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Nonprofit News & Notes

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Dear Readers,

We were gratified by the response to our inaugural issue of Robinson & Cole's Nonprofit News and Notes.

The current issue addresses broader implications for the tax-exempt sector, stemming from the IRS's interim report on compliance by colleges and universities.

We also discuss ongoing efforts by the IRS to monitor nonprofit governance. The new Form 990 drills deeper than ever into potential conflicts between a charity and its insiders. Below, we consider how to address these conflicts and ease compliance with the annual 990 requirements.

Finally, we provide an update on a topic discussed in the last issue: preserving tax-exempt status by those charities that have not filed Forms 990 in the past three years. Action is required by October 15, 2010.

As always, we welcome your comments and insights.

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RETHINKING THE CONFLICT OF INTEREST POLICY

On the revised Form 990, the Internal Revenue Service (IRS) asks filers whether a conflict of interest policy is in place; whether officers, directors, and key employees are required to make annual disclosures under the policy; and whether and how the organization monitors and enforces compliance with the policy.

A policy that requires annual disclosure of possible conflicts and, as appropriate, recusal of interested persons from debating or voting on a particular matter, is an organization's first line of defense against an excess benefit transaction. In general, the IRS recommends examination for conflicts where a director, officer, or member of a committee with board-delegated powers has a direct or indirect financial interest in a transaction. Many organizations expand the focus of

inquiry to include high-level employees who may negotiate or approve certain transactions. Conflict of interest policies encourage an examination of the appearance of a transaction as well as any actual improprieties. In all cases, an organization's conflict of interest policy should be reviewed for consistency with both state law and the practices recommended by the IRS.

The discipline of requiring annual disclosure by directors and others of potential conflicts is an excellent opportunity to ease compliance with an organization's Form 990 reporting responsibilities. For example, Schedule L of the new Form 990 requires reporting of several types of relationships. Perhaps the most complicated involves business transactions between the organization and "interested persons." An interested person, for purposes of Form 990, is a far-reaching term. By way of far-flung example, it could in theory extend to a partnership in which the spouse of a great-grandchild of a current director has only a 6 percent interest.

The correct reporting of business transactions on Schedule L can be largely accomplished by carefully surveying current officers, directors, trustees, key employees, and any nonboard members of a grant selection committee. Revising the annual conflict of interest disclosure form to ask specific questions designed to identify the types of business transactions covered by Schedule L will assist the organization in meeting its reporting responsibilities. Further, it will help those being surveyed to think clearly about what transactions may present a conflict of interest.

Schedule L also requires the organization to report business transactions with individuals who, for the tax year being reported, are classified as (1) former officers, directors, trustees, and key employees who received more than $100,000 in reportable compensation from the reporting organization or a related organization or (2) former directors or trustees who received, in their capacity as directors or trustees, more than $10,000 in reportable compensation from the reporting organization or a related organization. Thus, organizations may want to expand the distribution of annual conflict of interest inquiries to include such individuals.

Moreover, Schedule L requires a filing organization to report whether it receives management services from a management company of which any current or former officer, director, trustee, or key employee, whether or not such individual receives any reportable compensation from the organization or a related organization, is a direct or indirect 35 percent owner or an officer, director, trustee, or key employee. A "former" officer, director, trustee, or key employee is one who has held that position within the organization's last five tax years.

Perhaps in recognition of the fact that organizations may not be able to gather all information needed to accurately report business transactions of interested persons, the instructions to Schedule L provide that an organization is not required to furnish the requested information if it is "unable to secure the information regarding interested person status after making a reasonable effort to obtain it." Distribution of an appropriately tailored questionnaire to current and former officers, directors, trustees, and key employees, as well as any current nonboard members of a grant selection committee, may qualify as reasonable effort for this purpose.

IRS RELEASES INTERIM REPORT ON TAX COMPLIANCE BY COLLEGES AND UNIVERSITIES: BROADER IMPLICATIONS FOR THE TAX-EXEMPT SECTOR

The IRS recently released its interim report on the Colleges and Universities Compliance Project. The project surveyed 400 public and private colleges and universities on (1) organizational structure and governance practices; (2) the conduct and reporting of exempt or other activities that may generate unrelated business taxable income; (3) the investment, management, and use of endowment funds; and (4) executive compensation practices.

The preliminary data suggests that the IRS will more closely scrutinize whether unrelated business income-generating activities are reported, whether offshore investments and other

alternative investments are appropriate, whether comparability data is utilized to establish compensation, whether organizations have conflict of interest policies, and whether transactions with related entities occur at arm's length.

The project focused on colleges and universities because they comprise one of the largest segments of the tax-exempt sector based on revenue and assets. We presume, however, that any regulatory action or suggested best practices resulting from the IRS's analysis will apply to public and private schools in general, many of which resemble institutions of higher education in their governance structure, administration, and activities, and, possibly, to the tax-exempt sector as a whole. Accordingly, we suggest that tax-exempt organizations critically examine their practices in the areas reflecting the IRS's preliminary conclusions, which include the following:

- **Related Organizations**. Most colleges and universities have related entities, including tax-exempt organizations, taxable corporations, trusts, disregarded entities, and partnerships. A controlled entity is a related entity in which the organization possesses more than 50 percent control. Tax-exempt organizations are required to report certain transactions with controlled entities on their annual Form 990, including making loans, transferring funds, and receiving interests, annuities, royalties, or rents. The report indicated that controlling organizations may well be underreporting these transactions.

- **Endowment Funds**. In most cases, investment committees invest endowment assets in a variety of investments, predominantly domestic fixed-income and equity securities, according to an endowment fund investment policy. The organizations expend endowment assets according to spending policies, which approximate 5 percent. The majority of colleges and universities reported investing endowment assets in foreign investments. In response to the IRS's report, Theresa Pattara, Senate Finance Committee Tax Counsel, commented that Congress pays attention to offshore investments because of their potential as abusive tax shelters or tax avoidance schemes.

- **Executive Compensation** . Many colleges and universities reported awards of executive compensation according to a policy adopted by the institution's governing body. The Internal Revenue Code imposes nondeductible excise taxes on certain persons and organizations benefitting from, or participating in, excess benefit transactions, which may include colleges and universities providing unreasonable compensation to insiders. Insiders include directors, officers, trustees, and certain highly compensated employees. A transaction with an insider is presumed to be reasonable if the participating tax-exempt organization follows certain parameters set forth in the Treasury Regulations, including receiving advance approval by the organization's governing body, obtaining and relying on appropriate comparability data, and adequately documenting the basis for the organization's decision. The burden then shifts to the IRS to prove that such a transaction is not reasonable. The IRS noted that colleges and universities did not consistently rely on comparability data to support the reasonableness of transactions with insiders.

- **Policies**. Most large colleges and universities reported having conflict of interest policies for members of a governing body, top management officials, and full-time faculty. Some large organizations reported having written policies to assure that transactions with their controlled entities were at arm's length. Smaller and medium-sized institutions were less likely to have such policies.

- **Activities and Unrelated Business Income**. The project's questionnaire listed 47 activities that may result in unrelated business activities, including facility rental, use of athletic facilities, personal property rentals, advertising and corporate sponsorships, operation of bookstores, food services, catering services, travel tours, and parking lots, conduct of commercial research and income from controlled entities. Few colleges and universities that indicated engaging in an unrelated business activity reported that activity as unrelated business income on a schedule to their Form 990 (i.e., Form 990-T).

- **Use of Outside Advisors.** The majority of colleges and universities surveyed reported that they did not rely on outside advice with respect to unrelated business income issues, such as determining whether business activities were related or unrelated to their exempt purpose; with respect to, the allocation of expenses between related and unrelated business activities, and with respect to intercompany pricing between the organizations and related entities.

The IRS's final report will provide further analysis in a number of areas, including (1) the presence of organizations' policies and practices with respect to potential unrelated business activities, related organizations, and controlled entities; (2) the reporting of activities as exempt or unrelated and the allocation of expenses among activities and related organizations; (3) the reporting of recurring losses from certain exempt and unrelated activities and the reporting of incident to debt-financed property; and (4) the use of comparability data and compensation practices and procedures to establish compensation of executives and other insiders.

The IRS has initiated examinations of more than 30 colleges and universities, which were selected based upon their responses to the compliance questionnaire, largely focusing on executive compensation and unrelated business income. A summary of findings and information learned from the examinations will be included in the IRS's final report.

IRS ANNOUNCES FILING RELIEF FOR SMALL ORGANIZATIONS

As we noted in our May newsletter, thousands of small, tax-exempt organizations, including charities, trade associations, and membership groups, may lose their tax-exempt status for failure to file an annual informational return with the IRS for three consecutive years. For organizations on a calendar year, the filing deadline for the 2009 tax year was May 15, 2010.

On July 26, 2010, the IRS announced one-time relief for organizations required to file annual informational returns in the form of a Form 990-N (electronic postcard) or a Form 990-EZ.

Organizations eligible to file Form 990-N need only complete that filing prior to October 15, 2010, to avoid loss of tax-exempt status. Organizations, other than certain religious organizations or those that are included in a group return, whose gross receipts are normally $25,000 or less are generally required to file Form 990-N. Private foundations and supporting organizations, however, are not eligible to file Form 990-N.

Organizations eligible to file Form 990-EZ may avoid losing tax-exempt status by filing completed returns for the 2007, 2008, and 2009 tax years and paying a compliance fee based upon their gross receipts. Organizations were eligible to file Form 990-EZ for 2007 if gross receipts were less than $100,000 and total assets were less than $250,000; for 2008 if gross receipts were less than $1 million and total assets were less than $2.5 million; and for 2009 if gross receipts were less than $500,000 and total assets were less than $1.25 million.

Organizations required to file a Form 990 or Form 990-PF are not eligible for the program.

In addition to announcing the one-time relief program, the IRS posted a list of organizations at risk of automatic revocation of tax-exempt status. The list, which does not include certain small organizations or subordinate organizations in group rulings for which the parent organization has failed to make required filings, can be found on the IRS Web site.

The IRS has also posted a list of frequently asked questions about automatic revocation of tax-exempt status for failure to file an annual return or notice.

If you have questions about your organization's conflict of interest policy, procedures, or annual disclosure requirements, please contact a member of Robinson & Cole's Tax-Exempt Organizations Group.

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