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EXECUTIVE SUMMARY

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Corporate Governance Emphasis in Final Form 990 Instructions

Michael W. Peregrine, Esquire
Elizabeth M. Mills, Esquire
McDermott Will & Emery LLP
Chicago, IL

A series of important corporate governance issues are addressed in the final version of the Instructions to the Form 990 (Return of Organization Exempt from Income Tax), released on August 19, 2008. They combine to enhance significantly the 990's impact on boards of tax-exempt organizations.

Reflecting substantial public comment, the Final Instructions incorporate a number of significant revisions from their issuance in proposed form on April 7, 2008. These include (1) a revised definition of the critical concept of "key employee"; (2) a new standard for determining the independence of board members; and (3) standards for organizational "reasonable efforts" to obtain required information from "interested persons" or third parties on their relationships with each other. The Final Instructions reflect the Internal Revenue Services' (IRS') overarching emphasis on the corporate governance of tax-exempt organizations, as reflected in Part VI of the Form 990 and in broader IRS initiatives. As such, counsel may wish to brief corporate leadership on the governance implications of the Form 990, interpreted through the prism of the Final Instructions.

I. BACKGROUND—PART VI TO FORM 990

Part VI ("Governance, Management and Disclosure") to the redesigned Form 990 incorporates an extensive set of governance-related questions and is a particular manifestation of the IRS' focus on the corporate governance of charitable, tax-exempt

organizations. Part VI is divided into three main components: Section A (“Governing Body and Management”); Section B (“Policies”); and Section C (“Disclosure”). Specific governance topics addressed therein include board size and structure, conflicts 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 990. The IRS perceives the enhanced transparency and public disclosure required by the Form 990 as supporting both meaningful governance and accountability.

The Final Instructions have added a paragraph elaborating on the relationship of effective governance to tax compliance. As in the draft instructions, the introduction to Part VI refers to governance, management and disclosure policies, and procedures that the IRS acknowledges may not be specifically required by state or federal law (e.g., “best practices”) but that the IRS believes “generally improve tax compliance.” This is consistent with the IRS’ view that it has “implied jurisdiction” to evaluate corporate governance matters.

II. HIGHLIGHTS FROM FINAL INSTRUCTIONS

The following Form 990 governance practice highlights can be gleaned from the Final Instructions:

A. “Independent Voting Members” (Line 1b)

“Independence” is an important governance consideration, for both exempt organization tax and nonprofit corporate law/“best practices” purposes. The organization is required to state the number of “independent voting members” of the governing board as of the end of the organization’s tax year. The Final Instructions introduce a revised standard for determining director independence. This new standard focuses on whether the board member (or family member) was involved in a transaction or relationship reportable on the current year’s **Schedule L**, “Transactions with Interested Persons” (see below).

This means that a board member will be regarded as “independent” only if three specific circumstances are satisfied at all times during the organization’s tax year: that the board

member (1) was not a compensated employee of the organization or of a related organization; (2) did not receive total annual compensation or other payments therefrom in excess of \$10,000 as an independent contractor (other than reimbursement of expenses under an expense reimbursement procedure, or as reasonable compensation for services as an organizational director); and (3) neither the director, nor any family member of the director, was involved in a transaction with the organization reportable on the organization's **Schedule L**.

A series of helpful examples are provided applying this three-part independence test. Notably, a director's independence is not qualified merely because the director is a donor of the organization (regardless of the amount of the contribution).

B. Relationships (e.g., Among Officers, Directors) (Line 2)

One of the most controversial governance questions on the Form 990 is that which inquires about "horizontal" business and family relationships among officers, directors, and key employees during the organization's tax year. These relationships are to be described on **Schedule O**. By this question, the IRS seeks to identify relationships that could create bias in the decision-making process (apart from traditional "vertical" conflicts of interest). However, the question has prompted concern as to its invasiveness with respect to interests of individual board members. Significantly, the IRS has responded in part to this concern by entirely excluding privileged relationships (e.g., attorney–client or medical professional–patient) from the definition of "business relationship" for this question only.

It is also important to note in this regard that the extent of actual disclosure is limited. The organization is simply required to disclose the names of the persons involved in the relationship, and whether their relationship is a "family relationship" or a "business relationship," without greater detail. Definitions of "family relationship" and "business relationship" (which may involve one of three different types of arrangements) are provided in the Instructions. Again, a series of helpful examples are offered to assist in determining whether a particular relationship is subject to disclosure.

C. Changes to Organizational Documents (Line 4)

The organization is required to describe on **Schedule O** significant changes to its organizing documents (articles of incorporation and bylaws) implemented since the prior Form 990 was filed. The organization is not required to report changes to governance policies that do not also require a change to the articles or bylaws. The Final Instructions provide a series of examples of changes that should be reported on **Schedule O**.

The Final Instructions confirm that the IRS only seeks disclosure of significant changes to the organizational documents (e.g., changes in mission, board composition, and policies and procedures *contained in the organizational documents* addressing such key issues as conflicts of interest and compensation of officers and directors). Notably, changes to policies not contained within the articles or bylaws do not require disclosure. Similarly, ministerial changes (e.g., change in the organization's registered agent or the number or frequency of board meetings) need not be disclosed.

D. Material Diversion of Assets (Line 5)

The organization is asked whether it became aware during the year of a material diversion of its assets. This question reflects the IRS' concern with the increasing incidence of financial fraud committed against exempt organizations, including but not limited to embezzlement. If the answer to the question is "yes," the organization is required to describe on **Schedule O** the nature of the diversion, amounts or property involved, corrective actions taken to address the matter, and pertinent circumstances.

The Final Instructions contain an important and detailed definition (unchanged from the draft instructions) of "diversion of assets" that (notably) is not limited to embezzlement or theft. Such a diversion may, in certain cases, constitute a private inurement or excess benefit transaction.

E. Documentation of Meetings and Actions (Line 8)

The organization is asked whether it *contemporaneously documented* by any means permitted under state law every meeting held and action taken during the organization's tax year by its governing body and committees with board-delegated powers.

The Final Instructions provide (1) a series of examples of what may constitute permissible documentation under state law and (2) a definition of “contemporaneous.”

F. Local Chapters, Branches or Affiliates (Lines 9a–b)

Organizations are required to acknowledge whether they had any local chapters, branches, lodges, units, or similar affiliates during the tax year. If the answer is “yes,” they also are asked to acknowledge whether there are written governance policies and procedures in place with respect to such affiliates. If such local units exist but there are no written governance policies in place, the organization is requested to answer (on **Schedule O**) how it assures that the activities of the local units comply with its own policies.

G. Governing Body Review of Form 990 (Line 10)

Another controversial new Form 990 question asks whether the organization’s final Form 990 (and schedules), as ultimately filed with the IRS, was provided to each voting member of the organization’s board before filing with the IRS. In addition, the organization is requested to describe on **Schedule O** the extent to which (if at all) any of the organization’s officers, directors, trustees, board committee members, or management reviewed the prepared Form 990—including detail related to who conducted the review, when they conducted the review, and the scope of such review. This question reflects the value the IRS attributes to board awareness of the information contained in the Form. An example in the Final Instructions indicates that providing a copy of the final Form 990 to board members before filing would allow the organization to answer “yes” to the question in Line 10 even if there was actually no formal pre-filing governance review of the Form. The organization, however, must describe in **Schedule O** its review process (or lack thereof).

H. Conflicts of Interest Policy (Line 12)

The Form 990 reflects the IRS’ deep interest in the conflicts management practices of tax-exempt organizations.

- **Definition of “Conflict”:** A “conflict of interest” is defined in the Form 990 as when “a person in a position of authority over an

organization (e.g., an officer, director, or manager) may benefit financially from a decision he or she could make in such a capacity, including indirect benefits such as to family members of businesses with which the person is closely associated.” The IRS definition of conflicts excludes the so-called “duality of interest”—for example, a person serving on the board of the organization and of another (charitable) organization (even when they are in adversarial positions to one another), as long as such dual board roles do not involve a material financial interest of, or benefit to, the person.

- **Definition of “Policy” (Line 12a):** A “conflicts of interest policy” (Line 12a) is described as one that defines the conflict of interest, identifies the classes of individuals within the organization subject to the policy, facilitates information disclosure related to conflicts, and sets forth procedures to be applied when managing a conflict.
- **Disclosure (Line 12b):** The organization is required to disclose (1) whether it has a written conflict of interest policy; (2) whether officers, directors, trustees, and key employees are required to make annual (or more frequent) disclosure of interests that could create conflicts; and (3) whether the organization “regularly and consistently” monitors and enforces compliance with the policy (and if so, how this is done—with specific description on **Schedule O**).
- **Policy Enforcement (Line 12c):** **Schedule O** should be used to describe the extent to which the organization enforces its conflicts of interest policy. Any such explanation should summarize (1) the persons covered by the policy; (2) the organizational levels at which conflicts determinations are made, and at which actual conflicts are reviewed; and (3) conflicts management procedures (e.g., restrictions imposed on persons determined to have a conflict).

I. Whistleblower and Document Retention (Lines 13, 14)

The organization is required to disclose whether it has whistleblower and document retention policies in place as of the last day of its tax year. Note that, in this regard, the IRS recently issued information setting forth the procedure by which an “informant” may report a violation of tax law, and possibly qualify for a significant dollar award (IRS Notice 2008-4, Dec. 19, 2007.) The Final Instructions also contain a cross-reference to those provisions of the Sarbanes-Oxley Act addressing whistleblower retaliation and document destruction issues, which may in certain instances apply to tax-exempt organizations.

J. Process for Determining Compensation (Line 15)

The organization is asked whether it satisfies the “Rebuttable Presumption of Reasonableness” with respect to the process for determining compensation of the chief executive officer, and of other senior officials. The organization is to describe on **Schedule O** the offices or positions for which the rebuttable presumption of reasonableness was used to establish compensation.

K. Joint Ventures (Line 16)

A series of questions are presented with respect to whether the organization has invested in a joint venture with one or more taxable partners. (A definition of “joint venture,” basically, a partnership or limited liability company, is provided.) The organization is asked to acknowledge such participation, if any—and, if so, whether the organization has adopted specific safeguards (including policies and procedures) designed to safeguard the exempt assets with respect to the venture. Also included in the Final Instructions are several examples of such safeguards, such as joint venture document provisions. Note that, under the instructions for **Schedule H** (Hospitals), joint venture-type arrangements that need not be reported in Part VI still may have to be reported on **Schedule H**.

L. “Key Employee”

The term “key employee” is used throughout the Form 990 for questions relating to transactions with interested persons, “horizontal” business and family relationships, reporting executive compensation, and other questions.

“Key employee” is defined in a three-pronged manner as a person (other than an officer, director, or trustee), who (1) had reportable compensation from the organization and related organizations exceeding \$150,000 for the year (the \$150,000 test); (2) had or shared organization-wide control or influence similar to that of an officer, director, or trustee, or managed or had authority or control over at least 10% of the organization’s activities (the responsibility test); **and** (3) was within that group of the organization’s top twenty highest-paid employees who satisfied both the \$150,000 test and the responsibility test.

M. Interested Party Transactions

The Form 990 reflects the IRS’ interest in the organization’s transactions with “Interested Persons” (e.g., current or former officers, directors, trustees, key employees, and the five highest compensated employees). Substantial information is requested about such persons who are (1) disqualified persons participating in excess benefit transactions with the organization, (2) recipients of loans from the organization, (3) recipients of organizational grants or assistance, and (4) participants in business transactions with the organization that exceed certain reporting thresholds. Information with respect to Transactions with Interested Persons is to be set forth at **Schedule L**. **Schedule L** also is used to assist in determining the independence of governing board members, for purposes of Line 1b.

N. Audit Committee (Part XI, Line 2)

In a separate section (Part XI: Financial Statements and Books and Records), the Form 990 asks whether the organization has a committee responsible under its governing documents (or through delegation by its governing body) for oversight of the audit, review, and compilation of its financial statements and the selection of an independent accountant. This question, of course, refers to the presence of a discrete audit or similar

committee consistent with corporate responsibility principles. **Schedule O** should be used to describe the circumstances where the audit oversight process has changed from year to year. Significantly for multicorporate systems, if the reporting entity's financial statements were prepared only as part of a consolidated financial statement, the organization is to answer "no" to the question of whether its financial statements were audited, revised, or compiled and is not to answer the question about process. **Schedule O** can be used to explain that its financials were audited, reviewed, or compiled on a consolidated basis.

- NOTE: For several of the governance-related questions, the organization need not engage in more than "reasonable efforts" to obtain the required information from interested persons and third parties. The definition of "reasonable efforts" varies according to the specific question, but a "retrospective" questionnaire for directors and others will still be necessary.

The questions for which the "reasonable efforts" standard is applicable include:

- Part VI, Line 1b (Number of voting board members that are independent);
- Part VI, Line 2 (Whether an officer, director, trustee, or key employee had a family or business relationship with any other officer, director, trustee, or key employee);
- Part VII, Section A, Line 1a (Determining compensation payable to officers, directors, trustees, key employees, and highest compensated employees, by related organizations);
- **Schedule L**, "Transactions with Interested Persons," Part III: "Grants or Assistance Benefiting Interested Persons"; and
- Part IV, "Business Transactions Involving Interested Persons."

Thus, it will be important in each instance to evaluate what constitutes "reasonable effort" under the circumstances.

The Final Instructions provide examples of how the “reasonable efforts” standard may be satisfied with respect to each of these separate reporting requirements.

III. GOVERNANCE THEMES ARISING FROM FORM 990

With the release of the Final Instructions, the following themes regarding the relationship between corporate governance and tax-exempt status can be gleaned from the new Form 990.

A. The IRS is committed to exercise oversight of the corporate governance of tax-exempt organizations. It believes that there is a “clear nexus” between effective governance and tax compliance.

B. A formal internal process for the preparation and pre-filing 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 pre-filing oversight.

C. Greater focus on intraboard relationships will help identify potential bias in decision-making.

D. The independence of a certain percentage of directors continues to be viewed by the IRS as an important factor for tax-exempt status.

E. Director/former director-as-vendor relationships are subject to scrutiny for potential inurement/excess benefit/self-dealing.

F. Adoption of basic governance policies is an indicator of effective governance (see, e.g., Panel on Nonprofit Sector “Principles of Self Governance”).

G. Transparency of governing documents and key policies is consistent with corporate responsibility.

H. A conflict of interest policy should be supported by an effective conflicts review and management process.

I. Contemporaneous written documentation of board and key committee meetings is an indicator of effective governance.

J. The board should assure monitoring of the tax-exemption implications of organizational joint venture investments as part of its compliance oversight obligations.

K. 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.

L. Sarbanes-like policies with respect to whistleblower reporting and prevention of retaliation, and document preservation and destruction, are consistent with corporate responsibility expectations.

M. 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 (1) the increased IRS focus on corporate governance; (2) the specific governance-related provisions of the new Form; and particularly, (3) 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 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.

GENERAL COUNSEL FORM 990 GOVERNANCE CHECKLIST

The following “Action Items” are recommended for the general counsel of not-for-profit corporations in response to the governance-related provisions of the recently released Final Instructions to the IRS Form 990.

ACTION ITEM	DESCRIPTION
1	Educate senior leadership on (1) the increased IRS focus on corporate governance, (2) the specific governance-related questions on the new Form 990, and (3) the governance themes they represent.
2	Compare board governance policies against Panel on the Nonprofit Sector “best practices” (Introduction), including but not limited to having a committee responsible for oversight of audit and financial statements.
3	Evaluate impact of new board independence standards against current board policies and board composition (Line 1b).
4	Adopt a policy providing for an appropriate level of board or committee review of the final Form 990 (Line 10).
5	Review sufficiency of conflicts of interest management process; focus on (1) scope of policy; (2) sufficiency of disclosure questionnaire; and (3) enforcement and review processes (Line 12).
6	Adopt (or update existing) procedure for disclosure of intraboard (i.e., “horizontal”) business and family relationships (Line 2).
7	Assure application of whistleblower, document retention policies to tax forms and tax compliance matters (Lines 13, 14).
8	Confirm use of “Rebuttable Presumption of Reasonableness” to executive compensation decisions (Line 15); assure General Counsel pre-filing review of Schedule O .
9	Assure protocols to monitor organizational transactions with “Interested Persons” (e.g., excess benefit transactions, vendor relationships, loans) (Schedule L).
10	Evaluate adequacy of tax-exemption safeguards in joint venture arrangements with taxable entities (Line 16).
<p>Note: Attention should be given to what may justifiably be considered “reasonable efforts” of the organization in responding to questions on Lines 1b and 2 of Part VI, Line 1a of Part VII, and Schedule L.</p>	

For more information, please contact Michael W. Peregrine (312) 984-6933 (mperegrine@mwe.com) or Elizabeth M. Mills at (312) 984-7555 (emills@mwe.com).

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