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**GOVERNANCE ASPECTS
OF IRS FORM 990**

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I. OVERVIEW

IRS Form 990 has become a primary source of information about exempt organizations (EOs) for the Internal Revenue Service (IRS), Congress, nonprofit watchdog groups, and members of the public. While completing the detailed tax form can be an arduous task, it may also represent an opportunity for EOs. The information that an organization includes in its Form 990 may positively influence public perception of its mission, programs, and accomplishments. On the other hand, incomplete or misleading information on Form 990 may deter potential donors, invite public criticism, or even lead to government investigation.

Prior to 2007, the IRS had not made significant changes to Form 990 since 1979. In the interim, EOs have experienced many changes in tax laws, and the nonprofit sector has become increasingly larger, more diverse, and more complex. As a result, the IRS determined that the form no longer met the agency's tax compliance interests or the transparency and accountability needs of the states, the public, and local communities served by EOs.²

The IRS has recently increased its focus on EO governance, and has included many governance-related questions in the revised version of Form 990. EOs are formed under state nonprofit laws and the states have primary jurisdiction over most of their governance issues; federal tax law generally does not establish specific requirements for EO governance. However, the IRS may have what an agency official has called "implicit jurisdiction" to monitor and make suggestions about EO governance practices.³ There is, the official argued, a nexus between good governance and tax compliance. The IRS feels that it must be involved in governance issues to assure the integrity and compliance of EOs, and the public's confidence in the nonprofit sector.⁴ EOs should carefully review these Form 990 questions and determine how to answer them, and consider whether they should adopt or modify certain of their governance practices.

² IRS Background Paper, "Form 990 Redesign for Tax Year 2008," December 20, 2007, available at http://www.irs.gov/pub/irs-tege/background_paper_form__990__redesign.pdf (last visited February 13, 2009).

³ Remarks of Steven T. Miller, Commissioner, Tax Exempt and Government Entities, before the Georgetown Law Center Seminar on Representing and Managing Tax-Exempt Organizations (April 24, 2008), available at http://www.irs.gov/pub/irs-tege/represent_manage_speech_042408.pdf (last visited February 13, 2009).

⁴ Id.

II. IRS FORM 990

A. Background on IRS Form 990

Form 990 is an annual information return that most organizations exempt under Section 501(a)⁵ are required to file with the IRS.⁶ An organization is required to file Form 990 if the organization claims exempt status under Section 501(a), even if it has not yet established exemption by filing an application with the IRS and receiving a determination letter.

1. Due Date

Form 990 must be filed by the 15th day of the 5th month after an organization's accounting period ends. (For an organization that uses the calendar year ending December 31 for accounting purposes, the due date is May 15th of the following year.) An organization may request an automatic 3-month extension of time to file by submitting Form 8868 to the IRS. The same form may be used to request an additional 3-month extension (for a total of 6 months after the original due date), but the additional extension is not automatic, and an organization must show reasonable cause for the additional time requested.⁷

2. Penalties

If an EO fails to file Form 990 on time or files an incomplete return, the IRS may charge a penalty of \$20 for each day the failure continues. The amount of the penalty is capped at \$10,000 or 5% of the organization's gross receipts, whichever is smaller. For large organizations with annual gross receipts over \$1 million, the penalty is \$100 per day, capped at \$50,000. The IRS will waive the penalty if the EO can show that the late filing was due to reasonable cause.⁸

3. Public Disclosure of Information

Generally, the IRS will make publicly available all information that an EO reports on its Form 990 or submits as an attachment. Exceptions exist for the names and addresses of contributors to an organization and for trade secrets. An EO must make its Form 990 returns available for public inspection at its principal, regional, and district offices during regular business hours. An EO must also provide a copy without charge, other than a reasonable fee for copying and postage costs, to any individual who requests a copy, unless the EO has already

⁵ All references to Sections, unless otherwise indicated, are to the Internal Revenue Code of 1986, as amended, and the Treasury Regulations thereunder.

⁶ Smaller organizations must file Form 990-EZ or Form 990-N, and organizations that are qualified under Section 501(c)(3) and further classified as private foundations must file Form 990-PF. Churches and certain church-affiliated organizations, certain governmental organizations, and other specific types of organizations are not required to file Form 990, as described in the 2008 Instructions for Form 990. This paper focuses on EOs that are required to file Form 990, particularly Section 501(c)(3) and 501(c)(4) organizations.

⁷ 2008 Instructions for Form 990, Return of Organization Exempt From Income Tax, at p. 6.

⁸ Sections 6652(c)(1)(A), 6652(c)(4).

made such forms widely available on its website or another organization's website as part of a database of similar documents of other EOs (e.g., <http://www.guidestar.org>).⁹

B. Revisions to Form 990 in 2007

In 2003, the IRS began to redesign the form with three guiding principles in mind: increasing transparency, promoting compliance with the tax laws, and minimizing the burdens on filing organizations.¹⁰ Over four years later, in June 2007, the IRS released a discussion draft of the redesigned Form 990 for public comment. The Service received over 700 emails and letters during the comment period, and incorporated those comments and suggestions into a final revised draft, released in December 2007.¹¹

The revised Form 990 consists of an 11-page core form, which all filers must complete, and Schedules A through O, which may be required, according to the type and activities of the organization. The major changes in the new form include a summary page, an entire section devoted to governance issues, more detailed reporting of executive compensation and an organization's relationships with certain insiders and related organizations, and new disclosure of in-kind (non-cash) contributions. An EO also now has the opportunity to "tell its story" by providing narrative information on a Statement of Program Service Accomplishments included in the core portion of Form 990.¹² Many of the new schedules to revised Form 990 provide space to report information that the old form required as separate attachments. An organization may determine which additional schedules, if any, it is required to complete by filling out Part IV of the core form, Checklist of Required Schedules. The new Form 990 continues to allow EOs to report on a group return basis. Appendix E to the instructions describes the group return reporting requirements for the new form.

The new Form 990 requires EOs to obtain information from staff and board members, including former directors¹³, officers, and certain employees, that was not required to be reported in the past. As a consequence, EOs may consider revising their information-gathering processes to target the broader group. In addition, EOs may consider making substantive changes to their internal policies and procedures in response to the new reporting requirements.

C. Final Instructions to Form 990

In April 2008, the IRS released draft instructions to accompany the revised Form 990. The IRS received and considered approximately 120 comments, and released final instructions in August 2008. The instructions clarify the specific information required to be reported, provide examples, and include a glossary of specific terms for purposes of filing Form 990 and the

⁹ Section 6104. Section 501(c)(3) organizations that file Form 990-T, which is used to report unrelated business income, must also make those forms available for public inspection.

¹⁰ Quay, Christopher and Fred Stokeld, "IRS Releases Redesigned Form 990," *Exempt Organization Tax Review*, January 2008, p. 9.

¹¹ I.R. News Release 2007-204 (December 20, 2007), available at <http://www.irs.gov/newsroom/article/0,,id=176722,00.html> (last visited February 13, 2009).

¹² See Background Paper, Summary of Form 990 Redesign Process (August 19, 2008), available on the IRS website at http://www.irs.gov/pub/irs-tege/summary_form_990_redesign_process.pdf (last visited February 13, 2009).

¹³ References to directors throughout this paper also include trustees who are voting members of an EO's governing body.

accompanying schedules. The instructions include new definitions of terms that are relevant to the corporate governance questions, including definitions of “officer,” “director,” “key employee,” and “independent voting member.” The definition of “reportable compensation” is also clarified, and the instructions make clear that compensation reporting is now required by all types of EOs that file Form 990.

The instructions to the governance section of the revised Form 990 acknowledge that the questions require EOs to disclose whether they have adopted specific practices and policies that are not required under federal tax law. They also state that EOs should consider the organization’s particular situation when determining whether to revise certain of those governance practices or to adopt certain policies.¹⁴

D. Transition Relief for Smaller Organizations

For organizations with a tax year based on the calendar year, the first filing of the new Form 990 will be due on May 15, 2009. The IRS has provided additional time for smaller EOs to prepare to file the new Form 990 by phasing-in the new form over a 3-year period. For the 2008 tax year (filed in 2009), an organization may file a Form 990-EZ, rather than the new Form 990, if it had less than \$1 million in annual gross receipts and its assets are valued at less than \$2.5 million. In 2009 (for filings in 2010), the thresholds decrease to \$500,000 in gross receipts and less than \$1.25 million in assets. In 2010 and later years, an organization may file Form 990-EZ only if it has less than \$200,000 in gross receipts and less than \$500,000 in assets.¹⁵

The IRS has not yet made any changes to Form 990-PF, which must be filed by Section 501(c)(3) organizations that are further classified as private foundations, or to Form 990-EZ, filed by EOs with gross receipts or assets below certain threshold amounts. However, specific schedules created for the 2008 Form 990 will replace certain attachments required by the 2007 Form 990-EZ.¹⁶

III. INCREASED FOCUS ON EO GOVERNANCE

Many different nonprofit industry groups have issued lists of governance “best practices” in recent years. For the most part, the practices included in such lists are not required by law, but they reflect current developments and trends in nonprofit governance. The IRS recently issued its own draft list of best practices for EOs, and incorporated many of those recommended practices into the governance-related questions in the revised Form 990. The IRS’s role in EO governance issues has been questioned by some and criticized as an improper extension of its tax compliance authority, but it is clear that the IRS will continue to focus on EO governance practices and policies.

¹⁴ 2008 Instructions for Form 990, at p. 15.

¹⁵ Transition relief is also provided for organizations that must complete Schedules H (Hospitals) and K (tax-exempt bonds). Those organizations must complete only certain sections of the schedules for the 2008 tax year, but must complete the entire schedules beginning with the 2009 tax year. *See id.* at p. 4.

¹⁶ *See* Background Paper, Summary of Form 990 Redesign Process (August 19, 2008), available on the IRS website at http://www.irs.gov/pub/irs-tege/summary_form_990_redesign_process.pdf (last visited February 13, 2009).

A. Industry Groups on “Best Practices”

The nonprofit sector has led the charge in focusing on governance issues and suggesting best practices that nonprofit organizations should adopt.

1. Independent Sector

Independent Sector is a national trade association that is comprised of nonprofit organizations and foundations. In June 2005, Independent Sector published its Checklist for Accountability, a list of broadly-framed suggested best practices to help EOs create an environment of transparency, accountability, and integrity.¹⁷ The Checklist includes references to resources available for EOs to use as models in tailoring governance practices and drafting their own written policies.

The Checklist recommends that EOs adopt a written statement of values and code of ethics, conflict of interest policy, and whistleblower policy. It further recommends that EOs averaging \$1 million or more in annual revenues should have annual audits of their financial statements and operations. To become more transparent, Independent Sector recommends that EOs make financial statements available for public inspection, and post IRS Form 990, mission statements, and written policies on their websites.¹⁸

These suggested governance practices go beyond what is required by federal tax law and state laws governing nonprofit organizations. According to the Checklist, creating and maintaining a nonprofit organization committed to the highest ethical standards demands “more than just following the law.”¹⁹ Independent Sector suggested governance practices are intended to help EOs reassure stakeholders of their commitment to uphold the public trust, which is vital to earning support and fulfilling their missions. The Checklist recommends that EO board and staff members should review the suggested governance practices regularly, and adjust their rules, methods and communications as needed.²⁰

2. Panel on the Nonprofit Sector’s “Principles for Good Governance”

The Panel on the Nonprofit Sector was formed by Independent Sector with the encouragement of the U.S. Senate Finance Committee, and is comprised of leaders of a variety of nonprofit organizations. The Panel has focused on self-regulation within the charitable sector. In October 2007, the Panel released its “Principles for Good Governance and Ethical Practice: A Guide for Charities and Foundations.”²¹ The overarching philosophy behind the Principles is that government action cannot, and should not, replace strong and effective governance practices of individual organizations and constant vigilance by the nonprofit community.

¹⁷ Summary of Checklist for Accountability (June 2005), available at http://www.independentsector.org/issues/accountability/Checklist/Checklist_Summary.pdf (last visited February 13, 2009).

¹⁸ Id.

¹⁹ Id. at p. 1.

²⁰ Id.

²¹ “Principles for Good Governance and Ethical Practice: A Guide for Charities and Foundations,” Panel on the Nonprofit Sector (October 2007), available at http://www.nonprofitpanel.org/report/principles/Principles_Guide.pdf (last visited February 13, 2009).

The document includes 33 principles under four main categories: (1) legal compliance and public disclosure; (2) effective governance; (3) strong financial oversight; and (4) responsible fundraising. The document stresses that strengthening ethics and accountability within the sector requires an ongoing commitment by the board and staff of individual organizations and by the nonprofit community as a whole, and it is a process of continuing vigilance and adaptation. While the principles are expressed generally and may apply to most nonprofit organizations, the Panel makes clear that some organizations may conclude that certain practices do not apply to their operations.

B. IRS Draft Good Governance Practices

Adding to the best practices recommended by industry groups, in February 2007, the IRS released a preliminary staff discussion draft of its own suggested good governance practices for charitable organizations.²² The IRS acknowledged in the draft that the agency does not have authority to require organizations to comply with the suggested governance practices, because most nonprofit governance practices are regulated by state authorities. Nevertheless, the IRS stated that following its suggested practices may promote compliance with tax law and that an organization that adopts some or all of the practices is “more likely to be successful in pursuing its exempt purposes and earning public support.”²³ In addition, because the IRS issues determinations of exempt status under Section 501(a), it seems likely that the agency will look for compliance with these recommended practices when determining whether a new organization qualifies for tax exemption.

Several of the discussion draft’s recommendations pertain to composition of an organization’s governing body. The IRS suggested that charitable organizations maintain a medium-sized board, neither too large nor very small. Small boards may not effectively represent the public interest, and very large boards may not be as attentive to oversight duties. According to the IRS, the board should include individuals who are committed to the organization’s mission, as well as individuals who have expertise in areas such as finance and compensation.

The IRS suggested that generally, charities should not compensate their board members for service as directors, and should only do so after any such compensation is approved by an independent committee made up of individuals who are not compensated by the organization and who have no financial interest in determining the compensation. Other recommendations included annual independent financial audits for organizations with substantial assets or annual revenues, changing the auditor every five years, and regular board review of the organization’s financial statements, auditor’s letters, and finance and audit committee reports. The draft also suggested written policies that charitable organizations should consider adopting, including: a code of ethics and whistleblower policy, a fundraising policy to help ensure that the organization’s fundraising operations meet federal and state law requirements, and a document retention policy.

²² “Good Governance Practices for 501(c)(3) Organizations,” (on file with author).

²³ *Id.*

The IRS included many of its suggested practices and policies in the draft revised Form 990 later in 2007. After the IRS issued the final revised Form 990 and instructions, it removed the preliminary discussion draft of good governance practices from its website, noting that the most current IRS positions on nonprofit governance are best reflected in the reporting required by Form 990.²⁴ While federal tax law generally does not mandate these practices, the IRS now asks about an organization's governance practices (including many of the preliminary discussion draft's suggested good governance practices) annually as part of the revised Form 990 information return.

C. ACT Report

The Advisory Committee on Tax Exempt and Government Entities (ACT) is a public advisory committee comprised of members appointed by the Secretary of the Treasury that provides a venue for public input into tax administration issues. In June 2008, ACT released a report entitled "The Appropriate Role of the Internal Revenue Service With Respect to Tax-Exempt Organization Good Governance Issues" (ACT Report). The Report was critical of the IRS's increasing role in promoting particular EO governance practices. Addressing the IRS's claim that the agency's interest in the governance area is intended to promote EO compliance with tax laws, the Report states that it is not clear that requiring specific governance practices will result in greater compliance with federal tax laws. Good governance and tax law compliance may have more to do with the values, engagement, and accountability of those in charge of an organization than with the adoption of specific procedures and policies.²⁵

As the national nonprofit sector is made up of well over one million organizations of varying size, location, sophistication, available resources, and activities, effective governance practices among those organizations will differ according to those and other factors. Further, the Report states that the IRS is "a powerful force that can drive behavior merely by asking about specific governance practices."²⁶ An organization's board might feel pressured to adopt practices specified by the IRS even where doing so might be inadvisable in their situation, because they fear they will otherwise be perceived by the IRS and the public as poorly governed. The ACT Report asserted additional possible negative effects from the IRS's involvement in governance: the agency may effectively usurp the judgment of governing boards in determining what practices make sense in their specific contexts, place undue burdens on EOs, adversely affect the diverse makeup of the charitable sector, and divert organizations' attention to "proxies for governance," rather than actual governance.²⁷

The ACT Report describes five points of contact between the IRS and EOs in which the IRS has sought to promote good governance practices: (1) in creating standards for exemption

²⁴ Governance of Charitable Organizations and Related Topics, available on the IRS website at <http://www.irs.gov/charities/article/0,,id=178221,00.html> (last visited February 13, 2009). A list of suggested governance practices is still available, however, within the "Life Cycle of a Public Charity" section of the IRS website Governance and Related Topics – 501(c)(3) Organizations, available on the IRS website at http://www.irs.gov/pub/irs-tege/governance_practices.pdf (last visited February 13, 2009).

²⁵ Advisory Committee on Tax Exempt and Government Entities, The Appropriate Role of the Internal Revenue Service With Respect to Tax-Exempt Organization Good Governance Issues (June 11, 2008), p. 1, available on the IRS website at http://www.irs.gov/pub/irs-tege/tege_act_rpt7.pdf (last visited February 13, 2009).

²⁶ Id.

²⁷ Id.

for EOs; (2) on initial determination of an EO's exemption; (3) on examination of an EO or other compliance initiatives; (4) in Form 990 reporting; and (5) in education and outreach efforts to the nonprofit sector. While governance practices can be relevant factors that bear on an organization's initial and continuing qualification for exemption, the Report warns that IRS may be requiring specific governance practices on an ad hoc and inconsistent basis.²⁸

The Report makes twelve recommendations for the IRS to approach the governance area with caution. They include, among other suggestions, working collaboratively with the EO community in connection with governance initiatives, mandating specific governance practices only in rare circumstances, explaining the relationship between suggested governance practices and tax law compliance, and making governance inquiries and comments in as neutral a manner as possible. The Report also recommends that the IRS expressly acknowledge when the governance practices that it is addressing or inquiring about are not required by tax law.²⁹

The IRS demonstrated its growing involvement in the governance area by adding a substantial number of governance-related questions to the redesigned Form 990. While the Report acknowledges that the governance questions are largely appropriate and formulated in a relatively neutral manner, the Report asserts that merely by including those questions, the IRS intentionally suggested that it supports adoption of specific governance practices and policies.³⁰

D. Continuing IRS Focus on Governance Issues

1. Remarks by IRS Officials

Recent remarks by IRS officials address some of the concerns raised in the ACT Report, and make clear that EO governance issues will continue to be a focal point for the IRS. The commissioner of the IRS Tax Exempt and Government Entities Division (TE/GE), Steven T. Miller, has spoken publicly about the division's continuing activity in the governance area. He has stated that the IRS has no interest in telling EOs how to run their organizations.³¹ The agency hopes, however, to facilitate discussions within the organizations and to "let the sun shine" on governance practices, allowing the public to see how the organizations are run.³² Increasing transparency was one of the guiding principles behind the changes to revised Form 990.

In an April 2008 panel on nonprofit governance, Mr. Miller explained that there are no explicit federal statutory provisions that set forth clear governance standards, which he called "jurisdictional gaps."³³ Despite those gaps, he said, the effects of good or bad nonprofit governance cut across virtually everything that the division sees and does in its work. Poor

²⁸ Id. at p. 3.

²⁹ Id. at p. 5.

³⁰ Id. at p. 3.

³¹ Remarks of Steven T. Miller, Commissioner, Tax Exempt and Government Entities, Internal Revenue Service, Western Conference on Tax Exempt Organizations (November 20, 2008), available at http://www.irs.gov/pub/irs-tege/stm_loyolagovernance_112008.pdf (last visited February 13, 2009), at p. 2.

³² Id. at p. 3.

³³ Remarks of Steven T. Miller, Georgetown Seminar on Exempt Organizations, Panel on Nonprofit Governance (April 23, 2008), available on the IRS website at http://www.irs.gov/pub/irs-tege/gulc_governance_speech_042308.pdf (last visited February 13, 2009).

governance can lead to wasted assets, inefficient use of assets, and loss of public trust in the nonprofit sector.³⁴ He said, “The question is no longer whether the IRS has a role to play in this area, but rather, what that role will be.”³⁵

In February 2008, the IRS added an educational piece to its website devoted to nonprofit governance issues. The piece highlights governance matters that leaders of EOs of varying sizes and types should consider throughout the life cycle of their organizations. The section of the website ties into the new governance section of Form 990, and is designed to notify EOs about the questions they will now be asked annually when they file Form 990.³⁶ In addition, the IRS plans to implement Cyber Assistant, a new software system similar to tax preparation software, in 2009. Cyber Assistant will help applicants for tax-exempt status fill out the IRS Form 1023 application, and will also provide suggestions and educational material about relevant governance issues when appropriate.³⁷

2. IRS Fiscal Year 2009 Work Plan

The Exempt Organizations division of the IRS released its work plan for fiscal year 2009 in November 2008.³⁸ The plan includes a compliance initiative involving EO governance issues, with a focus on three areas. First, the division will work to develop a checklist for IRS agents to use in examinations of EOs to determine whether an organization’s governance practices impacted the tax compliance issues identified in the examination, and to educate organizations about possible governance considerations. After conducting an examination of an EO, IRS agents may be required to answer a set of questions in a post-exam checklist, including questions that get at whether problems were related to a governance weakness or could have been discovered and corrected without IRS intervention if appropriate governance structures had been in place.³⁹ Second, the division will develop a training program to educate IRS employees about nonprofit governance implications in the determinations, rulings and agreements, and education and outreach areas. Finally, the agency will analyze data received from EOs on the revised Form 990 to develop future projects. This includes identifying Form 990 governance questions that the IRS could use in conjunction with other Form 990 information in possible compliance initiatives, such as those involving executive compensation, transactions with interested persons, or diversion or misuse of exempt assets. The IRS could use this information in an attempt to prove the connection between certain governance practices and tax compliance.⁴⁰

IV. GOVERNANCE ISSUES IN REVISED IRS FORM 990

The “crown jewel” of the division’s efforts in the governance area is a new section of the revised Form 990.⁴¹ Part VI of the new form (“Governance, Management and Disclosure”)

³⁴ Id. at p. 5.

³⁵ Id. at p. 2.

³⁶ Remarks of Steven T. Miller (November 20, 2008), at p. 4.

³⁷ Id. at p. 6.

³⁸ Exempt Organizations Annual Report and Fiscal Year 2009 Work Plan (November 2008), available at http://www.irs.gov/pub/irs-tege/finalannualrptworkplan11_25_08.pdf (last visited February 13, 2009), at p. 20.

³⁹ Remarks of Steven T. Miller (April 24, 2008), at p. 4.

⁴⁰ Exempt Organizations Annual Report and Fiscal Year 2009 Work Plan, at p. 20.

⁴¹ Remarks of Steven T. Miller (April 23, 2008), at p. 2.

contains 28 questions that are fairly comprehensive. Part VI is divided into three main sections: Section A (“Governing Body and Management”); Section B (“Policies”); and Section C (“Disclosure”). Part VI of the new form requires each filing EO to provide information regarding the composition of its governing body, certain governance policies and practices, and the means by which it makes governance and financial information available to the public. The questions ask about governance practices that are for the most part suggestions, not requirements. The governance questions generally must be answered based on policies and practices in place on or before the last day of the 2008 tax year.⁴²

In a list of Frequently Asked Questions, the IRS explained why the new Form 990 contains a section on governance.⁴³ In the FAQ, the IRS stated that while many of the questions in the revised form request information on practices or policies that are not required by federal tax law, good governance and accountability practices provide safeguards to help ensure that the organization’s assets will be used consistently with its exempt purposes. The IRS feels that governance is a critical tax compliance consideration, particularly for those EOs, such as Section 501(c)(3) and 501(c)(4) organizations, that are subject to private benefit and private inurement rules. The IRS also stated that well-governed organizations are more likely to be transparent with regard to their operations, finances, fundraising practices, and use of assets for both exempt and unrelated purposes. Good governance practices allow EOs to self-identify and resolve problems before the IRS or any other regulatory body becomes involved.⁴⁴

A. Governance Practices

EOs are required to disclose in Form 990 transactions entered into with certain interested persons, including excess benefit transactions, loans, grants or other assistance, and other business transactions. Form 990 also inquires as to the independence of an EO’s board members; relationships among officers, directors, and certain other persons; whether an EO has an audit committee; and whether an EO’s governing board reviewed the organization’s Form 990 prior to filing.

1. Transactions With Interested Persons

The revised Form 990 includes a new Schedule L, “Transactions With Interested Persons.” Section 501(c)(3) public charities and Section 501(c)(4) organizations must disclose in Schedule L whether the organization engaged in an excess benefit transaction with a disqualified person during the year, or whether the organization became aware that it had engaged in an excess benefit transaction with a disqualified person from a prior year. All EOs filing Form 990 must disclose in Schedule L any loans to and/or from interested persons, grants or assistance benefitting interested persons, and business transactions involving interested persons.⁴⁵ The definition of “interested persons” differs for each of the sections of Schedule L,

⁴² Background Paper, Summary of Form 990 Redesign Process (August 19, 2008), at p. 5.

⁴³ Form 990 Redesign for Tax Year 2008 (Filed in 2009) Frequently Asked Questions (November 19, 2008), available on the IRS website at <http://www.irs.gov/charities/article/0,,id=176667,00.html> (last visited February 13, 2009).

⁴⁴ Remarks of Steven T. Miller (November 20, 2008), at p. 3.

⁴⁵ EOs that file Form 990-EZ are also required to complete the applicable portions of Schedule L. See 2008 Instructions for Schedule L (Form 990 or 990-EZ), at p. 1.

and therefore, determining whether a particular transaction must be disclosed requires a careful reading of the instructions to Schedule L.

a. Excess Benefit Transactions

Unlike many of the other governance-related issues included in the revised Form 990, excess benefit transactions are specifically addressed in the Internal Revenue Code. The prior version of Form 990 required Section 501(c)(3) public charities and Section 501(c)(4) organizations to disclose excess benefit transactions, and the revised version consolidates disclosure of these and other types of transactions with interested persons in one schedule.

Section 501(c)(3) and 501(c)(4) organizations are subject to rules that prohibit inurement of their net earnings to private individuals. The IRS used to have only one type of sanction against EOs that violated the private inurement prohibition – revocation of the organization’s exempt status. Revocation penalized the organization, but not the insider who obtained inappropriate compensation or other financial benefits. Section 4958 and the Treasury Regulations thereunder now provide for “intermediate sanctions” short of revocation for Section 501(c)(3) and Section 501(c)(4) organizations.

The intermediate sanctions rules impose excise taxes on the insider, known as a “disqualified person,” if he or she engages in an “excess benefit transaction” with the EO. Generally, disqualified persons include specified categories of persons, such as directors and officers of the EO and certain of their family members, and individuals who are in a position to exercise substantial influence over the organization.⁴⁶ An excess benefit transaction is any transaction in which the EO bestows an economic benefit directly or indirectly for the use of a disqualified person, if the value of that economic benefit exceeds the value of the consideration (including the performance of services) the EO receives in return.⁴⁷ Once an excess benefit transaction has occurred, Section 4958 imposes an excise tax on the disqualified person, and if the disqualified person does not correct the transaction within a prescribed time period, he or she is subject to an additional, punitive excise tax. Section 4958 also imposes an excise tax on any of the EO’s managers who knowingly participated in the excess benefit transaction, unless the participation was not willful and was due to reasonable cause.

Schedule L of the revised Form 990 requires Section 501(c)(3) and 501(c)(4) organizations to disclose the name of the disqualified person, a description of the excess benefit transaction, and whether or not the transaction was corrected. Those organizations must disclose the amount of excise tax imposed on disqualified persons or the organization’s managers during the year under Section 4958. If the EO reimbursed any amount of the excise taxes imposed

⁴⁶ See generally Sections 4958(f)(1), 4958(f)(4), Treas. Reg. §§ 53.4958-3(b)-(d). Some individuals, when not included in the “per se” categories of disqualified persons, are automatically deemed not to be disqualified persons. They include an individual whose total economic benefit derived from the EO is less than the amount that could cause the individual to be treated as a “highly compensated employee” under Section 414(q)(1)(B)(i) of the Code (*i.e.*, \$110,000 for 2009).

⁴⁷ Section 4958(c). Donor advised funds and supporting organizations are subject to additional rules that make certain grants, loans, compensation, or similar payments provided by the EO to certain donors or entities controlled by those donors or their family members automatic excess benefit transactions.

under Section 4958 to either the disqualified person or the organization's managers, it must report the amount of that reimbursement on Schedule L.

b. Loans to and/or From Interested Persons

EOs must also disclose on Schedule L whether the organization had a loan to or by certain interested persons outstanding as of the end of the EO's tax year. For purposes of this section of Schedule L, "interested persons" include the individuals listed in Part VII, Section A of Form 990 ("Compensation"): the EO's current officers, directors, key employees, and five highest compensated employees; former officers, directors, key employees, and highest compensated employees who received compensation in excess of certain thresholds; and for Section 501(c)(3) and 501(c)(4) organizations, "interested persons" include disqualified persons.⁴⁸

"Key employees" are those who meet all three of the following tests: (1) \$150,000 Test: the individual receives over \$150,000 in compensation from the EO and all related organizations for the calendar year ending with, or within, the EO's tax year; (2) Responsibility Test: the individual had organization-wide responsibilities, powers or influence similar to those of officers or directors; or managed a segment of the EO that represents 10% or more of the EO's activities, assets, income, or expenses; or had or shared control over 10% or more of the EO's capital expenditures, operating budget, or compensation for employees; and (3) Top 20 Test: the individual was within the EO's top 20 highest paid employees (who also satisfy the \$150,000 Test and the Responsibility Test).⁴⁹

EOs are required to report only loans between the organization and interested persons that are outstanding as of the end of the organization's tax year. EOs must also report loans that were originally made between a third party and an interested person, or between the EO and a third party, but were later transferred so as to become a debt outstanding between the EO and an interested person.⁵⁰ Schedule L requires EOs to disclose: the name of the interested person, the purpose of the loan, whether the loan was made to or from the organization, the original principal amount and the balance due, whether the loan is in default, whether the loan was approved by the organization's board or a committee, and whether the loan is the subject of a written agreement.

The Panel on the Nonprofit Sector, in its *Principals for Good Governance*, recommends that charitable organizations should not provide loans to their directors or officers.⁵¹ Federal tax law prohibits certain types of EOs, such as private foundations, supporting organizations, and donor-advised funds, from loaning money to substantial contributors, board members, certain organizational managers, and related parties.⁵² EOs that are organized under the Washington Nonprofit Corporation Act are prohibited from making loans to the organization's directors and officers. RCW 24.03.140 provides that directors who vote for or assent to the making of a loan to a director or officer of the organization, and any officer or officers participating in the making

⁴⁸ 2008 Instructions for Schedule L, at p. 2. For supporting organizations, disqualified persons as described in Section 4958(c)(3)(B) are also "interested persons" for purposes of this section of Schedule L.

⁴⁹ 2008 Instructions for Form 990, at p. 49.

⁵⁰ 2008 Instructions for Schedule L, at p. 2.

⁵¹ *Principles for Good Governance*, at p. 37.

⁵² Sections 4941(d)(1)(B), 4958(c)(2)-(3).

of such loan, will be jointly and severally liable to the organization for the amount of the loan until it is repaid.

Even when an EO is permitted by state and federal law to make such loans (such as loans to key employees or other staff members who are neither officers nor directors, or loans to the EO received from interested persons), the terms of any loan should be clearly understood and approved by the EO's board. The IRS may scrutinize the terms of the loan transaction to determine whether it is an excess benefit transaction.⁵³ EOs should follow a written conflict of interest policy to evaluate whether a proposed loan transaction constitutes a conflict of interest for any board members, and require those interested board members to recuse themselves from discussions and decisions regarding the proposed loan.

c. Grants or Assistance Benefiting Interested Persons

Schedule L also requires disclosure of organizational grants (*e.g.*, scholarships, fellowships, internships, prizes, and awards) or other assistance (including provision of goods, services, or use of facilities) to interested persons. EOs must report the gift portion of business transactions that contain a gift element. EOs must disclose the name of the interested person, the relationship between the interested person and the organization, and the amount of the grant or the type of other assistance.

The definition of "interested person" differs for this section of Schedule L:

- Current or former officers, directors, or key employees listed in Part VII of Form 990
- Substantial contributors: those persons who contributed at least \$5,000 during the EO's tax year, and who are required to be reported by name in Schedule B of Form 990 ("Schedule of Contributors"). If an EO is not required to complete Schedule B, the organization is not required to report transactions with substantial contributors and their related persons in this section of Schedule L.
- Related persons:
 - A member of the EO's grant selection committee
 - A family member of any of the above categories of "interested persons"
 - A 35% controlled entity of any of the above.
 - Related persons also include an employee (or child of an employee) of a substantial contributor or of a 35% controlled entity, but only if the employee or his/her child received a grant or assistance from the EO:
 - at the director or advice of the substantial contributor, or 35% controlled entity, or

⁵³ Principles for Good Governance, at p. 37.

- under a program that was funded by the substantial contributor that was intended primarily to benefit the employees (or their children).⁵⁴

The instructions to Schedule L include two notable exceptions for grants or assistance that are not required to be reported.⁵⁵ The first exception is for grants to the employees (or their children) of a substantial contributor, under which the grants are awarded on an objective and nondiscriminatory basis. The grants must be awarded based on pre-established criteria, and must be reviewed by a selection committee as described in Treasury Regulation § 53.4945-4(b). The second exception is for certain types of grants or assistance provided to an interested person as a member of the class of persons that the EO intends to benefit in furthering its exempt purpose.⁵⁶ The EO must provide the benefit on similar terms as provided to other members of the class.

The organization must make a “reasonable effort” to obtain information about grants or assistance to interested persons that would be required to be reported on Schedule L. The instructions to Schedule L provide that EOs may distribute a questionnaire sent annually to each interested person (including current or former officers, directors, and key employees, and each member of the grant selection committee) that includes the name, title, date, and signature of the interested person. The questionnaire must also contain the pertinent instructions and definitions for Part III of Schedule L.⁵⁷ EOs may consider including questions regarding grants or other assistance in an annual questionnaire in connection with the organization’s conflict of interest policy (described in more detail below). EOs are not expected to distribute such a questionnaire to a substantial contributor or a person related to a substantial contributor, except where that person advises the EO as to the specific recipients of grants or assistance, or with respect to the EO’s programs that are intended primarily to benefit employees (or their children) of the substantial contributor or its 35% controlled entities.⁵⁸

d. Business Transactions Involving Interested Persons

Finally, Section IV of Schedule L requires EOs to report business transactions (other than excess benefit transactions, loans, grants or other assistance already reported on Schedule L or compensation reported in Section VII of Form 990) involving interested persons that exceed certain thresholds. For purposes of Section IV of Schedule L, business transactions include (but are not limited to) contracts of sale, leases, licenses, and performance of services, and joint ventures in which the EO and the interested person each have over 10% interest in either the joint venture’s profits or capital. An EO’s charging membership dues is not considered to be a business transaction.⁵⁹ EOs must disclose the name of the interested person, the relationship between the interested person and the EO, the amount involved and a description of the transaction, and whether any of the consideration paid by the EO in the transaction was based on a percentage of the organization’s revenues.

⁵⁴ 2008 Instructions for Schedule L, at p. 2.

⁵⁵ *Id.*

⁵⁶ For Section 501(c)(3) charitable organizations, this generally means the organization’s charitable class.

⁵⁷ 2008 Instructions for Schedule L, at p. 3.

⁵⁸ *Id.*

⁵⁹ *Id.*

Once again, the definition of “interested persons” differs for this section of Schedule L. It includes:

- Current or former officers, directors, or key employees listed in Part VII of Form 990
- Family members of the individuals listed above
- An entity that is more than 35% owned (directly or indirectly), by one or more of the individuals listed above (individually or collectively)
- An entity, other than a Section 501(c) organization, of which the EO’s current or former officers, directors, or key employees listed in Part VII of Form 990 was serving at the time of the transaction as:
 - An officer, director, or key employee
 - A partner or member with an ownership interest of more than 5% (including ownership by a family member), if the entity is a partnership or limited liability company
 - A shareholder owning more than 5% (including ownership by a family member), if the entity is a professional corporation
- A management company of which one of the EO’s former (within the last 5 years) officers, directors, or key employees is an officer, director, key employee, or 35% owner (directly or indirectly).⁶⁰

EOs are only required to report business transactions in Part IV of Schedule L for which the dollar amount exceeds certain thresholds. To be reportable in Part IV, a business transaction must exceed \$10,000 or 1% of the EO’s total revenue for the tax year, whichever is greater. If, however, the transaction involved the EO’s payment of compensation to a family member of a current officer, director, or key employee of the organization, the transaction must be disclosed in Part IV of Schedule L if the compensation exceeded \$10,000 for the EO’s tax year. Another exception exists for multiple transactions between the EO and an interested person during the EO’s tax year. If total payments for all transactions between the parties exceeded \$100,000, the EO must report all transactions between the parties, regardless of the amounts of each individual transaction. The EO may either aggregate multiple transactions between the same parties, or list them separately.⁶¹ The instructions to Schedule L include several helpful examples to determine whether a business transaction must be reported in Part IV.

The organization must make a reasonable effort to obtain information about business transactions with interested persons that would be required to be reported in Part IV of Schedule L. The instructions to Schedule L provide that EOs may distribute a questionnaire sent annually to current or former officers, directors, and key employees that includes the name, title, date, and

⁶⁰ Id.

⁶¹ Id.

signature of each person reporting information. The questionnaire must also contain the pertinent instructions and definitions for Part IV of Schedule L.⁶² In order to satisfy the “reasonable effort” standard, EOs are not required to distribute such a questionnaire to organizations or individuals with which it does business, but who are not current or former officers, directors, or key employees of the organization.⁶³

e. Implications for EO Governance

While the first section of Schedule L, regarding excess benefit transactions, utilizes the federal tax law definition of “disqualified persons” to determine the relevant parties to a transaction that must be reported, the remaining sections of Schedule L include a different standard — “interested persons.” Even more confusingly, the definition of “interested person” varies depending on whether the transaction involves a loan, grant, or business transaction.

The transactions required to be disclosed on Schedule L do have something in common, however — they all involve potential or actual conflicts of interest. The different definitions of “interested person” attempt to cover individuals who could introduce bias into the EO board’s decision-making process when determining whether to enter into a particular transaction. The fact that certain transactions will be required to be disclosed on Schedule L may make more EOs think twice before engaging in such transactions with interested persons, and may cause EO boards to adhere strictly to procedures designed to protect the organization set out in the organization’s conflict of interest policy. Conflict of interest policies are discussed in greater detail below.

2. Independence of Board Members

Schedule L is also used to determine whether a member of the EO’s governing body is “independent” for purposes of the governance section of the new Form 990. In Part VI, line 1b of the new Form 990, EOs must disclose the number of “independent” voting members of the governing board as of the end of the organization’s tax year. The IRS reviews the board composition of charitable EOs to determine whether the board represents a broad public interest (rather than an impermissible private interest), and to identify the potential for insider transactions that could result in the misuse of charitable assets.⁶⁴ The IRS recommends that an EO’s governing board should include independent members and “should not be dominated by employees or others who are not, by their very nature, independent individuals because of family or business relationships.”⁶⁵

All directors of nonprofit corporations owe the organization a fiduciary duty of loyalty, which requires directors to put the interests of the organization above their own, and to make decisions that they believe are in the organization’s best interest. According to the Panel on the

⁶² 2008 Instructions for Schedule L, at p. 3.

⁶³ Id. at p. 4.

⁶⁴ Governance and Related Topics – 501(c)(3) Organizations, at section 3. The IRS also reviews whether an EO has independent members or other persons with the authority to elect directors or to approve or reject board decisions (Form 990 at Part VI, line 7), and whether the organization has delegated control or key management authority to a management company or other persons (Part VI, line 3).

⁶⁵ Id.

Nonprofit Sector, in its Principles for Good Governance, an individual who has a personal financial interest in the organization's affairs may not be as likely to question the decisions of other board members who determine that individual's compensation or fees, or to give unbiased consideration to changes in management or the organization's activities. The founders of a nonprofit corporation sometimes initially turn to family members and business partners to serve on the organization's board, but such interlocking relationships can prevent the board members from exercising the level of independent judgment required to satisfy the duty of loyalty to the organization.⁶⁶

While revised Form 990 now requires EOs to disclose the number of independent voting board members, federal tax law does not require a specific percentage or number of independent directors. The IRS's focus on whether the board is "dominated" by non-independent directors suggests that at least a majority of the voting board members should be independent. California state law requires nonprofit public benefit corporations to limit non-independent, or "interested," directors to not more than 49% of the board members.⁶⁷ There is currently no such limitation under the Washington Nonprofit Corporation Act.

The Panel on the Nonprofit Sector recommends that for public charities, a *substantial* majority of the board should be independent, usually meaning at least two-thirds of the board members.⁶⁸ The Panel acknowledges that requiring two-thirds of the board members to be independent may not be appropriate for some EOs, for example, Section 501(c)(3) organizations that are classified as private foundations, and certain other types of organizations that must adhere to specific legal restrictions regarding self-dealing transactions. In addition, organizations may have articles of incorporation or trust instruments that specify the required board composition.⁶⁹

The instructions to Form 990 define "independence" for purposes of Part VI, line 1b. A board member will be considered "independent" only if, at all times during the EO's tax year: (1) the board member was not a compensated employee of the EO or of a related organization; (2) he or she did not receive total annual compensation, or other payments from the EO, over \$10,000 as an independent contractor (other than as reasonable compensation for services as a board member, or by reimbursement of expenses under an expense reimbursement procedure); and (3) neither the board member, nor any family member, was involved in a transaction with the EO reportable on Schedule L ("Transactions with Interested Persons").⁷⁰ A board member may still be considered independent even if he or she is a donor to the organization, regardless of the amount of the donation. Also, a board member may still be independent if he or she receives financial benefits from the organization, solely in the capacity of being a member of the charitable class served by the organization in carrying out its exempt activities, so long as the

⁶⁶ Principles for Good Governance, at p. 23.

⁶⁷ Cal. Corp. Code § 5227.

⁶⁸ Principles for Good Governance, at p. 23.

⁶⁹ Id. at p. 24. A Section 501(c)(3) organization that is classified as a supporting organization may be required to have representatives of the supported organization on its board, or an organization established under the auspices of a religious institution may be required to include clergy or other paid representatives of that institution on its board.

⁷⁰ 2008 Instructions for Form 990, at p. 16.

financial benefits comply with the organization's terms of membership.⁷¹ The instructions provide examples that apply this three-part test.

To obtain the information necessary to determine whether a voting board member is "independent" for purposes of Form 990 reporting, EOs need only engage in a reasonable effort. The instructions to Form 990 provide that EOs may rely on information provided by board members, for example, information obtained in response to a questionnaire sent annually to each member of the board that includes the name, title, date, and signature of the board member. The questionnaire must also contain the pertinent instructions and definitions for "independence" for purposes of Part VI, line 1b.⁷² EOs should consider including questions regarding a board member's independence in an annual questionnaire in connection with the organization's conflict of interest policy (described in more detail below). If an EO determines that having a majority of independent board members is not appropriate, it should take other steps to ensure that board members are able to fulfill their duty of loyalty to the organization and to otherwise provide independent management and oversight.⁷³ A conflict of interest policy tailored to the needs of the organization may address these concerns.

3. Relationships Among Officers, Directors, and Others

Part VI, line 2 of the revised Form 990 asks whether any officer, director, or key employee has a family or business relationship with any other officer, director, or key employee. The question requires EOs to disclose whether these "horizontal" relationships exist, which could create a conflict of interest or bias in making decisions for the organization. In addition to the financial independence of board members, discussed above, the IRS is concerned that family or business relationships among an EO's management may threaten the ability of those individuals to make impartial decisions in the EO's best interest. Organizations that answer "yes" to this question must disclose further information on Schedule O, but the information that must be reported is limited to the names of the persons involved in the relationship, and whether it is a family or business relationship. No further detail is required.

The instructions to Form 990 define "family relationship" and "business relationship." Family relationships, for purposes of Form 990, include only an individual's spouse, ancestors, whole and half blood siblings, children, grandchildren, great-grandchildren, and spouses of siblings, children, grandchildren, and great-grandchildren.⁷⁴ Business relationships between two persons include employment relationships, whereby one person is employed by a sole proprietorship owned by the other person, or by an organization with which the other person is associated as a director, officer, key employee, or more than 35% owner. Business relationships also include situations in which one person is transacting business with the other, directly or indirectly. A direct transaction is one involving a sale, lease, license, loan, service arrangement, or other transaction that involves a transfer of money or property valued in an amount over \$10,000 in the aggregate during the year. An indirect business transaction is a transaction by one person with an organization of which the other person is a director, officer, key employee, or more than 35% owner. Ownership in an entity is measured by stock ownership voting power or

⁷¹ Id.

⁷² Id.

⁷³ Principles for Good Governance, at p. 24.

⁷⁴ 2008 Instructions for Form 990, at p. 46.

value in a corporation, or by profits or capital interest in a partnership or limited liability company, membership interest in a nonprofit organization, or beneficial interest in a trust.⁷⁵

Business relationships exclude transactions between two persons that take place in the ordinary course of either person's business, on the same terms that are generally offered to the public. Notably, in response to concerns about invasion of these individuals' privacy, the instructions to Form 990 also exclude privileged relationships — such as attorney-client or medical professional-patient — from the definition of “business relationship,” solely for purposes of Part VI, line 2.⁷⁶ The instructions also include five examples to help the EO determine whether a particular relationship must be disclosed.

To obtain the information necessary to determine whether a voting board member is “independent” for purposes of Form 990 reporting, EOs need only engage in a reasonable effort, the same standard for independent board members described above. EOs should consider including questions regarding a board member's independence in an annual questionnaire in connection with the organization's conflict of interest policy (described in more detail below). EOs may wish to limit or prohibit family or business relationships among directors, officers, and key employees, or consider developing a policy that spells out the circumstances in which such relationships will be permitted. Although no further explanation of such relationships is required to be disclosed on Form 990, EOs may want to consider how to explain a “yes” response on Part VI, line 2 to the media or the public, including potential donors.

4. Audit Committee

Part XI, line 2c asks whether an EO has an audit committee that assumes responsibility for oversight of the audit, review, or compilation of its financial statements and selection of an independent accountant. While this question is not included in Part VI (“Governance, Management, and Disclosure”) of Form 990, whether an EO has an audit committee certainly has governance implications. An organization is only required to complete this question if it responded affirmatively to questions asking whether the organization's financial statements are compiled, reviewed, or audited by an independent accountant.⁷⁷

State laws require certain organizations that meet annual gross revenue thresholds to conduct independent financial audits. Effective January 1, 2010, Washington State law will require charitable organizations that solicit funds from the public within the state and that have more than \$3 million in annual gross revenue (averaged over the last three fiscal years) to submit an audited financial statement prepared by an independent certified public accountant.⁷⁸ Washington will also require charitable organizations with more than \$1 million in annual gross revenue (averaged over the last three fiscal years) to have their federal financial reporting form (in most cases, IRS Form 990) prepared or reviewed by a certified public accountant or other

⁷⁵ Id. at p. 16.

⁷⁶ Id.

⁷⁷ The instructions to Part XI, lines 2a and b of Form 990 state that EOs should answer “no” if the organization's financial statements were only compiled, reviewed, or audited as part of a consolidated financial statement. The organization may explain in Schedule O that its financial statements were compiled, reviewed, or audited on a consolidated basis. 2008 Instructions for Form 990, at p. 39.

⁷⁸ RCW 19.09.315(2); WAC 434-120-107(3).

professional, independent third party who normally prepares or reviews such returns in the ordinary course of business. The state requires the independent preparer or reviewer to submit a signed form to the Secretary of State's office.⁷⁹ California state law now requires charities that receive or accrue \$2 million in gross revenue in any fiscal year to have a financial audit performed by an independent certified public accountant. Those organizations must prepare audited financial statements and make them publicly available, and they must appoint an audit committee. The law applies to charitable corporations that are incorporated in other states if they are required to register with California's Attorney General.⁸⁰

The IRS has suggested that even if not required by state law or other rules, an EO with substantial assets or revenue should consider obtaining an audit of its financial statements by an independent auditor.⁸¹ Independent Sector, in its Checklist for Accountability, recommends that EOs with annual revenues of \$1 million or more should have an audit conducted of their financial statements and operations. Organizations with between \$250,000 and \$1 million in annual revenues should have their financial statements reviewed (but not necessarily audited) by an independent public accountant, and organizations with less than \$250,000 in annual revenues should consider periodically obtaining a review of financial statements.⁸²

The independence of auditors became a focus for regulators in the for-profit sector after the Enron scandal, in which it was discovered that Enron's auditing firm, Arthur Andersen, also received fees from Enron for consulting services. The Sarbanes-Oxley Act of 2002 (SOX) now requires public companies to maintain stronger independence from their auditors, and prohibits auditors from performing a list of other services for audit clients.⁸³ SOX also requires public companies to create audit committees that must oversee the company's relationship with its auditor.

In "Governance and Related Topics – 501(c)(3) Organizations," the IRS encourages EOs to take steps to ensure the continuing independence of any auditor that conducts an audit of the organization. An organization may do so by establishing an audit committee responsible for selecting the independent auditor and reviewing the auditor's performance. According to the IRS, the committee should focus on whether the auditor has the competence and independence necessary to conduct the audit, the overall quality of the audit, and the independence and competence of the key personnel on the auditor's teams.⁸⁴

Independent Sector, in its Checklist for Accountability, recommends that EOs that conduct audits should avoid any conflict of interest in staff exchange between the organization and its audit firm, and should consider rotating audit firms or partners every five years or more when it makes sense to do so.⁸⁵ The Checklist sets out a list of responsibilities for an EO's audit committee, including retaining and terminating the independent auditor, reviewing the terms of

⁷⁹ WAC 434-120-107(2).

⁸⁰ Cal. Gov't Code § 12586(e)(1). The \$2 million threshold excludes grants from, or contracts for services with, governmental entities for which the governmental entity requires an accounting of the funds received.

⁸¹ Governance and Related Topics – 501(c)(3) Organizations, at Section 5 A.

⁸² Checklist for Accountability, at section 5.

⁸³ H.R. 3763, at § 201(a).

⁸⁴ Governance and Related Topics – 501(c)(3) Organizations, at section 5.A.

⁸⁵ Checklist for Accountability, at section 5.

the auditor's engagement at least every five years, overseeing the performance of the independent audit, and recommending approval of the annual audit report to the full board. In addition, according to Independent Sector, the audit committee should oversee procedures for encouraging whistleblowers to report questionable accounting or auditing matters of the organization, and approve any non-audit services (such as consulting services) performed by the auditing firm.⁸⁶

The Panel on the Nonprofit Sector, in its Principles for Good Governance and Ethical Practice, recommends that every charitable organization that has its financial statements independently audited (whether or not legally required to do so) should consider establishing an audit committee.⁸⁷ The committee should be made up of independent board members who have the appropriate financial expertise. To establish an audit committee, the board can adopt a resolution or amend the organization's bylaws to add it as a standing committee of the board. The resolution or the bylaw provision should address the criteria for membership on the committee, the committee's specific responsibilities, and situations in which the committee must make recommendations or reports to the full board of directors. The Panel notes, however, that smaller organizations and those organized as trusts may not choose to delegate the audit responsibility to a separate committee, but may wish to have the board of directors retain the auditor oversight responsibilities.⁸⁸

5. Review of IRS Form 990

Part VI, line 10 asks whether an organization provides a copy of the Form 990 to all board members before it is filed, and asks for a description in Schedule O of any internal process to review the Form 990 before it is filed. EOs must now disclose whether the final Form 990 was provided to each voting member of the organization's governing board prior to filing with the IRS, and the extent to which the EO's officers, directors, board committee members, or management reviewed the information return. An organization may answer "yes" on line 10, signifying that all board members received a copy of the Form 990 before it was filed, even if those board members did not actually review the copy they received. The instructions specify that EOs must separately describe in Schedule O who conducted the review, when they conducted it (before or after it was filed with the IRS), and the extent of any such review. If no review was or will be conducted, EOs must include a statement to that effect in Schedule O.⁸⁹

The purpose of the question, according to an IRS official, is to encourage the organization to consider the board's role in the Form 990 process. The agency expects that how each organization reviews the form, and how it will answer the question in Part VI, will vary depending on the size, nature, and culture of the organization.⁹⁰ The IRS has encouraged an active and engaged board, believing that it is important to the success of a charity and to its compliance with applicable tax law requirements.⁹¹ The question in Part VI, line 10 suggests

⁸⁶ Id.

⁸⁷ Principles for Good Governance, at p. 34.

⁸⁸ Id.

⁸⁹ 2008 Instructions for Form 990, at p. 18.

⁹⁰ Remarks of Steven T. Miller (November 20, 2008), at p. 7.

⁹¹ "Governance and Related Topics – 501(c)(3) Organizations, at section 3.

that the IRS considers the board's review of Form 990 as evidence of an active and engaged board.

The ACT Report criticized the value-laden way in which the IRS phrased the question in Part VI, line 10. While pre-filing review may be an acceptable approach for some EOs, the Report states, the volunteer governing body of a smaller EO may feel overwhelmed by the obligation to review Form 990, may expend limited resources that would be better utilized by having professionals assist the governing body, may be concerned about potential liability, or deterred from service as directors. Even larger EOs may encounter problems from the practice of pre-filing review, as directors may miss key aspects of the form due to an inability to "see the forest from the trees." According to the Report, a better practice for these EOs may be for management to cull the sensitive information from the draft Form 990 and present the information to the governing body, or a committee thereof.⁹²

In its Checklist for Accountability, Independent Sector recommends that EOs ensure the accuracy of the organization's Form 990 by having the form reviewed and approved by the board and signed by the organization's chief executive officer, chief financial officer, or the highest ranking officer of the organization.⁹³ Form 990 is one way that organizations share information about their finances and operations with regulators and the public, but in order to be effective, the information reported in Form 990 must be complete and accurate. Independent Sector suggests that either the EO's board or an appropriate board committee should review and approve Form 990 prior to filing it with the IRS.⁹⁴

B. Written Governance Policies

On the revised Form 990, Section B of Part VI requires EOs to answer a series of questions to disclose whether they have adopted particular written governance policies. They include: a conflict of interest policy, questions regarding the process for determining executive compensation, a whistleblower policy, document retention and destruction policy, and joint venture policy. This series of questions does not generally require a more elaborate response beyond merely checking a box to answer "yes" or "no." A list of resources for sample governance policies is included in Appendix 2.

1. Conflict of Interest Policy

Several sections of the new Form 990 illustrate the IRS's focus on whether an EO's governing body has taken steps to preserve impartial decision-making. Those steps include: monitoring the EO's transactions with interested persons, maintaining oversight of "horizontal" relationships among directors and officers, assuring board control by independent directors, and adopting a conflict of interest policy.⁹⁵ By adopting and rigorously enforcing a written conflict of interest policy, EOs may be less likely to engage in transactions with interested persons, or if they do so, they may be better able to ensure that any such transactions were on terms that were

⁹² ACT Report, at p. 52.

⁹³ Checklist for Accountability, at section 6.

⁹⁴ Id.

⁹⁵ Peregrine, Michael W., "More Than Just Conflicts: Form 990's Focus on Decision-Making Integrity," *The Exempt Organization Tax Review* (November 2008), Vol. 62, No. 2, at p. 154.

fair to the EO and did not involve bias in the decision-making process or violations of any director's or officer's fiduciary duties to the organization.

Part VI, line 12a asks whether an EO has a written conflict of interest policy. The instructions to Form 990 clarify the information that a conflict of interest policy should cover for purposes of line 12. The policy should: define conflicts of interest, identify the classes of individuals within the organization covered by the policy, facilitate disclosure of information that may help identify conflicts of interest, and specify procedures to be followed in managing conflicts of interest.⁹⁶

The instructions define a conflict of interest, stating that a conflict arises when a person in a position of authority over an EO (such as an officer, director, or manager) may benefit financially from a decision he or she could make in such a capacity.⁹⁷ The benefit may include indirect benefits, such as to family members, or businesses with which the person is closely associated. For purposes of this section of Form 990, conflicts of interest specifically do *not* include issues surrounding a person's competing or respective duties to the EO and to another organization — such as by serving on the boards of both organizations — that do not involve a material financial interest or benefit to that individual. Such “dualities of interest” do not have to be addressed in the conflict of interest policy for an EO to answer “yes” to Part VI, line 12a.⁹⁸

If an EO answers “yes” to line 12a, the organization must disclose whether its officers, directors, and key employees are required to annually disclose interests that could give rise to potential conflicts of interest. The instructions to Form 990 provide that an EO may answer “yes” if the organization's officers, directors, and key employees are required to make annual (or more frequent) disclosures of interests that could give rise to conflicts of interest, such as a list of family members, substantial business or investment holdings, and other transactions or affiliations with businesses and other organizations, including those of family members.⁹⁹

EOs must also disclose whether the organization regularly and consistently monitors and enforces compliance with the policy, and if “yes,” the organization must describe in Schedule O how this is done. The description should include an explanation of the persons covered by the policy, the organizational level at which a determination of whether a conflict exists is made, and the organizational level at which actual conflicts are reviewed. In addition, EOs must explain any restrictions imposed on persons who have an actual conflict, such as whether they are excluded from participation in the governing body's deliberations and decisions in the transaction.

In recent years, the IRS has clearly encouraged EOs to adopt a written conflict of interest policy. In *Governance and Related Topics – 501(c)(3) Organizations*, the IRS suggested that EOs adopt a conflicts policy that addresses directors' and officers' duty of loyalty to the organization. The duty of loyalty requires a director or officer of an EO to act in the interest of the organization, rather than in the personal interest of the individual, or some other person or

⁹⁶ 2008 Instructions for Form 990, at p. 18.

⁹⁷ *Id.*

⁹⁸ Peregrine, Michael W., “More Than Just Conflicts,” at p. 154.

⁹⁹ 2008 Instructions for Form 990, at p. 18.

organization.¹⁰⁰ The instructions to IRS Form 1023, the application for recognition of exemption under Section 501(c)(3), include a sample conflict of interest policy. Form 1023 asks whether EOs that are applying for exemption under Section 501(c)(3) have adopted a conflict of interest policy that is consistent with the IRS's sample policy.¹⁰¹ While Section 501(c)(3) does not explicitly require an organization to have such a policy in place, it is clear that the IRS is looking for such a policy when initially determining whether an organization qualifies for exemption, and that an organization may have an easier time clearing the determination hurdle if it has adopted the type of conflicts policy that the IRS has promoted.¹⁰²

Nonprofit industry groups have also recommended adoption of a written conflict of interest policy as a "best practice." In its Principles for Good Governance, the Panel on the Nonprofit Sector states that conflicts of interest arise when an officer's or director's duty of loyalty to the EO conflicts with a competing financial or personal interest that he or she (or his or her relative) may have in a proposed transaction. Some of these transactions may be illegal or unethical, while others may be in the EO's best interest, as long as certain clear procedures are followed.¹⁰³ It is important that EOs put in place a transparent process, in which board members engage, to understand the nature of the conflict and whether it can be appropriately managed.¹⁰⁴

Legal counsel can help EOs tailor the sample policy to their own situations and needs. The sample policy is a starting point, but it does not thoroughly cover the conflicts review and decision-making process, and larger, more sophisticated EOs may require a more detailed policy. The type of policy contemplated by line 12a of Form 990 covers only conflicts that involve a material financial interest, but EOs may wish to have one conflicts policy that covers other topics and guides directors and officers in fulfilling their fiduciary duties. The duty of loyalty is a state law concept, and encompasses conflicts of interest that do not necessarily involve a material financial relationship. EOs may also wish to tailor their conflicts policies to cover all arrangements or transactions with interested persons that must be disclosed on the new Schedule L to Form 990, to ensure that such transactions are subject to disclosure requirements and review by independent board members.

The IRS's sample policy does not include a questionnaire that requires directors and officers to disclose all of the relationships and interests that the revised Form 990 now requires EOs to report. EOs may consider combining the conflict of interest questionnaire with questions about director independence and relationships among directors and officers to satisfy the various "reasonable effort" standards described in the Form 990 instructions.

¹⁰⁰ Governance & Related Topics, at section 4.B.

¹⁰¹ IRS Form 1023, Part V, line 5a.

¹⁰² The IRS has required a conflict of interest policy as a condition for exemption in limited cases involving the health care arena, and in certain low-income housing joint ventures. See Memorandum for Manager, EO Determinations, from Director, EO Rulings and Agreements (July 30, 2007), at p. 2, available at http://www.irs.gov/pub/irs-tege/lihtcp_choimemo_073007.pdf (last visited February 12, 2009).

¹⁰³ Principles of Good Governance, at p. 12.

¹⁰⁴ Id. at p. 13.

2. Executive Compensation

Part VI, line 15 of the revised Form 990 requires EOs to disclose information regarding the process for determining compensation of certain management officials, including the organization's CEO, Executive Director, or top management official, as well as other officers or key employees of the organization. EOs must describe the process for determining compensation in Schedule O. Although Form 990 does not specifically ask whether an EO has adopted a written policy that governs the executive compensation determination process, line 15 of Part VI is included in a section with other questions about written governance policies. EOs may wish to adopt a written executive compensation philosophy and/or establish a compensation committee that has a written charter defining the committee's responsibilities.

Section 501(c)(3) and 501(c)(4) EOs may not pay more than reasonable compensation for services rendered to the organization.¹⁰⁵ Section 4958 provides for an "intermediate sanction," short of revoking the EO's exempt status, for excess benefit transactions between the EO and disqualified persons. The intermediate sanctions rules set out optional procedures that Section 501(c)(3) and 501(c)(4) EOs may choose to follow, in order to create a rebuttable presumption of reasonableness — a presumption that the compensation it pays to a disqualified person is reasonable. The procedures involve three steps: (1) approval in advance by a disinterested board or committee; (2) reliance upon appropriate data as to comparability; and (3) concurrent documentation of the decision, including a description of the comparability data relied upon.¹⁰⁶ If the EO satisfies this three-step process, the IRS may rebut the presumption to find an excess benefit transaction only if it produces "contrary evidence to rebut the probative value of the comparability data relied upon" by the EO's authorized body.¹⁰⁷ The questions at Part VI, line 15 of Form 990 inquire as to whether an EO's process for determining certain executive compensation included all three of the steps required to satisfy the rebuttable presumption of reasonableness.

a. Approval in advance by an independent, disinterested body

The optional rebuttable presumption procedures start with ensuring that the compensation decision is made by an independent body. This step will be satisfied if the members of the governing body have no conflict of interest in setting the individual's compensation, and receive no personal benefit with respect to the EO's payment of such compensation. While a traditional conflict of interest policy requires disclosure of both actual and potential conflicts and provides procedures for managing conflicts of interest, it is important to note that each member of the authorized body for purposes of the rebuttable presumption must have a complete absence of conflicts with respect to the compensation or transaction at issue.¹⁰⁸ The instructions to Form

¹⁰⁵ Compensation in excess of what is reasonable will be deemed an excess benefit transaction or private inurement, depending on the identity of the person providing the services (*i.e.*, whether a "disqualified person" or not).

¹⁰⁶ Treas. Reg. § 53.4958-6(a).

¹⁰⁷ Treas. Reg. § 53.4958-6(b).

¹⁰⁸ Peregrine, at p. 157. To satisfy this step in the rebuttable presumption process, an EO must establish that when the authorized body approved a particular compensation arrangement, none of the members of the authorized body had a conflict of interest regarding the proposed transaction. An exception exists for a voting member of the authorized body who met with the other members only to answer questions, recused himself or herself from the meeting, and was not present during debate and voting on the proposed transaction. Treas. Reg. § 53.4958-6(c)(1)(ii)

990 require EOs to use the definition of “conflict of interest” from the intermediate sanctions rules for purposes of the questions at Part VI, line 15a.

Federal tax law allows a board of directors to delegate compensation decisions to a committee of the board, if such delegation is also authorized by the EO’s bylaws and state nonprofit corporation law.¹⁰⁹ Washington’s nonprofit corporations statute provides that a board of directors may create one or more committees, which exercise the authority of the board of directors in the management of the corporation.¹¹⁰ To take advantage of the rebuttable presumption, EOs may wish to establish a compensation committee comprised entirely of independent board members that analyzes and makes recommendations regarding executive compensation, and require the full board of directors to review and finally approve such compensation. This follows emerging best practices in nonprofit governance. Alternatively, an EO’s board may delegate final authority to approve executive compensation to the compensation committee, which also fully complies with all applicable law and satisfies the first step in the rebuttable presumption procedures.

A compensation committee should be guided by a charter, adopted by the EO’s board of directors, under which it will seek to take all steps set out in the rules regarding the rebuttable presumption of reasonableness. Pursuant to that charter, the committee should develop goals and performance criteria to be used in determining annual and long-term executive compensation, and recommendations to be presented to the full board of directors. The compensation committee may also adopt a written compensation philosophy policy statement, which describes the values and parameters the committee will take into account when establishing market-based executive compensation, including: ensuring that the compensation packages paid to the EO’s executives constitute no more than reasonable compensation that is fair to the executive, allowing the organization to attract and maintain the best available leadership, and at the same time promoting the organization’s mission.

If the board of directors does not wish to delegate executive compensation decisions to a committee, the board should adopt a written executive compensation policy that would include many of the same provisions as covered by a compensation committee charter. The policy should provide that any director who has a conflict of interest with respect to the executive compensation at issue must recuse himself or herself from the meeting, and must not be present during debate and voting on the proposed compensation in order to comply with the rebuttable presumption’s requirement of an independent, disinterested governing body.

b. Reliance upon appropriate data as to comparability

The intermediate sanctions rules provide that relevant information regarding comparability of executive compensation includes: compensation levels paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions; the availability of similar services in the geographic area of the applicable tax-exempt organization; and current compensation surveys compiled by independent compensation consultants.¹¹¹ In

¹⁰⁹ Treas. Reg. § 53.4958-6(c)(1)(B).

¹¹⁰ RCW 24.03.115.

¹¹¹ Treas. Reg. § 53.4958-6(c)(2)(i).

establishing reasonable compensation, an EO may use comparability data from both other EOs and for-profit employers. An organization should look to the best available data, and the data from the most comparable organizations in terms of size, services, and types of positions, to determine the reasonableness of compensation. EOs with annual gross receipts of less than \$1 million can meet the comparability data requirements by reviewing data on compensation packages for similar positions offered by three comparable organizations operating in the same or similar communities.¹¹²

When determining whether the authorized body had appropriate data as to comparability, the IRS must also consider the knowledge and expertise of the members of that authorized body. If the members of an EO's compensation committee, given their knowledge and expertise, have information sufficient to determine whether the compensation arrangement with a disqualified person in its entirety is reasonable, then the committee has appropriate data as to comparability.¹¹³ The committee should include individuals with backgrounds in finance, and preferably some of whom have prior experience in compensation methodology.

Compensation consultants may assist EOs in obtaining appropriate comparability data, and comparing the proposed executive compensation arrangements against that comparability data. The IRS will look to the independence of any compensation consultant, and the quality of any study, survey, or other data used to establish executive compensation.¹¹⁴ EOs may obtain a reasoned written opinion on the reasonableness of the compensation from a consultant to help demonstrate satisfaction of this step in the rebuttable presumption process. The intermediate sanctions rules provide that the governing body may avoid the organization manager-level excise tax if it relies on a reasoned written opinion of an appropriate professional¹¹⁵; however, the governing body must still examine the comparability data to reach its own conclusion as to the reasonableness of compensation when compared against the data, and document the rationale for its decision in contemporaneous records.

c. Written documentation of the decision

To satisfy the third step in the procedures for the rebuttable presumption, the governing body must adequately document the basis for its determination concurrently with making its determination. To constitute "adequate documentation" for purposes of satisfying the rebuttable presumption of reasonableness, the written or electronic records of the authorized body must note: (i) the terms of the transaction that was approved and the date it was approved, (ii) the members of the authorized body who were present during debate on the transaction that was approved and those who voted on it, (iii) the comparability data obtained and relied upon by the authorized body and how the data was obtained, and (iv) any actions taken with respect to consideration of the transaction by anyone who is otherwise a member of the authorized body but who had a conflict of interest with respect to the transaction.¹¹⁶ If the authorized body determines that reasonable compensation is higher or lower than the range of comparability data obtained, the authorized body must record the basis for that determination.

¹¹² Treas. Reg. § 53.4958-6(c)(2)(ii).

¹¹³ Treas. Reg. § 53.4958-6(c)(2)(i).

¹¹⁴ Governance and Related Topics – 501(c)(3) Organizations, at section 4.A.

¹¹⁵ Treas. Reg. § 53.4958-1(d)(4)(iii).

¹¹⁶ Treas. Reg. § 53.4958-6(c)(3)(i).

To constitute “concurrent” documentation, the board or committee must prepare such documentation before the next meeting of the board or committee that authorized the compensation, or within 60 days, whichever is later.¹¹⁷ Note that Part VI, line 8 of Form 990 asks whether an EO contemporaneously documented every meeting held and action taken during the year by the organization’s governing body and all committees with board-delegated powers.

d. Implications for EO Governance

The IRS encourages charitable EOs to rely on the rebuttable presumption procedures set out in the intermediate sanctions rules, and executive compensation continues to be a focus point in the agency’s examination program.¹¹⁸ While the procedures are optional, it is likely that the IRS will be scrutinizing Form 990 returns for “yes” responses to the questions at Part VI, line 12. It is notable that Congress specifically found that EOs are more likely to make better decisions about the fairness of executive compensation and certain other transactions between the EO and disqualified persons if the organizations follow the three specified governance steps.¹¹⁹ As such, satisfying the rebuttable presumption steps appears to be a “best practice” recommended by both the IRS and Congress.

In its Principles for Good Governance, the Panel on the Nonprofit Sector recommends that an EO’s governing documents should require the full board of directors to evaluate the CEO’s performance and annually approve the CEO’s compensation annually, before making any change in compensation.¹²⁰ If the board delegates authority to a compensation committee, the Panel recommends that the committee be required to report its findings and recommendations to the full board for approval. The board should then document the basis for its decision. While the board or compensation committee should approve the compensation of the CEO and a range of compensation for other persons who are in a position to exercise substantial control of the EO’s resources, the Panel recommends that the CEO should set the compensation of other staff, consistent with the reasonable compensation guidelines established by the board.¹²¹

Even if an EO did not fulfill all steps required for the rebuttable presumption of reasonableness, however, that does not necessarily mean that the compensation it paid to a disqualified person during that taxable year was substantively unreasonable. The rebuttable presumption procedures are not required procedures for EOs under federal tax law, and EOs do not expose themselves to penalties for failure to satisfy the three-step process. The intermediate sanctions rules provide that the fact that a transaction between an organization and a disqualified person is not subject to the rebuttable presumption does not create “any inference that the transaction is an excess benefit transaction.”¹²²

¹¹⁷ Treas. Reg. § 53.4958-6(c)(3)(ii).

¹¹⁸ Governance and Related Topics – 501(c)(3) Organizations, at section 4.A.

¹¹⁹ ACT Report, at p. 30, citing H.R. Rep. No. 104-506, at p. 57 (1996).

¹²⁰ Principles for Good Governance, at p. 24.

¹²¹ Id. at p. 25.

¹²² Treas. Reg. § 53.4958-6(e).

3. Whistleblower Policy

Part VI, line 13 asks whether an EO has a written whistleblower policy. Whistleblower policies have become more prevalent following adoption of the Sarbanes-Oxley Act (SOX), which was the Congressional response to the Enron collapse and other scandals involving mismanagement of public corporations in the for-profit sector. SOX does not generally pertain to EOs, and it does not explicitly require EOs to adopt a written whistleblower policy. SOX does, however, prohibit all organizations, including EOs, from retaliating against whistleblowers who report the commission or possible commission of a federal offense to law enforcement.¹²³ While the application of SOX to EOs is therefore limited, the legislation has caused many organizations to consider adopting a policy that is intended not only to safeguard against violations of SOX, but also applies more broadly to prohibit retaliation against whistleblowers who report lesser offenses by the organization or its management.

The IRS encourages EOs to adopt a whistleblower policy with broader application. The IRS included adoption of a whistleblower policy in its draft good governance practices for Section 501(c)(3) organizations.¹²⁴ An effective whistleblower policy, as described by the IRS, establishes procedures for employees to report in confidence any suspected financial impropriety or misuse of the charity's resources. According to the Form 990 instructions, the purpose of a whistleblower policy is to encourage staff and volunteers to come forward with credible information on illegal practices, or violations of the organization's adopted policies. Whistleblower policies should specify that the organization will protect the individual from retaliation, and identify the parties to whom such information can be reported (whether they are staff, board members, or outside parties).¹²⁵

Independent Sector's "Checklist for Accountability" includes adoption of such a whistleblower policy as one of its suggested best practices for charitable organizations. According to the Checklist, encouraging individuals to come forward as soon as possible with information on illegal practices or violations of adopted policies will help protect the organization's credibility. Employees and volunteers who identify misbehavior must feel safe to report it.¹²⁶

In its Principles for Good Governance, the Panel on the Nonprofit Sector recommends that every charitable EO, regardless of size, should have clear policies and procedures that allow staff, volunteers, or clients of the organization to report suspected wrongdoing within the organization without fear of retribution.¹²⁷ The policy may encourage individuals to raise concerns first within the organization, rather than contacting the press or regulatory agencies, and may allow the EO's managers to become aware of and address problems before serious harm is done to the organization.¹²⁸

¹²³ 18 U.S.C. Section 1513(e).

¹²⁴ "Good Governance Practices for 501(c)(3) Organizations," (on file with author); now included in Governance and Related Topics, at section 4.G.

¹²⁵ 2008 Instructions for Form 990, at p. 18.

¹²⁶ Checklist for Accountability, at p. 3.

¹²⁷ Principles for Good Governance, at p. 14.

¹²⁸ Id.

An effective whistleblower policy should include a description of the chain of reporting within the organization, and may provide alternative reporting channels if the person raising the concern feels uncomfortable reporting to his or her supervisor, or the supervisor is the subject of the complaint. Small EOs, including some family foundations, may wish to designate an external advisor to whom concerns can be reported, while larger EOs may offer anonymous reporting services via a telephone number or email address.¹²⁹ The policy should name the individual, governing body, or committee that has ultimate responsibility for investigating and resolving all reported concerns and allegations related to the policy. While the policy should allow individuals to raise concerns on an anonymous basis, it should state that if the organization has insufficient information to contact the person making the complaint, the organization may be unable to pursue investigation of those concerns. Whistleblowers who provide identifying information should be assured that the organization will keep the individual's identity confidential except under certain circumstances, including when identification is required by law.

Legal counsel can help tailor a policy to meet an organization's particular needs, including a description of the misconduct that the policy is intended to help investigate and prevent, the procedures for investigating allegations, punitive actions against those who retaliate against whistleblowers in violation of the policy, and the consequences for making allegations maliciously or in bad faith.

4. Document Retention and Destruction Policy

Part VI, line 14 requires an EO to disclose whether it has a written document retention and destruction policy. SOX imposes criminal liability on organizations, including EOs, that destroy records with the intent to obstruct a federal investigation.¹³⁰ Beyond this limited application of SOX, EOs are subject to other records retention requirements. For example, federal tax law requires EOs to retain books and records relevant to their tax exemptions and their filings with the IRS, to explain items reported on Form 990 and support their exempt status. EOs may also be subject to records retention requirements of other regulatory agencies or industry organizations. The policy should be drafted to satisfy each of those various records retention requirements.

The instructions to Form 990 state that such a policy identifies the record retention responsibilities of staff, volunteers, board members, and outsiders for maintaining and documenting the storage and destruction of the organization's documents and records.¹³¹ In Governance and Related Topics –501(c)(3) Organizations, the IRS stated that it encourages charities to adopt a written policy establishing standards for document integrity, retention, and destruction.¹³² While the Form 990 refers to a "document" retention policy, the policy should include guidelines for handling electronic files, as well as paper documents. The policy should cover backup procedures, archiving of documents, and regular check-ups of the reliability of the system. Larger EOs may want the policy to identify an individual record manager for each discrete category of records.

¹²⁹ Id.

¹³⁰ 18 U.S.C. Section 1519.

¹³¹ 2008 Instructions for Form 990, at p. 19.

¹³² Governance and Related Topics – 501(c)(3) Organizations, at section 4.F.

Retention periods will vary for different types of records. The document retention and destruction policy should set out categories of records, types of records within those categories, and the period of time for which each of those types of records will ordinarily be retained by the organization. EOs should keep certain records permanently, including: Forms 990 and supporting documents, correspondence with the IRS or state regulators, organizational documents such as articles of incorporation and bylaws, board meeting minutes and unanimous written consents, opinion letters from legal counsel or compensation consultants. Other types of records should be scheduled for destruction in a certain number of years, which will vary depending upon the significance of the records and whether they are subject to records retention requirements of regulatory agencies or other groups. A record retention and destruction policy should also specify procedures to follow in the event of any pending or imminent investigation, audit, or lawsuit involving the organization, ensuring that any document destruction is immediately halted if an official investigation of the EO is underway or anticipated.¹³³

The ACT Report criticizes inclusion of the questions regarding written whistleblower and document retention policies in the new Form 990. Neither has an explicit relationship to the tax rules. According to the Report, while such policies may be important for certain large EOs, they may present an unnecessary burden for smaller and certain other types of EOs. Large EOs, such as hospitals, typically would already have such policies in place, so they do not need encouragement from the IRS in order to do so.

5. Joint Venture Policy

In Part VI, line 16a, the revised Form 990 first asks whether an EO invested in, contributed assets to, or participated in a joint venture or similar arrangement with a taxable entity during the year. If so, the organization is required to disclose at line 16b whether it has adopted a written policy or procedure requiring the organization to evaluate its participation in joint venture arrangements under applicable federal tax law, and taken steps to safeguard the organization's exempt status with respect to such joint venture arrangements. It is important to note that if an EO responds "no," that the organization did not participate in a joint venture or similar arrangement during the year, that it is not required to respond to the further question regarding a written policy. It is also noteworthy that in order to be disclosable on line 16a, the joint venture or similar arrangement must be with a *taxable entity*, not a partnership, collaboration or other arrangement with another EO.

The instructions for Form 990 define a joint venture or similar arrangement to mean any joint ownership or contractual arrangement through which there is an agreement to jointly undertake a specific business enterprise, investment, or exempt-purpose activity without regard to: (1) whether the EO controls the venture or arrangement, (2) the legal structure of the venture or arrangement, or (3) whether the venture or arrangement is treated as a partnership, association, or corporation for federal income tax purposes. Also, an organization should answer "no" on line 16a if the only ventures or arrangements in which it is involved meet both of the following requirements: (1) 95% or more of the venture's or arrangement's income for its tax year is not treated as unrelated business income because it is described in Sections 512(b)(1)-(5) (generally passive investment income such as dividends, interest, royalties, and rents, as distinguished from

¹³³ Principles for Good Governance, at p. 15.

net income generated by active participation in a business venture), and (2) the primary purpose of the EO's participation in the arrangement is to produce income or appreciation of property.¹³⁴

If an EO answers "yes" to line 16a, it must further disclose at line 16b whether it has adopted a policy that safeguards the organization's exempt status with respect to the reported joint venture. When an EO participates in a joint venture that also includes a taxable organization, the EO should structure the joint venture in a manner that does not jeopardize its own exemption. Generally, the less substantial the charitable activities carried on by the EO outside the joint venture, the greater the need will be for the EO to maintain control over the joint venture. A joint venture must also be analyzed to determine whether income from its activities allocated to the EO will constitute unrelated business income. The income may not constitute unrelated business income if the joint venture's activities further the EO's exempt purposes.

The instructions provide some examples of safeguards that might be included in such a policy. The EO could: require sufficient control over the joint venture to ensure that the venture will further the EO's exempt purpose; require that the joint venture give priority to exempt purposes rather than maximizing profits for the other participants; prohibit the joint venture from engaging in activities that would jeopardize the EO's exemption (*e.g.*, political intervention or substantial lobbying activities, which violate the requirements for exemption under Section 501(c)(3)); require that all contracts entered into with the EO be on terms that are at least arm's length, or are more favorable to the EO.¹³⁵

Because each joint venture or similar arrangement will likely be structured differently and include terms specific to that arrangement, an effective joint venture policy will focus not on the substance or actual structure of a joint venture, but rather on the procedures used by the EO's governing body in determining whether to engage in or continue a joint venture. The policy should define what is meant by a joint venture or similar arrangement, based on the definition from the instructions to Form 990. It should also require the governing body to include some or all of the safeguards from the Form 990 instructions in written joint venture agreements, as applicable. If the organization participates or plans to participate in sophisticated joint venture arrangements that have complex structures, legal counsel may assist in tailoring a policy that includes additional safeguards, as well as joint venture agreements that are consistent with the EO's exempt status.

V. CONCLUSION

The IRS is currently focused on EO governance issues, and that focus is reflected in the revised version of Form 990, which includes an entire section devoted to governance and management practices, along with governance-related questions included elsewhere in the form. Criticisms of the IRS's focus on governance, contained in the ACT Report, include concerns that merely by asking about specific governance practices, the IRS is a powerful force that can drive EO behavior, pressuring EOs to adopt the specified practices.¹³⁶ Prescribing a "punch list" of governance practices may inadvertently send a message to EO boards, causing them to believe

¹³⁴ 2008 Instructions for Form 990, at p. 19.

¹³⁵ *Id.*

¹³⁶ ACT Report at p. 1.

that governance is more a question of specific policies and procedures than of less tangible factors such as values, will, and commitment.¹³⁷ Policies may be no more than pieces of paper left in a file cabinet, and may actually be counterproductive if those policies are misguided or legally defective; a poorly crafted policy or one that an EO is not in a position to enforce can create liability.¹³⁸

While the governance practices suggested by the questions in the revised Form 990 are not “one size fits all” approaches to these issues, they are a starting point for discussions within EOs to determine what procedures and policies will advance their missions, present their organizations in the best possible light to the public and regulatory agencies, and ensure that assets are used for exempt purposes. EOs should perform a cost-benefit analysis when determining whether to adopt a particular governance practice.¹³⁹ Legal counsel may assist EOs in crafting governance practices and written policies that fit the organization’s particular situation. It is important to note that merely adopting a practice or policy in order to check off a box on the Form 990 will not improve an EO’s governance, if those policies are not effectively implemented.¹⁴⁰

¹³⁷ Id. at p. 44.

¹³⁸ Id. at pp. 45, 53.

¹³⁹ Id. at p. 54.

¹⁴⁰ Id. at p. 45.

APPENDIX 1

Governance Items Reported on Revised Form 990

The revised version of Form 990 increased the number of items that require information about governance practices, procedures, and policies. The schedules to Form 990 also require an organization to report particular information regarding executive compensation and transactions with insiders. These items are located both in the core form and on Schedules J and L as follows:

<u>Location on Revised Form 990</u>	<u>Description of Item</u>
Part I, Summary, line 3	Number of voting members of the governing body
Part I, Summary, line 4	Number of independent voting members of the governing body
Part I, Summary, line 15	Salaries, other compensation, and employee benefits for the prior year and current year
Part IV, Checklist of Required Schedules, line 23	Requires organizations to complete Schedule J, Compensation Information, for certain responses in Part VII of the core form
Part IV, Checklist of Required Schedules, line 25	Requires organizations that engaged in an excess benefit transaction with a disqualified person during the current or prior year to complete Schedule L, Transactions with Interested Persons
Part IV, Checklist of Required Schedules, line 26	Requires organizations that had outstanding loans to an insider at the end of their tax year to complete Schedule L, Transactions with Interested Persons
Part IV, Checklist of Required Schedules, line 27	Requires organizations that provided a grant or other assistance to an insider, substantial contributor, or to a person related to such an individual to complete Schedule L, Transactions with Interested Persons
Part IV, Checklist of Required Schedules, line 28	Requires organizations whose insiders or their family members have a direct or indirect business relationship with the organization, or who serve as insiders of an entity that does business with the organization to complete Schedule L, Transactions with Interested Persons
Part VI; Governance, Management, and Disclosure; Section A, Governing Body and Management; line 1a	Number of voting members of the governing body

<u>Location on Revised Form 990</u>	<u>Description of Item</u>
Part VI; Governance, Management, and Disclosure; Section A, Governing Body and Management; line 1b	Number of voting members that are independent
Part VI; Governance, Management, and Disclosure; Section A, Governing Body and Management; line 2	Questions whether the organization's insiders have a family or business relationship with any other insider
Part VI; Governance, Management, and Disclosure; Section A, Governing Body and Management; line 3	Questions whether the organization delegates control over management duties customarily performed by certain insiders to a management company or other person
Part VI; Governance, Management, and Disclosure; Section A, Governing Body and Management; line 4	Questions whether the organization made any significant changes to its organizational documents since the prior Form 990 was filed
Part VI; Governance, Management, and Disclosure; Section A, Governing Body and Management; line 6	Questions whether the organization has members or stockholders
Part VI; Governance, Management, and Disclosure; Section A, Governing Body and Management; line 7a	Questions whether the organization has members, stockholders, or other persons who may elect one or more members of the governing body, and whether any decisions of the governing body are subject to approval by members, stockholders, or other persons
Part VI; Governance, Management, and Disclosure; Section A, Governing Body and Management; line 8	Questions whether the organization contemporaneously documents the meetings held or written actions undertaken during the year by its governing body and each committee with authority to act on behalf of the governing body (contemporaneous documentation is one step in the rebuttable presumption process)
Part VI; Governance, Management, and Disclosure; Section A, Governing Body and Management; line 9	Questions whether the organization has local chapters, branches, or affiliates, and if so, whether the organization has written policies and procedures governing the activities of such chapters, branches, or affiliates to ensure their operations are consistent with those of the organization
Part VI; Governance, Management, and Disclosure; Section A, Governing Body and Management; line 10	Questions whether a copy of Form 990 was provided to the organization's governing body before it was filed; all organizations must describe in Schedule O the process, if any, the organization uses to review the Form 990

<u>Location on Revised Form 990</u>	<u>Description of Item</u>
Part VI; Governance, Management, and Disclosure; Section B, Policies; line 12	Questions whether an organization has a written conflict of interest policy, with insiders required to annually disclose interests that could give rise to conflicts, and whether compliance with the policy is regularly monitored and enforced
Part VI; Governance, Management, and Disclosure; Section B, Policies; line 13	Questions whether the organization has a written whistleblower policy
Part VI; Governance, Management, and Disclosure; Section B, Policies; line 14	Questions whether the organization has a written document retention and destruction policy
Part VI; Governance, Management, and Disclosure; Section B, Policies; line 15	Questions eliciting information as to whether the organization followed the rebuttable presumption procedures when determining compensation of certain listed persons
Part VI; Governance, Management, and Disclosure; Section B, Policies; line 16	Questions whether the organization participates in a joint venture and if so, whether the organization has adopted a written policy or procedure requiring the organization to evaluate the joint venture arrangements under federal tax law, and taken steps to safeguard the organization's exempt status with respect to such arrangements
Part X, Balance Sheet, line 5	Loans to certain interested persons
Part X, Balance Sheet, line 6	Loans to other disqualified persons
Part X, Balance Sheet, line 22	Loans to the organization from certain interested persons
Part XI, Financial Statements and Reporting, line 2	Questions whether the organization's financial statements were compiled, reviewed, or audited by an independent accountant and if so, whether the organization has an audit committee
Schedule J, Compensation Information, Part I, line 1	Check-boxes for specified perquisites provided to insiders, such as first-class travel and travel for companions, housing, health club dues, or other listed benefits; and whether the organization followed a written policy for payment or reimbursement of those expenses

<u>Location on Revised Form 990</u>	<u>Description of Item</u>
Schedule J, Compensation Information, Part I, line 2	Questions whether an organization required substantiation prior to reimbursing or allowing expenses incurred by insiders regarding items checked in Schedule J, line 1a
Schedule J, Compensation Information, Part I, line 3	Check-boxes for specified methods used to establish the compensation of the organization's CEO/Executive Director
Schedule L, Transactions with Interested Persons, Part I	Excess benefit transactions
Schedule L, Transactions with Interested Persons, Part II	Loans to and from interested persons
Schedule L, Transactions with Interested Persons, Part III	Grants or assistance benefitting interested persons
Schedule L, Transactions with Interested Persons, Part IV	Business transactions involving interested persons

APPENDIX 2

Resources for Model Written Policies

The following websites offer sample written governance policies that EOs may wish to tailor to meet their own situations and needs. These sample policies may not contain any provisions required under state law, or all of the relevant provisions about which the IRS is inquiring on the new Form 990.

1. Conflict of Interest Policies

- IRS Sample Policy for Form 1023: <http://www.irs.gov/instructions/i1023/ar03.html>
- Minnesota Attorney General's office:
<http://www.ag.state.mn.us/pdf/charities/ConflictInterestPolicy.pdf>
- National Council of Nonprofits: <http://www.councilofnonprofits.org/?q=conflict-of-interest>

2. Compensation Committee Charters; Executive Compensation Policies

- Donors Forum: http://www.donorsforum.org/forms_pdf/Compensation_Policy.pdf
(includes three samples)

3. Whistleblower Policies

- Independent Sector: <http://www.independentsector.org/about/finresp.html>
- National Council of Nonprofits: <http://www.councilofnonprofits.org/?q=whistleblower>
- New York State Community Action Association:
http://www.nyscaaonline.org/MembersArea/BoardTraining/OtherContent/FinancialOversightPoliciesAndReporting/9_04_Sample_Whistleblower_Policies.pdf

4. Document Retention and Destruction Policies

- National Association of Veterans' Research and Education Foundations:
http://www.navref.org/library/Records_Retention.htm
- Nonprofit Center of Northeast Florida:
www.nonprofitctr.org/attachments/DocRetDest.doc

5. Joint Venture Policies

- American Health Lawyers Association:
http://www.healthlawyers.org/Members/PracticeGroups/TF/PracticeCorner/Documents/JV_Policy.pdf (this sample is specifically for hospital systems)

- Evangelical Council for Financial Accountability:
<http://www.ecfa.org/TopicDisplay.aspx?PageName=TopicJointVenturePOLICYLong>