BUSINESS LAW SECTION
THE STATE BAR OF CALIFORNIA

November 9, 2010

Hon. Douglas Shulman
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C.

Re: Comments concerning Form 990- 2010 DRAFT

Dear Commissioner Shulman:

On behalf of the State Bar of California Business Law Section (the "Section"), I am pleased to submit the enclosed comments on Form 990- 2010 DRAFT version posted October 2, 2010, especially concerning governance matters (thru Part VI) and referencing the 2009 Instructions when necessary.

These comments are submitted by the Section on behalf of its Nonprofit and Unincorporated Organizations Committee in response to the request for comments contained in the October 2, 2010 posting of this form. The position is only that of the Section. This position has not been adopted by either the State Bar's Board of Governors or overall membership and is not to be construed as representing the position of the State Bar of California. Membership on the committee and in the Section is voluntary, and funding for their activities, including all legislative activities, is obtained entirely from voluntary sources.

Please note that these comments have been prepared with input and contributions from the American Bar Association, Section of Business Law, which plans to submit its own comments separately.

On behalf of the Section, thank you for considering our views on this important issue. If you have any questions, or if we can be of further assistance to you, please contact Lisa A. Runquist, principal drafter, at 818-609-7761, or Cherie Evans, the Chair of our Committee, at 415-703-0300 ext. 2. Our Nonprofit and Unincorporated Organizations Committee would be pleased to work with you on any of the matters discussed more fully in our comments.

Very truly yours,

Mark Porter
Chair, Business Law Section

Enclosure

cc: Michael F. Mundaca, Assistant Secretary (Tax Policy), Department of the Treasury
William J. Wilkins, Chief Counsel, Internal Revenue Service
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COMMENTS OF THE
STATE BAR OF CALIFORNIA BUSINESS LAW SECTION
REGARDING
FORM 990 - 2010 DRAFT VERSION

These Comments ("Comments) are submitted by the Section on behalf of its Nonprofit and Unincorporated Organizations Committee in response to the request for comments contained in the October 2, 2010 posting of this form. The position is only that of the Section. This position has not been adopted by either the State Bar's Board of Governors or overall membership and is not to be construed as representing the position of the State Bar of California. Membership on the committee and in the Section is voluntary, and funding for their activities including all legislative activities, is obtained entirely from voluntary sources.

These Comments were prepared with input and contributions from members of both the American Bar Association Business Law Section, Nonprofit Organizations Committee, and members of the State Bar of California Business Law Section, Nonprofit and Unincorporated Organizations Committee. Principal responsibility for preparing these Comments was exercised by Lisa A. Runquist of the Nonprofit Corporations Committee of the ABA Section of Business Law, and the State Bar of California, Business Law Section. Contributions were made by ABA members Karen J. Orlin, Willard L. Boyd III, Patrick B. Sternal, Henry Lesser, and by California Bar members Robert Siemer, Louis E. Michelson, Gary Wolberg, Lani Meanley Collins, Patrick B. Sternal, Henry Lesser, Cherie Evans, Barbara Rosen, and Nancy McGlamery. The Comments were reviewed by Willard L. Boyd III, Committee Chair, for the ABA Nonprofit Organizations Committee, and by Michael E. Malamut, Co-Chair of the ABA Business Law Section's Corporate Governance Committee's and Nonprofit Organization's Joint Subcommittee on Nonprofit Governance. They were further reviewed by Robert Schuchard, member, and Cherie Evans, Chair of the State Bar of California Business Law Section Nonprofit and Unincorporated Organizations Committee.

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INTRODUCTION

On October 2, 2010, the Internal Revenue Service ("IRS") posted, on its website, a draft of Form 990 - 2010. The draft indicated that any comments should be made within 30 days.

We would like to start by commenting that it is clear the Internal Revenue Service has put a significant amount of time, effort and thought into developing the new Form 990. We commend the drafters for the care and concern that is evident in this Form. Although it is significantly more difficult to complete than its predecessor, we expect that it will ultimately be of benefit, both to the nonprofits and the public, as everyone becomes familiar with the Form and the process.

Notwithstanding the above, as attorneys who work regularly with nonprofit organizations, especially in the areas of entity formation, organization and governance, we are concerned about a number of the provisions dealing with these areas. Our comments that follow are focused on these limited areas, which correspond to the areas of our focus as committees, and are not intended to be a comprehensive review of the entire Form.

We thank you for your willingness to consider these comments. We hope that they will be helpful as you consider further revisions of the Form and instructions.

1. **"Principal Officer" – Specific Instructions Heading.** Item F requires that the principal officer be "an officer of the organization who, regardless of title, has ultimate responsibility for implementing the decisions of the organization's governing body, or for supervising the management, administration, or operation of the organization." However, this person might not be the appropriate person with whom the IRS should communicate. The CFO is more likely the appropriate person than the CEO; however, the instructions make it clear that the principal officer is the CEO. If the organization does not direct the IRS to contact the paid preparer, then the instructions state that the IRS will contact the person listed in Item F.

Recommendation: In addition to the Principal Officer, if the IRS is not directed to contact the paid preparer, the form should provide the organization with an option of designating a person who is responsible for the Form 990, and with whom the IRS should communicate.

2. **"Terminated" - Specific Instructions Heading.** Item B, lines 31-32 of Part IV, and Schedule N should be amended to include merger as an example of when this box, line or schedule should be checked or completed. Merger is *not* a ceasing of operations or a dissolution; in fact, operations generally continue.

Recommendation: Define "Terminated" more broadly to clarify that it includes mergers, as the entity itself has ceased its separate existence, even though its operations continue.

3. **"Mission" - Part III.1** Part III.1 asks for a description of the organization's mission. The instructions to Line 1 indicate that, if the organization does not have a mission that has been adopted by its governing body, "None" should be entered in the space provided. By way of contrast, both Part III of the 2007 Form 990 and the Form 990-EZ ask, "What is the

organization's primary exempt purpose?" By changing the focus from the exempt purposes of the organization to the mission of the organization, the Form 990 equates the mission of the organization to the exempt purposes for which it is organized. Introducing the term "mission statement" without any definition or precedent in law is potentially confusing.

The recently issued Governance Check Sheet also contains questions addressing whether there are procedures to make sure the assets are used consistently with the organization's mission. It is clear that the IRS is interested in promoting a mission statement as a governance tool. Nevertheless, this emphasis on the mission statement, rather than the exempt purposes of the organization, is potentially confusing, because a nonprofit does not need a mission statement, and many nonprofit organizations do not have formal mission statements. Every organization exempt from taxation, on the other hand, must be organized and operated primarily for exempt purposes as set out in the Internal Revenue Code, and these purposes are stated in the organizing documents and the Form 1023 or 1024 application of the organization. Even if an organization has adopted a mission statement, the mission statement is *not* what limits the activities of the organization. Generally, a mission statement is the result of a strategic planning process and will often change according to a current fundraising or public relations campaign in which the organization is engaged. A mission statement is seldom included in the articles, bylaws, or other governing documents of the organization. In addition, a mission statement is often aspirational. It is worth noting in this regard that Line 7 of the Governance Check Sheet asks whether the organization has a written mission statement "that articulates its current I.R.C. § 501(c)(3) purpose(s)?" This question correctly ties the mission statement to the exempt purposes of the organization.

What *is* binding on the organization and what *should* be the focus of Part III.1 is the purpose clause contained in the governing documents (generally the articles of incorporation) and the exempt purposes described in the Form 1023 or 1024 and updated on the Form 990. The purpose clause in the articles is controlling. Any mission statement adopted by the board and the activities of the organization *must* be consistent with the *purpose* clause. It does not matter if the mission statement and the activities are consistent with each other, if they are inconsistent with the purpose clause.

Recommendation: The IRS should require the organization to specifically identify its purpose, as identified in its governing documents and as described to the IRS on its Form1023 or 1024 and updated on the Form 990. If the IRS wishes to continue to require a separate description of the organization's mission, the instructions should be modified to provide that if the organization does not have a mission statement adopted by the governing body, the mission should be described, based on the governing document purpose.

4. **Inconsistencies Still Exist.** Partly because of the Form 990's complexity, it is still impossible to know what many of the questions are actually asking without reading and analyzing the instructions. We expect that it is not the intention of the IRS that all nonprofits be required to use paid professionals to complete this form; however, when even professionals have a hard time understanding what is being asked, it is hard to imagine a lay person being able to effectively complete the form without assistance. In order to submit the comments within the IRS' deadline, we are providing only certain specific examples of our concern but would be

happy to discuss this comment more broadly with the IRS, if invited.

a. We notice that there have been changes to both the 2009 and 2010 versions to clarify the form. These additions are not always consistent. For example, the description in Part IV, Line 27 references "related individuals" and Lines 28 b and c reference "family members", but Line 26 does not include a reference to either, although they would generally be included in the definition of a disqualified person (and the 2009 instructions, which cover Lines 26 thru 28, do state that family members are also included). Because many of the Forms 990 are completed by the entities themselves, this type of inconsistency may lead to incorrect answers.

Recommendation: Revise Line 26 to make it clear that disqualified persons include family members/related individuals. Make Lines 27 and 28 consistent in the language used, or explain why there are different tests for the various lines.

b. Another example of an inconsistency that is likely to trip up the unsuspecting preparer is that there are 4 separate "reasonable efforts" tests.

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 <u>not</u> included in the instructions for Line 1b.

Other ambiguities arise from the wording of the description of what the questionnaire should include and the lack of clarity as to what degree the organization is required to pursue obtaining a response. One cannot distribute a questionnaire already signed by (i.e. containing the signature of) the person to whom it is distributed. One 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 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 an organization must 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, and even if responsive questionnaires are not received from everyone.

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.

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."

Recommendation: Determine whether it is necessary to have different reasonable effort tests for these different matters. If possible, use the same test for each situation. To the extent more than one reasonable effort test is necessary, use the same basic test to the extent possible, and identify any specific differences. Clarify the description of what the form must "contain" and when (e.g., when relied on by the organization). Clarify the requirement that the Questionnaire contain "pertinent instructions and definitions" by indicating to what purpose they are pertinent (e.g., to assist the recipient accurately to complete the questionnaire) and by stating exactly what should be given to the recipients to constitute "pertinent instructions and definitions.

5. **"Policies" - Part VI**. The 2008 version of the Form stated, at the beginning, that "Sections B and C request information about policies not required by the Internal Revenue Code." The 2009 version was amended to delete this statement, and instead, at the beginning of Section B, adds: "This Section B requests information about policies not required by the Internal Revenue Code." This change, which has been carried forward onto the 2010 version, is also reflected in the instructions.

This change implies that the policies and practices discussed in Sections A and C *are* required by the Internal Revenue Code. Since many of these are *not* required by the Code, this change is potentially misleading.

Recommendation: Add to the beginning of Part VI, "This Part requests information about policies and procedures that may not be required by the Internal Revenue Code" and remove the addition from Section B.

6. **"Governing Body" - Part VI A.1.**

a. There are significant differences between the governance of corporations, trusts, and unincorporated associations; there is no "one size fits all" description of the governance for these various entities. Further, the law of the state under which a nonprofit entity is organized will also impact the method of governance of the entity. What is appropriate and allowable in one state may be prohibited in another.

The instructions for Section A. Line 1a. state that "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." This is incorrect in many instances. Although with some entities (corporations, LLCs) the formation of the organization may be authorized under state law, and although for corporations, the state law may require a board of directors, it is often the internal documents of the organization that determine the governing body. The bylaws of a corporation often will define who the governing body is, how they are chosen, and what their responsibilities and duties are. With an LLC, the state law does not impose any type of structure and does not require a governing body separate from the members, unless the organization itself so decides (the governing body of an LLC would normally be the managers). And unincorporated associations and trusts are not creatures of the state at all; their organizational structure in most states is determined by the members (of an unincorporated association) or the trustors (of a trust).

Recommendation: At a minimum, the words "under state law" should be omitted and "person or group of persons" should be substituted for "group of persons."

b. This same paragraph states that "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)." Although a trust might decide to structure itself with a board of trustees, this would be the exception rather than the rule. Under common law, the trustees may act jointly or severally on behalf of the trust, unless the trust document specifies otherwise. There is no "board of trustees" for most trusts.

Recommendation: Delete "board of" before "trustees."

7. **"Delegation of Authority" - Part VI. A. 1a.** The third paragraph of the instructions for Line 1a does not reflect the common structure of many organizations, as found in their governing documents. The paragraph states: "If the organization's governing body delegated authority to act on its behalf to an executive committee or similar committee with broad authority to act on behalf of the governing body ...." However, the bylaws of many organizations provide, consistent with state law, for an executive committee with this authority, and will often specifically state who will make up the executive committee (e.g. the president, vice president, secretary and treasurer, or the board chair and the chairs of the board's standing committees). In such a case, the governing body did not delegate such authority, as such authority had already been conveyed by the governing documents. However, the language of the instructions states that information needs to be provided concerning the executive committee only when the governing body delegated such authority, and implicitly not when such authority was delegated by the governing documents.

Our point here and elsewhere in these comments is that, because the governing documents control the governing body, even if the governing body may amend the governing documents (which is not always the case), it must follow the provisions set forth therein prior to any amendment, and cannot act in a manner inconsistent therewith.

Recommendation: Assuming that the IRS seeks to identify situations in which the governing authority resides in (or is shared with) an entity other than the governing body, the instructions need to provide for delegations by other than the governing body, i.e. in the governing documents.

8. **"Independence" - Part VI, A.**

a. There are many situations where a director might be interested in one particular item, but is otherwise disinterested. However, even if that director is disinterested more than 99% of the time, if he or she is interested in one particular item, the IRS classifies the director as an interested director for all purposes. For purposes of discussion, let us assume that there are 5 directors, and that 4 of them fall into the category of having some interest (e.g., each receives, directly or indirectly more than $10,000 from the organization as an independent contractor, but each interest is different). With regard to each item in which a director is interested, the interested director recuses himself/herself, which means that 80% of the voting power is disinterested and voting on each matter. Let us also assume that each of those items has actually resulted in a benefit to the organization (e.g. provision of discounted services, etc.). Yet the required disclosure on the Form 990 will state that there are 5 directors, and that only one of them is independent.

To avoid a misperception of the governance of the organization reflected on a public document (since many people will not understand that there is additional explanation in Schedule O), it is likely that many organizations will forego the benefits that they could have derived from the directors.

Recommendation: Add an additional question: "Do interested directors vote on decisions in which they have an interest?"

b. At the same time the steps necessary to determine whether or not a director is independent are difficult to follow:

Line 1b. *Location of Tests.* In order to determine the number of independent voting members at the end of the organization's year, the instructions require that three tests be applied at all times during the year. The instructions for line 1b (on page 17) and the glossary (on page 51 and 52) set forth these three tests. To explore the parameters of these tests one needs to combine examples from three sources: one example of the second test is nestled in the line 1b instructions and in the glossary. Two examples encompassing all three tests are found at the end of instructions for line 1b. Finally, Examples 2 and 3 in the Instructions for Part VII, Section A, line 5 are found on page 30. One of these last two examples illustrates a situation where the director could qualify as independent; the second example illustrates where no independence exists.

Recommendation: All of the examples should be placed in the same location.

Line 1b. *Compensation of Directors.* The second test or circumstance to determine the number of independent voting members at the end of the organization's year contains two discrete

inquiries. One inquiry requires that the member not receive compensation or other payment that exceeds $10,000 as an independent contractor, whether from the organization or from a related organization. The second inquiry concerns the compensation that the director receives for services as a director (i.e., as a member of the governing body): this compensation is excluded from the $10,000 limitation as long as the compensation is reasonable.

When the second test is phrased as compound questions, with more than one thought per sentence, it invites misunderstanding. The "Tip" found on page 23 states an underlying position of the IRS regarding director compensation: "Corporate directors are considered independent contractors, not employees, and compensation, if any generally is required to be reported on Form 1099-MISC. See Regulations section 31-3401(c)-1(f)."

Recommendation: The second test should be clarified to state that there are two components of compensation that should be considered. One component is *for services not as a director* and one is *for services as a director.* The instructions should further clarify that only when the compensation for services as a director is not reasonable will it be included in determining whether the $10,000 cap is excluded.

It would be appropriate to include the "Tip" from page 23 before the examples for line 1b. and perhaps to include an example to illustrate this test: D, a director, is paid an unreasonable director fee. The organization also pays D an amount under $10,000 for management consulting services. D does not qualify as an independent member of the governing body due to the director fees.

9. **"Changes in Governing Documents" - Part VI, A.4** Line 4 and the corresponding instructions require the organization to summarize any significant changes to its governing documents on Schedule O. The IRS does not want to actually see the documents unless the name is being changed.

As noted in paragraph 3, above, the most important document that a corporation has is its articles of incorporation. The mission statement and the actual activities of the corporation *must* be consistent with the purpose clause in the articles. It is not sufficient to make sure that the activities are consistent with the mission statement; if either is contrary to the purpose clause, the organization is violating the purpose for which it is formed.

Recommendation: The instructions should be revised to require that, if the purpose clause of the articles/trust agreement is revised, the exact language of the purpose clause, as amended, should be included in Schedule O, although a description of any other changes to the governing documents should remain sufficient.

10. **"Members/Stockholders" - Part VI, A.6/7.**

a. Lines 6, 7a and 7b all ask essentially the same question. We are not clear what information the IRS is attempting to obtain. For example, what is the point of Line 6?

Recommendation: A more appropriate division might be:

1. Does the organization have members or stockholders or others who may elect one or more members of the governing body?

2. Does the organization have members or stockholders or others who have the right to participate in the organization's governance?

If desired, the form could then ask the organization to define these classes and rights, e.g. the right to approve the budget, or to vote on major items, such as mergers, dissolutions, amendments to articles and bylaws.

b. The instructions for line 6 state: "Answer 'No' if the organization is a trust for federal tax purposes." It is unclear why this directive is included; depending on the trust's structure there may be persons other than the trustees who have a right to participate in the organization's governance.

Recommendation: Delete the directive in the instructions for line 6 that states: "Answer 'No' if the organization is a trust for federal tax purposes."

c. The instructions to line 7b asks the organization to answer 'Yes' if there were persons "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." This instruction does not take into account the fact that in many membership organizations members may have the right to choose directly the members of the governing body and may also (in accordance with state law) have the right to dissolve the organization, separate and apart from any action of the governing body. In other words, in a membership organization that provides for voting members other than the governing body, the governing body answers to the members and has the authority that is granted by the members, rather than the other way around.

Recommendation: Restructure the questions as suggested in paragraph 10.a. above.

11. **"Local Chapters, Branches, Affiliates" - Part VI, B.10a.** Line 10a asks, "Does the organization have local chapters, branches, or affiliates?" The instructions explain that this refers to entities over which the organization has the legal authority to exercise direct or indirect supervision and control. Normally we would have expected this to refer to entities such as the American Red Cross, which has chapters throughout the country, or the National Assistance League, which has Assistance Leagues in various jurisdictions, or similar structures. In these cases, the local chapters, branches or affiliates are clearly separate from the organization, generally have different people running them, and in many ways may be similar in structure to a business franchise.

Contrary to the language of the question itself, the 2009 instructions also direct the organization to answer 'Yes' "if the organization had during its tax year any local chapters, ***disregarded entities***, branches, lodges, units, or similar affiliates ... ***and local units that are not separate legal entities under state law*** over which the organization has such authority." Disregarded entities, for tax purposes, are *not* separate entities and are discussed elsewhere in Form 990. And it is not clear to what "local units that are not separate legal entities under state law" refers.

If an organization controls various charitable remainder trusts, does each trust need to be listed? Or if the organization has divided its operations into three different parts, do they have to separately define each unit? For example, a federally qualified health organization may have a number of different clinics, educational programs, and a large WIC (women infants and children) program. These are all operated under the same corporate umbrella, and are not separate legal entities, even though they may be located in different geographic areas and each may have its own staff. It does not appear to be appropriate to ask this organization to answer 'Yes' to Line 10a, or to require it to list separate parts of itself. Another example would be a nonprofit incubator that is a fiscal sponsor for a number of nonprofit start-up operations. Does the IRS want *each* of these listed separately here, even though the organization has already described its programs in Part III of Form 990?

Recommendation: Delete the references to "disregarded entities" and to "local units that are not separate entities under state law" from the instruction concerning local chapters, branches or affiliates.

12. **"Local Consistency" - Part VI, B.10b.** Line 10b. asks if the entity has written policies and procedures to ensure that activities of local chapters, branches or affiliates are consistent with the activities of the organization itself. If there are no written policies and procedures, an explanation of how the organization ensures that the activities of the local chapters, branches or affiliates are consistent with its activities or with its tax exempt purpose.

Consistency is *not* required if the local chapter, branch or affiliate is separately incorporated and there is no group exemption; rather, the local chapter, branch or affiliate is separately responsible to assure that its activities are consistent with its own purpose and exempt status. It is only necessary when the local chapter, branch or affiliate is either not separately incorporated (but see comments in paragraph 11, above), or when there is a group exemption. But this question is NOT limited to situations involving group exemptions.

Recommendation: Limit the question concerning local consistency to organizations having a group exemption.

13. **"Key Employees and COI" - Part VI, B.12b.** We are concerned about the implied extension of the conflict of interest policy to include not only directors and officers, but also key employees. The instructions to the Form 1023 contain a sample conflict of interest policy that is limited to directors, principal officers, and members of board committees. As a result, a significant number of nonprofits have adopted a conflict of interest policy that follows the Form 1023 sample, and can answer 'Yes' to 12a, even though that policy does not mention key employees.

However, 12b then asks whether officers, directors, *and* key employees are required to make certain annual disclosures of interests that give rise to conflicts. This implies that the conflict of interest policy must apply to key employees, even though this result is not clear in the wording of 12a or in the corresponding instructions.

Although a conflicts of interest policy for key employees may be appropriate, the types of conflicts and appropriate policies might vary significantly from those for directors and officers.

Recommendation: Have separate sub-parts to the conflict of interest question relating to: 1. directors, members of board committees, and officers; and 2. key employees.

Revise the IRS sample conflict of interest policy included in the instructions to the Form 1023 to be consistent with question 12, as modified.

14. **"Whistleblower/Document Retention Policies" - Part VI, B.13/14.** Questions 13 and 14 ask about a written whistleblower policy and written document retention and destruction policy. Sarbanes-Oxley extends its whistleblower and prohibition of destruction of certain documents provisions to nonprofits; however, Sarbanes-Oxley does not require that the nonprofit actually have written policies in either area. Many nonprofits may feel pressured to answer yes to these questions, without appreciating the necessity for adopting policies that are tailored to their needs or their operations.

A good document retention and destruction policy may be helpful to an organization in litigation, not only to make sure that the law concerning destruction of documents is followed, but, perhaps even more importantly, to give the organization a justification for retaining certain documents and destroying others, thereby counteracting a presumption that documents were destroyed selectively because they were "incriminating." This strategy is effective only if the organization actually follows the policy to the letter. If the organization has such a policy and has not destroyed documents according to the schedule in the policy, or has destroyed some documents that should have been retained under the policy, then not only does the organization lose the benefit of a policy, but failure to adhere to the policy may lead to adverse consequences, such as evidentiary sanctions and spoliation claims.

Recommendation: Include, on the form and in the instructions, a caution that these policies should not be adopted without careful consideration of the legal implications inherent in the policies and the operations of the organization.

15. **"Joint Venture Policy" - Part VI, B.16b.** Question 16a asks whether the organization has participated in a joint venture with a taxable entity. If there is such a joint venture, 16b asks whether the organization has adopted a written policy or procedure concerning this matter, and whether it has taken steps to safeguard the organization's exempt status. There is no legal requirement that there be such a policy; in addition, such a policy is likely to be so generic as to be of limited value.

Recommendation: Reword 16b to read: "If 'Yes,' has the organization taken such steps as are necessary to evaluate its participation in the joint venture arrangement(s) under applicable federal tax law, and to safeguard the organization's exempt status with respect to such arrangement(s)?"

16. **"Public Availability of Documents" - Part VI, B.18-19.** We refer to comment 5, above, noting the fact that only section B is now identified as requesting information not required by the Internal Revenue Code; Question 19, contained in section C, *also* is asking for information about disclosures which are *not* required by the Internal Revenue Code. The IRS, in its "*Governance and Related Topics -- 501(c)(3) Organizations*" similarly does not clearly distinguish between what the organization must legally disclose and what it might decide to disclose. Rather, it lumps these documents together and states: "The Internal Revenue Service encourages every charity to adopt and monitor procedures to ensure that it's Form 1023, Form 990, Form 990-T, annual reports, and financial statements are complete and accurate, are posted on its public website, and are made available to the public upon request." We suggest that the IRS clarify, both in the Form 990 and in other IRS governance guidelines, that disclosures of annual reports, financial statements, governing documents, and conflict of interest policies are not legally required.

Another item to note is the Form 990 is made available through guidestar.org. There is currently no comparable site for Form 1023. However, the answer choices for question 18 apply to both forms, even if the answer is likely to be different ("Another's website" would be appropriate as an answer for the Form 990, but not for the Form 1023).

Recommendation: Identify that while Form 1023, Form 990 and Form 990-T must be furnished (question 18), the furnishing of governing documents, conflict of interest policy, and financial statements listed in question 19 is not legally required.

Divide question 18 so that separate answers can be given for each form.

17. **"Governance and Related Topics".** Many of the issues discussed herein also occur in "Governance and Related Topics - 501(c)(3) Organizations" and in the Governance Check Sheet issued by the IRS in December of 2009.

We note that "Governance and Related Topics" has been extensively rewritten, but that it continues to promote certain governance practices, without any evidence that these practices actually result in more effectively run organizations (for example, both small and large boards are cited as being problematic, despite our experience that both small and large boards can be extremely effective: the size of the board should be determined on a case by case basis by the particular organization, based on its organizational and operational needs). In fact, empirical evidence shows that large boards can be very effective for some organizations. *See* Katherine O'Regan and Sharon M. Oster, *Does the Structure and Composition of the Board Matter? The Case of Nonprofit Organizations,* 21 J.L. Econ. & Org. 205 (2005).

Recommendation: To the extent revisions are made to Form 990, these same changes should be made to these and any other relevant IRS publications.

We would also recommend that the IRS consider including references to the extensive materials that have been published by experts in the area of corporate governance.