

NEW DEVELOPMENTS IN TAX-EXEMPTION LAW: WHAT COMPLIANCE OFFICERS NEED TO KNOW

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I. COMMUNITY BENEFIT AND CHARITY CARE

A. Legal Background.

1. Rev. Rul. 56-185. Adopted the “financial ability” standard. A hospital is required to be “operated to the extent of its financial ability for those not able to pay for the services rendered and not exclusively for those who are able and expected to pay.”
2. Rev. Rul. 69-545. Adopted the “community benefit” standard.
 - a. A hospital must be operated for the benefit of the whole community. It may be acceptable if the poor do not receive direct benefits, so long as the class of indigents is very small.
 - b. Factors to consider include: (i) independent, community board that does not consist mainly of hospital administrators; (ii) open medical staff; (iii) full-time emergency room open to all regardless of ability to pay; (iv) the hospital provides care to all in community with ability to pay, including Medicare and Medicaid; (v) the hospital serves a broad cross section of community through research and charity care; and (vi) the hospital uses proceeds to improve patient care, expand facilities, and advance medical education, training, and research.
3. Rev. Rul. 83-157. A hospital does not have to have an emergency room if it would result in unnecessary duplication of services. In addition, specialty care providers (*i.e.*, cancer hospitals) do not have to maintain emergency rooms.
4. The community benefit standard has been expended to other healthcare related organizations, such as HMOs and free-standing clinics.

B. Criticism and Commentary: Community Benefit Standard Under Fire, 2004-2007.

1. Hearing before the Subcommittee of Oversight of the Committee on Ways and Means, Jun. 22, 2004. Chairman Bill Thomas announced that in the committee’s

review of IRC Section 501(c)(3), that exempt hospitals would be targeted, since hospitals received 41% of the revenues of tax-exempt organizations (although hospitals composed only 1.6% of the reported returns). Chairman Thomas pondered if there really was much of a difference between for-profit and nonprofit hospitals.

2. Sen. Chuck Grassley, Chair of the Senate Finance Committee, discussed the May 25, 2005 letter to 10 tax-exempt hospitals. The letter requests information on charitable activities, patient billing practices, and joint ventures with for-profit entities and physicians.
3. Hearing before House Committee on Ways and Means, on May 26, 2005.
 - a. Statement of Mark Everson, Commissioner, IRS. Mr. Everson declared that the problem is with lax corporate governance and understaffing for enforcement, and the not community benefit standard, which allows for flexibility in a constantly changing healthcare landscape. Instead, he noted that the focus should be on transparency, greater cooperation with state governments, and increases in the enforcement budget.
 - b. GAO Report: Nonprofit, For-Profit, and Government Hospitals: Uncompensated Care and Other Community Benefits, May 26, 2005. The Report concluded that government hospitals provided substantially more uncompensated care than *both* nonprofit hospitals and for-profit hospitals. Further, uncompensated health care was concentrated in a very small number of nonprofit hospitals. It also reported that government hospitals and for-profit hospitals provide a lot of the same community benefits (such as health education and screening) as nonprofit hospitals, but it was unable to measure or compare the differences, because of the inconsistencies in reporting.
4. Sen. Grassley Letters of Mar. 8, 2006 to American Hospital Foundation and the Catholic Health Association. He asked them to take a more active role in developing common standards in areas such as community benefit, charitable care, charges to the uninsured, debt collection, and joint ventures.
5. IRS Compliance Questionnaire, May 2006. This Questionnaire was sent to over 500 hospitals seeking information regarding community benefits standards and executive compensation.
6. Catholic Health Association Community Benefit Template for IRS Form 990, May 2006. The template was designed to provide a consistent approach for reporting community benefits on Part III of the Form 990. It was “blessed” by Sen. Grassley because it distinguishes between charity care and bad debt.
7. Catholic Health Association Guide on Reporting Community Benefits, Jun. 2006. The Guide contains 142 pages on planning and reporting community benefits, and can be purchased from CHA's website, www.chausa.org.

8. Sen. Grassley releases nonprofit hospital responses, Sep. 12, 2006. Sen. Grassley concluded that nonprofit hospitals often provide less charity care than for-profit counterparts, may charge uninsured patients more than insured patients, and sometimes give their executives “goldplated compensation packages” and generous perks.
9. Hearing before Senate Finance Committee, Sep. 13, 2006, on hospitals’ community benefits and tax-exemption. Sen. Grassley wanted a report on a common reporting system for charity care and community benefit.
10. PwC Report, My Brother’s Keeper: Growing expectations confront hospitals on community benefits and charity care, Oct. 11, 2006. The PwC Report examined challenges facing nonprofit hospitals with respect to providing community benefits and provides good recommendations for reporting of community efforts and charity care costs.
11. IRS FY 2007 Exempt Organizations Implementing Guidelines, Nov. 7, 2006. The IRS stated that it has received responses from most of the hospitals contacted through the Compliance Check Questionnaire in May 2006, and was evaluating the responses to determine the next steps, which could include education, guidance, examinations, and additional compliance check activity.
12. HFMA Principles & Practices Board Statement 15: Valuation and Financial Statement Presentation of Charity Care and Bad Debts by Institutional Healthcare Providers, Nov. 7, 2006. This statement provides advice on distinguishing bad debt from charity care.
13. AHA Guidance on Reporting Community Benefit, Nov. 13, 2006, with template. This Guidance recommends reporting bad debt as part of community benefits. It drew criticism from Sen. Grassley, who recommended that hospitals follow CHA template instead.
14. Ernst & Young report, Nov. 27, 2006. At the request of the American Hospital Association, Ernst & Young reviewed the submissions of 132 of the over 500 hospitals who received the IRS May 2006 Compliance Check. Ernst & Young concluded that all of the nonspecialty hospitals provided emergency rooms that were available to all regardless of ability to pay. Further, all of the hospitals charged patients the same price for the same services, regardless of insurance or ability to pay. The hospitals on average provided uncompensated care to 12% of their total patients. Among other things, the Ernst & Young report concluded that the questionnaire did not always allow the hospitals to fully describe their range of community benefits. For example, in response to a simple “yes or no” question, 10% of the surveyed hospitals indicated on the questionnaire that they had denied medical services. However, upon further examination, Ernst & Young found that these hospitals had diverted patients if they lacked bed capacity or if more specialized facilities were appropriate. The report made several suggestions to encourage more accurate and complete responses from hospitals.

15. CBO Report, Nonprofit Hospitals and the Provision of Community Benefits, Dec. 2006. Requested by the House Ways and Means Committee, this Report noted that while tax-exempt hospitals provide more charity care than for-profit hospitals, the percentage difference was only 0.6% after adjustments. The Report found that tax-exempt hospitals were more likely to provide less profitable specialized services (such as high-level trauma care) than for-profit hospitals, but provided care to a lesser percentage of Medicaid patients. The Report also found that, on average, exempt hospitals operated in areas with higher average incomes, lower poverty rates, and lower percentages of uninsured persons. Admittedly, the report was based on limited information. For instance, it only compared hospitals located in five states—California, Florida, Georgia, Indiana, and Texas. Further, it did not distinguish between charity care and bad debt, and did not fully examine and quantify as community benefits the provision of specialized and less profitable services by exempt health care providers.
16. Rep. Thomas introduces H.R. 6420, the Tax Exempt Hospitals Responsibility Act of 2006, Dec. 11, 2006. This act would have required exempt hospitals to provide various levels of charity care to indigents. Rep. Thomas stated that he hoped the bill “might serve as a discussion point in the next Congress,” but it did not become law.
17. Sen. Grassley requests that GAO Study Exempt Hospitals’ Community Benefits, Apr. 2007. Sen. Grassley requested that the GAO continue its studies of the community benefit standard, stating his concerns about the levels and imprecise measurements of community benefits. Sen. Grassley asked that the GAO study state community benefit standards, the standards used by hospitals to define and report community benefits, and how hospitals define and report community benefits other than uncompensated care.
18. Treasury Inspector General for Tax Administration, Tax-Exempt Hospital Industry Compliance with Community Benefit and Compensation Practices is Being Studied, but Further Analyses are Needed to Address Any Noncompliance, released Apr. 2007. The IRS interim report on the 2006 Compliance Questionnaire, which is expected to be released in July 2007, will present the results of the questions dealing with community benefits and outline the IRS’s immediate next steps. The IRS at this point has not analyzed the responses with respect to community benefits, and a final report, if needed, would not be issued until after the final report on executive compensation is issued as expected in Sept. 2008.

C. What’s New for 2007.

1. Change of guard in new Democratic Congress. Rep. Thomas has retired from Congress, and Charlie Rangel will serve as Chair of the House Ways and Means Committee. Sen. Max Baucus, who has urged caution in setting standards for charity care, has replaced Sen. Chuck Grassley as Chair of the Senate Finance Committee.

2. Transparency. Continued Focus on Governance/Transparency.
3. Caring for the Uninsured. There is a growing recognition of the burdens of providing health care to the uninsured, and a realization that tax-exempt hospitals cannot take on the task alone. The growing ranks of the uninsured threaten to overwhelm the health care delivery system. Various states have introduced legislation for universal health care.
4. Electronic Health Record Collaboratives. The collaboratives include organizations consisting of both exempt and for-profit health care providers. They seek to screen uninsured patients to determine if they qualify for governmental and other benefits and programs, and establish electronic health care records that are shared among participating providers to provide more efficient health care, and less duplication. The goal is to encourage more preventative care, and less use of the emergency room. The IRS has granted exempt status to these organizations.

D. **Suggestions.**

1. Adopt IRS recommendation for good governance practice.
2. Use CHA template, rather than AHA template, for reporting charity care.
3. Employ Sarbanes-Oxley governance principles.
4. Follow recommendations in PwC Brother's Keeper report.
5. Consider an EHR collaborative.
6. Consider charity care policies of affiliated organizations, especially physician organizations.
7. Consider the practicalities of communicating charity care policy: orally when patient presents, bilingual, sixth-grade reading level, etc.

II. COMPENSATION

A. **Tax Issues with Compensation.**

1. Private Inurement. Payment of excess or unreasonable compensation is "private inurement" under Code Section 501(c)(3), which may result in the loss of tax-exempt status.
2. Excess Benefits Rules. Under the intermediate sanctions rules of Code Section 4958, the payment of unreasonable compensation to (or certain revenue-sharing arrangements with) "disqualified persons" (usually officers, directors, and highly compensated employees) will subject the recipient to excise taxes. Additionally, "organization managers" (generally officers directors, trustees) that knowingly participate in an excess benefit transaction will be subject to excise taxes.
3. Excess Benefit Excise Taxes.

- a. Disqualified person. There is a first tier tax of 25% of the amount of the excess benefit and a second tier tax of 200% of the amount of the excess benefit if the transaction is not corrected in a specified time period.
 - b. Organizational manager. The organizational manager is subject to a tax of 10% of the amount of the excess benefit, up to the maximum of \$20,000.
 - c. Other possible penalties for excess benefit transactions include penalties for failure to file Form 4720, exempt organization's reporting of excess benefit transactions, and revocation of tax-exempt status.
4. "Automatic" Excess Benefits. If fringe benefits are not properly reported prior to an IRS inquiry, then the entire amount of the unreported fringe benefit is treated as an "automatic" excess benefit under Code Section 4958, even if total compensation including unreported fringe benefit is reasonable. The organization must indicate its intent to treat the benefit as compensation by "contemporaneous written substantiation", meaning:
 - a. Organization reporting (Form 990, Form W-2, Form 1099);
 - b. Disqualified person reporting (Form 1040);
 - c. Employment Agreement; or
 - d. Board resolution.
 5. Supporting Organization Automatic Excess Benefits. Discussed below under "Supporting Organizations."
 6. Fringe Benefits Treatment.
 - a. General Reporting Rule. The value of fringe benefits must be included in income unless specifically excluded from compensation by tax law.
 - b. For Determining Reasonable Compensation. Any fringe benefits that are nontaxable fringe benefits under Code Section 132 or that are reimbursed under an accountable plan are disregarded for the purposes of determining reasonable compensation under the excess benefit transaction rules.
 - c. For Determining Automatic Excess Benefits. There does not have to be contemporaneous substantiation for fringe benefits that are excluded from income. Thus, all excluded fringe benefits (and not just those under Section 132) are disregarded under the automatic excess benefit rules.
 7. Accountable Plan. Reimbursement for business expenses must be made under an accountable plan to be excluded from income and from consideration under Section 4958. An accountable plan must meet the following three requirements:
 - a. The reimbursed expenses must have a business connection;

- b. The employee must substantiate each business expense to the employer; and
- c. The employee must be required to return, within a reasonable time, any amount paid under the arrangement in excess of the expenses substantiated.

An accountable plan does not have to be in writing, but should be to avoid proof issues. A business expense that is reimbursed under a plan that is not an accountable plan must be included into an employee's W-2 income. If the amount reimbursed under a nonaccountable plan is not included into income and reported, there is an automatic excess benefit.

8. Nontaxable Fringe Benefits Under Section 132.

- a. Section 132 excludes from a taxpayer's gross income the following fringe benefits:
 - (1) No-additional-cost services;
 - (2) Qualified employee discounts;
 - (3) Qualified transportation fringes;
 - (4) Qualified moving expense reimbursements;
 - (5) Qualified retirement planning services;
 - (6) Qualified military base realignment and closure fringes;
 - (7) De minimus fringes; and
 - (8) Working condition fringes.
- b. Working Condition Fringe. A working condition fringe benefit is any property or services provided to an employee by his employer to the extent that: (1) the cost of the property or services would have been deductible by the employee had the employee paid for the property or services himself or herself; (2) the deduction would have been allowable as a trade or business expense; and (3) the employee's deduction (had he or she paid for the property or services) would have been in connection with the employee's trade or business of being the employee of the employer. Expenses that are not attributable to business or which are excessive are not working condition fringe benefits. Examples of working condition fringes may include:
 - (1) Subscriptions to business periodicals for employees;
 - (2) Professional dues or memberships to professional organizations;

- (3) Memberships to business leagues, trade associations, chambers of commerce, professional organizations, and civic or public service organizations;
 - (4) Expenditures for related education or on-the-job training;
 - (5) Expenditures for business travel (if reasonable and not excessive);
 - (6) Reimbursement of employee expenditures for business entertainment, if fully documented and substantiated (and if reasonable and not excessive);
 - (7) The use of employer-provided vehicles for business purposes (but not for commuting between the residence and business location);
 - (8) Professional liability insurance for directors and officers;
 - (9) Office décor; and
 - (10) Employer-provided home computers (subject to substantiation of business use).
- c. Section 132 fringe benefits are the only fringe benefits that can be disregarded for the purpose of Section 4958.
9. Other Nontaxable Fringe Benefits. If a fringe benefit is excluded under a Code Section other than Section 132, it must be valued and considered for the purpose of Section 4958.
- a. Medical, dental, life, and disability insurance;
 - b. Meals or lodging for convenience of employees (*i.e.*, discounts at physician or executive dining rooms);
 - c. Qualified scholarships and educational assistance programs;
 - d. Cafeteria plans; and
 - e. Dependent care assistance programs.
10. Taxable Fringe Benefits. Taxable fringe benefits must be included into income, reported, and considered for the purpose of Section 4958. Failure to report taxable fringe benefits will lead to automatic excess benefits. Taxable fringe benefits include:
- a. Auto allowances and expenses;
 - b. Country clubs;
 - c. Athletic clubs;
 - d. Cell phone, internet, periodicals that are reimbursed under a nonaccountable plan;
 - e. Cell phone, internet, periodicals if business use cannot be substantiated; and

f. Spousal travel and expenses.

11. Rebuttable Presumption of Reasonableness.

a. To establish this rebuttable presumption of reasonableness, the following must occur:

- (1) Compensation arrangement must be approved by organization's governing body (or committee thereof) composed entirely of non-conflicted individuals;
- (2) The governing body or committee must obtain and rely on appropriate data as to comparability of compensation before making its determination; and
- (3) The governing body or committee must adequately document the basis for its determination concurrently with making that determination.

b. Benefits of Establishing Presumption. Example, *Caracci*¹.

- (1) Compensation is presumed reasonable.
- (2) Relieves organization managers of liability for many excise taxes.
- (3) 25% excise tax on disqualified person likely will be abated.
- (4) Avoid penalties for failing to file Form 4720.

c. Non-Fixed Compensation. A rebuttal presumption cannot be established with respect to non-fixed payments until the final amount is determined, or the fixed formula for calculating the compensation is specified. Thus, the rebuttable presumption for discretionary bonuses or certain fringe benefits (other than amounts paid to an employee benefit plan that satisfied coverage and nondiscrimination rules under the Code) cannot be established until this amount is finalized. However, if non-fixed payments are subject to a cap, the rebuttable presumption can be established if the comparability data shows that amounts paid up to the cap represents reasonable compensation and the amount payable does not exceed the cap.

12. Physicians as Disqualified Persons. Normally, disqualified persons are officers and directors. However, under a facts and circumstances test, other persons, such as physicians who have a substantial influence on an exempt organization, may be classified as disqualified persons. For instance, a physician may be classified as a disqualified person if the physician: (a) receives compensation primarily from the

¹ *Caracci v. Comm'r*, 456 F.3d 444 (5th Cir. 2006) (reversing Tax Court decision imposing more than \$69 million in excise taxes partly because taxpayer obtained two valuation comparables prior to selling assets pursuant to a conversion).

activities of the exempt organization that the physician controls; (b) has or shares authority to control or determine a substantial portion of the organization's capital expenditures, operating budget (such as for a hospital department), or compensation for employees; or (c) manages a discrete segment or activity of the organization that represents a substantial portion of the activities, assets, income, or expenses for the organization as a whole (such as for a hospital department). The IRS may find a group of physicians acting collectively constitutes disqualified person status based on the influence exerted by the physician group practice. Even if physicians are not disqualified persons, establishing a rebuttable presumption is good governance practice and demonstrates good faith efforts to comply with applicable law.

13. Proposed Section 4958 Revocation Regulations. The proposed regulations provide a list of factors the IRS will consider in determining whether excess benefit transactions will lead to a loss of exempt status, including:
- a. The size and scope of organization's regular and ongoing activities that further exempt purposes before and after the excess benefit transaction occurred;
 - b. The size and scope of the excess benefit transaction in relation to the size and scope of the organization's regular and ongoing activities that further exempt purposes;
 - c. Whether the organization has been involved in repeated excess benefit transactions;
 - d. Whether the organization has implemented safeguards that are reasonably calculated to prevent future violations; and
 - e. Whether the excess benefit transaction has been corrected or the organization has made good faith efforts to seek correction from the disqualified persons who benefited from the excess benefit transaction.

Under the proposed regulations, the IRS considers all factors in combination with each other and may assign greater or lesser weight to some factors than to others. However, the proposed regulations also provide that the last two factors stated above will weigh more strongly in favor of continued tax-exempt status if the actions described therein are taken prior to the IRS discovery of the excess benefit transactions. Thus, correction of excess benefit transactions and the implementation of safeguards designed to prevent futures excess benefit transactions will weigh heavily toward maintaining tax-exempt status.

14. The IRS generally scrutinizes incentive compensation programs. However, in PLR 200601030, the IRS approved a compensation plan for executives of an exempt organization. The components of the plan are as follows: (1) the plan was written; (2) the executives were required to achieve "specific measurable goals that will continue and advance [the exempt organization's] exempt purposes by

maintaining the level of human and capital assets necessary to achieve its strategic agenda;” (3) the incentive compensation objectives for each executive (other than the CEO) for each year were established by a Compensation Committee consisting of independent Board members; (4) the objectives for the CEO were established each year by the Board of Directors (a majority of which, including the Chair, were independent); (5) after each year, the Compensation Committee or Board, respectively, assigned scores to each executive to document “objective performance;” (6) the incentive awards were based on a percentage of base salary; (7) the Compensation Committee and Board were expressly prohibited from granting an award that, when added to base salary and all other compensation and benefits, exceeded an amount determined by the Board and Compensation Committee to be reasonable; (8) the payment of an incentive bonus was conditioned on the organization achieving minimal financial goals; (9) the Board had discretion to cancel or reduce bonus at any time if payments jeopardized organization’s ability to carry out its exempt purposes; (10) the Compensation Committee had sole authority to administer and interpret the incentive plan; and (11) the Compensation Committee had authority to hire outside independent compensation consultants.

B. Enforcement and Legislative Initiatives.

1. 2004 Executive Compensation Initiative Project. The IRS sent compliance checks to over 1,200 organizations, and then opened almost 800 examinations. The IRS has completed most of the exams triggered by this project. IRS was supposed to issue a report in late 2006, but has not to date. In 2007, the IRS plans to look at how organizations set and determine executive compensation as part of other projects, including the hospital compliance questionnaire.
2. IRS Compliance Questionnaire, May 2006. This Questionnaire was sent to over 500 hospitals seeking information regarding community benefits standards and executive compensation.
3. IRS FY 2007 Exempt Organizations Implementing Guidelines, Nov. 7, 2006.
 - a. The IRS plans to finalize the Section 4958 revocation regulations in 2007.
 - b. The IRS had planned to issue a report on the 2004 Executive Compensation Initiative Project by the end 2006, but it was not finalized. Perhaps, we can expect to see the report in 2007.
 - c. In 2007 the IRS will work on cases involving loans to officers.
 - d. The IRS will look at executive compensation as part of other projects, including the 2006 compliance check questionnaire to hospitals.
4. GAO Report, Nonprofit Hospital Systems: Survey on Executive Compensation Policies and Practices, Jul. 31, 2006. The Grassley questionnaire and comments

at congressional hearings indicates that Congress may consider executive compensation along with community benefits.

5. IRS Proposed “Good Governance Practices for 501(c)(3) Organizations,” Feb. 2, 2007. IRS recommended that exempt organizations adopt governance practices pertaining to: (a) board size and composition; (b) mission statement; (c) ethics and whistleblower policies; (d) due diligence; (e) duty of loyalty; (f) transparency; (g) fundraising; (h) financial audits; (i) compensation practices; and (j) document retention.
6. IRS “Report on Exempt Organizations Executive Compensation Compliance Projects—Parts I and II,” Mar. 2007.
 - a. General Overview.
 - (1) Part I – Compliance letter sent to 1,233 organizations in May 2004.
 - (2) Part II – Exams of 782 organizations; 179 of which resulted from compliance letters.
 - (3) Part III – Based on information gathered in Part II – not part of report.
 - b. Part I – Target Compliance Check Letters.
 - (1) Triggers.
 - (a) 50 public charities with assets of \$1 million or more and revenue of \$5 million or more that reported significant compensation but no detail.
 - (b) 100 public charities reporting loans to disqualified persons in excess of \$100,000.
 - (c) 378 public charities that answered “yes” or failed to respond to question regarding excess benefit transactions.
 - (d) 497 public charities that answered “yes” or failed to respond to question regarding transactions with disqualified persons.
 - (e) Private foundations that did not respond to or report officers compensation.
 - (2) Part I Results.
 - (a) Significant reporting issues—31% of compliance check recipients were required to file amended returns; 15% were selected for exam.

- (b) Compensation reporting errors—of the 50 public charities reporting compensation of over \$250,000, none filed detailed schedules.
- (c) Loans to officers—37 public charities referred for examination.

c. Part II – Examination.

(1) *Status of Examinations.*

- (a) 782 exams; 179 arose out of compliance check.
- (b) 77 remain open.
- (c) 705 complete.

(2) 25 examinations resulted in proposed excess tax penalties in excess of \$21 million against 40 disqualified persons or organization managers. The excise tax penalties resulted from:

- (a) Excessive compensation—salary and incentives.
- (b) Payment for personal expenses—vacation homes, personal legal fees, personal auto.
- (c) Payment for personal meals and gifts on behalf of disqualified person not reported.
- (d) Payments to officers for-profit company in excess of FMV.

(3) 80% of proposed excise taxes were assessed against private foundations.

(4) 15% of public charities referred for examination made loans to or pledged assets for disqualified persons; 53% of the loans were more favorable than commercial loans and 31% were not repaid in accrual with stated terms.

(5) *Compensation Reporting for Public Charities.*

- (a) 85% properly compensation reported on Form 990.
- (b) 87% properly reported compensation on Form 941.
- (c) 85% properly reported on Form W-2.

(6) *Rebuttal Presumption.*

- (a) 51% of organizations attempted to satisfy all 3 prongs.

- (b) 54% of organizations obtained comparability studies, with 97% of studies looking at both similar type and similar size organizations.
- (c) 97% of organizations obtained comparability studies and net compensation in range of studies.
- (d) 95% of disqualified persons recused themselves from discussion and approval of their own compensation.

d. Findings.

- (1) Compliance checks were limited, and there is a need for more field audits to gain complete information.
- (2) Need additional education and guidance (for both public and agents) on reporting requirements and rebuttal presumptions.
- (3) Need Form 990 changes to reduce reporting errors and provide sufficient information to IRS.
- (4) Possible future penalties for incomplete Form 990.
- (5) Organizations should be encouraged to meet rebuttable presumption.
- (6) Project was way too big – need to break down and refine for future.

7. Sen. Grassley requests that GAO Study Exempt Hospitals' Community Benefits, Apr. 2007. In addition to requesting that the GAO study community benefits, Sen. Grassley, referring to “the alarming reports about the lifestyle that some of these individuals lead courtesy of the nonprofit hospital,” asked that the GAO study executive and board compensation and the extent to which hospitals engage in business transactions with businesses owned by these individuals.

C. Suggestions.

- 1. Match all compensation with Forms W-2 and 1099.
- 2. Correct reporting for all fringe benefits that are included in income.
- 3. Ensure that all required fringe benefits are valued and considered in determining reasonable compensation, including in compensation reports.
- 4. Minimize the use of discretion for determining compensation. Consider caps for non-fixed compensation.

5. Non-fixed compensation must be approved on both the front-end and the back-end to meet rebuttable presumption of reasonableness.
6. Establish written accountable plan for travel and business expenses. Have independent persons or committees review executive expenditures.
7. Cease reimbursements for personal expenses or mixed-use expenses that cannot be distinguished.
8. Stop paying for country club memberships.
9. Formalize the compensation processes in written policies.
10. Consider compensation arrangements for controlled physician groups.
11. Meet the rebuttable presumption of reasonableness.
12. Adopt IRS good governance practices.

III. SUPPORTING ORGANIZATIONS

A. Legal Background.

1. Private Foundation v. Public Charity. All 501(c)(3) organizations are treated as either private foundations or public charities.
2. Disadvantages of Private Foundation Status. Private foundations are not tax-favored.
 - a. There are taxes on net investment income, self-dealing, prohibitions on the failure to distribute income, excess business holdings prohibitions, investments that jeopardize charitable status and certain taxable expenditures.
 - b. There are limits on deductibility of contributions (limited to 20% of AGI).
 - c. There are additional reporting requirements.
3. Types of Public Charities.
 - a. Section 509(a)(1) Organizations.
 - (1) These organizations include churches, educational organizations, *hospitals* or medical research organizations operated in conjunction with a hospital, college endowment funds, governmental units. They are automatically considered public charities without having to meet special tests.
 - (2) Publicly Supported Organizations. These organizations must pass either the 1/3 support test or facts and circumstances test.

- (a) 1/3 Support Test. The organization normally receives at least 1/3 of its total support from governmental units and/or the general public. An organization will be considered as meeting the 1/3 support test for its current tax year and the next tax year if, for the 4 tax years immediately before the current tax year, the organization meets the 1/3 support test on an aggregate basis.
 - (b) Facts and Circumstances Test. If the organization fails to meet the 1/3 support test, the organization must meet the 10%-of-support requirement and show that it is organized and operated to attract public support.
 - b. Section 509(a)(2) Organization (Service Organizations). These organizations must meet 2 support tests:
 - (1) 1/3 Support Test. The organization normally receives more than 1/3 of its support in each tax year from any combination of: (a) gifts, grants, contributions, or membership fees, and (b) gross receipts from exempt function activities. Gross receipts from exempt function activities received from any one person or governmental agency are capped at the greater of \$5,000 or 1% of the organization's total support in that year.
 - (2) Not-More-Than-1/3 Support Test. The organization normally receives no more than 1/3 of its support in each tax year from the total of: (a) gross investment income, and (b) the excess of UBI over the tax imposed on that income.
 - c. Section 509(a)(3) Organization (Supporting Organizations). These organizations do not have to meet any public support test because they "piggyback" on a 509(a)(1) or 509(a)(2) organization.
- 4. Types of Supporting Organizations.
 - a. Type I. These are operated, supervised, or controlled by a publicly-supported organization and create a parent-subsidiary relationship. The publicly-supported parent appoints or elects a majority of the board of the supporting organization or the bylaws provide that majority are the same.
 - b. Type II. These are supervised or controlled in connection with a publicly-supported organization and create a brother-sister relationship. The supporting organization supports sister organization; both are controlled by common parent.
 - c. Type III. These are operated in connection with one or more publicly-supported organizations. The IRS has always had problems with Type III

supporting organizations, because they are not necessarily controlled by their supported organization.

5. Type III Supporting Organizations. For these types of organizations, there is no formal relationship with publicly-supported organization, so they must meet “responsiveness” and “integral part” tests.

a. Responsiveness Test.

- (1) First Alternative—corporation. The governing bodies of supported organizations must have “a significant voice” in investment policies and the timing of grants; and one of the following must apply:
- (a) At least one of the board members must be elected or appointed by the charitable organizations;
 - (b) There must be at least one overlapping board member; or
 - (c) A close and continuous working relationship.

The significant voice requirement will need to be met as a result of something other than having a charitable appointee on the board. The structure of the organization must give the appointee a meaningful voice regarding board decisions, i.e., possibly formal ability to make specific investment suggestions or to advise on needs in the community and the selection of donees. The significant voice test is a facts and circumstances test that has not been the subject of many rulings.

- (2) Second Alternative—The supporting organization is charitable trust, and each supported organization is a named beneficiary under trust instrument, and the charitable beneficiaries have power to enforce trust and to compel accounting under state law

b. Integral Part Test.

- (1) First Alternative—The supporting organization’s activities are activities to perform the functions of, or to carry out the purposes of, the supported 509(a)(1) or 509(a)(2) organization; and but for the involvement of the supporting organization, the supported 509(a)(1) or 509(a)(2) organization would normally perform those activities itself.
- (2) Second Alternative—The supporting organization pays substantially all of its income to supported organization and makes payments in such large amounts to make the supported organization “attentive” to actions of supporting organization.

6. Prior to April 2005, IRS did not determine whether the supporting organization was Type I, Type II, or Type III organization.

B. Supporting Organizations in Health Law Context:

1. Parent Organizations. System parents are not hospitals and do not have broad public support. Thus, the only way to escape private foundation status is to qualify as a 509(a)(3) supporting organization. The system parent is the supporting organization, and supports the hospital and other 509(a)(1) or 509(a)(2) organizations in the health care system. Normally, the supported organization controls the supporting organization. However, in the healthcare context, the roles are reversed, and the system parent (which is the supporting organization) controls the hospital by appointing the hospital's governing board. Thus, a system parent generally cannot be a Type I supporting organization. Generally, the governing documents will specify that the hospital and system parent share a majority of directors, thus allowing the system parent to qualify as a Type II supporting organization. At other times, the system parent will qualify as a Type III supporting organization.
2. Hospital Foundations. Hospital systems typically will have foundations to serve as fundraising arms and to manage endowments. Generally, these organizations receive public funds, and can potentially qualify as a 509(a)(1) organization. The foundation may be set up to support and be controlled by the hospital, thus making it a Type I supporting organization. Others foundations may have their boards elected by the system parent, but require that a majority of the foundation board members also be hospital board members, thus making them Type II supporting organizations. Some foundations are Type III supporting organizations.
3. Other Subsidiaries. Supporting organizations may be used for various other support services, such as holding or managing real estate, etc.

C. Pension Protection Act of 2006.

1. The act includes anti-abuse measures with respect to supporting organizations, especially Type III supporting organizations.
2. The Pension Protection Act divides Type III supporting organizations into those that are "functionally integrated" and those that are not. A "functionally integrated" Type III supporting organization is one that "performs the functions of" or "carries out the purposes of" its supported organization. A Type III supporting organization that merely makes payments to its supported organizations is not "functionally integrated."
3. Contributions or grants made by private foundations to Type III supporting organizations will not constitute a qualifying distribution, unless the Type III supporting organization is "functionally integrated" with its supported

organization (typically the hospital). Private foundations that fail to comply are subject to excise taxes.

4. Taxpayer may exclude from gross income up to \$100,000 in qualified charitable distributions from either a traditional IRA or a Roth IRA for 2006 and 2007. However, supporting organizations (even Type I or Type II) cannot be recipients of these distributions. This exclusion expires after 2007, but it may be revisited later.
5. The excess business holdings rules now apply to Type III organizations which are not functionally integrated.
6. The supporting organization's loan, grant, payment of compensation, and similar payments to a substantial contributor is automatic excess benefit transaction.
7. The supporting organization's loan to a disqualified person is automatic excess benefit transaction.

D. **IRS Reaction.**

1. The January 2007, TE/GE Commissioner Steven Miller announced that the Pension Protection Act guidance will drive much of agenda for TE/GE division for 2007.
2. Ann. 2006-93. Assistance in converting from supporting organization to public charity under Section 509(a)(1) or 509(a)(2). A supporting organization seeking to convert has to submit a written request which includes:
 - a. A statement requesting reclassification; and
 - b. Either:
 - (1) Page one and the signature page of most recently filed Form 990 or Form 990-EZ, and pages 2 and 3 (Parts IV and IV-A) of Schedule A related to the organization's most recently filed Form 990 or 990-EZ; or
 - (2) Form 8734, Support Schedule for Advance Ruling Period.
 - c. The organization has to write at the top of the request, "509(a)(3) Pension Protection Act".

By Dec. 2006, 70 organizations had reclassified.

3. Notice 2006-109. Instructions on proof need to qualify as a functionally integrated Type III supporting organization. The notice states that solely for purposes of a representation or opinion of counsel on which a grantor may rely, an organization will be considered a functionally integrated Type III supporting organization if it would meet the first alternative of the integral part test for Type

III supporting organizations, that is, the activities engaged in for or on behalf of the publicly supported organizations are activities to perform the functions of, or to carry out the purposes of, such organizations, and, but for the involvement of the supporting organization, would normally be engaged in by the publicly supported organizations themselves..

a. To establish that a grantee is a functionally integrated Type III supporting organization, a grantor, acting in good faith, may rely on a written representation signed by an officer, director or trustee of the grantee that the grantee is a functionally integrated Type III supporting organization, provided that:

(1) the grantee's representation identifies the one or more supported organizations with which the grantee is functionally integrated;

(2) the grantor collects and reviews copies of governing documents of the grantee (and, if relevant, of the supported organization(s)), and any other documents that set forth the relationship of the grantee to its supported organizations, if such relationship is not reflected in the governing documents; and

(3) the grantor collects and reviews a written representation signed by an officer, director or trustee of each of the supported organizations with which the grantee represents that it is functionally integrated, describing the activities of the grantee and confirming that but for the involvement of the grantee engaging in activities to perform the functions of, or to carry out the purposes of, the supported organization, the supported organization would normally be engaged in those activities itself.

b. As an alternative to relying on a written representation from a grantee and specified documents as described above, a grantor may rely on a reasoned written opinion of counsel of either the grantor or the grantee concluding that the grantee is a functionally integrated Type III supporting organization.

4. IRS FY 2007 Exempt Organizations Implementing Guidelines, Nov. 7, 2006. The IRS plans to issue additional guidance regarding supporting organizations in 2007. There should be more to come in 2007. In the interim, the IRS has stopped issuing determination letters for organizations seeking to be nonfunctionally integrated Type III supporting organizations. There is some talk of exempting parent health care organizations from requirements of Act.

E. **Suggestions.**

1. Classify organizations in health system as 509(a)(1), 509(a)(2), or 509(a)(3). Determine whether 509(a)(3) organizations are Type I, Type II, or Type III.

2. Get rid of 509(a)(3) supporting organizations. To the extent that supporting organization can qualify as 509(a)(1) or 509(a)(2) organization, reclassify the organization, especially fundraising foundations.
3. Get rid of Type III supporting organizations. For organizations that cannot be reclassified (system parents), ensure that such organizations are Type I or Type II supporting organizations, including through amending governing documents. If Type III classification is necessary, follow procedures to be classified as functionally integrated.
4. There should be no loans from supporting organizations, such as system parent organizations, to executives and directors, as these loans create automatic excess benefit problems.
5. There should be no financial arrangements between supporting organizations and substantial contributors, as these arrangement create automatic excess benefit problems.

IV. POLITICAL AND LOBBYING ACTIVITIES

- A. **Political Activities.** A Section 501(c)(3) organization may not participate or intervene in any campaign on behalf of, or in opposition to, any candidate for public office. This is an absolute prohibition.
- B. **Lobbying Activities.** No substantial part of the activities of a Section 501(c)(3) organization may be the carrying on of propaganda or otherwise attempting to influence legislation.
 1. “Legislation” defined relatively narrowly, e.g., does not include actions by executive branch or independent regulatory agencies.
 2. This prohibition covers legislative matters at all levels of government, however (i.e., local, state and federal).
 3. For those organizations seeking greater certainty, they can elect to be governed by a safe harbor, which provides a sliding scale of permissible lobbying expenditures.
- C. **IRS Guidance.**
 1. IR 2006-36, Feb. 22, 2006. The IRS began examining the political activities of numerous tax-exempt organizations during the 2004 election campaign after an increase in complaints about political activities. Nearly three-quarters of 82 examinations concluded that the tax-exempt organizations engaged in some level of prohibited political activity. These political activities included:
 2. Fact Sheet 2006-17, Feb. 2006. Provides guidance to exempt organizations.

- a. Political Campaign Intervention. Includes any and all activities that favor or oppose one or more candidates for public office, including:
 - (1) Contributions to political campaign funds or public statements of position (verbal or written) made by or on behalf of an organization in favor of or in opposition to any candidate for public office.
 - (2) Distributing statements prepared by others that favor or oppose any candidate for public office.
 - (3) Allowing a candidate to use an organization's assets or facilities if other candidates are not given an equivalent opportunity.
- b. Voter Registration. Section 501(c)(3) organizations may engage in some activities to promote voter registration, encourage voter participation, and provide voter education if done in a nonpartisan manner.
- c. Individual Activity by Organization Leaders. Leaders cannot make partisan comments in official organization publications or at official functions of the organization. To avoid potential attribution of their comments outside of organization functions and publications, organization leaders who speak or write in their individual capacity are encouraged to clearly indicate that their comments are personal and not intended to represent the views of the organization.

Example: President A is the Chief Executive Officer of Hospital J, a section 501(c)(3) organization, and is well known in the community. With the permission of five prominent healthcare industry leaders, including President A, who have personally endorsed Candidate T, Candidate T publishes a full page ad in the local newspaper listing the names of the five leaders. President A is identified in the ad as the CEO of Hospital J. The ad states, "Titles and affiliations of each individual are provided for identification purposes only." The ad is paid for by Candidate T's campaign committee. Because the ad was not paid for by Hospital J, the ad is not otherwise in an official publication of Hospital J, and the endorsement is made by President A in a personal capacity, the ad does not constitute campaign intervention by Hospital J.²

- d. Speaking as a Candidate. When a candidate is invited to speak at an organization event as a political candidate, the organization must take steps to ensure that:
 - (1) It provides an equal opportunity to political candidates seeking the same office;
 - (2) It does not indicate any support for or opposition to the candidate (this should be stated explicitly when the candidate is introduced and in communications concerning the candidate's attendance); and

² From Fact Sheet 2006-17.

(3) No political fundraising occurs.

- D. **IRS Audits:** NAACP, All Saint's Church.
- E. **New IRS Guidance.** The IRS plans to issue guidance in 2007 about political activities of tax-exempt organization.
- F. **Suggestions.** Adopt written policies that are in conformance with IRS guidance.

V. **UPDATE ON TAX-EXEMPT BOND INITIATIVE**

- A. **July 2005 Announcement.** The IRS TEB Division informally announced a new enforcement initiative aimed at tax-exempt and governmental entities. The focus was to be on post-issuance use of bond proceeds.
- B. **Tax Exempt Bonds FY 2007 Tax Exempt Bonds Work Plan Planning Guidelines.** Bond enforcement initiatives continue. As with previous fiscal year, the IRS deemed hospital/healthcare bonds to be at a medium risk of noncompliance for hospital/healthcare bonds, due to changing healthcare industry which forces mergers or privatization, thereby increasing noncompliance.
- C. **Federal Financing of Research.**
 - 1. Conflict between Bayh-Dole Act and Code Section 141.
 - 2. Federal government is a private user under Tax Code.
 - 3. Bayh-Dole Act, which applies to most federally funded research, gives federal government certain rights that result in private use under Tax Code.
 - 4. The IRS has indicated that it plans to issue guidance as to when and if facilities that conduct research under the Bayh-Dole Act are violating the private use rules.
- D. **Proposed Regulations for Mixed-Use Facilities, Sep. 26, 2006.** The proposed regulations provide guidance on the used of tax-exempt bond proceeds for mixed-use facilities. The regulations afford issuers with two elective methods for allocating bond proceeds across facilities that include government and private utilization:
 - 1. The discrete physical portion allocation method.
 - 2. The undivided portion allocation method.The IRS held a hearing on the proposed regulations on Jan. 11, 2007. Commentators suggested that the proposed regulations were too technical and difficult to apply.
- E. **CBO Report, Nonprofit Hospitals and Tax Arbitrage, Dec. 2006.** This report examined the benefits that exempt health care providers receive from the availability of tax-exempt bond financing. The report suggested that exempt hospitals use their reserves and endowments to increase their credit ratings and enhance tax-exempt bond financing.

The report noted that Treasury could increase its revenues if broadened the tax arbitrage restrictions to apply to such reserves and endowments.

F. **Legal Background**

1. **Qualified 501(c)(3) Bonds.**

- a. These bonds are often used by hospitals, universities and housing organizations to fund facilities.
- b. They are issued in form of tax-exempt qualified private activity bonds.
- c. They are issued by state or local governments.
- d. The proceeds must be used by 501(c)(3) organizations to further exempt purposes.
- e. The interest payable on bonds is not taxable to bondholders.

2. **Ownership, Use, and Payment Tests.**

- a. To maintain tax-exempt status, the bonds must either (a) satisfy the ownership test or (b) not satisfy both the private business use and the payment tests.
- b. Ownership test. All property financed by the net proceeds of a bond issue must be owned by an exempt organization or a governmental entity to maintain tax-exempt status.
- c. Private business use test. This test is met if more than 5% of net proceeds from bond issue is used for private business use. Private business use includes:
 - (1) unrelated trade or business use; and
 - (2) use by parties other than 501(c)(3) borrower.
- d. Private payment test. This test is met if more than 5% of the payment of principal or interest on the bond issue is either made or secured by payments or property used or to be used for private business uses.

3. **Costs Related to Bond Issuance.**

- a. Only 2% of bond proceeds can be used to pay issuance costs, such as underwriters' discount, counsel fees, financial advisory fees, etc.
- b. Any issuance costs in excess of 2% can be paid out of funds other than bond proceeds.

4. **Management Service Contracts.** Management service contracts between 501(c)(3) organizations and private parties who provide services with respect to bond-financed facilities may result in the loss of the tax-exempt status of the bonds. Observe safe harbors provided in Rev. Proc. 97-13 and Rev. Proc. 2001-39.

5. Remedial Actions for Nonqualified Use.
 - a. Redemption or defeasance of bonds.
 - b. Alternate use of disposition proceeds to acquire replacement properties within 6 months of disposition date if bond-financed property disposed of exclusively for cash.
 - c. Alternate use of bond-financed facilities.
 - d. TEB Voluntary Closing Agreement Program (VCAP) (See Notice 2001-60 for procedures).

6. Arbitrage Yield Restriction and Rebate Requirements.
 - a. Arbitrage earned if gross proceeds on the issue are used to acquire investments with materially higher yield than yield on the bonds.
 - b. Not all bonds that earn arbitrage lose tax-exempt status; bonds lose their tax-exempt status when they do not meet both the yield restriction requirements and rebate restriction requirements.
 - c. Yield restriction requirements.
 - (1) Investment of bond proceeds in investments earning a yield that is “materially higher” than the yield of a bond issue causes bonds to be arbitrage bonds. For general purposes, “materially higher” means 1/8 of a percentage point, although the number is different for different types of investments.
 - (2) However, they will not be arbitrage bonds if any of the 3 exceptions apply:
 - (a) Temporary period, *i.e.* 3 years for capital projects or 13 months for restricted working capital expenditures.
 - (b) Reasonably required reserve or replacement fund.
 - (c) Minor portion, *i.e.*, not exceeding the lesser of 5% of proceeds or \$100,000.
 - d. Rebate requirements.
 - (1) Generally, arbitrage amounts must be rebated to Treasury.
 - (a) Refunded arbitrage is based on the excess of amount earned on nonpurpose investments over the amount that would have been earned if those investments had a yield equal to the yield on the issue, plus any income attributable to such excess.
 - (b) Future value of earnings received and payments made on nonpurpose investments are included in determining the amount of rebate due

- (2) Spending exceptions to rebate requirement.
 - (a) 6-month spending exception—gross proceeds of the issue are allocated to expenditures for qualified purposes that incurred within 6 months after date of issue
 - (b) 18-month spending exception—gross proceeds of the issue are allocated to expenditures for qualified purposes that are incurred as follows: 15% within 6 months after issue date; 60% within 12 months after issue date; and 100% within 18 months after issue date.
 - (c) 2-year spending exception—for construction issues in which proceeds are allocated to constructions expenditures as follows: 10% within 6 months of issue date; 45% within 12 months of issue date; 75% within 18 months of issue date; and 100% within 24 months of issue date.
- (3) File Form 8038-T to make arbitrage payments.

7. Record Retention Requirements.

- a. Taxpayers generally must maintain records to support tax exclusions; with respect to tax-exempt bonds, records will usually be maintained by issuer, conduit borrower, or others.
- b. Records to maintain.
 - (1) Basic records relating to the bond transaction, such as trust indenture, loan agreements, bond counsel opinion.
 - (2) Documents evidencing expenditure of bond proceeds.
 - (3) Documents evidencing use of bond-financed property, such as management contracts and research agreements.
 - (4) Documents evidencing sources of payment or security for the bonds.
 - (5) Documents regarding investments of bond proceeds, yield calculations for investments, actual investment income received on investments of proceeds, guaranteed investment contracts, and rebate calculations.
 - (6) All other records that are material to bond transaction based on particular facts.
- c. Records should generally be kept for as long as the bonds are outstanding, plus 3 years after the final redemption date of the bonds.
- d. Possible consequences if records are not properly maintained:

- (1) Interest on bonds treated as taxable.
 - (2) Additional arbitrage rebates should be owed.
 - (3) Conduit borrower not entitled to certain deduction.
 - (4) Accuracy-related penalties on conduit borrower on underpayment of tax attributable to denied deductions.
 - (5) Penalty taxes for negligence or disregard of rules or regulations.
8. Voluntary Closing Agreement Program. Notice 2001-60 contains the procedures for submitting Voluntary Closing Agreements to TEB. Requests can be anonymous.

VI. FIN 48

A. Financial Accounting Standard Board (FASB) Interpretation No. 48 (“FIN 48”).

1. Intended to clarify manner in which entities must account for tax uncertainties.
2. Effective for all fiscal years beginning after December 15, 2006.
3. Applies to all entities that prepare GAAP financial statements including nonprofit organizations and pass-through entities (*i.e.*, LLCs).
4. All “tax positions” that impact current or deferred income or liabilities are impacted. Fin 48 position applies to past, current, and future tax positions
5. “Tax position” is very broad and includes decision to classify a transaction or entity as tax-exempt.
 - a. Private inurement.
 - b. Political activities.
 - c. Joint venture activities.
 - d. UBI.

B. Two-Step Process.

1. Can entity recognize tax position?
2. How do you measure tax position?

C. Recognition.

1. Tax position will be recognized if it is more likely than not (*i.e.*, greater than a 50% likelihood) to be sustained upon examination by taxing authority.
2. In evaluating whether position will be sustained:

- a. Each position must be evaluated separately with no offset or aggregation.
- b. Presumption that all positions will be audited by taxing authority with full knowledge of relevant information.
- c. Must accrue penalties and interest on difference between tax benefit expected to be recognized under general tax principles and amount recognized in accordance with FIN 48.

D. **Measuring a Tax Position.**

1. Can fully recognize tax positions based on “clear and ambiguous tax law”.
 - a. Legislation, statutes, legislative intent, regulations, rulings, and case law.
 - b. Prior administrative practices and precedents of tax authority if widely understood.
 - c. Judicial doctrines, like step transaction and economic substance.
2. All others recognize only largest amount of tax benefit for which there is greater than 50% likelihood of being sustained.
3. Must re-evaluate positions prior to any reporting period to determine whether any of its positions has been impacted by new available information.

E. **Disclosures Required.**

1. Amount of unrecognized tax benefits, that if recognized, would change effective tax rate.
2. Tax positions for which it is “reasonably possible” that the total amount of unrecognized tax benefits will significantly increase or decrease within next 12 months.
3. Description of tax years that remain subject to examination.
4. Must continue to evaluate tax positions recognized in prior periods. If tax positions can no longer meet more-likely-than-not test, then they must be de-recognized.

F. **Issues.**

1. Conflicts between auditors and tax advisors, because return position cannot be relied on for FIN 48 purposes.
2. Difficulty in constructing probabilities.
3. Attorneys and accountants will not want to give opinions.

4. Taxing authorities often overstate tax deficiencies and there is a presumption of correctness – entity must overcome burden.
5. Disclosure can trigger IRS scrutiny.

G. **IRS Pronouncements.**

1. IRS will now review disclosures made by taxpayers under FIN 48 as part of its examination process. (statement of IRS Large and Mid-Size Business Division Commissioner on Apr. 12). IRS still uncertain on whether taxpayers should be required to disclose a list of uncertain tax positions.
2. IRS reconsidering its long-standing policy of restraint when deciding when to request taxpayers' accrual work papers on audit.

VII. DEFERRED COMPENSATION

A. **Final 409A Regulations For Nonqualified Deferred Compensation Plans, Apr. 2007.**

1. The final regulations are voluminous—almost 400 pages long—and generally follow the proposed rules issued in Sept. 2005.
2. Statutory Background. Code Section 409A was enacted in 2004, and requires that all amounts deferred under a nonqualified deferred compensation plan be included in income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income, unless the plan: (a) meets the distribution, acceleration of benefit, and election requirements of Code Section 409A; and (b) is operated in a accordance with those requirements.
3. Exclusions. The regulations broadly define a “deferred compensation plan” as any plan that provides for a deferral of compensation. Qualified plans (such as 401(k) plans and 403(b) plans), disability plans, death benefit plans, sick leave or vacation plans, and certain medical expense reimbursement arrangements are excluded from Code Section 409A. Code Section 409A is not applicable to 4579b) plans, but is applicable to 457(f) plans.

B. **403(b) Plans.**

1. Recent IRS Comments on Common Problems with 403(b) Plans.
 - a. *Ineligible employees* who are not exempt organization employees.
 - b. *Excess elective deferrals.* The maximum elective deferral is \$15,500, unless the person has worked for the organization for more than 15 years or is over age 50. Refer to IRS Publication 571 for the correct amount of additional referral.

- c. Nondiscrimination testing. If 50% of employees have right to elective deferrals, the remaining 50% must have same right. Employees who work less than 20 hours per week can be permissibly excluded from testing. Some plans define part-time employee who can be excluded as those who work less than 2,000 per year, which is a violation. Additionally, right to make elective deferrals must be communicated to employees.
 - d. Serial loans. Plan participant max out loan limitations from multiple vendors.
 - e. Serial hardship distributions. Plan participants receive serial hardship distributions from multiple vendors.
 - f. Inadequate plan provisions. There are three written provisions needed for an annuity contract that is part of a 403(b) annuity plan: (i) a provision stating that annuity contract is nontransferable; (ii) a provision complying with Code Section 401(a)(3), which states there cannot be excess elective deferrals; and (iii) a provision in compliance with Code Section 401(a)(31), which allows direct rollovers. A custodial account contract only requires the second two provisions stated above.
 - g. Improper Deferral of Sick Pay. Deferral of cash payout for unused sick pay or vacation to 403(b) plan is generally not permitted, except for elective deferrals made within 2 and ½ months after separation from service.
2. Final Regulations. Regulations were proposed in 2004, and may become final this year. Regulations may provide as follows:
- a. Requirements for a written plan that complies with Code Section 403(b). IRS will publish revenue ruling with model plan.
 - b. Form requirements for annuity contracts or custodial accounts.
 - c. Clarification of treatment of seasonal employees who work more than 20 hours per week on temporary basis.
 - d. Hardship requirements similar to 401(k) plans.
 - e. Various other requirements.
- C. Pension Protection Act of 2006. Various notice and minimum funding changes are required for 2007 and 2008, which may require amendments to the written plan.

VIII. OTHER

A. Form 990 and Other Forms.

1. Form 990-T. These forms now must be made available for public inspection.
2. New Form 8913. This form which should be out in early 2007 must be filed along with a Form 990-T for exempt organizations to claim a telephone excise tax refund.
3. Changes in 2006 Form 990 Reporting.
 - a. The Pension Protection Act requires the following changes to the 2006 Form 990 and/or 990-T;
 - (1) Whether 509(a)(3) organization is classified as Type I, Type II, or Type III.
 - (2) If the organization is a controlling organization, the name of each controlled organization, and a description of the amounts of interest, annuities, royalties, or rents received from the controlling organization.
 - b. Changes to Reporting of Compensation Information.
 - (1) The definition of related organization (used for purposes of completing Form 990 line 75c) is clarified by listing 8 specific relationships which are listed on page 35 of the Form 990 Instructions.
 - (2) The definition of related organization excludes certain bank or financial institution trustees and certain common independent contractors.
 - (3) Organizations no longer have to report the amount of compensation where: (a) the organization conducts joint programs or shares facilities or employees; (b) one or more persons exercise substantial influence over two organizations; and (c) volunteers control 2 organizations.
 - (4) The definition of substantial influence is clarified by referencing Code Section 4958(f)(1) and Regulations section 53.4958-3.
4. Form 4720—This form now requires disclosure as an excess benefit of the full amount of any grant, loan, compensation, or other similar payment to a substantial contributor, family member, or 35% controlled entity.
5. Redesigned Form 990—This is IRS continuing to redesign Form 990, and plans to issue a new form and instructions in 2007.

B. Joint Ventures

1. Rev. Proc. 2006-4. Effective Jan. 3, 2006, the IRS will not issue letter rulings as to whether a joint venture with a for-profit party affects an organization's exempt status or results in unrelated business income.
 2. Exemption Denial Ruling 2006-35018. The IRS stated that "an organization that provides medical services on an outpatient services basis must be controlled by a Board composed of civic leaders and must provide its services to all." This statement may hint at how the IRS views exempt health care operations, no matter the legal form. Even though this assertion does not appear to be supported by Rev. Rul. 69-545, it still gives one an idea of the IRS's view that community control is the basis for treating an outpatient healthcare activity as nontaxable.
- C. **Rents From Controlled Subsidiaries.** Rents from a controlled subsidiary are no longer treated as UBI so long as the rent arrangement was in effect on August 17, 2006 and rents are at (and not above) FMV.
- D. **Information-Sharing with State Charity Officials.** Under the Pension Protection Act, the IRS may disclose certain information to State officials: notices of denial or revocation of exempt status, proposed deficiency notices for certain private foundation or lobbying taxes, information on organizations that have applied for exempt status, returns and return information if the above information is disclosed. Disclosure is permitted for and only to extent necessary for administration of State laws relating to exempt organizations. Disclosure can be made at request of Attorney General, State tax officer, or other State official charged with charitable oversight. Disclosure may also be made in certain civil administrative and judicial proceedings.
- E. **Miscellaneous.**
1. Accommodation Parties and tax shelter transactions.
 2. Vision Service Plan, 501(c)(4).