2008 Year In Review for Tax-Exempt Charitable Organizations

It's been a wild year in the normally staid world of tax-exempt charitable organizations. Congress, the IRS and state legislators all seem to want a piece of the action in seeking to ensure that exempt organizations fully report on their activities, distribute lots of money to charitable programs, do not overcompensate their executives, and avoid conflict-of-interest entanglements. So here is the whole story (or at least the parts that fit). If this update doesn't satiate your curiosity, then come to Boston on Wednesday, March 25, to hear Kendi Ozmon and Lorry Spitzer orchestrate a panel of experts at Massachusetts Continuing Legal Education's 10th Annual Nonprofit Law Conference.

IRS Form 990 For Tax Years Beginning in 2008 Requires Increased Disclosure

By now, most tax-exempt organizations are aware that the IRS has released a substantially revised Form 990 for tax years beginning in 2008. The new form contains separate schedules on topics such as compensation, transactions with "interested persons," activities outside the U.S. and non-cash contributions. Hospitals and organizations that issue tax-exempt bonds must also complete detailed schedules for tax years beginning in 2009 (limited information on these topics needs to be reported for tax years beginning in 2008). The IRS also seeks new information about governance, including board member independence and compensation-setting practices, and asks whether the organization has certain policies in place, including policies on conflicts of interest, document retention, whistleblowers, joint ventures and gift acceptance. The filing thresholds for the Form 990 have changed; for tax years beginning in 2008, organizations with less than $1 million in gross receipts and less than $2.5 million in total assets may file the simpler Form 990-EZ rather than the Form 990. Organizations with $25,000 or less in gross receipts may file the Form 990-N, an electronic postcard that reports minimal information about the organization and its activities.

IRS Eliminates Advance Ruling Process for Publicly Supported Charities

In September 2008, the IRS announced the elimination of the advance ruling process for section 501(c)(3) organizations that derive public charity status based on being publicly supported. Previously, an organization that applied for public charity status on this basis received an advance ruling, and needed to file Form 8734 with the IRS after completing five tax years to show it met the relevant public support test. Under the new rules, an organization seeking to be classified as a publicly supported charity is automatically classified as such for the first five years of its existence at the time the IRS provides a determination of tax-exempt status. Beginning with the organization's sixth taxable year, it must establish on its regularly filed Form 990 that it meets the relevant public support test. Filing the Form 8734 is no longer required. The new rules apply to organizations with advance ruling periods that had not yet expired as of June 9, 2008. These organizations will not receive a final determination letter from the IRS; rather, the IRS will treat such organizations as public charities provided they meet the public support tests on the Form 990.

Enactment of the Uniform Prudent Management of Institutional Funds Act Affects Endowment Spending Rules

As of March 2009, 26 states and the District of Columbia have enacted the Uniform Prudent Management of Institutional Funds Act (UPMIFA), which replaces the Uniform Management of Institutional Funds Act (UMIFA). More states, including

Massachusetts, are expected to enact UPMIFA shortly. Issued in 1972, UMIFA has governed the management, investment and expenditure of charitable funds, including endowments, held by tax-exempt organizations in 48 states and jurisdictions.

For many organizations, the most important part of UPMIFA is its endowment spending provision, which eliminates UMIFA's "historic dollar value" threshold for spending from endowment funds. Under UMIFA, a charity can spend appreciation from an endowment fund over the fund's historic dollar value —the aggregate value of all contributions to an endowment fund at the time they were made—to the extent the charity deems prudent, but may only distribute current income (*e.g.*, dividends and interest) from a fund whose value has decreased below historic dollar value. Under UPMIFA, an organization is no longer restricted to spending amounts above a fund's historic dollar value, but instead may spend the amount it deems prudent after considering the donor's intent, the purposes of the fund, and several economic factors. States may adopt an optional rule that presumes expenditure exceeding 7 percent of total return is imprudent (this optional rule is a part of the legislation that has been proposed in Massachusetts).

UPMIFA provides other changes from UMIFA, including new procedures for releasing restrictions on small funds that have been held for a long period of time, requiring only notice to the Attorney General.

FASB Staff Position FAS 117-1 Requires New Disclosure for Endowment Funds

On August 6, 2008, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) FAS 117-1, "Endowments of Not-for-Profit Organizations: Net Asset Classification of Funds Subject to an Enacted Version of the Uniform Prudent Management of Institutional Funds Act, and Enhanced Disclosures for All Endowment Funds" (FSP). Most of the FSP's provisions apply only to organizations in states that have adopted UPMIFA, but the FSP also requires all organizations with endowment funds, whether or not subject to UPMIFA, to provide additional disclosures about their endowments. The new disclosures include a description of the governing board's interpretation of the laws underlying the organization's net asset classification, a description of the organization's endowment spending policy, and a description of the organization's investment policy. The FSP is effective for fiscal years ending after December 15, 2008.

IRS Releases Final Report on Hospital Compliance Initiative

In 2006, the IRS commenced a hospital compliance initiative by sending "compliance check questionnaires" to over 500 hospitals. The questionnaire focused on community benefit expenditures and executive compensation practices. In a preliminary report on the initiative, the IRS recommended developing a new schedule to the Form 990 to enable hospitals to report community benefit activities (this schedule has been made a part of the 2008 Form 990). The IRS released its final report on the hospital compliance initiative in February 2009. In the report, the IRS observed that any attempt to change the existing community benefit standard for tax-exempt status would affect the hospital sector due to hospitals' varied practices and financial capabilities. The IRS also observed that, although certain compensation reported on the questionnaires may appear high, nearly all of these amounts were upheld as reasonable upon IRS examination. Senator Charles Grassley, ranking minority member of the Senate Finance Committee, expressed disappointment that the IRS report did not include new community benefit guidelines and suggested that Congressional action may be necessary to impose charity care requirements on nonprofit hospitals. Senator Grassley has also suggested he may introduce legislation that would address executive compensation at nonprofit hospitals.

Increased Scrutiny of Colleges and Universities

In October 2008, the IRS began another compliance check project designed to obtain information about how colleges and universities report revenue and expenses (including unrelated business income), how they manage and spend their endowments and how they determine "executive compensation." Compliance check questionnaires were sent to 400 small, medium and large colleges and universities, and the IRS has stated that it will analyze the results of the survey, conduct audits of a sample of the organizations, and issue a report on the project in 2009 (the surveys were due in February 2009). It has also been suggested that the survey will result in a new Form 990 schedule specifically directed at colleges and universities. The compliance check is but one manifestation of a general increase in governmental scrutiny toward colleges and universities that includes the new Form 990; the January 2008 letter to colleges and universities from Senators Baucus and Grassley requesting information about endowments; suggestions from Congress (and the Massachusetts legislature) that a mandatory payout requirement be imposed on endowments; and a January 2009 comment by an IRS official that universities may receive yet another IRS questionnaire, this time concerning academic research, federal financing, and intellectual property.

Pension Protection Act of 2006 Extenders in Bailout Legislation

Several popular charitable-giving provisions were extended by the Emergency Economic Stabilization Act of 2008, including the IRA charitable rollover, charitable-giving incentives for contributions by S corporations and gifts of inventory such as food and books. The Act also extended the exclusion from unrelated business income for fair market value payments of interest, rent, royalties and annuities received from controlled entities. The provisions previously had expired on December 31, 2007, and were extended through December 31, 2009.

Final Regulations Issued on Revocation of Exemption in Addition to Intermediate Sanctions

In March 2008, the IRS and Treasury issued final regulations that address the interaction of the so-called "intermediate sanctions" rules (which impose excise taxes when certain types of tax-exempt organizations engage in "excess benefit transactions" with insiders) and revocation of an organization's tax-exempt status. In issuing these regulations, the IRS made clear that the penalty for engaging in one or more excess benefit transactions could be revocation of tax-exempt status (and not simply excise taxes), depending on the facts and circumstances. Although the final regulations are in substance the same as regulations proposed in 2005, they include several new examples and emphasize the importance of implementing internal procedures to establish that compensation paid to executives is reasonable (specifically, use of the "safe harbor" procedure in the intermediate sanctions regulations that establishes a rebuttable presumption that payments to insiders represent reasonable compensation).

IRS Guidance on Ancillary Forms Attached to Form 990

Since the enactment of the Pension Protection Act of 2006, tax-exempt organizations that file Form 990-T (used to report unrelated business taxable income, (UBTI)) have been required to make that form available to the public upon request. A technical correction enacted at the end of 2007 requires the IRS to also make the 990-T publicly available. In 2008, the IRS issued Notice 2008-49, which clarifies that schedules, attachments, and other documents filed with Form 990-T that do not relate to the calculation of UBTI are not required to be made available for public inspection and copying. This means that non-UBTI-related schedules and attachments (such as those provided by investment partnerships) do not have to be disclosed.

Section 457(f) Partial Year Compensation Development

The IRS issued interim guidance in Notice 2008-62 indicating that certain types of recurring part-year compensation arrangements – common among schools, colleges and universities that annualize faculty salaries based on work performed on a nine- or 10-month schedule – generally will not constitute deferred compensation. Beginning the first taxable year that includes July 1, 2008, arrangements in which an employee or independent contractor receives recurring part-year compensation will not constitute nonqualified deferred compensation under section 457(f) if the following two conditions are met: (1) all wages for the year of service (which may begin before the first day of classes) must be paid by the last day of the 13th month following the beginning of the service period; and (2) the amount of wages that are deferred from one taxable year to the next taxable year must not exceed the limit under section 402(g)(1)(B) for the calendar year in which the service period begins. (The 2008 contribution limit of $15,500 applies for the 2008-2009 school year.) The IRS expects this rule to be included in upcoming proposed regulations.

Student FICA Exception Developments

The IRS announced in Revenue Procedure 2009-3 that it will no longer grant rulings on whether certain research training fellowships qualify for an exception to withholding on wages. Prior to 2009, the IRS had frequently ruled that certain research training fellowships modeled after the National Institutes of Health's National Research Service Award (NRSA) program would not be considered "wages" subject to FICA, FUTA, or income tax withholding. In our conversations with the IRS, we have also learned that the treatment of fellowship grants, particularly by medical institutions, is drawing increased scrutiny from the IRS, and that it has transferred authority over fellowship grant questions to the Tax-Exempt and Government Entities Division, which will be studying the issue before deciding on a course of action.

Several court decisions in 2008 and early 2009 reopened the question of whether medical residents qualify for the student exception to FICA taxation. In 2004, the IRS issued final regulations stating that to qualify for the student FICA exception, the employer must carry on educational activities as its "primary function." The limitation most affected teaching hospitals, since their primary function is health care, not education. In 2007, a federal district court in Minnesota held that this regulation was invalid, since the "primary function" test was counter to the ordinary meaning of a "school, college, or university." *Mayo Foundation for Medical and Educational Research v. United States*, 503 F. Supp. 2d 1164 (D. Minn. 2007). In 2008 and early 2009, several other courts (including the U.S. Courts of Appeals for the Sixth and Seventh Circuits) explored the question of whether medical residents qualified for the student FICA exception, holding that the student FICA exception was not per se inapplicable to medical residents. See *University of Chicago Hospitals v. United States*, 545 F.3d 564 (7th Cir. 2008); *United States v. Detroit Medical Center*, —F.3d—(6th Cir. 2009); *United States v. Partners Healthcare System, Inc.*, 591 F. Supp. 2d 116 (D. Mass. 2008). And in *United States v. Mount Sinai Medical Center of Florida, Inc.*, 2008 WL 2940669 (S.D. Fla. 2008), the District Court for the Southern District of Florida held affirmatively that Mount Sinai Medical Center was a "school, college, or university" and that medical residents were "students" for purposes of the student FICA exception. It is important to note, however, that each of these cases dealt with time periods prior to the applicability of the 2004 regulations, and that currently only the District Court for the District of Minnesota has held that the regulations are invalid.

Proposed Legislative Relief for Cell Phones

Under current rules, the value of personal use of employer-provided cell phones and other mobile communications devices must be included in an employee's wages, and if record-keeping requirements are not met, the value of both business and personal use of the equipment is included in the employee's wages. While this rule is a problem for all employers and employees, section 501(c)(3) and 501(c)(4) organizations face an additional risk if the value of the personal use of cell phones and similar equipment is not properly documented as compensation for officers and other high-level employees. For these individuals, failure to properly document personal use of the equipment as compensation can result in "automatic" excess benefit transactions that are subject to excise taxes under the intermediate sanctions rules.

In 2008, Congress and the IRS acknowledged that the record-keeping requirements for cell phones and similar equipment date from a time when an employer-provided cell phone was an unusual fringe benefit and that the rules should be modernized. Several bills were introduced in the House and Senate that would eliminate the onerous record-keeping requirements for cell phones and similar equipment. None of the bills was passed, but they were widely supported and are likely to be reintroduced. In addition, the IRS indicated on its Priority Guidance Plan for 2008-2009 that it may provide simplified record-keeping procedures for cell phones and similar equipment.

Extension of Written Plan Requirement for 403(b) Plans

As of January 1, 2009, under new final regulations, sponsors of section 403(b) retirement plans were required to maintain a written plan that contains all of the material terms and conditions for eligibility, benefits, contribution limitations, and distributions. However, because many plan administrators expressed anticipated difficulties in meeting the January 1, 2009 deadline and because there currently is no program under which a plan sponsor can obtain assurance that the written form of its plan satisfies section 403(b) (other than through a private letter ruling), the IRS has extended the deadline for adopting new written plans or to amend existing plans. In Notice 2009-3, the IRS states that plans will be treated as meeting the requirements of 403(b) and the regulations during the 2009 calendar year if: (1) by December 31, 2009, the plan sponsor has adopted a written 403(b) plan that is intended to satisfy the requirements of 403(b) and the regulations; (2) during 2009, the plan sponsor operates the plan in accordance with a reasonable interpretation of 403(b) and the related regulations; and (3) by the end of 2009, the plan sponsor makes its best effort to retroactively correct any operational failure during the 2009 calendar year to conform to the written plan. The IRS plans to issue further guidance on 403(b) plans, including a revenue procedure establishing programs for 403(b) plans to obtain IRS approval of the plan documents and allowing plans to make remedial amendments to retroactively fix provisions under rules similar to those for 401(a) qualified plans.

IRS Guidance on Website Links to Political Content

A section 501(c)(3) organization that permitted a related section 501(c)(4) organization to post political campaign material on the 501(c)(3)'s website was found to have engaged in prohibited political campaign activity, according to an IRS "technical advice memorandum" issued in February 2009 (TAM 200908050). The section 501(c)(4) organization (which, unlike a section 501(c)(3) organization, is not banned from engaging in political campaign activity) shared a majority of its board of directors with the section 501(c)(3) organization and posted the material on the 501(c)(3)'s website after its own website had technical problems. However, because all of the 501(c)(4)'s content was posted on pages that included the 501(c)(3)'s logo, banner, disclaimer, copyright notice, as well as site links to information about the 501(c)(3), the IRS found that the 501(c)(3) was itself responsible for posting the material—which included candidate endorsements and candidate questionnaires—on its own website and therefore had engaged in prohibited political campaign activity. The fact that the section 501(c)(4) organization had reimbursed the related section 501(c)(3) organization for its share of the cost of the website did not change the conclusion. While a technical advice memorandum does not represent binding precedent, this guidance (as well as the IRS's activities during the election season, especially with respect to churches) demonstrates that the IRS is continuing to take seriously and monitor political activities of section 501(c)(3) organizations.

Reporting of Foreign Bank and Financial Accounts (Treasury Form 90-22.1)

In October 2008, the IRS released a revised version of Form TD F 90-22.1, *Report of Foreign Bank and Financial Accounts* (FBAR). The FBAR must be filed by any U.S. person, including a tax-exempt organization, with a financial interest in or signature authority over any foreign financial account (including an interest in a mutual fund) if the aggregate value of such accounts exceeds $10,000 during the calendar year. The recently revised 2008 Form 990 alerts tax-exempt organizations to their FBAR filing obligation with a question about foreign bank accounts in Part V (question 4). In addition, an employee of a tax-exempt organization who has signature authority over the employer's foreign account is required to acknowledge the account on Schedule B of the employee's individual Form 1040. The FBAR must be filed by June 30 after the calendar year in which the relationship existed. The penalty for non-willful failures to report the information required on TD F 90-22.1 can be up to $10,000.

Massachusetts Charities – Changes to Filing Requirements

For fiscal years ending on or after January 1, 2008, the filing threshold has been changed for Massachusetts charities required to file an accountant's review report with the Division of Non-Profits/ Public Charities. Charities that receive more than $200,000 in gross support and revenue (up to $500,000) during the fiscal year are required to submit a financial statement reviewed by a certified public accountant (the threshold for fiscal years ending before December 31, 2007 was more than $100,000). The threshold for submitting audited financial statements remains unchanged, and is required when gross support and revenue exceed $500,000.

Although charities with $25,000 or less in gross receipts may file a Form 990-N (e-Postcard) with the IRS, Massachusetts charities that file the Form PC must nevertheless file a completed IRS Form 990 or Form 990-EZ with the Division of Non-Profits/Public Charities, even if that form is not submitted to the IRS.

If you have any questions about this update, please contact your usual Ropes & Gray attorney or one of the following:

Lorry Spitzer	Carolyn Osteen	Kendi Ozmon
Peter Erichsen	Martin Hall	Morey Ward