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The 2011 Form 990: More than Simple Tinkering at the Margins

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While recent changes to the Form 990 make it more reader friendly, filing organizations must carefully review it for substantive changes to determine the impact on their reporting requirements, particularly tax-exempt hospitals filing Schedule H.

On January 21, 2012, the Internal Revenue Service (IRS) released an updated Form 990 for fiscal year 2011 (*i.e.*, forms for fiscal years beginning on or after January 1, 2011, to be filed in 2012). This version is more reader friendly, resizing questions to fit on one line of text, eliminating redundancies and trimming "of" phrases. Substantively, the revised form updates financial data reporting requirements for joint ventures and investment partnerships, clarifies governance and compensation disclosures, and expands Schedule H reporting for tax-exempt hospitals. These changes modify or clarify various reporting items as the exempt organization sector grows increasingly familiar with the redesigned 990 format. Filing organizations should evaluate the changes to Form 990 and determine the impact on their reporting requirements.

Financial Reporting of Joint Ventures

An organization must proportionately report the activities of a joint venture, partnership, limited liability company or any entity treated as a partnership for federal tax purposes (collectively, a "joint venture") as its own activities based on its ownership interest in the entity. On prior forms, organizations could rely on their own books and records to report how joint venture activities affected their financial statements. Now, for Core Form, Parts VIII and IX, organizations must report their distributive share of joint venture income and expenses using Form 1065, Schedule K-1. Further, the instructions for Part X, Balance Sheet, Line 12, explain that the organization should report its distributive share of assets according to its ending capital account as reported on Schedule K-1. Filers should use information from the Schedule K-1 for the joint venture's tax year ending with or within the organization's tax year. If a Schedule K-1 is unavailable, the instructions to Schedule H permit hospitals to use other business records to make reasonable estimates, including the most recently available Schedule K-1. The IRS should consider adding such flexibility to the financial reporting requirements.

Governance

In Part VI of the Core Form, it is more apparent that questions use past tense—changing 2010's "does" to 2011's "did"—to reinforce that governance questions are backward-looking. The policies and procedures at issue are those that were in place as of the last day of the filing organization's tax period, not those that have been implemented after the end of the tax period but before the 990 filing deadline.

- **Governing Body Voting Rights.** The face of Section A, Line 1a, has been modified to request additional information about governing body voting rights. Organizations must explain in Schedule O if there are material differences in voting rights among governing body members or if the governing body has delegated broad authority to another body, like an executive committee. While the 2010 instructions directed organizations to provide the same explanation, the IRS has clarified this issue by moving the instruction to the form's face. The instructions also clarify that governing bodies may consist of one or more persons.

- **Broadening and Clarifying Independence.** In a significant relaxation of the independence standards for board members, directors remain independent even though they, or a family member, serve as "key employees" of an entity engaged in a Schedule L business transaction with the filing organization. Before 2011, such directors would have lost their statuses as independent members of the governing body. Also, perhaps in a nod to the growing practice of compensating tax-exempt organization board members, the IRS added three new examples to the Line 1b instructions that explore independence issues for a compensated board chair. The examples clarify a director's independence survives even when he or she receives compensation as a board member. If, however, the director is compensated as an officer or for non-director activities, then that director's independence is compromised.

- **Reporting Business Relationships.** Organizations must report business relationships between and among their officers, directors, trustees and key employees (ODTKEs) on Line 2. In a change that will, at minimum, simplify annual board questionnaires, the IRS has modified the definition of "business relationship" to exempt business relationships from reporting where the ODTKE is merely a key employee of the other organization. This exemption also extends to indirect transactions,

and the term key employee has been removed from Examples 2 and 5 in the instructions. By relaxing the business relationship reporting standards the IRS has made it easier to meet the "reasonable effort" threshold, which organizations are encouraged to meet when gathering information from third parties for the Form 990.

- **Members are not Board Members.** The instructions to Line 6 clarify members do not include governing body members. Although the instructions define member to include any person who has the right to participate in the organization's governance, here, the IRS is focusing on corporate entities or individuals with governance authority other than the filing organization's board members.

- **The Power of Members, Stockholders or Other Persons.** Line 7a was amended to more closely mirror language used in the instructions. The question asks if the organization had members, stockholders or other persons "who had the power to elect or appoint one or more members of the governing body," bringing to the form's face language that has appeared in the instructions since the form's 2008 overhaul. Line 7b has been expanded to ask if members, stockholders or other persons exercise reserved powers over the filing organization's governance decisions. Probing to identify the possible, the instructions provide that reserved powers over governance decisions must be reported even if no such decision was made during the tax year. For example, if the members have reserved authorities over dissolution determinations, the filing organization must report that authority whether or not the governing body considered dissolution alternatives during the reporting period.

- **Governance Policies Generally.** The general Section B instructions clarify an organization may answer "yes" to policy-related questions if either its board or a board-delegated committee adopted the policy during the reporting period. Previously, the instructions forbade organizations from "yes" answers if departments or committees, not the board, had adopted the policy. Also, the instructions condition "yes" answers on that adopted policy applying to the entire organization, not on a department-wide or division-wide level.

- **Board Review of Form 990.** The IRS expressly requires a "no" answer to Line 11 (asking if a copy of Form 990 was provided to all board members before it was filed) if the organization merely informed its board members that the Form 990 was available upon request. To answer "yes," filing organizations must be more proactive and encourage their board members to review the form.

- **Compensation Review Process.** The instructions to Line 15 (which asks whether the organization reviewed and approved executive pay in a manner that satisfied the three-part rebuttable presumption of reasonableness process) clarifies that organizations should answer "yes" only if the three-part review process was applied "during the tax year." Not all filing organizations conduct full-blown rebuttable presumption compensation reviews during each tax period. In fact, organizations may rely on comparability data for two or three years between review cycles. Such organizations must answer "no" on Line 15 during off-cycle years. These filers would be well-served to fully explain their compensation determination process in Schedule O.

Also, a change to the Glossary's definition of "significant disposition of net assets" has governance implications. The definition has been revised to exclude grants or other assistance made in the ordinary course of the filing organization's exempt activities to accomplish the organization's exempt purposes. As an example, the Glossary sites regular charitable distributions to the United Way or another federated fundraising organization. For organizations that require a finance committee, or that reserve to their corporate members decision-making authority over significant dispositions of assets, this language may provide for flexibility.

Compensation—Core Form and Schedule J

The 2011 Form 990 also provides a number of clarifications surrounding the reporting of various pieces of compensatory income.

- **Positions Held.** The instructions clarify that, when reporting the "position" (*i.e.*, officer, key employee, highly compensated employee, etc.) of any person required to be reported on Part VII, only one position should be checked unless the person was both an officer and a director/trustee for the organization in the same tax year. As such, if several descriptors could apply to a reportable person, the organization should instead check the one that is most representative of why that person is included in the chart.

- **Reportable Compensation Totals.** With respect to reportable compensation in Columns D or E of Part VII, the instructions now clarify the organization is required to report the larger amount of Box No. 1 or Box No. 5 of Form W-2 for that person, for that tax year. The difference in these two boxes results when income taxation occurs at a different time than the FICA taxation. Requiring that the organization report the greater of these two amounts in any tax year means the reportable amounts will always be reported as early as possible in Part VII.

- **Short Years.** When a short-year return is required for reporting purposes, unless there is a calendar year that ends with or within the short-year end date, Columns D and E of Part VII should be left blank. However, if the short-year return is the final return year for the organization, then Columns D and E of Part VII should be completed even if the final Forms W-2 of Forms 1099-MISC have not yet been issued.

- **Short-Term Deferrals.** With respect to deferred compensation that is required to be reported in Column F, the instructions now clarify that compensation paid within two and a half months of the end of the tax year (and thereby meets the "short-term deferral exception" of Code Section 409A) should NOT be reported in Column F because, based on qualification under the exception, that income does not constitute "deferred compensation." Instead, those amounts would simply appear on the following year's Form W-2 as reportable compensation in Column D or E.

- **Defined Benefit Accruals.** With respect to deferred compensation plans that are defined benefit arrangements, Column F should include the actuarial increase or decrease in that particular accrued benefit from one year to the next. However, when determining whether this same reportable person must be disclosed on Schedule J of Form 990 (*i.e.*, whether the person received or accrued income in excess of $150,000 of reportable compensation during the year), the instructions clarify that decreases in actuarial values are to be disregarded and ignored. In theory, this rule would even out inclusion in one year and exclusion in another due to mere fluctuations in interest rates when making computations.

- **Elimination of Transition Rule for Non-Code Section 501(c)(3) Organizations.** Before 2011, organizations other than Code Section 501(c)(3) organizations were not required to report any "former" highly compensated employees. For 2011 the IRS has eliminated that rule, and all organizations filing a Form 990 are now required to report any persons qualifying as former highly compensated employees.

- **Independent Contractors.** For independent contractors reported in Part VII, Section B, of the Core Form, the instructions now clarify the contractor's compensation should be reported based on the calendar year compensation (*i.e.*, Form 1099-MISC from the organization) that ends on the last day of the tax year or ends within the filing organization's reportable tax year.

- **Compensation Approval Practices.** Schedule J, Part I, Line 3, which asks check-the-box questions about an organization's CEO compensation approval practices, now clarifies organizations should "not check any boxes for methods used by a related organization to establish compensation of the CEO/Executive Director." While leaving these boxes unchecked might support a negative inference, many organizations that only complete Schedule J to report the compensation practices of their related organizations already leave blank Line 3. All filing organizations are encouraged to provide a narrative explanation in Part III of Schedule J, which has been expanded to solicit descriptions from additional Part I and Part II questions.

Schedule H

The 2011 Form 990 also makes significant changes to Schedule H for hospital reporting. For purposes of Schedule H, the definition of hospital and hospital facility has been amended throughout to remove references to the Secretary's authority under Section 501(r)(2)(A) to determine if a facility has the provision of hospital care as its principal function or purpose. Now the Schedule H definition looks only to state law licensure requirements. The definition of hospital and hospital facility continues to include facilities operated through disregarded entities or joint ventures treated as partnerships, an issue that has received public comment and about which the IRS and the U.S. Department of Treasury have promised to include in forthcoming Section 501(r) guidance.

- **Denying Financial Assistance for Budgetary Considerations.** The instructions to Line 5c (asking if the hospital was unable to provide free or discounted care to otherwise eligible patients because of budget considerations) clarifies hospitals should answer this question for patients eligible under any of their financial assistance policies (FAPs), not just the primary FAP. This change reflects the understanding that hospitals often have a patchwork of policies that apply to indigent patients.

- **Cost of Financial Assistance and Certain Other Community Benefits.** The instructions to Line 7, Column F (*Percent of total expense*), now clarify that, if a net community benefit expense in Column E is a negative number, the hospital should report "0" in Column F rather than a negative percentage.

- **Community Building Activities.** The instructions to Part II of Schedule H make clear that some community building activities may meet the definition of community benefit. Hospital organizations are instructed not to report community building costs that are reported on Part I, Line 7(e), as part of community health improvement services. In addition, the instructions to Part II, Line 4 (environmental improvements), now permit hospitals to include environmental improvement activities designed to ameliorate their own environmental impact, so long as the primary purpose is to improve community health; the activities address a known environmental issue; the organization subsidizes the activity at a net loss; and is the activities are not conducted primarily for marketing purposes.

- **Bad Debt Methodology.** Both the face of Part III and the instructions have been amended to remove references to cost reporting for bad debt expenses. Hospitals have more flexibility to answer Lines 2 (asking for the organization's amount of bad debt expense) and 3 (estimating the bad debt expense amount attributable to patients eligible under the FAP). In exchange, hospitals must explain in Part VI why their chosen methodology is the most accurate way. Because of these changes, the IRS removed from the instructions former Worksheet A, which was used to estimate bad debt expense at cost.

- **Written Debt Collection Policy.** Line 9 of Part III asks if the hospital had a written debt collection policy during the tax year. The instructions explain a "written debt collection policy" includes any written policy that describes the actions a hospital may take if patients do not pay. This is important because many hospitals may not have a stand-alone written debt collection policy and instead include these provisions in their FAP.

- **Management Companies and Joint Ventures.** The instructions to Part IV clarify only companies owned by the organization *and* its officers or physicians must be reported on Part IV. On prior forms, an example directed hospital organizations to report companies owned by the organization's officers or physicians even though the organization was not a partner to, or shareholder in, the entity. The instructions also provide that Part IV can be duplicated if additional space is needed.

- **Listing Facility Information.** Organizations must list all hospital facilities in order of their size, from largest to smallest. Before, the order was based on "total revenue per facility." Now, the instructions clarify ordering can be based on number of patients or any other reasonable method.

- **Part V, Section B.** Many of the most significant Schedule H changes appear in Part V, Section B, which asks questions related to Section 501(r), added by the Patient Protection and Affordable Care Act. This entire section was voluntary for the 2010 tax reporting cycle. For 2011, only Lines 1 through 7—which ask about community health needs assessment practices (Needs Assessment)—remain optional. Lines 8 through 21—which ask about financial assistance and emergency medical care policies, billing and collection practices, and limitations on charges for medical care—are now mandatory.

    - *Community Health Needs Assessment*. Even if Lines 1–7 of Part V, Section B, remain optional for 2011, the IRS has improved and expanded the instructions for hospital facilities interested in volunteering information for 2011 or in learning how to better gather information for 2012. Borrowing from Notice 2011-52, the IRS describes in the instructions to Line 3 how hospital facilities can take into account input from the community, including focus groups, interviews and surveys. While Line 3 asks a "yes" or "no" question, hospital facilities answering "yes" are directed to describe their efforts in Part VI. Instructions to Line 5 explain, in effect, that only the most recently conducted Needs Assessment must remain widely available to the public. Further, if the Needs Assessment is posted to any website, hospital facilities must disclose the web address in Part VI. Instructions to Line 7 (which asks about addressing all identified needs) clarify that hospital facilities may answer "yes" if they take action to address all needs. The IRS recognizes that hospital facilities cannot possibly resolve all community health needs. Instead, the IRS is only looking for hospital facilities to begin taking steps to address identified needs.

    - *Financial Assistance Policy*. Schedule H and the instructions clarify that "no" answers to Lines 9 or 10 (asking if the facility used federal poverty guidelines to determine eligibility for free care or discounted care, respectively) trigger a narrative discussion requirement in Part VI. The instructions to Line 11 have been updated to provide explanations for

various check-the-box factors used by the facility to calculate patient charges. If a facility provides a summary of its FAP to help publicize the FAP within its community, then it should check Line 13g and describe in Part VI.

- *Billing and Collections*. Lines 15 (asking which collection actions were permitted under the FAP) and 16 (asking which collection actions were performed by the hospital facility or an authorized party) explain the IRS is focusing on only those actions that take place before the facility has made reasonable efforts to determine the patient's eligibility under the FAP. Notably absent from Schedule H and the instructions is the work "collection," which was widely used in the 2010 version. A note in the instructions offers that the listed actions are not meant to represent "extraordinary collection actions," which Section 501(r)(6) disallows. While the IRS note explains that "yes" answers to these questions carries "no inference," any facility checking "yes" to liens on residences, body attachments or other similar actions had better prepare an articulate response in Part VI even though narratives are only required to describe other similar actions. On Line 18, hospitals may check "yes" (that they have a written, nondiscrimination policy about emergency medical care) if it had a written policy that required compliance under the Emergency Medical Treatment and Active Labor Act (EMTALA).

- *Individuals Eligible for Financial Assistance*. Lines 19 through 21 apply to patients eligible under the facility's FAP. While Line 19 in 2010 focused on "individuals who did not have insurance coverage," the IRS has broadened the question's reach by introducing FAP-eligible individuals. To put it another way, for most hospital facilities, the universe of FAP-eligible individuals is much broader than the universe of uninsured patients. Line 19 also focuses on the "maximum" amounts that can be charged to FAP-eligible patients, which is not the requirement under Section 501(r)(5). However, hospital facilities that answer "yes" to Line 20 (asking if the hospital facility charged FAP-eligible patients to whom it provided emergency or other medically necessary services more than the amounts generally billed to individuals who had insurance covering such care) have larger issues to deal with than how to draft their description for Part VI. If the hospital facility did not know the patient was FAP-eligible at the time, it may check "no" and avoid an embarrassing answer if it corrected the bill within a reasonable period of time after learning the patient was FAP-eligible. Similarly, on Line 21 (which asks if the hospital facility charged any of its FAP-eligible patients an amount equal to the gross charges, prohibited under Section 501(r)(5)(B)), a hospital facility may answer "no" if it applied gross charges to a FAP-eligible patient's bill if it takes the corrective actions described above. Here, the IRS recognizes that mistakes happen. Hospital facilities must be proactive about addressing any billing oversights or else risk answering "yes" to Lines 20 and 21.

- **"Other" Health Care Facilities.** In Part V, Section C, hospital organizations must list each of their "other" health care facilities. The instructions now provide additional examples of "other" facilities, including rehabilitation clinics, other outpatient clinics, diagnostic centers, skilled nursing facilities and long-term acute care facilities. In addition, like the listing of hospital facilities in Section A, "other" facilities may be listed from largest to smallest using any reasonable method.

Schedule L

Schedule L is used to report certain financial arrangements or transactions between organizations and interested persons. As noted above in the governance discussion, business transactions with an entity of which a current or former ODTKE serves as a key employee need not be reported for purposes of Part IV to Schedule L. The instructions to Part IV also clarify organizations must report compensation exceeding $10,000 paid to family members of current or former ODTKEs listed in the organization's Core Form compensation table. Finally, the instructions provide that other Section 501(c)(3) organizations, other Section 501(c) organizations of the same subsection as the reporting organization, and governmental units or instrumentalities do not count as 35 percent controlled entities for Part IV reporting purposes.

Schedule R

For purposes of determining whether a partnership is a related organization, the definition of "control" has been revised to clarify that a "managing partner" is the designated-partner according to the partnership agreement or, regardless of designation, a partner regularly engaged in the partnership's management.

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