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Exempt Organizations Update

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in this issue

Inaugural Issue

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The Form 990-N and Form 990-EZ Filing Relief Program for Small Charities

On July 26, 2010, the IRS announced a one-time filing relief program for small exempt organizations that have failed to file annual returns for the past three years. Generally, exempt organizations that fail to file annual returns for three consecutive years automatically lose their tax-exempt status. However, under the filing relief program, non-filing organizations have, for a limited time, the opportunity to come back into compliance and retain their tax-exempt status.

Two types of relief are available for small exempt organizations under this program.

- First, the May 17, 2010 due date for filing the 2009 Form 990-N (electronic postcard) has been extended to October 15, 2010. The Form 990-N (electronic postcard) is the annual return applicable to small organizations with annual gross receipts normally below $25,000. Non-filing organizations can take advantage of the program by going to the IRS website at http://www.irs.gov/charities/article/0,,id=169250,00.html and filing their 2009 Form 990-N on or before October 15, 2010.

- Second, a voluntary compliance program (VCP) has been created for organizations eligible to file a Form 990-EZ for each of the past three years. To participate in the VCP, an organization must (1) file a complete and accurate paper Form 990-EZ and/or Form 990 for its current year and each of the two prior tax years by October 15, 2010, (ii) submit a signed checklist agreeing to the terms of the VCP, and (iii) submit a check in the amount of the applicable compliance fee. Non-filing organizations participating in the program must file all three returns in a single envelope addressed to Internal Revenue Service, M/S 1114, P.O. Box 12610, Ogden, UT 84412. The organization must write "Filing Relief VCP" on the outside of the envelope and on the top of each form submitted to

> *IRS Humor:*
>
> *"Income tax has made more liars out of the American people than golf."*
>
> *Will Rogers, Humorist*

the IRS. The required checklist is available at the IRS's website at http://www.irs.gov/pub/irs-tege/nonfilervcp_checklist.pdf. The filing fee is based upon the organization's 2009 gross receipts and is $100 if gross receipts are $100,000 or less, $200 if gross receipts are $100,001 to $200,000, and $500 if gross receipts are $200,001 to $499,999.

Relief is not available under the filing relief program for private foundations or large organizations that must file Form 990.

Planning Tip. If you are unsure if your organization has filed its returns, go to http://www.irs.gov/charities/article/0,,id=225889,00.html and review the IRS's "List of Organizations at Risk of Automatic Revocation of Tax Exempt Status."

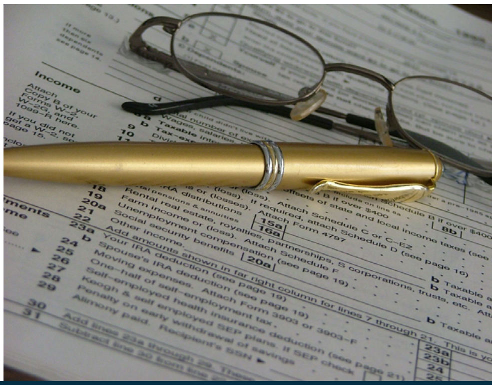
Officer and Director Indemnification

Generally, an officer or director of a Connecticut nonstock corporation is shielded from personal liability for the organization's liabilities if the individual discharges his or her duties (i) in good faith, (ii) with the care an ordinarily prudent person in a like position would exercise under similar circumstances, and (iii) in a manner that he or she believes to be in the best interests of the organization. However, this liability protection does not shield the officer or director from being sued personally for matters arising out of the person's status as an officer or director. Thus, individuals are increasingly aware that accepting a position with a tax-exempt organization comes with certain risks. Organizations that do not protect their officers and directors by indemnifying them from the costs associated with such lawsuits face difficulty recruiting top individuals.

There are three levels of indemnification available to tax-exempt organizations in Connecticut, mandatory indemnification (good), permissive indemnification (better), and maximum indemnification (best).

- The lowest level of indemnification, mandatory indemnification, is automatically available to a tax-exempt organization's officers and directors. Under mandatory indemnification, a tax-exempt organization is required to indemnify an officer or director who is wholly successful in the defense of any proceeding to which he or she is a party because he or she was an officer or director. Under mandatory indemnification, the organization is required to indemnify the officer or director only for reasonable expenses incurred in connection with the proceeding. Thus, under mandatory indemnification, an organization need only indemnify an officer or director if the officer or director (i) successfully defends the lawsuit (wins), and (ii) demonstrates that his or her expenses in defending against the lawsuit were reasonable. Many exempt organizations, as well as their officers and directors, are not comfortable relying on Connecticut's mandatory indemnification laws.

- The second level of indemnification, permissive indemnification, is not mandatory; it is optional. Under permissive indemnification, a tax-exempt organization can choose to indemnify an officer or director who is a party to a proceeding because of his or her status as an officer or director. If the organization so chooses, it can indemnify an officer or director against any liability incurred in the proceeding, and without regard to whether the officer is successful in the defense of the proceeding. However, to qualify for permissive indemnification, the officer or director must have (i) conducted himself of herself in good faith, (ii) reasonably believed that his or her conduct was, depending on the circumstances, in the best interests of the corporation or at least not opposed to the corporation's best interests, and (iii) if the proceedings are criminal, that the officer or director had no reasonable cause to believe his or her conduct was unlawful. However, even if an officer or director could qualify for this level of indemnification, a tax-exempt organization is not required to provide such indemnification unless the organization (i) authorizes the indemnification, and (ii) determines that the officer or director has met the relevant standard of conduct described above. Fortunately, to provide officers and directors with a high level of comfort that their organization will stand behind them and authorize permissive indemnification if the need



arises, an organization can obligate itself to provide such permissive indemnification in advance of an act or omission that could give rise to a legal proceeding. This advance authorization can be accomplished by including appropriate provisions in the organization's certificate of incorporation or bylaws.

- The highest level of indemnification that is available, maximum indemnification, may be provided only if the organization's certificate of incorporation contains a provision permitting or making such indemnification mandatory. Provisions in a certificate of incorporation that make maximum indemnification mandatory provide directors with a high level of assurance that their organization will support them in the event of a proceeding arising out of the individual's status as a director. Under maximum indemnification, a director can be indemnified for a liability arising out of any action taken, or any failure to take any action, as a director, provided the director's conduct did not (i) involve a knowing and culpable violation of the law by the director, (ii) enable the director or an associate to receive an improper gain, (iii) show a lack of good faith and conscious disregard for the director's duty in a situation where he or she was aware that his or her conduct or omission created an unjustifiable risk of serious injury to the Corporation, or (iv) constitute such a sustained and unexcused pattern of inattention that it amounted to an abdication of the director's duty to the organization. Indemnification under Connecticut's maximum indemnification provision is available only to directors.

However, an organization's officers are not precluded from being indemnified beyond Connecticut's mandatory and permissive levels of indemnification. An organization can provide its officers with such additional indemnification so long as such indemnification is consistent with public policy. In addition, an organization may, under appropriate circumstances, advance funds to an individual to pay for reasonable expenses incurred in connection with a proceeding against such individual arising from such individual's status as an officer or directors.

Planning Tip. An organization has many choices with respect to the indemnification it can provide to its officers and directors (and, in fact, its other employees, agents and volunteers). If you are an office or director of an organization, or an advisor to an exempt organization, review the organization's organizational documents (certificate of incorporation, bylaws, etc.) and determine the level(s) of indemnification that the organization is permitted or (even better) obligated to provide to its officers and directors.

Corporate Governance and the New IRS Governance Check Sheet

Accountability, transparency, corporate responsibility - themes we often hear in the news, in board meetings, and in guidance provided by the IRS. It is no secret that the IRS believes that well-governed charities are more likely to obey tax laws, safeguard charitable assets, and serve charitable interests than are a poorly governed charities. The IRS's interest in good governance is well documented in its forms and publications. The IRS Form 1023 (tax-exemption application) requires the submission of an organization's organizational document (certificate of incorporation, charter, etc.) and bylaws. In addition, the Form 1023 requires an organization to describe its policy on ensuring that the compensation paid to its officers, directors, trustees and certain employees is reasonable. Moreover, the IRS Form 990 (annual return) has an entire section devoted to corporate governance with specific subsections addressing (i) governing body and management issues, and (ii) organizational policies, such as conflict of interest policies,

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whistleblower policies, document retention and destruction policies, and joint venture participation policies.

In December of 2009, the IRS published a "Governance Check Sheet" to be used by IRS Revenue Agents conducting audits of publicly supported tax-exempt organizations. The Governance Check Sheet addresses corporate governance with respect to the following areas: (i) Governing Body and Management; (ii) Compensation; (iii) Organizational Control; (iv) Conflict of Interest; (v) Financial Oversight; and (vi) Document Retention.

The Governance Check Sheet contains simple questions including those directed to whether the organization has a written mission statement, conflict of interest policy and/or document retention and destruction policy. In addition, the Check Sheet contains more complicated questions, such as the following:

1. Are compensation arrangements for all officers, directors, trustees and key employees approved in advance by an authorized body of the organization composed of individuals with no conflict of interest with respect to the compensation arrangement?

2. Did any of the organization's voting board members have a family relationship and/or outside business relationship with any other voting or non-voting board member, officer, director, trustee or key employee?

3. Are there systems or procedures in place intended to make sure that assets are properly used, consistent with the organization's mission?

Planning Tip. It is always a good idea for an organization's directors to review periodically both the organization's governing documents, policies and procedures as well as the organization's adherence to and compliance with such governing documents, policies and procedures. However, with the increased scrutiny that the IRS is giving to exempt organizations and their governing documents, it is now, more than ever, important for an organization's board of directors to understand the IRS governance guidelines and whether or not their organization's policies and procedures comply with those guidelines.

Employment Tax Audits

The IRS announced that its exempt organization unit is participating in a national research program focusing on employment tax compliance. Under this program, approximately 500 exempt organizations will be selected for employment tax audits during 2010. In addition to exempt organizations, federal, state and local governmental units will also be audited.

In addition to the national research program, the IRS and the Connecticut Department of Revenue Service have been actively and aggressively conducting audits of exempt organizations for payroll tax issues. Auditors typically concentrate on under-withholding, unremitted tax, unreported wages, deposit and reporting compliance, and whether a worker is properly classified as an employee or as an independent contractor. These audits often result in the imposition of taxes, penalties and interests against the exempt organization. In some cases, penalties are imposed directly on the individuals responsible for payroll functions.

> *Interesting Fact!*
>
> *According to the IRS, 20% of the U.S. workforce is employed by tax exempt organizations*

Planning Tip. Be prepared! Do not wait for an audit to ensure that your organization is in compliance with its payroll tax withholding, reporting, payment and filing obligations. Learn your employment tax obligations and then review your payroll functions to ensure that they are in compliance with the tax laws. In addition, review the relationships between your organization and those individuals considered to be independent contractors. Many individuals claiming to be independent contractors do not satisfy the IRS's requirements to be treated as such for payroll tax purposes. Failing to treat these individuals as employees can result in the imposition of taxes, interest and penalties against your organization.

New Exemption Requirements for Charitable Hospitals

As part of the Patient Protection and Affordable Care Act, the United States Congress enacted new Section 501(r) of the Internal Revenue Code imposing new requirements that must be satisfied by a charitable hospital in order to maintain its exemption from federal income taxation.

Effective for taxable years beginning on or after March 23, 2010, a charitable hospital can lose its tax-exempt status if it fails to satisfy any of the following four additional requirements:

- The hospital must conduct a community health needs assessment once every three taxable years and adopt an implementation strategy to meet the community needs identified through the assessment. The assessment process must take into account input from persons who represent the broad interests of the community served by the hospital, including those with special knowledge of or expertise in public health, and the assessment must be made widely available to the public. Failure to complete the assessment in any three-year period results in a $50,000 penalty on the hospital. The first community health needs assessment and implementation strategy must be completed by the hospital no later than its third taxable year after March 23, 2010.

- The hospital must adopt, implement and widely publicize a written financial assistance policy. The policy must include: (i) eligibility criteria for financial assistance, and whether such assistance includes full or discounted care; (ii) the basis for calculating amounts charged to patients; (iii) the method for applying for financial assistance; (iv) if the hospital does not have a separate billing and collections policy, the actions that may be taken in the event of nonpayment, including collections actions and reports to credit agencies; and (v) measures to widely publicize the policy within the community. The hospital also must have a written policy to provide emergency medical treatment to individuals without discrimination against those individuals who are eligible for assistance under the hospital's financial assistance policy or for government assistance.

- If an individual qualifies for assistance under the hospital's financial assistance policy, the hospital may not use gross charges (i.e. "chargemaster" rates) for emergency or other medical necessary care, but must use one of the following: (i) the best negotiated commercial rate; (ii) the average of the three best negotiated commercial rates; or (iii) the Medicare rate.

- A hospital may not undertake extraordinary collection actions (including lawsuits, liens on residences, reports to credit rating agencies, etc.) against an individual without first making reasonable efforts to determine whether the individual is eligible for assistance under the hospital's financial assistance policy. "Reasonable efforts" include notification of the policy upon admission and in written and oral communications with the patient regarding the patient's bill, including invoices and telephone calls, and before a collection action or a report to a credit rating agency is initiated.

In addition to the foregoing, the charitable hospital will be required to disclose on its Form 990 how the hospital is addressing the needs identified in each community health needs assessment and, if it is not addressing a particular need, why that is the case. Hospitals also will be required to provide audited financial statements with their Form 990.

Planning Tip. Each charitable hospital should work now to amend their financial assistance policies, billing and collection forms and related public materials so that they are in compliance with the law as of the first day of their next fiscal year. Since the first community health needs assessment need only be performed within the next three fiscal years, and the IRS has published a request for comments (IRS Notice 2010-39) on what should be included in an assessment, we would recommend that hospitals should wait for further guidance on the topic from the IRS prior to conducting an assessment.

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Employee Housing Provided by Schools

Educational institutions often consider supplementing the income of key faculty members by providing on- or near-campus housing. The advantage of this type of in-kind benefit is that it provides value to employee with little or no cash outlay by the non-profit employer. Moreover, schools often view faculty housing as instrumental in promoting a collegial, community atmosphere. Despite these advantages, schools (and other not-for-profit organizations) should be aware that providing housing to employees could result in unwanted tax consequences. Most notably, employees could be liable for federal and state income tax on the value of the housing they receive.

Generally, where lodging is provided to an employee for free, or on discounted terms, the net fair market value that benefit must be reported by the recipient as W-2 wage income, subject to withholding. Notwithstanding the above, there are two avenues through which free or discounted lodging may be provided to an employee of an educational institution on a tax-preferred basis.

First, the tax code allows an employee to exclude from his or her gross income the value of lodging furnished to that employee on the business premises of the employer, so long as (i) the housing is provided to the employee for the convenience of the employer, and (ii) the employee is required to accept the housing as a condition of his or her employment. Where each of the above three criteria are met, regardless of whether the lodging proves to be convenient or beneficial to the employee as well as the employer, no income is considered to accrue to the employee as a result of the lodging provided.

Second, under section 119(d) of the tax code, a provision directed solely to educational institutions, there exist a “safe harbor” for the provision of certain housing benefits. In particular, current tax law allows an employee of an “educational institution” to exclude from his or her gross income the value of “qualified campus lodging” furnished to that employee during the taxable year, provided that the employee pays “adequate rent.”

Planning Tip. Each of the above tests are fraught with ambiguities and pitfalls, but properly understood, may allow an educational institution to provide an attractive benefit to its key employees, without saddling those employees with additional taxable income. Proper tax advice is critical to ensure compliance with these complex rules, and to avoid taxes, interest and penalties that may accrue where a taxable benefit, such as housing that does not satisfy the above exceptions, is not properly reported to the Internal Revenue Service.

Questions or Assistance?
If you have questions about any of the topics we have discussed in this newsletter, please feel free to contact one of the attorneys listed on page 3 of this newsletter.

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