
CORPORATE GOVERNANCE

What Corporate Lawyers Need to Know about New IRS Form 990

Nonprofits need to begin planning for the new and extensive governance and related disclosures that the Internal Revenue Service's redesigned Form 990 soon will require. Considerable time and group effort is likely to be required to prepare for, and respond to, the new form.

by **Stephanie Tsacoumis**

Although corporate lawyers generally relegate matters involving tax returns to the tax and accounting experts, because the Internal Revenue Service's (IRS) redesigned Form 990 (the annual informational tax return that nonprofits must file) delves extensively into governance matters, corporate lawyers who advise nonprofits need to pay attention. Additionally, time is of the essence; action in anticipation of the new requirements needs to be taken in 2008 because the new Form 990 disclosures will apply to the 2008 fiscal year activities of the largest nonprofits.

Overview of Form 990

The new Form 990 will, for the first time, require nonprofits to publicly disclose a significant amount of governance-related information. Not only will these new disclosure requirements substantially increase the time and resources needed to prepare the Form 990, nonprofits whose disclosures do not reflect compliance with the IRS's recommended governance policies may face a greater risk of audit. Moreover, donors, potential contributors, foundations, grant awarders, and states attorneys general can be expected to examine Form 990 information, all of which must be publicly available.

The new requirements will be effective beginning with the fiscal year 2008 Form 990's filed in 2009 by

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the largest nonprofits.¹ Nevertheless, they have several immediate and practical implications:

- *Policies and procedures should be reviewed now* in light of IRS "best practices" guidance² and in anticipation of upcoming Form 990 disclosure. Organizations that do not follow IRS guidance are likely to receive additional scrutiny. Organizations that have not implemented, or do not enforce, policies to be disclosed in the new Form 990 may wish to take action now so that related disclosure can be made when filing the new form. IRS guidance and key policies are highlighted below.
- *The new Form 990 is a "group project" and will take longer to prepare.* No longer can preparation of the information return be delegated entirely to an auditor or chief financial officer. Operational, management, board, and legal input will be necessary to respond to many of the items relating to governance and management practices. Required descriptive responses may be complex and time-consuming. Additionally, the organization's process for reviewing the Form 990 and whether the form was provided to the board before filing must be disclosed. Thus, nonprofits should build into their Form 990 preparation calendars the time necessary to coordinate input from multiple parties plus an opportunity for the board to review the completed form.
- *Accounting processes and recordkeeping practices may need adjustment to capture new Form 990 information.* For example, the new Form 990 calls for detailed fundraising and donation schedules that will require specific records. Other new disclosures include: the number of volunteers (which can be estimated if there is a reasonable basis for the estimate); whether written minutes are prepared for all board and board committee meetings before the next meeting or within 60 days; as well as, board member, number of employees, and independent contractors who received compensation or payment for services exceeding \$100,000. Changes in program services during the year also must be summarized.

General Disclosure Approach

In a departure from its prior approach, the IRS in the revised Form 990 requires substantive information about a nonprofit's board, governance and management policies, and transparency and accountability. Although questions were raised in the comment process about IRS authority to mandate governance-related disclosures, the IRS continues to assert an interest in governance and accountability practices relating to the safeguarding of an organization's assets consistent with its exempt purposes. As articulated by the IRS:

while tax law generally does not mandate particular management structures, operational policies, or administrative practices, it is important that each charity be thoughtful about the governance practices that are most appropriate for that charity in assuring sound operations and compliance with tax law.

In the IRS's view, "a well-governed charity is more likely to obey the tax laws, safeguard charitable assets, and serve charitable interests than one with poor or lax governance."

Not only must a nonprofit respond to yes or no governance-related inquiries in the "core" section of the revised Form 990, but in many instances the nonprofit also must include descriptions in related schedules. For example, the processes for electing directors and for determining compensation must be described. Further, the manner in which an organization's conflicts of interest policy is monitored and enforced must be described. The process employed by the organization for reviewing the Form 990 itself also must be described. These descriptions should be drafted and reviewed carefully for accuracy and completeness.

Governing Body and Management

In published guidance accompanying the revised Form 990, the IRS affirms the importance of an informed, active, and engaged board that oversees operations and finances and that is selected with the organization's needs in mind. The IRS indicates that it will review board composition as disclosed in the Form 990 to assess whether the board represents a

broad public interest. It also will assess the potential for insider transactions that might result in misuse of charitable assets.

Board Size and Composition

The redesigned Form 990 will elicit information about board size, board independence, and the process of electing board members. The focus is on voting board members who serve a governance function, and not on members of advisory boards or board members who do not vote or exercise any governance authority.

The number of voting board members and the number who are independent must be disclosed in the new Form 990. In addressing board size, IRS guidance cautions against "very small or very large" governing boards, which "may not adequately serve the needs of the organization." Consistent with best practices regarding governing board size, the IRS notes that small boards may lack necessary skills and resources and may not represent a sufficiently broad public interest, and that very large boards may find decisionmaking difficult. The IRS also suggests that large governing boards consider delegating responsibilities to an executive committee.³

Board independence is a critical touchstone, regardless of board size. Just as a consensus exists that a majority of the members of public company boards should be directors who qualify as independent,⁴ a consensus has emerged that a significant portion of a nonprofit board should consist of independent members.⁵ The IRS will review the extent to which the board consists of independent members, including whether board members, officers, or key employees have family or business relationships with other directors, officers, or employees, and the extent to which control or management authority has been delegated to a management company or other person.

According to the new Form 990 instructions, issued in draft form on April 7, 2008, a board member would be considered "independent" only if the person:

- Was not compensated as an officer or other employee of the organization or a related organization;

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- Did not receive total compensation or other payments exceeding \$10,000 (other than expense reimbursement or reasonable director compensation);
 - Did not directly or indirectly receive “material financial benefits” from the organization; and
 - Did not have a family member⁶ that received compensation or material financial benefits from the organization or a related organization.⁷

In the draft Form 990 glossary, the IRS clarified that the board member is independent only if all four circumstances apply at all times during the organization’s tax year. Independence would not be tainted if the member is a major donor, receives compensation as agent of a religious order that has taken a bona fide vow of poverty under circumstances in which the individual does not receive taxable income, or receives financial benefits from the organization solely in the capacity of a member of the class served by the organization in the exercise of its exempt function.⁸

Beyond independence, the IRS encourages an informed, active, and engaged board as important to the success of the nonprofit as compliance with tax law requirements. The IRS cautions that a board-tolerated “climate of secrecy or neglect” could lead to diversion of resources to benefit insiders at the expense of public and charitable interests.

Significant Organizational Document Changes

In addition to submitting organizational documents and bylaws initially as part of an application for exemption under Section 501(c)(3), significant changes to those documents now must be reported and described on an annual basis in the Form 990.⁹ Significant changes would include amendments to: quorum provisions; voting approval requirements; number, composition, qualification, authority or duties of officers or key employees; policies or procedures regarding officer or director compensation, conflicts of interest, whistleblowers or document retention; and the role of stockholders or members in governance, among others.

Member and Stockholder Authority

The new Form 990 also addresses the governance role of members and stockholders. If members or

stockholders elect one or more board (or other governing body) members, a description of the process is required. Similarly, if board decisions are subject to approval by members, stockholders, or others, a description is required.

Minutes

Board and committee minute-taking procedures are the subject of new Form 990 line items. Nonprofits must disclose in the new Form 990 whether the organization contemporaneously documents *every* meeting held and written action taken by the board (or other governing body) and by committees with delegated authority. “Contemporaneous” for this purpose means no later than the next meeting of the board or committee or within 60 days.¹⁰ The IRS “encourages” governing bodies and authorized committees to take steps to see that minutes of meetings and written actions without a meeting are contemporaneously documented.

Chapters and Affiliates

The new Form 990 also addresses whether nonprofits with local chapters, branches or affiliates have written policies and procedures “governing the activities of such chapters, branches or affiliates to ensure their operations are consistent with those of the organization.” If such policies and procedures are not in place, the nonprofit must explain in the Form 990 how the organization “ensures that the local unit’s activities are consistent with its own.”¹¹

Executive Compensation

Nonprofit executive compensation has garnered significant public and Congressional attention and is a “focus point” for the IRS, which has noted “significant” errors and omissions in the reporting of executive compensation in filed Form 990s.¹² The redesigned Form 990 requires a description of the compensation-setting process as well as disclosure of the number of individuals with compensation over \$100,000, detailed disclosure of compensation paid to certain executives, and information about perquisites, such as first class travel, housing allowances, and tax gross-up payments.

Compensation Amounts

Compensation is defined broadly in the draft Form 990 glossary to include all forms of cash or non-cash payments and benefits. Additionally, for the first time, compensation disclosure will include amounts paid by “related organizations;” disclosure must be made with respect to compensation from the reporting nonprofit entity and all related entities, including related for-profit entities.¹³

Specifically, comprehensive compensation disclosure is required in the redesigned Form 990 for:

- All current officers and directors and trustees who are voting members of the organization’s governing body;
- Current key employees with reportable compensation exceeding \$150,000;
- The five most highly compensated employees other than officers, directors or trustees, with reportable compensation exceeding \$100,000;
- Former officers, key employees and highest compensated employees, with reportable compensation exceeding \$100,000; and
- Former directors and trustees, with reportable compensation exceeding \$10,000.¹⁴

“Key employee” for this purpose is an employee with responsibilities or authority similar to that of officers, directors or trustees; an employee who manages a segment or activity of the organization that represents 5 percent or more of the activities, assets, income or expenses of the organization; or an employee who has or shares authority to control or determine 5 percent or more of the organization’s capital expenditures, operating budget or compensation for employees.

Independent contractor compensation also must be disclosed for the first time. The amount of compensation and a description of services is required for the five highest compensated independent contractors that received more than \$100,000 in compensation. Additionally, the aggregate number of independent contractors receiving more than \$100,000 must be stated.

Compensation Determinations

While the IRS does not mandate adherence to any particular compensation decisionmaking process, the IRS has conveyed guidance regarding compensation determinations. First, the IRS emphasizes the importance of compensation-related expertise and independence. According to the IRS, the compensation of directors, officers, key employees, and others in a position of substantial influence over the nonprofit should be determined by persons who are knowledgeable in compensation matters and who have no financial interest in the compensation decision.

Second, the IRS encourages reliance on a rebuttable presumption test whereby compensation is presumed to be reasonable¹⁵ if: (1) approved in advance by an authorized body of individuals who have no conflict of interest; (2) the authorized body obtained and relied on appropriate data regarding comparability before making a decision; and (3) the authorized body adequately documented the basis for the decision concurrently with the decision.

Noting that compensation consultants often provide comparable compensation data, the independence of any consultant and the quality of any data used in the compensation determination will be subject to IRS review.

Compensation Process

In the “core” portion of the redesigned Form 990, nonprofits must state whether the compensation process includes:

- Review and approval by independent persons, such as a governing body or compensation committee without involvement by persons with a conflict of interest,
- Use of data as to comparable compensation for similarly qualified persons in functionally comparable positions at similarly situated organizations, and
- Contemporaneous documentation and record-keeping with respect to the compensation-related deliberations and decisions.

Nonprofits may not respond “yes” unless the compensation process included all of the above elements.

Descriptive information about the compensation process also is required. In a new Form 990 schedule, nonprofits must describe the process for determining compensation for the CEO or top management official and for other officers or key employees.

Perquisites

For individuals for whom compensation disclosure is required, the organization must disclose whether perquisites (including those listed below) were provided and also must provide “relevant information” regarding the perquisites. The relevant information includes the type of benefit, the identity of the individual receiving the benefit and whether any part of the benefit was treated as taxable compensation to the recipient. The nonprofit also must disclose whether the organization follows a written policy regarding the provision of these perquisites, and whether the organization requires substantiation before reimbursing or allowing expenses relating to the perquisites. If the organization does not follow a written policy regarding the provision of perquisites, the organization must identify who decided that the organization would provide the benefits and must explain the decisionmaking process.

Perquisites encompassed in the Form 990 questions include: first-class and charter travel, travel for companions, payment or reimbursement of tax obligations, discretionary spending accounts, payment or provision of housing by the organization, payment for business use of a personal residence, payment of dues for the membership in a health, fitness, social or recreational club, and personal services (such as services of a chauffeur, chef, babysitter, bodyguard, maid).

Policies

The redesigned Form 990 requires information regarding a number of policies.

Conflicts of Interest

As noted by the IRS, the duty of loyalty requires directors and officers to avoid conflicts of interest

that are detrimental to the nonprofit. Consistent with best practice recommendations, the IRS “encourages” a nonprofit’s board to “adopt and regularly evaluate” a conflict of interest policy. As defined by the IRS in the draft Form 990 glossary, a conflict of interest policy should:

- Define conflict of interest;
- Identify the classes of individuals within the organization to whom the policy applies;
- Facilitate disclosure of information that may help identify conflicts of interest; and
- Specify procedures to be followed in managing conflicts of interest.

The IRS has published a sample conflict of interest policy¹⁶ that can be tailored to a particular nonprofit’s needs. The IRS also “encourages” nonprofits to require directors, officers and others covered by a conflict of interest policy to disclose periodically in writing any known financial interest that the individual or a family member has in any business entity that transacts business with the nonprofit.¹⁷

A nonprofit must state in the redesigned Form 990 whether it has a written conflict of interest policy (that, by definition, has the elements described above). If a conflict of interest policy is in place, the reporting nonprofit must disclose whether the nonprofit, in fact, requires officers, directors, trustees, and key employees to disclose annually interests that could give rise to conflicts. Additionally, the organization must state whether it “regularly and consistently” monitors and enforces compliance with the conflict of interest policy, and must describe how it so does.

Code of Ethics and Whistleblower Policy

The IRS also has focused on compliance by nonprofits with ethical standards that promote the public good. The IRS notes that a nonprofit’s board is responsible for setting ethical standards and “ensuring they permeate the organization and inform its practices.” As a result, adoption and regular evaluation of a code of ethics is “encouraged.”

In the same vein, the IRS “encourages” nonprofits to adopt a whistleblower policy, a policy as defined by the IRS that

- Encourages staff and volunteers to come forward with information regarding illegal practices or policy violations;
- Specifies that the organization will protect the reporting individual from retaliation; and
- Identifies those individuals to whom such information can be reported.

As with the conflict of interest policy item, a nonprofit must state in the redesigned Form 990 whether it has a written whistleblower policy (that, by definition, has the elements described above).

Conclusion

In summary, the breadth of the governance topics addressed by the new Form 990 and the form's requirements for descriptions and detail will necessitate input from a nonprofit's management and the board and assistance from corporate counsel and tax advisors. Although the requirements do not apply until the Form 990s filed in 2009 by the largest nonprofits, the substance of the Form 990s to be filed in 2009 relates to 2008. As a result, nonprofits who want their disclosures to reflect governance best practices and IRS guidance should take appropriate action now.

NOTES

1. Beginning in May 2009, nonprofits with gross annual receipts over \$1 million or total assets over \$2.5 million must use the new Form 990 for fiscal year 2008 activities. Nonprofits with gross annual receipts over \$500,000 or total assets over \$1.25 million must use the new Form 990 for the 2009 tax year, and those with gross receipts over \$200,000 or total assets over \$500,000 must use the new form beginning with the 2010 tax year.
2. See generally IRS, "Governance and Related Topics" (February 4, 2008) http://www.irs.gov/pub/irs-tegel/governance_practices.pdf.
3. See *id.* at 2–3.
4. See Business Roundtable, "Principles of Corporate Governance 2005," Nov. 2005.
5. Colin B. Carter & Jay W. Lorsch, Back to the Drawing Board: Designing Corporate Boards for a Complex World 79 (2004) at 16; NACD Blue Ribbon Commission on Director Professionalism (2005) (calling for a "substantial majority" of directors to be independent); Calpers Corporate Governance Core Principles & Guidelines (updated March 13, 2006), available at <http://www.calpers-governance.org>.
6. The "family" of an individual means his or her spouse, 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. See 2008 Form 990 Glossary Draft, April 7, 2008 at 9, http://www.irs.gov/pub/irs-tegel/990_instructions_glossary_040708.pdf (hereinafter 990 Draft Glossary).

7. This definition is similar to the independence standards recommended by the Panel on the Nonprofit Sector, and those set forth in a handful of state statutes governing nonprofit boards. See Panel on the Nonprofit Sector, "Strengthening Transparency, Governance and Accountability of Charitable Organizations—A Final Report to Congress and the Nonprofit Sector 15" (June 2005) at 7, http://www.nonprofitpanel.org/final/Panel_Final_Report.pdf. A few states have enacted somewhat similar definitions with respect to these persons who may serve on nonprofit boards. See Cal. Corp. Code § 5227; Me. Rev. Stat. Ann. tit. 13-B, § 713-A; N.H. Rev. Stat. Ann. § 292:6-a.
8. 990 Draft Glossary at 12–14
9. Significant changes to organizational documents must be described in a schedule to the Form 990; the actual documents are not required to be filed.
10. 2008 Form 990 Core (Parts VI) Instructions—Draft, April 7, 2008 at 5, http://www.irs.gov/pub/irs-tegel/990_instructions_partvi_040708.pdf.
11. Note also that if the local organizations rely on a group exemption ruling, the central or parent organization must exercise oversight over the local organizations as a condition of the group exemption. See instructions 2008 Form 990 Core (Highlights and General) Instructions—Draft, April 7, 2008 at 14–15, http://www.irs.gov/pub/irs-tegel/990_instructions_highlights_general_040708.pdf. Existing filing eligibility requirements for group returns are not changed by the Form 990 revisions.
12. On March 1, 2007, the IRS reported on the progress of its Executive Compensation Compliance Project, which involved examinations of 782 tax exempt organizations. In addition to errors and omissions in Form 990s, the IRS assessed \$21 million in excise taxes attributable to excess benefit transactions.
13. "Related organizations" include parent entities, subsidiaries, brother/sister entities, and other organizations controlled by the reporting nonprofit, that control the reporting nonprofit, or that are under common control with the reporting nonprofit. 990 Draft Glossary at 20. Control is defined to include ownership of more than a 50 percent equity, profits or capital interest or power to remove and replace a majority of the entity's directors or trustees. *Id.* at 4.
14. Compensation is to be reported for the calendar year ending with or within the organization's fiscal year. 2008 Form 990 Core (Parts VII) Instructions—Draft April 7, 2008 at 1, http://www.irs.gov/pub/irs-tegel/990_instructions_partvii_040708.pdf.
15. A nonprofit may not pay more than reasonable compensation for services rendered; the individual should not receive any "excess benefit." If an individual in a position to exercise substantial influence over the affairs of a nonprofit is deemed to receive "excess benefit," the IRS may impose sanctions. See generally IRS, "Governance and Related Topics" (February 4, 2008) at 3, http://www.irs.gov/pub/irs-tegel/governance_practices.pdf; Internal Revenue Code Section 4958.
16. Internal Revenue Service, Instructions for Form 1023, Appendix A.
17. IRS, "Governance and Related Topics" (February 4, 2008) at 3, http://www.irs.gov/pub/irs-tegel/governance_practices.pdf.