JONES DAY

MAY 2006

NONPROFIT PANEL RELEASES REPORT ON TRANSPARENCY, GOVERNANCE, AND ACCOUNTABILITY

On April 25, 2006, the Panel on the Nonprofit Sector released a supplement to its June 2005 report to Congress addressing transparency, governance, and accountability in the nonprofit sector. Many of the recommendations from the original report have been included in legislation that is currently pending in Congress, and Senator Chuck Grassley (R-Iowa), Chairman of the United States Senate Committee on Finance, has stated that he foresees more nonprofit governance reforms coming in future bills. At the same time, more and more states are taking action legislatively or administratively to reform the rules of nonprofit governance, and the IRS is drastically stepping up the breadth of its enforcement activities in the nonprofit sector. The Panel's supplemental report could provide the impetus for acceleration of these various enforcement activities.

CONVERSIONS TO FOR-PROFIT STATUS

The supplemental report notes that one area of concern is the potential for windfalls and loss of community services that may result from nonprofit conversions. Although the volume of such deals spiked in the 1990s, for approximately four decades a variety of nonprofit organizations (frequently hospitals) have converted from nonprofit to for-profit status. Those conversions have taken the form of asset sales, stock sales (after a state law change from nonprofit to business corporation form), joint ventures, and mergers. Historically, these transactions have been regulated by the states, through the attorneys general or other regulators. A number of organizations, however, have questioned whether there is sufficient state (and federal, for the tax implications) oversight of nonprofit conversions.

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One potential concern with nonprofit conversions relates to the compensation and other benefits provided to the executives and, at times, the directors of the nonprofit. These benefits may include generous severance payments, signing bonuses and other rich compensation packages with the for-profit successor, stock options, and windfalls from a rapid appreciation in the value of the acquired operations (which typically leads to suspicion concerning the reliability of the valuations obtained in the conversion process). If the directors and officers (or other insiders who are disqualified persons) receive potentially excessive payments *(i.e.*, an amount in excess of fair market value) from the nonprofit, they may be subject to excise taxes at rates of up to 225 percent of the excess. Such payments, besides undervaluing the assets of the nonprofit in any conversion or giving up too much control over the charitable assets in a joint venture, can lead to a finding of inurement or more than incidental private benefit, which in turn would jeopardize the nonprofit's tax-exempt status. If the conversion is structured as an "in-place conversion" where the nonprofit becomes a stock corporation and the shares are acquired by a for-profit or individuals, then future payments to insiders must continue to meet fair market value limits or they will be subject to the 225 percent excise tax.

Regardless of the financial benefits to private parties from the conversion, communities and regulators are often apprehensive about the effect the conversion will have on services to the community. Although most conversions result in the funding of an existing or new charity (in an amount equal to the fair market value of the nonprofit's assets), that charity may benefit the community in different ways, potentially unrelated to the charitable mission of the converted nonprofit. In other cases, state authorities attempt to appropriate the conversion proceeds to provide short-term budget relief in an economic crisis, rather than allowing the creation of an endowment to benefit future generations. Some of those concerned with conversions have suggested that federal legislation and regulation are needed to correct the perceived problem. In fact, under a 2005 proposal from the Joint Committee on Taxation, all conversions would be subject to advance review and approval from the IRS with a one-year time line for the reviews.

In its supplemental report, the Panel recommends that state charity officials, not the federal government, are in the best position to evaluate the effect of conversions quickly and should continue to be responsible for prospective review of conversion transactions. The Panel also recommends that nonprofits support the enactment of legislation on a state level that would clearly subject all proposed nonprofit conversions to a notice, disclosure, and review process. In addition, the Panel believes that nonprofits should urge the National Association of Attorneys General and the National Association of State Charity Officials to develop a model act governing conversions, with guidelines for the appropriate role of state regulators in nonprofit conversions, including safeguards to avoid the diversion of charitable assets for other governmental purposes (*e.g.*, to meet other budget deficits). Finally, the Panel recommends that the current laws regarding inurement, private benefit, and excess benefit applicable to conversions be "vigorously enforced" by the IRS in reviewing completed transactions.

UNRELATED BUSINESS INCOME TAX

Currently, 501(c)(3) organizations are required to make their three most recent annual Forms 990 available to the public. That disclosure requirement, however, does not apply to the annual return for unrelated business income tax (Form 990-T). The Panel's supplemental report notes that there has been some concern that nonprofits are understating their unrelated business income tax liability and that insiders are personally benefiting financially from the unrelated business activities. One suggestion proposed to alleviate these concerns is to mandate public disclosure of all Forms 990-T. Going beyond disclosure, legislation currently pending in Congress would require independent certification of the determination of unrelated business income tax liability on the Form 990-T by an organization's professional advisors.

As the supplemental report notes, requiring disclosure of Form 990-T would be contrary to the traditional confidentiality protection afforded to tax returns in this country. The two IRS forms routinely filed by nonprofits—990 and 990-T—serve

distinct purposes. Form 990 is an information return; its purpose is to provide information about the activities of the organization, more similar in nature to a public company's annual report, including narrative descriptions and basic financial information. Form 990-T, on the other hand, is the actual tax return of a charity, with more detailed information on business operations that may be fairly considered proprietary. The supplemental report notes that making such information publicly available would destroy the level playing field created by the enactment of the unrelated business income tax provisions in the 1950s and provide an unfair advantage to for-profit competitors. As a result, nonprofits could have great difficulty recruiting joint venture partners (who would object to such public disclosure of sensitive business information) and could see an undervaluation of taxable subsidiaries in the market, thereby reducing likely sale proceeds and ability to fund future charitable activities by disposing of the taxable operations.

The Panel recommends that the IRS amend Form 990 to require clear disclosure in that form of all of an organization's unrelated business activities, while preserving the confidentiality of the 990-T tax return. In addition, the supplemental report suggests further clarification from the IRS that compensation paid to directors, trustees, officers, and key employees from any affiliate, taxable or tax-exempt, must be reported on the Form 990 if above a specific dollar threshold (currently total compensation of $100,000 from all related parties, at least $10,000 of which was provided by the affiliate). The Panel also recommends that charities be required to disclose any circumstance where a director, trustee, or officer owns 10 percent or more of any entity in which the charity also has at least 10 percent ownership (*e.g.*, joint ventures with insider investment or stock options).

TAX COURT JURISDICTION AND PRIVATE RIGHT OF ACTION

Enforcement of fiduciary duties and breaches of charitable trust are typically within the purview of state attorneys general or the directors, trustees, and officers of the organization through suits filed in state court. Where specific donations are affected, the donors also may have standing to challenge a charity's actions. By contrast, the Tax Court's jurisdiction over exempt organization matters generally has been limited to reviewing IRS exemption determinations or excise tax assessments. The Tax Court does not have broad equitable powers over exempt organizations, nor do private individuals have standing to bring suit to enforce Section 501(c)(3) or other provisions of the Internal Revenue Code. The recent wave of unsuccessful purported class action lawsuits filed against hospitals related to care of the uninsured resoundingly confirmed this lack of standing.

In its supplemental report, the Panel notes that limiting enforcement of the tax laws to actions brought by the federal government is necessary to protect charities from nuisance suits and to prevent the wasting of charitable assets to pay for the defense of those suits. Furthermore, the expertise of the IRS and the Tax Court lies in the area of applying federal tax laws, and they are not well equipped in the Panel's view to deal with disputes related to corporate governance, fiduciary duties, and charitable trust principles. As the Panel notes, adding a layer of federal fiduciary duties to the already intricate network of rules faced by the nonprofit sector (particularly in health care) would increase the confusion and uncertainty of nonprofits attempting to comply with the differing standards.

The Panel recommends against any expansion of the equitable powers or jurisdiction of the Tax Court or any private right of action in the Tax Court for individual directors or the public at large. Instead, it notes that existing enforcement mechanisms, such as prohibited self-dealing for private foundations and the excise tax on excess benefits for charities, are "powerful tools to protect charitable assets." In the Panel's view, expanding the jurisdiction of the Tax Court would do little to improve compliance with fiduciary duties in the nonprofit sector.

JONES DAY EXPERIENCE WITH NONPROFIT CORPORATE GOVERNANCE AND ACCOUNTABILITY

We have assisted a number of clients in the process of establishing, reviewing, and modifying a wide array of corporate policies regarding conflicts of interest, related party transactions, charity care and other community benefits, reporting community benefit activities, self-audit and review of unrelated business activities, and corporate accountability, as well as responding to legislative inquiries on the topic. In addition, Jones Day has represented hospitals and health systems nationally in eight different cases in the recent wave of purported class actions filed by plaintiffs' lawyers on behalf of the uninsured and underinsured. Jones Day attorneys are also experienced in structuring and dealing with state regulators and the IRS in nonprofit conversions of a variety of organizations, including hospitals, HMOs, home health agencies, and research organizations. In addition, our substantial transaction experience, coupled with our regulatory knowledge, positions Jones Day to advise clients regarding the potential issues that may arise surrounding valuation of nonprofit assets and compensation packages.

LAWYER CONTACTS

We would be glad to talk with you regarding how your organization addresses these important areas. If we can be of assistance or if you would like further information, please contact your principal Firm representative or one of the lawyers listed below. General e-mail messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

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