

Part VI of the New Form 990

New Requirements for Reporting Governance Practices and Policies

John Christopher

Background

For several years the IRS has been showing its interest in the governance practices of tax exempt organizations. While acknowledging that the tax law does not require the disclosure of information on the governance practices of a filing entity, its stated position has been that well governed exempt organizations are more likely to be in compliance with the tax law. The IRS's position has now essentially become policy to be effectuated through the new Form 990, the final, filing version of which was posted to the IRS website on December 24, 2008.

The new Form 990 contains a section (Part VI) devoted to the collection of information on a reporting organization's governance practices. Importantly, the Form 990-EZ *does not* have nearly the same level of questions relating to governance. Despite the IRS's admonition that the tax law does not require the disclosure of governance practices, an exempt organization Filing Form 990 should expect that failure to do so will be viewed negatively by the IRS.

As the first filing season under the new Form 990 is about to commence, it is important that the Boards of Tax Exempt Organizations ensure that the staff members charged with collecting the information to be reported on the Form 990 are educated with respect to these new rules.

Which Return to File

The Form 990 series of tax reporting forms is filed by virtually all tax exempt organizations (notable exceptions are churches, certain types of schools, mission societies, governmental units and private foundations (private foundations file Form 990-PF)). The Form 990 series is comprised of three main forms: 990, 990-EZ and 990-N. Form 990-N is a completely new form, just implemented in the last year, which is filed online by exempt organizations with gross receipts of \$25,000 or less.

Form 990-EZ is the "short-form" return for an organization exempt from income tax. Historically, the 990-EZ has been filed by small organizations (i.e., for 2007, organizations having gross receipts of less than \$100,000 and total assets of less than \$250,000). For 2008, much larger organizations will be able to file the Form 990-EZ (see chart, below). The Form 990-EZ has been revised for 2008, but much more modestly than the Form 990. *A significant difference* between the new Form 990-EZ and the new Form 990 is that new Form 990-EZ *does not* request the magnitude of information on governance that Form 990 does (see below). As responding to the governance provisions of the new Form 990 may be quite burdensome or problematic for some organizations, *it may be beneficial for an entity permitted to file Form 990-EZ to do so* for 2008. That way it can learn from the mistakes of larger tax exempt organizations, and use the time to fully design and implement appropriate governance measures and policies.

In contrast with the Form 990-EZ, the new Form 990 is substantially different from its predecessor in both format and, in some significant parts of the form, the type of information requested. The format of the new Form 990 is that of a core form of 11 pages that collects data common to all or most organizations, and a lot of schedules aimed at collecting data from organizations engaging in particular activities. With respect to the type of information requested, the new Form 990 will require many tax exempt organizations to collect and report different information than previously required.

Corresponding with the IRS's belief that a well governed organization is more likely to comply with tax rules, a substantial part of the new information requested on the core form relates to the governance of the organization. The questions asked on the form seem geared toward eliciting responses to help the IRS understand what decisions are being made by the persons in control of the organization (e.g., how are the organization's taxpayer subsidized assets being used) and also in understanding how the organization ensures the integrity of its decision making process. With respect to the last point, the IRS seeks to know whether the organization polices the decision making process through the implementation, monitoring and enforcement of policies aimed at: (i) preventing uninformed decision-making by the board; and (ii) discovering, disclosing and correcting improper activities of the board, officers, employees and others who are in a position to act on behalf of the organization.

As mentioned previously, gathering and analyzing the new information requested on Form 990 will be burdensome to some degree. This is particularly true for small and midsize organizations who cannot support a large administrative staff. To allow these organizations time to adjust to the new forms, the IRS is phasing in the new Form 990 during a three-year transition period. During the transition, an organization's annual filing requirement depends on its financial activity. The charts below indicate the general exempt organization filing requirements during the transition period.

<i>2008 Tax Year (Filed in 2009 or 2010)</i>	<i>Form to File</i>
Gross receipts normally \leq \$25,000	990-N
Gross receipts $>$ \$25,000 and $<$ \$ 1 million, and Total assets $<$ \$2.5 million	990-EZ or 990
Gross receipts \geq \$1 million, and/or Total assets \geq \$2.5 million	990
<i>2009 Tax Year (Filed in 2010 or 2011)</i>	<i>Form to File</i>
Gross receipts normally \leq \$25,000	990-N
Gross receipts $>$ \$25,000 and $<$ \$500,000, and Total assets $<$ \$1.25 million	990-EZ or 990

Gross receipts \geq \$500,000, and/or Total assets \geq \$1.25 million	990
<i>2010 Tax Year and later (Filed in 2011 and later)</i>	<i>Form to File</i>
Gross receipts normally \leq \$50,000	990-N
Gross receipts $>$ \$50,000 and $<$ \$200,000, and Total assets $<$ \$500,000	990-EZ or 990
Gross receipts \geq \$200,000, and/or Total assets \geq \$500,000	990

New Governance and Management Disclosures Under the New Form 990

If it is determined the new Form 990 is to be filed, then the organization, through its board, officers and key employees must be in a position to respond to the questions in Part VI of the new form titled "Governance, Management and Disclosure". The three sections of Part VI (Sections A, B and C) request information on the organization's Governing Body and Management, Policies and Disclosure respectively. In the instructions to Part VI, the IRS acknowledges that federal tax law does not mandate particular management structures, operational policies or administrative policies, but goes on to say, however, that every organization is required to answer every question in Part VI. *So, while it is legally acceptable to answer "no" to the questions in Part VI, it should not be done without careful consideration.* Answering "no" may raise suspicion as to the organization's compliance with the terms of its tax exempt status. A summary of the questions, and the types of information required to answer the questions, in Part VI follows.

Section A. Governing Body and Management

The questions in Section A of Part VI seek information related to the characteristics of the governing board (e.g. number of voting board members, number of voting board members that are independent), the familial and business relationships between board members and certain aspects of the decision making process of the board (e.g., committee authority, the maintenance of minutes and other records of board and committee meetings and the process of director review of the organization's completed Form 990 prior to filing).

In order to respond to the questions in Section A, the organization will have to:

1. Know who the voting board members of the organization are.

A **voting board member** is defined as a member of the organization's governing body with power to vote on all items that may come before the governing body.

2. *Know which voting board members are **independent**.*

A voting board member is **independent** if the member satisfies a three part test at all times during the organization's tax year:

1. The member was not compensated as an officer or other employee of the organization or of a related organization.
2. The member did not receive total compensation or other payments exceeding \$10,000 for the year from the organization or from a related organization as an independent contractor, other than reimbursement of expenses or reasonable compensation.
3. Neither the member, nor any family member of the member, was involved in a transaction with the organization that is an excess benefit transaction under Code Section 4958(c), a loan or a grant or similar economic assistance (including provision of goods, services, or use of facilities).

3. *Know whether any director, officer or **key employee** has a **family or business relationship** with any other director, officer or key employee.*

A **key employee** is any employee who meets all three of the following tests:

1. \$150,000 Test. Receives reportable compensation from the organization and all related organizations in excess of \$150,000 for the calendar year ending with or within the organization's tax year.
2. Responsibility Test. The employee:
 - a. has responsibilities, powers or influence over the organization as a whole similar to those of officers, directors, or trustees;
 - b. manages a discrete segment or activity of the organization that represents 10% or more of the activities, assets, income, or expenses of the organization, as compared to the organization as a whole; or
 - c. has or shares authority to control or determine 10% or more of the organization's capital expenditures, operating budget, or compensation for employees.
3. Top 20 Test. Is one of the 20 employees with the highest reportable compensation from the organization and related organizations for the calendar year ending with or within the organization's tax year, *and* also satisfies the \$150,000 Test and the Responsibility Test.

A **family relationship** includes spouses, ancestors, brothers and sisters (whether whole or half blood), children (whether natural or adopted), grandchildren, great-grandchildren, and spouses of brothers, sisters, children, grandchildren, and great-grandchildren.

A **business relationship** between two persons include the following:

1. One person is employed by the other in a sole proprietorship or by an organization with which the other is associated as a trustee, director, officer, key employee, or greater-than-35% owner.
2. One person is transacting business with the other (other than in the ordinary course of either party's business on the same terms as are generally offered to the public), directly or indirectly, in one or more contracts of sale, lease, license, loan, performance of services, or other transaction involving transfers of cash or property valued in excess of \$10,000 in the aggregate during the organization's tax year. Indirect transactions are transactions with an organization with which the one person is associated as a trustee, director, officer, key employee, or greater-than-35% owner.
3. The two persons are each a director, trustee, officer, or greater than 10% owner in the same business or investment entity.

Ownership is measured by stock ownership (either voting power or value) of a corporation, profits or capital interest in a partnership or limited liability company, membership interest in a nonprofit organization, or beneficial interest in a trust. Ownership includes indirect ownership (e.g., ownership in an entity that has ownership in the entity in question); there may be ownership through multiple tiers of entities.

4. *Know whether any management duties were delegated to a **management company** or other person.*

A **management company** is an organization that performs management duties for another organization customarily performed by or under the direct supervision of the other organization's officers, directors, trustees, or key employees. These management duties include, but are not limited to, hiring, firing, and supervising personnel; planning or executing budgets or financial operations; and supervising exempt operations or unrelated trades or businesses. They do not include administrative processes such as payroll, nor do they include investment management unless the organization provides investment management as part of its activities.

5. *Know whether any **significant changes** were made to the organizational documents since the last Form 990 was filed.*

Examples of **significant changes** to the organizational documents include changes to such documents:

- in the number, composition, qualifications, authority, or duties of the governing body's voting members;
- in the number, composition, qualifications, authority, or duties of the organization's officers or key employees;
- in the role of the stockholders or membership in governance;
- in the distribution of assets upon dissolution;
- in the provisions to amend the organizing or enabling document or bylaws;
- in the quorum, voting rights, or voting approval requirements of the governing body members or the organization's stockholders or membership;
- in the organization's exempt purposes or mission;

- in the policies or procedures regarding compensation of officers, directors, trustees, or key employees, conflicts of interest, whistleblowers, or document retention and destruction; and
- in the composition or procedures of an audit committee.

Significant changes must be described in the **Schedule O** to the new Form 990. **Schedule O** is essentially a blank page of the Form on which an organization will elaborate upon answers provided on the "core form."

*6. Know whether the board became aware of a **material diversion of assets**.*

For this purpose, a diversion is considered **material** if it exceeds the lesser of \$250,000 or 5 percent of the organization's gross receipts for its tax year or total assets as of the end of its tax year. A **diversion of assets** includes any unauthorized conversion or use of the organization's assets other than for the organization's authorized purposes, including but not limited to an embezzlement or theft.

If the board became aware of a material diversion of assets, the nature of the diversion, amounts or property involved, corrective actions taken to address the matter, and pertinent circumstances must be explained in Schedule O, though the person or persons who diverted the assets should not be identified by name.

*7. Know whether the organization has **members or stockholders**.*

An organization has members or stockholders if it is organized as a stock corporation, a joint-stock company, a partnership, a joint venture, or a limited liability company. A non-stock, non-profit, or not-for-profit corporation or association has members for this purpose if (1) the right to participate in and benefit from the organization's activities is limited primarily to members (as with a cooperative or mutual benefit corporation), (2) the members elect the members of the governing body (but not if the persons on the governing body are the organization's only members), (3) the members approve decisions of the governing body, or (4) the members may receive a share of the organization's profits, excess dues, or net assets upon the organization's dissolution.

A trust does not have members or stockholders.

The classes of members or stockholders should be described in Schedule O.

8. Know whether any person other than the board had the authority to appoint a member of the board.

In other words, know whether one or more persons (other than the organization's governing body itself, acting in such capacity) have the right to elect or appoint one or more members of the organization's governing body, whether periodically, as vacancies arise, or otherwise. If so, describe on Schedule O.

9. Know whether there are any categories of decisions of the board that are subject to the approval of members, stockholders or other person.

In other words, know whether one or more persons (whether members, stockholders, or otherwise) have

the right to approve or ratify decisions of the governing body, such as approval of the governing body's election or removal of members of the governing body, or approval of the governing body's decision to dissolve the organization. If so, describe on Schedule O.

*10. Know whether the board and committees kept **contemporaneous** minutes of meetings and maintained copies of written actions during the year.*

Documentation may include approved minutes, strings of e-mails, or similar writings that explain the action taken, when it was taken, and who made the decision. For this purpose, **contemporaneous** means by the later of (1) the next meeting of the governing body or committee (e.g., approving the minutes of the prior meeting), or (2) 60 days after the date of the meeting or written action.

*11. Know whether the organization has **local chapters, branches or affiliates** and, if so, know whether **written policies and procedures** exist governing the activities of the chapters, branches or affiliates to ensure their operations are consistent with those of the organization.*

The terms **local chapters, branches or affiliates** include organizations over which the organization has the legal authority to exercise supervision and control, such as subordinate organizations in a group exemption, as well as local units that are not separate legal entities under state law over which the organization has such authority.

Written policies and procedures for this purpose are documents used by the organization and its local units to address the policies, practices, and activities of the local unit. Such policies and procedures may include required provisions in the chapter's articles of organization or bylaws, a manual provided to chapters, a constitution, or similar documents.

12. Know whether a copy of the completed Form 990 (and all schedules) was provided to the governing body prior to filing.

Clearly, here, the organization will want to say that it has provided the completed form 990 to its board prior to it being filed. To do so, the final Form 990 and schedules must be provided to each voting member of the organization's governing body, whether in paper or electronic form, prior to its filing with the IRS.

13. Know whether a process of reviewing the Form 990 was undertaken and, if so, be able to describe it.

An organization will want to be able to describe to the IRS a meaningful review process undertaken prior to the filing of Form 990. The description should include specifics regarding who conducted the review, when they conducted it, and the extent of any such review.

14. Know whether any officer, board member or key employee cannot be reached at the organization's mailing address.

The IRS needs a mailing address to contact the organization's officers, directors, trustees, and key employees. The organization may use its official mailing address stated on the first page of Form 990 as

the mailing address for such persons if the persons can be reached there. If they cannot, the mailing addresses for such persons should be listed on Schedule O.

Section B Policies.

The questions in Section B of Part VI elicit responses regarding the policing of the organization's decision making processes. Specifically, Section B asks whether the organization:

*1. Has implemented, **annually updates and consistently monitors and enforces compliance with, a written conflict of interest policy.***

A **conflict of interest policy** defines conflicts of interest, identifies the classes of individuals within the organization covered by the policy, facilitates disclosure of information that may help identify conflicts of interest, and specifies procedures to be followed in managing conflicts of interest. A “**conflict of interest**” arises when a person in a position of authority over an organization, such as an officer, director, or manager, may benefit financially from a decision he or she could make in such capacity, including indirect benefits such as to family members or businesses with which the person is closely associated. For this purpose, a conflict of interest does not include questions involving a person’s competing or respective duties to the organization and to another organization, such as by serving on the boards of both organizations, that do not involve a material financial interest of, or benefit to, such person.

A conflict of interest policy is **annually updated** if the organization’s officers, directors, trustees, and key employees are required to disclose or update annually (or more frequently) their 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.

A description of the organization's **monitoring and enforcement** procedures should include an explanation of which persons are covered under the policy, the level at which determinations of whether a conflict exists are made, and the level at which actual conflicts are reviewed. Also explain any restrictions imposed on persons with a conflict, such as prohibiting them from participating in the governing body’s deliberations and decision in the transaction.

An organization can state affirmatively on its Form 990 that it has a conflict of interest policy so long as it is adopted on or before the last day of the organization's tax year for which the Form 990 is being filed.

*2. Has a written **whistleblower policy.***

A **whistleblower policy** encourages staff and volunteers to come forward with credible information on illegal practices or violations of adopted policies of the organization, specifies that the organization will protect the individual from retaliation, and identifies those staff or board members or outside parties to whom such information can be reported. An organization can state affirmatively on its Form 990 that it has a whistleblower policy for a tax year so long as it is adopted on or before the last day of the organization's tax year for which the Form 990 is being filed. The Sarbanes-Oxley Act imposes criminal

liability on tax-exempt and other organizations for retaliation against whistleblowers.

*3. Has a written **document retention and destruction policy**.*

A **document retention and destruction 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. An organization can state affirmatively on its Form 990 that it has a whistleblower policy for a tax year so long as it is adopted on or before the last day of the organization's tax year for which the Form 990 is being filed. The Sarbanes-Oxley Act imposes criminal liability on tax-exempt and other organizations for destruction of records with the intent to obstruct a federal investigation. A key part of a document retention and destruction policy is the provision requiring the immediate suspension of document destruction upon any indication of an official investigation or when a lawsuit is filed or appears imminent.

*4. Has a **procedure for determining reasonable compensation** for the executive director, CEO, other **top management official**, other officers and key employees.*

An acceptable **procedure for determining reasonable compensation** includes the following elements:

Review and approval by a governing body or compensation committee, provided that persons with a conflict of interest with respect to the compensation arrangement at issue were not involved.

Use of data as to comparable compensation for similarly qualified persons in functionally comparable positions at similarly situated organizations.

Contemporaneous documentation and recordkeeping with respect to the deliberations and decisions regarding the compensation arrangement.

The elements of an acceptable procedure for determining reasonable compensation may sound familiar as they appear to call for the same type of supporting documentation necessary to establish a rebuttable presumption that payments under a compensation arrangement are reasonable under the intermediate sanctions provisions of the Treasury Regulations promulgated under IRC § 4958. If a procedure for determining reasonable compensation exists, it must be described on Schedule O. The description of the procedure must identify the offices or positions for which the process was used to establish compensation of the persons who served in those offices or positions, and state the year in which this process was undertaken.

A **top management official** is a person who has ultimate responsibility for implementing the decisions of the organization's governing body or for supervising the management, administration, or operation of the organization (for example, the organization's CEO or executive director).

*5. If the organization participated in a **joint venture or similar arrangement** with one or more taxable persons or entities during the year, has a written **joint venture policy** under which it evaluates its participation in a joint venture and has taken **steps to safeguard the organization's status** with respect to such arrangements.*

A **joint venture or similar arrangement** means 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 organization 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 for federal income tax purposes, or as an association, or corporation for federal income tax purposes.

Steps to **safeguard the organization's exempt status** with respect to the venture or arrangement include:

- Control over the venture or arrangement sufficient to ensure that the venture furthers the exempt purpose of the organization;
- Requirements that the venture or arrangement give priority to exempt purposes over maximizing profits for the other participants;
- The venture or arrangement not engage in activities that would jeopardize the organization's exemption; and
- All contracts entered into with the organization be on terms that are arm's length or more favorable to the organization.

According to the IRS, "the absence of appropriate policies and procedures may lead to opportunities for excess benefit transactions, inurement, operation for non-exempt purposes, or other activities inconsistent with exempt status." It is clear, then, that while an organization is not *required* to have these policies, the IRS feels strongly that tax exempt organizations should have, and actively utilize, the foregoing policies. Not having one or more such policies *may* be a significant factor in IRS's audit selection process.

Section C – Disclosure

In this section, the organization must:

1. List the states in which it is required to file a Form 990.

Depending on state law, this may include states in which the organization is located, conducts business or raises funds. This question is similar to, but appears to be more encompassing than, a question on the prior version of the Form 990. The question on the prior version of the Form 990 read: "List the states with which a copy of this return is filed." The new version seems to require the organization survey the law of the 50 states each year to determine which of them require it to file a Form 990.

2. Indicate whether and how the organization makes its Forms 990 and 1023 (Application for Recognition of Exemption) available to the public.

All tax exempt organizations must make publicly available their Form 1023 or 1024 application for recognition of exemption except that applications filed before July 15, 1987, need not be made publicly available unless the organization had a copy on July 15, 1987. Organizations that file Form 990 must

make it publicly available for 3 years from the date it is required to be filed (including extensions) or, if later, is actually filed. The organization must withhold from public inspection the names and addresses of contributors (as set forth in Form 990 Schedule B). Organizations exempt from federal income tax under Section 501(c)(3) of the Internal Revenue Code that file Form 990-T (Exempt Organizations Business Income Tax Return) also are required to make their Form 990-T publicly available for the corresponding three-year period (this only applies to forms 990-T filed after August 17, 2006).

3. Describe whether and how the organization makes its governing documents, conflict of interest policy and financial statements available to the public.

Federal tax law does not require that such documents be made publicly available except as part of a form that is publicly available (such as Form 1023 or 1024). However, making these documents and policies publicly available indicates an effort by the organization to be transparent. Many organizations have found it helpful to post these documents on their websites as part of their efforts to be accountable to donors and the public.

4. State the name, physical address, and telephone number of the person who possess the books and records of the organization.

Conclusion

As the first filing season under the new Form 990 is about to commence, it is important for the Boards of Tax Exempt Organizations to ensure that the staff members charged with collecting the information to be reported on the Form 990 are educated with respect to these new rules.