

GOVERNANCE POLICIES THE IRS THINKS YOUR ORGANIZATION SHOULD HAVE

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You may need to act by December 31!

The revised Form 990 (the annual information return that most tax-exempt organizations are required to file) was released by the Internal Revenue Service in December 2007. The revised form imposes significant reporting and recordkeeping changes on filing organizations. Detailed information regarding the revisions to Form 990 can be found in our February 2008 update, available at <http://www.quarles.com/Publications/detail.aspx?publication=371>.

Included among the changes to the Form 990 is an increased focus on internal governance. As a result, the revised Form 990 asks many questions regarding the existence and details of various policies and procedures. Most new policies and procedures must be adopted by the end of the organization's tax year beginning in 2008 — by December 31, 2008, for calendar-year filers — in order to be reported on the 2008 Form 990. While private foundations do not file the Form 990, most of these policies are appropriate for them as well.

Governing Policies and Procedures

The focus on tax-exempt organizations' governance led the Internal Revenue Service to add a number of new questions to the revised Form 990. These questions request information on a variety of internal policies and procedures, which the Internal Revenue Service believes are indicative of a well-governed organization. The Service has also said that the failure to have many of these policies, without indicating good reason for that failure, may lead to a higher likelihood of audit of the Form 990.

Although not all of these policies and procedures are appropriate for every tax-exempt organization, all tax-exempt organizations should make a considered decision regarding whether or not they should be adopted or modified. If a



tax-exempt organization finds that a specific policy would be appropriate, then the organization should consult with its lawyers now to prepare and adopt that policy.

- Conflict of Interest Policy and Annual Disclosures. The revised Form 990 asks whether the filing organization has adopted a conflict of interest policy. The revised form also inquires whether the organization requires annual disclosures of interests by officers, directors, trustees, and key employees. These questions reflect the long-standing Internal Revenue Service belief that conflict of interest policies are key governing documents for tax-exempt organizations. In addition, other parts of the revised Form 990 ask detailed questions about any relationships among the officers, directors, and key employees. It will be necessary to have a mechanism to gather this information in order to be able to answer these questions appropriately.

We believe that virtually all tax-exempt organizations should have a conflict of interest policy and should require annual disclosures under that policy. If your organization does not currently have a conflict of interest policy, then it should work with its lawyers to implement one as soon as possible. If your organization has a conflict of interest policy, but it does not cover key employees or require annual disclosures, then the organization should modify the policy and adopt a disclosure process now. For example, a review of the conflict of interest policy could occur and the annual disclosures could be made in connection with the organization's annual meeting each year.

- Written Whistleblower Policy. The Sarbanes-Oxley Act imposes criminal liability on those organizations, including tax-exempt organizations, that retaliate against whistleblowers. The revised Form 990 specifically asks whether the filing organization has a written whistleblower policy. If your organization does not currently have such a policy, then it should consult with its lawyers to prepare and adopt one now. This policy can be rather simple, but it should be tailored to address the particular governance structure and review processes of your organization.
- Written Document Retention and Destruction Policy. The Sarbanes-Oxley Act also imposes criminal liability on those organizations, including tax-exempt organizations, that destroy records with the intent to obstruct a federal investigation. The revised Form 990 inquires whether your organization has adopted a written document retention and destruction policy. If your organization has not already adopted such a policy, it should

consult with its lawyers to prepare and adopt one that adequately addresses the types of documents and electronic records with which your organization typically works, as well as any specific retention requirements that your organization's activities may entail. It should also prohibit destruction of documents in certain circumstances.

- Compensation Review Procedures. The revised Form 990 requests information regarding the procedures the filing organization uses to establish compensation for its officers and certain key employees. The revised form inquires whether the organization has established a compensation policy that includes review and approval by independent persons, that considers comparability data, and in which the deliberation and decision-making processes are contemporaneously documented.

Under the Internal Revenue Code, public charities and certain other tax-exempt organizations can establish a presumption that the compensation they pay to their officers and employees is reasonable if they follow certain procedures. The questions on the revised Form 990 reflect the procedures necessary to establish the "rebuttable presumption" of reasonableness for these organizations. If your organization compensates its officers or has employees, then it should have a written compensation policy, it should consider taking steps to comply with the rebuttable presumption procedures, and it should document that it has determined that any such procedures are not appropriate and why. The Internal Revenue Service has recently demonstrated, through its audit activity, a strong interest in the compensation paid by tax-exempt organizations. Failure to follow the rebuttable presumption procedures is sure to draw the Internal Revenue Service's attention, so the organization should provide a clear explanation of the reasons for any such failure.

- Written Expense Reimbursement Policy. Schedule J to the revised Form 990 requires specific information regarding compensation paid by the filing organization to officers, directors, trustees, key employees, and highest-compensated employees. Schedule J asks if the filing organization provides certain types of benefits, including such things as first-class, chartered, or companion travel; tax gross-up or reimbursement payments; discretionary spending accounts; certain housing-related allowances or payment; club dues; and personal services (such as maids, chauffeurs, and chefs). If the filing organization provided payment or reimbursement for such expenses, then it must indicate whether or not it followed a written policy with respect to such expenses.



Even if your organization does not compensate or reimburse for these types of expenses, it should consider implementing a general expense reimbursement policy. The IRS has demonstrated a strong audit interest in the area of expense reimbursement, including such items as cell phone, laptop, and PDA expenses.

- U.S. Grant Procedures. Schedule I of the revised Form 990 requires certain information regarding the filing organization's record-keeping practices with respect to grants it makes to U.S. organizations and individuals. The filing organization must indicate whether or not it maintains records that substantiate the amount of grants or assistance awarded, the grantee's eligibility for the grants or assistance, and the selection criteria used to award the grants or assistance. Most organizations currently keep such records with respect to their U.S. grants, although it may be advisable at this time to review those procedures to ensure that they adequately and accurately track the information described in Schedule I. If your organization does not currently keep such records, then it should develop and implement a procedure by which such records will be kept.
- Foreign Grant Procedures. Schedule F of the revised Form 990 requests certain information regarding an organization's policies and procedures with respect to non-U.S. grant-making activities. If a filing organization makes foreign grants, it must indicate whether or not it maintains records that substantiate the grants or awards given, the grantees' eligibility for the grants or awards, and the selection criteria used to award those grants. The filing organization must also describe the procedures that it uses to monitor the use of grant funds outside the United States. If your organization makes foreign grants, then it should take steps to ensure that its processes and monitoring procedures are adequate to respond to Schedule F.
- Gift Acceptance Policy. Schedule M of the revised Form 990 asks if the organization has a gift acceptance policy that requires the review of any non-standard contribution. Generally, a "non-standard contribution" is an item that is not expected to be used by the organization in its charitable operations and which is not readily convertible to cash, making the item's value difficult to ascertain. This might include gifts of investment real property or interests in a closely held business. If your organization intends to or does accept such non-standard contributions but does not have such a policy, then it should consult with its lawyers to develop an appropriate gift acceptance policy.

- Policies Governing Chapters, Affiliates, and Branches. The revised Form 990 requires disclosure of whether or not the filing organization has local chapters, branches, or affiliates. If the organization does have local chapters, branches, or affiliates, then the organization must disclose whether or not it has written policies and procedures governing the activities of affiliates to ensure that their operations are consistent with those of the filing organization. Generally such policies are desirable for a number of reasons and should be considered.
- Joint Venture Policy. The revised Form 990 requires the filing organization to disclose whether it participated in a joint venture or similar arrangement with a taxable entity during the reporting year. For these purposes, a “joint venture or similar arrangement” means any joint ownership or contractual arrangement through which there is an agreement to jointly undertake a specific business enterprise, investment, or exempt-purpose activity without regard to: (1) whether the organization controls the venture or arrangement, (2) the legal structure of the venture or arrangement, or (3) whether the venture or arrangement is taxed as a partnership or as an association or corporation for federal income tax purposes. If the organization has conducted such investments or activities, then the revised Form 990 asks whether the filing organization has adopted a written policy with respect to the negotiation and oversight of such activities. If your organization participates in joint ventures or similar arrangements with taxable entities, then it should consider adopting appropriate policies.
- Conservation Easements. For those organizations that are recipients of interests in conservation easements, Section D of the revised Form 990 asks if the organization has a written policy regarding the monitoring and enforcement of the easements it holds. Many organizations may have procedures in place regarding conservation easement enforcement, but have not reduced these procedures to a written policy. Any organization holding conservation easements should consider adopting or formalizing these oversight procedures.
- Policies for Hospitals. The revised Form 990 contains a new Schedule H, which is directed specifically toward hospitals. Schedule H asks hospitals about a number of different policies, including multiple questions regarding the hospital’s charity care policy and bad debt collection policy. The new reporting requirements on hospitals in Schedule



H are significant and complicated. As a result, all tax-exempt hospitals should contact their lawyers promptly regarding these policies as well as other reporting issues on the revised form. We note, however, that the portions of Schedule H that discuss these policies are optional for 2008, but will be required for 2009. Therefore, hospitals may have some extra time to comply with these particular policies.

- Policies for Tax-Exempt Bond Issuers. Tax-exempt bond issuers are now subject to heightened reporting requirements on new Schedule K. Schedule K requests information regarding an issuer's recordkeeping procedures and post-issue compliance policy. As with Schedule H, significant portions of Schedule K are optional for 2008, becoming mandatory in 2009. Therefore, tax-exempt bond issuers, like hospitals, will have extra time to comply with these specific policy issues. Despite the additional time that may be available, however, the new policies and reporting requirements for tax-exempt bond issues are significant and complicated. Therefore, we strongly recommend that all tax-exempt bond issuers should contact their lawyers regarding these policies and other compliance issues.

Phase-In Filing Obligations

The Internal Revenue Service has implemented a phase-in timeline for the revised Form 990. This means that not all organizations will be required to use the revised Form 990 for tax years beginning in 2008; instead, certain organizations will be able to file the simpler Form 990-EZ for some period of time. Some very small organizations need only file the Form 990-N "e-Postcard." Below are Internal Revenue Service charts illustrating the filing requirements for organizations during the next several years.

Please note that sponsoring organizations of donor-advised funds and controlling organizations described in Internal Revenue Code section 512(b)(13) must file Form 990 regardless of the amount of their gross receipts or assets. Also, section 509(a)(3) supporting organizations must file the Form 990 or the Form 990-EZ and are not eligible to file the Form 990-N regardless of size.



2007 Tax Year (Filed in 2008 or 2009)	Form to File
Gross receipts normally \leq \$25,000	990-N
Gross receipts $>$ \$25,000 and $<$ \$100,000, and Total assets $<$ \$250,000	990-EZ or 990
Gross receipts \geq \$100,000, and/or Total assets \geq \$250,000	990
2008 Tax Year (Filed in 2009 or 2010)	Form to File
Gross receipts normally \leq \$25,000	990-N
Gross receipts $>$ \$25,000 and $<$ \$ 1 million, and Total assets $<$ \$2.5 million	990-EZ or 990
Gross receipts \geq \$1 million, and/or Total assets \geq \$2.5 million	990
2009 Tax Year (Filed in 2010 or 2011)	Form to File
Gross receipts normally \leq \$25,000	990-N
Gross receipts $>$ \$25,000 and $<$ \$500,000, and Total assets $<$ \$1.25 million	990-EZ or 990
Gross receipts \geq \$500,000, and/or Total assets \geq \$1.25 million	990
2010 Tax Year and later (Filed in 2011 and later)	Form to File
Gross receipts normally \leq \$50,000	990-N
Gross receipts $>$ \$50,000 and $<$ \$200,000, and Total assets $<$ \$500,000	990-EZ or 990
Gross receipts \geq \$200,000, and/or Total assets \geq \$500,000	990

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This update is intended as a general summary of legal matters and not as specific advice to any particular client. If you have any questions concerning the subject matter of this update, please contact Elaine Waterhouse Wilson at 312-715-5141 / ewilson@quarles.com, or Norah L. Jones at 414-277-5827 / njones@quarles.com, or your Quarles & Brady attorney.