New economic realities mean new operational realities for tax exempt organizations.

IN ADDITION TO a new presidential administration, tax exempt organizations are facing unprecedented economic challenges and increased scrutiny from the Internal Revenue Service (Service). With an economic landscape that is drastically different from what it had been for the last 10 years, many tax exempt organizations are facing an unfamiliar territory filled with economic challenges to fundraising, increased reporting requirements, congressional hearings, higher internal governing standards, and greater public scrutiny. Public charities, community foundations, and private foundations are faced with greater fundraising goals based on past income and expenditure levels that may or may not be realistic in the near future as the pool of likely donors shrinks due to poor market conditions. Despite these challenges, the services of some tax exempt

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organizations have become increasingly important as they provide basic human needs such as food, clothing, shelter, and emergency assistance to those that have been negatively affected by recent events taking place on Wall Street and Main Street.

Additionally, in light of the current economic landscape, it may be less appealing for talented individuals to serve as directors on the boards of not-for-profit organizations. Adherence to proper governance and more attention to the process associated with the decisions made by directors will be more important. Failure to participate in the process of governing as a director is an indication that that director may not be meeting the standards set forth under state law for the duty of care and the duty of loyalty. This article addresses a few of the challenges tax exempt organizations are facing.

**FIRST CHALLENGE: REVISED FORM 990**

- Public charities have to file a Form 990 Information Return (990) with the Service. In the past, the 990 has evolved from a basic source to gather information for the Service to a form that potentially satisfies the reporting requirements imposed by state governments. The new 990 was redesigned with three basic underlying goals: “(1) increasing transparency by giving the Service and the public a more comprehensive picture of a tax-exempt organization, including its mission, programs and goals, its revenues and expenses, and its internal policies and practices; (2) promoting accountability by publicly sharing the way that organizations use their assets and conduct their operations; and (3) encouraging compliance by accurately reporting on the organization’s operations so the Service may effectively assess the risk of noncompliance.” Lois Lerner, *First Annual Report, November 2008, Introducing the Work Plan for FY 2009*, p. 10, available at [www.irs.gov/pub/irs-tege/finalannualrptwork-planII_25_08.pdf](http://www.irs.gov/pub/irs-tege/finalannualrptwork-planII_25_08.pdf). As one commentator noted, the Service believes compliance is linked to good governance practices. Fred Stokeld, *Year in Review: Exempt Organizations Faced Challenges, Opportunities in 2008*, 122 Tax Notes 50 (Jan 5, 2009). The result is that the 990 now has a core form and 16 schedules that deal with public charity status, contributors, political campaign and lobbying activities, financial statements, states of activities engaged in outside the United States, fundraising activities, grants, compensation, interested party transactions, non-cash contributions, and related organizations. Some of the schedules pertain only to a few organizations such as Schedule H Hospitals, or Schedule E Schools or to a specific event such as Schedule N Liquidation, Termination, Dissolution or Significant Disposition of Assets.

**The Phase-In**

All public charities will eventually be required to file the new 990, but the Service is phasing in the requirements to file the new 990 to allow smaller organizations to prepare and adjust to the record keeping required by the new Form. For 2008, an organization that satisfied the gross receipts and assets test could file Form 990-EZ. The gross receipts test is a measure of the gross receipts for the tax year. The assets test measures the fair market value of the assets of the organization. For 2008, if an organization had gross receipts greater than $25,000 but less than $1 million and had assets less than $2,500,000, it could file Form 990-EZ. By 2010, organizations that have gross receipts of less than $200,000 and total assets of less than $500,000 may file either the 990 or the 990-EZ. Form 990-EZ will be retained in its present form, although schedules that were added to the new Form 990 will replace attachments required by the 2007 Form 990-EZ.

Lois Lerner, who is the head of the Service’s Exempt Organization’s division, has acknowledged that the new 990 asks for a “lot of information.” Grant Williams, *More Scrutiny of Charities Expected, Regulators Told*, Chronicle of Philanthropy, October 16, 2008, p. 33. She noted in *The Chronicle of Philanthropy* that when the Forms are filed, the
Service will be “looking to see if there are questions that people did not answer or they answered in a way that was very different than what [was] anticipated.” Id. There are indications, based on the Exempt Organization’s First Annual Report, which details the Exempt Organization’s Work Plan for FY 2009, that the Service will study the information collected on the 990 to determine what areas require further regulation to obtain greater tax compliance. Lerner, supra, at p. 18-22. Areas of potential future scrutiny include “compliance initiatives, learning about the sources and uses of funds in the charitable sector”, … “valuation issues surrounding non-cash gifts”, … and “EO will begin identifying Form 990 governance questions that could be used in conjunction with other Form 990 information in possible compliance initiatives.”

**What To Do**

Due to the goals of the new 990, a tax exempt organization may want to consider the following measures.

**Adopt A Formal Mission Statement**

The new 990 will require an organization to state what its mission is. From a marketing perspective, this is the first thing the public will see because it is on the first page of the new return. Organizations such as Guidestar publish the 990 returns of organizations on the Web, and these may be viewed by the public. Additionally, the organizations are required to furnish this return upon request, either on a web site or by photocopy. (Internal Revenue Code (Code) section 6104(d)(1) requires public charities to mail their last three 990s and Form 1023 within 30 days of receiving a request to do so unless it is made widely available. This requirement does not apply to private foundations.) The mission statement should comport with the charitable purpose for which the organization was granted tax-exempt status. The mission statement is the first opportunity to make a good impression to the Service and the public.

**Adopt A Conflict Of Interest Policy**

The new 990 will ask the organization whether it has adopted a conflict of interest policy. The question is meant to prompt the organization to focus on governance. Williams, supra. A conflict of interest policy does not need to be complicated to be effective. The goal of the policy should be to ensure that directors who have a financial interest in a business opportunity do not usurp the opportunity from the organization or attempt to financially gain from a business opportunity with the organization. Requiring directors who have a conflict to disclose the factual basis for the conflict to the board of directors and abstain from voting on matters pertaining to the conflict should be sufficient. In addition to a clear statement of the governing conflict policy (whether included in the bylaws or as a separate policy), there should be standard procedures for notifying existing and new directors of the policy and communicating potential conflicts to the board.

Adopting a conflict of interest policy is formalizing the duty of loyalty that governs a trustee’s behavior to administer a trust solely for the benefit of the beneficiary, an agent’s duty to a principal, and a director’s duty to a for-profit business organization. The duty of loyalty owed by a director of a tax-exempt organization is violated when the director:

- Is on both sides of a transaction;
- Receives personal benefit from a transaction; or
- Usurps or appropriates a financial opportunity for his or her own personal gain.

Restatement (Second) of Trusts §170 (hereinafter Restatement 2d). In the exempt organization area, failure to set forth and follow a policy may cause the organization to be subject to greater scrutiny by the Service. Entering into a transaction where there is a potential conflict is not necessarily a violation of
the Code, but failure to follow a process to disclose, review, and vote on the matter is a problem.

**Adopt A Whistleblower Policy**

The new 990 is going to ask whether the organization has a whistleblower policy. Section 1107 of the Sarbanes-Oxley Act of 2002 makes it a criminal offense to take any action “knowingly, with the intent to retaliate” that is harmful to an employee for providing information relating to the commission, or possible commission, of a federal offense. This section applies to for-profit and not-for-profit organizations. A whistleblower policy may incorporate provisions for anti-harassment measures, communication of concerns or complaints, evaluation procedures for dealing with a complaint, and documentation of the concerns.

**Adopt A Compensation Policy**

The 990 contains questions about how compensation is determined and tax exempt organizations should formalize their compensation policies. The Service has standardized reporting to make tracking salaries easier and is requiring organizations to provide more information about the processes they use to determine compensation for management and directors. In the past, compensation may have taken many different forms, such as salary, deferred compensation, fringe benefits, and perks such as a car allowance or social club dues. Organizations must now disclose not only salaries paid, but also perks such as club dues, housing allowances, travel allowances, deferred compensation, and insurance. The Service has undertaken several extensive surveys of traditionally tax exempt industries, such as hospitals and educational institutions, to analyze the issue of executive compensation. The result of the surveys may affect the way the Service views comparable data used by organizations when determining reasonable compensation under the Regulations.

Part VII of the 990 requires that all officers, directors, trustees, the top management official (CEO), the top financial officer (CFO), be listed regardless of the level of compensation. Any person with reportable compensation over $100,000 must be listed and the organization must determine if they are in the “key employee category” or the “five highest paid employee category.” The “key employee category” includes those receiving compensation over $150,000 and satisfy a responsibility test. The “five highest paid employees” are those who receive more than $100,000 and are the highest paid employees. Lastly, former officers, directors, trustees, and key employees who receive over $100,000 in compensation must be reported.

Schedule J “Compensation” of the new 990 asks for information on whether:

- There was any first-class or charter travel provided, travel for companions, discretionary spending accounts, housing allowances, payments for the use of a personal residence, health or social club dues, personal services (chef, maid, chauffeur, etc.) to key employees, officers, trustees, or directors;
- There is a written policy regarding payments or reimbursements;
- There is a compensation committee and if so, what information did it use to establish the compensation of the CEO/director;
- There were any severance payments paid to any individual required to be listed on Part VII of the return (“Part VII individual”). Part VII of Form 990 requires that current officers, directors, trustees, and key employees be listed regardless of compensation amount. Additionally, the list must include (i) the five current highest paid employees, (ii) former officers, key employees, or highest compensated employees who received more than $100,000 of reportable compensation from the organization or any related organization, and (iii) any former director or trustee that received, in the capacity
as a former trustee or director, an amount that exceeds $10,000;
• A Part VII individual participated in a non-qualified retirement plan or received an equity-based compensation arrangement.

To satisfy the reporting required for Part VII and Schedule J of the new 990, an organization should have:
• Copies of contracts;
• Minutes of the board that reflect consideration of the compensation matter; and
• Any other information supporting the compensation paid to the CEO or director or any other person that is required to be listed.

Information regarding retirement plans, insurance, or other compensation agreements should be gathered for use in reporting the information requested on Schedule J. Additionally, cooperation from the individuals required to be listed on the 990 regarding their other sources of income is going to be required.

A formalized compensation policy can, if drafted correctly, aid in the record keeping and disclosure required by the new form. A compensation policy should be in writing and adopted by the board of directors for the organization. A compensation policy should address the following matters:
• Who will be compensated and how the compensation will be determined;
• Whether the organization will use an independent committee to determine compensation and whether there is a process in place for deliberation and documentation of the decision; and
• Which expenses are reimbursable and what taxable fringe benefits are being offered.

Steps that an organization can integrate into a compensation policy include, but are not limited to:
• Comparing 990 data from similar organizations, both for-profit and tax exempt, and analyzing executive pay on an “industry-wide” basis to establish what the Service calls a “rebuttable presumption of reasonableness” for a salary. Code §4958;
• Setting up a committee to review compensation that is truly independent;
• Formalizing a policy for items for which the organization will reimburse the employee, such as mileage, dues, seminars, or other related costs associated with the performance of job duties;
• Formalizing a policy for items that the organization will pay for all employees, such as health insurance, parking, and retirement contributions; and
• Reviewing activities on an annual basis that concern rentals, royalties, copyrights, appraisals accepted, and major projects undertaken to ensure that these transactions did not result in a hidden benefit to an employee.

A goal of the compensation policy should be the creation of a committee to review compensation and provide procedures to educate the committee members about their responsibilities and the potential consequences. The Service encourages charities to go through a series of steps to ensure that executive compensation is set appropriately and may levy fines on officials that receive inappropriate compensation and is investigating certain industries within the exempt organization umbrella to investigate potential abuses. The Service has sent questionnaires to hospitals and universities to review compensation paid to executives to determine if there is a problem with excessive compensation. Code section 4958 provides a safe harbor for compensation amounts if determined by an indepen-
dent committee that relied on reasonable data and documented the basis for the decision.

The focus is on the process engaged in by the committee or the organization and how the decision is documented and not necessarily the outcome. Therefore, education of the compensation committee members on the process, and their responsibilities may lead to the increased governance the Service is seeking.

Code section 4958 imposes a fine on transactions that cause anyone in a position with perceived influence over the affairs of the organization (disqualified person) to receive, either directly or indirectly, an excess benefit such as compensation. In order to avoid the imposition of an excess benefit fine, salary should fall within a safe harbor or have a “rebuttable presumption of reasonableness.” The House Ways and Means Committee Report (Report 104-506, Doc. No. 96-100000) establishes a rebuttable presumption of reasonableness for compensation plans in which there is “an arrangement with a disqualified person which is approved by a board or committee composed entirely of individuals unrelated to and not subject to the control of the disqualified person; the board or committee obtained and relied upon appropriate comparability data; and adequate documentation is made by the board or committee to show the basis for the determination that compensation was reasonable.” If a policy incorporates these measures, then there is a presumption that the salary of the employee falls within a safe harbor and the payment of the compensation will not result in the imposition of the excess benefit fines under Code section 4958.

**Adopt A Document Retention Policy**

An organization should determine what their document retention and destruction policy is going to be. The 990 is going to ask whether this has been formalized into a policy. Pursuant to section 1102 of the Sarbanes-Oxley Act, there are penalties for the destruction of documents that are or are anticipated to be the subject of litigation or government investigation. Failure to have a written policy is not a violation of the Code, however adopting a policy for record retention does show the Service that the organization is serious about tightening internal governance of the organization — which is one of the goals of the redesigned 990. A document retention policy should set forth the measures a tax exempt organization will follow to ensure that documents required to be retained under applicable law or that may be relevant in a legal proceeding or investigation are kept safe. Code section 6104 requires tax exempt organizations to keep certain records and make them available for public inspection (Form 990 and Form 1023). Part VI, section C, questions 18 and 19 of the 990 will require information on the retention of documents and how the organization will make them available for public inspection.

**Adopt Review Procedures**

The board of directors may want to create a review committee that oversees the finances and 990 review of the exempt organization. The 990 requires, in part VI, section A, question 10 to provide information on how the 990 return is reviewed before it is filed. A review committee could expedite this process by providing a system for review by the committee before the board members approve the 990 for filing. The review committee should be responsible for internal auditing, risk management, financial reporting, oversight of legal and ethical compliance matters, and maintaining the records and reports required by the board on financial matters. In certain instances, a review of the organization’s bylaws and applicable state law will be required to determine whether an amendment to the bylaws will be necessary to appoint and structure such a committee. Also, the new Form will request details on how the organization transmits a copy of the tax return to each member of the board of directors, and this process should be memorialized.
in the minutes of the board, or the directives given to the committee.

SECOND CHALLENGE: INCREASED COMPETITION FOR DONATIONS • The first 990 returns filed for 2008 were due May 15, 2009 and resulted in more disclosure of information about the activities of these organizations to the Service and to the public. The economic climate has resulted in fewer charitable contributions by individuals and corporations, resulting in increased competition among exempt organizations for donations. Stephanie Strom, Increase in Charitable Giving Dampened by Signs of Belt-Tightening, New York Times, June 23, 2008, available at www.nytimes.com/2008/06/23/US/23giving.html?_r=1.

As early as October of 2008, commentators were already discussing the impact of the financial market upon exempt organizations. Ben Gose, Paula Wasley, and Ian Wilhelm, After the Fall, The Chronicle of Philanthropy, October 14, 2008, available at www.charitynavigator.org/index.cfm/bay/content.view/cpid/820print/1.htm. The impact has caused some directors to take pay cuts, lay off employees, and find creative ways to fundraise. Id. Several large foundations are trimming their annual grants, either by number or amount. Id. “The William and Flora Hewlett Foundations is ... cutting grant making by three to five percent next year ... by reducing the number of grants it awards to new beneficiaries.”

THIRD CHALLENGE: TREATMENT OF CHARITABLE TRUSTS • With changes brought on by the Pension Protection Act of 2006, there are new rules regarding organizations that are controlled by publicly supported organizations. When a public charity has a supporting relationship with another publicly supported organization, the Service deems it to be a supporting organization rather than a private foundation. In the past, these organizations were classified as a Type I, II, or III supporting organization (SO) under Code section 509(a)(3), which requires the entity to be organized exclusively “for the benefit of” the publicly supported organization (the entity classified as a public charity under Code section 501(c)(3)). In addition to organizational test, there are operational and relationship tests which an SO must meet. The operational test requires the SO to show that its activities will support or benefit the public charity it supports, which requires close examination of the organization to consider the nature and scope of any proposed activity. The relationship test can be satisfied with a showing that the SO is (1) “operated, supervised, or controlled by,” (2) “supervised or controlled in connection with,” or (3) “operated in connection with” one or more supported organization. See Code §509(a)(3).

The Pension Protection Act added six new rules for Type III SOs. The new rules:
• Require minimum distribution requirements;
• Impose new excess business holdings rules;
• Require notification to the supported organizations;
• Prohibit support of foreign organizations;
• Prohibit the receipt of contributions from individuals who control the supported organization; and
• Treat grants to other Type III, non-functionally integrated SOs as taxable expenditures. Grants to any functionally integrated supported organization from a private foundation will have a new expenditure responsibility process that the organization must follow. These grants will not count toward a private non-operating foundation’s minimum distribution requirement.

FOURTH CHALLENGE: INCREASED TIME AND EXPENSE • With increased regulation comes increased recordkeeping. The new form requires enough changes to significantly alter the accounting systems of many organizations. The new documentation of procedures and compensa-
tion will add significant time to the data collection process as well as the tax reporting process. New procedures will have to be put in place retroactively to capture much of the information that the Service is requesting. In some cases, professional assistance may be needed to determine what information will need to be reported both to the Service and to the public.

Many organizations can expect to be part of the sweeping trend to see an increase in fees associated with tax compliance. The increase in size of the Form and needed expertise to meet the new regulations will increase the preparation time by public accounting firms and the use of resources. While no firm can accurately predict the new margin of fees that will have to be billed, it seems to be the current consensus in the industry to increase anywhere from 20-50 percent based on the organization’s filing requirements.

**CONCLUSION** • Because of these and other challenges, exempt organizations should take a closer look at their structures and past practices to determine if the status quo is going to meet the demands of the Service and the public sector. An increased focus on the process of governing, and the procedures followed by the directors, will be required in light of their challenges. A bad result will not necessarily result in liability for a director or the organization, but failure to follow the processes set forth under governing law and the organization’s governing documents are likely to produce an unfortunate result due to the challenges of the current environment. Greater demand for donor dollars in a tight economy may force many exempt organizations to cease operations or merge with similarly situated organizations in order to continue operation, but may also have an effect on governance — which is the goal the Service seeks to achieve.

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**PRACTICE CHECKLIST FOR**
**Tax Exempt Organizations: Change Is In The Air**

With a new economy and a new administration, many tax exempt organizations will find themselves in unfamiliar territory. The new terrain presents four distinct challenges.

- First, the revised Form 990. The new 990 was redesigned with three basic underlying goals — “(1) increasing transparency by giving the Service and the public a more comprehensive picture of a tax-exempt organization, including its mission, programs and goals, its revenues and expenses, and its internal policies and practices; (2) promoting accountability by publicly sharing the way that organizations use their assets and conduct their operations; and (3) encouraging compliance by accurately reporting on the organization’s operations so the Service may effectively assess the risk of noncompliance.” To meet these goals the organization should adopt:
  
  __ A formal mission statement;
  __ A conflict of interest policy;
  __ A whistleblower policy;

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__ A compensation policy;
__ A document retention policy; and
__ Review procedures.

• Second, the competition for donations has increased, calling for increasingly vigorous fundraising campaigns carried out on reduced budgets.

• Third, charitable trusts are treated differently. With changes brought on by the Pension Protection Act of 2006, there are new rules regarding organizations that are controlled by publicly supported organizations. When a public charity has a supporting relationship with another publicly supported organization, the Service deems it to be a supporting organization rather than a private foundation. The Pension Protection Act added six new rules for Type III supporting organizations. The new rules:
  __ Require minimum distribution requirements;
  __ Impose new excess business holdings rules;
  __ Require notification to the supported organizations;
  __ Prohibit support of foreign organizations;
  __ Prohibit the receipt of contributions from individuals that control the supported organization; and
  __ Treat grants to other Type III, non-functionally integrated SOs as taxable expenditures. Grants to any functionally integrated supported organization from a private foundation will have a new expenditure responsibility process that the organization must legally follow. These grants will not count toward a private non-operating foundation’s minimum distribution requirement.

• Fourth, with increased regulation comes increased recordkeeping. The new Form 990 requires enough changes to significantly alter the accounting systems of many organizations. The new documentation of procedures and compensation will add significant time to the data collection process as well as the tax reporting process.