

**HCLS Presentation**

**Tax-Exempt Primer**

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# Outline

- General Tax-Exempt Principles
- IRS Views of Nonprofit Governance
- Intermediate Sanctions ("TBOR2")
- Redesigned Form 990

# General Tax-Exempt Principles

- 501(c)(3) status
  - Determined by the IRS
  - Exempt from federal income tax
  - May receive tax deductible charitable contributions
  - Purpose must be promotion of health, education, religious, scientific (among others)

# 501(c)(3) Status Limitations

- No political campaigning
- Limited lobbying activities
- Earnings shall NOT inure to the benefit of any individual/entity
- Shall NOT operate for the benefit of private interests
- Shall NOT operate for primary purpose of conducting a trade/business unrelated to exempt purpose
- Shall NOT have purpose/activity that is illegal or violates fundamental public policy

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# Other Classifications

## 501(c)(4) Status

- Promotion of social welfare
- Routinely used for health plans
- Exempt from fed'l inc tax, but no deduction allowed for charitable contributions

## Nonprofit Corporation

- creature of state law
- does not allow for fed'l tax exemption

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# Non-Profit Governance

- Oct. 18, 2007: Panel on the Non-Profit Section published a compilation of advice on good governance practices
- Feb. 26, 2008: IRS issued a comprehensive update to its position concerning tax-exempt org. governance

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# Non-Profit Governance

## TWO THEMES:

1. Transparency
2. Accountability

Note these same themes in Form 990

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# IRS Position Paper on Corporate Governance

- IRS views corporate governance as a “pillar” of its education and enforcement program for tax-exempt organizations
- Expands upon the Feb 2007 “Good Governance Practices” issued by IRS, which have now been removed from IRS website
- Contains noteworthy perspective of IRS on governance and indicates IRS’ commitment to monitoring these practices
- A MUST READ!

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# IRS Position Paper on Corporate Governance: SCOPE

- Duty of Care of Board—must be active and engaged, knowledgeable, transparent
- Board Size-too small/too large
- Board Composition-controlled by a majority of independent directors
- Governance Policies-recommended
- Executive Comp-utilize rebuttable presumption, use independent comp consultant and comparability data

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# IRS Position Paper on Corporate Governance: SCOPE

- Investments (joint ventures, for-profit subs)-adopt written policies related to supervising investments
- Fundraising-Board should have oversight of costs and methods of charitable solicitation activities
- Compliance Plans-document retention policies, whistleblower procedures
- Form 990-Board review prior to filing

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# Intermediate Sanctions ("TBOR2")

Excessive compensation packages and non-fair market value transactions with management, key employees and other insiders of a TE org can trigger personal liability to organization directors and officers.

Congress enacted Taxpayer's Bill of Rights 2 in 1996 (Section 4958)

# Intermediate Sanctions ("TBOR2")

- Applies to any transaction with a charity in which a "Disqualified Person" receives an excess benefit.
- Two-tier tax imposed on DP: 25% on excess benefit; if not corrected before tax assessment or within 90 days of deficiency notice then 200% tax

# Intermediate Sanctions ("TBOR2")

- Officers, directors and key employees of the TE org ("Organization Managers") who participate in the EBT knowingly and willfully and without reasonable cause to believe it is not an EBT are jointly/severally liable for excise tax of 10% of the EB up to \$10,000/transaction.
- Additional 100% penalty applies if willful and flagrant activity of OM found.

# Intermediate Sanctions ("TBOR2")

- Disqualified Persons: any person or entity in a position (at the time of or within 5 yrs prior to the EBT) to exercise substantial influence over the affairs of the TE org, even if power not used.
- Deemed DP: CEO, COO, CFO, Board members.

# Intermediate Sanctions ("TBOR2")

- Factors in favor of DP finding:
  - Founder
  - Substantial contributor (greater of \$5,000 or 2% of annual contributions)
  - Compensation based primarily on revenues or a dept. controlled by DP
  - Controls substantial portion of expenditures, operating budget or activities.
  - Member of rebuttable presumption committee

# Intermediate Sanctions ("TBOR2")

## Rebuttable Presumption Procedure

- Shifts burden of proof to IRS on fair market value issues and provides Organization managers with a virtual safe harbor absent an OM's "actual knowledge" of an EBT.
- Very useful tool!

# Intermediate Sanctions ("TBOR2")

## Rebuttable Presumption: 3 Steps

1. Arrangement must be reviewed and approved by the governing board or designated board committee, all the participating members of which must be independent (no conflicts of interest with the subject arrangement).

# Intermediate Sanctions ("TBOR2")

## Rebuttable Presumption: 3 Steps

2. The TBOR2 Committee must rely on appropriate data as to comparable arrangements prior to making its determination.
3. The TBOR2 Committee must adequately document the basis for its decision concurrently in the minutes.

# Intermediate Sanctions ("TBOR2")

## Rebuttable Presumption: 3 Steps

3. Minutes must contain: terms of transaction, date approved, members present for debate and who voted, comparability data relied upon, the reasons for approving the transaction outside the FMV range (if applicable), prepared before the next meeting and approved within a reasonable time.

# Intermediate Sanctions ("TBOR2")

## Rebuttable Presumption

- Applies to all payments under arrangement absent material change.
- Establishes presumption only for fixed payment portions of arrangement, non-fixed payments the amount of which have been determined, or non-fixed payments to employees subject to a cap on comp.

# Intermediate Sanctions ("TBOR2")

## Rebuttable Presumption

- Arrangement must be evaluated "in its entirety" for reasonableness (must include the value of any in-kind payments).
- **USE THIS TOOL!**

# Redesigned Form 990

- On June 19, 2007, IRS released draft
- First substantial redraft since 1979
- Purpose: enhance transparency, promote compliance and minimize the burden on filing organizations
- Many public comments were submitted, including from HCLS

# Redesigned Form 990

- On December 20, 2007, IRS released the Final Form 990 for use beginning in the 2008 tax year (returns filed in 2009)
- See also detailed instructions

# Redesigned Form 990

- Key Issues:
  - Summary page that shows snapshot of charity's activities and financial status
  - Detailed Schedule H required for hospitals (charity care)
  - Schedule K required for charities with outstanding tax-exempt bonds

# Redesigned Form 990

- Key Issues cont'd:
  - Detailed requirements for Board members, officers, executive compensation and related organizations
  - Focus is on transparency and providing more information to the IRS to ensure compliance with tax-exempt requirements and limitations

# SUMMARY

- ❑ IRS actively interested in monitoring and enforcing tax-exempt laws and regulations
- ❑ Use all tools available (i.e., rebuttable presumption, compliance initiatives)
- ❑ Work diligently for accurate Form 990 filings