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IRS Releases Draft Instructions to Revised Form 990

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On April 7, 2008, the Internal Revenue Service (IRS) released draft instructions to the revised Form 990 income tax return and requested public comment by June 1, 2008. The draft instructions may be accessed at http://www.irs.gov/charities/article/0,,id=181089,00.html. Exempt organizations will use these instructions in completing their annual informational returns beginning in fiscal year 2008. Similar in form to instructions used for years past, these draft instructions provide general Form-wide instructions and specific line-by-line instructions. In addition, the draft instructions include a glossary of terms, sequencing lists (which help determine the order for filling out the Form) and compensation tables (which help determine how and where to report items of compensation). The IRS's stated goal for these instructions is to make the annual reporting obligation more logical and user friendly for organizations, and to promote uniformity.

Governance, Management and Disclosure

Consistent with the significant emphasis on corporate governance in the Form 990, the proposed instructions contain valuable insight on responding to Part VI of the Form. The final Form 990 retained detailed questions on governance policies and practices. While the IRS believes that these policies and procedures generally improve tax compliance, it notes that many of the policies or practices are not legally required under the Internal Revenue Code. The IRS's draft instructions define many terms used in Part VI of the core form with substantive effect.

INDEPENDENT VOTING MEMBERS

A definition of "independent voting member" of the board is provided. The definition contains four specific criteria, all of which must be satisfied at all times during the organization's tax year. These criteria are: the board member was not compensated as an officer or other employee by the organization or a related organization; the member did not receive compensation exceeding $10,000 as an independent contractor from the organization or a related organization; the member did not receive direct or indirect material financial benefits from the organization or a related organization; and no family member of the member received compensation or material financial benefits from the organization. For these purposes, a board member receives indirect financial benefits if the reporting organization enters into transactions exceeding $10,000 with: an entity more than 35 percent owned by the board member or family members; an entity of which the board member is an officer, director, trustee or key employee; a partnership or limited liability company of which the board member is a partner or member; or a professional corporation of which the board member is a shareholder. In the case in which a board member is a partner, member or shareholder, no minimum level of ownership is prescribed. Note that this definition, for purposes of answering the question at Line 1b, may not necessarily be consistent with independence/"disinterested director" definitions already established under state law, nonprofit sector governance best practices or previously existing protocols of the exempt organization. Accordingly, in some circumstances the organization may be required to apply a different definition of independence to its board, for purposes of completing Line 1b.

RELATIONSHIPS AMONG OFFICERS, DIRECTORS, *ETC.*

One of the most controversial governance questions on the Form 990 in recent years is that which inquires about horizontal business and financial relationships among officers, directors and key employees. The goal is to identify relationships that could create bias in the decision-making process. Proposed definitions of "family relationship" and "business relationship" are provided. Note that the definition of "business relationship" includes types of employment relationships, business arrangements, common ownership of business entities and board service on the same business entity.

MATERIAL DIVERSION OF ASSETS

The new Form 990 asks whether there has been a material diversion of assets. This question reflects the IRS's concern with the increasing incidence of financial fraud committed against exempt organizations, including but not limited to embezzlement. The question does not inquire as to board action taken to prevent such fraud (*e.g.,* enhanced audit committee oversight). In the

draft instructions, the materiality threshold is set sufficiently high as to exclude some common types of cash misappropriation, and non-extraordinary expense account abuse.

DOCUMENTATION OF MEETINGS AND ACTIONS

The new Form 990 asks whether the organization contemporaneously documents board and committee meetings. The proposed definitions of "documentation" (*i.e.,* approved minutes, e-mail strings, similar writings) and "contemporaneous" (*i.e.,* by the later of the next board or committee meeting, or 60 days after the date of the meeting) are provided. These proposals are reasonably consistent with similar definitions as applicable to the satisfaction of the rebuttable presumption of reasonableness under the intermediate sanctions regulations. However, the examples of permissible documentation in the proposed instructions are more expansive that those contained in the regulations.

GOVERNING BODY REVIEW

Another area of controversy with the development of the Form 990 is whether the exempt organization's governing board is required to review the Form 990 before filing (Line 10). The proposed instructions make it clear that the IRS's principal interest is whether such a review took place, and if so, how (although the inference is that such a review is preferred practice). Details concerning the review (who conducted it, whether it was conducted before or after filing, the extent of the review) are to be described on Schedule O.

CONFLICTS OF INTEREST POLICY

The proposed instructions provide substantial guidance on the Line 12 questions regarding the exempt organization's conflict of interest policy. For example, a definition of "conflict of interest" is provided (Note: the IRS template conflicts policy does not contain any such definition). In addition, "dualities of interest" are not considered conflicts unless they involve material financial interest or benefit to the person. A description is provided of the types of conflicts disclosures to be made on the annual questionnaire (*e.g.,* list of family members, substantial business or investment holdings, and other transactions or affiliations with businesses and other organizations). Also significant is the detail sought (for Schedule O) on conflicts enforcement practices, whether discovered before or after the transaction has occurred. This includes a description of the types of persons covered by the policy, the level at which the conflicts determination is made and at which actual conflicts are reviewed, as well as any restrictions imposed upon persons determined to have a conflict with respect to a particular transaction.

EXECUTIVE COMPENSATION

The proposed instructions confirm that the IRS is interested in Line 15 in determining whether the organization satisfied the rebuttable presumption of reasonableness for purposes of particular compensation decisions. The Line 15b question appears particularly designed to inquire as to the basis by which comparability determinations were made.

JOINT VENTURES

The new Form 990 asks on Line 16 whether the organization invested or participated in a joint venture with a taxable entity during the year. In the draft instructions, additional clarity is provided with respect to the types of joint venture information sought for purposes of Line 16. For example, the term "joint ventures" includes not only those formed as partnerships but also corporations. Information as to the purpose of the venture (*e.g.,* conduct an exempt purpose, an investment activity, or an unrelated trade or business) is to be provided. Certain types of joint ventures (*e.g.,* those with primarily passive investments) can be disregarded for purposes of Line 16. The "policy or procedure" referenced in Line 16b is described as one that requires the organization to actually negotiate into its joint venture agreements exempt purposes safeguards, primarily from Rev. Rul. 98-15. Several examples of exempt purposes safeguards are also provided.

Compensation

The draft instructions discuss how organizations must report compensation information for officers, directors, trustees, key employees and five highest paid employees, and independent contractors. Some areas of interest include the following.

KEY EMPLOYEES

An organization must disclose all compensation and benefits of current "key employees" (*i.e.,* executives who do not fit within the fairly narrow definition of "officer"), and the Form 990 indicated that this would have to be done regardless of the compensation level of the key employee. The instructions provide a surprising $150,000 threshold for this purpose—the compensation of current key employees is not reported at all if the total is less than $150,000 for the year. "Key employee" is defined to include any employee who manages a portion of the organization representing 5 percent or more of the total activities, assets, income, expenses or employee compensation of the organization. As an example, the IRS expects that physicians who chair medical departments of the hospital would be treated as key employees for this purpose. This may result in an expansion of reporting for such organizations as hospitals, universities and academic medical centers.

FORMER OFFICERS

For purposes of reporting compensation of former officers, directors, trustees, key employees and five highest paid employees, a five-year lookback period applies.

$10,000 EXCLUSIONS

As a general rule, an organization must report the combined compensation from the organization and all related organizations. However, the instructions allow the exclusion of less than $10,000 received from any related organization. This exclusion applies to each related organization. Additionally, in reporting “other compensation” on the core form, an organization may exclude employee benefits that have less than $10,000 each, although this exclusion does not apply to tax-qualified defined contribution retirement plans, health benefit plans (and flexible spending plans used to pay for health benefits) and contributions to nonqualified deferred compensation arrangements.

SCHEDULE J

On the more detailed compensation chart in Schedule J, an organization need not report any fringe benefit that is excluded from taxable income. This includes all working condition fringe benefits.

For Line 1a purposes, an organization must disclose whether it has paid for first-class travel for any person whose compensation is being reported, including first-class upgrades on air travel (if paid for with organization funds). Another box under Line 1a requires that organizations disclose providing personal services for any person whose compensation is being reported. In disclosing “personal services” provided with organization funds, a very extensive list of personal services is contemplated, including payment by the organization for legal services (provided personally to the executive).

On Line 3, in disclosing whether the organization reviews and approves executive compensation in a manner that qualifies for the IRS safe harbor, the IRS contemplates that a “yes” answer would include the use of an independent compensation consultant (or the use of data from an independent consultant). For this purpose, the IRS provides a fairly broad definition of independence: the consultant is independent if he or she does not have a family or business relationship with the CEO, and if a majority of the consultant's appraisals during the same year are for other organizations, even if the consultant's firm also provides tax and audit services to the organization. This will enable many organizations that use their consultant for multiple engagements to take the position that the consultant is nevertheless independent.

Transactions with Interested Parties

The proposed instructions include detailed information on reporting transactions with insiders (*i.e.,* transactions between the organization and its officers, directors, trustees and key employees, or their family members or the businesses in which they exercise significant ownership or control). Organizations must report transactions with insiders in excess of the $10,000 per transaction threshold. Each payment falling under a separate contract or transaction is considered separately for purposes of applying this $10,000 threshold. Of note is that transactions with partnerships, limited liability companies or professional corporations owned to any degree by officers, directors, trustees or key employees count as transactions with interested parties.

In reporting transactions with insiders, an organization with more than 20 voting board members, and having an executive committee that has the power to act on behalf of the entire board, may disregard all current and former board members who are not current members of the executive committee, and who are not officers, key employee or one of the five highest paid employees.

Loans between the organization and any executive or other disqualified person (under the intermediate sanctions rules) need not be disclosed if the loans are no longer in existence on the last day of the fiscal year to which the Form 990 relates.

Hospitals

Those that have been following the IRS's comments since the release of the revised Form 990 will find few meaningful surprises in the draft instructions to Form 990, Schedule H. The draft instructions, however, serve as a stark reminder that many (if not all) hospitals and health care systems are ill equipped at the present to completely and accurately gather the information required to complete the full Schedule H when due in tax years starting in 2009. It is strongly recommended that hospitals use Schedule H and its draft instructions as a compliance tool for determining not only how the health care entity will be viewed to the general public when the full Schedule H is filed, but also as an immediate reality check on the current information-gathering systems in place and their ability to accurately gather and collect the significant volume of data required to complete Schedule H.

The draft instructions to Schedule H contain the following areas of particular interest.

DEFINITION OF HOSPITAL

As previously announced by the IRS, the term "hospital" is defined as a "facility" that is licensed or certified in its state as a hospital, regardless of whether it is operated directly by the organization or indirectly through a disregarded entity or joint venture taxed as a partnership. The term "facility" is defined as a physical location or address at which the organization provides medical or hospital care, including a hospital, outpatient facility, surgery center, urgent care clinic or rehabilitation facility, whether operated directly by the filing organization or indirectly through a disregarded entity or joint venture. The inclusion of joint ventures in this definition will likely require such joint ventures to develop methods of collecting community benefit information as it relates to the joint venture. Pursuant to the instructions, even if a hospital-licensed facility represents a small portion of a tax-exempt health care entity's overall operations, and even if such entity is not classified as a hospital under Section 170(b)(1)(A)(iii), the health care entity must still file a Schedule H.

ENTITY-BY-ENTITY ANALYSIS

The Form 990, Schedule H (as well as the rest of the revised Form 990) requires hospitals to report their results on an entity-by-entity basis. Accordingly, if a single health care system operates hospitals through multiple entities (other than disregarded entities or joint ventures), they will not be able to aggregate their results on Schedule H. (However, Schedule O may provide an avenue for hospitals wishing to include a narrative statement regarding the overall charitable aspects of their systems.) Conversely, if a single corporation operates multiple hospitals, it is instructed to fill out only one Schedule H.

COST ALLOCATIONS IN PART I

According to the instructions to Part I, a hospital is required to use the "most accurate costing methodology" in reporting various costs on Schedule H. Recall, however, that for purposes of calculating unrelated business income tax, a hospital is permitted to use "any reasonable method" for allocating costs. For hospitals that may use a different cost methodology for reporting costs on Schedule H, Part I and for reporting costs on Form 990-T, a potential audit trap awaits. Stated simply, IRS agents reviewing unrelated business income tax issues may seize on the cost methodology used in Schedule H, Part I and argue that because the hospital used a different cost methodology in preparing Schedule H, the method used on the Form 990-T for reporting costs is not a "reasonable method."

BAD DEBTS

Bad debts continue to be an area of controversy, with the IRS viewing such costs as having little, if any, charitable relevance. The IRS takes an unusual approach in defining the terms "bad debt" and "charity care." On the one hand, the IRS states unequivocally in the draft instructions that the IRS is not requiring hospitals to adopt the definitions of "bad debt" and "charity care" contained in HFMA Statement No. 15. However, the Form 990, Schedule H still requires a hospital to indicate whether it has, in fact, adopted such Statement No. 15. Accordingly, the Form 990, Schedule H results in a negative inference against hospitals that have not adopted Statement No. 15. In essence, the IRS is attempting to "shame" hospitals into adopting HFMA Statement No. 15 since it cannot require hospitals to do so.

BAD DEBT EXPENSE RELATED TO CHARITY CARE

Schedule H, Part III requires hospitals to provide: (1) an "estimate" of the percentage of bad debt expense attributable to persons who qualify for financial assistance under its charity care policy and (2) a rationale for what portion of bad debt expense the hospital believes should constitute community benefit. In arriving at the estimate, the draft instructions clarify that hospitals may use any reasonable methodology to estimate this percentage, including record reviews, assessment of charity care applications that were denied as a result of incomplete documentation, analysis of demographics or other analytical methods. If, upon review, the hospital determines that a patient would have been eligible for discounted care, but not free care, the hospital may only include the costs of treating that patient less the amount of the discount in its estimate.

JOINT VENTURES AND MANAGEMENT COMPANIES

Pursuant to the instructions, the requirement in Part IV to report interests in management companies and joint ventures is only applicable: (1) when directors, officers, key employees or medical staff physicians, in the aggregate, own 10 percent or more of the interests in such entities, and (2) the joint ventures or management companies (A) provide management services used by the organization in its provision of medical care, or (B) provide medical care, or own or provide real, tangible personal or intangible property used by the organization or by others to provide medical care. The instructions clarify that joint venture entities required to be reported by the hospital in this section include corporations.

INFORMING PATIENTS OF ELIGIBILITY FOR ASSISTANCE

In Part VI of Schedule H, hospitals are required to describe the manner in which patients are informed as to the potential availability of financial assistance under government programs or under the hospital's charity care policy. The draft instructions provide greater detail on the ways in which a hospital may inform patients about eligibility for assistance, including posting the policy in admission areas, emergency rooms and other areas in which eligible patients are likely to be present; providing a copy of the policy (or summary of the policy) and including financial assistance contact information as part of the intake or discharge process; and including such information in patient bills.

COMMUNITY BUILDING ACTIVITIES

This section of Schedule H requires hospitals to list the costs associated with "community building activities" and describe how such activities provide community benefit and promote the health of the community the hospital serves. Curiously, with respect to reporting "Workforce Development" expenses, the instructions provide as an example that recruitment costs of physicians and other health professionals to medical shortage areas or other areas designated as underserved may be included in this section. By negative implication, the costs associated with recruiting such health care professionals to areas that are not so designated are not includible in this section of the Schedule. Rev. Rul. 97-21, however, expressly recognizes that the recruitment of physicians to a hospital need not be in a medical shortage area or area designated as underserved in order to be considered a charitable activity. Accordingly, the instructions to Schedule H appear to be in direct conflict with established IRS precedent in this area.

WORKSHEET 5 – HEALTH PROFESSIONS EDUCATION

Worksheet 5 is to be used by hospitals to calculate the net cost of providing education to health professionals, a recognized charitable benefit. The instructions include a chart to illustrate those types of professional educational expenses that are includible in this calculation and those that are not. For example, providing education to nurses is considered a community benefit program only if the nurses are free to seek employment at any organization. If the nurses receiving the education are required to become employees of the hospital, the cost is not considered a community benefit by the IRS because such costs primarily benefit the hospital, not the community.

In summary, one would be hard pressed to find a Section 501(c)(3) hospital that does not believe it is worthy of its charitable status. However, when the entire Schedule H is required to be filed in 2010, this sense of entitlement to charitable status could be the tax reporting equivalent of "The Emperor's New Clothes"—where the hospital's perception of how it views itself and how the IRS, media and general public will actually view the hospital may be vastly different. Accordingly, the early release of the instructions to Schedule H represents a useful planning opportunity for hospitals to self-assess how charitable they will look to the general public when the Schedule must be fully completed. Hospitals should review whether current mechanisms in place accurately capture the data required by Schedule H, prepare narrative descriptions to be included in the full Schedule H when due and, if appropriate, consider whether some minor changes in corporate structure or joint venture ownership may better reflect their charitable operations.

Group Returns

The draft instructions include additional information for organizations filing group returns. The IRS wants to know whether organizations filing forms on behalf of groups understand how to complete the Form based on these draft instructions. The instructions are littered with examples designed to guide organizations filing group returns, a few of which are discussed below.

SCHEDULE H

One helpful example appears in the instructions for Schedule H, which state that, in the case of group returns, if the group operates multiple hospital facilities, then it should report aggregate information from all of the hospitals on one Schedule H.

COMPENSATION

The instructions for Part VII of the core form (dealing with compensation) have specific instructions for group returns. For example, a parent organization filing a group return has two choices for completing Part VII and Schedule J: (i) it may file a Form 990, Part VII and Schedule J, Part II for itself and another Form 990, Part VII and Schedule J, Part II with information for each subordinate included in the group return; or (ii) it may file a single consolidated Form 990, Part VII and Schedule J, Part II for itself and all subordinates included in the group return. Whatever method it selects, the filing organization must report this method on Schedule O and adhere to this method in future years.

Related Organizations, Disregarded Entities and Joint Ventures

The draft instructions guide organizations through Schedule R's questions on organizations to which they are related and on the activities they conduct through disregarded entities and joint ventures. Of particular interest are the instructions on the following issues.

RELATED ORGANIZATIONS

The instructions define the term "related organization" to include an organization's parents, subsidiaries, brothers and sisters under common governance or control, and any section 509(a)(3) supporting or supported organizations of the filing organization. In the required listing of related organizations, the instructions indicate that if the related organization is a Section 501(c)(3) supporting organizations (*i.e.,* described in Section 509(a)(3)), the reporting organization must specify the type of supporting organization (Type I, Type II, Type III-functionally integrated or Type III-other).

UNRELATED ORGANIZATIONS

Tax-exempt organizations must disclose "significant activities" conducted through unrelated organizations taxable as partnerships. For these purposes, under the draft instructions, a tax-exempt organization conducts a significant activity through an unrelated partnership (or LLC) if it receives either more than 5 percent of its total revenues from the unrelated partnership or if its partnership interest represents more than 5 percent of its total assets. The proposed instructions to Schedule R include an example illustrating the application of the 5 percent of total revenues or total assets test. The instructions also note that if the unrelated partnership's primary purpose is the production of income (other than program-related investment income), then the filing organization need not disclose its activities on Schedule R. Also, a filing organization need not complete this Schedule R disclosure if 95 percent of its gross income from the unrelated partnership is excluded from unrelated business taxable income as interest, dividends, royalties, rents and capital gains.

DISPROPORTIONATE ALLOCATIONS

On Schedule R, Part III (Column H) and VI (Column F), the IRS asks whether the organization received disproportionate allocations from either related or unrelated organizations that were taxable as partnerships. The draft instructions clarify that an organization need only report disproportionate allocations it receives based on its own investment in the partnership. To determine if an allocation is disproportionate, an organization should measure its share of income, deduction, gain, loss or credit, or right to distribution against its overall share of the entity. For a joint venture, this calculation is made using the ending capital account percentage listed on the Schedule K-1 for the partnership tax year ending in the organization's tax year. If the Schedule K-1 is not available, the organization may make a reasonable estimate based on its business records.

Comments Requested

Generally, the IRS is requesting comment on how certain portions of the instructions may be streamlined or eliminated. In special "highlights" to the instructions, the IRS indicates specific issues on which it hopes to receive public comment. One of these is the description of program service accomplishments. An area of emphasis for the IRS throughout the redesign process has been increasing uniformity in reporting. To improve uniformity and comparability in narrative sections, the IRS plans to include sector-specific program accomplishment statements as examples in its final instructions. The IRS is requesting comment on whether organizations in particular sub-sectors (such as all nursing homes, all hospitals or all trade associations) should uniformly report certain kinds of information in their statements of accomplishment.

The IRS plans to list on its website all comments received on the instructions, just as it listed the comments it received on the draft Form 990. The comment period on these draft instructions is open until June 1, 2008, a comment period notably longer than was initially anticipated. The IRS prefers to receive comments to the draft instructions in text format documents (*i.e.,* not picture format) via e-mail at Form990Revision@irs.gov. Although the IRS prefers to receive comments via e-mail, it will also accept comments at the following address:

Internal Revenue Service
Draft 2008 Form 990 instructions, SE:T:EO
1111 Constitution Ave., NW.
Washington, D.C. 20224

The IRS plans to issue final instructions by the end of 2008.

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