The past year has been an active one for tax-exempt organizations. The charitable community has struggled to adapt to changes made by the Pension Protection Act of 2006 (PPA), and the IRS has issued guidance to implement some of the statutory changes. A renewed Congressional focus was directed to college and university endowments. The IRS cast a harsh light on several churches thought to be engaged in impermissible political campaign activities, including All Saints Church in Pasadena, California, but was unable to make a case for revocation of exemption.

The Senate Finance Committee continues to examine estate tax reform and extension, but has made no real progress. Instead, the Senate prefers to investigate use of performance-enhancing drugs by prominent baseball players.

Substantially Revised Form 990 Released for Tax Years Beginning in 2008

In December 2007, the IRS released the final version of the new Form 990, the annual information return filed by tax-exempt organizations. The new Form 990 replaces the current nine-page form and its two schedules with an 11-page "core form" and 16 schedules, including separate schedules for schools and hospitals, as well as schedules about compensation, tax-exempt bonds, related organizations and unrelated partnerships, political and lobbying activities, and non-cash contributions. The core form includes a summary page intended to provide a snapshot of the filing organization's activities, governance, revenue, expenses, and net assets. The core form also includes a section on governance that asks for information about the organization's policies and board structure.

In response to numerous comments, the IRS will phase in the new schedules for hospitals and tax-exempt bonds so that only identifying information will be required for the first filing year, with the entire schedules to be completed for tax years beginning in 2009. The instructions for the Form 990 will provide necessary definitions and will reveal the scope of the questions on the new form. The instructions are scheduled to be released in April 2008.

Calendar year organizations will be required to file the new Form 990 during 2009, but fiscal year organizations will not be required to file it until 2010 (for their fiscal year that commenced in 2008). Due to the extensive additional reporting now required, particularly for larger organizations, it will be important to carefully examine the new form and put systems in place to gather the required information for 2008. For more detailed information on the new Form 990, please see our alert and materials from our February 2008 teleconference on the subject.

Substantially Revised Form 5227 Released for the 2007 Tax Year

In response to changes enacted by the PPA, the IRS released a substantially revised Form 5227 (Split-Interest Trust Information Return) for reporting by split-interest trusts described in section 4947(a)(2). This includes charitable remainder trusts, pooled income funds and charitable lead trusts. Split-interest trusts are no longer required to file Form 1041-A. The Form 5227 – except for Schedule A, which includes private beneficiary information – is also open for public inspection. The Internal Revenue Code makes clear that individual donor/beneficiary information may not be publicly disclosed, but this is an apparent conflict with the statutory requirement that the IRS disclose the name of the trust (which would generally include the individual donor's name). We have been in contact with the IRS to determine how to avoid disclosing the name of the trust but have not received a definitive answer.

Major changes to the form include the following: all trusts must now complete Part I Sections A through D; Part III-A and Part III–B are revisions of Form 1041-A Parts III and II, respectively; Part V-B provides a simplified format for determining the required distribution for various charitable remainder trusts; and former Part III is revised and is now new Schedule A. Schedule A also expands former Part II (Accumulation Schedule), showing distribution information

for individual beneficiaries and requests information about the donor and donated assets. In addition, non-filing penalties have been increased and expanded to include incorrect and incomplete Form 5227 filings. Trusts excepted from the Form 5227 filing requirement include those split-interest trusts created before May 27, 1969 to which no additional contribution has been made since that date and for which a deduction was allowed under any section listed in section 4947(a)(2).

IRS Required to Make Form 990-T Available to Public

Since August 2006, tax-exempt organizations that file the Form 990-T (used to report unrelated business taxable income, or UBTI) have been required to make that form available to the public upon request. A technical correction enacted at the end of December 2007 requires the IRS to also make the 990-T publicly available, meaning that individuals wishing to examine an organization's Form 990-T will no longer need to contact the organization directly. To fulfill its obligation, we expect the IRS will provide the Form 990-T to GuideStar, which currently makes the Form 990 available at www.guidestar.org. We understand from IRS officials that discussions are underway to ensure that only information pertinent to the calculation of UBTI will be disclosed to the public, which would not include many ancillary forms typically attached to the Form 990-T (such as those provided by investment partnerships). This will be an important issue to watch.

Congressional and IRS Interest in College and University Endowments

In January 2008, Senate Finance Committee chairman Max Baucus and ranking minority member Chuck Grassley sent a letter to 136 colleges and universities with endowments of $500 million or more. The letter requested information about tuition and financial aid, endowment growth, management, costs, payout and spending restrictions, and fee arrangements with investment advisors. The letter followed hearings held by the Senate Finance Committee in the fall of 2007 that focused on university endowments and prompted Senator Grassley to comment publicly that he would like to see Congress adopt a minimum payout requirement for university endowments, such as the payout requirement that currently applies to private foundations. Separately, the IRS announced in its implementing guidelines for the 2008 fiscal year that it would be sending a "compliance check questionnaire" to a cross-section of approximately 500 small, medium and large colleges and universities that would cover, among other topics, investment and use of endowments. For more information on the IRS initiative, please see our alert.

IRS Good Governance Guidelines

The IRS has recently expressed a particular interest in "good governance" and in February 2008 released "Governance and Related Topics" for 501(c)(3) organizations. These guidelines expand upon draft guidelines released in February 2007 and provide important commentary on the new governance-related questions in the revised Form 990 for 2008. The new guidelines make more explicit than ever the IRS's specific expectations as to the governance of public charities, including board size and composition, executive compensation, various written policies (conflicts of interest, investments, code of ethics, whistleblower) and audited financial statements. The new Form 990 incorporates a number of questions that draw upon the content of these IRS guidelines. For more information on the good governance guidelines, please see our alert.

New Form 990-N Electronic Return Filing Requirement for Smaller Organizations

The PPA included a provision requiring tax-exempt organizations with $25,000 or less in gross receipts to file an annual "e-postcard" with the IRS (these organizations are not required to file a Form 990 or Form 990-EZ, and therefore previously had no IRS filing requirement). The IRS has released Form 990–N for this purpose, which must be filed

electronically. The form must be filed starting with tax years that began in 2007. This requirement does not apply to churches or their integrated auxiliaries, conventions or church associations. If an organization fails to file the Form 990-N (or if required, the Form 990) for three consecutive years, its tax-exempt status will be revoked.

We continue to advise that if gross receipts are less than $100,000, the best practice is to file Form 990-EZ (appropriate for public charities but not private foundations), which, unlike the Form 990-N, permits an organization to identify the basis for non-private foundation status on Schedule A. A private foundation is required to file Form 990-PF regardless of the amount of its gross receipts.

Possible Private Foundation Classification for Certain Supporting Organizations Structured as Trusts

Before the enactment of the PPA, a trust could meet the responsiveness test for "Type III" supporting organization (SO) status by virtue of naming charitable beneficiaries in its governing instrument, provided those beneficiaries had the power to enforce the trust and compel an accounting under state law. Beginning on August 17, 2007, trusts that qualified as SOs by virtue of this special rule lost their SO status and immediately became classified as private foundations unless they could otherwise establish public charity status. In Notice 2008-6, the IRS provided transitional relief to trusts affected by this change. If the trust is able to meet the so-called "significant voice" test by virtue of the fact that the officers or trustees of the charities it supports have a significant voice in investment policies, grant making and direction of the use of income or assets of the SO, then it may retain Type III status. Otherwise, it must either establish a closer Type I or II relationship or become a private foundation. These former SOs may file the Form 990 for taxable years that began before January 1, 2008, but must file the Form 990-PF and pay private foundation excise taxes for taxable years beginning on or after January 1, 2008.

New Guidance on Type III Supporting Organizations

The IRS has been busy issuing guidance on the numerous restrictions imposed on SOs as a result of the PPA. The anticipated study on donor-advised funds and SOs required by the PPA (and technically due in August 2007) has not yet been released. The IRS did, however, release an "advance notice of proposed rulemaking" (indicating an intent to propose regulations) that sets forth anticipated new requirements for SOs. It is expected that a Type III "functionally integrated" SO will be required to satisfy two new tests to qualify for SO status in addition to demonstrating that it performs functions or carries out activities that its supported charity would have engaged in itself were it not for the SO's involvement. These two tests – an expenditure test and an assets test – currently apply to private operating foundations and are intended to ensure that the SO spends sufficient resources on activities directed to furthering its supported charities' exempt purposes. The advance notice also states that Type III "non-functionally integrated" SOs will be subject to a new minimum payout requirement equal to 5 percent of the fair market value of its assets (replacing the current requirement of 85 percent of net income). This is the same payout requirement applicable to private non-operating foundations. In addition, the IRS released an SO guide sheet and an explanation that together provide insight into the IRS's views about the various requirements for SO status. These documents have been incorporated into the Internal Revenue Manual.

Many Charitable Giving Incentives, Including IRA Rollover, Expired in 2007

The popular IRA charitable rollover enacted by the PPA expired at midnight on December 31, 2007 along with other provisions allowing for favorable treatment of contributions by S corporations, gifts of inventory such as food and books and gifts of conservation restrictions. In spite of much bipartisan protest, no extensions of those provisions have been adopted, though such provisions are frequently extended after they have expired.

Guidance on Gifts of Appreciated Property by S Corporations

Although the favorable S corporation provision in the PPA expired at the end of 2007, the IRS has issued a revenue ruling addressing charitable gifts of appreciated property by an S corporation during 2006 and 2007. Revenue Ruling 2008-16 confirms the view expressed in the legislative history that the intent of the PPA provision was to permit an S corporation shareholder to deduct his or her pro rata share of the fair market value of the contributed property, as a partner in a partnership is permitted to do. Under prior law, an S corporation shareholder's charitable deduction was limited to his or her basis in the S corporation stock. This ruling provides a detailed calculation for determining the amount of the charitable deduction allowed in the case before it, which will serve as useful guidance for future situations if the legislation is extended. In addition to the revenue ruling, a technical correction enacted just days before the provision expired confirmed that a fair market value deduction was permitted.

Fractional Interest Gifts of Tangibles

The PPA adopted significant changes in the law relating to gifts of fractional interests in tangible personal property (such as art work) affecting the income tax deduction and estate and gift tax deductions. For later gifts of an additional fractional interest of the property, the PPA effectively froze the amount of the deduction at the fair market value of the property at the time of the initial transfer. This change produced the untenable result that subsequent partial interest charitable gifts in appreciating tangible personal property would give rise to an estate or gift tax liability. The problem with the estate and gift tax liability has been resolved retroactively through technical corrections legislation, which provides that the fair market value of the retained interest will be fully offset by the charitable gift of that interest.

Proposed Regulations Regarding Effect of Unrelated Business Taxable Income on Charitable Remainder Trusts

On March 6, 2008, the IRS released proposed regulations that would amend regulations under section 664(c) to provide that charitable remainder trusts with UBTI in taxable years beginning after December 31, 2006 are exempt from federal income tax, but are subject to a 100 percent excise tax on the UBTI earned by the trust. These proposed regulations would implement a change to the Internal Revenue Code enacted in 2006. Before the 2006 change, a CRT with any UBTI became subject to tax on all of its income. These proposed regulations clarify that the excise tax is treated as paid from corpus or principal of the trust and does not reduce its net income which is otherwise fully taxable as distributed to the beneficiary (first as ordinary income and then as capital gain in accordance with the usual tier system).

Inflated Contribution Scheme

Senate Finance Committee chairman Max Baucus and ranking minority member Chuck Grassley wrote to the Treasury Department recently to point out a complex scheme promoted by certain tax shelter operators. The scheme involved a gift of a sole membership interest in a limited liability company (LLC) to a charity, such as a college or university, claiming a value of several times the price originally paid for the property. The LLC holds only a remainder interest in the property following the expiration of a long-term lease, sometimes as long as 60 years. The charity is asked to agree not to dispose of the interest in the property until the expiration of the period required for filing of the Form 8282 (now required to be filed in the event of disposition of the property within three years of the gift date). Following the expiration of the time period, the charity is permitted to sell its interest in the LLC to the promoter for a price substantially below the value deducted, and the promoter then repeats the transaction with the same property in another group of investors and charities. The IRS first became aware of such transactions in August 2006 and has identified 48 entities participating in transactions involving deductions of approximately $271 million, mostly in New York but in some other states as well. The IRS has aggressively audited the entities known to have made these contributions and claimed such

deductions. Overvaluation of contributed property (along with other abuses of charitable organizations and deductions) appears on the IRS's "2008 Dirty Dozen" of "the most egregious tax schemes and scams."

IRS 501(c)(3) Bond Enforcement Initiatives

The IRS has been increasingly active in 501(c)(3) bond enforcement. In 2006, the Service conducted audits of approximately 20 to 30 borrowers to determine the compliance of their 501(c)(3) bonds with applicable tax rules. It found numerous instances of noncompliance and particular problems in the area of record retention. During 2007, the IRS sent "compliance check questionnaires" to approximately 200 additional 501(c)(3) borrowers. The IRS said recently that it is evaluating the responses received on the questionnaires and considering its next course of action, which may include sending questionnaires to additional 501(c)(3) organizations, sending follow-up questionnaires to the organizations that received the original survey, or commencing targeted audits of 501(c)(3) bond issuers. In addition, the new Form 990 for 2008 contains an expanded array of questions regarding compliance with the various limitations imposed on tax-exempt bonds, and a number of 501(c)(3) organizations have determined that this is an appropriate time to strengthen their internal bond compliance programs. We have prepared a set of model post-issuance compliance procedures for 501(c)(3) borrowers, and would be happy to provide additional information about this program.

IRS Releases Reports on Compliance Initiatives

In 2007, the IRS issued reports on two high-profile initiatives: one on executive compensation and the other on hospitals and community benefit. The IRS began its executive compensation initiative in 2004. The initiative involved contacting over 1,800 tax-exempt organizations and included almost 800 audits. The IRS report on the initiative found that significant reporting issues exist and noted that 25 of the audits resulted in aggregate excise taxes in excess of $21 million. The report also concluded, however, that high compensation amounts generally were substantiated with comparability data. Furthermore, the report recommended that the Form 990 be modified to reduce reporting errors.

The hospital compliance initiative commenced in 2006. Over 500 hospitals were sent a compliance check questionnaire that was returned to the IRS for data analysis. The questionnaire focused on community benefit expenditures and executive compensation practices. In its preliminary report on the initiative, the IRS recommended the development of a new schedule to the Form 990 that would enable a hospital to report community benefit activities. This recommendation is reflected in Schedule H of the revised Form 990 released in December 2007.

IRS Releases Proposed and Temporary Regulations on Prohibited Tax Shelter Transactions

Code section 4965, enacted in 2006, was intended to target tax-exempt organizations that serve as "accommodation parties" in tax shelter transactions by facilitating a benefit (such as a tax loss) for a taxable party. In July 2007, the IRS issued proposed and temporary regulations to implement this provision, which imposes penalties on tax-exempt organizations that become parties to "prohibited tax shelter transactions" (PTSTs), as well as on managers who knowingly approve an organization's participation in such transactions. When section 4965 was enacted, there was significant concern among tax-exempt investors that investments in partnerships could expose them to penalties if the partnerships engaged in a PTST. The proposed regulations state that a tax-exempt investor will be subject to penalties in such a situation only if the investor facilitated the transaction by reason of its tax-exempt status; is identified in published guidance by type, class or role as a party to a PTST; or entered into a "listed" transaction and its tax return reflected reduced tax liability as a result (listed transactions are those specifically identified by the IRS in published guidance as abusive). These statements, as well as a particular example in the proposed regulations, suggest that section 4965 penalties should not apply in most instances to indirect partnership investments, including investments in private equity funds, venture capital funds and hedge funds.

Heightened IRS Interest in Political Activities

The IRS periodically reminds charitable organizations of the absolute prohibition against their engaging in political activity in support of, or in opposition to, a candidate for public office. The IRS issued such a reminder in November 2007 in IR-2007-190. Also in 2007, the IRS issued Revenue Ruling 2007-41, which describes numerous factual situations in which charitable organizations have, or have not, engaged in prohibited political activity. In addition, the IRS and All Saints Church of Pasadena, California continued to face off over the question of whether the church violated the political activity prohibition. The IRS found that the church had violated the prohibition, but did not seek to revoke the church's tax-exempt status. Finally, in a case that is still unfolding, the IRS has notified the United Church of Christ that there is reason to believe a speech made by Senator Barack Obama at the church's 50th General Synod violated the political campaign activity prohibition.

Proposed Regulations Regarding Exchange of Property for a Private Annuity

Proposed regulations on private annuities would reverse the long-standing rule that allows an annuitant to recognize capital gain on the transferred property ratably over his or her life expectancy, rather than initially upon the transfer. The regulations are effective for annuity transactions taking place after October 18, 2006, or, for individually issued annuities that are not secured, if the assets transferred in exchange for the annuity are not sold or otherwise disposed of in the initial two years of the annuity arrangement, after April 18, 2007.

While the proposed regulations apply only to private annuities, and do not alter the treatment of capital gains in connection with charitable gift annuities under Treasury Regulation § 1.1011-2, the IRS has requested comments as to whether those regulations should be changed to conform the tax treatment of the two types of annuities. The IRS held a hearing in February 2007 on the topic, and the American Council on Gift Annuities, among others, testified against such a conforming change to the rules.

Formula Disclaimer to Charity Upheld by Tax Court

In *Estate of Christiansen v. Commissioner*, 130 T.C. No. 1 (2008), the Tax Court held that a formula disclaimer - whereby any increase in the federal estate tax valuation of an estate passed to charity - was not void as against public policy (although partially disqualified on other grounds). In so holding, the Court refused to apply or extend the *Procter* decision to these facts. *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944). In the *Christiansen* case, a daughter disclaimed a testamentary bequest of family limited partnership units to the extent the value of the units exceeded a formula determined amount. The disclaimed amount passed, by the terms of the will, to a charitable lead annuity trust and a private foundation. The lead trust was payable to the disclaimant at the end of the lead term, thus disqualifying the portion of the disclaimed property passing to the lead trust. The portion of disclaimed property passing to the foundation was upheld. Citing the fiduciary duties of executors and directors of the foundation, as well as the role of the state attorneys general in upholding those duties, the Court concluded that the increased charitable deduction reflecting an increased valuation of estate property, which passed to the foundation, did not violate public policy. It rejected the government's argument that allowing such formula disclaimers would undermine its incentive to audit, which, in turn, would encourage taxpayers to minimize the value of estate assets at the expense of charity.

Private Letters Rulings on Early Termination of Charitable Remainder Trusts

The IRS has continued to issue private letter rulings stating in a variety of situations involving the early termination of charitable remainder trusts, that such terminations will not be considered acts of self dealing or taxable expenditures, nor will they subject the CRTs to termination tax under section 507.

Some recent examples include early terminations of standard CRTs and the distribution of the trust corpus to the income and remainder beneficiaries according to the present value of their respective interests. Ltr. Ruls. 200739004, 200727013. In another ruling, the IRS held that the division of a CRT with "flip" provisions into two separate trusts, so that the remainder of one of the trusts could be assigned to the remainder beneficiary, would entitle the income beneficiary to income and gift tax deductions for the present value of the remaining income interest and would not cause the income recipient to recognize any undistributed gains relating to the transferred interest. Ltr. Rul. 200808018.

Among these routine rulings, a few are of particular note, including Private Letter Rulings 200725044 and 200733014. Like many similar rulings, the IRS held that the early termination of a net-income-with-makeup charitable remainder unitrust (NIMCRUT) would not constitute an act of self-dealing and the entire amount received by the income recipients would be treated as long-term capital gain. However, the IRS also held that the net-income provisions must be taken into account when calculating the actuarial values of the income and remainder beneficiaries of the NIMCRUT. In doing so, it used a payout method based on the lesser of the section 7520 rate in effect on the date of termination and the unitrust amount in the trust agreement, resulting in a less favorable calculation for the taxpayer than that used with the early termination of a standard CRT. Not surprisingly, the IRS has also applied this methodology to a net-income charitable remainder unitrust (NICRUT) without any make-up provisions. Ltr. Rul. 200809044 (involving the early termination of a CRT created by a family limited partnership by means of a sale of the income recipient's interest to the remainder beneficiary).

IRS Issues Safe-Harbor Charitable Lead Annuity Trust Samples

The IRS has issued samples of inter vivos grantor and nongrantor, as well as testamentary, charitable lead annuity trusts (CLATs). CLATs that are substantially similar to the IRS samples, or that properly integrate alternate provisions found in the samples, will be qualified trusts and the donor will receive applicable charitable deductions. A CLAT that uses a power other than in the samples to qualify the trust for grantor trust status (assuming the power otherwise complies with CLAT requirements), or that provides for an increasing annuity payment over the course of the trust, so long as the value is ascertainable upon creation of the CLAT, will also be qualified, as will a CLAT that provides for an alternate disposition upon termination of the lead interest. The samples provide a clear road map for creation of a CLAT, with substantial alternate provisions to permit ample flexibility for donors. The IRS has yet to issue samples for charitable lead unitrusts, which are established less frequently than CLATs, but such samples are on the IRS target list for completion this year.

Substantial Compliance Doctrine Did Not Apply to Defective Charitable Remainder Unitrust

In *Estate of Tamulis v. Commissioner*, 509 F.3d 343 (7th Cir. 2007), a defective testamentary charitable remainder unitrust created by a Catholic priest for the benefit of family members and his diocese was not reformed using proper judicial reformation procedures within the time required (90 days after the estate tax return was due, including extensions). The trustee nonetheless argued that the estate was entitled to an estate tax charitable deduction for the charitable interest in the trust based on the substantial compliance doctrine because she administered the trust according to the CRT rules. The U.S. Court of Appeals for the 7th Circuit disagreed. It found that the trustee (who was also the executor of the estate) was aware of the tax deduction at stake and had ample opportunity to reform the trust, that there were clear and unambiguous methods to do so, and that the trustee had no excuse for not taking advantage of them.

Flexible Starting Date Charitable Gift Annuities

The IRS previously approved, in a private ruling, the deferred charitable gift annuity. Ltr. Rul. 200449033. In a recent private ruling, the IRS answered the question of whether a donor whose charitable gift annuity agreement allows her to choose when the annuity payments are to begin, within a specified period in the future, is deemed to receive construc-

tive income at the earliest possible time she is able to receive annuity payments. The new ruling provides that no amount will be constructively received by the annuitant until she actually begins receiving payments from the annuity. Ltr. Rul. 200742010.

Proposed Regulations on Estate Tax Inclusion of Inter Vivos Charitable Remainder Trusts for Life of Donor

The IRS has issued proposed regulations that address the estate tax inclusion of an inter vivos charitable remainder annuity trust or unitrust created for a donor's lifetime. The proposed regulations do not address estate tax issues with respect to inter vivos pooled income funds or gifts of remainder interests in a personal residence or a farm. The proposed regulations provide that when a decedent transfers property during his lifetime to a trust and retains the right to an annuity, unitrust or other income payment from the trust for life (or for a period that does not in fact end before his death or is not ascertainable without reference to his death), the interest is includable in his estate under section 2036. Although section 2039 may also be applicable to such a situation, the regulations also make clear that section 2039 shall not apply to an annuity, unitrust or other payment retained by a decedent in a CRT. The regulations further provide that the portion of the trust that is includable under section 2036 is that portion of the trust corpus, valued as of date of death (or alternate valuation date, if applicable), necessary to yield the annual payments provided under the trust, using the section 7520 rate in effect on date of death (or alternate valuation date, if applicable). Prop. Reg. § 20.2036-1; Prop. Reg. § 20.2039-1. The effect of these regulations is that less than the entire amount of the trust may be includable in the donor's estate for federal estate tax purposes. However, if the donor retains a testamentary right to revoke the interest of a successor beneficiary in the trust, the entire value of the trust will be includable in his estate.

Massachusetts Unrelated Business Income Tax

Massachusetts issued final regulations in 2007 regarding the taxation of unrelated business income of exempt organizations, clarifying the fact that a tax-exempt organization structured as a corporation is subject to tax on its UBTI in Massachusetts. However, the property or net worth of the corporation is not subject to tax, nor is the corporation subject to the minimum excise tax as if it were a taxable business corporation. An exempt organization structured as a trust is also subject to tax on any UBTI; however, because it is permitted an offsetting deduction for all amounts paid or set aside for charitable purposes, such an entity may avoid payment of any tax on UBTI (however, the income and offsetting deductions must be reported on the Form 2 filed with the Department of Revenue).

As always, we remain happy to assist you with any of your questions or issues. If you have any questions, please contact a member of the Exempt Organization Practice Group at Ropes & Gray.

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