

Governance Challenges for Nonprofits Posed by the New IRS Form 990

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In light of the *Enron* debacle and parallel scandals in the nonprofit world, Congress and the IRS have put nonprofits, and specifically nonprofit governance, under the microscope. Prior to Sarbanes-Oxley (SOX), corporate governance was under the purview of state law. SOX instituted federal oversight over corporate governance of public companies. Although governance of nonprofits has continued to be a matter of state law, this may be changing, through the IRS' recent foray into "regulation through disclosure."

Form 990 is the annual return required to be filed, both with the IRS, and with a significant number of states, by most tax-exempt organizations. In addition, all Forms 990 are available for public inspection. The forms are regularly examined by many potential contributors, as well as other interested parties.

In December, 2007, the IRS issued a significantly revised Form 990. The revised Form 990 must be used for annual returns filed for tax year 2008 (for fiscal years ending from Dec. 31, 2008, through November 30, 2009), by most large exempt organizations (\$1,000,000 or more in gross receipts or \$2,500,000 or more in assets). For the 2009 tax year, the new Form 990 must be used by organizations with at least \$500,000 in gross revenues or \$1,250,000 in assets, with limited exceptions. For the 2010 tax year, intended as final phase-in, almost all exempt organizations with gross receipts above \$200,000 or assets over \$500,000 will be covered. This phase-in will allow smaller organizations more time to prepare; however, some of the schedules of the revised Form 990 have already been incorporated into the recently revised Form 990-EZ, which may be used by smaller organizations instead of the Form 990. Most organizations with less than \$25,000 in income (increasing to \$50,000 in 2010) may, instead, make an e-filing (also referred to as Form 990-N).

Although the revised form also contains many other changes that will require significant time and attention from the exempt organization and its accountants, Form 990 now contains an emphasis that should be of particular concern to corporate attorneys. The IRS has added a new Governance Section as well as additional governance-related questions throughout the form. On August 19, 2008, the IRS issued instructions for the revised form and provided additional guidance on the nature of the governance policies that the IRS would like to see.

Despite the IRS's best efforts to publicize the changes, the word has not reached the many small-to-medium nonprofits without regular retained counsel as well as those attorneys and accountants whose practice does not concentrate on work with tax-exempt organizations. As a result, it is possible that organizations will not realize the impact of decisions they will need to make to appropriately answer some of these questions until they are actually faced with filling out the form.

There is a larger problem as well: accountants, and to a lesser extent tax attorneys, have largely left internal governance of tax-exempt organizations up to nonprofit practitioners and business lawyers. To a certain extent, then, this IRS foray into

governance has fallen between these cracks and is likely to catch many organizations and their advisors unaware.

While the governance practices that must now be disclosed in the Form do not have mandated “correct” answers, donors, ratings agencies, and local tax and nonprofit governance regulators can be expected to review governance responses on the Form 990 in their evaluations. The IRS may also use responses to evaluate which returns warrant more careful review or possible audits. Disgruntled members and miscellaneous gadflies can be expected to review organizations’ publicly available Form 990 filings. For these reasons, exempt organizations filing the new Form 990 are likely to feel significant pressure either to adopt policies that will allow them to put down what is considered the “right” answer to the governance questions, or to carefully craft their accompanying explanations to provide a reasonable description of why the “correct” answer is not applicable in their case.

The governance questions on the form, 28 in the new Governance Section alone, may require many exempt organizations to review their bylaws and determine whether it is appropriate to adopt several new policies:

- *Independent Directors.* The Form 990 inquires about the total number of directors and the number of independent directors who meet the definition in the instructions. Comparison of the numbers readily discloses the percentage of independent directors. The definition of *independent* used by the IRS excludes ordinary members of membership associations and substantial donors who do not have other transactions with the organization. Exempt organizations may wish to consider amending their bylaws or adopting nomination policies to encourage board composition with a high percentage of members meeting the instructions’ definition of *independent*. Alternatively, the organization should determine why it does not consider this an appropriate requirement, and be prepared to defend this position.
- *Governing Document Changes.* A Narrative description is required for all significant changes in an organization’s “organizational documents,” typically articles of incorporation or association, bylaws, and, for trusts, a trust instrument or declaration of trust. That means that an organization contemplating any bylaw change must review the instructions to determine if the change is significant and consider the public perception of its narrative description of the change before making any amendments to its governing documents. This requirement might, in some instances, discourage bylaws amendments, and might further encourage migration of provisions from bylaws, which are reportable, to policies, which are not reportable.
- *Minutes.* The Form asks whether the organization contemporaneously documents its board meetings and meetings of committees with power to act. These questions encourage boards and board committees to formalize the recording of their procedures and to determine what level of detail they want in the minutes. It may encourage adoption of minutes policies or adoption of standards contained in a reference work that prescribes methods for recording and adopting minutes.

- *Chapter Relations Policies.* The Form asks whether multi-level associations have policies and procedures to ensure consistency throughout the organization. This appears to encourage central or superior organizations within multi-level associations to adopt chapter relations policies (or unit, division, lodge, constituent, component, regional, or local relations policies, as the case may be). Similarly, associations will be encouraged to adopt bylaws provisions and consistent sample chapter (or other appropriate unit) charters and bylaws with stronger oversight provisions.¹ The requirements being suggested could also result in the associations finding themselves running afoul of franchise law in some states unless they carefully tailor their response.
- *Form 990 Review.* The Form asks whether each member of the Board reviewed the final draft of the Form 990 before it was filed and requires a narrative description of the review process. cursory submission to Board members immediately before filing, just to be able to answer “yes,” is unlikely to be considered sufficient. Boards will need to consider adopting a Form 990 review policy that provides adequate time for meaningful review by at least a subcommittee of the Board and a method for allowing feedback and revisions based on Board input.
- *Standard Policies.* The Form 990 asks whether organizations have conflict of interest, whistleblower, and document retention/destruction policies. Conflict of interest policies have long been a good governance standard and are prescribed for many nonprofits by state statute, such as New York. The Form 1023. Application for Recognition of Exemption Under §501 (c) (3) has, for several years, suggested that applicants adopt a conflict of interest policy. Whistleblower and document retention/destruction policies are fallout from SOX, as its whistleblower and document destruction sanctions apply to nonprofits. The Form 990 encourages exempt organizations that have not yet adopted such policies to consider doing so.
- *Compensation Policy.* Executive compensation has been a significant issue for exempt organizations since the introduction of intermediate sanctions.² A number of the high profile nonprofit scandals, such as American University and United Way, have involved excess compensation issues. The Form asks for a narrative description of the organization’s executive compensation procedures and suggests certain basic parameters: review and approval by independent persons, use of comparability data, and contemporaneous substantiation of the deliberation and decision. These details encourage the adoption of a formal compensation process complying with the terms suggested in the Form.
- *Joint Venture Policy.* If the organization engages in most forms of joint ventures or other joint investments, whether with nonprofit or for-profit partners, it must relate whether it has in place a joint venture policy. The questions and instructions define such a policy as one that safeguards the organization’s tax-exempt status during its participation in the endeavor.

¹ See <http://www.michaelmalamut.com/articles/AssociationRelationshipsUnderScrutiny.pdf>

² See http://www.runquist.com/article_intermedsancts.htm for more information.

- *Governance Disclosure Policy.* A further question requests a narrative response to how the organization makes its governing documents, conflict of interest policy, and financial statements available to the public. Despite the ready availability of Form 990s gratis online,³ another question inquires about how the organization disseminates its Form 990. Affected organizations need to think about whether they wish to disclose their significant governing documents and, if so, which documents and in what manner, and, if the organization determines that such disclosure is not required or appropriate, what explanation they might provide for such a decision.
- *Audit Committee Charter.* The Form asks, in Part XI, whether the filing organization has an audit committee to review its outside audit. Not any committee denominated the “audit committee” will do. The instructions include a detailed description of a compliant audit committee.
- *Gift Acceptance Policy.* If the organization has received more than \$25,000 in noncash contributions or contributions of art or historic items, regardless of value, it must complete Schedule M. Schedule M in turn inquires whether an organization that receives nonstandard gifts has a gift acceptance policy.

Some of the policies suggested by the new Form 990 are closely related to tax compliance, such as compensation policies (related to intermediate sanctions for potential overcompensation) and gift acceptance policies, or to legal mandates, like whistleblower and document retention policies derived from Sarbanes-Oxley. Others, however, are apparently thought by the IRS to be general good governance strictures based on little or no empirical evidence and no longstanding sector agreement on best practices. On June 11, 2008, the Advisory Committee on Tax Exempt and Government Entities issued a thorough report on the appropriate role of the IRS in governance issues, cautioning that IRS should take on any new initiatives in the area cautiously.

The IRS has thus become the leading impetus behind governance reform for nonprofit organizations. Many smaller organizations that prepare their own returns or that work with accountants or lawyers unfamiliar with the new form will only become aware of the new governance suggestions while they are filing their first post-2008 tax return. Many such organizations have gone about their missions quietly and effectively for years without governance review or policy drafting. They will now have to create more formalized systems, but need to make sure that these systems work for them, and should not be forced into a policy that simply does not fit their structure. And because Form 990 responses refer to the end of the tax year and not the date of filing, even if the organization decides to put in place the referenced policy, these organizations may have to respond “No, but ...” in the first year of phase-in, with an explanation that the relevant policy was adopted after the end of the tax year, but before filing, or remains under study and is expected to be finalized shortly. In following years, they will need to be up to speed. Moreover, the IRS has signaled that the “right” answer may not be enough. The next concern is implementation. The new Form 990 already asks a question relating to implementation of conflict of interest policies.

³ See <http://www.guidestar.org>

The phase-in period gives affected organizations limited time to implement governance policies called for in the new Form. Practitioners who work with nonprofits of all sizes that have not yet started to prepare for the new Form 990 should start thinking about how to guide their clients through a serious governance review.

The 2008 Form 990 and instructions are available on the IRS website at <http://www.irs.gov/charities/article/0,,id=185561,00.html>. Links to background papers and commentary on the draft form and instructions are available at <http://www.irs.gov/charities/article/0,,id=181089,00.html> and <http://www.irs.gov/charities/charitable/article/0,,id=185892,00.html>. The June 11, 2008, ACT report is available at http://www.irs.gov/pub/irs-tege/tege_act_rpt7.pdf.

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