ROPES & GRAY
ONE INTERNATIONAL PLACE BOSTON, MA 02110-2624 617-951-7000 F 617-951-7050
BOSTON NEW YORK SAN FRANCISCO WASHINGTON, DC

MEMORANDUM

DATE: January 22, 2003

TO: Exempt Organization Clients and Friends

FROM: The Exempt Organization Practice Group
at Ropes & Gray

SUBJECT: The Year 2002 in Review (Things Have to be Looking Up Soon!)

2002 was a year marked by scandals in the business world and a downturn in the economic markets. As a result, a hot regulatory spotlight has been focused on accounting practices of public companies. Large gifts to charities, which traditionally have been made in the form of appreciated securities, have been somewhat disappointing due in large part to declines in the stock market. 2003 has already brought dramatic proposals from the President for changes in the tax system, and we all devoutly hope to see an upswing in the economy and a Dow Jones Industrial Average at 10,000 once again!

There have been several developments of note for exempt organizations during the past year.

<u>Intermediate Sanctions: IRS-1, Taxpayers-0.</u>

The IRS has aggressively pursued a number of cases involving the intermediate sanctions rules of Internal Revenue Code Section 4958. Those rules penalize "disqualified persons," including donors, officers and trustees (generally referred to as insiders) engaged in transactions with a public charity (but not a private foundation which is subject to a separate set of rules) if the transaction inappropriately benefits the disqualified person. The IRS had its first real court victory in May, 2002 in <u>Caracci v. Commissioner</u> in which the Tax Court concluded that the fair market value of the assets of a charity that were purchased by its directors and officers substantially exceeded the purchase price. The court concluded that the purchasers had received excess benefits of more than $5 million and were liable for significant penalty taxes; however, the court refused to revoke the tax exempt status of the charity itself. The case emphasizes the importance of making an independent determination of the market value of property through an independent broker or adviser and soliciting bids from unrelated independent purchasers before selling to an insider. It may not be sufficient to rely on a single appraisal of market value before selling or engaging in any transaction with an insider.

The IRS, in its Continuing Professional Education Text for fiscal 2003 released in October, 2002, identified a number of intermediate sanctions issues that have been addressed by the IRS in recent technical advice memoranda and private letter rulings. Situations which could be expected to attract attention include:

- disqualified persons receiving compensation packages that may be unreasonable,
- substantial reimbursements of personal expenses,
- use of charity-owned vehicles for personal purposes,
- use of charity-owned real estate for personal purposes,
- leases or loans by disqualified persons to the charity for excessive rent or interest, and
- publication of books and materials by the organization when ownership and royalties are received by an employee, not as employment compensation, but rather because of the employee's retained ownership.

Finally, it is important to remember that when an executive's compensation package is reviewed by a compensation consultant in order to assist the charity's board, the consultant must consider <u>all</u> forms of compensation to be paid including funded and unfunded deferred compensation arrangements, even if forfeitable, and all forms of expense allowances and perquisites.

<u>Joint Ventures: St. David's Health Care Case</u>.

In Rev. Rul. 98-15, the IRS provided some bare bones guidance as to how an exempt organization might enter into a joint venture through a limited liability company or partnership with a for-profit partner. That ruling has been frequently criticized for setting unrealistically high standards, requiring that the exempt organization control all critical aspects of the venture in order to assure that the charitable interests are completely protected. Such a control arrangement is generally inconsistent with the economic interests of the for-profit partner and sometimes of the partnership generally. In 2001 the IRS had prevailed in the Ninth Circuit which upheld the Tax Court's findings in <u>Redlands Surgical Services</u>. However, in June 2002, a Texas federal district court looked at the situation differently and found in favor of St. David's Health Care System which had entered into a limited partnership with a for-profit, Columbia/HCA, for the operation of the hospital which St. David's had transferred into the partnership. The IRS had revoked St. David's exemption retroactive to 1996 on the basis that the partnership prevented St. David's from engaging in activities that were exclusively charitable. The court held that St. David's had sufficient control of the venture to protect its interests even though only half of the members of the partnership board represented St. David's appointees, and it was not controlled by a community board. A favorable factor was the language of the partnership agreement recognizing the importance of charitable functions. On the minus side, the partnership had entered into long-term management contract with an affiliate of the for-profit that could be terminated only for cause. The partnership also employed all of the executives of the entity and paid them incentive compensation. However, those factors were not regarded as entirely inconsistent with the exempt status of St. David's. St. David's had the unilateral right to dissolve the partnership if the hospital were not operated by the partnership in accordance with community benefits standards.

The St. David's joint venture was a classic "whole hospital" venture in which the entire activity of the exempt organization was transferred to a partnership, risking the exempt status of the organization unless the court refused to revoke exemption. The ruling of the court tells us that a joint venture in which the interests of both parties are reasonably represented may meet the standard required to maintain exempt status. In a brief filed with the Fifth Circuit Court of Appeals earlier this week, the Department of Justice has appealed the St. David's decision.

An *ancillary* joint venture is the one that arises more frequently in actual practice than the whole hospital or whole exempt activity venture, but we have almost no guidance in this area. An ancillary joint venture is created by one or more exempt organizations, such as when a university undertakes a commercial publishing program through a joint venture with a for-profit partner. It is unlikely that such a venture would be sufficiently significant to cause the university to lose tax-exempt status. The real issue of concern is whether the university will recognize unrelated business taxable income. It should be possible to structure the joint venture so as to allow the university to receive income on a pass-through basis, protecting the tax-exempt nature of some, if not all, of the income since some will be related to the exempt function and thus not taxable. Whether the joint venture is of the whole hospital type, or is an ancillary joint venture, careful structuring can prevent loss of exemption and reduce UBTI exposure.

Patent Royalties as Capital Gains – Recent IRS Ruling.

The IRS released in December a "technical advice memorandum" that clarifies the treatment of patent royalties received by university professors that are obliged to turn over to their employer all rights to discoveries made in the course of their employment. The IRS held that the faculty member in question was entitled to treat such payments as long term capital gains under Internal Revenue Code section 1235 (TAM 200249002). While we have long advised clients that this is the appropriate treatment, it is significant that the IRS has come to the same conclusion. The ruling can be viewed in PDF format at: http://www.irs.gov/pub/irs-wd/0249002.pdf.

Corporate Scandals: Sarbanes-Oxley Act of 2002 and the Audit Committee.

After the disastrous disclosures relating to Enron, Global Crossing, WorldCom and Arthur Andersen in 2002, the Senate launched an investigation into the for-profit corporate world that revealed rampant conflicts of interest, accounting irregularities, inadequate monitoring by boards of directors and breaches of fiduciary duties. And now for the news . . . In July, 2002 the Sarbanes-Oxley legislation was passed to require accounting reform and protection of investors. The Act requires publicly traded companies to establish independent audit committees as committees of the board of directors. Members of an audit committee may not accept compensation from the corporation other than as a member of the audit committee or member of the board of directors. The audit committee must have the authority to engage independent counsel and other advisors as necessary. The chief executive officer and chief financial officers of such companies are now required to certify to the accuracy of financial statements and other disclosures. Auditing firms are now prohibited from providing both auditing and consulting services to a client.

There has been no suggestion as yet that the constraints imposed by Sarbanes-Oxley will be imposed on non-profit corporations; even hospitals which are much scrutinized and regulated are not yet subject to such strictures. Exempt organizations are already subject to a great deal of public disclosure and scrutiny. The last three years of any exempt organization's federal tax filings, for example, are available for public review on the web at www.guidestar.org. Nevertheless, it is important to remember that trustees or directors of a charitable organization have a duty that is every bit as great (and in some jurisdictions greater) to monitor the affairs of the charity, put private interests strictly aside, and look exclusively at the interests of the organization. The New York Attorney General's Office (when not otherwise engaged) has publicly advocated the need to focus on the duty of the non-profit director to pursue the interests and mission of the organization with undivided allegiance. This same standard is applied in Massachusetts and many other jurisdictions.

Adoption of the Sarbanes-Oxley Act provides an opportunity for every exempt organization to review its own audit and board practices to be sure they are consistent with sound practices. Every exempt organization actively engaged in any sort of educational, health care or other significant program should have an independent audit committee of its board, for example, and should have a conflict of interest policy consistent with the intermediate sanction rules discussed earlier.

Insurance Review: It's Almost Midnight, Do You Know Where Your D&O Policy Is?

The recent boardroom disclosures also provide a reminder that every organization should look carefully at its insurance arrangements to provide sufficient insurance to protect itself and its employees, officers and directors. Every exempt organization should review its insurance coverage to be certain that it has general liability coverage to protect against injury occurring in its facilities or caused by its personnel. Organizations having endowments or active programs should also have officers' and directors' liability coverage to protect against charges of breach of fiduciary duty and similar situations. It is also possible under certain circumstances to obtain insurance to assist in dealing with intermediate sanctions penalties.

Corporate Sponsorship: Exclusive sponsor – yes; Exclusive use – no.

In April, 2002 final regulations were issued under IRC section 513 addressing the tax treatment of payments from corporate sponsors to exempt organizations in order to provide guidance as to when those payments represent unrelated business taxable income ("UBTI"). The new regulations allow an organization to make a deal with a commercial sponsor allowing that sponsor to be the exclusive sponsor of the event, exhibition, or program. However, if the sponsor enters into an "exclusive provider" arrangement whereby the sponsor's product to be sold at the event will be the exclusive representative of that product, the payment will not constitute a qualified sponsorship and may give rise to unrelated business income. In other words, if a university enters into an arrangement with XYZ Ski Manufacturer whereby XYZ is the sole sponsor for the ski race and exhibition conducted by the university, the income is treated as a non-taxable contribution; but in the event that that XYZ insists that no other skis be used by participants, that could cause part of the payment to be treated as taxable to the university. Also of note, if the exempt organization permits the corporate sponsor to have a hyperlink on the organization's website, payment for the link is not treated as UBTI provided the organization does not endorse the sponsor's product.

Termination of Private Foundations: 100% of zero is ... zero.

Revenue Ruling 2003-13, published January 7, 2003, will eliminate the need for many ruling requests submitted to the IRS as insurance against the possible imposition of the termination tax on a private foundation going out of business. The exempt organizations committee of the Tax Section of the American Bar Association had almost ten years ago submitted to the IRS a draft revenue ruling which has been finally issued by the IRS to clarify the fact that when a private foundation terminates and transfers its assets to a public charity, the confiscatory termination tax does not apply. The statutory provision dealing with foundation termination blesses certain terminations in favor of a public charity which is a school, hospital, church, government entity or publicly supported organization and has been in existence for at least 60 months, but many other terminations are not so blessed. The fear has been that when a foundation terminates in favor of another type of public charity, the tax might apply, unlikely though that might seem. The ruling concludes that even though the precise circumstances described by the statute do not apply, the termination tax will not apply since all of the net assets have been distributed by the private foundation to a public charity and since the private foundation has no more assets, the termination will not be subject to any penalty tax. We're gratified to see the IRS putting on its creative hat in order to resolve this issue.

Charitable Gift Issues: Interest rate arbitrage for fun and (eleemosynary) profit.

2002 was another year marked by sharp fluctuations in interest rates. The Section 7520 rate – the interest rate mandated by the IRS for calculating the value of and deduction permitted for split interest gifts – increased in the first five months to 6.0% in May, only to collapse as the year progressed, with a low point of 3.6% in November and an ending rate of 4.0% in December. The low rates have continued into early 2003 (4.2% for January and a 4.0% rate just announced for February).

The current low interest rate environment makes certain types of deferred or split-interest charitable gifts very appealing. In particular, the deduction generated by a gift of a remainder interest in a personal residence is substantially enhanced as the Section 7520 rate drops. A simple example will illustrate. Assume a donor is age 65 who owns a personal residence worth $500,000 (the "net depreciable" portion being worth $320,000). The donor gives a remainder interest in the residence to charity, retaining use of the property for her remaining lifetime. If the

Section 7520 rate is 6.0%, the charitable deduction for this gift is $170,440; if instead the Section 7520 rate is 3.6%, the deduction is $226,278, or almost one-third more than at the higher interest rate.

In contrast, the deduction generated by a charitable remainder annuity trust gift or a charitable gift annuity is adversely affected by declining interest rates. If a donor aged 72 donates property to charity worth $500,000 in exchange for a $37,000 annuity payable in quarterly installments, her deduction is only $144,933 if the Section 7520 rate is 3.6%, as opposed to $197,615 if the interest rate is 6.0%. Of course, in the reverse situation – a charitable lead annuity trust paying an annuity to charity and returning the remainder to the donor's family – the lower interest rate environment works in favor of the taxpayer and substantially increases the charitable deduction permitted for gift tax purposes.

The low interest rate environment and poor investment climate in 2002 have also affected the amount a charity can pay to a donor under a gift annuity arrangement. Effective January 2003, the American Council on Gift Annuities ("ACGA") has reduced its recommended payouts to ensure that the residual value to the charity will not drop below its guideline of 50% of the value of the funding assets. Also, certain of the recommended rates under the prior ACGA schedule violated the Internal Revenue Code rule that requires an annuity's present value to be less than 90% of the amount transferred by the donor in order for the charity to avoid tax when it sells the assets received in exchange for the annuity.

It should of course be remembered that the deduction for some split interest gifts such as to charitable remainder unitrusts and pooled income funds is not affected by the changes in interest rates; however, such vehicles still remain prey to a poor investment environment!

<u>Gifts of IRAs and Minimum Required Distributions from Retirement Plans –Does Anyone in Washington CARE?</u>

IRA and retirement accounts are increasingly important gift assets. The IRS reports that in 1986 individual retirement accounts and similar deferred compensation arrangements appeared on 25% of federal estate tax returns and represented only 2.3% of the assets on those returns. For returns filed in 2000 they appeared on 53% of all such returns and represented 8% of reported assets. They represent a larger portion of smaller estates than larger ones. These assets play an increasingly important role in charitable giving. The CARE Act, which stalled in Congress in October, 2002, would have permitted an IRA owner age 59 or older to roll the IRA assets into an outright charitable gift without income tax consequences. It would also have allowed the IRA to roll into a charitable remainder trust ("CRT"), pooled income fund or gift annuity without an immediate income tax liability. In April 2002, final regulations were issued dealing with minimum required distributions ("MRDs"), mostly following the proposed regulations issued in 2001. The new regulations affect distributions during lifetime and after death. They substantially modify and simplify the distribution rules in place since 1987 and remove many of the complications that resulted if a charity or CRT was named as the beneficiary of part or all of a retirement plan. The new regulations employ the concept of a "uniform distribution period", under which distributions are based on the joint life expectancy of the plan participant and an individual who is deemed to be ten years younger than the plan participant. This puts all retirement account owners in the most advantageous position that was available in most cases under the old regulatory scheme. It also has the effect of permitting a participant to name a charity or a CRT as a beneficiary of a retirement plan without affecting the participant's lifetime MRDs. Changes in the post-death distribution rules also mean that it is now possible to avoid accelerating distributions after the participant's death to individual beneficiaries named in addition to the charity or CRT.

<u>Transfer Tax Provisions of the 2001 Tax Act: Rates are Down but the "Death Tax" Still Lives (for Now)</u>.

As you are no doubt aware, in June, 2001, Congress passed the Economic Growth and Tax Relief Reconciliation Act of 2001 ("the 2001 Act") which substantially changes and will eventually repeal the estate and generation-skipping transfer ("GST") taxes, but not the gift tax. The more dramatic changes do not take effect for a number of years and may never occur at all. In particular, the entire 2001 Act, including the transfer tax provisions, is subject to a sunset clause, mandated by the Congressional Budget Act, under which all the changes made by the 2001 Act cease to be effective after December 31, 2010 and the tax laws in effect prior to the 2001 Act again become effective. Accordingly, further Congressional action will be necessary in order for any of the changes made by the 2001 Act to become permanent. Although President Bush has pushed hard for the permanent and quicker repeal of what he refers to as the "death tax," this did not appear as part of the most recent wish list from the administration.

Changes effective in 2003. The top estate and gift tax rate has gone down to 49% (applicable to estates and aggregate taxable gifts in excess of $2 million). The exemption equivalent of the unified credit in 2003 remains at $1,000,000 for both estate and gift taxes. The federal generation-skipping transfer tax exemption is up to $1,120,000 for 2003.

The credit against the federal estate tax permitted for payment of state inheritance and estate taxes has been reduced further to 50% of the previously allowable amount (the credit will be phased out entirely at the end of 2004). Under the current law of many states, this change will have no effect on the total estate taxes payable, since the state estate tax is limited to the amount for which a credit is allowable against the federal estate tax. However, an increasing number of states (including Maryland, Massachusetts, New Jersey, Pennsylvania, Rhode Island and Vermont) have already reacted by decoupling from the change in the federal law to stem the loss of tax revenue. Unfortunately, these responses have not been uniform, and more careful attention must now be paid to state estate tax provisions.

<u>Individual Income Tax Rates.</u>

The federal income tax rates remain unchanged from 2002. There have been minor adjustments to the bands of income to which the 15%, 27%, 30%, 35% and 38.6% rates apply to reflect cost of living adjustments. The higher four bands are scheduled to decrease further in 2004 and then 2006 as follows:

INDIVIDUAL TAX RATE REDUCTIONS

Calendar Year	27% rate reduced to	30% rate reduced to	35% rate reduced to	38.6% rate reduced to
2004-2005	26%	29%	34%	37.6%
2006 and later	25%	28%	33%	35%

The President has recently proposed bringing the reduction schedule forward so that the 2006 changes take effect this year.

Impact on Charitable Giving.

Will the rate reductions, whether in the income, estate, gift, or GST tax area, cause charitable contributions to diminish? It is still too soon to tell. As the economy improves, we will have a better sense of the impact attributable to the tax changes.

Continuing Education.

Nonprofit Conference. Massachusetts Continuing Legal Education, Inc. will be hosting its fourth annual Nonprofit Conference in Boston on February 6, chaired by Lorry Spitzer and featuring many leading exempt organization practitioners. This is their fourth attempt to get it right; not a single participant in prior conferences has asked for a refund or disturbed their neighbor with excessively loud snoring, so the conference has to be good. This may be your first opportunity to learn more about some of the current developments described above. A brochure describing the conference is enclosed.

As always, we remain happy to assist you with any of your questions or issues. Please contact Carolyn Osteen, Lorry Spitzer or Martin Hall if we can be of help.

Happy New Year!

The Exempt Organization Practice Group at Ropes & Gray