A PUBLICATION OF THE AMERICAN HEALTH LAWYERS ASSOCIATION

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IRS Mandates Heightened Transparency in Redesigned Form 990

—Page 8

Lessons from Libby: Be Prepared for Government Investigations

—Page 20

Focus On Ligitation Support—29

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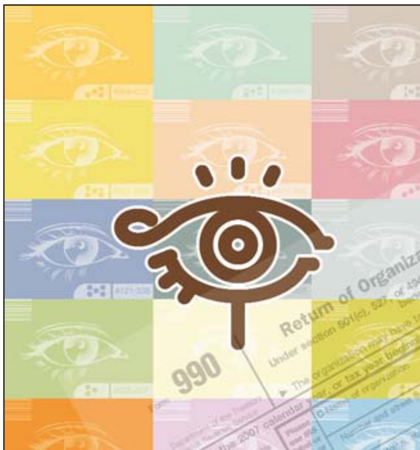

On the Cover

8 IRS Mandates Heightened Transparency in Redesigned Form 990

On June 14, 2007, the Internal Revenue Service released a draft redesigned Form 990, which includes a Core Form and 15 associated Schedules. This article, by Gerald M. Griffith, James R. King, and Daniel J. Bacastow from Jones Day, examines the draft redesigned Form 990 and discusses its significant implications for tax-exempt healthcare organizations.

20 HEALTH LAW **ANALYSIS**

Lessons from Libby: Be Prepared for Government Investigations

Departments

16 Education at a Glance

Forms

Focus On Litigation Support— Page 29

Reserve 33-34 Resource Guide Now

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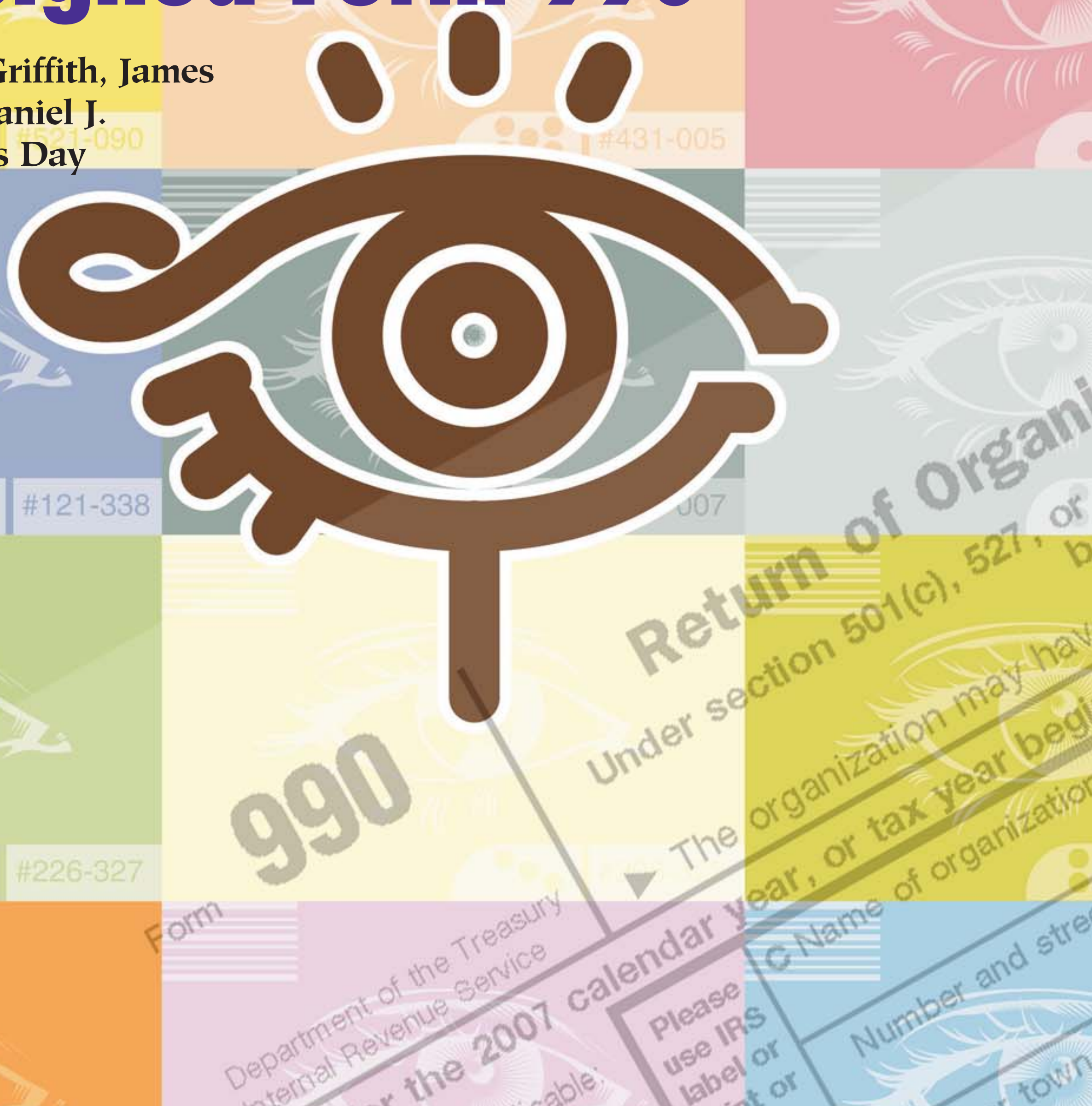
IRS Mandates Heightened Transparency in Redesigned Form 990

By Gerald M. Griffith, James R. King, and Daniel J. Bacastow, Jones Day



This Feature Article was drafted by members of a Practice Group of the American Health Lawyers Association (Health Lawyers). The views are those of the authors and do not represent the position of the Association or the sponsoring Practice Group. Health Lawyers is a non-partisan educational organization that does not take positions on public policy issues and instead provides a forum for an informed exchange of views. Health Lawyers invites those with opposing views on the Feature to submit letters or articles, which will be reviewed, published and edited on a space available basis. Letters to the Editor should be no longer than 250 words in length. If those seeking to respond would like to do so in the form of an article, he or she may submit it for consideration to editorial@healthlawyers.org, and the proposed article will be considered in the ordinary editorial process.

On June 14, 2007, the Internal Revenue Service (IRS) released a draft redesigned Form 990 ("Discussion Draft"), the annual information return filed by many Section 501(a) tax-exempt healthcare organizations.[1] The IRS hopes to finalize the redesigned Form 990 for the 2008 tax year, and it provided for a 90-day comment period (expiring September 14, 2007). The Discussion Draft includes a Core Form and 15 associated schedules.[2] It does not involve any changes in the substantive rules governing tax-exempt organizations; however, in many respects it is more important than many substantive positions the IRS has adopted. It will impact all tax-exempt healthcare organizations in several very significant ways. It is too early to say whether the IRS will provide any transitional relief for the new disclosure standards.

Impact of New Format

Under the Discussion Draft format, the Form 990 has become an SEC-like disclosure document containing a vast store of information about an organization's activities and the extent to which it engages in financial transactions with insiders. With this new approach, the IRS has taken full advantage of its authority to require extensive reporting and disclosure by exempt organizations, including payments to highly compensated employees,[3] information regarding disqualified persons, and any other information that the Secretary may require for purposes of carrying out the tax laws.[4]

This new format is extremely important from an enforcement perspective, and it has the potential to significantly enhance transparency. The constant theme of the Discussion Draft is to ask for detailed information about what organizations are doing and how they are doing it, particularly in areas where the IRS has perceived the potential for abuse. This approach gives the IRS ready access to hard factual data to make judgments about the need for enforcement action,[5] and sets up a possible focus on false or fraudulent returns in the future.

In addition, because the Form 990 is publicly available, the IRS will be assisted in its enforcement efforts by the "eyes and ears" of state attorneys general, legislative bodies, the press, and other interested members of the general public—many of whom will have "an agenda" and all of whom will have quick and easy access to a substantial amount of information. With the electronic filing of recent Forms 990, the IRS also will be able to slice and dice the information and develop lists of audit targets and potential audit issues significantly faster than in the past.

> "Under the Discussion Draft format, the Form 990 has become an SEC-like disclosure document containing a vast store of information about an organization's activities and the extent to which it engages in financial transactions with insiders. "

Recent amendments to Section 7623 increasing to 30% the maximum potential whistleblower award for tax law violations (for tax liability in excess of $2 million) also will provide a financial incentive for private citizens to ferret out the next big tax gaffe, including among large nonprofits. Private causes of action to enforce the federal tax laws are not permitted. Earlier this year, however, the IRS created a new Whistleblower Office to receive and follow up on tips from informants about potential tax law violations. The jurisdiction of that office includes the tax-exempt sector.

The Core Form itself is likely to draw attention to many organizations. Much like the front page of a newspaper, the first page of the Core Form is designed to provide a snapshot of key metrics about an organization without having to go beyond the "front page." This snapshot includes information regarding the total size of the governing board, the number of "independent" members of the governing board, the amount paid to the highest paid employee, and total executive compensation paid as a percentage of overall program service expense.

In addition to increasing transparency, the Discussion Draft is likely to significantly increase administrative recordkeeping and disclosure burdens on complex organizations, particularly healthcare organizations. Many tax-exempt healthcare systems would file as many as 12 schedules or perhaps all 15 in larger systems. Although some schedules are largely drawn from existing Form 990 disclosures, others are almost entirely new or substantially expanded and reflect an emphasis on transparency as much as or more than tax accounting.

Community Benefit

While there are other important items in the Discussion Draft, Schedule H will be the key schedule for healthcare organizations in explaining how they meet the community benefit standard for exemption.[6] As drafted, Schedule H also must be filed by many tax-exempt clinics and faculty practice plans. Highlights of Schedule H include a Community Benefit Report (Part I) that asks for cost-based data for various community benefits, including charity care, Medicaid, and "other government programs" (without clarifying whether Medicare shortfalls are included for this purpose);[7] a description of

any written Charity Care Policy (including use of the Federal Poverty Guidelines, asset tests, variations for socio-economic and other local factors, budget caps or other limits on charity care, and publicity for the policy); a description of how the organization assesses the healthcare needs of its community; information about ER policies and procedures, including hours of operation; and how the operation of the hospital facilities furthers exempt purposes (including a description of activities and programs conducted at each facility).

Schedule H (Part II) also goes beyond the elements of the community benefit test by requiring a break-out of billing information by categories of healthcare coverage as follows: (i) Medicare; (ii) Medicaid; (iii) Other Governmental Programs; (iv) Private Insurance; and (v) Uninsured. It also requires a description of any written Collection Policy (including how and when the policy is disclosed to patients and how the organization collects patient debts), and a description of the patient intake process (including how patients are educated about their eligibility for government assistance or charity care).

In addition to helping the IRS develop benchmarks for what level of community benefit should be required for exemption, Schedule H will provide free discovery for plaintiffs lawyers on healthcare organizations' charity care and billing practices, potentially leading to more consumer fraud and fair billing and collection law challenges. State attorneys general also likely will look very closely at these disclosures to identify healthcare organizations that may not be meeting state law charity requirements or reporting obligations (including those filing inconsistent state reports).

Joint Ventures

The new joint venture disclosures in the Core Form (Part VII) and schedules vary depending on the nonprofit's level of equity or control and include partnerships, LLCs, and corporations. For joint ventures that are more than 50% controlled by the nonprofit or where the nonprofit is the managing or general partner or the managing member, the nonprofit must complete Schedule R (which lists assets; income; control; ownership; character of income as related, unrelated or investment; grants and loans; shared facilities, services and employees; and other transfers and reimbursements). Nonprofits also must disclose whether they conducted all or a substantial part of their exempt activities through a joint venture, and whether they participated in any joint venture (regardless of substantiality, ownership or control) that was managed by the for-profit venturer or an affiliate. If the nonprofit had 50% or less control or ownership over a substantial joint venture, it also must identify the name and primary activity of the venture, ownership percentage (higher of vote or value), and type of entity.

Substantiality is reflected in levels of capital expenditures, operating budget, or a discrete operation representing a substantial portion of the nonprofit's overall assets, income, or expenses. Substantiality is not defined; however, based on guidance in other areas, anything over 15% may be substantial.[8] Organizations with disclosable joint ventures may be targeted in future compliance checks or audits to assess compliance with the *St. David's* control test.[9] In that regard, the Core Form also asks if the nonprofit has a written policy requiring review of participation in joint ventures and one that requires the nonprofit to safeguard its exempt status with respect to transactions and arrangements with related organizations. Safeguards identified in the instructions include control by the nonprofit, mandating priority of exempt purposes in the joint venture over maximizing profits, precluding any joint venture activities that would jeopardize exemption, distributions proportionate to ownership interests, and arm's-length, fair market value contracts.

Healthcare providers must identify in Schedule H all management companies and joint ventures in which the organization is either a partner or shareholder if (a) current or former (within the past five years) directors, trustees, officers or key employees or physicians own in the aggregate 5% or more of the profits interest or stock; and (b) the venture manages hospital or medical care operations for the filing organization, or directly provides hospital or medical care, or owns any property used by the filing organization or others to provide hospital or medical care.

Finally, Schedule N requires reporting any substantial contraction (i.e., sale, exchange, disposition or other transfer of more than 25% of assets). This includes transfers to joint ventures and for-profits even if the nonprofit receives fair market value in return as an equity interest, and also includes transfers to other tax-exempt organizations.

TAX AND FINANCE
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Thanks go to the Practice Group for sponsoring this feature.

Governance

The IRS believes that good governance and accountability practices provide safeguards to ensure nonprofit assets are used consistently with exempt purposes and not to provide excess benefits, inurement, or non-incidental private benefit. These tax principles are based on state charitable law and fiduciary duty concepts. For example, the duty of loyalty corresponds directly with the concept of avoiding inurement. The duty of care corresponds to the concept of "reasonable cause" or ordinary business care and prudence.[10] Establishing the rebuttable presumption switches the burden of proof to the IRS,[11] the functional equivalent of the business judgment rule (i.e., if, in good faith, the organization follows correct processes, the IRS and the courts are likely to defer to the board's judgment). These similarities reinforce the Discussion Draft's emphasis on good governance.

In order to assess how well-managed the nonprofit is, the Core Form (Part III) requires certain information regarding: board composition (number and how many are independent, contemporaneous minutes, use of an audit committee, pre-filing board review of Form 990); governance and financial statement practices (significant changes to governing documents, role of independent accountants, number of conflict transactions reviewed); and existence and/or public disclosure of certain governance information (whistleblower, record retention and conflict of interest policies, governing documents, financial statements and audit report). Answers indicating a lack of transparency may increase the audit risk.

Compensation and Loans

The Core Form (Part V) requires aggregate compensation disclosures for disqualified persons. Part II also requires reporting compensation of current and former (within past five years) officers, directors, trustees, key employees and top five highest paid employees ("Listed Persons"). The IRS defined "officers" broadly in the Glossary as anyone who, regardless of title, has even shared responsibility for: implementing board decisions; supervising management, administration, or operations; or managing finances. Officers would include the President/Chief Executive Officer, Chief Operating Officer, Treasurer, Chief Financial Officer, chief legal and compliance officers, and anyone designated as an officer in the governing documents or applicable state law. It would not include assistant or subordinate officers and those with only ministerial duties (e.g., assistant secretary).

The Discussion Draft departs from the current Form 990 by requiring reporting of compensation based on Forms W-2 (Box 5 Medicare wages) and 1099 (Box 7) amounts. Organizations hitting certain compensation triggers also would file Schedule J,[12] a one-page form with 11 pages of instructions requiring substantial additional information (including bonus, severance, nonqualified deferred compensation, supplemental nonqualified retirement plan, equity-based compensation including phantom/shadow stock in related entities, revenue-based compensation, non-taxable benefits, and non-taxable expense reimbursement). Schedule J also asks whether the organization adopted and followed a written travel and entertainment expense policy, if it paid for first class travel, club dues, or use of personal residences, and whether it intends to rely on the initial contract exception to the excess benefit rules.[13]

Given the size and complexity of healthcare organizations, and the resulting need to attract and retain individuals with the talents and skills necessary to run these organizations, all healthcare organizations will need to master Schedule J. In addition to the information required on Schedule J, new Schedule L requires reporting of all loans, advances, and receivables for current and former Listed Persons and for all disqualified persons (including original principal amount, balance, interest rate, security, purpose of loan, and whether there is a written agreement).

Bonds

The extensive reporting for bonds in the Discussion Draft includes some redundancies, matters unlikely to have a tax impact, and recordkeeping that goes beyond what many hospitals have done historically and will require substantial effort to compile (e.g., investment income and private use related to defeased bonds).[14]

Bond-related items to be reported in the Core Form include:

- Investment income from unspent bond proceeds, reserves, escrows, and similar amounts, including earnings on escrows securing defeased bonds, which may not appear on the borrower's financial statements, and earnings on debt service funds.
- Liabilities with respect to tax-exempt bonds (which may include legally defeased bonds).
- Existence of defeasance escrows (other than advance refunding escrows but apparently including current, i.e., within 90 days of closing, refunding escrows, and non-traditional escrows created outside bond documents).
- Whether the organization invested any net proceeds of tax-exempt bonds beyond a temporary period exception, generally three years for project bonds. (Answering "yes" likely will raise an audit flag, even though unspent proceeds may be invested later subject to yield restrictions or yield reduction payments or where unspent proceeds were due to unforeseeable circumstances.)

In addition, Schedule K calls for a myriad of additional details to address what the IRS believes is significant noncompliance with recordkeeping and record retention requirements that have made enforcement difficult. Schedule K also focuses on investment of bond proceeds that may circumvent arbitrage rebate requirements. Some information on Schedule K (Parts I & II) related to the original issuance (names, dates of bonds and project completion, purpose, principal amount, plan of finance, issuance costs, refunding or new money, etc.) duplicates what is already reported on Form 8038, which should be reviewed for consistency.

Part III of Schedule K requires detailed information regarding private use of bond-financed facilities, including: whether the filing organization was a general partner, managing member, or held more than a 50% profits interest in a partnership or LLC that owned property financed by tax-exempt bonds; any management contract for the facility and whether it met the safe harbor;[15] any research contract involving the facility and whether it met the safe harbor;[16] highest percentage of the project subject to a management or research contract (even if in a safe harbor, making this number irrelevant for enforcement); any other private use; and the highest percentage of that other private use. The level of due diligence each year that will be necessary to fully and accurately answer these questions will be significant, essentially requiring a self-audit of private use for each individual bond issue.

Part IV of Schedule K requires disclosure of compensation for all third parties paid over $10,000 with respect to the issuance of tax-exempt bonds and potential financings. The required information includes the third party's name, role (e.g. bond counsel, borrower's counsel, financial advisor, underwriter), total paid, total paid from bond proceeds, and whether the third party was selected through a "formal selection process" (undefined).

Finally, Schedule N (described above) requires disclosure of the details of defeasance, discharge or settlement of tax-exempt bond obligations related to a liquidation, termination or dissolution of the issuer or conduit borrower filing the Form 990. As drafted, Schedule N fails to take into account that transferring assets to another Section 501(c)(3) organization with similar operations or a state or local governmental entity may avoid the need for any defeasance.[17]

Recommendations

Although the specifics may change in the final Form 990, the scope of disclosure and the format likely will be comparable to the Discussion Draft. Accordingly, healthcare attorneys should advise their clients to consider at least the following steps to prepare for implementation of the redesigned Form 990:

- Educate management and boards about the scope and implications of the new Form 990.
- Complete a mock version of the Discussion Draft for a recent tax year (under privilege) to identify areas of concern and develop explanations or remedial actions.

- Advise the IRS of practical problems of implementation, even if the comment deadline has passed.
- Reevaluate the scope of financial and governance information available on the organization's website.
- Consider restructuring financial arrangements and operating procedures where feasible to present a better public profile on the new Form 990.
- Review existing and pending joint ventures in light of the new reporting standards.
- Compile a list of potential disqualified persons and update it annually.
- Update record retention policies to reflect the new disclosure standards, especially for bonds.
- Implement a monitoring system for private use of tax-exempt bond proceeds.

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End Notes

1 All section references in this article refer to the Internal Revenue Code of 1986, as amended, Title 26 of the U.S. Code.

2 The Discussion Draft is *available at* www.irs.gov/charities/index.html.

3 The threshold for being a "highly compensated employee" changes annually under Section 414(q)(1)(B)(i). The most recent pronouncement from the IRS pegged it at $100,000 for 2006 and 2007, up from $95,000 for 2005. *See* IR-2006-162 (Oct. 18, 2006).

4 Code § 6033.

5 For example, Schedule D asks for financial statement disclosures of uncertain income tax positions, including exemption, as required by FASB Financial Interpretation 48 (*available at* http://www.fasb.org/st/).

6 Rev. Rul. 69-545, 1969-2 C.B. 117.

7 The definition of "Other Government Programs" for Part II, however, expressly excludes Medicare.

8 Internal Revenue Manual [7.8.1] 27.10.1 (May 25, 1999) (withdrawn Section 501(m) audit guidelines).

9 349 F.3d 232 (5th Cir. 2003).

10 *See, e.g.*, Treas. Reg. § 301.6651-1(c).

11 Treas. Reg. § 53.4958-6.

12 $10,000 to any former Listed Person, $150,000 for others or over $250,000 in accrued compensation, or if any Listed Person is compensated by a third party for services to the filing organization.

13 Treas. Reg. § 53.4958-4(a)(3).

14 For pre-1986 bonds, private use was allowed up to 25% for qualified 501(c)(3) bonds as compared to the current 5%.

15 *See* Rev. Proc. 97-13, 1997-1 C.B. 632.

16 *See* Rev. Proc. 2007-47, 2007-29 I.R.B. (superseding Rev. Proc. 97-14, 1997-1 C.B. 634).

17 *See* Treas. Reg. §§ 1.145-2(a) & 1.141-12.