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NATIONAL ASSOCIATION OF
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GOVERNANCE SERIES

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Corporate Responsibility and the New IRS Form 990: Meeting the Challenge as a Health Center Board Member

“The crown jewel of this effort is the governance section of the revised Form 990, effective for 2008.”

*Steven T. Miller
Commissioner, Tax Exempt and Government
Entities, Internal Revenue Service*

*At Western Conference on Tax Exempt Organizations,
Los Angeles, California, November 20, 2008*

In 2008, the Internal Revenue Service (IRS) issued a significantly revised Form 990, the information return that most nonprofit organizations, including health centers, must file annually with the IRS. Many health centers (*i.e.*, those with gross receipts over \$1 million or total assets over \$2.5 million) will have their first experience with completing the new Form 990 in calendar 2009.¹ Smaller health centers (*i.e.*, those with gross receipts over \$500,000 and total assets over \$1.25 million) will not have to file the new form until the 2010 filing season.² No matter the size of the health center, though, the breadth and scope of the information that must be compiled and analyzed in order to accurately complete the new Form 990

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- 1 Form 990 is due the 15th day of the fifth month after the end of an organization's tax year, which means that health centers reporting taxes on a calendar year basis must file Form 990 by May 15 of the following year.
 - 2 Beginning in 2011 (for returns for the 2010 tax year), the thresholds for filing the new Form 990 will be set permanently at \$200,000 gross receipts and \$500,000 total assets.

undoubtedly will test the reserve of the health center staff as well as financial and accounting professionals charged with preparing the return.

The new Form 990 is designed to elicit, for the first time, a substantial amount of information about the organization's governance and compensation practices. In many respects, the emphasis in the new form on governance (in contrast to the old form's focus on financial information) is its most important feature.

The IRS believes that a tax-exempt organization that demonstrates good governance practices is more likely to comply with the income tax laws. Thus, the new Form 990 requires tax-exempt organizations to provide information on certain practices that the IRS views as promoting good governance (although, in most cases, those practices are not legally required for income tax exemption). To the extent that Form 990 provides the public with a "window" into an organization's governance, that transparency, according to the IRS, also is likely to promote compliance.

Form 990 now challenges a health center's board of directors to consider:

1. How the health center's practices measure up to these unofficial "standards";
2. How the center's practices will be perceived by grantors, donors, and regulators who utilize Form 990 information;
3. Whether the health center should modify current policies or establish new ones so that the health center "puts its best foot forward" on the Form 990; and
4. Where to identify resources for the additional costs to compile the source information and complete the new form.

This Information Bulletin is intended to assist health center board members to deal with those challenges. In short, preparation of Form 990 no longer can be entrusted solely to the accountants!

BACKGROUND

IRS Form 990 is an "information return" since it is not used to report taxable income to the IRS.³ Form 990 serves as the primary tool for the IRS to collect information about the activities of an exempt organization and, in the aggregate, the activities of the tax-exempt community as a whole. The last major revision of Form 990 prior to 2008 was in 1979. In the intervening years, the number of tax-exempt organizations grew rapidly and their financial relationships, both internal and external, became increasingly complex. There was no significant effort to keep Form 990 up to date, and Form 990 remained a relatively basic disclosure document.

Meanwhile, Congress became increasingly concerned about abuses (both real and perceived) in the tax-exempt community including, among other things:

- ◆ **Excess benefits** (below market loans, unreasonable compensation, *etc.*) and other "perks" being provided to board members, executives, and other "insiders" of tax-exempt organizations;
- ◆ **Illegal intervention** by exempt organizations (or individuals acting in the name of the organization) in political campaigns; and

3 Tax-exempt organizations report taxable income from unrelated business activities on Form 990-T.

- ◆ **Exempt organizations** participating in shady, if not outright illegal, tax shelter schemes.

Two other developments influenced the new Form 990.

- ◆ First, the **“corporate responsibility” movement**, spawned in the wake of the Enron and other financial scandals among publicly traded corporations, resulted in a parallel, although largely voluntary, emphasis in the nonprofit sector on transparency and sound governance practices.
- ◆ Second, a **public policy debate** emerged over the role that tax-exempt organizations play, or should play, in society.

In particular, Members of Congress and other policy makers began to question the rationale for tax exemption of health care providers by asking:

1. What characteristics distinguish a tax-exempt health care provider from a taxable provider?
2. What activities (*e.g.* free care, discounts based on ability to pay, *etc.*) should be required in order for a provider to be tax exempt?

It was in this context that the IRS began the process of revising Form 990 in 2007.

FORM 990's ROLE IN TAX ADMINISTRATION AND PUBLIC POLICY

The new Form 990 serves important interests of the government, the public, and, importantly, the exempt organizations such as health centers. As previously noted, the IRS believes that the new Form 990 will enhance operational transparency and, as a result, improved compliance with the income tax laws.

Form 990 is important to the public because it is a convenient and readily accessible source of information about an exempt organization. In addition to basic financial information, including transactions with insiders and related entities, it discloses information about the organization's governance and management policies.⁴

Finally, the new Form 990 is important to a health center because it essentially documents the organization's case for retaining its tax exemption – that the health center is organized and operated for tax-exempt purposes, including compliance with applicable income tax laws. However, the most important function of the new Form 990 may well be the opportunity that it provides for a health center to describe its activities in substantial detail. Health center boards of directors would be well advised to see that the health center takes this opportunity to prepare what is, in effect, an “annual report” describing the benefits the health center provides to the community.

“ . . . the new Form 990 is important to a health center because it essentially documents the organization's case for retaining its tax exemption . . . ”

⁴ An exempt organization's Form 990 is available on public websites such as www.guidestar.org. Furthermore, an exempt organization is required to make its three most recent Forms 990 and its application for income tax exemption and related documents (if the application was filled after July 15, 1987) available for public inspection and for copying upon request. See Section 6104(d) of the Internal Revenue Code.

OVERVIEW OF THE NEW FORM 990

The new Form 990 consists of an 11-part “core” form with 16 supplemental schedules. All tax-exempt health centers are required to complete the core form, and most will have to complete several of the schedules, depending upon the information reported on the core form.⁵

Health center board members should pay particular attention to Parts I, III, VI, and VII of the 11-part “core” form more fully described below.⁶

Part I: Summary Page

According to the IRS, Part I of Form 990 is designed to provide an easy-to-use snapshot of the organization’s key financial, governance, and operational information, including a two-year comparison of financial results. Virtually all of the information requested in Part I is derived from other parts of the core form and related schedules.

In Part I, an exempt organization is asked to “briefly” describe its mission *or* most significant activities. In that regard, Part I summarizes information reported in more detail in Part III (discussed below). Health centers would be well advised *not* to interpret the word “briefly” literally, notwithstanding the approximately four lines provided in Part I for a response.⁷ The IRS strongly encourages exempt organizations to explain their

activities and accomplishments in detail. Moreover, the summary page will establish the reader’s first impression of a health center and, as a practical matter, may be all that some readers actually look at on Form 990. In short, Part I, in conjunction with Part III, provides a health center with an excellent “marketing” opportunity and should be used to explain in substantial detail the full range of its activities as a safety net health care provider and how the health center benefits the entire community it serves.

Part III: Statement of Program Service Accomplishments

Part III asks for the following information:

♦ A “brief” statement of the health center’s mission

According to the Form 990 instructions, the mission statement must have been adopted by the organization’s governing body⁸, presumably either as a stand-alone document or as part of the organization’s bylaws. The critical factor is that it must be adopted by the board of directors. Otherwise, the organization must report that it does not have a mission statement. Note that, as with other IRS “good governance”

5 The complete Form 990 and schedules, along with detailed instructions, can be found at and downloaded from the IRS website, www.irs.gov. Additional background information on Form 990 redesign and a tutorial on completing the form also can be accessed through the IRS website at the “Charities & Non-Profits” tab on the IRS web page.

6 The other components of the core form are: Part IV, Checklist of Required Schedules; Part V, Statements Regarding Other IRS Filings and Tax Compliance; Part VIII, Statement of Revenue; Part IX, Statement of Functional Expenses; Part X, Balance Sheet; and Part XI, Financial Statements and Reporting. Part II of the core form contains the signature block for the health center officer signing the form (which must be signed under penalty of perjury) and the signature of the health center’s tax preparer.

7 The Form 990 reporting package includes Schedule O which is to be used to provide additional and/or explanatory information that cannot otherwise be accommodated on the core form. There is no page limit to Schedule O. Therefore, health centers can use Part I and, as explained below, Part III (as supplemented by Schedule O of the form) to describe their operations and their services to the community in great detail.

8 “Governing body” is synonymous with “board of directors.” Form 990 also refers to members of the governing body as “directors” or “trustees.” This Information Bulletin refers to members of a health center’s governing body as “board members.”

practices, it is not necessary for an organization to have a board-adopted mission statement in order for it to qualify for federal income tax exemption.

- ◆ **Whether the organization undertook any significant program activities during the reporting year that were not reported on a prior Form 990;**
- ◆ **Whether the organization ceased conducting or made significant changes in how it conducts program services, and a description of those changes;**
- ◆ **A description of the exempt purpose achievements of the organization's three largest program services, measured by expenses incurred for those services, and including revenue derived from those services.**

The IRS defines “program service” as a particular activity of the organization that accomplishes its exempt purpose. The activities reported on Form 990 should promote the exempt purposes that the health center articulated in its application for federal income tax exemption. For health centers, “exempt purposes” likely would include, for example, providing health care to low-income, underserved, and uninsured persons. Indeed, many health centers described their charitable activities simply in those terms on the old

Form 990. According to the instructions for the new Form 990, an exempt organization should describe its activities using specific measurements, such as number of patients served, units of care provided, *etc.*, and the description should be clear, concise, and complete. Accordingly, a health center should report the three largest components of its health care delivery program, (*e.g.*, pediatrics, ob/gyn, internal medicine, *etc.*) to better illustrate the breadth of its scope of services.

- ◆ **A statement of revenue and expenses from other program services**

This includes all other program services (as defined above) that are not among the three largest programs. They should be listed on Schedule O (*see* note 7 above), but do not require the same level of detail as is required for the top three service programs. However, a health center should feel free to provide as much detail as it wishes.

In short, in order to take full advantage of Form 990 as a public relations tool, a health center might consider reporting its most significant activities on the Part I summary page (but, as noted, in some detail), and provide a complete description of its mission along with the more detailed statement of all of its program services on Part III.

Part VI: Governance, Management, and Disclosure

With a few minor exceptions, Part VI reflects entirely new reporting obligations not required in previous versions of Form 990. The information reported in Part VI goes to the heart of the good governance/corporate responsibility practices that the IRS sought to promote in revising Form 990. In that regard, the form clearly states that the IRS is requesting information about an organization's policies that IS NOT required by the Internal Revenue Code and, therefore, is not required for obtaining or maintaining income tax exemption. ***However, every organization is required to answer each question on Part VI. Failure to do so could lead to sanctions for failing to file a complete and timely Form 990.***

It is noteworthy that health centers for years have followed some of the “good governance” policies identified in Part VI (*e.g.*, maintaining minutes of board meetings) in order to comply with federal health center regulations and policies. Other policies addressed in Part VI (*e.g.*, a written document retention and destruction policy) may be less common among health centers. However, given the IRS's view that these policies promote good governance and the fact that Form 990 is a readily accessible

public document, a health center may well create a negative impression if it indicates on Form 990 that it has not adopted those policies.

Therefore, health center boards of directors should consider adopting the policies identified in Part VI (to the extent that they are applicable and appropriate for the health center), or, at a minimum, should provide a clear and complete explanation for not adopting such policies. If the health center has implemented alternative means for accomplishing the purpose of a policy without actually adopting the policy itself, this information also should be provided on Form 990. In that regard, the IRS recognizes that a mere “yes” or “no” check on the core Form 990 may not give the complete picture. Accordingly, it encourages exempt organizations to use Schedule O to fully explain their responses.⁹

Part VI is divided into three sections addressing: (1) governing body and management; (2) organization policies; and (3) disclosure of information. The information to be reported in each section is highlighted below.

Part VI, Section A: Governing Body and Management

This section of Part VI focuses on the organization’s governance and management structure and is designed, in part, to highlight actual or potential conflicts of interest among board members and senior staff that could undermine an organization’s ability to fulfill its charitable mission.

◆ Number of voting members of the governing body

According to the Form 990 instructions, an organization should report the number of voting board members in office as of the end of the organization’s tax year. Board members who do not have voting rights, such as health center CEOs or others who serve as *ex-officio* nonvoting members, should be described on Schedule O.

Assuming that a health center board has an executive committee

with broad authority to act on behalf of the full board of directors, the composition of the executive committee (specifically identifying any member of the executive committee who is not on the board of directors) must also be reported on Schedule O, along with a statement of the scope of the executive committee’s authority.

◆ Number of independent voting board members

Form 990 defines “independent board member” broadly. A board member is considered independent *only* if all three of the following conditions are met:

1. The board member was not compensated as an officer¹⁰ or other employee of the organization or as an officer or employee of a related organization¹¹;

9 Please note that it is too late to adopt policies suggested by Part VI for Form 990 purposes after a health center’s tax year has ended. However, a health center could indicate on Schedule O that it plans to adopt pertinent policies and report them as such on a subsequent Form 990.

10 For Form 990 reporting purposes, an “officer” is any person who is elected or appointed to handle daily operations of the organization, including, at a minimum, officers required by state law but also including the top management official (*e.g.*, CEO) and top financial official (*e.g.*, CFO) without regard to title.

11 A “related organization” is one that controls or is controlled by the organization, is under common control with the organization, or is a supporting or supported organization of the organization. Since HRSA polices prohibit a health center from being under the control of any other entity, related organizations of a health center are likely to be subsidiaries controlled by, or supporting organizations of, the health center.

2. The board member did not receive total compensation or other payments exceeding \$10,000 during the tax year from the organization or a related entity as an independent contractor; and
3. Neither the board member nor a family member¹² of the board member was involved in a business transaction with the organization, including loans.

Because health center board members and family members of board members cannot be employees of the health center (and taking into account affiliation policies issued by the Health Resources and Services Administration (HRSA), *see* note 11), only health center board members who serve as officers of a controlled subsidiary or a supporting organization of the health center, or who are compensated more than \$10,000 for services provided to the health center unrelated to their board service (such as consulting services), would not be counted

as independent. Health center board members who serve on the board of a related organization would still be counted as independent, other factors that might affect independence not being considered.

It should be noted that a board member who receives financial benefits from an organization solely in the capacity of being a member of the charitable or exempt class served by the organization is not considered to lack independence. For example, a health center board member who is a patient and eligible to receive discounts from charges for services under the health center's "sliding fee" schedule would be considered to be an independent director absent any other factors that would affect his or her independence.

According to the Form 990 instructions, an organization: (1) need not engage in more than a reasonable effort to obtain the necessary information to determine the independence of members of the board of directors; and (2) may rely on information provided by

board members, such as a signed response to a written questionnaire concerning relationships that would affect their independence (as defined in Form 990). Such a questionnaire could be included in an annual conflict of interest disclosure form, discussed below.

♦ **Did any of the organization's board members, officers, or key employees¹³ have a family or business relationship with any other board member, officer, or key employee during the tax year?**

Business relationships are defined broadly to include: (1) employer-employee relationships; (2) joint directorships in a business; (3) co-ownership of more than 10% of a business; or (4) transacting business with the other party, other than in the ordinary course of either person's business on the same terms that are generally offered to the public.

Relationships between an attorney and client, medical professional and patient, and clergy/communicant need not be reported. Family relationship is defined the same as "family member." *See* note 12. Each family and business relationship, the persons involved, and the nature of the relationship (family or business) must be described on Schedule O.

12 "Family member" includes spouse, brothers and sisters, children, grandchildren, great-grandchildren, and spouses of these relatives.

13 For Form 990 purposes, a "key employee" is any employee (other than an officer as defined above) who receives more than \$150,000 in compensation who: (1) has responsibilities, powers, and influence over the organization as a whole that is similar to officers and board members; (2) manages a discrete segment of the organization that accounts for more than 10% of the organization's assets, income, or expenses; or, (3) has or shares authority to control or determine 10% or more of the organization's capital expenditures, operating budget, or compensation for employees, but only if the employee is one of the top 20 in compensation of those employees paid over \$150,000 per year.

An organization is not required to provide information about a family or business relationship between two board members, officers, or key employees if it is not able to secure the information after making a reasonable effort to obtain it. An example of a reasonable effort, according to the Form 990 instructions, would be for the health center to distribute a questionnaire annually to each board member, officer, and key employee. The questionnaire should include the name, title, date, and signature of each person who is reporting information and contain pertinent instructions regarding the definition of “family relationship” and “business relationship” used for purposes of Form 990 reporting. This information also could be obtained through an annual conflict of interest disclosure statement.

◆ **Did the organization delegate control over management duties customarily performed by or under the direct supervision of officers, directors, or trustees, or key employees, to a management company or other person?**

For purposes of Form 990, management duties include, but are not limited to: (1) hiring, firing, and supervising personnel; (2) planning or executing budgets or financial operations; or (3) supervising exempt operations

or unrelated trades or business of the organization.

Management duties do not include administrative services, such as payroll processing, that do not involve significant managerial decision-making. Nor do they include investment management services. An affirmative response must be explained on Schedule O.

Although health centers typically do not outsource key management functions, there are instances where shared services (e.g., shared CFO or CMO services) have proven to be cost effective. However, in those cases, HRSA policy requires that the health center board (through the CEO) exercise final authority. Accordingly, health centers that report on Form 990 that they delegate management functions (in accordance with HRSA policy) would be well advised to explain the retained authority of the board of directors on Schedule O.

◆ **Did the organization make any significant changes to its organizational documents (i.e., articles of incorporation and bylaws) since the filing of the prior Form 990?**

Examples of “significant” changes include changes in: (1) the number, composition, qualifications, authority, or duties of the board of directors; (2) exempt purposes or mission

of the organization; and (3) the quorum or voting rights of members of the board of directors. Significant changes must be described on Schedule O.

◆ **Did the organization become aware during the tax year of a material diversion of its assets?**

A “diversion” is any conversion or use of the organization’s assets for unauthorized purposes, including, *but not limited to*, embezzlement or theft. A diversion is considered “material” if the gross dollar amount (not taking into account insurance, restitution, or similar recoveries) exceeds the lesser of \$250,000 or 5% of an organization’s gross receipts for the tax year. If such a diversion took place, the organization must explain the nature of the diversion, the amounts involved, and the circumstances, including any corrective action taken, on Schedule O, but the persons or persons involved should not be identified by name. Diversion by board members, employees, volunteers, and independent contractors must be reported. Note that diversion includes any unauthorized use of the organization’s assets, not just outright theft.

The Form 990 instructions note that a diversion of assets by board members and other insiders may, in some cases, constitute private inurement (which would

constitute grounds for revocation of tax exemption) or the imposition of tax sanctions as an excess benefit transaction.¹⁴ In short, this question is designed to focus attention on whether there has been significant misuse of an organization's assets.

◆ **Does the organization have members?**

The Form 990 instructions define a "member" as a person who, pursuant to a provision of the organization's governing documents or applicable state law, has the right to participate in the organization's governance (other than a board member) or to receive distributions of income or assets from the organization. The instructions indicate, by way of example, that a membership organization includes members with the right to: (1) elect members of the board of directors; (2) approve significant decisions of the board of directors; or (3) receive a share of the organization's net assets upon dissolution.

Most health centers do not have individual members, although some organized in the early days of the health center movement may mention "community members" or have comparable references in their articles of incorporation or bylaws. They would be reported as members if they have the requisite authorities under the health center's governing documents.

Similarly, the articles or bylaws of some health centers may provide (under provisions of state law) that the members of the board of directors are the only "members" of the organization. In that case, the health center is *not* considered to be a membership organization.

It appears that the definition of "member" for Form 990 reporting purposes also includes other organizations, to the extent that the particular organization has one or more of the powers referenced in Form 990. HRSA affiliation policy discourages health centers from having organizational members and, to the limited extent that they are permitted, prohibits such members (or appointees) from exercising control over the authorities that are reserved solely to the health center board.¹⁵ Accordingly, a health center should review its articles of incorporation and seek knowledgeable legal counsel on state law requirements and HRSA policy guidance that may influence its response to this question.

◆ **Did the organization contemporaneously document the meetings held or written actions taken by the board of directors and any committee authorized to act on behalf of the board of directors?**

Appropriate recordkeeping is an important element of the IRS's notion of good governance. This question illustrates that the IRS suspects that there are some tax-exempt organizations that do not do so. For purposes of Form 990, "contemporaneous" approval means that minutes or other written documentation of the action are approved at the next meeting of the board or committee, or no later than 60 days after the date of the meeting or action taken that is reflected in the record. Health centers should have no difficulty responding "yes" to this question.

14 Section 501(c)(3) of the Internal Revenue Code prohibits the assets of the organization from "inuring" to (specially benefiting) any private party. Typically, this prohibition has been applied to "insiders" of the organization, such as board members, senior staff, and others in a position to divert the organization's assets to their personal benefit. Section 4958 of the Internal Revenue Code imposes tax sanctions on certain "insiders," such as board members, the CEO, and the CFO (called "disqualified persons" in the statute) if they derive an "excess benefit" (typically unreasonable compensation or other financial consideration) from the organization.

15 See Policy Information Notice (PIN) 97-27, *Affiliation Agreements of Community and Migrant Health Centers*, as modified by PIN 98-24, *Amendment to PIN 97-27 Regarding Affiliation Agreements of Community and Migrant Health Centers*.

◆ **Was a copy of the Form 990 provided to the organization's board of directors before it was filed with the IRS?**

According to the Form 990 instructions, an organization can respond in the affirmative *only* if a complete copy of the final Form 990, including all required schedules, as ultimately filed with the IRS was provided to each voting member of the board (either in paper or electronic form) before it was filed with the IRS. This does *not* require that all members of the board have actually reviewed the Form 990 before it is filed.

However, the Form 990 instructions make clear that all organizations must describe on Schedule O the process, if any, by which the organization's officers, board members, board committee members, or members of the organization's management team, reviewed the Form 990 (whether before or after it was filed with the IRS), including: (1) specifics regarding who conducted the review; (2) when they conducted it; and (3) the extent of the review. If no review was or will be conducted, the organization must so state. This question conveys a clear IRS message on "corporate responsibility." The IRS does not expect every board member to review Form 990 prior to filing or to participate in its preparation. However, it does expect every board member

to have a copy of the form and, presumably, to be familiar with what is reported on it.

Part VI, Section B: Policies

Part B focuses on various operational policies of the organization that the IRS believes promote good governance practices and compliance with the tax laws. These policies are not legally required for tax exemption. However, the board of directors should seriously consider adopting them, as appropriate, if it has not already done so. Section B requires reporting of the following information:

◆ **Does the organization have a written conflict of interest policy?**

The Form 990 instructions state that a conflict of interest arises when a person in a position of authority over an organization, such as a board member, officer, or manager, may benefit financially from a decision he or she could make in such capacity, including indirect benefits provided to family members. The IRS definition of a conflict of interest *does not* include

conflicts that could result from a person's having competing duties to another organization, such as by serving on the boards of both organizations (sometimes referred to as organizational conflicts of interests), so long as they do not involve a material personal financial interest of, or benefit to, such person.

HRSA requires health centers to have a written conflict of interest policy.¹⁶ Accordingly, health centers with such a conflict of interest policy should respond "yes." No further explanation is required for Form 990 reporting purposes. However, HRSA policy does not address the content of a conflict of interest policy. Because health centers typically have relationships with other organizations in the community and may well draw board members from those organizations, a health center board should adopt a more comprehensive conflict of interest policy than the "bare bones" one necessary to answer affirmatively to this question on Form 990.¹⁷

Health centers that do not have a written conflict of interest policy must answer "no." Although no explanation is required on Form 990, the board of directors

16 See Health Center Program Requirements, Program Information Notices & Program Assistance Letters at <http://bphc.hrsa.gov/about/requirements.htm>, Expectations, Health Center Expectations, Policy Information Notice (PIN) #98-23 (August 7, 1998), III Governance, B.2. Board Composition, e. Conflict of Interest.

17 For further information, see NACHC Governance Information Bulletin #16, *Identifying, Disclosing, and Managing Board Members' Conflicts of Interest* (September, 2008); NACHC Risk Management Information Bulletin #14, *Developing Comprehensive Standards of Conduct* (May, 2006).

should understand the negative impression answering “no” to this question will convey.

◆ **Are board members, officers, and key employees required to disclose and update annually interests that could give rise to conflicts?**

The instructions to Form 990 state that disclosure should include interests of family members of board members, officers, and key employees that could give rise to conflicts of interest, such as substantial business or investment holdings and other transactions or affiliations with businesses and other organizations. Disclosure is an essential part of an effective conflict of interest policy. A health center board of directors should ensure that its conflict of interest policy includes provisions for disclosing, and updating as appropriate, relationships that could result in a conflict of interest.

◆ **Does the organization regularly and consistently monitor and enforce compliance with its conflict of interest policy?**

This question focuses on whether an organization’s conflict of interest policy is effective. Obviously, a conflict of interest policy that is not monitored and

enforced on a consistent basis is worthless. Thus, a “no” to this question speaks volumes for organizations that have previously indicated on Form 990 that they have a conflict of interest policy.

However, a “yes” answer to this question must be supplemented with a detailed response on Schedule O that describes the organization’s practices for monitoring proposed or ongoing transactions for conflicts of interest and the procedure for dealing with potential or actual conflicts, whether discovered before or after a transaction has occurred. According to the Form 990 instructions, the description should include: (1) which persons are covered under the policy; (2) the level at which determination of whether a conflict exists is made; (3) the level at which conflicts are reviewed; and (4) any restrictions imposed on a person with a conflict, such as prohibiting them from participating in the governing body’s deliberations and decisions with respect to the transaction.

Accordingly, it is critical that the board of directors review the health center’s conflict of interest policy to ensure that it has the appropriate features and, importantly, that it is enforced. Although the IRS does not explicitly ask whether the conflict policy includes consequences for persons violating the policy or the nature of the consequences,

the board of directors should understand that enforcement is an essential feature of an effective conflict of interest policy.

◆ **Does the organization have a written whistleblower policy?**

According to the Form 990 instructions, a whistleblower policy: (1) encourages staff and volunteers to come forward with credible information on illegal practices or violations of organizational policies; (2) identifies those to whom such information can be reported; and (3) states that the organization will protect the individual reporting violations from retaliation.

A whistleblower policy is an essential element of an effective corporate compliance program. While not required for income tax exemption, every health center should have at least a basic corporate compliance program, as health center board members have a legal duty to ensure the health center’s compliance with applicable federal and state laws and regulations.¹⁸

18 See 42 C.F.R. § 51c.304(d)(3)(v).

◆ **Does the organization have a written document retention and destruction policy?**

The Form 990 instructions indicate that such a policy should identify the responsibilities of staff, volunteers, board members, and contractors for maintaining and documenting the storage and destruction of the organization's documents and records.¹⁹

◆ **Did the process for determining the compensation of the organization's CEO/ Executive Director (or other top management official) and other officers and key employees of the organization include: (1) review and approval by independent persons (i.e., persons who have a conflict of interest with respect to the compensation arrangement at issue were not involved)²⁰; (2) salary comparability data; and, (3) contemporaneous substantiation of the deliberation and decision on such compensation?**

This question is intended to establish whether the organization made use of the rebuttable presumption provisions of federal tax regulations when setting compensation for certain key employees, referred to as "disqualified persons." Following

that procedure, which must include all three features identified in the question, will protect the persons receiving compensation and the health center's managers (including board members, as applicable) who approve the compensation from potential tax sanctions should the IRS attempt to establish that the amount of the compensation was unreasonable for the services provided.²¹

An organization that answers "yes" with regard to either the CEO/Executive Director (or other top management official) or other officers or key employees must respond on Schedule O by: (1) describing the process that was used; (2) identifying the offices or positions for which the procedure was used; and (3) stating the year in which the procedure was last undertaken for each person in the position. While the board of directors is not required to follow the rebuttable presumption procedure in setting the CEO's compensation, it is strongly advised to do so because of the protection from potential liability it provides.

◆ **Did the organization invest in, contribute assets to, or participate in a joint venture or similar arrangement with a taxable entity (i.e., an organization or individual that is not a tax-exempt entity) during the tax year?**

Joint ventures or similar arrangements with another tax-exempt organization or establishing a for-profit entity that an organization wholly owns or controls need not be reported. The IRS's concern here is that, in a joint venture with a for-profit entity (including an individual), charitable assets will be diverted improperly to the benefit of the other party. Accordingly, if an organization has entered into a joint venture with a taxable party (and indicates by responding "yes"), it must further indicate whether or not it has adopted a written policy or procedure to ensure that the organization's tax-exempt status is protected. No further explanation of the joint venture is required.

19 For further information, see NACHC Risk Management Information Bulletin # 18, *Record Retention Requirements for Business, Financial, and Clinical Information* (September, 2007); NACHC Human Resources Information Bulletin #3, *Human Resources Recordkeeping Requirements for Health Centers* (August, 2004).

20 For this purpose, a conflict of interest is defined in federal tax regulations 26 C.F.R. § 53.4958-6(c)(1)(iii).

21 A complete discussion of the sanctions as well as the rebuttable presumption can be found in NACHC Governance Information Bulletin # 6, *Compensating Health Center Executives* (August, 2003).

Further, it appears that an organization does not have to report whether it has a policy on joint ventures unless it has actually entered into a joint venture with a for-profit entity. However, in order to ensure that the health center's assets are protected should it enter into a joint venture arrangement with a for-profit partner, the board of directors would be well advised to adopt such a policy.²²

Part VI, Section C: Disclosure

Section C promotes the concept that the transparency into a tax-exempt organization's governance and finances advances good governance practices and corporate responsibility. Section C solicits responses to the following:

◆ List the states with which a copy of Form 990 is required to be filed.

Some states require or permit tax-exempt organizations to file Form 990 in order to fulfill state exempt organization or charitable solicitation reporting requirements. This particular Form 990 item has very little to do with federal tax law. However, the IRS is increasing its coordination with state tax and charity regulatory authorities, and this information likely is intended to promote that activity.

◆ Indicate how the organization makes its Forms 990, 990-T, and application for recognition of exemption (Form 1023 for charitable organizations) available to the public.

As previously discussed, federal law requires an exempt organization to make its Form 990 and application for income tax exemption available for public inspection, and for copying if requested. An organization must report the methods it employs to make those documents available on Form 990 (such as through personal inspection, either on the organization's website or on another organization's website). No further explanation is required.

◆ Describe on Schedule O whether (and, if so, how) the organization makes its governing documents (i.e., articles of incorporation and bylaws, conflict of interest policy, and financial statements) available to the public.

The Form 990 instructions make it clear that federal tax law *does not* require that these documents be made publicly available. However, articles of incorporation and bylaws that were included in an application

for income tax exemption would have to be made available in response to a request for the exemption application (although the attachments to the application may not reflect the current version of the articles or bylaws). By way of example, the IRS suggests that the following are appropriate means of disclosure: (1) posting on the organization's website; (2) providing copies on request; and (3) making documents available for inspection at an office of the organization.

If the organization does not make any of these documents available to the public, it is instructed to state: "No documents available to the public."

Obviously, this question is designed to "encourage" organizations, at a minimum, to make these documents available on request. While not explicitly indicated in the instructions, an organization that makes some, but not all, of their governing documents available to the public probably should identify those documents on Schedule O.

A health center's board of directors should carefully consider its policy on disclosure, keeping in mind that transparency is favored by the IRS and other policy makers, and that limiting disclosure

²² For further information on joint ventures, see NACHC Integrated Services Delivery Networks Information Bulletin #6, *Tax-Exemption Considerations In Structuring ISDN Affiliations Involving For-Profit Entities* (October, 2002).

may not necessarily be in the health center's best interests. For example, a health center's Circular A-133 audit is available to the public under the federal Freedom of Information Act (FOIA) once it has been accepted by the government. If a health center refuses a request for a copy of its financial statements, the requesting party may file a FOIA request for the health center's entire audit report, which could result in disclosure of more significant information than contained in the basic financial statements.

Part VII: Compensation of Officers, Board Members, Key Employees, Highest Compensated Employees, and Independent Contractors

The IRS has been concerned for some time with the accuracy and completeness of reporting of executive compensation by tax-exempt organizations. According to the IRS, the public has come to share this concern. Much of the compensation information required to be reported on the new Form 990 (and its associated Schedule J) was required to be reported on the old form. However, the reporting format in the new

Form 990 has been changed so that the reporting of compensation paid to particular individuals (and categories of individuals) is highlighted in the interests of transparency. For example, compensation must be reported on a calendar-year basis (based on compensation reported on Forms W-2 and 1099 MISC) to enhance consistency of reporting, without regard to the organization's fiscal year.

Board members should understand what compensation information will be reported, and why. For some health centers, the new Form 990 compensation reporting thresholds may be sufficiently high so that reporting obligations actually will be reduced. For others, the scope of the reporting obligations may require additional staff time and/or other resources to compile all of the information necessary to file Form 990.

“A health center’s board of directors should carefully consider its policy on disclosure, keeping in mind that transparency is favored by the IRS and other policy makers, and that limiting disclosure may not necessarily be in the health center’s best interests.”

Part VII, Section A: Officers, Board Members, Key Employees²³, and Highest Compensated Employees

Section A requires the following:

- ◆ **A list of all of the organization's current officers, board members, and key employees regardless of compensation**
- ◆ **A list of the organization's five current highest compensated employees (other than an officer, board member, or key employee) who received reportable compensation (as indicated on Box 5 of Form W-2 and/or Box 7 of Form 1099-MISC) of more than \$100,000 from the organization and any related organizations**

Compensation should be reported for the calendar year ending with or within the organization's tax year. Only the five highest compensated employees must be reported, ranked in order of compensation.

- ◆ **A list of all of the organization's former officers, key employees, and highest compensated employees who received more than \$100,000 in reportable compensation from the organization and any related organizations**

"Former" refers to anyone who served in the capacity of an officer, key employee, or highest paid employee for any one or more of the prior five years and was reported as such (or should have been reported as such) according to the rules then in effect on the organization's Form 990.

- ◆ **A list of all of the organization's former board members that received, in the capacity as a former board member or trustee of the organization, more than \$10,000 of reportable compensation from the organization and any related organization**

"Former" refers to anyone who served as a board member for any one or more of the prior five years. However, unlike former officers, key employees, and highest compensated employees, former board members must be

reported only if they received more than \$10,000 in the tax year for their services as a former board member, a situation that is highly unlikely to occur in a health center.

Section A further requires the organization to report, for each individual listed:

1. The average hours per week worked;
2. The amount of compensation received from the organization;
3. The amount of compensation received from all related organizations; and
4. An estimated amount of other compensation that is not otherwise currently reportable on Form W-2 or Form 1099-MISC (*e.g.*, tax-deferred contributions to a qualified defined contribution retirement plan, any increase in the actuarial value of a retirement plan, and the value of health insurance premiums paid by the employer).

In sum, Part VII seeks to insure that all types of compensation provided are reported.

²³ See definitions above at notes 8, 10 and 13.

In addition, an organization must provide information on Schedule J (as described below) with respect to any of the following individuals reported on Part VII, Section A:

- ◆ **Former officer, board member, key employee, or highest compensated employee;**
- ◆ **Any person listed in Section A of Part VII with reportable compensation from the organization and any related organization greater than \$150,000;**
- ◆ **Any person listed in Section A of Part VII who received or accrued compensation from any unrelated organization for services rendered to the reporting organization.**

The latter provision is intended to prevent organizations from circumventing the compensation rules by having another organization with which the reporting organization has a relationship (but that does not meet the definition of a related organization) pay a portion of certain employees' compensation.

Schedule J: Reporting

Schedule J requires reporting of the following information with regard to persons identified above:

◆ Did the organization provide any of the following to or for their benefit?

1. First-class or charter travel
2. Travel for companions
3. Payment of any tax obligation
4. Discretionary spending account
5. Housing allowance or residence for personal use
6. Payments for business use of personal residences
7. Health or social club dues or initiation fees
8. Personal services (*e.g.*, maid, chauffeur, chef)

◆ If provided, did the organization follow a written policy?

If the organization did not have or did not follow a written policy, it must provide an explanation on Schedule J.

◆ Did the organization require substantiation (*i.e.*, documentation) prior to reimbursing or allowing expenses incurred by all officers, board members, and the CEO/Executive Director regarding any of the items listed above?

◆ Which, if any, of the following does the organization use to establish the compensation of the organization's CEO/Executive Director?

1. Compensation committee
2. Independent compensation consultant
3. Form 990 of another organization
4. Written employment contract
5. Compensation survey or study
6. Approval by the board or compensation committee

This question is designed to elicit information as to whether the organization follows the basic requirements for establishing the reasonableness of executive compensation. A health center board of directors should, at a minimum, consider some form of salary comparability data prior to approving the compensation of the CEO/Executive Director.²⁴

24 For further information on executive compensation see NACHC Governance Information Bulletin # 6, *Compensating Health Center Executives* (August, 2003); NACHC Human Resources Information Bulletin # 7, *Developing Provider Incentive Programs that Pass Muster under IRS and Other Regulatory Standards* (October, 2002).

◆ **During the year, did any officer, board member, key employee, or highest compensated employee listed in Part VII (see above):**

1. Receive a severance payment or similar payment;
2. Participate in, or receive payment from, a supplemental nonqualified retirement plan (*i.e.*, a nonqualified retirement plan that is not generally available to all employees but is available only to a certain class or classes of management or highly compensated employees); and/or
3. Participate in, or receive payment from, an equity based compensation arrangement (*i.e.*, stock or stock options from a compensation plan sponsored by the organization or a related organization)?

If the answer is “yes” to any of the above, the organization must list the persons and provide the applicable amounts for each item. Note that none of these items of compensation is inherently improper. This question is directed at uncovering compensation arrangements that, taken with other forms of compensation, could result in the payment of unreasonable compensation.

◆ **Did the organization pay or accrue any compensation for any officer, board member, key employee, or highest compensated employee listed in Part VII (see above) contingent on the revenues or net earnings of the organization or any related organization?**

An organization responding “yes” must describe the circumstances. Contingent compensation is not inherently improper. However, the IRS is concerned about such arrangements because they could result in the payment of

unreasonable compensation and because, to the extent they result in the sharing of the organization’s net income, they can threaten the organization’s tax exemption.

◆ **With respect to any officer, board member, key employee, or highest compensated employee listed in Part VII (see above), did the organization provide any non-fixed payment (*i.e.*, a discretionary amount not established by contract or not established by reference to a predetermined formula dependent on future events or contingencies)?**

◆ **Were any amounts (paid to anyone) reported on Part VII paid or accrued pursuant to the “initial contract exception?”**

These two questions, taken together, address the oversight (or lack thereof) of the organization’s compensation practices. The “initial contract exception” refers to a provision of the tax regulations that effectively exempts from potential tax sanctions the compensation paid to a newly hired CEO, CFO, or other “disqualified person” working under compensation terms set out in their first written contract with the organization. However, the initial contract exception does not apply to discretionary compensation

“A health center board of directors should, at a minimum, consider some form of salary comparability data prior to approving the compensation of the CEO/Executive Director.”

(i.e., compensation that is not specifically fixed in the initial contract). Payment of discretionary compensation will make the entire compensation package subject to a “reasonable compensation” analysis.

That is not to say that discretionary compensation is inherently improper or that such payments necessarily will result in payment of unreasonable compensation that could put both the recipient of the compensation and those who knowingly approved it at risk of tax sanctions. On the other hand, payment of such discretionary amounts does raise the question of whether the board of directors (or the CEO or other responsible senior official of the health center, as appropriate) has exercised appropriate oversight of compensation decisions.

An affirmative response to either of these questions must be explained on Schedule J. Accordingly, the board of

directors should ensure that the rationale for its compensation decisions (typically with respect to the compensation of the CEO/Executive Director) as well as compensation decisions made pursuant to board-approved budgets is appropriately documented.²⁵

Part VII, Section B: Independent Contractors

Part VII, Section B requires the reporting of the following information: (1) the name and business address of the five highest compensated independent contractors²⁶ who received more than \$100,000 from the organization in the tax year; (2) a description of services provided in consideration of such compensation; and (3) the total compensation paid to each. The new Form 990 raised the reporting threshold for independent contractors from \$50,000 to \$100,000 which, in this respect, may well reduce the reporting obligation for health centers.

CONCLUSION

A health center board’s first experience with the new Form 990 is likely to be accompanied with some uncertainty, perhaps discomfort. Proper preparation undoubtedly will require additional work from all persons involved, including staff and board members. Nevertheless, board members should view filing the new Form 990 as an opportunity to review the health center’s governance practices and to demonstrate to the community that the health center is a valuable and responsible health care resource for the community.

25 Compensation paid under the initial contract exception does not have to be reported at all on Part III if the board of directors followed the rebuttable presumption procedure described previously in setting the amount of the compensation.

26 Independent contractors include, for example, consultants, accounting and auditing firms, law firms, fundraisers, and other vendors, and may include individuals, such as health care providers, who are not employees of the health center.

ADDITIONAL RESOURCES

- ◆ NACHC Governance Information Bulletin # 10, *Translating Corporate “Responsibility” Legislation and Guidance into Good Governance* (October, 2003). See www.nachc.com, Publications & Resources.
- ◆ BoardSource (www.boardsource.org), a national nonprofit organization dedicated to advancing the public good by building exceptional nonprofit boards, has a library of useful materials on governance issues including policy development.
- ◆ The IRS’s statements on *Governance and Related Topics – 501(c)(3) Organizations* can be found on the IRS website, Charities & Non-Profits tab, at Life Cycle of an Exempt Organization, Charitable Organizations, Public Charities. See www.irs.gov.



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