

## EO Special Edition

### Impact of the New Form 990 on Conflicts and Disclosure Policies

To Our Clients and Friends

October 2008

In our EO Special Edition this summer, we explored ways in which questions asked on the revised Form 990 may cause organizations to review and revise their governance procedures and various policies.<sup>1</sup> This EO Special Edition focuses on how the new Form 990 could affect one of those policies – an organization's conflict of interest policy – and explains in greater depth the related disclosure requirements on the new Form 990.<sup>2</sup>

The new Form 990 requires organizations to disclose a wide array of relationships, arrangements and transactions involving conflicts of interest and independent decision-making by their governing bodies. Organizations, in turn, will need to adopt new procedures in order to collect this information and figure out what to do with it. In the final analysis, many organizations may choose to modify their conflict of interest policies – renaming them, perhaps, as "conflict of interest and disclosure policies" – in order to meet these new compliance burdens. The burdens extend well beyond state law conflict of interest rules and prior Form 990 disclosure requirements, and organizations and individuals may find them onerous and intrusive. Organizations also may choose to adopt "board independence guidelines" designed to demonstrate that board members can act without being unduly influenced by their relationships with each other outside the organization or by their arrangements or transactions with the organization.

### Overview of the New Disclosure Requirements

The new disclosure requirements generally are built around three categories, each of which is separately explained below:

1. **interested persons** (i.e., those possessing conflicts of interest);
2. **independent directors or trustees** (i.e., those who are independent of the organization);  
and
3. **relationships among directors, trustees, officers and key employees**  
(i.e., those between the two parties and not between a party and the organization).

Disclosures about *relationships among directors, trustees, officers and key employees* have been required for several years on Line 75 of the old Form 990, but the categories of *interested persons* and *independent directors or trustees* are new to the Form 990. While the concepts underlying these three categories overlap, they are different and play out in different ways on the new Form 990.

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<sup>1</sup> The Summer EO Special Edition can be found on our website at:  
<http://www.pbwt.com/resources/alerts/detail.aspx?id=591f926c-0d59-4360-8101-0189efdd560e>.

<sup>2</sup> The IRS issued draft instructions to the new Form 990 in April 2008. Revisions to the draft instructions were issued August 19, 2008. The information in this EO Special Edition is based on the draft instructions as revised. Although the IRS does not expect to issue the final version of the instructions until late 2008, the IRS has stated that it intends not to make significant changes in content from the instructions issued in August 2008.

The questions regarding *interested persons* require disclosure on Form 990 of particular arrangements and transactions that involve conflicts of interest, presumably so regulators and others have an opportunity to evaluate whether the arrangements or transactions were carried out pursuant to appropriate procedures and on fair and reasonable terms. The term "interested persons" has been broadly defined and will undoubtedly provoke many organizations to adopt more expansive definitions in their existing conflicts policies. In fact, because the IRS now requires reporting on a host of transactions with certain *former* directors, trustees, officers and key employees, the definition is so broad that no conflicts policy will be capable of picking up all transactions with interested persons. Organizations will need to enlist their staff to collect some of the information separately.

On the other hand, the question about *independent directors or trustees* merely requires reporting the total number of directors or trustees and the number of these directors or trustees who are independent. Similarly, the questions about *relationships among directors, trustees, officers and key employees* require no more than disclosure of the relationships themselves. These questions seem to be aimed primarily at providing regulators and other readers of Form 990 with a clearer sense of whether the governing board is able to bring independent judgments to bear in performing its fiduciary responsibilities – e.g., independence in evaluating whether staff are doing a good job in fulfilling the mission, meeting budgets, etc., and independence in implementing and overseeing meaningful policies and procedures to handle conflicts of interest.

In the long run, it seems likely that the added transparency about interested person transactions will deter many organizations from engaging in them, will lead to more stringent enforcement of conflicts policies governing such transactions or will lead to special policies and guidelines to deal with particular types of recurrent transactions that involve interested persons. The new transparency about *independent directors or trustees* and *relationships among directors, trustees, officers and key employees* may cause some organizations to adopt procedures designed to promote or require the independence of board members from possible influence by the organization, its staff or one another.

## ***Interested Persons***

With the introduction of Schedule L (Transactions with Interested Persons) of the new Form 990, the IRS has invented a new term – "interested persons" – and given it several meanings, depending on the context. There are different definitions of the term "interested persons" for:

- ❖ business transactions with interested persons;
- ❖ loans to or from interested persons; and
- ❖ grants or other assistance provided to interested persons.

Depending on the context, the term is broader than or narrower than the term "disqualified persons" for purposes of the excise tax on "excess benefit transactions" between a Section 501(c)(3) or 501(c)(4) organization and its disqualified persons under Section 4958 of the Internal Revenue Code ("IRC") (which has not changed). As such the new definitions could result in the disclosure of transactions that may or may not expose the organization's managers and others to liability for that excise tax.<sup>3</sup>

Faced with the prospect of disclosing such information to the IRS – and the general public – organizations may well conclude that any arrangement or transaction with an interested person that must be disclosed on Schedule L of the new Form 990 should be brought within the organization's conflict of interest policy and subject to disclosure and disinterested review whenever possible. This course of action would also be a step toward satisfying the new IRS requirement that an organization

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<sup>3</sup> Our alert "IRS Issues Final Regulations on Intermediate Sanctions" discussing Section 4958 can be found on our website at: <http://www.pbwt.com/resources/alerts/detail.aspx?id=dfc912db-03fa-4f67-862a-ffcda3b87482>.

make a "reasonable effort" to obtain the information required for all three types of transactions with interested persons because an organization's distribution of an annual questionnaire qualifies as a "reasonable effort." This standard presumably implies reasonable follow-up by the organization to collect the responses.

### *Business Transactions with Interested Persons*

An organization is required to report each business transaction with an interested person that exceeds the greater of \$10,000 or 1% of the organization's total revenue for the prior tax year. An organization is also required to report business transactions with interested persons that fall below this threshold when:

- ❖ total payments during the year between the organization and the interested person exceeded \$100,000 (in which case the organization must report all transactions regardless of the amount of each individual transaction); or
- ❖ the transaction was the organization's payment of compensation to a family member of a current officer, director, trustee or key employee of the organization (in which case payment of reportable compensation must be reported if in excess of \$10,000).

The term "**business transactions**" includes, but is not limited to, contracts of sale, leases, licenses, arrangements for the performance of services, and joint ventures in which the interests of the organization and the interested person each exceeds 10%. Membership dues, grants and loans are not considered to be business transactions.

The term "**interested person**" with respect to business transactions includes the following:

- ❖ any current officer, director, trustee or key employee;
- ❖ any former director or trustee who received, in that capacity, more than \$10,000 of reportable compensation from the organization and any related organizations;<sup>4</sup>
- ❖ any former officer or key employee who received more than \$100,000 of reportable compensation from the organization and any related organizations (the above three categories, collectively, "**Tier 1 interested persons**");
- ❖ any family member of a Tier 1 interested person;
- ❖ an entity more than 35% owned, directly or indirectly, by one or more Tier 1 interested persons and/or their family members, whether individually or collectively;
- ❖ an entity (other than a Section 501(c) organization) of which a Tier 1 interested person or a family member was serving at the time of a transaction as:
  - an officer;
  - a director or trustee;
  - a key employee;

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<sup>4</sup> The term "**former**" applies to directors, trustees, officers, key employees and highest compensated employees reported on the organization's Form 990 for one or more of the five prior years. "**Reportable compensation**," whenever it is used in this EO Special Edition, generally is compensation reported on Form W-2, box 5 or Form 1099-MISC, box 7.

- a partner or member with an ownership interest in excess of 5% if the entity is treated as a partnership for tax purposes; or
  - a shareholder with any ownership interest in excess of 5% if the entity is a professional corporation;<sup>5</sup> or
- ❖ any management company of which a former officer, director, trustee or key employee within the past five years is an officer, director, trustee, key employee or direct or indirect 35% owner.<sup>6</sup>

Note that the ownership of shares in a publicly traded corporation by Tier 1 interested persons and family members generally will not cause the corporation to be an interested person, except in the highly unusual situation where the collective ownership exceeds 35%.

The term "**key employee**" means an employee who is not an officer, director or trustee, and who meets all of the following tests.

- ❖ \$150,000 Test: The employee had reportable compensation from the organization and all related organizations exceeding \$150,000 for the year.
- ❖ Responsibility Test: The employee had organization-wide responsibilities, powers or influence similar to that of an officer, director or trustee; or managed a segment of the organization that represents 10% or more of the organization's activities, assets, income or expenses; or had or shared control over 10% or more of the organization's operating budget or compensation for employees.
- ❖ Top 20 Test: The employee was within the organization's top 20 highest paid employees for the year who satisfied the two above tests.

The term "**family member**" includes an individual's spouse, ancestors, siblings (whether of the whole or half blood), children (natural or adopted), grandchildren, great grandchildren, and spouses of siblings, children, grandchildren and great grandchildren.

The term "**officer**" is defined as a "person elected or appointed to manage the organization's daily operations, such as a president, vice-president, secretary or treasurer." Additionally, the organization's "top management official" and "top financial official" are to be treated as officers.

The term "**related organization**" means a parent or subsidiary organization or an organization with a brother/sister type of affiliation. It also includes an organization's supported and supporting organizations under IRC Section 509(a)(3).

### *Loans to or from Interested Persons*

Generally speaking, organizations are now required to disclose all loans (including salary advances and receivables) outstanding at the end of the tax year between the organization and any interested person. This includes loans originally made between the organization and

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<sup>5</sup> A "**professional corporation**" is a corporation whose purposes are limited to professional services, such as those performed by doctors, dentists and attorneys.

<sup>6</sup> A "**management company**" is a company that performs management duties (such as the hiring or firing of personnel, the planning or executing of budgets or the supervising of exempt operations) for another organization customarily performed by or under the direct supervision of the other organization's officers, directors, trustees or key employees.

a third party or between an interested person and a third party that were transferred so as to become a debt outstanding between the organization and an interested person.

The term "**interested persons**" with respect to loans is limited to:

- ❖ Tier 1 interested persons;
- ❖ the organization's current and former highest compensated employees who received more than \$100,000 of reportable compensation from the organization and related organizations; and
- ❖ any person who is a "disqualified person" for purposes of IRC Section 4958 (the "intermediate sanctions" or "excess benefit transaction" rules).

Organizations eligible to file Form 990-EZ are required to disclose loans only to current officers, directors, trustees and key employees.

### *Grants and Assistance Benefiting Interested Persons*

Organizations are required to disclose grants (e.g., scholarships, internships and prizes) or similar economic assistance (e.g., the provision of goods, services or use of facilities) to any interested person. For the purposes of these disclosures, a grant includes the gift portion of a part-sale, part-gift transaction, but not a business transaction that does not include a gift element, such as compensation to an employee or contractor in exchange for services of comparable value.

The term "**interested person**" with respect to grants or other assistance means:

- ❖ any current director, trustee, officer or key employee;
- ❖ any "substantial contributor;" or
- ❖ any "related person."

The term "**substantial contributor**" is a person who contributed at least \$5,000 to the organization during its tax year and is required to be reported by name in Schedule B, Schedule of Contributors, for the organization's tax year. (Thus, organizations that are not required to file Schedule B are not required to report transactions with substantial contributors and their related persons.)

The term "**related person**" means:

- ❖ a member of the organization's grant selection committee;
- ❖ a family member of an officer, director, trustee, key employee, substantial contributor or member of the grant selection committee;
- ❖ a corporation, partnership, trust or estate in which persons described above own more than 35% of the combined voting power, profits interest or beneficial interest (a "35% controlled entity"); or
- ❖ an employee or child of an employee of a substantial contributor or of a 35% controlled entity of a substantial contributor, but only if he or she received the grant or assistance (a) by the direction or advice of the substantial contributor or 35% controlled entity or

(b) pursuant to a program funded by the substantial contributor that was intended primarily to benefit such employees or their children.

There is an **exception for grants to the employees of a substantial contributor**, under which such grants should not be disclosed if awarded on an objective and nondiscriminatory basis. There is also an **exception for grants or assistance provided to an interested person as a member of the charitable class** supported by the organization, if provided on similar terms as those to other members of the class. This exception applies to support such as short-term disaster relief or trauma counseling and does not apply to grants for travel, study or other similar purpose involving achieving a specific objective or enhancing certain literary, artistic, teaching or similar skills.

## Independent Directors or Trustees

Separate and apart from the new disclosure requirements for arrangements or transactions with interested persons, the new Form 990 (Part VI, Line 1) also introduces the category of the "independent" voting member of the governing body, generally referred to as a director or trustee.<sup>7</sup> This category refers to the independence of these individuals from the organization itself, not their independence *vis à vis* one another. The new Form 990 does not say that organizations must have independent directors or trustees, nor does it say what is an allowable ratio of independent to non-independent directors. Instead, the new form simply asks for the total number of voting members of the governing body and the number of independent voting members.

In a 2008 publication entitled *Governance and Related Topics – 501(c)(3) Organizations*, available at [http://www.irs.gov/pub/irs-tege/governance\\_practices.pdf](http://www.irs.gov/pub/irs-tege/governance_practices.pdf), the IRS said that a governing board "should not be dominated by employees or others who are not, by their very nature, independent individuals because of family or business relationships."

Generally speaking, a director is "**independent**" if the director meets each of the following tests:

- ❖ The director is not compensated as an officer or other employee of the organization or any related organization.
- ❖ The director did not receive total compensation or other payments exceeding \$10,000 per year from the organization or related organizations as an independent contractor, other than reimbursement of expenses or reasonable compensation for services provided as a member of the governing body.
- ❖ Neither the director nor any family member of the director was involved in a direct or indirect transaction with the organization that is required to be reported in Schedule L for the organization's tax year, or in a transaction with a related organization that would be reportable on Schedule L if filed by the related organization.

As discussed above, Schedule L is the new schedule on which transactions involving "interested persons" must be reported. The cross-reference to Schedule L ties the concept of disinterestedness to that of independence because engaging in a reportable transaction as an "interested person" precludes one from being designated an "independent" director.

Note that a director who is a donor to the organization, even a major donor, may still be considered independent. A director may also still be deemed independent if he or she receives financial benefits

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<sup>7</sup> The term "director," whenever used in this EO Special Edition, means a voting member of a governing body, which in some organizations may be called a trustee, governor, manager or some other term.

from the organization solely in the capacity of being a member of the charitable or other class served by the organization (such as a member of a Section 501(c)(6) business league), so long as the benefits are consistent with such membership.

As is the case with transactions involving interested persons, an organization need not engage in more than a "reasonable effort" to obtain the information necessary to determine the independence of its directors. A "reasonable effort" is satisfied by distribution to each director (presumably accompanied by reasonable attempts at collection) of an annual questionnaire that, if answered, would supply the organization with the required information.

## Relationships Among Directors, Trustees, Officers and Key Employees

The new Form 990 (Part VI, Line 2) asks whether any director, trustee, officer or key employee has a "family or business relationship" with any other director, trustee, officer or key employee. (The term "key employee" is defined above in the discussion of interested persons.) The business relationships that must be disclosed are subject to certain limitations and exceptions, described below, which make this disclosure requirement less onerous than it may seem at first.

The "relationship" question and the "independence" question are in many ways trying to get at the same core concerns—namely, threats to impartiality and to loyalty to the organization. The relationship question is concerned with the possibility that a family or business relationship having nothing to do with the organization itself might call into question the impartiality or motives of those with such relationships. In the Section 501(c)(3) universe, if all or the majority of a board's membership consists of individuals with family or business relationships, there may be a perception that the organization's governance more closely resembles that of a private foundation than that of a typical public charity. As the IRS has said in *Governance and Related Topics – 501(c)(3) Organizations*, the agency "reviews the board composition of charities to determine whether the board represents a broad public interest, and to identify the potential for insider transactions that could result in misuse of charitable assets."

A "**family relationship**" means a relationship as a spouse, ancestor, brother or sister (whether of the whole or half blood), child (natural or adopted), grandchild, great grandchild, or spouse of a sibling, child, grandchild or great grandchild.<sup>8</sup>

A "**business relationship**" between two persons includes (but presumably is not limited to) the following types of relationships:<sup>9</sup>

- ❖ One person is employed by a sole proprietorship owned by the other person or by an organization of which the other person is a director, trustee, officer, key employee or greater-than-35% owner.
- ❖ One person is transacting business with the other, directly or indirectly, in one or more contracts of sale, leases, licenses, loans, service arrangements or other transactions involving transfers of cash or property valued in excess of \$10,000 in the aggregate during the year. An indirect transaction is a transaction by one person with an organization of which the other person is a director, trustee, officer, key employee or greater-than-35% owner.
- ❖ The two persons are each a director, trustee, officer or greater-than-10% owner in the same business or investment entity.

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<sup>8</sup> Note that a similar question is asked in Line 75b of the 2007 Form 990.

<sup>9</sup> Note that this definition is more expansive than the one used for Line 75b of the 2007 Form 990.

A "business relationship" does not, however, include the following:

- ❖ **"ordinary course of business exception"**: a transaction between the two persons in the ordinary course of either party's business and on the same terms as are generally offered to the public; and
- ❖ **"privileged relationship exception"**: a relationship between attorney and client, medical professional and patient, or priest/clergy and penitent/communicant.

At a minimum, organizations will need to develop some mechanism for collecting the information necessary to answer this newly formulated question about family and business relationships. The annual disclosure required under an organization's conflicts policy may provide the best vehicle for asking each director, trustee, officer and key employee to disclose his or her family or business relationships with other directors, trustees, officers or key employees, particularly as the annual disclosure will satisfy the IRS's requirement that the organization undertake a "reasonable effort" to collect the information.

Going still further, an organization will face the question of whether it wishes to bar such relationships altogether in order to be able to answer "No" to this question or if it wishes to impose some limitation on the percentage of directors or trustees who may have such relationships or if it wishes to identify some specific relationships that are barred (e.g., no key employee may have a family or business relationship with any director). Although such precautions are by no means mandated by the new Form 990, much less by Federal tax law, the mere presence of this new question on Form 990 necessarily presents the issue of how an organization wants to be able to answer it, and if the answer is to be "Yes," how the answer can be contextualized should funders, the media or the general public raise questions about the nature and extent of family and business relationships and the rationale for permitting them.

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