (December 2007) at p. 241.

10. The board should assure monitoring of the tax exemption implications of organizational joint venture investments, as part of its compliance oversight obligations.
11. A written process assuring independent, impartial review of executive compensation (e.g., satisfaction of “Rebuttable Presumption” criteria) is an important safeguard against excessive compensation arrangements.
12. Sarbanes-like policies with respect to whistleblower 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 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 both the specific governance-related provisions of the new Form and, particularly, the governance themes they reflect.

*Second*, by working with the inter-disciplinary organizational team responsible for completing the Form to help advise on how best to gather the information required by the governance provisions of the new form.

*Third*, by advising the Board on an appropriate level of diligence to be applied in its review and approval of the final version of the Form.

**\*Corporate Governance Task Force Leadership for FY 2008:**

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