Tax-Exempt Organizations Ensuring Governing Board Independence

Tax-Exempt Organizations (TEOs) are facing increased scrutiny from governmental agencies, watchdog groups and Congress regarding their corporate governance practices. Such groups view good governance practices as essential to ensuring that TEOs comply with the tax laws, protect their charitable assets and serve the best interests of their charitable beneficiaries.[1] A key component in ensuring proper governance is the presence of an independent governing board.

For many TEOs the concept of independent members on a governing board is not new. In 1969, the Internal Revenue Service (IRS) published Revenue Ruling 69 545 requiring TEOs to meet a community benefit standard.[2] Among the factors considered when determining compliance with the community benefit standard is the presence of a community board— defined as a board in which independent community representatives comprise a majority.[3] Although the revenue ruling did not specifically define "independence," the IRS indicated that practicing physicians affiliated with the hospital, officers, department heads and other employees of the hospital are not independent due to their close and continuing connection with the TEO.[4] Notably, however, representatives that may have had business dealings with the TEO were not excluded from the majority.[5]

Almost 50 years later, the IRS provided TEOs with the definition of "independence" that its 1969 Revenue Ruling lacked. On December 20, 2007, the IRS released the redesigned Form 990, Return of Organization Exempt from Income Tax. The new Form 990 not only required TEOs to report the number of "independent" voting members serving on their governing board but mandated that such board members fit within the new Form 990 three-part definition of independence. The IRS indicated that it will use the reported information to determine whether the board represents a broad public interest and to identify the potential for transactions that could result in the misuse of charitable assets.[6]

Despite the fact that many TEOs have completed one (if not two) Form 990 reporting cycles, many still struggle with the implications of the new definition of independence. This article provides guidance on three key issues that TEOs continue to struggle with: (1) whether board members are truly independent under the new Form 990 definition of independence; (2) the necessity of independent board leadership; and (3) what to do with internal policies and

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Governing Board Independence

Many TEOs lack a clear understanding of whether a director is independent under the new Form 990 definition.

Three-Part Definition of Board Independence. For Form 990 purposes, a director is considered independent only if the director satisfies all three of the following requirements at all times during the TEO's tax year:

1. The director was not compensated as an officer or other employee of the TEO or a related TEO (unless a religious organization exception applies).
2. The director did not receive total compensation or other payments exceeding $10,000 during the TEO's tax year from the TEO or from related TEOs as an independent contractor, other than reimbursement of expenses under an accountable plan or reasonable compensation for services provided in the capacity as a director. For example, a person who receives reasonable expense reimbursement and reasonable compensation as a director of the TEO does not cease to be independent merely because he or she also receives $7,500 from the TEO for other arrangements.
3. Neither the director, nor any family members of the director was involved in a transaction with the TEO (whether directly or indirectly through affiliation with another TEO) that is required to be reported on Schedule L (Form 990) for the TEO's tax year, or in a transaction with a related TEO of a type and amount that would be reportable on Schedule L (Form 990) if required to be filed by the related TEO.

The first and second prongs of the three-part test do not vary significantly from the IRS's past guidance. As stated previously, TEO officers or other employees are not independent because of their close and continuing connection with the TEO. Likewise, non-employed physicians practicing and providing treatment within a charitable hospital or other independent contractors receiving compensation would fall within the second prong of the three-prong test. However, the third prong of the three-prong test may vary from current TEO practices. Historically, directors may be considered independent despite the fact that the director may have business dealings with the TEO. Although this principle remains sound, the new Form 990 limits the business dealings a director may have with the TEO to transactions that do not need to be reported on Schedule L.

Schedule L and the Interested Person

On Schedule L, a TEO reports information on certain financial transactions or arrangements between the TEO and "Interested Persons." Schedule L has the four subparts sets forth below, and for each subpart, there is a separate definition of "Interested Person."

- Part I. Excess Benefit Transactions (generally refers to transactions in the current tax year where an Interested Person received a benefit in excess of fair market value.
- Part II. Loans To and From Interested Persons (generally refers to the receipt of a loan by an Interested Person that remains outstanding in the current tax year);
- Part III. Grants or Assistance Benefiting Interested Persons (generally refers to that receipt by an Interested Person of a scholarship, internship, prize or award from the TEO); and
- Part IV. Business Transactions Affecting Interested Persons.

The term "Interested Person," for the purpose of Schedule L, Part IV, includes a current and/or a former officer, director, trustee, key employee and any of the following:

1. a family member of any current or former officer, director, trustee, key employee;
2. an entity more than 35% owned directly or indirectly individually or collectively by one or more of the current and/or former officers, directors, trustees or key employees or their family members; and
3. an entity (other than a TEO) of which a current or former officer, director, trustee or key employee was serving at the time of the transaction as (A) an officer; (B) a director; (C) a trustee; (D) a key employee; (E) a partner or member with direct or indirect ownership interest in excess of 5% (including the ownership by a family member) if the entity is treated as a partnership; or (F) a shareholder with an ownership interest in excess of 5%.

It is important to note that not all business transactions must be reported on Schedule L. Rather, a TEO must report business transactions in Schedule L, Part IV with respect to an interested person if:

1. all payments during the tax year between the TEO and the interested person exceeded $100,000 (multiple transactions);
2. all payments during the tax year from a single transaction between such parties exceeded the greater of $10,000 or 1% of the TEO's total revenues;
3. compensation payments during the tax year by the organization to a family member of certain persons exceeded $10,000.00; or
4. in the case of a joint venture with an interested person, the organization has invested more than $10,000 or more in the joint venture whether or not the investment was made during that tax year.[7]

Accordingly, a TEO need not report transactions (other than compensation payments to family members) with an interested person that do not exceed $10,000 or 1% of the TEO's total revenue for that tax year unless the total payments for all transactions between the parties during the TEO's tax year exceeded $100,000.[8] If the business transaction was the TEO's payment of compensation to a family member of a current officer, director, trustee or key employee of the organization, payment of compensation in excess of $10,000 of the organization's tax year must be reported.[9]

Key Employees

Though it is clear whether a current board member is a current or former officer, director or trustee, many TEOs are confused about the meaning of "key employee." For purposes of Form 990, a current "key employee" of the TEO (other than an officer, director or trustee) is one who meets all three of the following tests, applied in the following order[10]:

1. **$150,000 Test**. Receives reportable compensation from the TEO and all related organizations in excess of $150,000 for the calendar year ending with or within the TEO's tax year.
2. **Responsibility Test**. At any time during the calendar year ending with or within the TEO's tax year:
    1. Has responsibilities, powers or influence over the TEO as a whole that is similar to those of officers, directors and trustees;
    2. Manages a discrete segment or activity of the TEO that represents 10% or more of the activities, assets, income or expenses of the TEO, as compared to the TEO as a whole; and
    3. Has or shares authority to control or determine 10% or more of the TEO's capital expenditures, operating budget or compensation for employees.

3. **Top 20 Test**. Is one of the 20 employees (other than officers, directors and trustees that satisfy the $150,000 Test and Responsibility Test) with the highest reportable compensation from the TEO and related TEOs for the calendar year ending with or within the TEO's tax year.

Determining Independence for the Form 990

TEOs must obtain a clear understanding of the type of business transactions that may be taking place between the TEO and any voting member of the governing board. In addition, the Form 990 makes it clear that even if a director is not personally involved in a business transaction with the TEO, the director may be deemed "not independent" by virtue of his or her employment. Although this information may be difficult to obtain, TEOs must engage in a reasonable effort to obtain the information necessary to accurately report on director independence. The IRS has indicated that a reasonable effort would include the annual distribution of a questionnaire to each of its current or former officers, directors, trustees, key employees and, if relevant, its grant selection committee members requesting relevant information.[11] The following checklist may provide TEOs some guidance in creating such forms and questionnaires to distribute to board members.

Director of Tax-Exempt Organization Questionnaire

Date ________________					
1.	Are you currently an officer or key employee of the Corporation?	Yes		No	
2.	Are you currently compensated by the Corporation as an independent contractor with payments that exceed $10,000 in the current tax year, except for reasonable expense reimbursement?	Yes		No	
3.	Has a family member of yours received direct compensation in excess of $10,000 from the Corporation in the current tax year?	Yes		No	

4.	Have you received an economic benefit from the Corporation that exceeds the amount of consideration received by the Corporation? (i.e., an arrangement at less than fair market value)	Yes		No	
5.	Have you received a loan from the Corporation that remains outstanding in the current tax year?	Yes		No	
6.	Have you or a family member received a scholarship, internship, prize or award from the Corporation?	Yes		No	
7.	Are you or a member of your family a director, officer, trustee or key employee, a partner or member with a direct or indirect ownership interest in excess of 5% (including ownership by your family member) or a shareholder with a direct or indirect ownership interest in excess of 5% in company that has entered into a business transaction(s) with the Corporation? If the answer is "Yes" please list all business transactions and total payments associated with such transactions on the attached exhibit.	Yes		No	
8.	Are you part of a joint venture with the Corporation in which the Corporation has invested a total of $10,000 or more?	Yes		No	
By: ______________________________					
Name: ___________________________					
Title: _____________________________					

Board Leadership

In light of the new Form 990 requirements, many TEOs are taking a second look at succession planning and board leadership. Namely, TEOs are starting to tackle the question of what to do if the chairperson of the board does not meet the Form 990 definition of "independence." Although the IRS does not specifically require board leadership to be independent, various government agencies and Congress have made it clear that the tax-exempt status of TEOs is being carefully scrutinized. In light of the fact that corporate governance practices and board independence are viewed as integral to maintaining 501(c)(3) status, TEOs are wise to consider not only majority independence but whether board leadership represents that majority.

Although independent board membership is not new to TEOs, many publicly traded, for-profit corporations faced this challenge for the first time in 2002. In response to many high profile corporate and accounting scandals in 2001 and 2002, Congress passed the Sarbanes-Oxley Act of 2002. Characterized as the "most far reaching reforms of American business practices since the time of Franklin Delano Roosevelt," the Act instituted a number of reforms to enhance corporate responsibility.[12] Shortly thereafter, the New York Stock Exchange, Inc. and The Nasdaq Stock Market, Inc. published rules regulating corporate governance practices. At the heart of these new rules and regulations was the increased emphasis on governing board independence. Specifically, requiring a majority of independent directors will increase the quality of board oversight and lessen the possibility of damaging conflicts of interest.[13]

To ensure proper oversight and management, rules and regulations also require certain board committees of publicly traded corporations be comprised entirely of independent members.[14] Specifically, only independent directors may serve on the key board committees of publicly traded corporations such as the nominating/corporate governance committee, compensation committee and audit committee. The nominating/corporate governance committee is viewed as central to the effective functioning of the board.[15] New director and board committee nominations are important board functions.[16] Placing this responsibility in the hands of independent directors will further enhance the independence and quality of the nominees.[17] Likewise, the compensation committee is primarily responsible for ensuring quality board oversight. Independent directors are a key component of the effectiveness of this committee because they are able to objectively evaluate management's performance. Finally, a major focus of the Act, rules and regulations is the independent audit committee. Audit committees comprised of independent members are responsible for ensuing the accuracy of a publicly traded company's financial statements and ensuring the independence of all external auditors.

In light of the increased requirements, many publicly traded corporations have introduced the concept of a "lead director." A lead director is an independent member of the board that is responsible for ensuring that the board of directors independently evaluates management and remains responsible to the corporation's shareholders. Additionally, the lead director may take on key roles on the nominating/governance committee, compensation committee and the audit committee. This may be particularly important in cases where the CEO and the chairperson of the board are held by the same person or the chairperson is otherwise non-independent.

In response to the increased scrutiny over governance practices, many TEOs are considering amending their bylaws or adopting detailed independence policies to ensure the independence of the board and the board's leadership. An integral part of such amendments and policies is the independence of key board committees such as the nominating/governance, compensation and audit committees. TEOs may also want to consider including the role of a "lead director" in the by-laws or independence policies to ensure that the governing board remains independent to ensure that the board and board committees remain independent even if the board's leadership is not independent. Specifically, TEOs may choose to specify that the leader of the governance/nominating and/or compensation committee always be independent. Accordingly, in cases where board leadership is not independent, the board could look to a committee leader to fill the role of lead director.

Similar to a for-profit corporation, a lead director would ensure that the board acts independently and that the TEO fulfills its tax-exempt purpose and remains committed to providing community benefit. In addition, the lead director could take on a key role on the nominating/governance committee, compensation committee and audit committee. For TEOs, the compensation committees are of particular importance because such committees are largely responsible for ensuring proper corporate management. In addition, a nominating/governance committee comprised of independent members will enhance board independence and quality. A lead independent director could be responsible for ensuring that such committees provide quality oversight and abide by the TEO's responsibility to the community it serves.

Independence Policies

Although the Form 990 introduced a new definition of "independence," the IRS has not mandated that TEOs implement the new definition in internal policies and procedures. In other words, a TEO may adopt its own definition of "independence" for use in internal conflict of interest and board independence policies. However, TEOs will still be required to analyze and report on independent board members in accordance with Form 990 requirements.

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Accordingly, TEOs that choose to use different definitions of independence must ensure that their governance practices comply with both internal policies and Form 990 requirements. At best, such TEOs will have twice the amount of work as those with streamlined definitions. At worst, TEOs that adopt a more liberal internal definition of independence may find themselves out of compliance with the Form 990 requirements. Although not required, best practices would suggest that TEOs revisit their internal policies and procedures to ensure that each complies with the new Form 990 definition of independence. Doing so will ensure compliance with IRS requirements and significantly reduce workload by eliminating the need to analyze transactions under two separate definitions of independence.

Conclusion

Although many TEOs have dedicated significant time, resources and attention to the new Form 990, many still struggle with the practical implications of the new definition of independence. Best practices would suggest that TEOs: take great care in collecting information and analyzing the independence of voting directors; create a lead director position to ensure board independence; and revisit policies that may contain definitions of independence that may differ from the Form 990 definition.

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[1] Internal Revenue Service, Governance of Charitable Organizations and Related Topics, IRS.gov (last visited August 13, 2010.)
[2] Rev. Rul. 69-545, 1969-2 C.B. 117.
[3] Id.
[4] Lawrence M. Brauer and Charles F. Kaiser, "Tax-Exempt Health Care Organizations Community Board and Conflicts of Interest Policy", IRS Exempt Organizations Continuing Professional Education Technical Instruction Program for FY 1997, available at IRS.gov.
[5] Id.
[6] Internal Revenue Service, Governance and Related Topics-501(c)(3) Organizations, available at IRS.gov.
[7] Internal Revenue Service, 2009 Instructions for Form 990
[8] Id.
[9] Id.
[10] Id.
[11] Id.

[12] The laws that govern the Securities Industry, SEC.gov (last visited August 13, 2010).
[13] Final NYSE Corporate Governance Rules (last visited August 16, 2010).
[14] Sarbanes-Oxley, the NYSE rules and the Nasdaq rules all require audit committees to be comprised entirely of independent members. The NYSE also requires the nominating/corporate governance and compensation committees to be comprised of independent members.
[15] Id.
[16] Id.
[17] Id.