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# Tax-Exempt Organizations and the Independent Governing Board

**POSTED:**

Feb 25, 2010

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Tax-exempt organizations continue to face scrutiny from governmental agencies, watchdog groups and Congress with respect to their governance practices. One area that is receiving increased scrutiny is the "independence" of governing boards. For example, the latest revisions to the IRS Form 990 informational tax return (filed by many exempt organizations) requires all filing organizations to report the number of independent voting members on their governing body.

The IRS (and many donors) view an independent board as a key protection against abuse of nonprofits. An organization with an independent board is less likely to provide improper benefits to private individuals that control the organization. While not a strict legal requirement for exemption, a lack of an independent board could result in increased negative scrutiny from the IRS and donors.

The new Form 990 reporting requirement, combined with the increased scrutiny on the nonprofit sector, should spur a renewed focus on Board composition. Every tax exempt organization should determine whether a restructuring is necessary to align with current best practices related to director independence. The ultimate goal should be to adopt and maintain an independent board policy.

## Who Is an Independent Director?

For many charitable, tax-exempt organizations, the concept of independent members on a governing board is not new. One of the factors that the IRS has historically used to determine if a hospital meets the community benefit standard is whether the hospital's governing board is composed of independent members of the community (*i.e.*, a majority of independent members on the board).

Whether a director is "independent" depends on the various relationships (*e.g.*, financial, familial, etc.) between the director and the organization. The board policy should describe the test to determine whether a governing board member is independent. In defining "independence," the board should carefully consider the organization's own unique circumstances balancing the goal of having independent directors free of real or perceived conflicts of interest with the organization against the realities of a potentially small pool of possible directors.

An independent director may have a conflict of interest with respect to a particular transaction yet retain his or her status as "independent" if conflict does not disqualify the member from classification as independent under the organization's independence definition. For example, a director who receives a small, market rate fee for an isolated consulting service may be considered an independent director.

As a guide to developing its definition of an independent director for purposes of its governance policies, a tax-exempt organization could look to one of the various definitions released by governmental and policy organizations in recent years.

## IRS Form 990 Definition of Independence

For purposes of answering relevant questions on the Form 990, the instructions (IRS.gov) state that a director is considered independent only if the director satisfies all three of the following at all times during the organization's relevant tax year:

1. The director was not compensated as an officer or other employee of the organization or of a related organization (unless a religious organization exception applies).

2. The director did not receive total compensation or other payments exceeding $10,000 during the organization's tax year from the organization or from related organizations 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 reimbursements and reasonable compensation as a director of the organization does not cease to be independent merely because he or she also receives $7,500 from the organization for other arrangements.

3. Neither the director, nor any family member of the director, was involved in a transaction with the organization (whether directly or indirectly through affiliation with another organization) that is required to be reported on Schedule L (Form 990 or 990-EZ) for the organization’s tax year, or in a transaction with a related organization of a type and amount that would be reportable on Schedule L (Form 990 or 990-EZ) if required to be filed by the related organization.

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Schedule L to the Form 990 requires an organization to report information on certain financial transactions and arrangements between the organization and an "Interested Person." There are four parts to Schedule L, each with its own separate definition of "Interested Person":

- Part I - excess benefit transactions (transactions where the Interested Person received a benefit in excess of fair market value);
- Part II - loans to and from Interested Persons;
- Part III - grants or assistance benefitting interested persons (generally refers to receipt by an Interested Person of a scholarship, internship, prize or award from the organization); and
- Part IV - business transactions affecting interested persons.

Part IV of Schedule L to the Form 990 defines the term "Interested Person" to mean any of the following: (1) a current and/or former officer, director, trustee, key employee; (2) a family member of any person listed in (1); (3) an entity more than 35% owned directly or indirectly, individually or collectively, by one or more person listed in (1); or (4) an entity (other than a tax-exempt entity) of which a person listed in (1) 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%, or (F) a shareholder with an ownership interest in excess of 5%. Note that the organization is not required to report business transactions under Part IV of Schedule L if the transactions do not meet minimum reporting thresholds, as described in the instructions to Schedule L.

## Panel on the Nonprofit Sector and Director Independence

According to the Panel on the Nonprofit Sector's website, the Panel is "an independent effort by charities and foundations to ensure that the nonprofit community remains a vibrant and healthy part of American society." The Panel is comprised of "24 nonprofit and philanthropic leaders whose organizations encompass great diversity in location, mission, perspective, and scope of work." The Panel also received guidance from an expert advisory group and a citizens advisory group in developing recommendations for strengthening the nonprofit sector.

The Panel released a report to Congress in 2005 with a series of recommendations for actions to be taken by the nonprofit community, Congress and the IRS. The Panel also released final self-governance recommendations to the charitable community in October 2007. One of the Panel's 2007 principles for self-governance states that a "substantial majority" of the board of a public charity should be independent. The Panel defined a "substantial majority" as being at least two-thirds of the board members.

In its 2007 principles for self-governance, the Panel provided that independent individuals of a governing board are those individuals:

1. who are not compensated by the organization as an employee or independent contractor;
2. whose compensation is not determined by individuals who are compensated by the organization;
3. who do not receive, directly or indirectly, material (not defined by the Panel) financial benefits from the organization except as a member of the charitable class served by the organization; and
4. who are not related to (as a spouse, sibling, parent or child), or do not reside with, any individual described above.

## The Governance Institute

The Governance Institute provides informational services for boards and executives of health care organizations, with a stated purpose of improving the effectiveness of hospitals and health care systems by continually strengthening their boards of directors, medical leadership and management performance.

The Governance Institute recommends that hospitals and health care systems adopt a definition of an "independent" board member with measurable standards for making that determination, and that at least a majority of board members meet the board's definition of "independent" persons.

More information on the Governance Institute's recommendations can be found at: Governance Institute.

## Guidance for Publicly Traded Corporations—NYSE and NASDAQ

Both the New York Stock Exchange (NYSE) and the NASDAQ have developed guidelines for listed companies regarding independence of the board members of those companies. Both exchanges require that listed companies have a majority of independent directors (more than 50%), believing that this requirement will increase the quality of board oversight and lessen the possibility of damaging conflicts of interest.

The NYSE defines independence in the Corporate Governance section of its Listed Company Manual.

NASDAQ defines independence in its Listing Rules

This chart briefly describes certain characteristics of the various definitions of independent directors that are discussed in this article.

## How Many Independent Board Members Should an Organization Have?

An exempt organization should have at least 50% of its governing board made up of individuals who qualify as independent in accordance with the organization's definition of that term. This is in line with the IRS community benefit standard, the NYSE and NASDAQ listing rules and the recommendation of the Governance Institute.

Some organizations may even wish to have a governing board made up of more than a simple majority of independent members. The Panel on the Nonprofit Sector has recommended that a "substantial majority" (defined as at least two-thirds) of the board of a public charity should be independent, for example, and forward-thinking organizations might want to consider a similar standard.

## Conclusion

With the release of the IRS Form 990 and continued scrutiny on tax-exempt organizations by Congress and watchdog groups, tax-exempt organizations should strongly consider reviewing and revising their policies and requirements on the independence of their governing boards. This might involve revising corporate policies and amending governance documents such as articles of incorporation, corporate bylaws and committee charters.

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