

## **EO Special Edition**

### **New IRS Form 990 Changes the Landscape for Public Disclosure by Exempt Organizations**

*To Our Clients and Friends*

Summer 2008

In June 2007, the IRS released a draft of a revised Form 990 and provided the public with an opportunity for comments. This new IRS Form 990 was designed to be a significant departure – in both format and substance – from the old Form 990. Rather than a "one size fits all" approach, the draft Form 990 relied on a "core" form that would be filled out by all organizations, together with a lengthy set of schedules that would be filled out depending on the particular type of organization (for example, if it is a school or hospital) and on its particular activities (for example, whether it conducts activities outside the United States, whether it receives non-cash gifts, or whether it engages in transactions with board members or other interested persons).

The IRS sought public comment on the draft form, and hundreds of exempt organizations, individuals, and firms (including Patterson Belknap) provided comments. In December 2007, the IRS released a revised draft of the new Form 990, and it is anticipated that the final version of the form will closely resemble the IRS's second draft. In April 2008, the IRS released voluminous draft instructions and initiated another public comment period on the instructions. This EO Special Edition is based on the second draft Form 990 and the draft instructions, which are available on the Internet at <http://www.irs.gov/charities/article/0,,id=181091,00.html>.

Generally speaking, Form 990 must be filed by all tax-exempt organizations (other than private foundations and those churches that are not required to file Form 990). The class of exempt organizations that must file Form 990 includes:

- **Section 501(c)(3) (organizations not classified as private foundations)**
- **Section 501(c)(4) (social welfare organizations)**
- **Section 501(c)(6) (business leagues and trade associations)**
- **Section 501(c)(7) (social clubs)**

Small organizations may qualify to continue filing IRS Form 990-EZ during a transition period, and other transition relief may be provided from the obligation to file particular schedules. Private foundations will continue to file Form 990-PF.

The new Form 990 covers tax years beginning in 2008, which means that the earliest due date for the new Form 990 is not until May 15, 2009. But tax-exempt organizations should be preparing now for the vastly expanded degree of disclosure that the new form will require. Even though private foundations will not have to file the new Form 990, they should be paying attention to it because it will affect the way they evaluate grantees that do file Form 990, and it may be a harbinger of expanded disclosure requirements for private foundations.

## ***Raising the Bar for Governance***

Because an organization's Form 990 is now available at little or no cost on the Internet, the form has become a truly public document. It is not just an information return filed with the IRS and disclosed on an "as requested" basis to those who ask the organization or the IRS to see it. Thanks to the web, it has become an integral part of the public face that every exempt organization presents to the world – to its donors, its critics, and its peer organizations, to journalists, public officials, and watchdog organizations. The content of Form 990, in other words, is a matter of critical importance, not only to an organization's Chief Financial Officer, Audit Committee, and General Counsel. It is also important to the organization's development officers, its public information staff, and its Chief Executive Officer, and ultimately, to the governing board as a whole.

As if to underscore the importance of Form 990, the new core form, in a section called "Governance, Management and Disclosure," asks the following new question:

***Was a copy of Form 990 provided to the organization's governing board before it was filed? All organizations must describe ... the process, if any, the organization uses to review the Form 990.***

This question about the review of Form 990 is indicative of a notable characteristic of the new form: It asks many "yes/no" questions that are not grounded in any specific provision of Federal tax law. For example, there is no statutory or regulatory requirement that an organization's governing board be supplied with Form 990 before it is filed; nor is there any required "process" for the board's review. The form and the instructions strive to be clear that many of the new questions do not correspond to requirements of Federal tax law. Yet the new Form 990 effectively raises the bar for the Form 990 review process and other aspects of exempt organization governance. Does an organization want to say in a public document that its Form 990 was *not* provided to the board prior to filing? Probably not. Does an organization want to say that it has *no* process for the review of its Form 990? Again, probably not. As a consequence, it can be predicted that many organizations will develop policies and practices designed to enable them to answer "yes" to the question quoted above and to other questions like it.

Critics have complained that the new Form 990 asks questions unrelated to Federal tax law compliance. However, the IRS has explained its rationale as follows:

Many of the questions request information on practices or policies that are not required by Federal tax law. However, good governance and accountability practices provide safeguards that the organization's assets will be used consistently with its exempt purposes. This is a critical tax compliance consideration, especially for organizations that are subject to private benefit, excess benefit, and private inurement prohibitions. In addition, well-governed and well-managed organizations are more likely to be transparent organizations with regard to their operations, finances, fundraising practices, and use of assets for exempt and unrelated purposes.

In this article, we will describe and offer comments about many of the "yes/no" questions asked on the new Form 990 that bear upon an organization's procedures and policies. In those cases where an organization determines that a "yes" answer is desirable, it will need to make certain it has the type of procedure or written policy contemplated by the IRS. In other cases, the organization will want to think carefully about its rationale for *not* having a

particular procedure or written policy so that it will be able to explain – without apologies – why it lacks a procedure or policy that the new Form 990, simply by asking a question, has implied is necessary or desirable.

All organizations are required (in Part VI of the "core" Form 990) to disclose whether they have written policies to address the following:

- **Conflicts of interest**
- **Whistleblower protection**
- **Document retention and destruction**

The questions about conflicts policies have appeared on Form 990 for several years. The questions about whistleblower protection and document retention and destruction policies are new.

Part VI of the "core" of the new Form 990 also asks whether organizations have certain procedures concerning:

- **The review of Form 990 itself (discussed above)**
- **Setting compensation for the officers and "key" staff**
- **Contemporaneously documenting board and certain committee meetings**
- **Providing public access to governance documents, the conflict of interest policy, and financial statements**

In other parts of the new Form 990:

- **Organizations that make foreign grants** are asked to describe their procedures for monitoring the use of grant funds outside of the United States. *Schedule F.*
- **Organizations with tax-exempt bonds** are asked an array of questions that bear on their practices and procedures, including whether they have practices and procedures to ensure post-issuance compliance with their tax-related obligations under tax-exempt bonds. *Schedule K.*
- **Organizations that provide certain perquisites** (e.g., first-class or charter travel, dues to a health or social club, a housing allowance or use of a personal residence, a maid or a chauffeur) to the board or key staff are asked if they have a written policy on such matters and if they do not, are asked to provide an explanation of how such perquisites are approved. A follow-up question asks whether the organization requires substantiation before such an expense is reimbursed or allowed. *Schedule J.*
- **Organizations that participate in joint ventures** with taxable entities are asked if they have a written policy or procedure requiring an evaluation of their participation under Federal tax laws and if they have taken steps to safeguard their exempt status. *Core Form 990, Part VI.*
- **Organizations with local chapters or affiliates** are asked if they have written policies or procedures by which the parent organization ensures that local operations are consistent with its own. *Core Form 990, Part VI.*

- **Organizations with an independent accountant** are asked if they have a committee that assumes responsibility for selection of the independent accountant and oversight of the accountant's work. *Core Form 990, Part XI.*
- **Schools** are asked whether they have a racially nondiscriminatory policy towards students in either their charter, bylaws, other governing instrument, or a resolution of the governing body. Schools also face an array of other questions on related issues. *Schedule E.*
- **Hospitals** are asked whether they have a written charity care policy, a written debt collection policy that includes provisions on the collection practices to be followed for patients who are known to qualify for charity care or financial assistance, and an annual community benefit report. *Schedule H.*
- **Museums and other organizations that accept "non-cash contributions"** are asked whether they have a gift acceptance policy that requires the review of non-standard contributions. "Non-standard contributions" are defined as including items that are *not* reasonably expected to be used to satisfy or further the organization's exempt purposes and for which there is no ready market to liquidate the item, provided the value of the item is highly speculative or difficult to ascertain. Under the current wording of the question, it appears that every organization required to complete Schedule M must answer this question, even if the policy of the organization is not to accept any "non-standard contributions." *Schedule M.*

## ***IRS Guidance About Policies and Procedures***

The new Form 990, the draft instructions, and other publications by the IRS provide some guidance about what the IRS expects with regard to some of the procedures and written policies it asks about.

*Conflicts of Interest.* The IRS has supplied a model conflict of interest policy as Appendix A of the Instructions for the Form 1023 (the application for tax-exempt status), and the questions in the new Form 990 itself show some characteristics that the IRS evidently expects to see (at a minimum) in a conflicts policy:

- (i) a requirement that directors, trustees, officers, and key employees disclose annually any interests they have that could give rise to conflicts, *and*
- (ii) a mechanism by which the organization "regularly and consistently" monitors and enforces compliance with the policy.

The mechanism for monitoring and enforcing the conflicts policy must be described in Schedule O of the new Form 990, Schedule O having been adopted by the IRS as an all-purpose repository for an organization to explain some of the policies and procedures contemplated by the new Form 990 or the organization's rationale for not having those policies and procedures. (It is fair to predict that Schedule O will be among the most read and most scrutinized aspects of the new Form 990.)

The draft instructions explain that a conflicts policy should define conflicts of interest, identify the classes of individuals within an organization who are covered by the policy, facilitate the disclosure of information that may help identify conflicts, and specify procedures to be followed in managing conflicts. According to the draft instructions,

a conflict of interest arises when "a person in a position of authority over an organization... 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." The draft instructions indicate that there must be a "material" financial interest or benefit to an individual (or a family member or an associated business) in order for service on multiple charity boards to result in a conflict of interest. An example in the draft instructions indicates that an individual who serves on the boards of two charities does not have a conflict (for IRS purposes) if one charity is deciding whether to endorse a legislative proposal favored by the other charity. (Perhaps the IRS will eventually provide examples of situations where it believes dual board service *would* present a conflict of interest within the IRS definition.)

In addition to its questions about the conflicts policy, the new Form 990 also requires disclosures about certain transactions with "interested persons" (Schedule L) and about the number of "independent" board members (Core Form 990, Part VI, Line 1). The new Form 990 also expands the existing scope of inquiry about business and family relationships among directors, trustees, officers, and key employees (Core Form 990, Part IV, Line 28). The "interested director" disclosures provide regulators and others with an opportunity to identify a wide array of interested party transactions and evaluate their terms and how they were approved. The questions about "independent" directors or trustees and "related" directors, trustees, officers, and key employees seem to be aimed primarily at providing regulators and other readers of Form 990 with a clearer sense of whether the governing board is generally 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.

Many organizations may conclude that they need to update their conflicts policies – perhaps recasting them as "conflict of interest and disclosure policies" – in order to collect sufficient information to file an accurate Form 990 and meet the IRS expectations for nonprofit governance seemingly reflected in these aspects of the new Form 990. This topic will be considered in a forthcoming Patterson Belknap report.

*Whistleblower Protection.* The draft instructions state that 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.

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 explains whistleblower protection policies in the context of an organization's ethical standards. The IRS says that a charity board bears "the ultimate responsibility for setting ethical standards and ensuring they permeate the organization and inform its practices." Accordingly, the IRS "encourages" each charity board to adopt and regularly evaluate "a code of ethics that describes behavior it wants to encourage and behavior it wants to discourage." So far, however, Form 990 does not inquire about codes of ethics.

*Document Retention.* The draft instructions provide 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. In *Governance and Related Topics – 501(c)(3) Organizations*, the IRS says a document

retention policy should "establish standards for document integrity, retention, and destruction," should include guidelines for handling electronic files, and should cover back-up procedures, archiving of documents, and regular check-ups of reliability. The IRS also refers taxpayers to IRS Publication 4221, *Compliance Guide for 501(c)(3) Tax-Exempt Organizations*, available at <http://www.irs.gov/pub/irs-pdf/p4221pc.pdf>. The draft instructions to the new Form 990 contain a reminder that the Sarbanes-Oxley law imposes criminal liability on all organizations – even if they are tax-exempt – for retaliating against whistleblowers or destroying documents with the intent to obstruct a federal investigation.

*Setting Compensation.* The new Form 990 asks whether the organization's process for setting compensation for its CEO, Executive Director, or other top management official and for its officers and other key employees required (a) review and approval by independent persons, (b) comparability data, and (c) contemporaneous substantiation of the decision. In all events, the process must be described in Schedule O. Additionally, Schedule J asks whether a compensation committee is used to establish the compensation of the organization's CEO or Executive Director. Furthermore, the new Form 990 also expands generally the disclosure requirements for compensation (Core Form 990, Part VII). This enhanced degree of transparency may argue in favor of new procedures not only to collect sufficient information to file a complete return but also to ensure that the compensation review process is sufficiently robust.

*Documenting Meetings and Actions.* An organization must "contemporaneously document" every meeting held and written action taken in order to answer "Yes" to the new question about documentation of meetings and actions. The documentation question applies to all meetings of the governing body and committees with authority to act on behalf of the governing body. According to the draft instructions, 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." The documentation is "contemporaneous" if it is made by the later of the next meeting of the governing body or committee or 60 days after the meeting or written action. If an organization is unable to answer "Yes" to this question, it must explain in Schedule O its practices or policies, if any, for documenting meetings and written actions by the governing body and committees with authority to act on its behalf.

*Public Access to Governing Documents, the Conflicts Policy, and Financial Statements.* Schedule O is to be used for an organization to state whether and, if so, how it makes its governing documents (e.g., certificate of incorporation and bylaws), its conflicts policy, and its financial statements available to the public. Notably, there is no requirement in Federal or New York law that an organization make such materials available to the public, although some of these materials may ordinarily be obtained from public sources by persistent members of the public.

*Joint Ventures.* In disclosing to the IRS whether it has invested in (or has contributed assets to or otherwise participated in) a joint venture, an organization must apply the relatively broad definition under the draft instructions, which define joint ventures to be any "joint venture or similar arrangement with one or more taxable persons, regardless of whether the venture or arrangement is taxed as a partnership or as an association taxable as a corporation." The draft instructions say to include "all such arrangements whether the purpose is to conduct an exempt activity, an investment activity, or an unrelated trade or business, and regardless of whether the organization controls the joint venture or arrangement." The wording of the draft instructions is broad enough to suggest that all joint ventures extant during the tax year must be disclosed, even if they were entered

into in a prior tax year. However, an organization is permitted to exclude any venture or arrangement that meets the following two tests:

- 95% or more of the income of the venture or arrangement is described in IRC Section 512(b)(1)-(5) (e.g., interest, dividends, capital gains, rents, or royalties), even if the income is debt-financed, *and*
- The primary purpose of the organization's participation in the venture or arrangement is the production of income or appreciation of property.

If an organization has participated in a joint venture, it must then answer a follow-up question concerning whether it has a written policy or procedure meeting certain requirements. According to the draft instructions, the policy or procedure must "require[] the organization to negotiate in its transactions and arrangements with other members of the partnership [*sic*] such terms and safeguards adequate to ensure that the organization's exempt status is protected." Additionally, the organization must also be able to assert that it has taken steps to safeguard its exempt status with regard to the venture or arrangement.

The draft instructions provide the following examples of steps that safeguard exempt status: control over the venture or arrangement is sufficient to ensure that the venture furthers the exempt purpose of the organization; the venture or arrangement is required to give priority to exempt purposes over maximizing profits for the other participants; the venture or arrangement is barred from engaging in activities that would jeopardize the organization's exemption; and all contracts entered into with the organization are on terms that are "arm's length or more favorable to the organization."

*Conclusion.* The new Form 990 will provide the impetus to almost all organizations that file Form 990 to develop a conflicts policy, a whistleblower protection policy, and a document retention and destruction policy, if they do not have such policies already. For organizations that already have those policies, the new Form 990 may cause them to consider whether updates or refinements are needed in light of the expanded degree of disclosure required by the new form. As to other matters, such as the process for setting compensation or deciding to enter into a joint venture, each organization will need to assess – based on its own activities – whether procedures or written policies need to be adopted or strengthened in order for the organization to present to the IRS, and to the world at large, the best possible picture of the way the organization is governed.

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