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New IRS Form 990 Calls for Immediate Review of Governance Practices

IRS Form 990, which all 501(c)(3) organizations must file annually, has been substantially revised beginning with the 2008 reporting year. The 2008 return introduced sweeping changes and requires reporting in substantially greater detail than in the past. The new form now asks specific questions about many corporate governance issues. Many tax-exempt organizations have sought extensions of time to file their 2008 annual returns to November 15. For these organizations, time is running out. Regardless of whether the organization has already filed its return, the new format requires all tax-exempt organizations to review and document certain corporate governance procedures. This Alert provides some practical guidance as to how the new form impacts corporate governance.

How to Approach Form 990.

Although Form 990 is a tax return, it is unlike the returns of taxable entities because it is open to public inspection. Whenever stakeholders, government regulators, donors, grant makers or the press want to learn more about the organization, they will turn first to the organization's Form 990. For this reason, tax-exempt organizations should view its Form 990 as a public relations document as well as a regulatory compliance document. A carefully prepared Form 990 that includes detailed explanations of the organization's achievements and governance practices places the organization's best foot forward with government regulators and the public.

New Questions Regarding Governance.

The new Form 990 asks a number of questions regarding the organization's corporate governance practices. Specifically, the new form asks whether the organization has adopted a written *Conflict of Interest Policy*, a *Whistleblower Policy*, and a *Document Retention Policy*. Although adoption of these policies is not a legal requirement, these questions suggest that the IRS considers adoption of these policies to constitute "best practices" in corporate governance. The new form also asks whether the persons setting the compensation of key management employees relied on comparability data or a review of the compensation arrangements by independent persons. Form 990 asks whether the organization kept contemporaneous records (e.g. minutes) of deliberations regarding compensation, and questions whether the organization's Board of Directors reviewed the Form prior to filing.

Schedule O.

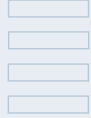
Form 990 contains a free-form schedule that allows organizations to provide explanations not otherwise required by the Form (Schedule O). In some cases, the return requires that additional explanations be added to Schedule O. However, there is no prohibition against adding other supplemental information. Expansive use of Schedule O allows the organization its best opportunity to "tell its story" to the public.

Reporting of Corporate Governance Matters.

We recommend that Boards of organizations avoid the rush to adopt "boilerplate" *Conflict of Interest Policies*, *Whistleblower Policies*, and *Document Retention Policies* solely for the sake of checking "yes" on the appropriate lines of its Form 990. The better approach is for the organization to undertake a careful review of its actual practices regarding conflicts of interest, whistleblower protections and

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document retention, change them as necessary to comply with best practices, and document those practices. The Board should ask itself whether the organization's current conflict of interest, whistleblower and record retention practices are workable, whether they are understood by those who must implement them, and whether they are followed in practice. Counsel should be consulted to advise whether those practices comply with best practices in corporate governance. If the answer to any of these questions is "no", changes would be in order. Once that review has been completed, and any changes implemented, the Board can reduce those practices to writing as a formal policy.

In some cases, a formal written "policy" may not be required to implement best practices. For example, if adequate whistleblower protections are already included in an employee manual, are workable, known to the employees, and followed, there is little advantage to be gained by the Board's adoption of a duplicative Whistleblower Policy. Schedule O provides the organization an outlet to describe its actual practices in detail. In such a case, an organization should not jump to the conclusion that checking the "no" box on Form 990 is a "bad" response. In many cases, directing the reader of the form to a detailed explanation of actual practices on Schedule O provides the organization a better opportunity to explain its practices to the public than the "check-the-box" response on the form.

Conflicts of Interest and Compensation.

Notwithstanding the foregoing, every Board should adopt a written *Conflict of Interest Policy*. Prior to adopting a conflicts policy, the Board should review its actual procedures for disclosing and resolving conflicts. The Board should compare its actual practices to the sample Conflict of Interest Policy provided by the IRS in its instructions to Form 1023 (application for recognition of tax-exempt status). If the Board's practices do not conform to the IRS model, it should change its practices. Schedule O provides the organization an opportunity to highlight its review and modification of its conflict of interest practices.

The new form reflects the IRS' long-standing concern with excessive executive compensation. We recommend that the Board focus on the method by which it approves the compensation of its management employees, and to add safeguards to ensure objectivity (such as independent reviews and use of comparability data). Prior to adopting a formal policy, the Board should be guided by the same criteria as other policies: is the policy workable; is it known and understood by those who must implement it; is it followed; and does it comport with best practices?

Board Review of Form 990.

The new form asks the organization to disclose whether its Board reviewed its Form 990 prior to filing. Although Board review of Form 990 is not required, such review reflects that the organization's decision makers have a sufficient degree of understanding of the organization's operations to serve effectively. Regardless of whether the Board reviews Form 990 prior to filing, the new form requires the organization to explain (on Schedule O) the process, if any, that the organization employs to review the return.

Conclusion.

An organization's approach to the disclosures on the new Form 990 requires a careful analysis and documentation of the organization's actual practices regarding conflicts of interest, whistleblowing, record retention and executive compensation. Hiscock & Barclay, LLP has substantial experience in advising non-profit organizations with respect to best practices in corporate governance and drafting compliant, workable corporate policies. Should you need assistance in these matters, please contact David P. Glasel, Chair of the Firm's Health Care and Human Services Practice Area (212-784-5800); or Raymond N. McCabe of the Firm's Tax Practice Area (716-566-1408). ■

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