Recent Developments and Trends for Exempt Organizations

2012 was a busy year for the IRS with respect to tax-exempt organizations and 2013 promises more of the same. While the effects of the budget sequester on the IRS regulation writers and auditors is uncertain, we anticipate the IRS will plunge ahead bravely with its various guidance and compliance projects. Implementation of the Patient Protection and Affordable Care Act, in particular, will doubtless continue to be a primary focus of the IRS in the coming months. Summarized below are some of the important exempt organization developments during 2012 and early 2013, plus a forecast of things to come.

IRS Continues Focus on Healthcare Reform and Compliance Issues

IRS Exempt Organizations (EO) recently released its 2012 Annual Report and 2013 Workplan highlighting projects the division carried out over the past year and activities it intends to pursue in 2013. In 2012, EO focused primarily on continuing implementation of the Patient Protection and Affordable Care Act (ACA) and on compliance initiatives, and this focus is expected to continue for 2013.

Significant resources were devoted during 2012 to implementing provisions of the ACA that affect tax-exempt hospitals and employers. Among other activities, Treasury and the IRS:

- Continued to revise Form 990 and Schedule H for tax-exempt hospitals to report their compliance with the requirements imposed by new section 501(r) of the Internal Revenue Code (the Code);
- Issued proposed regulations on certain requirements under section 501(r) for tax-exempt hospitals, including guidance on financial assistance and emergency medical care policies, limitations on charges, and billing and collections (for further information, see our alert here);
- Issued proposed regulations on the ACA's new employer shared responsibility provisions (for more information, see our alert here); and
- Issued temporary regulations regarding qualification as a section 501(c)(29) qualified nonprofit health insurance issuer.

During 2013, Treasury and the IRS expect to finalize the section 501(r) regulations proposed in 2012 and issue proposed regulations on the section 501(r) community health needs assessment requirements.

On the compliance front, EO worked on various projects in 2012 that will continue into 2013 and that reveal IRS compliance concerns. Following the recent trend, many of these projects begin with questionnaires issued to a subset of organizations that are the focus of the particular EO project. Highlights include the following:

- EO entered the final phase of its colleges and universities initiative, which began in 2008, by completing a significant number of examinations and working to finish its report, which is expected shortly. The report will likely discuss results from the examinations and an analysis of data collected from questionnaires.
- EO continued to examine potential compliance issues associated with international activities of public charities and private foundations, including the potential diversion of income sent overseas. EO has completed examinations of organizations that reported foreign bank accounts on their Forms 990 and intends to examine during 2013 organizations with high amounts of foreign grant expenditures.

- As anticipated, EO also continued to focus on unrelated business income (UBI), completing compliance checks of 400 organizations that reported UBI on their Forms 990, but did not file Form 990-T. This year, EO intends to study whether organizations are accurately reporting and calculating UBI by examining organizations that have reported substantial gross UBI on their tax returns, but have not reported any tax liability.
- EO launched a program designed to determine whether section 501(c)(4) social welfare organizations, 501(c)(5) labor and agricultural organizations, and 501(c)(6) trade associations have classified themselves correctly under the Code and whether they are in compliance with the federal tax law. In 2013, EO will send a questionnaire to a sample of such organizations.
- EO initiated a project intended to learn more about group exemptions and the ways in which central organizations and their subordinates satisfy filing requirements. More than 2,000 central organizations received an IRS questionnaire earlier this year.
- EO will continue in 2013 to carry out projects that examine compliance of large private foundations with the tax rules, the sources and uses by nonprofits of charitable funds, and compensation practices of tax-exempt organizations.

Following recommendations by the Advisory Committee on Tax Exempt and Government Entities (ACT) that the IRS make extensive changes to Form 1023, *Application for Recognition of Exemption*, EO acknowledged in its annual report that the waiting period for a response to applications for recognition of exemption has increased over the last several years and that applicants have been confused by the IRS's internal processes. The ACT's recommendations included expediting the IRS's internal review processes and making Form 1023 simple, educational, consistent with Form 990, and effective at identifying whether organizations meet the requirements for exemption under section 501(c)(3). In 2013, EO intends to begin to implement certain of the ACT's suggestions by developing and publishing an interactive, educational version of Form 1023.

In late 2012, the IRS made permanent the Fast Track Settlement program for taxpayers with issues under examination by the IRS's Tax Exempt and Government Entities Division (TE/GE). The program, which was initiated as a pilot project in 2008 and is intended to reduce the time and costs associated with examinations, provides participating taxpayers with a means to expedite the resolution of certain issues by working together with TE/GE and the IRS's Office of Appeals. Additional information about the Fast Track Settlement program, including eligibility, exclusions, and the application and settlement processes, is available in IRS Announcement 2012-34.

Tax Incentives for Charitable Giving Extended

The American Taxpayer Relief Act of 2012 extended through 2013 several expiring charitable giving incentives. The most significant of these provisions is the IRA charitable rollover. Under the IRA charitable rollover rules, individuals over the age of 70½ may make donations of up to $100,000 per year directly to charitable organizations from their IRAs, without including such amounts in taxable income (and without receiving a charitable deduction). These charitable distributions are also counted toward the minimum distributions that holders of traditional IRAs are required to make upon reaching age 70½. As under prior law, IRA rollover contributions generally may be made only to public charities, excluding supporting organizations, and cannot be made to donor-advised funds, private non-operating foundations or split-interest trusts. In addition, the IRA charitable rollover continues to be available only for distributions from traditional and Roth IRAs; donations from 401(k), 403(b) and similar retirement plans, in contrast, are not eligible under the provision.

In addition to the IRA charitable rollover, the recent legislation extended several other expiring charitable giving incentives through 2013. In particular, qualified conservation contributions to charitable organizations, whether in the form of a complete interest, a remainder interest, or a restriction (in perpetuity) on the use of real property, continue to be eligible for an enhanced deduction and extended contribution carryforward period. To incentivize charitable giving by businesses, the legislation also extended the enhanced charitable deduction for contributions of food inventory (although it did not extend the enhanced deduction for other types of contributions, such as book inventory and computer equipment). This provision is beneficial to businesses other than C corporations (which were already eligible for the enhanced deduction under prior law), including S corporations, partnerships, and sole proprietorships. In addition, shareholders of S corporations will continue, under the legislation, to benefit from increased charitable deductions under a provision that permits shareholders of an S corporation to take into account their pro rata share of the S corporation's charitable deductions, even if the deductions would exceed the shareholders' adjusted bases in the S corporation. It remains to be seen whether Congress will extend these charitable giving incentives to tax years after 2013.

Charitable Deduction Permitted for Gifts to Certain Single-Member LLCs

In July, the IRS released long-awaited and welcome guidance in the form of Notice 2012-52, clarifying that donations made to single-member, domestic LLCs that are wholly owned and controlled by an organization described in section 170(c)(2) of the Code (which includes most section 501(c)(3) organizations) will be treated for purposes of the federal charitable deduction as if they were made to the member charity directly. Such donations will be deductible assuming that they otherwise meet the requirements of Code section 170. In the past, the tax treatment of such donations had been uncertain. The Notice specifies that the U.S. charity serving as the sole member of the LLC is the donee for purposes of the substantiation and disclosure requirements applicable to charitable gifts. In addition, "to avoid unnecessary inquiries by the IRS," the Notice recommends that the charity disclose in its gift acknowledgement to donees that the single-member LLC is wholly owned by the charity and treated as a disregarded entity. While the Notice provides much needed guidance, certain questions regarding the tax treatment of charitable contributions to single-member LLCs remain unanswered. In particular, the Notice fails to address deductibility for gift and estate tax purposes. In addition, the treatment of contributions to foreign disregarded entities owned by U.S. charities remains unclear.

Political Campaign Activity of Social Welfare Organizations Results in Calls for IRS Action, More Disclosure

The 2012 election saw renewed interest and debate concerning political activity by tax-exempt organizations. Section 501(c)(3) organizations are not permitted to engage in any activity in support of, or in opposition to, a candidate for public office. In contrast, section 501(c)(4) social welfare organizations, which are not obligated to disclose their donors and do not need to apply for recognition of tax-exempt status, have become a favored entity for those wishing to engage in political campaign activity. Such organizations from across the political spectrum were active in the year leading up to the election, bringing scrutiny from legislators and regulators at both the state and federal levels, as well as from the press.

The summer before the election, IRS EO Director Lois Lerner acknowledged the increased public concern about section 501(c)(4) organizations and promised to consider proposals for change. While no regulatory changes have been announced, the IRS did take steps throughout the year to determine whether current or new social welfare organizations were complying with existing regulations. This effort, however, has led to charges that the IRS was acting in a partisan manner by selectively challenging the activities of only certain organizations.

Several states have also increased regulation of the political activities of tax-exempt organizations. For example, existing California regulations require that organizations, including entities exempt under both sections 501(c)(3) and 501(c)(4), disclose the identity of donors who made contributions to the organization and who requested or knew that the organization would use the contribution to support or oppose a candidate or ballot measure in California. Proposed legislation in California would codify this requirement, with increased disclosure requirements. Proposed regulations issued in late December by New York's Attorney General take a similar approach, and would require disclosure of certain political expenditures by, and donors to, all nonprofit organizations otherwise obligated to register with its office (other than those exempt under section 501(c)(3)) that spend at least $10,000 to influence elections. Public hearings on the proposed regulations are currently under way.

New Guidance and Focus on Private Foundations

IRS Workplan Signals Increased Scrutiny of Large Private Foundations

As noted earlier, the IRS continues its ongoing examination of large private foundations with international operations to determine compliance with both the general requirements of section 501(c)(3) and the special rules for private foundations. According to the IRS Exempt Organizations 2012 Annual Report and 2013 Workplan, this examination has resulted in additional liability for several private foundations for excise taxes on net investment income, taxes on UBI, employment taxes, and excise taxes on taxable expenditures. The Workplan also states that roughly half of the examinations to date have been closed, with examination of the remaining returns to be completed in 2013.

Proposed Regulations Clarify Rules on Good Faith Reliance for Equivalency Determinations

Proposed regulations were issued which are intended to increase the cost-effectiveness of foreign grant-making by private foundations by expanding the categories of advisors on which a foundation may rely in making a good faith determination that a foreign organization is the equivalent of a U.S. charity. Such a determination prevents a grant to the foreign charity from being considered a taxable expenditure that would subject the foundation to excise taxes. Whereas previously a private foundation could rely only on the advice of an attorney, the proposed regulations permit reliance on written advice given by a "qualified tax practitioner," which could include not only an attorney, but also an enrolled agent or a CPA.

Proposed Regulations Expand Eligibility for Program-Related Investments (PRIs)

Proposed regulations contain nine new examples illustrating situations in which a private foundation may be treated as having made a program-related investment (an investment designed to further a foundation's exempt purposes and therefore not subject to excise taxes under the excess business holdings or taxable expenditure rules). The proposed regulations do not change the substantive rules regarding PRIs, but update the examples to address current financing and programmatic considerations.

Supporting Organizations and Donor-Advised Funds

New "Type III" Supporting Organization Regulations

The IRS issued final regulations on the qualification requirements for "Type III" supporting organizations (SOs) and accompanying temporary regulations establishing a new payout requirement for "non-functionally integrated" Type III SOs (for more information, see our alert here). The regulations, which implement statutory changes to the Type III SO rules introduced by the Pension Protection Act of 2006, were effective December 28, 2012 (although certain transition rules are included for Type III SOs in existence on that date). In a memorandum issued earlier this year, the Director of EO Rulings and Agreement clarified that determination letters regarding Type III SO status will now be based on the criteria in the final and temporary regulations rather than on the criteria in the 2009 proposed regulations.

The final regulations impose a notice requirement on Type III SOs, requiring that they provide certain annual disclosures to their supported organizations. The final regulations also provide that a Type III SO is "functionally integrated" if either (1) it is a "parent" organization of one or more supported organizations (with proposed regulations defining the "parent" relationship promised in the near future), or (2) but for the SO, substantially all of its activities would normally be engaged in by the supported organizations and those activities "directly further" the exempt purposes of the supported organizations. As compared with the 2009 proposed regulations, the temporary regulations impose a less onerous, although still significant distribution requirement on non-functionally integrated Type III SOs of the greater of 85 percent of adjusted net income or 3.5 percent of the net fair market value of their non-exempt-use assets for the immediately preceding taxable year.

No New Donor-Advised Fund Guidance Yet

The wait continues for the IRS to issue guidance on the excise taxes imposed on donor-advised funds and fund managers for "taxable distributions" and "prohibited benefits" as enacted by the Pension Protection Act of 2006. This guidance project remains on the IRS's most recent priority guidance plan, as it has been for a number of years. Perhaps now that the supporting organization regulations have been largely finalized, the IRS will be able to turn its attention to these open donor-advised fund issues.

Private Benefit Issues and Increasing Activity on the Border Between Tax-Exempt and Taxable Organizations

Continuing its trend of aggressively applying the private benefit doctrine to revoke or deny tax-exempt status under section 501(c)(3), in 2012 the IRS showed increasing reliance on *Redlands Surgical Services v. Commissioner* (113 TC 47), a 1999 Tax Court case (affirmed by the 9th Circuit) which dealt with a joint venture between a charity and a for-profit organization. Demonstrating the broad reach of the private benefit doctrine, the IRS invoked the *Redlands* case to support use of the doctrine in three private letter rulings where an organization was considered to have ceded too much operational control to a third party as well as in instances where the organization was considered to be impermissibly controlled by its founders (or parties related to the founder). *See Priv. Ltr. Ruls.* 201202041 (revoking the tax-exempt status of a credit counseling organization where the IRS found that the organization allowed a third-party for-profit company "to dictate charges and methods of operation," and that the organization's activities "serve[d] to promote the private business interest of [the company], rather than promote the public interest."); 201215010 (denying tax-exempt status to a hedge fund that intended to donate a portion of its profits to charity because, among other concerns, the organization's board and its initial funders were dominated by parties closely related to each other, and was therefore considered to be operated for private benefit); and 201226029 (denying tax-exempt status to an organization dedicated to helping people at risk of losing their homes, due to its close connection to a law firm, two members of which founded the organization and served as its sole board members).

While these rulings are not in and of themselves groundbreaking, they raise important questions about the scope of the private benefit doctrine. Specifically, does or should the IRS apply a different standard of scrutiny to a charity that cedes control to a third-party organization at arms' length, as opposed to one which may be controlled by its founder? Also, although the IRS invoked *Redlands* in all three rulings, does that case in fact control straightforward self-dealing concerns? The rulings also highlight an important issue arising with increasing frequency. Namely, under what circumstances can the founder of a charitable organization (or a disqualified person of such organization under the intermediate sanctions rules, such as a substantial donor) also have an ongoing business relationship with the organization? While the IRS understandably looks askance at such an inherent conflict of interest, a carefully crafted and applied conflict of interest policy, administered by independent board members, can in some instances approve such a relationship.

Increased Scrutiny by State Regulators Regarding Governance and Conflicts of Interest

A continuing trend involves state charity regulators pursuing action against those who control or manage nonprofit organizations who may have neglected their governance responsibilities. Most notably, in December 2012, New York's Attorney General reached a $5.5 million settlement with the CEO and board of directors of Educational Housing Services, Inc. ("EHS"), a New York not-for-profit corporation, to resolve an investigation into self-dealing and excessive executive compensation. The Charities Bureau determined that the CEO siphoned off millions of dollars from EHS as a result of EHS's purchase of telecom services at above market rates from a company controlled by the CEO and his wife. In addition, the Charities Bureau found that EHS directors breached their fiduciary duties to the organization by (i) failing to carefully evaluate the interested-party transactions; (ii) approving compensation and benefits to the CEO that "exceeded the reasonable value of his services"; and (iii) awarding "unreasonably high compensation" to themselves "simply for serving as directors" and, in the case of two directors, "for providing services of little value to EHS." The settlement is particularly noteworthy for, in addition to the monetary component, permanently barring the CEO and the directors from serving as an officer, director, trustee, or fiduciary of any not-for-profit or charitable organization incorporated, registered, operating or soliciting contributions in New York. The increased scrutiny by state regulators with respect to governance of charitable organizations serves as a reminder that charities should have in place, and ensure compliance with, robust governance and conflict of interest policies.

State Compensation Initiatives

Massachusetts Attorney General's Continuing Interest in Nonprofit Compensation

The Nonprofit Organizations/Public Charities Division in the Massachusetts Attorney General's Office has shifted some of its focus from nonprofit director compensation to chief executive officer compensation. The Division is in the midst of a "focused review" of CEO compensation at 25 of Massachusetts' largest charities, which includes primarily hospitals and universities. The targeted organizations have now submitted responses to information requests issued by the Division as part of its review, and we await the results of the Division's efforts, which could involve a report compiling data from the review.

Massachusetts Initiatives to Curb Nonprofit Executive and Director Compensation

Following the Massachusetts Attorney General Office's April 2011 report asserting that the compensation of nonprofit board members "creates an unavoidable conflict of interest inherent in the unchecked ability to self-elect compensation with charitable funds," the Massachusetts legislature considered legislation that proposed limits on the compensation of officers and directors of charitable organizations in 2011 and 2012. This legislation did not pass, and similar bills are under review once again.

One bill (H.1683; similarly under consideration in the Senate as S.766) would prohibit any "compensation" (excluding reasonable expense reimbursements) to any non-employee officer, director or trustee of a "Massachusetts-based public charity" (a term that includes private foundations), unless such compensation is approved in advance by the Attorney General, or the relevant individual in question is being compensated for service as a "professional fiduciary." Under the proposed bill, the Attorney General would be authorized to develop filing requirements and guidelines for the compensation approval process, and would be permitted by regulation to exempt categories of public charities from the compensation prohibition "if the exemption serves the public interest."

Another bill under consideration in the Massachusetts legislature (S.768) would place limits on officer, senior manager and director compensation that could be waived only by decision of a newly created commission after a public hearing. In particular, the bill would prohibit any public charity with annual gross revenues in excess of $1,000,000 from paying compensation in excess of $500,000 to any officer, director serving in an executive capacity, or senior manager (a term not defined in the proposal) and would prohibit director compensation.

A third bill (H.1714) would limit compensation of executives at Massachusetts nonprofits that receive more than 30 percent of their annual budgets from state funds.

New York Releases "Revised Proposed Regulations" Regarding Nonprofit Executive Compensation and Administrative Expenses

Following the New York Attorney General's January 2012 promise to "reform and revitalize" the state's nonprofit sector, Governor Andrew Cuomo signed an Executive Order limiting spending for administrative costs and executive compensation by certain state-funded service providers. In May 2012 the applicable state regulatory agencies unveiled new regulations intended to permanently implement the Executive Order. The proposed regulations were then released in revised form and, if finalized, are scheduled to take effect July 1, 2013. If finalized, the regulations will take effect with respect to the service provider's first completed annual reporting period commencing on or after July 1, 2013. The immediate effect of the revised proposed regulations, if finalized, will be to implement the general requirements of the original Executive Order, capping executive compensation at certain defined service provider organizations at $199,000 per year, and requiring that a service provider's reimbursable "administrative expenses" not exceed 25 percent of the organization's total operating expenses, which percentage will be lowered incrementally to 15 percent by 2015. Compensation paid to "covered executives" may exceed this $199,000 limit without penalty absent a waiver, but only when (i) that compensation is at or below the 75th percentile of compensation to comparable executives, as demonstrated in a compensation survey of comparable organizations recognized by the state budget director, and (ii) the service provider's governing body (including two independent voting members) reviews and approves the compensation agreement, including the appropriate supporting comparability data. These limitations apply only to defined categories of state-funded service providers, and may be waived by the state budget director and the agency source of the state funding, or that agency's designee, based on criteria enumerated in the regulations. Contracts with covered executives agreed to prior to July 1, 2012 and terminating before April 1, 2015 will also be exempt thanks to a "grandfathering" provision in the revised proposed regulations.

Upcoming Nonprofit Law Conference

If this summary of developments only whets your appetite for more, you are invited to join us in Boston (or from anywhere, by webcast) on April 10 for MCLE's 13th Annual Nonprofit Law Conference, co-chaired by Kendi Ozmon and Lorry Spitzer. This half-day conference will review current developments and also cover several hot topics, such as commercial activities engaged in by nonprofits and challenging charitable giving issues.

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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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