Recent Developments and Trends for Exempt Organizations

Recent months have been eventful for exempt organizations and their advisors. While fundamental tax reform remains a possibility, with a number of proposals on the table that would significantly change the rules for exempt organizations, Congress has also acted to protect the *status quo*, extending certain expiring provisions of interest to exempt organizations and their donors, but only through the end of 2014. Meanwhile, the IRS has struggled to keep up and by early 2014 the processing of tax exemption applications had seemingly slowed to a crawl. In response, the IRS Exempt Organizations Division sought to implement a "Lean Six Sigma" strategy designed to eliminate various forms of waste, or "muda." The result was a streamlined application process designed to clear much of the existing inventory of applications. While perhaps somewhat unusual for the IRS to be adopting Lean Six Sigma strategies (next year it might re-brand itself as a "disruptive" enterprise), the streamlining seems to be working and the processing of applications has sped up dramatically. The states, meanwhile, have themselves stepped into the exempt organizations fray with important developments in New York, California and Massachusetts.

Federal Legislative Developments

Tax Extenders

In December, Congress once again approved tax extenders legislation (H.R. 5771) that retroactively reinstated nearly 50 tax provisions that had previously expired at the end of 2013. While taxpayers may rely on these provisions when preparing their tax returns for the 2014 tax year, the provisions expired again on December 31, 2014, which means further legislative action will be necessary for the provisions to apply in the current tax year. A number of these provisions were relevant to tax-exempt organizations, including the following:

- the IRA charitable rollover, which allows 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
- a limited 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).[1]

Tax Reform

In December, House Ways and Means Committee Chair Dave Camp formally introduced the Tax Reform Act of 2014 (H.R. 1) in the House of Representatives. The bill is identical to a draft tax reform plan released in February 2014 and includes numerous proposals that, if enacted, would have significant impact on tax-exempt organizations and their donors. See our previous Alert for a summary of these proposals.

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

In January, Senate Finance Committee Chair Orrin Hatch and Ranking Member Rob Wyden announced the creation of five tax reform working groups to study the following broad areas: (1) individual income tax; (2) business income tax; (3) savings and investment; (4) international tax; and (5) community development and infrastructure. The working groups will prepare comprehensive analyses of these tax areas in conjunction with the Joint Committee on Taxation to prepare for a possible overhaul of the tax code. The working groups are expected to issue their reports by the end of May of this year.

America Gives More Act

In February, the House of Representatives passed the America Gives More Act of 2015 (H.R. 644), which would:

- permanently extend the IRA charitable rollover;
- permanently extend the enhanced charitable deduction and extended contribution carryforward period for contributions of real property made for conservation purposes;
- reduce the excise tax on the investments of large private foundations from a 2% rate to a 1% rate; and
- permanently extend and expand the charitable deduction for contributions of food inventory.

The legislation must still be passed by the Senate, and no timeline has yet been set for the Senate to vote on the bill.

IRS/Treasury Developments

Priorities for Exempt Organizations

For the second year in a row, the IRS Exempt Organizations (EO) Division did not issue its Annual Report and Workplan, which in previous years highlighted the projects it intended to pursue in the coming year. While the Tax Exempt and Government Entities Division released a program letter discussing how the division will be administered during 2015, the letter did not identify substantive projects upon which the EO Division will focus.

At a recent conference, the Director of the EO Division, Tamera Ripperda, commented publicly that the IRS will shift its approach in examinations to focus on data-driven analysis of specific compliance issues, rather than undertaking projects to examine a specific segment of the EO sector, such as group exemptions or supporting organizations. In explaining the new approach, Ms. Ripperda commented that the IRS's new "issue-focused strategy" would be used to identify cases for examination, and noted that such issues included protecting charitable assets, the tax gap, the unrelated business income tax, excise taxes and international activities.

Additional insights into EO initiatives for 2015 are found in the Treasury Department's 2014-2015 Priority Guidance Plan. Identified priorities include:

- new regulations related to political campaign intervention by section 501(c)(4) organizations, as well as organizations exempt under other subsections of 501(c);
- guidance on the implication of the "self-dealing" rules when a private foundation co-invests in a partnership with disqualified persons;
- guidance on how to allocate expenses for facilities that are used both to carry on exempt activities and to conduct unrelated trade or business activities;
- additional guidance on section 509(a)(3) supporting organizations; and

- guidance on the excise tax provisions related to donor-advised funds.

New Location (and Fees) for IRS Rulings

In December 2014, the IRS announced that, beginning in January, the Office of Associate Chief Counsel (Tax Exempt and Government Entities) would assume responsibility for preparing much of the guidance affecting tax-exempt organizations, including revenue rulings, revenue procedures, announcements, notices, technical advice memoranda, certain letter rulings, and certain information letters. These responsibilities were previously carried out by the IRS Tax Exempt and Government Entities Division. As a result of the realignment, exempt organizations will be required to pay substantially higher user fees when requesting rulings from the IRS – for example, the cost of some types of private letter rulings has increased from $10,000 to $28,300.

IRS Releases Streamlined Application for Section 501(c)(3) Status

During the summer, the IRS released Form 1023-EZ, a streamlined application for 501(c)(3) tax-exempt status, in an effort to alleviate its backlog of unprocessed applications. In comparison to the standard Form 1023, Form 1023-EZ is shorter (only three pages long) and does not require an organization to provide disclosures, instead relying upon affirmations by the organization that it complies with the requirements for 501(c)(3) status. Form 1023-EZ is only available for relatively small organizations – those whose assets do not exceed $250,000 and whose annual gross receipts do not exceed $50,000 – and may not be used by certain types of organizations, such as supporting organizations, hospitals, schools, and private operating foundations.

Developments for Health Care Organizations

Guidance for Tax-Exempt Hospitals on Section 501(r) Compliance

At the end of 2014, final regulations were released under section 501(r). Enacted as part of the Patient Protection and Affordable Care Act in 2010, section 501(r) requires tax-exempt hospital organizations to conduct community health needs assessments (CHNAs) and establish certain policies and procedures for each hospital facility, including a financial assistance policy (FAP) for low-income patients, written policies for the provision of emergency care, and limitations on charges and collection activities for individuals eligible for the FAP. The final regulations apply to taxable years beginning after December 29, 2015; until then, hospital organizations may rely on a reasonable, good faith interpretation of section 501(r).

Among other provisions, the final regulations:

- provide detail about how a hospital facility may solicit input when developing a CHNA, which health needs may be considered, and how joint CHNAs may be developed with others;
- clarify that multiple hospital facilities may have identical FAPs, billing and collection policies, and/or emergency medical care policies established for them (or may share one policy document);
- specify how hospitals are to calculate limits on charges for emergency or other medically necessary care provided to FAP-eligible individuals;
- enumerate the types of activities that are (and are not) considered extraordinary collection actions; and
- provide additional guidance on the consequences of failing to satisfy the requirements of section 501(r) and how to correct certain minor errors.

A more detailed summary of the final regulations is found in our Alert on this topic.

In addition, on March 10, 2015, the IRS released Revenue Procedure 2015-21, which provides guidance on how hospital organizations can correct failures to meet the requirements of section 501(r) and thereby avoid losing tax-exempt status. A correction must be made as promptly as is reasonable after the hospital organization discovers the error. To the extent reasonably feasible, the correction must be made with respect to all affected individuals and must restore those individuals to the positions in which they would have been had the failure not occurred. The hospital organization must also establish or modify practices and procedures, as necessary, to avoid future failures. Finally, the hospital organization must disclose and describe the failure, the correction and any policy or procedure changes on its publicly available Form 990.

IRS Releases Final Guidance for Section 501(c)(29) Health Insurers

Enacted as part of the Patient Protection and Affordable Care Act, section 501(c)(29) provides a basis for tax exemption to certain qualified nonprofit health insurance issuers that offer qualified health plans in the individual and small group markets and that receive a loan or grant under the Center for Medicare and Medicaid Services' (CMS) Consumer Operated and Oriented Plan program. Among the requirements for obtaining tax exemption under section 501(c)(29) is giving notice to the IRS. In January, the IRS issued final guidance in the form offinal regulations and Revenue Procedure 2015-17 regarding the manner for providing such notice. This final guidance tracks earlier proposed regulations and an accompanying revenue procedure issued in 2012 without any substantial changes, requiring that applications be made by letter to the IRS rather than pursuant to a published form and including, among other information, a copy of both the Notice of Award issued by CMS and a fully executed loan agreement with CMS.

Forgivable Loans

The topic of employer-issued "forgivable loans" is one we have received numerous inquiries about recently, brought on, in part, by the relatively recent decision in *Vancouver Clinic, Inc. v. U.S.* (W.D. Wash, 2013). In that case, the District Court for the Western District of Washington held that a loan extended to an employee and forgiven after the employee completed a specified period of service constituted current (as opposed to deferred) compensation includible in the employee's income at the time of the loan, based on the reasoning that the loan was never expected to be repaid. This decision follows IRS Technical Advice Memorandum 20004004 in which the IRS took the even tougher stance that a loan made in connection with a deferred compensation arrangement that was structured to pay back the loan constituted a forgivable loan giving rise to current income to the employee at the time the loan was made. Employers issuing forgivable loans to their employees should take note of the IRS's restrictive view of these arrangements, a view that has now been adopted by a district court.

Sports-Related Developments

Two recent decisions threaten to shake up the world of collegiate athletics, potentially changing the tax treatment of athletic scholarships and of university athletics more generally. Last spring, a National Labor Relations Board (NLRB) regional director in Chicago ruled that Northwestern University football players receiving university scholarships were employees of the university and as such had to be permitted to unionize. A few months later, the District Court for the Northern District of California in *O'Bannon v. NCAA* held that certain NCAA rules violate anti-trust laws because they prevent student athletes from receiving compensation for the use of their names and likenesses.

Currently, a "qualified scholarship" does not constitute income to the recipient for federal income tax purposes, while additional scholarship amounts (most notably, amounts used to pay for room and board), though technically taxable income to the recipient, are exempt from IRS information reporting requirements.

The NLRB decision, which was based in part on the fact that student athletes' scholarships are frequently tied to their continued participation in university athletics, raises the possibility that athletic scholarships will be considered payment for services rendered by the student athletes and, as a result, not qualify for tax-free treatment. Even absent such complete recharacterization, the additional amounts payable to student athletes as a result of *O'Bannon* would likely fall outside the existing reporting exemptions, and payment of such amounts would therefore add significant administrative and reporting obligations for schools. Going even further, the perception that collegiate athletics are becoming increasingly commercial in nature – a perception no doubt bolstered by the recent decisions – may lead the IRS to revisit its efforts to treat revenue from collegiate athletics as UBTI in the hands of the recipient universities.

Continued Focus On Section 501(c)(4) Organizations

The fallout continues from the IRS's controversial handling of applications for section 501(c)(4) "social welfare organization" status. After allegations that the IRS targeted conservative political groups for heightened scrutiny led to the departure of a number of senior officials and several lengthy and ongoing investigations, the IRS issued proposed regulations in late 2013 designed to clarify which political activities do not promote social welfare under section 501(c)(4). The proposed regulations greatly expanded the scope of activities considered political and met with fierce criticism from both liberal and conservative groups and commentators alleging that the regulations threated tax-exempt organizations' freedom of speech. After receiving a record number of comments (almost 170,000), most of them negative, the IRS withdrew the proposed regulations last spring.

The IRS intends to issue a new set of proposed regulations this year that is likely to apply not only to 501(c)(4) organizations, but to other 501(c) entities as well. According to IRS Commissioner Koskinen, the revised proposed regulations would further clarify the amount of political activity in which these organizations would be permitted to engage without jeopardizing their tax-exempt status. Dissatisfied with the IRS's actions, lawmakers in both chambers of Congress have also introduced legislation aiming to prohibit the IRS from changing the standard it applies to political activities of section 501(c)(4) organizations until the end of 2017. Similar legislation introduced last year passed in the House, but stalled in the Senate.

Form 990 Developments

Supporting Organizations

Beginning with the 2014 Form 990, supporting organizations will be required to complete a new, detailed four-page addition to Form 990 Schedule A (Public Charity Status and Public Support), intended to solicit information regarding compliance with the hornet's nest of rules applicable to supporting organizations. Aside from imposing new obligations on supporting organizations, the new components to Schedule A bring together in one place a comprehensive checklist for supporting organizations of the rules by which they need to operate.

Interested Person Transactions

The 2014 instructions to Schedule L (Transactions with Interested Persons) make significant changes to the definition of an "interested person," which are likely to simplify the reporting obligations of organizations that engage in business transactions with entities with which their officers or directors are affiliated. For purposes of the 2013 Form 990 and for prior years, business transactions with "interested persons" included transactions with any entity in which a current or former officer, director, trustee, key employee, or family member served as an officer, director, or trustee, held a greater than 5% membership interest (in a partnership or LLC), or was a greater-than-5% shareholder (in a professional corporation). Beginning with the 2014 Form 990, such an entity is not considered an "interested person" for Schedule L purposes. In addition to reducing the reporting burden for purposes of Schedule L, this change may affect an organization's tally of its independent directors for Form 990 purposes since a director is not considered independent if, among other things, he or she is involved in a transaction that would be reportable on the Schedule L of the organization, or a related organization. Note, however, that a greater-than-35% controlled entity is still considered an interested person for Schedule L reporting purposes, and so transactions with an entity that is more than 35% controlled by one or more directors is still reportable on Schedule L and will continue to render a director "non-independent" for Form 990 reporting purposes.

Donor Disclosure Rules

There is a special reporting rule on Schedule B (Schedule of Contributors) that permits certain publicly supported organizations to limit disclosure of specific donors 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. The 2013 Form 990 suggested organizations that rely on this special rule might be required to complete the public support schedule on Schedule A, even if they otherwise would not do so (because, for example, they file as universities or hospitals). The instructions to the 2014 Form 990 resolve any possible ambiguity that existed on this question and specifically require any organization that relies on the special rule (and that is not within the first five years of its existence) to complete the public support schedule to demonstrate that it qualifies as a section 170(b)(1)(A)(vi) publicly supported charity.

State Developments

New York Nonprofit Law Legislation Takes Effect

The New York Non-Profit Revitalization Act of 2013, which enacted many changes applicable to nonprofits that are formed in or conduct activities in New York, generally took effect on July 1, 2014, although certain provisions relating to the financial oversight of nonprofits became effective on January 1, 2015 (for more information, see our earlier Alert). Among the changes that became effective in 2015 is the requirement that a nonprofit with annual revenues over $500,000 (that is required to register in New York to conduct charitable solicitations) have its accounting and financial reporting functions and audits of its financial statements overseen by "independent directors." In addition, a nonprofit with annual revenues greater than $1,000,000 must now review and discuss with its independent auditor: the scope and planning of the audit prior to its commencement, any material risks and weaknesses in internal controls identified by the auditor, any restrictions on the scope of the auditor's activities, significant disagreements between the auditor and management, and the adequacy of the nonprofit's accounting and financial reporting process.

New Attorney General in Massachusetts – Charities Agenda Still Under Development

Maura Healey was sworn in as the new Attorney General of Massachusetts in January and immediately set to work by opposing nonprofit health system Partners HealthCare's plan to expand by acquiring additional hospitals. Partners has since withdrawn its bid to acquire South Shore Hospital. Attorney General Healey has restructured her office into six bureaus, including the Health Care and Fair Competition Bureau, of which the Public Charities Division is now a part. Mary Beckman, current Chief of the Public Charities Division, has been named head of the Health Care and Fair Competition Bureau. Ms. Beckman's successor as the Chief of Public Charities Divisions has not yet been announced. Attorney General Healey's priorities in the charities area – beyond her interest in the activities of nonprofit health care organizations – have not yet been announced.

California Revokes Blue Shield's Tax-Exempt Status

In March, it came to light that California's Franchise Tax Board had revoked the state income tax exemption of non-profit health insurer Blue Shield of California. Blue Shield has for years been subject to federal income tax, and is now in the position of paying state income tax (reportedly tens of millions of dollars for 2013 and 2014). This action reflects a growing trend among state and local governments to seek tax revenues from non-profit organizations, including when such organizations are exempt from taxation at the federal level (for example, property taxation of non-profit hospitals).

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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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