Recent Developments and Trends for Exempt Organization

2013 was something of a lost year for the Exempt Organizations (EO) Division of the IRS. In the spring, the Division was embroiled in a controversy involving the targeting of conservative advocacy groups that led to the resignation or departure of no fewer than four high-level officials in the EO Division, together with the resignation of the Acting IRS Commissioner (and former head of the EO Division). Undaunted, in the fall the Division came back with a set of proposed regulations governing conservative *and* liberal advocacy groups, thus helping to forge a rare consensus across the political spectrum—disapproval of the proposed regulations.

This alert touches on those areas of the law that did change during the past year, whether by IRS action (e.g., new regulations governing tax-exempt hospitals) or Congressional inaction (e.g., expiring tax provisions affecting exempt organizations).

We start, however, with a look forward: a description of a tax reform proposal that is based on the understandable premise that what we have isn't working very well. Whether the proposals affecting exempt organizations are a step forward or a step back remains very much an open question.

A Look to the Year Ahead for Exempt Organizations

Ways and Means Chairman Releases Draft Tax Reform Package

On February 26, 2014, Ways and Means Committee Chairman Dave Camp released a comprehensive draft tax reform plan. As Chairman Camp promised, the draft reform plan's scope is broad and dramatic, including changes to individual and corporate rate structures, as well as specific changes to employment taxes, business deductions and credits, financial products, international tax, and tax administration.

Legislation implementing the draft reform plan is not expected to pass during this Congress. Members of both parties have indicated that there is limited interest in undertaking major tax policy changes before midterm elections in the fall. Nevertheless, the draft reform plan presumably will accomplish Chairman Camp's goal of generating discussion about tax reform, and proposals in the draft reform plan may reappear in future legislation.

The draft reform plan includes the following proposals of particular interest to tax-exempt organizations and their donors:

- *Limitations on Charitable Contributions:* An individual's charitable contributions could be deducted only to the extent they exceed 2% of the individual's adjusted gross income. Deductions for most contributions of real property would be limited to cost basis. The income-based percentage limit for certain charitable contributions to public charities and certain other organizations would be reduced from 50% to 40%.
  - The Obama administration is also taking a close look at the charitable contribution deduction. Following the trend of each of the President's budget proposals for the past six years, the Administration's budget proposals for fiscal year 2015 (released March 4) include a provision that would reduce the value of itemized deductions, including the charitable contribution deduction, for taxpayers in the 33%, 35% or 39.6% tax brackets.
- *Executive Compensation:* Tax-exempt organizations would be subject to a 25% excise tax on compensation in excess of $1 million paid to any of its five highest paid employees for the tax year.

- *College and University Investment Income:* Private colleges and universities with assets of at least $100,000 per full-time student would be subject to a 1% excise tax on net investment income.
- *Unrelated Business Income Tax (UBIT):* The draft proposes numerous changes to the UBIT rules. Particularly notable changes include (1) royalties from licensing an organization's name or logo would be subject to UBIT; and (2) losses generated by one unrelated trade or business could not be used to offset income derived from a different unrelated trade or business.
- *Supporting Organizations:* Supporting organization status would be eliminated for Type II and III supporting organizations.
- *Intermediate Sanctions:* The draft proposes a fundamental change to the intermediate sanctions rules, as tax-exempt organizations themselves (not just disqualified persons) would be subject to intermediate sanctions excise taxes for engaging in excess benefit transactions. Furthermore, investment advisors and athletic coaches would be treated as *per se* disqualified persons. In addition, the "rebuttable presumption" of reasonableness, which permits an organization that follows certain procedures in approving a transaction with a disqualified person to presume that the transaction is at fair market value, would be eliminated.
- *Private Foundations:* Private foundations would be subject to a 2.5% excise tax if an excise tax is imposed on a disqualified person under the self-dealing rules of section 4941 (currently no organization-level tax is imposed).[1] The section 4940 excise tax on net investment income would be reduced to 1%. Private operating foundations would be subject to the section 4942 excise tax on failure to distribute income, currently imposed only on private non-operating foundations.
- *Professional Sports Leagues:* Tax-exempt status for professional sports leagues would be repealed.

The Joint Committee on Taxation and the Staff of the Ways and Means Committee have both issued explanations of the draft tax reform plan.

Treasury Announces 2013-2014 Priority Guidance Plan—No Exempt Organizations Workplan Issued

In a departure from historical practice, the IRS Exempt Organizations (EO) Division did not issue its Annual Report and Workplan, which typically highlights the projects it carried out in the prior year and outlines those it intends to pursue in the coming year. As a result, we look to the Treasury Department's 2013-2014 Priority Guidance Plan to anticipate the EO initiatives for 2014.

Of particular interest, the IRS plans to issue guidance on co-investment arrangements between a private foundation and its disqualified persons (e.g., investments by a private foundation and one or more substantial contributors in the same pooled investment vehicle). The IRS has not yet issued any precedential guidance on how co-investment arrangements can be structured to avoid being classified as acts of self-dealing under section 4941. The Priority Guidance Plan also promises action on new excise taxes on donor-advised funds, added by the Pension Protection Act of 2006, although this item has also been on Treasury's Priority Guidance Plan since 2007.

No Extension of Temporary Charitable Tax Provisions

Congress regularly extends temporary tax provisions that are set to expire through tax extenders legislation. At the end of 2013, however, five temporary provisions of importance to charitable organizations and their donors expired and no extenders legislation has yet been passed. These include the following:

[1] All section references are to the Internal Revenue Code of 1986, as amended.

- The IRA charitable rollover, which allowed individuals over age 70½ to make donations of up to $100,000 per year directly to charitable organizations from their IRAs without including the amount in taxable income;
- A provision giving individuals who contribute S Corporation property to charity a more favorable basis adjustment;
- An enhanced charitable deduction for contributions of food inventory;
- An enhanced charitable deduction and extended contribution carryforward period for contributions of real property made for conservation purposes; and
- An exclusion from unrelated business taxable income (UBTI) of certain rents, royalties, annuities, and interest paid by a controlled organization to its exempt parent, which ordinarily would be considered UBTI pursuant to section 512(b)(13).

What will happen to these provisions has yet to be determined. Congress may (1) retroactively extend the provisions, (2) address the provisions as a component of broader tax reform legislation, or (3) allow the provisions to lapse permanently. For the full list of lapsed provisions, including individual, business, charitable, community assistance, and energy provisions, please refer to the Congressional Research Service Report.

A Look Back at Developments from the Past Year

IRS Releases New Guidance for Non-Profit Hospitals

In 2013, the Treasury Department and the IRS continued to roll out guidance in connection with the new requirements imposed on tax-exempt hospitals by section 501(r), enacted as part of the Affordable Care Act. Section 501(r) requires all tax-exempt "hospital organizations" to have certain policies and procedures in place for each "hospital facility" they operate, with failure to comply potentially resulting in loss of tax-exempt status and/or penalty excise taxes. A hospital facility includes any facility that is required to be licensed, registered, or similarly recognized as a hospital under state law.

Proposed Regulations on Section 501(r) Requirements

Proposed regulations issued in 2012 address the requirement that each hospital facility establish financial assistance and emergency care policies, and meet certain requirements with respect to limitations on charges and billing and collections activities. In April 2013, the Treasury Department released proposed regulations that provide guidance on the other major component of section 501(r), the community health needs assessment (CHNA) requirement, as well as other rules, including consequences of failing to comply with the requirements of 501(r) and the $50,000 excise tax imposed by section 4959 for failure to satisfy the CHNA requirement (for more information, see our alert here). The Treasury Department's 2013-2014 Priority Guidance Plan (discussed above) has listed issuing final regulations on the return and filing requirements for the section 4959 excise tax as a priority for this year. In December, in Notice 2014-2, the IRS also clarified that hospitals may rely upon the 2012 and 2013 proposed regulations in meeting the requirements of section 501(r) until final regulations, temporary regulations, or other guidance is released.

Proposed Procedures for Correction and Disclosure of Compliance Failures

A hospital's failure to comply with section 501(r) with respect to one or more hospital facilities it operates may result in the hospital's section 501(c)(3) status being revoked. The 2013 proposed regulations set forth guidelines for excusing certain minor, inadvertent errors and omissions. In December 2013, the IRS also issued Notice 2014-3 to address the process for excusing, through correction and disclosure, errors or omissions that rise above the level of being minor and inadvertent but that are neither willful nor egregious.

In general, a hospital may rely on the Notice to correct any failure to meet a requirement of section 501(r) that is not willful or egregious, provided that (1) corrective action is being taken and (2) the organization has disclosed the failure to the IRS. The corrective action should be reasonable and appropriate for the failure and should begin promptly after the failure's discovery. To satisfy the disclosure requirement, a hospital must report the following information on Schedule H of its Form 990: a description of (1) the failure, (2) the discovery, including the timing of the discovery, (3) the corrective action, and (4) the practices and procedures, if any, that were revised or newly established to minimize the likelihood of the type of failure recurring, and if no practices and procedures were revised or newly established, an explanation of why no changes were necessary. The Notice also provides that, even if failures are excused and the hospital is allowed to maintain its section 501(c)(3) status, the hospital may still be subject to the excise tax imposed by section 4959 for failure to satisfy the CHNA requirement.

IRS Colleges and Universities Report Focuses on Compensation and UBTI

The IRS released its long-awaited final report on its Colleges and Universities Compliance Project in April 2013. The project, which commenced in 2008, involved sending questionnaires to 400 colleges and universities and resulted in the IRS conducting 34 audits (for more information, see our alert here). The final report focused on two key compliance issues that emerged from the audits—compensation and UBTI—and suggested that the IRS intends to initiate compliance efforts in these areas. In particular, the IRS noted in the report that it plans to examine UBTI reporting more broadly and to ensure, through education and examinations, that tax-exempt organizations are aware of the importance of using appropriate comparability data when setting compensation.

With respect to compensation, the IRS focused on schools' efforts to establish the rebuttable presumption under section 4958 that compensation paid was reasonable and concluded that a number of schools did not meet the requirements of the "safe harbor" procedure set forth in the Treasury regulations. In particular, the IRS noted a number of weaknesses in the comparability data used by schools to establish the rebuttable presumption, including the inclusion of institutions that were not similarly situated and failure to specify in the comparability data whether the data included all elements of an individual's compensation. The report also noted that the IRS's audits resulted in wage adjustments for a variety of reasons, including personal use of vehicles, housing, social club memberships, personal travel, misclassification of employees as independent contractors, and issues related to deferred compensation.

With respect to UBTI, the IRS noted significant compliance issues, which resulted in increased UBTI to 90% of the examined schools. In particular, the IRS disallowed losses and net operating losses (NOLs) on 75% of returns examined. The most common reason for disallowance of losses and NOLs was that the claimed losses were connected with an activity for which the IRS concluded the school lacked a profit motive, as evidenced by years of sustained losses, and therefore did not qualify as a "trade or business" for UBTI purposes. The IRS also noted that UBTI adjustments resulted from the misallocation of expense deductions between related and unrelated business activities and the misclassification of activities as related or unrelated businesses.

Proposed Regulations Define Prohibited Political Activity for 501(c)(4) Social Welfare Organizations—Possible Implications for 501(c)(3)s

In November 2013, the IRS issued proposed regulations that would clarify which political activities do not promote social welfare under section 501(c)(4). To qualify as a section 501(c)(4) organization, an entity must be operated exclusively for the promotion of social welfare, which Treasury regulations interpret as requiring that the organization be *primarily* engaged in the promotion of social welfare. The current regulations exclude "direct or indirect participation or intervention" in political campaigns from activities promoting social welfare. As such, while a 501(c)(4) organization may engage in substantial amounts of political activity, such activity must not be its primary activity.

Under the current rules, what constitutes "direct or indirect participation or intervention" is based on a facts and circumstances test. The proposed regulations, by contrast, aim to provide a clearer standard by stating that direct or indirect "candidate-related political activity" does not promote social welfare and by defining such activity as including the following:

- Any communication that expressly or implicitly advocates supporting or voting for or against a candidate;
- Any public communication within 30 to 60 days of an election that identifies a candidate or any event where a candidate appears as part of a program;
- Contributions or solicitations of contributions for any candidate;
- Voter registration drives or "get out the vote" drives; and
- The distribution of material on behalf of a candidate.

The proposed regulations would apply only to section 501(c)(4) organizations and are not intended to affect the types of activities that would be prohibited as political activity under section 501(c)(3). However, the IRS and Treasury have requested comments on whether the same or similar rules should apply to other types of tax-exempt organizations. In particular, some of the activities that would be treated as political activity for 501(c)(4)s are expressly permitted for 501(c)(3)s, such as voter registration drives. The IRS has received over 110,000 comments, most of them negative, regarding the proposed regulations. Both conservative and liberal groups have criticized the proposed rules, with the general concern that the rules are too sweeping in the activities defined as constituting candidate-related political activities, and thus not constituting social welfare activities. On February 26, the House passed legislation, largely on party lines, that would delay by one year the implementation of the new rules.

Self-Declarer Questionnaire for 501(c)(4), (5), and (6) Organizations

Unlike section 501(c)(3) organizations, section 501(c)(4), (5), and (6) organizations are not required to apply to the IRS for recognition of their tax-exempt status. Rather, they may "self-declare" and simply file the appropriate Form 990 with the IRS at the end of their tax year.

In response to concern about improper self-declarations, the IRS sent informational questionnaires to 1,300 self-declared organizations in 2013. The IRS indicated that the purpose of the questionnaire was to increase voluntary compliance by allowing the IRS to understand both what types of organizations self-declare and also how the statutory exemption requirements are satisfied.

The questionnaire was not mandatory, and only the organizations that received a letter from the IRS were permitted to complete it. As has been the case with previous questionnaires, if an organization chose not to submit the questionnaire, no automatic penalty was applied, but the IRS noted it might refer the organization for an examination or audit. We now await the IRS's report on its findings, although the IRS has historically taken a good deal of time to issue reports resulting from informal questionnaire projects.

Guidance regarding Type III Supporting Organizations

In December, the IRS issued Notice 2014-4, which provides interim guidance for Type III supporting organizations (SOs). In particular, the guidance:

- Provides interim rules pursuant to which an organization may qualify as a functionally integrated Type III SO of one or more governmental organizations, an area left unresolved by final regulations released in 2012 (for more information about the final regulations, see our alert here).
- Permits private foundations and donor-advised funds to continue to rely on the guidance of Notice 2006-109 for purposes of determining whether a grantee organization is an SO, including obtaining a written representation from the grantee organization or relying upon a reasoned opinion of counsel. To determine that a grantee is a functionally integrated Type III SO, the representation or opinion of counsel must demonstrate that the grantee meets the requirements in the 2012 final regulations or the interim rules for supporting governmental organizations set forth in Notice 2014-4.

New Procedures for Reinstatement of Tax-Exempt Status after Automatic Revocation

At the beginning of 2014, the IRS released Revenue Procedure 2014-11, which provides guidance for the reinstatement of tax-exempt status of organizations whose exemptions were automatically revoked under section 6033(j)(1) for failing to file their required annual information returns or notices for three consecutive years. The guidance presents three alternative procedures for seeking reinstatement of an organization's tax-exempt status retroactively to the date that the exemption was revoked. The procedure available to a particular organization will depend on the organization's size and the period of time that has elapsed since its tax-exempt status was revoked. The IRS has been inundated with exemption applications as a result of the Pension Protection Act of 2006 provision that requires the IRS to revoke the exempt status of any organization that is required to file an annual return (Form 990, 990-N, 990-EZ, or 990-PF) but has failed to do so for three consecutive years, and processing times for most exemption applications have slowed considerably. The objective of the Revenue Procedure is to simplify the process of obtaining retroactive reinstatement of tax-exempt status, particularly for smaller organizations, and to expand the group of organizations eligible for retroactive reinstatement rather than reinstatement as of the date the organization reapplies for tax-exempt status.

Potential Additional Form 990 Reporting for Organizations Using Schedule B "Special Rule"

In October, the IRS released final instructions for Form 990 for tax years beginning in 2013. Notably, the instructions "clarify" the required reporting of contributors on Schedule B for certain 501(c)(3) organizations. As in prior years, the final instructions allow certain 501(c)(3) organizations that meet the 33⅓% public support test of sections 509(a)(1) and 170(b)(1)(A)(vi) to limit disclosure in Schedule B to only those contributors who provided contributions equal to the greater of $5,000 or 2% of the organization's total gifts, grants, and contributions. However, in a departure from prior years, the instructions now expressly limit this special reporting rule to organizations that check one of the boxes on Schedule A indicating that they satisfy the public support test (or check the box indicating that they are still within their first five years of existence). Absent further guidance on these instructions from the IRS, organizations that use this special rule for Schedule B and have not completed the Schedule A support schedule in prior years (such as universities and hospitals) should be prepared to compile the necessary information to check the relevant box on Schedule A for tax years beginning in 2013.

Selected State Level Developments

New York Enacts Major Nonprofit Legislation

Following a number of high-profile news stories involving nonprofits, New York enacted the Non-Profit Revitalization Act of 2013, which changes many requirements applicable to domestic and foreign nonprofits that conduct activities in New York (for more information, see our alert here). Among a number of governance-related changes, the Act prohibits a nonprofit's governing board from entering into a "related party" transaction unless it has determined that the transaction is fair, reasonable, and in the nonprofit's best interests. In addition, the Act generally prohibits individuals who may benefit from compensation paid by a nonprofit from participating in board or committee deliberations or votes concerning such compensation, mandates that all nonprofits adopt a conflict of interest policy, and requires that nonprofits with over $1 million in annual revenues and 20 or more employees adopt a whistleblower policy. The Act also imposes several changes intended to strengthen the financial oversight of nonprofits. In particular, the Act requires that the "independent directors" of a nonprofit with annual revenues over $500,000 that is required to register in New York to conduct charitable solicitations oversee the organization's accounting and financial reporting, including its audits, and imposes additional audit oversight requirements on nonprofits with annual revenues over $1 million. Other changes are intended to simplify or modernize certain nonprofit operations, including simplification of the approval process for nonprofit merger or consolidation plans. The Act will generally become effective July 1, 2014.

New York Attorney General Enters $7.7 Million Settlement with Company Foundation

The New York Attorney General (AG) announced in late 2013 that it entered into a $7.7 million settlement agreement with the Pearson Charitable Foundation (the Foundation), a private charitable organization affiliated with the for-profit education company Pearson, Inc. (Pearson). The settlement followed an investigation by the AG into the Foundation's alleged misuse of its charitable assets for the benefit of Pearson and serves as a reminder of the importance of maintaining appropriate safeguards between a company foundation and its corporate sponsor. The AG stated that its investigation revealed that Pearson developed educational course materials through the Foundation, which Pearson intended to sell commercially, in order to attract foundation support and credibility for its commercial products. In addition, the Foundation provided grants in support of and helped organize conferences that the AG determined benefited Pearson's business. The Foundation did not admit or deny these findings, but agreed to pay $7.7 million to resolve the investigation as well as implement several programmatic and governance reforms. In particular, the settlement requires that the Foundation include at least three independent directors on its board of directors and, for three years following the settlement, obtain AG approval of such individuals. Foundation transactions that could reasonably be expected to benefit Pearson will also require a finding by the independent directors that the transactions are fair, reasonable, and in the best interests of the Foundation.

Massachusetts Attorney General Releases Charity CEO Compensation Report

The Non-Profit Organizations/Public Charities Division of the Massachusetts Office of the Attorney General released its results of a "focused review" of CEO compensation at 25 of Massachusetts' largest charities, primarily within the health care and higher education sectors (for more information, see our alert here). Among other observations, the Division concluded in its report that compensation at the charities was "generally high" and expressed a particular interest in retirement compensation. The Division also announced that a new Schedule EC, requiring more detailed information about CEO compensation, will be made part of the annual Form PC that charities file in Massachusetts. It is possible that the new schedule will be released early this year.

Massachusetts Property Tax Exemption Case Raises Novel Conservation Questions

A recent decision of the Massachusetts Appellate Tax Board (ATB), *New England Forestry Foundation, Inc. v. Board of Assessors of the Town of Hawley*, denying property tax exemption to a nonprofit conservation organization largely on the grounds that the organization failed to promote regular public access to its property, has raised concerns among the conservation community that the case could establish a troublesome precedent. The case arose following a Western Massachusetts town's refusal to abate property tax on a 120-acre parcel of forestland owned by the New England Forestry Foundation, Inc. (NEFF), a Massachusetts-based conservation organization that holds the land open to the public and maintains the land primarily for the purposes of conservation and demonstration of sustainable forestry practices. Massachusetts law exempts from taxation real estate owned and occupied by a charitable organization for the purposes for which it is organized. The ATB concluded, however, that NEFF was not entitled to exemption because land conservation is not a "traditionally charitable" activity, because NEFF had not ensured a sufficient level of public access to the property, and because land conservation does not constitute an "active appropriation" of land to a charitable purpose. Ropes & Gray represented NEFF on a pro bono basis in connection with its appeal of the case to the Massachusetts Supreme Judicial Court (SJC). The SJC held oral arguments in January 2014 and is expected to issue an opinion later this year. In particular, NEFF has noted that the question of whether a charitable conservation organization is entitled to property tax exemption for its conservation lands is a matter of first impression for the SJC. NEFF has argued that the ATB's "public access" requirement has no statutory basis and has stressed that requiring public access to conservation lands could undermine organizations' charitable efforts to preserve the properties.

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Please do not hesitate to contact Lorry Spitzer, Kendi Ozmon, Morey Ward, Gil Ghatan, Sarah Tomeo Hertzog, or your usual Ropes & Gray attorney, if you have any questions.

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IRS Circular 230 Notice

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