

Form 990 Policy Series

The attached Memorandum is a part of the *Form 990 Policy Series*, developed by a group of lawyers, all members of the California bar and practicing nonprofit law (the “Form 990 Policy Series Group”). The *Form 990 Policy Series* includes Memoranda containing rationales and procedures for legal counsel to use in advising their clients on drafting and adopting appropriate policies responding to the new Form 990 as well as form policies and/or questionnaires.

The members of the Form 990 Policy Series Group with respect to the attached Memorandum (posted July, 2011) were as follows: Joel S. Corwin, Co-Chair; Barbara Rosen, Co-Chair; Elizabeth Bluestein; Lani Meanley Collins; the late Gerald A. Laster; Henry Lesser; Nancy McGlamery; Louis Michelson; Joy P. Paeske; Alicia Plerhoples; Lisa A. Runquist; Robert Siemer; Myron Steeves; Patrick Sternal; and Martin J. Trupiano. The views expressed in the Memoranda do not necessarily reflect the views of the law firms or employers at which these lawyers practice or any individual member of the Group.

The date at the top of the attached Memorandum is the date that the Memorandum was finalized, and the Memorandum may not reflect changes in law or practice since that date.

**FORM 990 POLICY SERIES
MEMORANDUM**

**Re: Independent Members of Governing Body; Business and Family Relationships
Form 990, Part I, Lines 3 and 4; Part VI, Section A, Lines 1a, 1b, 2, 7a and 7b
(Form 990 Policy Series Memo #2.2)**

Date: August 22, 2010

NOTE ON THE SCOPE OF THIS MATERIAL

This material is designed to provide general guidance about an aspect of nonprofit corporate governance in the specific and limited context of the governance questions contained in the new IRS Form 990 (published by the IRS in 2008 and applicable to 990 filers based on a 2009-2011 filing year phase-in period depending on the size of the nonprofit). It is intended to provide some general guidance on the establishment of processes and/or policies to address a specific governance question in the Form. The subject matter of that question implicates a broad array of legal and practical issues ranging far beyond the immediate subject matter of the question itself. This material may address some of those issues but does NOT attempt to review them comprehensively and is NOT intended to be relied on for guidance on how they should be addressed in any specific situation.

Whether or not a nonprofit organization adopts a specific governance process or policy (or modifies an existing one), either in response to the disclosure requirements of the new IRS Form 990 or to change its governance practices for other reasons is a matter to be carefully considered by that organization, with input from its board and advisors and evaluation of its specific circumstances. The IRS has explicitly stated that adoption of the policies and practices about which the new Form 990 asks is not mandatory, although the IRS has also indicated that it attaches significance to the manner in which all tax-exempt nonprofit organizations govern themselves. The inclusion of a sample policy in this material is not intended to suggest that the policy is appropriate for every nonprofit organization nor that, if a policy on that topic is determined to be appropriate, the formulation in the sample necessarily fits the needs of an individual nonprofit organization. A customized approach, with outside professional advice, is recommended. Accordingly, this material is intended as general information for legal practitioners advising nonprofit organizations as to their governance and does not constitute legal advice for any particular nonprofit organization.

Although the subject matter of this material may have relevance to nonprofit organizations that are not required to file informational tax returns with the IRS or are permitted to file on an IRS form other than Form 990, the focus of this material is 990 filers. While this material is meant to apply to Form 990 filers who are exempt under Section 501(c) of the Internal Revenue Code, certain portions of this material may be applicable only to Section 501(c)(3) organizations. In addition, although this material may be of assistance with respect to nonprofit organizations that are not subject to oversight under California law, there may be portions of this material that are relevant only to nonprofits organized under, or (by reason of their California-related activities) otherwise subject to, California law and, except as specifically discussed in this material, the laws of other States are not addressed.

1. Summary

The “independence” questions in the new form 990 apply to all 990 filers, not just to charities. Adopting and following a procedure or policy to determine what members of the organization’s governing body are independent and what persons have business or family relationships will allow the organization to answer the questions in the Form 990. In addition, if the policy or procedure is properly drafted and implemented, the “reasonable effort” tests set forth in the instructions to the new Form 990 will be satisfied.

The “independence” questions in the Form 990, by topic, are as follows: Form 990, Part I, Lines 3 and 4 and Part VI, Section A, Lines 1a and 1b (Independent Members of Governing Body); Part VI, Section A, Line 2 (Business and Family Relationships); Part VI, Section A, Line 7a (Right to Elect/Appoint Members of Governing Body); and Part VI, Section A, Line 7b (Governing Body Decisions Subject to Approval by Others).

2. Rationale for Adoption of the Policy or Procedure

Stephen Miller, the Internal Revenue Service Commissioner of Tax Exempt and Government Entities at the time the new Form 990 was developed, said on more than one occasion that, outside of *very* small organizations and perhaps family foundations, the “gold standard” should be an active, independent, and engaged governing body overseeing the organization.

The desired “gold standard” is highlighted in the new Form 990 not once, but twice: first on page 1, Lines 3 and 4 of Part I, and second on page 6, Lines 1a and 1b of Part VI.A. In both Parts, the organization must enter the number of voting members of the governing body and then the number of voting members of the governing body that are “independent,” as that term is defined in the instructions to the Form 990.

The gold standard is further encouraged by the question in Line 2 of Part VI.A: “Did any officer, director, trustee, or key employee have a family relationship or a business relationship with any other officer, director, trustee, or key employee?”¹ There are two more

¹ The new Form 990 introduced the concept of “key employee.” A key employee is defined in the Glossary in the Instructions to Form 990 as follows:

For purposes of Form 990 reporting, an employee of the organization (other than an officer, director, or trustee) who meets **all three** of the following tests:

1. **\$150,000 Test**. Receives reportable compensation from the organization and all related organizations in excess of \$150,000 for the calendar year ending with or within the organization’s tax year.
2. **Responsibility Test (which may be met at any time during the tax year)**. The employee:
 - a. has responsibilities, powers or influence over the organization as a whole similar to those of officers, directors, or trustees;
 - b. manages a discrete segment or activity of the organization that represents 10% or more of the activities, assets, income, or expenses of the organization, as compared to the organization as a whole;
 - c. or has or shares authority to control or determine 10% or more of the organization’s capital expenditures, operating budget, or compensation for employees.
3. **Top 20 Test**. Is one of the 20 employees (that satisfy the \$150,000 Test and Responsibility Test) with the highest reportable compensation from the organization and related organizations for the calendar year ending with or within the organization’s tax year.

A “related organization” as used in the definition of “key employee” is an organization with one or more of the following relationships to the organization filing the return:

- **Parent**: an organization that controls...the filing organization.
- **Subsidiary**: an organization controlled...by the filing organization.

questions in Part VI.A that touch on the independence of the governing body: Line 7a asks who has the right to elect or appoint members of the governing body and Line 7b asks if decisions of the governing body are subject to the approval of others.

Any organization that must file the new Form 990 must develop some policy or procedure to be able to answer the questions regarding independent voting members of the governing body and persons with business and family relationships. It is strongly recommended that the organization draft the policy or procedure with the “reasonable effort” examples in mind that are contained in the instructions to the Form 990. A questionnaire for the members of the governing body and others to complete on an annual basis, sufficiently supplemented with definitions of terms used in the Form 990 instructions, will allow the organization to obtain the needed information to answer some of the questions on the Form 990. It also will allow the members of the governing body and others to answer the Questionnaire with some degree of assurance that (a) their answers are responsive to the questions and (b) they have not wasted their time trying to answer the Questionnaire without understanding the concepts.

3. Background of Requirements/Sources for the Policy

A. *Independent Governing Body*

Line 4 of Part I and Line 1b of Part VI.A of the new Form 990 require the organization to state the number of voting members of the governing body that are “independent.” The instructions to the Form 990 explain who is and is not an “independent” voting member of the governing body, subject to listed exceptions.

The time at which the organization determines how many voting members of its governing body are “independent” is the end of the organization’s tax year. However, for a voting member to be considered “independent,” three circumstances must have existed with respect to that member at all times during the organization’s tax year. The following is the “three-part definition” of “independent” from the instructions (emphasis added):

1. The member was not compensated as an officer or other employee of the organization or of a related organization (see the instructions for Schedule R, Related Organizations and Related Partnerships) except as provided in the religious exception discussed below.

• **Brother/Sister:** an organization controlled...by the same person or persons that control the filing organization.

• **Supporting/Supported:** an organization that is (or claims to be) at any time during the organization’s tax year (i) a supporting organization of the filing organization within the meaning of section 509(a)(3), if the filing organization is a supported organization within the meaning of section 509(f)(3); (ii) or a supported organization, if the filing organization is a supporting organization.

2. The member 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 reasonable compensation for services provided in the capacity as a member of the governing body. 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 payments of \$7,500 from the organization for other arrangements.
3. Neither the member, nor any family member of the member, was involved in a transaction with the organization (whether directly or indirectly through affiliation with another organization) required to be reported on Schedule L (Form 990 or 990-EZ), Transactions With Interested Persons, 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.

The instructions further state that a member of the governing body is not considered to lack independence "merely" because of the following circumstances:

1. The member is a donor to the organization, regardless of the amount of the contribution.
2. Religious exception: The member has taken a *bona fide* vow of poverty and either (a) receives compensation as an agent of a religious order or a section 501(d) religious or apostolic organization, but only under circumstances in which the member does not receive taxable income (see Rev. Rul. 77-290, 1977-2 C.B. 26 and Rev. Rul. 80-332, 1980-2 C.B. 34) or (b) belongs to a religious order that receives sponsorship or payments from the organization which do not constitute taxable income to the member.
3. The member receives financial benefits from the organization solely in the capacity of being a member of the charitable or other class served by the organization in the exercise of its exempt function, such as being a member of a Section 501(c)(6) organization, so long as the financial benefits comply with the organization's terms of membership.

The first two parts of the definition of "independent" set forth above are fairly easy to understand without much explanation. The third part, that "neither the member, nor any family member of the member, was involved in a transaction with the organization (whether directly or indirectly through affiliation with another organization) required to be reported on Schedule L," cannot be understood without reading the instructions to Schedule L in full. Part I of Schedule L applies to 501(c)(3) and (4) organizations and concerns excess benefit

transactions. Parts II (loans), III (grants), and IV (business transactions) apply to all organizations. The definitions of “interested persons” for each of Parts I-IV of Schedule L are not identical, and each Part has its own exceptions. Note that the “ordinary course of business” exception to reporting business relationships on Form 990, Part IV, Line 2, discussed below, does not apply for purposes of Part IV of Schedule L.

One way to manage the third part of the “independent” test and Schedule L might be to establish one or more policies to the effect that the organization:

- (1) always follow the presumption of reasonableness three part test under Internal Revenue Code section 4948 (which should be included in the organization’s compensation and conflict of interest policies) so there will be no excess benefit transactions to report on Schedule L;
- (2) make no loans not excepted in the instructions to Schedule L to (a) current or former officers, directors, trustees, key employees, and highest compensated employees listed on Form 990, Part VII, Section A, and (b) disqualified persons as described in 4958(f)(1) for 501(c)(3) or (4)s and as described in 4958(c)(3)(B) for 509(a)(3)s so there will be no loans to report on Schedule L;
- (3) make no grant or assistance that is not excepted in the instructions to Schedule L that benefits (a) a current or former officer, director, trustee, or key employee listed on Form 990, Part VII, Section A, (b) a substantial contributor, (c) a member of the grant selection committee, (d) a family member of any of the organization’s current or former officers, directors, trustees, or key employees listed on Form 990, Part VII, Section A, (e) a 35% controlled entity of any former or current officer, director, trustee, key employee, substantial contributor or member of the grant selection committee, or (f) an employee (or child of an employee) of a substantial contributor or of a 35% controlled entity of a substantial contributor and was made by the direction or advice of the substantial contributor or 35% controlled entity or under a program funded by the substantial contributor that is intended primarily to benefit such employee or his or her children, so there will be no such grant or assistance to report on Schedule L; and
- (4) enter into no business transactions that exceed the reporting thresholds for Schedule L or that are not otherwise excepted in the instructions to Schedule L that involve the following “interested persons:” (a) a current or former officer, director, trustee, or key employee listed on Form 990, Part VII, Section A, (b) a family member of a current or former officer, director, trustee or key employee listed in Form 990, Part VII, Section A, (c) an entity more than 35% owned, directly or indirectly, individually or collectively, by one or more current or former officers, directors, trustees, or key employees listed on Form 990, Part VII, Section A, or their family members, (d) an entity (other than a 501(c) or governmental unit or instrumentality) of which a current or

former officer, director, trustee, or key employee listed in Form 990, Part VII, Section A is serving at the time of the transaction as (i) an officer, (ii) a director, (iii) a trustee, (iv) a key employee, (v) a partner or member with a direct or indirect ownership interest in excess of 5% (including ownership by a family member) if the entity is treated as a partnership, or (vi) a shareholder with a direct or indirect ownership interest in excess of 5% (including ownership by a family member) if the entity is a professional corporation, so there will be no such business transactions to report on Schedule L. The business transactions thresholds that must be reported on Schedule L include: (1) all payments during the tax year between the organization and an interested person that exceed \$100,000; (2) all payments during the tax year from a single transaction between such parties that exceed the greater of \$10,000 or 1% of the organization's total revenues; (3) compensation payments during the tax year to a family member of an interested person that exceed \$10,000; and (4) in the case of a joint venture with an interested person, the organization invested \$10,000 or more in the joint venture, whether or not during the tax year.

The examples in the instructions for independent voting member of the governing body are illustrative:

Example 1. B is a voting member of the organization's board of directors. B is also a partner with a profits and capital interest greater than 5% in a law firm, C, that charged \$120,000 to the organization for legal services in a court case. The transaction between C and the organization must be reported on Schedule L (Form 990 or 990-EZ) because it is a transaction between the organization and an entity of which B is a more-than-5% owner, and because the payment to C from the organization exceeded \$100,000 (see the instructions to Schedule L (Form 990 or 990-EZ), Part IV, regarding both factors). Accordingly, B is not an independent member of the governing body because the \$120,000 payment must be reported on Schedule L (Form 990 or 990-EZ) as an indirect business transaction with B. If B were an associate attorney (an employee) but not an officer, director, trustee, key employee, or owner of the law firm, the transaction would not affect B's status as an independent member of the organization's governing body.

Example 2. D is a voting member of both the organization's governing body and the governing body of C, a related organization. D's daughter, E, received \$40,000 in taxable compensation as a part-time employee of C. D is not an independent member of the governing body, because E received compensation from C, a related organization to D, and the compensation was of a type (compensation to a family member of a member of C's governing body) and amount (over \$10,000) that would be reportable on Schedule L (Form 990 or 990-EZ) if the related organization, C, were required to file Schedule L (Form 990 or 990-EZ).

See also *Examples 2 and 3* in the Instructions for Form 990, Part VII, Section A, line 5.

Note that the definitions of “interested director” and “interested persons” under California law do not correlate with the definition of “independent members of the governing body” and “interested persons” under the instructions to the Form 990. One could be an interested director or an interested person under state law and at the same time be an independent member of the governing body under federal law. In addition, the organization’s conflict of interest policy likely contains yet another definition of “interested” or “independent” person.²

B. Family or Business Relationship between Any Officer, Director, Trustee, or Key Employee and Any Other Officer, Director, Trustee, or Key Employee

The instructions for Line 2 of Section A of Part VI state that the organization must answer “Yes” if “any of the organization’s officers, directors, trustees, or key employees” (“key employee” is a defined term³; key employees must be reported in Part VII.A) had a “family relationship” or “business relationship” with another of the organization’s officers, directors, trustees, or key employees at any time during the organization’s tax year. For each family and business relationship, the organization must, on Schedule O of the Form 990, identify the

² The definition of “independent” in the Instructions to the Form 990 likely will not be the same as other definitions and meanings of the term “independent” that apply to the organization, such as under state law or in an internal conflict of interest policy (see Conflict of Interest Policy Memo #2.1). For example, “interested director” under California Corporations Code section 5233 concerns a transaction with the organization in which one or more of the organization’s directors has a material financial interest. The conflict of interest policy usually addresses such interested directors, and usually expands the scope of the policy beyond directors. It is possible for a director to be an “interested director” under section 5233 and an “independent member of the governing body” under the instructions to Form 990.

In addition, “interested director” under section 5233 is not the same as “interested persons” under California Corporations Code section 5227. Whereas the focus of section 5233 is on transactions with “interested directors,” Section 5227 governs how many “interested persons” may serve on the board at the same time. Section 5227 provides that no more than 49 percent of the persons serving on the board may be “interested persons,” and defines “interested persons” to mean either:

(1) Any person currently being compensated by the corporation for services rendered to it within the previous 12 months, whether as a full- or part-time employee, independent contractor, or otherwise, excluding any reasonable compensation paid to a director as director; or

(2) Any brother, sister, ancestor, descendant, spouse, brother-in-law, sister-in-law, son-in-law, daughter-in-law, mother-in-law, or father-in-law of any such person.

³ See note 1 above.

persons and state if the relationship is a “family relationship” or “business relationship.” No greater detail is required on Schedule O.

As defined by the instructions to the Form 990, a “business relationship” between two persons includes the following:

1. One person is employed by the other in a sole proprietorship or by an organization with which the other is associated as a trustee, director, officer, key employee, or greater-than-35% owner.
2. One person is transacting business with the other (other than in the ordinary course of either party’s business on the same terms as are generally offered to the public), directly or indirectly, in one or more contracts of sale, lease, license, loan, performance of services, or other transaction involving transfers of cash or property valued in excess of \$10,000 in the aggregate during the organization’s tax year. (*Indirect transactions* are transactions with an organization with which the one person is associated as a trustee, director, officer, key employee, or greater-than-35% owner). Such transactions do not include charitable contributions to tax-exempt organizations.
3. The two persons are each a director, trustee, officer, or greater-than-10% owner in the same business or investment entity (but not in the same tax-exempt organization).

Ownership is measured by stock ownership (either voting power or value) of a corporation, profits or capital interest in a partnership or limited liability company, membership interest in a nonprofit organization, or beneficial interest in a trust. Ownership includes indirect ownership (for example, ownership in an entity that has ownership in the entity in question); there may be ownership through multiple tiers of entities.

However, the instructions provide a “privileged relationship exception” for purposes of answering Line 2. A “business relationship” for Line 2 does not include a relationship between an attorney and client, a medical professional (including psychologist) and patient, or a priest/clergy and penitent/communicant.

Again, the examples in the instructions for Form 990 regarding Line 2 are helpful:

Example 1. B is an officer of the organization, and C is a member of the organization’s governing body. B is C’s brother-in-law. The organization must report that B and C have a family relationship.

Example 2. D and E are officers of the organization. D is also a partner in an accounting firm with 300 partners (with a 1/300 interest in the firm’s profits and

capital) but is not an officer, director, trustee, or key employee of the accounting firm. D's accounting firm provides services to E in the ordinary course of the accounting firm's business, on terms generally offered to the public, and receives \$100,000 in fees during the year. The relationship between D and E is not a reportable business relationship, either because (1) it is in the ordinary course of business on terms generally offered to the public, or because (2) D does not hold a greater-than-35% interest in the accounting firm's profits or capital.

Example 3. F and G are trustees of the organization. F is the owner and CEO of an automobile dealership. G purchased a \$45,000 car from the dealership during the organization's tax year in the ordinary course of the dealership's business, on terms generally offered to the public. The relationship between F and G is not a reportable business relationship because the transaction was in the ordinary course of business on terms generally offered to the public.

Example 4. H and J are members of the organization's board of directors. Both are CEOs of publicly traded corporations and serve on each other's boards. The relationship between H and J is a reportable business relationship because each is a director or officer in the same business entity.

Example 5. K is a key employee of the organization, and L is on its board of directors. L is a greater-than-35% partner of a law firm that charged \$60,000 during the organization's tax year for legal services provided to K that were worth \$600,000 at the law firm's ordinary rates. Thus, the ordinary course of business exception does not apply. However, the relationship between K and L is not a reportable business relationship, because of the privileged relationship of attorney and client.

C. Reasonable Effort and Use of Questionnaire

For both Line 1b (independent voting members of the governing body) and Line 2 (business and family relationships) of Part VI, Section A, the organization is required to make no more than a "reasonable effort" to obtain the necessary information to answer the questions and may rely upon the information provided by the persons submitting the information. For Line 1b, the Instructions to the Form 990 state:

The organization need not engage in more than a reasonable effort to obtain the necessary information to determine the number of independent voting members of its governing body and can rely on information provided by such members. For instance, the organization can rely on information it obtains in response to a questionnaire sent annually to each member of the governing body that includes the name, title, date, and signature of each person reporting information, and containing the pertinent instructions and definitions for line 1b, to determine whether the member is or is not independent.

For Line 2, the Instructions state:

The organization is not required to provide information about a family or business relationship between two officers, directors, trustees, or key employees if it is unable to secure the information after making a reasonable effort to obtain it. An example of a reasonable effort would be for the organization to distribute a questionnaire to each such person that contains the name, title, date, and signature of each person reporting information and contains the pertinent instructions and definitions for line 2.

The Instructions are unclear on a number of points. For example, although similar, the example for Line 1b is not the same as the example for Line 2. As quoted above with respect to Line 2, the organization is not required to provide information if it is unable to secure the information after making a reasonable effort to obtain it. This sentence is not included in the instructions for Line 1b.

Another ambiguity is that one cannot distribute a questionnaire already signed by the person to whom it is distributed. An interpretation of this portion of the Instructions is that if the organization wants to rely upon the reasonable effort examples in the Instructions, the organization must not only distribute the questionnaire to each person, but also must be sure to receive it back from each person and be sure that each questionnaire includes the person's name and title and is signed and dated by the person. Another interpretation of the Instructions is that the questionnaire simply needs to include blanks for the name, title, date and signature of the person completing it, and that the organization need not ensure that the person completing the Questionnaire in fact dates and signs it and states the person's name and title.

Regardless of whether the example in the Instructions requires each person to date and sign the Questionnaire to come within the protection of the example, the issue is "reasonable effort" and to what extent must an organization attempt to obtain the signatures, dates, and titles of all persons to whom the Questionnaire is distributed. At some point "reasonable effort" certainly could have been made even if all signatures could not be obtained.

Another ambiguity in the instructions concerns what is meant by "pertinent instructions and definitions." One interpretation is that the Questionnaire itself must contain the instructions and definitions sufficient for the person who completes the Questionnaire to determine if he or she is an independent member of the governing body and/or has a business or family relationship that must be disclosed. Another possible interpretation of the instructions is that the Questionnaire may be designed to elicit the information necessary for the organization itself to make those determinations. You will see both approaches in the two sample Questionnaires attached.

The instructions for Part III (grants) and Part IV (business transactions) of Schedule L also provide separate "reasonable effort" and questionnaire examples. Note that Schedule L requires the Questionnaire to be submitted not only to current but also to former officers, directors, trustees and key employees listed in Form 990, Part VII, Section A. In addition to the persons just identified, for Part III, the Questionnaire is to be delivered also to

each member of the grant selection committee and to certain substantial contributors and to certain related persons to substantial contributors.

With respect to Part III (grants):

“An example of a reasonable effort for Part III is for the organization to distribute a questionnaire annually to each current or former **officer, director, trustee, and key employee** listed in Form 990, Part VII, Section A, and each member of a grant selection committee that includes the name, title, date, and signature of each person reporting information and contains the pertinent instructions and definitions for Schedule L, Part III. The organization is not expected to distribute such a questionnaire to a substantial contributor or a related person to a substantial contributor, except (1) where the substantial contributor or such related person advises the organization as to the specific recipients of grants or assistance, or (2) with respect to programs of the organization intended primarily to benefit employees (or their children) of the substantial contributor or their 35% controlled entities.”

With respect to Part IV (business transactions):

“An example of a reasonable effort for Part IV is for the organization to distribute a questionnaire annually to each current or former **officer, director, trustee, and key employee** listed on Form 990, Part VII, Section A, that includes the name, title, date, and signature of each person reporting information and contains the pertinent instructions and definitions for Schedule L, Part IV. The organization is not required to distribute such a questionnaire to organizations or individuals with which it does business, but who are not current or former officers, directors, trustees, or key employees of the organization, in order to have made a reasonable effort for this purpose.”

It should also be noted that the instructions to Form 990 did not exist until late 2008. As a result, any Conflict of Interest policy created before then likely will not address the questions in Lines 1b and 2 and certainly will not meet the “reasonable effort” examples set forth in the instructions to the Form 990.

D. Right to Elect or Appoint Members of the Governing Body

Line 7a of Part VI.A of the Form 990 asks: “Does the organization have members, stockholders, or other persons who may elect one or more members of the governing body?” The instructions state:

Answer “Yes” on line 7a if at any time during the organization’s tax year there were one or more persons (other than the organization’s governing body itself, acting in such capacity) that had the right to elect or appoint one or more

members of the organization's governing body, whether periodically, or as vacancies arise, or otherwise. If "Yes," describe on Schedule O (Form 990) the class or classes of such persons and the nature of their rights.

E. Decisions of the Governing Body Subject to Approval by Members, Stockholders, or Other Persons

Line 7b of Part VI.A of the Form 990 asks: "Are any decisions of the governing body subject to approval by members, stockholders, or other persons?" The instructions state:

Answer "Yes" on line 7b if at any time during the organization's tax year there were one or more persons (whether members, stockholders, or otherwise) who had the right to approve or ratify decisions of the organization's governing body, such as approval of the governing body's election or removal of members of the governing body, or approval of the governing body's decision to dissolve the organization. If "Yes," describe on Schedule O (Form 990) the class or classes of such persons, the decisions that require their approval, and the nature of their voting rights."

4. Considerations and Procedures for Implementation of the Policy

A conflict of interest policy may or may not result in disclosing (a) who on the governing board is "independent" and (b) business and family relationships among the officers, directors, trustees and key employees, as those terms are defined by the instructions to the IRS Form 990. Even if the conflict of interest policy does use federal law definitions, the annual disclosure of interests form under the conflict of interest policy (which looks forward toward the coming year) is not the same as the reasonable effort questionnaire under federal law (which looks backwards over the past tax year). At a minimum, the organization must determine if its current annual disclosure of interests form under its conflict of interest policy can be modified to provide both the annual disclosure of interests (looking forward to the coming year) and to address the independent members and family and business relationship questions in the new Form 990.

The organization also must determine if it wants to meet the "reasonable effort" examples contained in the instructions to the Form 990. If so, and if the organization wants to come within the literal wording of the examples, (1) first, it will need to develop a questionnaire that includes the "pertinent instructions and definitions" for a voting member of the governing body to be able to determine (for Line 1b) if the member is or is not "independent" and (for Line 2) for the person to determine if the person has a business or family relationship with another officer, director, trustee or key employee of the organization; (2) second, it must annually distribute the questionnaire (after the close of each fiscal year) to each voting member of the governing body (with respect to the independent member question) and to each officer, director, trustee, and key employee (with respect to the family and business relationships question); (3) third, it must follow up with each such member/person to be sure that each questionnaire is

returned (some say the examples in the Instructions do not require such follow up, and others say that some follow up is required to constitute “reasonable effort”); and (4) fourth, it must be sure that each returned questionnaire includes the name, title, date and signature of the member/person reporting the information (some say the examples in the Instructions do not require such follow up, and others say that some follow up is required to constitute “reasonable effort”).

Other considerations are the organization’s size and how much the organization believes it can ask of its governing body. Are members of the governing body willing and able to read through definitions and examples like those in Sample Questionnaire A and each conclude whether he or she is independent and has business or family relationships that must be disclosed? Or, conversely, does the organization have the staff and financial resources to pay the staff or others to analyze the information submitted in a questionnaire intended to elicit information like Sample Questionnaire B so the staff or paid professionals can determine which members of the governing body are and are not independent and which persons have business and family relationships that must be disclosed?

One must consider how the Form 990 questions and definitions concerning independence of the governing body and business and family relationships intersect not only with the organization’s conflict of interest policy but also the organization’s compensation policy. Some organizations may combine the conflict of interest and compensation policies into one policy. However, even though the review and approval of compensation can give rise to conflicts of interest and questions of independence of the governing body and business and family relationships, on many occasions there is no overlap at all. While the purpose of a compensation policy is to create a process to set reasonable compensation for insiders, the purpose of a conflict of interest policy is to address all types of conflicts arising from insiders’ transactions with the organization. Both a compensation policy and a conflict of interest policy look to current or future happenings. The independent governing body and business and family relationships questions on the Form 990 look backward to the tax year just ended and identify those relationships that may have affected the decision making process of members of the governing body and other insiders in all instances.

To complicate matters further, the definitions under state and federal law do not match, and even under California law “interested” has different meanings depending on if the focus is on transactions with the organization or on how many interested persons can serve on the board.

Accordingly, when working in any one or more of these areas – compensation, conflict of interest, independent members of the governing body, and business and family relationships – one must look at the other areas as well. The Form 990 Policy Series, of which this Memorandum is a part, has memoranda addressing each perspective. Before finalizing a policy or questionnaire that addresses compensation, conflicts of interest, independence of the governing body and business and family relationships, it is recommended that the memorandum for each topic be carefully reviewed.

Prior to adoption, it should be determined where the policy or policies should be placed in the organization's documentation. Alternatives may include, for example, in an employee manual, in the bylaws, in a board policies and procedures manual, and/or as a stand-alone item. The manner in which the policy or procedure must or will be adopted – such as by the board of directors (recommended), by the members, or both – should also be determined. In every case, the policy or procedure must be disseminated to all affected constituencies, such as, for example, employees, directors, members, and volunteers. Finally, the organization should only adopt policies and procedures that it is confident it can follow. It could well be worse to adopt a policy or procedure that is not followed than to have no policy or procedure at all.

5. Sample Policy and Procedure and Questionnaires

A. *Sample Policy.*[This Policy can be used with Questionnaire A or B, or the Questionnaires can be used independently.]

INDEPENDENT GOVERNING BODY AND FAMILY AND BUSINESS RELATIONSHIPS POLICY OF _____

1. Policy and Purpose

This Policy represents the policy of _____ (the “organization”) with respect to the independent governing body and family and business relationships items in the IRS Form 990. The purpose of this Policy is to provide a policy, including procedures, to be able to answer the questions regarding independent voting members of the governing body and persons with business and family relationships in the Form 990.

2. Questionnaire

In order to meet the “reasonable effort” standard in the instructions to the Form 990, the organization may utilize a questionnaire as referred to in the instructions (“Questionnaire”). The Questionnaire, for the members of the governing body and others to complete on an annual basis, sufficiently supplemented with definitions of terms used in the Form 990 instructions, will allow the organization to obtain the needed information to answer some of the questions on the Form 990. It will also allow the members of the governing body and others to answer the Questionnaire with some degree of assurance that (a) their answers are responsive to the questions and (b) they have not wasted their time trying to answer the Questionnaire without understanding the concepts.

3. Procedures

3.1 Responsibilities of the Administrator. The organization's _____ [CEO, President, Executive Vice President, Vice President for ____, etc.] shall be the administrator (“Administrator”) in charge of the administration of this Policy. The Administrator's responsibilities shall include supervising and coordinating the adoption and distribution of an

appropriate Questionnaire. The Administrator shall also be responsible for follow-up with respect to the Questionnaire, including reminders, receipt of Questionnaires, tabulation of data and communication of the resulting information to the individual or individuals responsible for completing the Form 990. The Administrator may also modify the Questionnaire from time to time as necessary to comply with law and/or to include additional or revised questions as may be appropriate. The Administrator is also authorized to periodically review this Policy and Policy compliance with legal counsel and to report to the Board of Directors as to compliance. The Administrator may also appoint one or more assistants to assist in carrying out the Administrator's responsibilities. However, the Administrator retains ultimate responsibility for administration of this Policy. The Administrator shall also keep the governing body informed as to compliance with this Policy.

3.2 Responsibilities of Other Constituencies. It shall be the responsibility of the governing body to appoint, dismiss and replace the Administrator, as appropriate. It shall be the responsibility of the members of the governing body and the officers, directors, trustees and key employees of the organization for a particular tax year in question to reasonably cooperate with the Administrator and staff in candidly answering the Questionnaire and returning it to the Administrator in a timely fashion.

3.3 Questionnaire: Adoption, Distribution and Follow-up.

1. The governing body shall appoint the Administrator who shall work with the governing body in adopting the Questionnaire.
2. At the close of the tax year for the organization, the Administrator shall prepare the list of names of the members of the governing body and the officers, directors, trustees and key employees for the tax year just ended and attach it to the Questionnaire as appropriate.
3. As soon as reasonably possible after the close of the tax year, the Administrator shall distribute the Questionnaire to each person on such list and make sure each person knows the due date for returning the Questionnaire.
4. As the Administrator receives each completed Questionnaire, the Administrator shall check to ensure that the Questionnaire is completed in full, including that it has been signed and dated.
5. The Administrator shall follow up on any Questionnaires not received by the due date and make reasonable efforts to obtain completed Questionnaires.
6. The Administrator shall tabulate the data (total number of voting members of the governing body is __ and the number of independent voting members of the governing body is _____), summarize the information needed for Schedule O of the Form 990, and provide the tabulation and summary to the person preparing the Form 990.

3.4 Privacy. It shall be the responsibility of the Administrator, after consultation with counsel, if necessary, to determine how privacy laws will apply to the organization's collection and use of information on the Questionnaires; to establish reasonable procedures for compliance with such privacy laws; and to allow for their audit and review on a regular basis, if appropriate.

B. Sample Procedure and Questionnaire A. The following procedure and questionnaire is designed to determine the number of independent members of the organization's governing body and to determine what family and business relationships need to be disclosed of officers, directors, trustees, and key employees of the organization. Section I sets forth instructions for the Administrator. Section II is the Questionnaire. Section III and Section IV comprise the "pertinent instructions and definitions" that are to accompany the Questionnaire. The Administrator must prepare and attach Sections IV and V, which may change each year depending on who served as officers, directors, trustees, and key employees at any time during the tax year just ended and previous years. Sample Procedure and Questionnaire A is designed so that the person who receives the Questionnaire (Section II) and pertinent instructions and definitions (Sections III and IV) may determine himself or herself if he or she is an independent member of the governing body and if he or she has business or family relationships that must be disclosed.

(Sample Procedure and Questionnaire A continued on next page)

SECTION I INSTRUCTIONS FOR ADMINISTRATOR

1. Appoint a person responsible for the distribution and collection of the Questionnaire (“Administrator”).
2. At the close of the tax year for the organization, the Administrator shall prepare two lists:
 - 2.1 A list of the names of the members of the governing body and the officers, directors, trustees and key employees that served in any one or more of those roles during any part of the tax year just ended. The list should be labeled SECTION IV and should be attached behind Section III. See Section III for definition of “key employee.”
 - 2.2 To the extent not listed in the Section IV list, a list of the names of all current and former officers, directors, trustees and key employees required to be listed in Form 990, Part VII, Section A. The list should be labeled SECTION V and should be attached behind Section IV.
3. As soon as reasonably possible after the close of the tax year, the Administrator shall distribute Sections II, III, IV, and V to each person listed on Sections IV and V and make sure each person knows the due date for returning Section II.

A line should be drawn through 2.1 – 2.3 and 3 of Section II of the Questionnaires distributed to those listed on Section V because only Questions 1.1 – 1.4 of Section II must be answered by the persons listed on Section V.

The Administrator must determine if any substantial contributors and any persons related to substantial contributors must be asked to answer Question 1.3 of Section II of the Questionnaire (see Instructions to Schedule L of Form 990).

In addition, if there is a Grant Selection Committee, each member of the committee must be asked to answer Question 1.3 of Section II of the Questionnaire.
4. As the Administrator receives each completed Section II, the Administrator shall check to be sure Section II is completed in full, including that it has been signed and dated.
5. The Administrator shall follow up on any Questionnaires not received by the due date and make reasonable efforts to obtain all Questionnaires completed in full.
6. With respect to question 1.2 in Section II, the Administrator must determine if any loans were outstanding at the close of the tax year between the organization and (a) any highest compensated employees required to be listed in Form 990, Part VII, Section A and (b) for 501(c)(3) and 501(c)(4) organizations any disqualified persons described in Section 4958(f)(1).
7. The Administrator shall tabulate the data (total number of voting members of the governing body is ___ and the number of independent voting members of the governing body is _____), summarize the information needed for Schedule O, and provide the tabulation and summary to the person preparing the Form 990. Consider including on Schedule O a statement to the following effect: “with respect to all matters voted on by the governing body during the tax year just ended, no one voted on a matter with which he or she was an ‘interested person’ as defined by the Instructions to the Form 990” [consider if you want or need to add: “that exceeded the ‘business transaction thresholds’ defined by the Instructions to the Form 990”].
8. The Administrator will determine how to comply with any privacy laws that may apply to the collection and use of the information on the Questionnaires and to the storage and destruction of the Questionnaires.

SECTION II
INDEPENDENT GOVERNING BODY AND FAMILY AND BUSINESS
RELATIONSHIPS ANNUAL QUESTIONNAIRE
(See Section III for Definitions)

Tax Year Just Ended: _____ Return to _____ Due: _____

Name: _____

Your Title(s) (during tax year just ended): _____

1. Transactions that may need to be reported on Schedule L of Form 990:

1.1 Excess Benefit Transaction. Are you aware of any transaction that took place during the organization's tax year just ended between the organization and you, any of your family members, or any entity owned more than 35% by you that:

- (a) was not approved in advance by an authorized body of the organization composed entirely of individuals who did not have a conflict of interest in the arrangement/transaction? Yes No
- (b) the authorized body did not rely upon appropriate comparability data prior to making its decision (e.g. independent valuations, other bids or offers)?
 Yes No
- (c) the authorized body did not adequately document the basis for its decision concurrently with making that decision (i.e., the decision was not recorded in the minutes)?
 Yes No

If you answered "yes" to any of (a) – (c), state each such business transaction separately (use a separate sheet if necessary): _____

1.2 Loans. Were any loans, including salary advances, or other advances between you and the organization outstanding as of the end of the organization's tax year?

Yes No

If yes, state each such loan, separately: _____

1.3 Grants. Did you or any of your family members or a 35% controlled entity (by you alone or with any of the organization’s current or former officers, directors, trustees or key employees listed in Sections IV and V to this Questionnaire), directly or indirectly, receive from the organization during the organization’s tax year a grant, scholarship, fellowship, internship, prize, award or other assistance (including the provision of goods, services, use of facilities, or part gift/part sale transaction), regardless of amount, other than (a) as a member of a charitable class or other class that the organization intends to benefit in furtherance of its exempt purpose and (b) the grant was provided on terms similar to terms provided to other members of the class? Yes No

If yes, state each such grant or other assistance, separately:

1.4 Business Transactions with Interested Persons. Were payments made during the organization’s tax year just ended on a business transaction (e.g., sale, lease, license, performance of services), whether the transaction was initiated during the tax year or ongoing from a prior year, between the organization and any “interested person” (defined below) that exceeded a business transaction threshold (also defined below)? Yes No

(Note, the “ordinary course of business exception” to reporting business relationships (Question 3 below in this Section II) does not apply for purposes of this Question 1.4).

“**Interested persons**” include: (a) you, (b) any of your family members, (c) an entity more than 35% owned, directly or indirectly, individually or collectively, by one or more of you and current or former officers, directors, trustees or key employees (named in Sections IV and V of this Questionnaire) and your and their family members, (d) an entity (other than a 501(c) or governmental unit or instrumentality) of which you served at the time of the transaction as (i) an officer, (ii) a director, (iii) a trustee, (iv) a key employee, (v) a partner or member with a direct or indirect ownership interest in excess of 5% (including ownership by a family member) if the entity is treated as a partnership, or (vi) a shareholder with a direct or indirect ownership interest in excess of 5% (including ownership by a family member) if the entity is a professional corporation.

Business Transaction Thresholds: (1) if all payments during the tax year between the organization and the interested person exceeded \$100,000, then report all transactions regardless of the individual amounts of each individual transaction; (2) if all payments during the tax year from a single transaction between the organization and the interested person exceeded the greater of \$10,000 or 1% of the organization’s total revenues; (3) if compensation payments during the tax year to a family member of an interested person exceeded \$10,000; or (4) in the case of a joint venture with an interested person, if the organization invested \$10,000 or more in the joint venture, whether or not during the tax year.

State each such business transaction separately (use a separate sheet if necessary):

2. Independent Member of the Governing Body. If you were a voting member of the governing body (e.g., a voting member of the board of directors or board of trustees) at the close of the tax year, were you or were you not an “independent” member of the governing body, as that term is defined by the instructions to the IRS Form 990? See Section III for definitions, exceptions and examples of an “independent” member and the following questions to help you answer this question.

2.1 Were you compensated as an officer or other employee of the organization or of a related organization during the organization’s tax year just ended?

Yes No

2.2 Did you receive total compensation or other payments exceeding \$10,000 during the organization’s tax year just ended from the organization or from related organizations as an independent contractor other than reasonable compensation for services provided in the capacity as a member of the governing body?

Yes No

2.3 Were you or any of your family members involved in a transaction with the organization (whether directly or indirectly through affiliation with another organization) required to be reported on Schedule L 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 if required to be filed by a related organization? (check “Yes” if you checked “Yes” on any of the questions in 1.1 – 1.4 above; check “No” if you checked “No” on all of questions in 1.1 – 1.4 above)

Yes No

Check “Yes” below if you checked one or more of questions 2.1 – 2.3 “Yes.” Check “No” below if you checked “No” on all of questions 2.1 – 2.3 above.

Yes I was/ No I was not an independent voting member of the governing body for the organization’s tax year just ended as defined by the instructions to the IRS Form 990.

3. Business and Family Relationships. If you are listed in Section IV, then you were an officer, director, trustee or “key employee” at some time during the organization’s tax year just ended. Did you have a “family relationship” or a “business relationship” (as defined in Section III) with any other of the organization’s officers, directors, trustees, or key employees listed on Section IV at any time during the tax year? See Section III for definitions and examples. (Check "Yes" or "No):

Yes I did/ No I did not have a “business relationship” with anyone listed in Section IV as the term “business relationship” is defined in the instructions to Line 2 of Part VI.A of the IRS Form 990. If yes, identify (name) the person(s):

Yes I did/ No I did not have a “family relationship” with anyone listed on Section IV as the term “family relationship” is defined in the instructions to the IRS Form 990. If yes, identify (name) the person(s):

Dated: _____

(Signature)

SECTION III DEFINITIONS AND EXAMPLES FROM IRS FORM 990 INSTRUCTIONS

A. Independent Members of Governing Body

Definition from the Glossary to the Instructions to Form 990

A voting member of the governing body is independent if all three of the following circumstances applied at all times during the organization's tax year:

1. The member was not compensated as an officer or other employee of the organization or of a related organization (see the instructions for Schedule R, Related Organizations and Unrelated Partnerships), except as provided in the religious exception discussed in the instructions for Form 990, Part VI.

2. The member 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 reasonable compensation for services provided in the capacity as a member of the governing body. 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 received payments of \$7,500 from the organization for other arrangements.

3. Neither the member, nor any family member of the member, was involved in a transaction with the organization (whether directly or indirectly through affiliation with another organization) required to be reported on Schedule L (Form 990 or 990-EZ), Transactions With Interested Persons, 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. (See questions 1.1 – 1.4 in Section II of this Questionnaire to determine if you or any of your family members were involved in any transactions that must be reported on Schedule L.)

Explanation from the Instructions to the Form 990

A member of the governing body is not considered to lack independence "merely" because of the following circumstances:

1. The member is a donor to the organization, regardless of the amount of the contribution.
2. Religious exception: The member has taken a *bona fide* vow of poverty and either (a) receives compensation as an agent of a religious order or a section 501(d) religious or apostolic organization, but only under circumstances in which the member does not receive taxable income (see Rev. Rul. 77-290, 1977-2 C.B. 26 and Rev. Rul. 80-332, 1980-2 C.B. 34) or (b) belongs to a religious order that receives sponsorship or payments from the organization which do not constitute taxable income to the member.
3. The member receives financial benefits from the organization solely in the capacity of being a member of the charitable or other class served by the organization in the exercise of its exempt function, such as being a member of a Section 501(c)(6) organization, so long as the financial benefits comply with the organization's terms of membership.

Example 1. B is a voting member of the organization’s board of directors. B is also a partner with a profits and capital interest greater than 5% in a law firm, C, that charged \$120,000 to the organization for legal services in a court case. The transaction between C and the organization must be reported on Schedule L (Form 990 or 990-EZ) because it is a transaction between the organization and an entity of which B is a more-than-5% owner, and because the payment to C from the organization exceeded \$100,000 (see the instructions to Schedule L (Form 990 or 990-EZ), Part IV, regarding both factors). Accordingly, B is not an independent member of the governing body because the \$120,000 payment must be reported on Schedule L (Form 990 or 990-EZ) as an indirect business transaction with B. If B were an associate attorney (an employee) but not an officer, director, trustee, key employee, or owner of the law firm, the transaction would not affect B’s status as an independent member of the organization’s governing body.

Example 2. D is a voting member of both the organization’s governing body and the governing body of C, a related organization. D’s daughter, E, received \$40,000 in taxable compensation as a part-time employee of C. D is not an independent member of the governing body, because E received compensation from C, a related organization to D, and the compensation was of a type (compensation to a family member of a member of C’s governing body) and amount (over \$10,000) that would be reportable on Schedule L (Form 990 or 990-EZ) if the related organization, C, were required to file Schedule L (Form 990 or 990-EZ).

B. Family or Business Relationship between Any Officer, Director, Trustee, or Key Employee and Any Other Officer, Director, Trustee, or Key Employee.

A “family relationship” or “family members” includes your: legal spouse, ancestors (this category does not include step-parents/grandparents), children (biological or adopted) and their legal spouses, grandchildren and great-grandchildren and their legal spouses, and siblings (whether by whole or half blood) and their legal spouses.

A “business relationship” between two persons includes the following:

1. Employment. One person is employed by the other in a sole proprietorship or by an organization with which the other is associated as a trustee, director, officer, key employee, or greater-than-35% owner.

2. Transaction. One person is transacting business with the other (other than in the ordinary course of either party’s business on the same terms as are generally offered to the public), directly or indirectly, in one or more contracts of sale, lease, license, loan, performance of services, or other transaction involving transfers of cash or property valued in excess of \$10,000 in the aggregate during the organization’s tax year. (*Indirect transactions* are transactions with an organization with which the one person is associated as a trustee, director, officer, key employee, or greater-than-35% owner). Such transactions do not include charitable contributions to tax-exempt organizations.

3. Common Governance or Ownership. The two persons are each a director, trustee, officer, or greater-than-10% owner in the same business or investment entity (but not in the same tax-exempt organization). Ownership is measured by stock ownership (either voting power or value) of a corporation, profits or capital interest in a partnership or limited liability company, membership interest in a nonprofit organization, or beneficial interest in a trust. Ownership includes indirect ownership (for example, ownership in an entity that has ownership in the entity in question); there may be ownership through multiple tiers of entities.

However, the instructions provide a “privileged relationship exception.” A “business relationship” does not include a relationship between an attorney and client, a medical professional (including psychologist) and patient, or a priest/clergy and penitent/communicant. (Note that the privilege relationship exception for Item 2 of Part VI, Section A of the Form 990, [Question 3 of Section II of this Questionnaire] does not apply for the business transactions that must be reported on Schedule L of the Form 990 [Question 1.3 of Section II of this Questionnaire].)

Example 1. B is an officer of the organization, and C is a member of the organization’s governing body. B is C’s brother-in-law. The organization must report that B and C have a family relationship.

Example 2. D and E are officers of the organization. D is also a partner in an accounting firm with 300 partners (with a 1/300 interest in the firm’s profits and capital) but is not an officer, director, trustee, or key employee of the accounting firm. D’s accounting firm provides services to E in the ordinary course of the accounting firm’s business, on terms generally offered to the public, and receives \$100,000 in fees during the year. The relationship between D and E is not a reportable business relationship, either because (1) it is in the ordinary course of business on terms generally offered to the public, or because (2) D does not hold a greater-than-35% interest in the accounting firm’s profits or capital.

Example 3. F and G are trustees of the organization. F is the owner and CEO of an automobile dealership. G purchased a \$45,000 car from the dealership during the organization’s tax year in the ordinary course of the dealership’s business, on terms generally offered to the public. The relationship between F and G is not a reportable business relationship because the transaction was in the ordinary course of business on terms generally offered to the public.

Example 4. H and J are members of the organization’s board of directors. Both are CEOs of publicly traded corporations and serve on each other’s boards. The relationship between H and J is a reportable business relationship because each is a director or officer in the same business entity.

Example 5. K is a key employee of the organization, and L is on its board of directors. L is a greater-than-35% partner of a law firm that charged \$60,000 during the organization’s tax year for legal services provided to K that were worth \$600,000 at the law firm’s ordinary rates. Thus, the ordinary course of business exception does not apply. However, the relationship between K and L is not a reportable business relationship, because of the privileged relationship of attorney and client.

C. Key Employee

The new Form 990 introduced the concept of “key employee.” A key employee is defined in the Glossary in the Instructions to Form 990 as follows:

For purposes of Form 990 reporting, an employee of the organization (other than an officer, director, or trustee) who meets all three of the following tests is a “key employee”:

1. **\$150,000 Test.** Receives reportable compensation from the organization and all related organizations in excess of \$150,000 for the calendar year ending with or within the organization’s tax year.
2. **Responsibility Test (which may be met at any time during the tax year).** The employee:
 - a. has responsibilities, powers or influence over the organization as a whole similar to those of officers, directors, or trustees;

- b. manages a discrete segment or activity of the organization that represents 10% or more of the activities, assets, income, or expenses of the organization, as compared to the organization as a whole;
 - c. or has or shares authority to control or determine 10% or more of the organization's capital expenditures, operating budget, or compensation for employees.
3. Top 20 Test. Is one of the 20 employees (that satisfy the \$150,000 Test and Responsibility Test) with the highest reportable compensation from the organization and related organizations for the calendar year ending with or within the organization's tax year.

D. Related Organization.

A "related organization," as used in the definition of "key employee" and as used in the instructions regarding "independent" members of the governing body, is an organization, including a nonprofit organization, a stock corporation, a partnership or limited liability company, a trust, and a **governmental unit** or other government entity, that stands in one or more of the following relationships to the filing organization at any time during the **tax year**.

- Parent: an organization that **controls** the filing organization.
- Subsidiary: an organization **controlled** by the filing organization.
- Brother/Sister: an organization **controlled** by the same person or persons that control the filing organization.
- Supporting/Supported: an organization that is (or claims to be) at any time during the organization's tax year (i) a **supporting organization** of the filing organization within the meaning of section 509(a)(3), if the filing organization is a **supported organization** within the meaning of section 509(f)(3); (ii) or a supported organization, if the filing organization is a supporting organization.

See definitions below in Section F (Other Definitions) of "control," "controlled" and "controls."

E. Excess Business Transactions, Part I of Schedule L Reported Transactions.

Part I of Schedule L is where excess benefit transactions are reported. The Treasury Regulations include a rebuttable presumption to protect against an excess benefit transaction. If the rebuttable presumption requirements are met, then the transaction will not be an excess benefit transaction. Our organization's conflict of interest policy and compensation policy include the steps required by the rebuttable presumption [drafter: be sure the organization's conflict of interest policy does include the steps necessary to qualify for the rebuttable presumption]. If the conflict of interest policy and compensation policy were followed in every case, there should be no transactions to report on Part I of Schedule L. If they were not followed in every case during the tax year just ended, then so state in Question 1.1of Section II.

Generally, an "excess benefit transaction" is a transaction in which an excess economic benefit is provided by the exempt organization directly or indirectly to or for the benefit of any "disqualified person." (Members of the governing body and officer, directors, trustees and key employees are "disqualified persons." The definition of "disqualified person" in the regulations for IRC section 4958 includes "any person who was, at any time during the 5-year period ending on the date of such transaction, in a position to exercise substantial influence over the affairs of the organization.") An "excess benefit" occurs "if the value of the economic benefit provided exceeds the value of the

consideration (including the performance of services) received for providing such benefit.” Disqualified persons who receive the benefit, as well as the officers and directors (and persons with duties similar to that of officers and directors) who knowingly participated in the transaction, may be liable for excise taxes: 25% on the benefiting disqualified persons and 10% on the organization managers (there are additional penalties of 200% of the excess benefit on the disqualified person if the transaction is not corrected within a specified period).

F. Other Definitions.

1. **“Compensation” (“compensated”)** is all forms of cash and noncash payments or benefits provided in exchange for services, including salary and wages, bonuses, severance payments, deferred payments, retirement benefits, fringe benefits, and other financial arrangements or transactions such as personal vehicles, meals, housing, personal and family educational benefits, below-market loans, payment of personal or family travel, entertainment, and personal use of the organization's property.

2. For purposes of determining **related organizations**, **“control”** or **“controlled”** or **“controls”** means:

Control of a nonprofit organization (or other organization without owners or persons having beneficial interests, whether the organization is taxable or tax-exempt):

One or more persons (whether individuals or organizations) control a nonprofit organization if they have the power to remove and replace (or to appoint or elect, if such power includes a continuing power to appoint or elect periodically or in the event of vacancies) a majority of the nonprofit organization's directors or trustees, or a majority of the members who elect the nonprofit organization's directors or trustees. Such power can be exercised directly by a (parent) organization through one or more of the (parent) organization's officers, directors, trustees, or agents, acting in their capacity as officers, directors, trustees, or agents of the (parent) organization. Also, a (parent) organization controls a (subsidiary) nonprofit organization if a majority of the subsidiary's directors or trustees are trustees, directors, officers, employees, or agents of the parent.

Control of a stock corporation

One or more persons (whether individuals or organizations) control a stock corporation if they own more than 50% of the stock (by voting power or value) of the corporation.

Control of a partnership or limited liability company

One or more persons control a partnership if they own more than 50% of the profits or capital interests in the partnership (including a limited liability company treated as a partnership or disregarded entity for federal tax purposes, regardless of the designation under state law of the ownership interests as stock, membership interests, or otherwise). A person also controls a partnership if the person is a managing partner or managing member of a partnership or limited liability company which has three or fewer managing partners or managing members (regardless of which partner or member has the most actual control), or if the person is a general partner in a limited partnership which has three or fewer general partners (regardless of which partner has the most actual control).

Control of a trust with beneficial interests

One or more persons control a trust if they own more than 50% of the beneficial interests in the trust.

3. **Indirect control.** Control can be indirect. For example, if the filing organization controls Entity A, which in turn controls (under the definition of control in these instructions) Entity B, the organization will be treated as controlling Entity B. To determine indirect control through constructive ownership of a corporation, rules under section 318 apply. Similar principles apply for purposes of determining constructive ownership of another entity (a partnership or trust). If an entity (X) controls an entity treated as a partnership by being one of three or fewer partners or members, then an organization that controls X also controls the partnership.

Example 1. B, an exempt organization, wholly owns (by voting power) C, a taxable corporation. C holds a 51 % profits interest in D, a partnership. Under the principles of section 318, B is deemed to own 51 % of D (100% of C's 51 % interest in D)). Thus, B controls both C and D, which are therefore both related organizations with respect to B.

Example 2. X, an exempt organization, owns 80% (by value) of Y, a taxable corporation. Y holds a 60% profits interest as a limited partner of Z, a limited partnership. Under the principles of section 318, X is deemed to own 48% of Z (80% of Y's 60% interest in Z). Thus, X controls Y. X does not control Z through X's ownership in Y. Y is a related organization with respect to X, and (absent other facts) Z is not.

Example 3. Same facts as in Example 2, except that Y is also one of three general partners of Z. Because Y controls Z through means other than ownership percentage, and X controls Y, in these circumstances, Z is a related organization with respect to X. The other general partners of Z (if organizations) are not related organizations with respect to X, absent other facts.

4. The “**governing body**” is the group of persons authorized under state law to make governance decisions on behalf of the organization and its shareholders or members, if applicable. The governing body is, generally speaking, the board of **directors** (sometimes referred to as board of **trustees**) of a corporation or association, or the board of trustees of a trust (sometimes referred to simply as the trustees, or trustee if only one trustee). Advisory members that do not exercise governance authority over the organization are not members of the governing body.

5. A “**director**” or “**trustee**” is a member of the **governing body**.

6. An “**officer**” is a person elected or appointed to manage the organization's daily operations, such as a president, vice-president, secretary, or treasurer. The officers of an organization are determined by reference to its organizing document, bylaws, or resolutions of its governing body, or as otherwise designated consistent with state law, but at a minimum include those officers required by applicable state law. For purposes of Form 990 reporting, officers also include the organization's (i) **top management official** (the person who has ultimate responsibility for implementing the decisions of the organization's **governing body** or for supervising the management, administration, or operation of the organization [for example, the organization's CEO or executive director]) and (ii) top financial official (the person who has ultimate responsibility for managing the organization's finances).

7. An “**employee**” is any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee, and any other individual who is treated as an employee for federal employment tax purposes.

8. An “**independent contractor**” is a person who provides services to the organization but who is not treated as an **employee**.

SECTION IV
**LIST OF MEMBERS OF THE GOVERNING BODY AND OF OFFICERS,
DIRECTORS, TRUSTEES, AND KEY EMPLOYEES WHO SERVED IN ONE OR
MORE OF THOSE POSITION AT ANY TIME DURING THE TAX YEAR JUST
ENDED**

NAME

POSITION

SECTION V
**LIST OF ORGANIZATION'S FORMER OFFICERS, DIRECTORS, TRUSTEES, AND
KEY EMPLOYEES LISTED IN FORM 990, PART VII, SECTION A**

NAME

POSITION

C. Sample Questionnaire B.

This sample questionnaire was developed by DLA Piper LLP (US). As explained in the Memorandum, this Questionnaire does not require the person to determine if he or she is an independent board member. This form is for the person completing the form to provide the information necessary to make that determination, but leaves that determination to be made by the staff of the organization or by its paid professionals.

(Sample Questionnaire B continued on next page)

[NAME OF ORGANIZATION]

ANNUAL INDEPENDENCE QUESTIONNAIRE

As you may be aware, the IRS released a redesigned Form 990 that [*will soon be*] [*is now*] effective for [NAME OF ORGANIZATION] (the “Organization”). The new Form 990’s section on governance asks questions related to your independence.⁴ In order to assist us in completing the new Form 990, we ask that you please complete the following questionnaire. You may attach additional pages if necessary. We recognize that many of the questions below are technical and that the appropriate responses to such questions may be difficult to determine. Please contact us if you are uncertain about any question or your response to such question. Note that definitions of the words in **bold** are defined in Appendix A attached to the back of this questionnaire. In addition, the attached Appendix B lists each person whom the Organization considers to have been an **officer, director, trustee** or **key employee** at any time during the Organization’s [2009] tax year.

1. Payments by the Organization. Have you been **compensated** as an **officer** or other **employee** of this Organization during the Organization’s [2009] tax year?

ANSWER: YES NO

If you answered “Yes,” please describe such **compensation**:

⁴ Note: A member of the governing body is not considered to lack independence merely because of the following circumstances:

- i) The member is a donor to the Organization, regardless of the amount of the contribution;
- ii) The member has taken a *bona fide* vow of poverty and either: (a) receives compensation as an agent of a religious order or a section 501(d) religious or apostolic organization, but only under circumstances in which the member does not receive taxable income or (b) belongs to a religious order that receives sponsorship or payments from the organization that do not constitute taxable income to the member; or
- iii) The member receives financial benefits from the Organization solely in the capacity of being a member of the charitable or other class served by the organization in the exercise of its exempt function, so long as the financial benefits comply with the organization’s terms of membership.

2. Payments by a Related Organization. Have you been **compensated** as an **officer** or other **employee** of one of the following related organizations (“Related Organizations”) during the Organization’s [2009] tax year?

i) An organization where this Organization has the right to appoint, **control** or remove a majority of the **directors**;

-OR-

ii) An organization where this Organization owns more than 50 percent of the Related Organization’s stock, the right to more than 50 percent of that Related Organization’s profits or the right to more than 50 percent of the beneficial interest in a trust;

-OR-

iii) A subsidiary of this Organization or any Related Organization of any subsidiary of this Organization.

ANSWER: YES NO

If you answered “Yes,” please describe such **compensation**:

3. Payments to Independent Contractors. Have you received total **compensation** or other payments exceeding \$10,000 from the Organization or from a Related Organization as an **independent contractor**, other than reimbursement of expenses under an **accountable plan** or reasonable **compensation** for services provided in the capacity as a member of the **governing body**, during the Organization’s [2009] tax year?

ANSWER: YES NO

If you answered “Yes,” please describe such **compensation**:

4. Transactions with the Organization. Have you, or any of your **family members**, been involved in a transaction with the Organization in one of the following threshold amounts (whether directly or indirectly through affiliation with another organization) during the Organization's [2009] tax year?

i) \$100,000 in the aggregate;

-OR-

ii) \$[insert the greater of either \$10,000 or 1% of revenue] in a single transaction.

-OR-

iii) \$10,000 in compensation to a **family member**.

ANSWER: YES NO

If you answered "Yes," please describe such transaction(s):

5. Family Relationship. Have any of your **family members** been employed as an **officer, director, trustee or key employee** of the Organization during the Organization's [2009] tax year?

ANSWER: YES NO

If you answered "Yes," please describe such **family members'** employment:

6. Employment Business Relationship.* Have you, or any **family member**, been employed during the Organization's [2009] tax year by either a sole proprietorship or an organization with which an **officer, director, trustee, key employee** or greater-than-35% owner of the Organization is associated?

ANSWER: YES NO

If you answered "Yes," please describe such business relationship:

7. Transaction Business Relationship.* Have you, or any **family member**, directly or indirectly,⁶ made one or more contracts of sale, lease, license, loan, performance of services or other transaction involving transfers of cash or property valued in excess of \$10,000 in the aggregate with an **officer, director, trustee** or **key employee** of the Organization during the Organization's [2009] tax year?

ANSWER: YES NO

If you answered "Yes," please describe such business relationship:

* A "business relationship" does not include a relationship between an attorney and client, a medical professional (including psychologist) and patient, or a priest/clergy and penitent/communicant.

⁵ For the purpose of question 7, "indirectly" means a transaction with an organization with which either you or the **officer, director, trustee** or **key employee** is associated as a **trustee, director, officer, key employee** or greater-than-35% owner.

8. Investment Business Relationship.* Have you, or any **family member**, been a greater-than-10% owner⁸ in the same business or investment entity as any **officer, director, trustee or key employee** of the Organization during the Organization's [2009] tax year?

ANSWER: YES NO

If you answered "Yes," please describe such business relationship:

Please sign, date and return this questionnaire as soon as possible. Responses may be sent to:

[Include Contact Information]

By signing below, I affirm that my answers to the foregoing questions are true and accurate to the best of my knowledge. I understand that the Organization will rely on my answers in completing its Form 990.

I will promptly advise the Organization if, after the date hereof, I become aware of any information that would change my responses to this questionnaire.

Dated: _____, [2009]
(Required)

Signature: _____

Name:

Title(s):

(Title or Titles of position(s) with the Organization at any time during the Organization's [2009] tax year.)

* A "business relationship" does not include a relationship between an attorney and client, a medical professional (including psychologist) and patient, or a priest/clergy and penitent/communicant.

⁷ Ownership is measured by stock ownership – either voting power or value – of a corporation, profits or capital interest in a partnership or limited liability company, membership interest in a nonprofit organization or beneficial interest in a trust. Note that ownership includes indirect ownership, for example, ownership in an entity that has ownership in the entity in question. There may be ownership through multiple tiers of entities.

APPENDIX A

“**Accountable Plan**” means a reimbursement or other expense allowance for business expenses incurred by the employee in connection with the performance of services as an employee which can be substantiated as bona fide expenses related to the employer’s business and which requires the employee to return any moneys paid by the employer which are in excess of the expenses substantiated.

“**Business Relationship**” as between two persons includes the following:

(i) One person is employed by the other in a sole proprietorship or by an organization with which the other is associated as a trustee, director, officer, key employee, or greater-than-35% owner.

(ii) One person is transacting business with the other (other than in the ordinary course of either party’s business on the same terms as are generally offered to the public), directly or indirectly, in one or more contracts of sale, lease, license, loan, performance of services, or other transaction involving transfers of cash or property valued in excess of \$10,000 in the aggregate during the organization’s tax year. Indirect transactions are transactions with an organization with which the one person is associated as a trustee, director, officer, key employee, or greater-than-35% owner.

(iii) The two persons are each a director, trustee, officer, or greater than 10% owner in the same business or investment entity.

Ownership is measured by stock ownership (either voting power or value) of a corporation, profits or capital interest in a partnership or limited liability company, membership interest in a nonprofit organization, or beneficial interest in a trust. Ownership includes indirect ownership (e.g., ownership in an entity that has ownership in the entity in question); there can be ownership through multiple tiers of entities.

“**Compensation**” (or being “**compensated**”) means all forms of cash and noncash payments or benefits provided in exchange for services, including salary and wages, bonuses, severance payments, deferred payments, retirement benefits, fringe benefits and other financial arrangements or transactions such as personal vehicles, meals, housing, personal and family educational benefits, below-market loans, payment of personal or family travel, entertainment and personal use of the organization’s property.

“**Control**” means:

(i) **Control of a nonprofit organization (or other organization without owners or persons having beneficial interests, whether the organization is taxable or tax-exempt).** One or more persons (whether individuals or organizations) control a nonprofit organization if they have the power to remove and replace (or to appoint or elect, if such power includes a continuing power to appoint or elect periodically or in the event of vacancies) a majority of the nonprofit organization’s directors or trustees, or a majority of the members who elect the nonprofit organization’s directors or trustees. Such power can be exercised directly by a (parent)

organization through one or more of the (parent) organization's officers, directors, trustees, or agents, acting in their capacity as officers, directors, trustees, or agents of the (parent) organization. Also, a (parent) organization controls a (subsidiary) nonprofit organization if a majority of the subsidiary's directors or trustees are trustees, directors, officers, employees, or agents of the parent.

(ii) ***Control of a stock corporation.*** One or more persons (whether individuals or organizations) control a stock corporation if they own more than 50% of the stock (by voting power or value) of the corporation.

(iii) ***Control of a partnership or limited liability company.*** One or more persons control a partnership if they own more than 50% of the profits or capital interests in the partnership (including a limited liability company treated as a partnership or disregarded entity for federal tax purposes, regardless of the designation under state law of the ownership interests as stock, membership interests, or otherwise). A person also controls a partnership if the person is a managing partner or managing member of a partnership or limited liability company which has three or fewer managing partners or managing members (regardless of which partner or member has the most actual control), or if the person is a general partner in a limited partnership which has three or fewer general partners (regardless of which partner has the most actual control).

(iv) ***Control of a trust with beneficial interests.*** One or more persons control a trust if they own more than 50% of the beneficial interests in the trust.

“Director” means a member of the organization's governing body, but only if the member has any voting rights. A member of an advisory board that does not exercise any governance authority over the organization is not considered a director or a trustee.

“Employee” means any individual who, under the usual applicable common law rules, has the status of an employee, and any other individual who is treated as an employee for federal employment tax purposes.

“Family Members” means the family of an individual which only includes his or her spouse, ancestors, brothers and sisters (whether whole or half blood), children (whether natural or adopted), grandchildren, great-grandchildren and spouses of brothers, sisters, children grandchildren and great-grandchildren.

“Governing Body” means the group of persons authorized under state law to make governance decisions on behalf of the Organization and its shareholders or members, if applicable.

“Independent Contractor” means a person who provides services to the Organization but who is not treated as an employee.

“Key Employee” means an employee of the Organization, other than an officer, director or trustee, who meets all three of the following tests:

(i) Receives reportable compensation from the Organization and all Related Organizations in excess of \$150,000 for the calendar year ending with or within the Organization's [2009] tax year.

(ii) (a) has responsibilities, powers or influence over the organization as a whole similar to those of officers, directors or trustees; (b) manages a discrete segment or activity of the Organization that represents 10% or more of the activities, assets, income or expenses of the Organization, as compared to the Organization as a whole; or (c) has or shares authority to control or determine 10% or more of the Organization's capital expenditures, operating budget or compensation for employees.

(iii) Is one of the 20 employees (which satisfy (i) and (ii) above) with the highest reportable compensation from the Organization and Related Organizations for the calendar year ending with or within the Organization's [2009] tax year.

“**Officer**” means a person elected or appointed to manage the Organization's daily operations, such as president, vice-president, secretary or treasurer, as determined by the organizational documents and state law. For purposes of this questionnaire, an officer includes any top management official and top financial official.

“**Trustee**” has the same meaning as **Director** above.

APPENDIX B

The following are the individuals whom the Organization considers to have been an **officer, director, trustee** or **key employee** at any time during the Organization's [2009] tax year:

Name

Title(s)