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Recent Developments for Exempt Organizations, Including 2010 Year in Review

Rather than relying solely on Twitter, Facebook and other forms of social networking to keep our friends and clients up to date, we are continuing our long-standing practice of summarizing important developments in an annual "year in review" memo. We hope you find the attached summary helpful and that you will contact any member of the Ropes & Gray Tax or Employee Benefits practice groups with any questions you may have. We will continue, of course, to keep you informed of important developments as they occur throughout the year.

Items of Particular Interest to Health Care Organizations

Health Care Reform Legislation Imposes New Requirements on Tax-Exempt Hospitals

As part of the *Patient Protection and Affordable Care Act* (PPACA) enacted on March 23, 2010, four new requirements have been imposed on non-profit hospitals.

Under new section 501(r) of the Internal Revenue Code, in order to maintain its tax-exempt status, a hospital will now need to conduct a community health needs assessment once in every three-year period, implement a financial assistance policy, place certain limitations on charges, and abide by certain billing and collection requirements. These new requirements apply to any organization that operates at least one facility required by a state to be licensed, registered or similarly recognized as a hospital, and any other organization the IRS determines has the provision of hospital care as the principal function or purpose for which it obtained tax-exempt status. For any tax-exempt organization that owns and operates more than one hospital facility, each facility must separately meet the new requirements, which generally became effective for taxable years beginning after March 23, 2010. The community health needs assessment must be completed for taxable years beginning after March 23, 2012 or a tax of $50,000 will be imposed on a hospital for each taxable year that it fails to conduct such assessment.

At this time no formal regulatory guidance has been issued on how to meet the requirements of Code section 501(r) and many questions remain concerning practical implementation by hospitals. Guidance on this Code section is part of the IRS 2011 work plan, and IRS officials have commented that efforts are under way to address the complex issues presented by these requirements.

IRS Releases 2010 Form 990 Schedule H and Instructions

Last week, the IRS released a revised Form 990 Schedule H (Hospitals) for the 2010 filing year (fiscal years beginning in 2010) which incorporates questions to address the additional requirements imposed on tax-exempt hospitals by Code section 501(r).

The changes to Schedule H are reflected in Part V (Facility Information) and Part VI (Supplemental Information). Because Code section 501(r) requires that a hospital organization meet the PPACA requirements with respect to each of its hospital facilities, Part V has been expanded to include a new Section

A, entitled "Hospital Facilities," which directs an organization to list its facilities that were required to be licensed, registered or similarly recognized as a hospital under state law. A new Section B in Part V, entitled "Facility Policy and Practices," must be completed for each of the hospital facilities listed in Section A and requires an indication of each facility's compliance with the policies and practices addressed in Code section 501(r) through a series of "yes/no" and "check all that apply" questions. Certain responses to these questions must be explained in greater detail in Part VI. A hospital organization that is required to complete Part V, Section B must also attach its audited financial statements for the tax year to its Form 990. Part V also includes a new Section C, in which the organization must list all of the non-hospital health care facilities that it operated during the tax year.

IRS Extends 2010 Form 990 Filing Deadline for Tax-Exempt Hospitals

In Announcement 2011-20, the IRS extended the 2010 Form 990 filing deadline for tax-exempt hospital organizations by three months. The automatic extension applies only to hospital organizations that are required to file Schedule H with the 2010 Form 990 and would otherwise be required to file before August 15, 2011. In the announcement, the IRS also directed such organizations *not* to file 2010 Forms 990 before July 1, 2011, as the IRS is delaying the beginning of the filing season for tax-exempt hospitals in order to implement changes to IRS forms (e.g., Schedule H, noted above) and systems to reflect additional requirements imposed by Code section 501(r). Hospitals are not required to file a Form 8868 to take advantage of the automatic extension, and one additional three-month extension may be requested.

Extension of Expiring Tax Provisions that Affect Exempt Organizations

On December 17, 2010, President Obama signed the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, which extended until December 31, 2011 certain tax provisions that expired at the end of 2009. Several of these provisions affect exempt organizations.

- The exclusion from unrelated business taxable income (UBTI) of rents, royalties, annuities and interest paid by a controlled organization to its tax-exempt parent, which ordinarily would be considered UBTI pursuant to section 512(b)(13) of the Internal Revenue Code. This exclusion is only applicable to payments made pursuant to either (i) a binding written contract in effect on August 17, 2006, or (ii) a contract which is a renewal, under substantially similar terms, to a binding written contract in effect on August 17, 2006.
- Enhanced charitable contribution deductions for (1) contributions of capital gain real property made for conservation purposes, (2) contributions of food and book inventory from the trade or business of corporate and non-corporate taxpayers, and (3) contributions of computer technology equipment by corporate taxpayers.
- The IRA charitable rollover, which permits individuals age 70½ and older to exclude from gross income distributions from a traditional or Roth Individual Retirement Account of up to $100,000, if given for charitable purposes, provided the distribution is made directly by the IRA trustee to a public charity other than a supporting organization or donor-advised fund. Distributions made from IRAs as charitable contributions do not qualify for an income tax charitable deduction.

The new law also made significant (albeit temporary) changes to the federal gift, estate and generation skipping transfer taxes, summarized here.

IRS Releases Interim Report on Colleges and Universities Compliance Project

In May 2010, the IRS released an interim report on the Colleges and Universities Compliance Project, a product of the October 2008 compliance questionnaire sent to approximately 400 colleges and universities. The questionnaire requested details (beyond the level reported on the IRS Form 990) about executive compensation, endowment funds, unrelated business taxable income, and controlled organizations. Based on the responses to the questionnaire, the IRS has initiated selective audits of more than 30 college and universities.

The interim report features preliminary information on the respondents' organizational structures, demographics, exempt and unrelated business activities, endowments, executive compensation, and governance practices. The IRS concluded in its report that some answers to the questionnaire show potentially conflicting responses. For example, many schools reported controlling entities, engaging in rental activities, and receiving corporate sponsorships, yet few reported such activities on the Form 990-T (used to report unrelated business taxable income). The IRS anticipates issuing a final report that will include information obtained from both the audits and further analysis of the responses to the questionnaire. In addition, the IRS has stated that it expects that "the information learned from the questionnaire responses and examinations will identify issues and areas that warrant additional guidance and further scrutiny."

IRS Launches Employment Tax and Charitable Spending Initiatives; New Focus on International Activities

With the Colleges and Universities Compliance Project well under way, the IRS announced a multi-year National Research Program study of employment tax returns. As part of this three-year initiative, the Exempt Organizations Office will examine 1,500 employment tax returns. Audits will focus on issues such as worker classification, fringe benefits, officer compensation and employee expense reimbursements.

The Exempt Organizations Office has also embarked on a charitable spending initiative, which in its first phase will involve audits of organizations with high levels of fundraising expenses and officer compensation, and high levels of unrelated trade or business income relative to program spending.

IRS officials have also commented that they are developing a sharper focus on the international activities of exempt organizations, based on concerns that charitable assets may be diverted internationally for non-charitable purposes.

Supreme Court Upholds Denial of Student FICA Exception for Medical Residents; IRS Will Honor Certain Claims

Ending nearly six years of uncertainty, on January 11, 2011, the U.S. Supreme Court upheld the validity of Treasury regulations that, for the purpose of the student FICA tax exception, exclude from the definition of "student" any employee whose normal work schedule is 40 or more hours per week. In *Mayo Foundation for Medical Education and Research v. United States*, Chief Justice Roberts presented the issue as whether medical residents were "workers who study or students who work." The Court adopted the former interpretation, holding that the Treasury regulations drew a reasonable line.

The case is the culmination of a series of rulings and appeals that began in 2003, when the U.S. District Court for the District of Minnesota held that stipends paid by the Mayo Clinic to medical residents from 1994-96 qualified for the statutory "student exception" to FICA taxes which exempts "service performed in the employ of … a school, college, or university … if such service is performed by a student who is enrolled and regularly attending classes at such school, college, or university." In 2004, however, the IRS released Treasury regulations, effective April 1, 2005, providing that medical residents who worked at least 40 hours a week would not qualify as "students" for the purpose of the statutory exclusion. In 2007 and 2008 the U.S. District Court for the District of Minnesota, in two separate rulings, held the Treasury regulations invalid and again affirmed that medical residents qualified for the student FICA exception. These two cases were consolidated on appeal in the Mayo Foundation case and in 2009 the Eighth Circuit reversed both decisions and upheld the Treasury regulations. The case was then appealed to the Supreme Court.

The decision will most likely eliminate the possibility of obtaining FICA tax refunds for full-time medical residents for periods ending after March 31, 2005. On March 2, 2010, however, the IRS announced that it will honor claims, if timely made, for FICA tax refunds with respect to medical residents for tax periods ending before April 1, 2005 (when the current regulations were adopted). The IRS is contacting hospitals, universities, and medical residents who filed for refunds during these periods with more information.

Final Rules on Foreign Financial Account Reporting

Last week, the Financial Crimes Enforcement Network (FinCEN) issued final regulations regarding Form TD F 90-22.1, the Foreign Bank and Financial Account Report (FBAR). The FBAR generally requires each U.S. person (including tax-exempt organizations and their employees) with a financial interest in, or signature authority over, one or more financial accounts in a foreign country to report those accounts annually to the IRS if the aggregate value exceeds $10,000 at any time during the calendar year. FinCEN's final regulations clarify when an individual has signature authority over a foreign financial account that would require the individual to file an FBAR. In order to have signature authority, the regulations indicate that an individual must have authority to control the disposition of money, funds or other assets held in the account by direct communication to the person with whom the financial account is maintained. In other words, the mere ability to participate in the asset allocation decision process or to instruct or supervise others with signature authority would not trigger an FBAR filing obligation. Individuals who have deferred filing FBARs for 2009 and prior years under previously issued guidance may apply this new definition to determine whether they are required to file FBARs for those years. Importantly, what remains missing from the final regulations is guidance on whether private investment funds organized outside the U.S., such as offshore private equity and hedge funds, constitute foreign financial accounts subject to FBAR reporting. A more complete summary of the final rules is here.

Final Regulations on Prohibited Tax Shelter Transactions

On July 6, 2010, the IRS issued final regulations regarding excise taxes imposed under section 4965 of the Internal Revenue Code on prohibited tax shelter transactions (PTSTs). Section 4965 defines certain transactions as PTSTs and imposes excise taxes and disclosure requirements with respect to PTSTs to which a tax-exempt entity is a party. When section 4965 was enacted, there was uncertainty and concern within the tax-exempt community as to whether a tax-exempt investor in a partnership that engages in a PTST would be considered "a party" to a PTST. The final regulations clarify that a tax-exempt organization will not be considered a party to a PTST merely because it invests in a partnership that engages in a PTST.

Under the final regulations a tax-exempt entity is a party to a PTST if the entity – (1) facilitates a PTST by reason of its tax-exempt, tax indifferent or tax-favored status; or (2) is identified in published guidance, by type, class or role, as a party to a PTST. Therefore, as long as a tax-exempt organization's investment in a partnership that engages in a PTST does not trigger either of these prongs, the tax-exempt organization will not be considered a "party to" a PTST. The preamble to the regulations also provides that a tax-exempt entity that enters into a transaction to reduce or eliminate its own tax liability generally will not be considered a party to a PTST. However, the IRS and the Treasury Department have reserved the ability to identify in published guidance specific transactions or circumstances in which a tax-exempt entity that enters into a transaction to reduce or eliminate its own tax liability will be treated as a party to a PTST for purposes of section 4965. The regulations are effective for taxable years ending after July 6, 2007.

Health Care Reform's Impact on Employers and Group Health Plans

Many of the provisions of the health care reform legislation (PPACA) impose new obligations on employers generally, including tax-exempt organizations, and require modifications to employer-provided group health plans.

Although PPACA does not obligate an employer to provide health insurance coverage to its employees, as of January 1, 2014 in certain circumstances an employer may be required to pay penalties if it either does not offer coverage to its employees or if the coverage offered is too costly for employees. Certain tax-exempt organizations that provide health insurance to their employees may be eligible to take advantage of a small business health care tax credit of up to 25% of premiums paid, which is claimed on a revised Form 990-T. The amount of the credit increases to a maximum of 35% of premiums paid in 2014. Employers must comply with new information requirements which impose a responsibility to issue new plan literature and to insure that internal communications and vendor communications meet legal specifications. Additionally, starting in 2012 employers will have to report the cost of coverage under an employer-sponsored group health plan on each employee's Form W-2, and in 2014 employers will have to fulfill new obligations to file information returns with the IRS describing the health insurance coverage provided.

Key health plan reforms include the requirement to provide dependent coverage for children up to age 26, the elimination of lifetime or annual limits on benefits, a prohibition on exclusions from coverage for pre-existing conditions, a requirement to provide "first-dollar" coverage for certain preventive services, a prohibition on rescinding coverage for a covered employee except in cases of intentional fraud or misrepresentation, and changes to FSAs and HSAs. Many of these requirements are already effective, and implementing guidance has been issued by regulatory agencies. The effective dates of other key reforms, including a prohibition on discrimination in favor of highly compensated employees, have been delayed pending further guidance.

An employer who has made no or only limited changes to its plan terms since March 23, 2010 may be eligible to grandfather its plan to avoid implementing certain of the reform provisions, provided the employer continues to meet specific requirements.

For further information, please visit the Ropes & Gray Health Reform Resource Center.

Expanded Hospital and Tax-Exempt Bond Reporting on IRS Form 990

The 2008 Form 990 required only limited reporting for hospitals and organizations with outstanding tax-exempt bond issues. Beginning with the 2009 Form 990 (which for many fiscal year filers will be filed for fiscal year 2010 during 2011), the hospitals and tax-exempt bond schedules to the Form 990 must be completed in full.

Schedule H (Hospitals) must be completed by any organization that operates one or more facilities that are, or are required to be, licensed, registered, or similarly recognized by a state as a hospital. In addition to providing facility information, Schedule H requires reporting about charity care, community-building activities, bad debt, Medicare and collection practices, and management companies and joint ventures.

Schedule K (Supplemental Information on Tax-Exempt Bonds) must be completed by any organization with an outstanding tax-exempt bond issue (i) issued after December 31, 2002, and (ii) with a principal amount in excess of $100,000 as of the last day of the organization's tax year. Schedule K requires detailed reporting on 501(c)(3) bond compliance, including, in particular, private business use calculations.

Update on Employer-Provided Cell Phones

The use of employer-provided cell phones is no longer subject to the burdensome substantiation rules previously required to be met for employees to exclude from income the benefit of the business use of such phones. As part of the Small Business Jobs Act of 2010 (SBJA), cell phones have been removed from the definition of "listed property" for purposes of Internal Revenue Code section 274(d), under which employees were required to keep detailed records of their personal and business use of the phones. The change is effective for tax years beginning after December 31, 2009. In its technical explanation of the SBJA, the Joint Committee on Taxation indicated that the law did not affect the IRS's authority to determine the appropriate treatment of employer-provided cell phones as a working condition fringe benefit or a *de minimis* fringe benefit.

Prior to the passage of the SBJA, the IRS issued Notice 2009-46, which sought comments on proposed simplified procedures for substantiating the business use of employer-provided cell phones. The IRS has not yet provided updated guidance as to what substantiation procedures apply in determining that the benefit of an employer-provided cell phone is excludable from an employee's income as a working condition fringe benefit or a *de minimis* fringe benefit. Until such guidance is issued, employers and employees should continue to endeavor to meet the existing requirements under the working condition fringe or *de minimis* fringe benefit rules by, for example, requiring substantiation of the business use of employer-provided cell phones or limiting personal use of such phones.

IRS Announces Relief for Trusts that Mistakenly Filed as Private Foundations

On August 16, 2007, one year after the enactment of the Pension Protection Act of 2006, numerous trusts that previously qualified as Type III supporting organizations were reclassified as private foundations due to the elimination of a regulatory test that that permitted trusts organized under state law with certain provisions to qualify for supporting organization status. Some trustees, confused over whether the trusts they administered could continue to qualify as supporting organizations using other regulatory tests, simply filed the Form 990-PF required of private foundations and paid the private foundation excise tax on net investment income. In Announcement 2010-19, the IRS provided a procedure for trusts to request a ruling that they continued to qualify as supporting organizations despite the change in law effected by the Pension Protection Act, and to request a refund for excise taxes paid as a result of filing erroneously as private foundations.

Enactment of the New York Prudent Management of Institutional Funds Act Brings Both Welcome Relief and New Responsibilities to New York Endowments

Effective September 17, 2010, New York State adopted the New York Prudent Management of Institutional Funds Act (NYPMIFA), removing it from the shrinking list of states that had yet to adopt a version of the Uniform Prudent Management of Institutional Funds Act (UPMIFA).

Prior New York law generally prohibited spending from an endowment fund below its "historic dollar value," an amount that generally corresponds to the original dollar value of the gift establishing the fund. Under NYPMIFA, a charity may choose to spend from underwater endowment funds as the charity deems prudent after considering eight factors. In appropriating funds for expenditure, a charity must keep a contemporaneous record describing the consideration given by its board to each of the eight factors. To apply NYPMIFA to spend from endowment funds created by gift instruments executed before the effective date of the law, a charity must follow a notice procedure asking available donors to indicate whether the charity may spend below the original dollar value of their gift. Although NYPMIFA provides New York charities with increased flexibility, it also creates a rebuttable presumption of imprudent spending where a charity spends, in any given year, an amount greater than seven percent of the fair market value of an endowment fund, calculated on the basis of market values determined at least quarterly and averaged over a period of at least five years immediately preceding the year of the expenditure. This presumption applies only to gift instruments executed on or after the effective date of the law.

NYPMIFA provides default rules upon which a charity cannot rely if an endowment fund is governed by a gift instrument that otherwise restricts how the charity may spend from the fund. In addition to rules on expenditures from endowment funds, NYPMIFA contains provisions governing the release and modification of donor restrictions, the management and investment of charitable funds and solicitation for endowment funds. NYPMIFA also requires that charities adopt a written investment policy setting forth guidelines on investments and the delegation of management and investment functions.

Delaware Makes Changes to General Corporation Law Affecting Nonprofits

Effective August 2010, Delaware adopted changes to the Delaware General Corporation Law (DGCL) that affect charities formed as nonstock corporations in that state. Among the changes introduced is a new provision clarifying the applicability of the various provisions and terms of the DGCL to nonstock corporations. Prior to the changes, the DGCL was primarily worded in terms applicable only to stock corporations, making the effect of many of its provisions on nonstock corporations somewhat unclear.

As a result of the revisions, all Delaware nonstock corporations are now required to have members. The absence of members, however, will not invalidate corporate acts or cause the forfeiture or dissolution of a corporation. If neither the certificate of incorporation nor the bylaws of a nonstock corporation state the conditions for membership or other criteria for identifying members, the members of the corporation are deemed to be those entitled to vote for members of the governing body. Other provisions that took effect in August 2010 include new rules for mergers involving nonstock corporations, voting rights of members of nonstock corporations and indemnification rights of individuals serving as directors, officers, employees or agents of another entity or enterprise at a corporation's request.

Items of Special Interest to Massachusetts Charities

New Dissolution Guidelines

During 2010, Massachusetts adopted changes to the statute governing dissolutions of charitable corporations. Under prior law, all charitable corporations seeking to dissolve were required to obtain the approval of the Supreme Judicial Court (SJC). Under the revised statute, corporations with no net assets are permitted to dissolve through an administrative dissolution petition filed with the Attorney General's office. In addition, the revised statute authorizes the SJC to permit administrative dissolutions for charities with net assets below a certain threshold (with such threshold to be determined by SJC rules). No SJC action has yet been taken to implement this provision.

New Rule Permits Non-Judicial Modification of Some Donor-Restricted Gifts

The SJC has adopted a new rule, effective January 1, 2011, allowing non-judicial modification of certain restrictions in a gift instrument of a qualifying endowment. The rule was enacted pursuant to the Uniform Prudent Management of Institutional Funds Act (adopted in Massachusetts in 2009) and applies to institutions seeking to modify an institutional fund (such as an endowment) that has been in existence for 20 years or longer and has a total value of $75,000 or less at the end of its last fiscal year. If the fund qualifies, the following modifications to a gift instrument may be made without petitioning the court: (a) modification of a restriction contained in a gift instrument on the management, investment, or duration of the institutional fund; or (b) modification of the purpose of the institutional fund or the restriction on the use of a fund in an administrative *cy pres* proceeding. To apply for such modifications, an institution should submit a Form PC-IF with required supporting documentation.

Changes in Filing Requirements for Small Charities

The Nonprofit Organizations/Public Charities Division has long required all organizations filing the annual MA Form PC to attach a completed IRS Form 990 or Form 990-EZ to the Form PC, even when the organization was not required to file the IRS form. For fiscal years beginning on or after December 31, 2010, the Division will no longer require organizations with gross support and revenue of $5,000 or less to attach a completed Form 990 or 990-EZ to the Form PC.

Annual Nonprofit Law Conference

Kendi Ozmon and Lorry Spitzer will again be chairing the Massachusetts Continuing Legal Education Nonprofit Law Conference, this year on Thursday, April 14, 2011. We have assembled an all-star cast of speakers, who will bring you up to date on developing nonprofit law in Massachusetts and elsewhere, and we would love to see you there, either in person or via the Webcast!