

## CLIENT ADVISORY

## REPORTING GOVERNANCE PRACTICES ON THE NEW FORM 990—DO YOU HAVE A COMPLIANCE PLAN?

On August 19, 2008, the Internal Revenue Service (IRS) released the final version of the Instructions to the new Form 990, the annual information return filed by public charities and certain tax-exempt organizations in the United States.<sup>1</sup> Although the Instructions will not be published in final form until later in the year, the IRS does not expect the final Instructions will contain significant changes in content from the August release.

Nonprofit organizations that have not taken steps to comply with the new reporting requirements of the redesigned Form 990 still have time to avoid the unwelcome attention that may follow when it is time to file the new form. Organizations that wait until after the end of the year to prepare for the new form may increase their chances of triggering an audit by the IRS and scrutiny from state regulators and funders, and will fail to capitalize on the opportunity to shine a positive light on their governance practices. Therefore, charitable organizations should begin to adopt and implement new procedures and policies before the end of the year to comply with the new reporting requirements of the form.

The redesign of Form 990 has been one of the most significant undertakings by the IRS in recent years, and reflects the tremendous growth and change that have occurred in the nonprofit sector over the past three decades. The IRS redesigned Form 990 based on three guiding principles: to enhance transparency, promote tax compliance, and minimize burden on the filing organization.<sup>2</sup> The new form, which is significantly different from the old Form 990, consists of an 11-page “Core” form and 16 separate schedules that must be completed depending on the filing organization’s activities.

### GOVERNANCE AND TAX COMPLIANCE

In the wake of a number of high-profile scandals involving nonprofit organizations over the past few years, and increased Congressional scrutiny of the nonprofit sector, the IRS has increasingly cast its focus on examining the governance practices of tax-exempt organizations. This is a notable change because the IRS has no express authority to regulate the governance of nonprofit organizations,

<sup>1</sup> The new form was released in December 2007. The Form and Instructions, along with background documents, are available on the IRS’s website at <http://www.irs.gov/charities/article/0,,id=181089,00.html>

<sup>2</sup> See IRS Information Release 2007-117 (June 14, 2007).

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and therefore, in general, has left governance issues to the purview of state law and regulators. The reason for the shift is simple. The IRS believes that there is a “nexus between good governance and tax compliance.”<sup>3</sup>

Charitable organizations should understand that tax compliance is one of the key components of the redesigned Form 990. Information requested by the new form about various governance practices will undoubtedly form the basis of some of the new triggers the IRS is developing for selecting an organization for examination.

### STEPS TO TAKE NOW TO COMPLY WITH THE NEW FORM 990

Many tax-exempt organizations are expected to have to invest significant time and resources into revising, updating, and implementing accounting and tracking systems and governance policies and practices to comply with the reporting requirements of the new Form 990. To assist with the transition to the new form, charities can take some proactive measures.<sup>4</sup>

#### *Review Governance Policies*

The new form asks organizations if they have various written governance policies, including:

- Conflict of interest policy
- Whistleblower policy
- Document retention and destruction policy
- Policy for participating in joint ventures with for-profit entities

While these policies are not required by law, nonprofits will not want to answer “no” to the questions in this section.<sup>5</sup>

<sup>3</sup> Remarks of Steven T. Miller, Commissioner, Tax Exempt and Government Entities, IRS, Georgetown Law Center Seminar on Representing and Managing Tax-Exempt Organizations (April 24, 2008), available at [http://www.irs.gov/pub/irs-tege/represent\\_manage\\_speech\\_042408.pdf](http://www.irs.gov/pub/irs-tege/represent_manage_speech_042408.pdf).

<sup>4</sup> There are too many changes contained in the new Form 990 to provide a comprehensive list here.

<sup>5</sup> The Sarbanes-Oxley Act (SOX) does not require nonprofit organizations to have written whistleblower or document retention policies. However, SOX does make it a criminal offense for anyone—including tax-exempt organizations—to retaliate against an employee who provides truthful information relating to the commission of any federal offense to a law enforcement officer. In addition, SOX makes tax-exempt organizations subject to the criminal penalties imposed for destroying documents that are anticipated to be the subject of

To avoid answering “no,” nonprofits will need to adopt new policies and practices. These policies should be tailored to their particular organizations that make sense for them and can be enforced by them. Organizations should resist the urge to adopt generic policies that make their Form 990 look good on paper, or to adopt policies that are then not followed.

#### *Review Governance Practices*

The new form asks a number of questions about an organization’s governance practices that, while important to good governance, are generally not required by law. Charities should review these questions carefully and determine what steps they should take if they are not complying with these practices.

- Reviewing Form 990 by their board of directors before it is filed.
- Contemporaneously documenting meetings and actions taken by their board and certain committees.
- Following the “rebuttable presumption of reasonableness” rules (under Section 4958) in setting compensation for the CEO and key employees. Organizations should take note that the new form requires greater reporting and transparency with respect to the compensation of officers, directors, trustees, key employees, and highest compensated employees, including reporting of first-class or charter travel, travel for companions, housing allowances, tax indemnification and gross-up payments, discretionary spending accounts, payments for business use of personal residence, payments for health or social club membership, and personal services (e.g., maid, chauffeur, chef). Organizations are also asked if they have a policy for providing such perquisites.
- Retaining an independent accountant to compile, review, or audit the organization’s financial statements, and creating a committee to provide oversight of financial reporting and the audit process.

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a federal investigation. Therefore, having a written policy to address these areas is recommended.

### ***Implement New Systems to Track Conflict of Interest Transactions***

The new form requires organizations to track a wide variety of conflict of interest transactions with a very broad group of individuals directly or indirectly related to the filing organization. These transactions include:

- Excess benefit transactions
- Loans to and from interested persons
- Grants or assistance benefiting interested persons
- Business transactions with interested persons

Charities should review their conflict of interest policies to ensure that they capture all the transactions required to be tracked by the new form. However, not every transaction will have to be reported on the new form, if certain exceptions apply.

One of the key challenges of tracking these transactions is that the definition of “interested persons” is different for each of the four categories above. In some cases, organizations will also have identify and track former officers, directors, trustees, and key employees.<sup>6</sup>

**Organizations may rely on “reasonable efforts.”** In light of the overwhelming comments from the nonprofit sector that some of these transactions are impossible or impractical to track, and do not necessarily provide important information in evaluating an organization’s governance, the IRS will allow organizations to rely on “reasonable efforts” to obtain information from interested persons or third parties with respect to (a) grants or assistance benefiting interested persons and (b) business transactions with interested persons.<sup>7</sup> The Instructions state that an organization may rely on information provided by interested persons, for example, through an annual questionnaire.

### ***Identify “Independent Directors”***

Organizations are required to indicate the number of voting

<sup>6</sup> The IRS has limited the look-back period for these individuals to five years.

<sup>7</sup> The “reasonable efforts” standard also applies to identifying “independent directors” and some other transactions and relationships.

members of their board of directors that are “independent.” The Instructions to the form provide a three-part test for determining whether a board member is “independent.” In general, a board member is considered “independent” if he or she (a) is not compensated as an officer or employee of the organization (or a related organization); (b) does not receive more than \$10,000 from the organization (or a related organization) as an independent contractor, other than reimbursement of expenses under an accountable plan or reasonable compensation or reimbursement as a board member; and (c) was not involved (and did not have a family member who was involved) in a transaction with the organization (or a related organization) that was required to be reported on Schedule L by the organization (or by a related organization).<sup>8</sup>

### ***Identify “Key Employees”***

Organizations will have to identify “key employees” for a number of purposes on the new form, including reporting executive compensation and transactions with interested persons. A three-part test defines who is a “key employee.” In general, a “key employee” is an employee who (a) has reportable compensation exceeding \$150,000 for the year (the “\$150,000 test”); (b) has control or influence similar to an officer or director or has authority or control over at least 10 percent of the organization’s activities (the “responsibility test”); and (c) is within the organization’s top 20 highest paid employees who satisfy both the \$150,000 test and the responsibility test.

### ***Prepare Documents for Public Access***

Charitable organizations are required to make their Forms 1023, 990, and 990-T<sup>9</sup> available for public inspection. The new form asks how the filing organization makes these forms available to the public, including posting on the

<sup>8</sup> Four types of transactions are generally required to be reported on Schedule L: excess benefit transactions; loans to and from interested persons; grants or assistance benefiting interested persons; and business transactions involving interested persons.

<sup>9</sup> As part of the charitable reforms enacted by the Pension Protection Act of 2006, Congress extended the public disclosure requirements to Form 990-T, the annual report used for reporting unrelated business taxable income. The new disclosure requirement applies only to organizations exempt under section 501(c)(3).

organization's or another organization's website<sup>10</sup> or upon request.

An organization is also required to describe whether (and how) it provides its governing documents, conflict of interest policy, and financial statements available to the public. As the Instructions make clear, federal tax law does not require that the organization make these documents available for public inspection. However, many charitable organizations are beginning to post these documents voluntarily on their websites to enhance disclosure and transparency of their activities to their stakeholders. An organization that does not make these documents publicly available should be ready to explain why it has chosen not to do so.

### ***Review State Governance and Filing Requirements***

Although complying with federal tax and IRS requirements is the primary concern for most charitable organizations, tax-exempt organizations should not forget that they are also subject to state law and regulation. Organizations should not be confused by the fact that a governance practice or policy may be voluntary for federal tax purposes, but may be required under state law. Examples include:

- Approximately 39 states and the District of Columbia have enacted laws to regulate charitable fundraising. Most of these states require organizations that conduct charitable fundraising to have a financial review or independent financial audit, depending on the amount of contributions raised.<sup>11</sup>
- Some states, like California, require organizations with assets and receipts above a certain threshold to have an audit committee (the new Form 990 asks if an organization has an audit committee); while other states, like New Hampshire, require certain organizations to have a written conflict of interest policy.

<sup>10</sup> It is not clear if posting by GuideStar on its website satisfies this requirement.

<sup>11</sup> The new Form 990 asks if an organization's financial statements are compiled, reviewed, or audited by an independent accountant.

Organizations can also expect that state regulators will be looking at the increased disclosure of an organization's investment activities provided by the new form. State regulators have been known to begin audits based on an organization's investment practices that were not considered to be consistent with prudent investment standards. In many cases, these organizations did not have an investment policy or were not following the ones they adopted.

### ***Other Reporting Provisions***

Depending on its activities, an organization may have to complete one of the 16 new schedules that are part of the new Form 990. There are separate schedules for reporting and disclosing information about a number of important activities—in great detail in some cases—including:

- Conducting political campaign and lobbying activities
- Maintaining donor advised funds or other funds or accounts; maintaining endowment funds; being the beneficiary of agency endowment or designated funds held by another organization
- Making grants or conducting activities outside of the United States
- Conducting charitable fundraising or gaming activities
- Receiving non-cash contributions
- Information about “related organizations”
- Liquidation, termination, dissolution, or significant disposition of assets

### ***Phase-in of New Form 990***

Tax-exempt organizations will have to start filing the new Form 990 starting with their 2008 tax year. To provide relief to smaller organizations, the IRS will phase in the new Form 990 over a three-year period, depending on the organization's gross receipts and assets, as provided in the chart below. These organizations will be allowed to file Form 990-EZ instead.

May file 990-EZ for:	If gross receipts are:	If assets are:
2008 tax year (filed in 2009)	greater than \$25,000 and less than \$1 million	less than \$2.5 million
2009 tax year (filed in 2010)	greater than \$25,000 and less than \$500,000	less than \$1.25 million
2010 and later tax years	greater than \$50,000 and less than \$200,000	less than \$500,000

### **Form 990-N (e-Postcard)**

An organization that is not required to file Form 990 or 990-EZ because its annual gross receipts are normally less than \$25,000 must file Form 990-N.<sup>12</sup> This new filing requirement for small organizations was enacted by the Pension Protection Act of 2006 and is effective for tax years ending on or after December 31, 2007. Form 990-N must be filed electronically every year. The return requires the organization to provide information about its Employer Identification Number (EIN), tax year, legal name and mailing address, other names the organization uses, the name and address of a principal officer, website address (if any), confirmation that the organization's annual gross receipts are normally less than \$25,000, and, if applicable, a statement the organization has terminated or is in the process of terminating.

### **Failure to File**

Under a new requirement enacted as part of the charitable reforms included in the Pension Protection Act of 2006, an organization's tax-exempt status will be automatically revoked if it fails to file a required Form 990, 990-EZ, or 990-N for three consecutive years.<sup>13</sup> The revocation of the organization's tax-exempt status will not take place until the filing due date of the third year.

*We hope you find this summary helpful. If you would like more information about the new IRS Form 990, please feel free to contact your Arnold & Porter attorney or*

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<sup>12</sup> The IRS expects to increase the threshold to \$50,000 starting with the 2010 tax year.

<sup>13</sup> See Internal Revenue Code Section 6033(j).