LEGAL CHALLENGES FOR NON-PROFIT ORGANIZATION MANAGEMENT

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Background: IRS reports there are more than 1.5+ million organizations in their Tax Exempt Non-profit mailer file, almost double that of 10 years ago. About 1/3 are religious or charitable organizations. There are 317,000 charities that file Form 990. This group is very diverse by type, mission and size. Many share little in common with others as to structure, revenue streams, assets, compensation practice and other characteristics. Majority have revenue under $1million, one-half are not subject to financial statement audit. About ½ of non-filers are not even aware of requirements to file. Between 2004 and 2005 the total number of tax exempt organizations grew from 1,504,554 to 1,570,023; charities grew from 1,010,365 to 1,045,979; 68,203 new favorable D-Letters were issued; 63,042 for charities (approximately twice that many withdrew their application or failed to supply requested information).

I. LEGISLATIVE CHALLENGES

A. Sarbanes-Oxley Act

1. Although most provisions of the Sarbanes-Oxley Act of 2002 (the "Act") apply only to publicly traded companies, it has had a significant impact on the non-profit sector. For example, many non-profit organizations have voluntarily adopted some of its provisions, watchdog groups have revised their standards, some states are considering legislation that would apply similar provisions to non-profit organizations, and the IRS is considering the Act in connection with forthcoming guidance for exempt organizations. The result is that the Act may well be giving rise to new standards of "best practices" for non-profit corporate governance. To insure that their practices are in compliance with these new standards, non-profit organizations and their advisors should become familiar with the Act and consider whether they should make changes in their own corporate policies and practices. Like the for-profit sector, the non-profit sector has seen its share of high profile scandals:

a. The Nature Conservancy, the largest environmental non-profit board includes representatives of industries that are major polluters and big contributors. The Conservancy does not speak out on environmental issues. The Director's salary was reported at $420,000 with a $1,700,000 below market home loan.

b. Adelphi University paid high salaries while enrollment dropped.

c. Conviction of Bill Aramony, CEO of the United Way of America, for misuse of funds.

d. Paul and Virginia Cabot paid executives salaries of $5,200,000 in 1999 through 2003 (including a $400,000 raise to pay for his daughter's $200,000 wedding, while grants were only $400,000 per year. Executives repaid $5,000,000 and his sisters, on the board, were fined for inattention.

e. New York Attorney General Spitzer's lawsuit related to Dick Grasso's $187 million compensation package from the New York Stock Exchange.

f. The Kimbell Art Foundation paid Kay and Ben Kimbell $750,000 and $747,000 salaries while Ben continued to run an oil business full-time. Compensation was mostly returned.

g. The Baptist Foundation of Arizona ("BFA"), whose mission was to solicit donations in support of Southern Baptist causes such as funding church start-ups and providing aid for children and the elderly, changed its focus and decided to invest in Arizona real estate and to sell retirement programs and engaged in one of the most significant non-profit fraud schemes ever.

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h. The Foundation for New Era Philanthropy defrauded investors for large and small charities on the promise of gifts from undisclosed donors. Ponzi scheme that went bankruptcy.

i. Madisona v. Telemarketing, Inc. – case decided by the Supreme Court. Money solicited for Viet-Now for the benefit of veterans. Eighty-five (85%) of the money went to fund raisers.

2. Highlights of the Sarbanes-Oxley Act include the following:

2.1 Independent and Competent Audit Committee. Each member of a company's audit committee must be a member of the board of directors and must be independent. "Independence" is defined as not being a part of the company's management team or receiving any indirect compensation from the company for professional services. Generally, a public company must also have a financial expert on its audit committee. See Exhibit "A" - Sample Audit Committee Charter.

2.2 Responsibilities of Auditors. The Act requires that the main partners of the auditing firm reviewing the company's books serve for no more than five years. In addition, Sarbanes-Oxley prohibits the auditing firm from providing most non-audit services to the company at the same time it serves as auditor.

2.3 Certified Financial Statements. Perhaps the most well-known provision of the Sarbanes-Oxley Act is the new requirement that the chief executive officer and chief financial officer certify the accuracy of their company's financial statements. Criminal sanctions can be imposed for false certifications. (Legislation proposed by IRS)

2.4 Insider Transactions and Conflicts of Interests. The Act prohibits loans to directors and members of the company's management team. See Exhibit "B" - Sample Conflict of Interest Policy, and Exhibit "C" - Sample Conflicts Disclosure Form. (Legislation proposed by IRS)

2.5 Disclosure. A number of new disclosures are required under Sarbanes-Oxley, including corrections to past financial statements and significant off-balance sheet transactions. (Legislation proposed by IRS)

2.6 Whistleblower Protection. There are new protections for whistleblowers and criminal penalties for retaliatory actions against whistleblowers. See Exhibit "D" - Sample Whistleblower Policy. (Applies to charities)

2.7 Document Destruction. In direct response to the Enron case, the Act makes it a crime to alter, cover up, falsify, or destroy any document to prevent its use in any official proceeding, including a lawsuit, investigation, or bankruptcy proceeding. (Applies to charities)

3. While most of the provisions of Sarbanes-Oxley are directly applicable only to public, for-profit companies, the whistleblower protections and document destruction prohibitions of the Act apply to all corporations, both for-profit and non-profit. Absent more specific guidelines on whistleblower protection and document maintenance in other federal and state laws, it is likely that Sarbanes-Oxley will become the standard by which non-profit conduct is governed.

4. Although Sarbanes-Oxley's other provisions are not on their face applicable to non-profit organizations, non-profit law and practice frequently evolve from corporate law developments. Thus, non-profits must be familiar with the governance and accounting standards required by Sarbanes-Oxley in anticipation that some of these concepts will also become the standard in the non-profit sector. Many larger foundations, community foundations, supporting organizations, hospitals and universities can be expected to institute audit committees like those under Sarbanes-Oxley.

For example, the provisions of Sarbanes-Oxley could have an impact on non-profits through increased disclosure requirements imposed by Congress, the IRS or under state non-profit law, or through auditing and accounting requirements as certified public accountants adopt Sarbanes-Oxley as the standard for auditing the non-profit industry. See Exhibit "E" - Sample Ethics Policy.

B. State "Sarbanes-Oxley" Like Legislation

1. California adopts Non-profit Integrity Act of 2004 – incorporates some of the Sanbanes-Oxley provision and takes a balanced approach to accountability. Does not include Sanbanes-Oxley Section 404 internal audit evaluation.

2. The Uniform Supervision of Trustees for Charitable Purposes Act requires trustees and others holding funds for charitable purposes to report the existence of the trust relationship to the Attorney General's Office, and to make subsequent reports to that office. This Act has been adopted by California, Illinois and Michigan. Parts have been adopted by Oregon.

3. The Uniform Management of Institutional Endowment Funds Act provides statutory guidelines for management, investments and expenditure of endowment funds of institutions, and enable them to maximize resources consistent with the standard of prudence. Most states, including Oklahoma, (60 O.S. 300.1, et seq.) have adopted.

C. Oklahoma Statutory Regulation

1. Lotteries and Raffles by Charities

a. Title 21 § 1052 – - Every lottery is unlawful, and a common public nuisance.

b. Title 21 § 1054 – Every person who sells, gives or in any manner whatever furnishes or transfers to or for any other person, any ticket, chance, share or interest, or any paper, certificate or instrument, purporting or represented or understood to be or represent any ticket, chance, share or interest in or depending upon the event of any lottery, is guilty of a misdemeanor.

c. Title 21 § 1051 – Charitable Lotteries; multiple Amendments enacted during 2003 and 2004 Legislative sessions and approved by election held November 2004. See Exhibit "F".

d. Title 68 § 1356(56) – Sales Tax Exemption for sales by charity at an auction event for the preservation and conservation of wild turkeys.

e. Most persons who buy raffle tickets for the benefit of a charitable organization intend primarily to make a contribution although the gambling aspects may lend an element of excitement or suspense. But if the raffle ticket entitles the buyer to a chance for valuable prizes, then the payment for the ticket *is not* a charitable contribution to any extent; it is merely the price paid for a chance at a valuable prize. (However, the Sixth Circuit suggested that if a charitable organization puts a reasonable value on the raffle ticket and designates the excess of the ticket price above that value as a contribution, the *excess may possibly* be deductible; see § K-3089.) Goldman, Douglas v. Com., (1967, CA6) 21 AFTR 2d 301, 388 F.2d 476, affg (1966) 46 TC 136. Amounts paid for the raffle tickets are not deductible charitable contributions. Rev. Rul. 83-130, 1983-2 CB 148. Winnings are included in gross income.

If a donee organization disposed of a car (or other donated property) by means of a raffle, the raffle proceeds do not represent the proceeds of the sale of the car. See Information Release 2005-0133. Be aware of guidance for car donations, Notice 2006-1 and 2005-44 and Code § 6720 penalties upon donee organizations that fail to provide tax information to donors.

In the case of a lottery ticket received as a gift, the value of the ticket at the time of the gift reduces the amount of the winnings. When the ticket is given before it becomes a winner, its value is usually equal to its cost. Rev. Rul. 55-638, 1955-2 CB 35. Macri Corp., (1976) TC Memo 1976-273.

2. Wine Tasting Events – 37 O.S. § 521.W. (New House Bill 1903). Provides for a charitable auction or charitable wine event license. The amendment provides that the holder of a charitable wine event license may conduct a wine tasting event, wine dinner, or wine auction. Such event shall be conducted for the sole purpose of raising funds for charitable purposes; wine used may be purchased by the charitable organization or donated by any person or entity; and the license shall be issued for no more than four days. Provides that the holder of a charitable wine event license shall not be required to obtain a special event license. The maximum amount of wine auctioned is limited to 50 gallons. Reinstates the provisions regarding the maximum amount of wine that may be auctioned and provisions regarding registration and payment of taxes, and forms of auctions authorized.

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3. Oklahoma Open Meetings Act – Title 25 O.S. § 301, *et seq.*. The Act announces that it is the policy of the State of Oklahoma to encourage and facilitate and inform citizenry's understanding of the governmental processes and governmental problems. See Section 302. Under the Act, all meetings of public bodies shall be held at specified times and places which are convenient to the public and shall be open to the public, except as specifically provided. All meetings of such public bodies, except those specifically excluding, shall be preceded by advance public notice specifying the time and place of each such meeting to be convened, as well as the subject matter or matters to be considered at such meeting. See Section 303. For purposes of the Act, "public body" means governing bodies of municipalities, counties, state boards, authorities, committees, etc., in the state supported, in whole or in part, by public funds or intrusted with the expending of public funds or administering public property. See Section 304. The Act requires the recording of votes (Section 305) and written minutes of meetings (Section 312). Section 311 describes how notice may be given by public bodies.

Certainly not all charitable non-profit organizations are subject to the provisions of the Act. However, for those that are, provisions should be made in the Bylaws and policies of the organization to assure compliance. Attached hereto is Exhibit "G" – Sample language which might be included in Bylaws indicating the organization's intent to comply with the Act.

4. Oklahoma Open Records Act –Title 51 O.S. § 24A.3, *et seq*. The Act generally provides that every public body shall keep and maintain complete records of the receipt and expenditure of public funds reflecting all financial and business transactions relating thereto, except that such records may be disposed of as provided by law. See Section 24A.4. For this purpose, the term "public body" shall include any entity, group or organization supported in whole or in part by public funds or entrusted with the expenditure of public funds, or administering or operating public property and all committees and subcommittees thereof. See Section 24A.3. The term "record" means all kinds of documents regardless of how stored or retained with but few exceptions, including computer software, non-governmental personal effects and certain records that are maintained exclusively by governmental organizations. See Section 24A.3. All public records of public bodies will be kept open to any person for inspection, copying or mechanical reproduction during regular business hours provided that such inspection or copying does not extend your records specifically required by law to be kept confidential. A public body may charge a fee for recovering the costs of copying, not to exceed 25¢ per page, and must designate certain persons who are authorized to release records of the public body for inspection and copying. See Section 24A.5.

5. Oklahoma Charitable Fiduciary Act - Title 60 O.S. § 3001.1, *et seq*. The Act permits charitable organizations to act in certain specified fiduciary capacities generally in connection with acting as trustee under charitable trusts, regardless of how created, the execution of such trust, the acceptance of property into trust and the investment and administration thereof. See Section 301.4. For purposes of the Act, a charitable organization is limited to an organization domiciled in the State of Oklahoma recognized under Section 501(c)(3) of the Internal Revenue Code, which has been in existence for at least five (5) years, if the organization's administers charitable trusts which benefit private individuals, and having a governing board of which a majority of the members are persons who qualify by education and experience to provide direction of the charitable organization and the administration of its charitable trust, at least 40% of whom are residents of the State of Oklahoma, and which organization has filed the Comprehensive Annual Report required by the law. See Section 301.3.

Under the Act, the governing body of the charitable organization must require Fidelity Bonds on all officers and employers who are involved in the funding and administration of a charitable trust. See Section 301.6. The Act also provides for the establishment, administration, accounting for common charitable trust funds retained by such charitable organizations. See Section 301.7. Each year charitable organizations acting in fiduciary capacity under the Act must have prepared a Comprehensive Annual Audit conforming to generally accepted accounting principals which is certified by an independent certified public accountant, and a copy of which is delivered to the Oklahoma Banking Department within ninety (90) days of receipt of the final audit. See Section 301.9.

6. The Oklahoma Solicitation of Charitable Contributions Act - Title 18 O.S. § 550, *et seq*. The Act generally provides that no charitable organization, except those incorporated for religious purposes, educational institutions which have a faculty, fraternal organizations which solicit for their own members, shall solicit or accept contributions from any person in the state until the charitable organization shall have registered at the Office of the

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Secretary of State and paid the registration fee of $15.00. The registration is valid for one (1) year from the date of filing with the Secretary of State. See Section 552.3. An additional exception to registration is provided for persons soliciting contributions for a named individual person. When such individual is specified by name, the purpose of such contribution is clearly stated and if those contributions collected are deposited in a bank account in the name of the beneficiary and are used for the direct benefit of the named individual person or beneficiary. See Section 552.4. A copy of the Charitable Organization Registration forms, information and instructions is attached hereto as Exhibit "H".

Every charitable organization subject to the provisions of the Act, which has received contributions during the previous calendar year, shall file a statement with the Secretary of State containing the name of the organization, the gross amount of contributions pledged or collected, the gross amount given or to be given to the charitable purpose presented, the aggregate amount paid or to be paid for the expenses of solicitation and the aggregate amount paid or to be paid to professional fund raisers or solicitors. See Section 552.5. Every charitable organization shall keep full and true record as will enable the charitable organization to accurately provide information required for these records. See Section 552.6.

The Act also provides that no person shall act as a professional fund raiser for any charitable organization, including those organizations listed under Section 552.4, until the person has first registered with the Office of the Secretary of State stating the legal name of the professional fund raiser and the full legal names and addresses of the charitable organizations with which it has entered into contracts or agreements, accompanied by an annual fee of $50.00. In addition, the applicants all at the time of making the application, filed with the Secretary of State, a bond running to the Secretary of State with one or more sureties. A professional fund raiser shall not engage in fund raising activities for a charitable organization which is not registered with the Secretary of State unless the organization is exempt. See Section 552.7.

All contracts and agreements entered into by a professional fund raiser and charitable organization shall be in writing and maintained on file in the office of the charitable organization and the fund raiser for three (3) years, from the date of solicitation and contributions. Section 552.8. In addition, every professional solicitor employed or retained by a professional fund raiser required to register shall, before accepting employment by the professional fund raiser, register with the Office of the Secretary of State and pay a registration fee of $10.00. The registration may be renewed annually. See Section 552.9. Solicitors accepting funds for charitable purposes are required to issue a receipt in duplicate. See Section 552.10.

7. Ad Valorem Tax Exemption

a. Art. 10 § 6, Oklahoma Constitution – Property exempt from taxation – all property used exclusively for religious and charitable purposes shall be exempt from taxation. See Exhibit "I".

b. Title 68 O.S. § 2887.8 – All property of any charitable institution organized or chartered under the laws of this state as a nonprofit or charitable institution, provided the net income from such property is used exclusively within this state for charitable purposes and no part of such income inures to the benefit of any private stockholder, including property which is not leased or rented to any person other than a governmental body, a charitable institution or a member of the general public who is authorized to be a tenant in property owned by a charitable institution under Section 501(c)(3) of the Internal Revenue Code and which includes but is not limited to an institution that either:

(1) additionally satisfies the income standards set forth in Internal Revenue Service Revenue Procedure 96-32, which may be audited by the county assessor of the applicable county, in addition to other requirements of this subparagraph, as a condition of obtaining and maintaining the exemption, if:

(2) the property provides residential rental accommodations regardless of whether services or meals are provided, and

(3) the property:

i. is occupied as of the applicable January 1 assessment date if the structure is a single-family dwelling, or

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ii. has an average seventy-five percent (75%) occupancy rate, based upon the total number of units suitable for occupancy, during the calendar year preceding the applicable January 1 assessment date if the property contains multiple structures suitable for multi-family housing. The owner of any property subject to the occupancy requirements prescribed herein shall submit a report to the county assessor of the county in which the property is located no later than December 15 each year regarding the occupancy rate for the preceding eleven (11) months. If the report indicates that the average occupancy rate was less than seventy-five percent (75%), the county assessor shall determine the taxable value of the property for the succeeding assessment year and the property shall not be exempt for any subsequent assessment year unless the average occupancy rate is at least seventy-five percent (75%) during the succeeding eleven-month period. No asset consisting of a single-family or multi-family dwelling unit owned by an entity the property of which would otherwise be exempt pursuant to subparagraph a of this paragraph shall be exempt from ad valorem taxation if any such dwelling unit was improved with or acquired with any portion of proceeds from the sale of obligations issued by any entity organized pursuant to Section 176 of Title 60 of the Oklahoma Statutes if the interest income derived from such obligations is exempt from federal income tax, or

iii. is a continuum of care retirement community providing housing for the aged, licensed under Oklahoma law, owned by a nonprofit entity recognized by the Internal Revenue Service as a Section 501(c)(3) tax-exempt entity and located in a county with a population of more than five hundred thousand (500,000) according to the latest Federal Decennial Census;

c. 68 O.S. § 2887.9 – All property used exclusively and directly for charitable purposes within this state, provided the charity using said property does not pay any rent or remuneration to the owner thereof unless the owner is a charitable institution described in Section 501(c)(3) of the Internal Revenue Code, 26 U.S.C., Section 501(c)(3), or a veterans' organization described in Section 501(c)(19) of the Internal Revenue Code, 26 U.S.C., Section 501(c)(19);

d. Decisions

(1) Ferguson v. Zion Lutheran Church of Christ, 190 P.2d 1019 (Okla. 1948). Exemption continued after acceptance of contract for sale of property until closing.

(2) Oregon Methodist Homes, Inc., Willamette View Manor, Inc. v. State Tax Commission, 360 P.2d 293 (Ore. 1961). Establishes 6 part test adopted in Oklahoma to establish charitable use: (1) whether the receipts are applied to the upkeep, maintenance and equipment of the institution or are otherwise employed; (2) whether patients or patrons receive the same treatment irrespective of their ability to pay; (3) whether the doors are open to rich and poor alike and without discrimination as to race, color or creed; (4) whether charges are made to all patients and, if made, are lesser charges made to te poor or are any charges made to the indigent; (5) whether there is a charitable trust fund created by benevolent and charitably-mined persons for the needy or donations made for the use of such persons; and (6) whether the institution operates without profit or private advantages to its founders and the officials in charge. In addition, the courts give attention to the articles and bylaws of the corporation to ascertain what provisions, if any, have been made to dispose of its surplus assets on dissolution.

(3) Topeka Presbyterian Manor, Inc. v. Board of County Commissioners, 402 P.2d 802 (Kan. 1965). Home operated at a deficit, sought fees and monthly payments from residents and received gifts to offset deficit.

(4) Glass v. Oklahoma Methodist Home for Aged, 502 P.2d 1268 (Okla. 1972). Facts similar to Topeka Presbyterian Manor, addresses nature of "Founders Gifts" paid in advance by applicants seeking admission.

(5) Lutheran Home, Inc. v. Board of County Commissioners, 505 P.2d 1118 (Kan. 1973). Overrules Topeka Presbyterian Manor, "To have charity there must be a gift from one who has to one who has

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not." What a charity does for others it does free or as nearly free as to make charges nominal for those unable to provide for themselves.

(6) In the Matter of the Assessment of Real Property of Integris Realty Corporation, 58 P.3d 200 (Okla. 2002). Exemption prorated where non-profit tenants received credits against rental for tax exemption allowed. Decision based upon Constitution, not statute.

8. Title 18 § 866 – Immunity of Board of Directors – Scope. No member of the board of directors of a nonprofit corporation that holds a valid exemption from federal income taxation issued pursuant to Section 501(a) of the Internal Revenue Code or Section 528 of the Internal Revenue Code and is listed as an exempt organization in Section 501(c) of the Internal Revenue Code or files as such pursuant to Section 528 of the Internal Revenue Code shall be held personally liable for damages resulting from:

a. any negligent act or omission of an employee of the nonprofit corporation; or

b. any negligent act or omission of another director.

The immunity provided by subsection A of this section shall not extend to intentional torts or grossly negligent acts or omissions personal to any director of the nonprofit corporation.

9. Title 76 § 31 – Volunteers – Charitable Organizations – Immunity from Liability. Any volunteer shall be immune from liability in a civil action on the basis of any act or omission of the volunteer resulting in damage or injury if:

a. The volunteer was acting in good faith and within the scope of the volunteer's official functions and duties for a charitable organization or not-for-profit corporation; and

b. The damage or injury was not caused by gross negligence or willful and wanton misconduct by the volunteer.

The term "volunteer" means a person who enters into a service or undertaking of the person's free will without compensation or expectation of compensation in money or other thing of value where the person does not offer that type of service, care, assistance, advice or other benefit for sale to the public.

10. Unfunded Mandates. In Oklahoma and other states it is becoming more common for the legislature to mandate the information of private non-profit foundations to fund projects. Foundations should consider complying with these laws to the extent they administer public money.

II. REGULATORY CHALLENGES

A. Professional Accounting Standards

1. FASB Statement No. 117 – Financial Statements. This Statement requires that all not-for-profit organizations provide a statement of financial position, a statement of activities, and a statement of cash flows. It requires reporting amounts for the organization's total assets, liabilities, and net assets in a statement of financial position; reporting the change in an organization's net assets in a statement of activities; and reporting the change in its cash and cash equivalents in a statement of cash flows.

This Statement also requires classification of an organization's net assets and its revenues, expenses, gains, and losses based on the existence or absence of donor-imposed restrictions. It requires that the amounts for each of three classes of net assets-permanently restricted, temporarily restricted, and unrestricted-be displayed in a statement of financial position and that the amounts of change in each of those classes of net assets be displayed in a statement of activities.

2. FASB Statement No. 116 – Accounting for Contributions Received and Contributions Made. This Statement applies to all entities that receive or make contributions. Contributions, including unconditional promises to give, are recognized are revenues in the period received at their fair values. Contributions made, including unconditional promises to give, are recognized as expenses in the period made at their fair values. Conditional promises are recognized when they become unconditional. This Statement requires organizations to distinguish between restricted assets and unrestricted net assets. This Statement also allows certain exemptions for contributions of services and works of art,

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historical treasures, and similar assets. Contributions of services are recognized only if the services received (a) create or enhance nonfinancial assets or (b) require specialized skills provided by individuals possessing those skills, and would typically need to be purchased if not provided by donation.

3. FASB Statement No. 136 – Transfers of Assets Non-Profit that Raises or Holds Contributions.

a. This Statement requires a recipient organization that accepts cash or other financial assets from a donor and agrees to use those assets on behalf of or transfer those assets, the return on investment of those assets, or both to a specified unaffiliated beneficiary to recognize the fair value of those assets as a liability to the specified beneficiary concurrent with recognition of the assets received from the donor.

b. If the donor explicitly grants the recipient organization variance power or if the recipient organization and the specified beneficiary are financially interrelated organizations, the recipient organization is required to recognize the fair value of any assets it receives as a contribution received. Not-for-profit organizations are financially interrelated if (a) one organization has the ability to influence the operating and financial decisions of the other and (b) one organization has an ongoing economic interest in the net assets of the other.

c. This Statement doe not establish standards for a trustee's reporting of assets held on behalf of specified beneficiaries, but it does establish standards for a beneficiary's reporting of its rights to assets held in a charitable trust.

d. This Statement requires that a specified beneficiary recognize its rights to the assets held by a recipient organization as an asset unless the donor has explicitly granted the recipient organization variance power. Those rights are either an interest in the net assets of the recipient organization, a beneficial interest, or a receivable. If the beneficiary and the recipient organization are financially interrelated organizations, the beneficiary is required to recognize its interest in the net assets of the recipient organization and adjust that interest for its share of the change in net assets of the recipient organization. If the beneficiary has an unconditional right to receive all or a portion of the specified cash flows from a charitable trust or other identifiable pool of assets, the beneficiary is required to recognize that beneficial interest, measuring and subsequently remeasuring it at fair value, using a valuation technique such as the present value of the estimated expected future cash flows. If the recipient organization is explicitly granted variance power, the specified beneficiary does not recognize its potential for future distributions from the assets held by the recipient organization. In all other cases, a beneficiary recognizes its rights as a receivable.

e. This Statement describes four circumstances in which a transfer of assets to a recipient organization is accounted for as a liability by the recipient organization and as an asset by the resource provider because the transfer is revocable or reciprocal. Those four circumstances are if (a) the transfer is subject to the resource provider's unilateral right to redirect the use of the assets to another beneficiary, (b) the transfer is accompanied by the resource provider's conditional promise to give or is otherwise revocable or repayable, (c) the resource provider controls the recipient organization and specifies an unaffiliated beneficiary, or (d) the resource provider specifies itself or its affiliates as the beneficiary and the transfer is not an equity transaction.

f. This Statement requires certain disclosures if a not-for-profit organization transfer assets to a recipient organization and specifies itself o its affiliate as the beneficiary or if it includes in its financial statements a ration of fundraising expenses to amounts raised.

4. FASB Interpretation No. 46 – Transfers to Organization with Variance Power.

B. IRS Initiatives

1. IRS White Paper (June 22, 2004). Recommends 5-year review of Form 990s, restricting or eliminating Type 3 Supporting Organizations, regulation of Designated Funds, Insider Transaction reforms, limiting compensation paid by charities, grant and expense reforms, limits on board size, excise tax used in enforcement. (Fall 2005) Sen. Grassley indicates huge reform effort in the Senate. House Ways & Means Chairman says he sees no momentum in the

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House. Sweeping proposals would be "Dead on Arrival." Commissioner Miller says his organization will focus on identified problem areas: high compensation, out of wack loans, admission or omission on Form 990 response regarding inurement and credit counseling organizations. On June 1, 2006, Grassley said he expects the Service to do more, in particular to police nonprofit health care organizations, and gave the IRS thirty days to provide information concerning the specific initiatives, reviews, and enforcement actions they have taken in overseeing the tax-exempt community they regulate. He would like the IRS to focus on including the definition of charity care, the requisite level of charity care, the definitions and level of community benefit, the definition of joint ventures, joint ventures involving non-profit hospitals, the payment of excessive compensation and the use of tax exempt bond proceeds. In addition, he asked for continuing study of compensation issues related to foundations and charities.

2. New Form 1023

a. LLCs added to list of eligible entities: See Exhibit "J". PLRs 200134025 and 200150027 make it clear that single member LLCs with a 501(c)(3) organization as the sole member are disregarded entities and tax exempt;

b. IRS has published guidelines for consideration of multiple member LLCs for recognition of Tax Exempt Status; and

c. more extensive disclosures and schedule requirements are designed to disclose potential private inurement and conflicts of interest.

d. Part V - Form 1023 provides questions appropriate for consideration by audit committees and boards regarding compliance with conflicts of interest policies and avoidance of intermediate sanctions.

3. Revised Form 990. Expanded disclosures will help identify highly paid employees and contracting listed transactions, conflicts of interest and compensation of Directors, private inurement, and excess benefit transaction that will require intermediate sanctions and excise taxes. Section also calls for information regarding prior Directors and officers. Design to be used by IRS as well as state tax authorities, charity regulators, researchers and public. It provides public accountability disclosure. One state regulator refers to it as a sunshine document.

The IRS is staffing to provide "soft" contacts by revenue agents to assist and encourage proper record keeping by non-profit organizations. New requirements for electronic filing have been initiated and will be expanded. Look for proposed expanded filing for small non-profits. IRS Advisory Committee report calls for universal filing requirement.

4. Expanded IRS Audit Activity. The IRS has hired and trained dozens of new agents assigned to examine returns filed by non-profit organizations and initiated a program of "soft" contacts to help identify potential examination targets. IRS has issued proposed regs that would clarify the substantive requirements for tax exemption under Code Sec. 501(c)(3) and the relationship between those requirements and the imposition of Code Sec. 4958 excise taxes.

5. Rev. Proc. 2005-24. IRS issued a safe harbor for charitable remainder trusts annuity trusts (CRATs) and unitrusts (CRUTs) that are created during the trust's grantor's life and are subject to a right of election on the part of the grantor's spouse to take against the grantor's will.

Most states prevent an individual from disinheriting the individual's spouse by giving the spouse a right to take an elective share of the estate. In some states, the elective share is based solely on the probate estate. Other states include property transferred during life within the elective share. Thus, a charitable remainder trust (CRT) established during a grantor's life could be subject to an elective share, depending on state law. A trust whose assets may be used to satisfy a spouse's elective share can not qualify as a CRAT under Code Sec. 664(d)(1)(B) or as a CRUT under Code Sec. 664(d)(2)(B).

Rev Proc 2005-24 provides a safe harbor procedure under which IRS will disregard the right of election for p8urposees of determining whether the CRAT or CRUT meets the requirements of Cod Sec. 664(d)(1)(B) or Code Sec. 664(d)(2)(B) continuously since its creation if the CRT grantor's spouse irrevocably waives the right of election in the manner set forth in Rev Proc 2005-24, or in other words, if the grantor's spouse right of election on the grantor's death could be satisfied out of the assets of the CRAT or CRUT created by the grantor during life.

For CRATs and CRUTs created on or after June 28, 2005, the waiver must be effected on or before the date that is six (6) months after the due date for the year in which the later of the following occurs:

- the creation of the trust;
- the date of the grantor's marriage to the spouse;
- the date the grantor first becomes domiciled or resident in a jurisdiction whose law provides a right of election that could be satisfied from assets of the Trust; or
- the effective date of applicable state law creating a right of election.

In Notice 2006-15 the IRS announced it had extended, eased and is re-examining the safe harbor. Pending further guidance, no spousal waiver of the right of election will be required for CRAT or CRUT.

6. IRS News Release Regarding Political Activity.

7. Recent Regulatory Proposals.

a. Background on Code Sec. 501(c)(3) Organizations. To qualify for tax exemption under Code Sec. 501(c)(3), an organization must be organized and operated exclusively for religious, charitable, scientific, or educational purposes. In addition, no part of its net earnings may inure to the benefit of any private shareholder or individual, no substantial part of its activities may include attempts to influence legislation, and the organization may not intervene in political campaigns. Under existing regs, an organization isn't exempt under Code Sec. 501(c)(3), if it is organized or operated for the benefit of private interests such as designated individuals, the creator or his family, the organization's shareholders, or persons controlled, directly or indirectly, by such interests (Prop Reg §j 1.501(c)(3)-1(d)(1)(ii)).

b. Proposed Code Sec. 501(c)(3) Regs. The proposed regs would add several examples to illustrate the requirement that an organization serve a public rather than a private interest. They would show that prohibited private benefits may involve non-economic benefits as well as economic benefits. In addition, they would indicate that a prohibited private benefit may arise regardless of whether payments made to private interests are reasonable or excessive. (Prop Reg § 1.501(c)(3)-1(d)(1)(iii)).

c. Excise Tax Background. Code Sec. 4958 imposes excise taxes on transactions that provide excess economic benefits to disqualified persons with respect to public charities and social welfare organizations described in Code Sec. 501(c)(3) and Code Sec. 501(c)(4), which are collectively referred to by Code Sec. 4958(e) as "applicable tax-exempt organizations."

d. Proposed Regs Relating to Excise Taxes. The proposed regs would amend the Code Sec. 501(c)(3) regs to provide guidance on certain factors that the IRS will consider in determining whether an applicable tax-exempt organization described in Code Sec. 501(c)(3) that engages in one or more excess benefit transactions continues to exempt from tax. (Prop Reg § 1.501(c)(3)-1(g)) They also would amend the Code Sec. 4958 regs to clarify that the IRS has discretion to refuse to issue a ruling recognizing exemption under Code Sec. 501(c)(3) to any applicant whose purpose or activities violate any of its provisions, including the inurement prohibition and the limitation on private benefit, even though the violation could serve as grounds for imposing Code Sec. 4958 excise taxes if the applicant's tax-exempt status were recognized. (Prop Reg § 53.4958-2(a)(6))

8. IRS Compensation Initiative. Beginning in late 2004, the IRS contacted a broad spectrum of over 1800 public charities and private foundation seeking information about their compensation practices and procedures. They also just started a new phase of the initiative that we will talk about later, involving an additional 250 contracts. Results of the compensation initiative will be included in a report that they expect to produce in late August or September.

a. About 1200 of the initial contacts were something we call compliance checks. The other contacts, initially about 600, were examinations. A compliance check is a review to determine whether an organization is adhering to recordkeeping and information reporting requirements

b. Four general areas that triggered a compliance check:

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(1) Schedule A, Part 3, the schedule that lists the transactions between related individuals or leases of property to officers, directors, or shareholders;

(2) Form 990, Part 4, line 50 asks about receivables from trustees, officers, directors and key employees;

(3) Leaving Column B, of Part V of Form 990 blank generated a compliance check; and

(4) Question 89 on the Form 990 about whether they entered into an excess benefit transaction. If they answered "yes" they didn't attach an explanation.

About 200 of the compliance check letters did in fact result in the organization subsequently being examined.

c. Part of the compensation initiative also involved single issue examinations – examining only the compensation of disqualified persons to determine if their compensation is reasonable and is in accord with other compensation rules – such as the private foundation rules that apply to loans to disqualified persons, purchase of charity assets at below market prices or sales by disqualified persons to charities at an inflated price.

d. The examination letter asks for much more detailed information than is required in a compliance check:

(1) How do you establish compensation - what are your policies and procedures?

(2) What are the duties and responsibilities of the persons listed in Part 5?

(3) Do you intend to establish the rebuttable presumption?

(4) Did the board approve the compensation? If so, provide copies of the approval and any employment contracts and agreements.

(5) Does the compensation reported agree with the W-2s and 1099s issued?

(6) Did individuals use the organization's property for any purpose other than to further the organization's exempt purpose? If so, was this reported as compensation on the W-2s and 1099s?

e. Numerous organizations have failed to report fringe benefit perks, like personal use of an automobile or reimbursement of personal expenses. Once an exemption starts, it's too late. That's why it's critical to know whether a contact is a compliance check or an examination.

f. Compliance questionnaire to hospitals. Compliance questionnaires were sent to several hundred hospitals asking questions about the hospitals' compliance with the community benefit standard and detailed questions about how the hospitals set compensation. Expect to see more of this approach in the future.

g. Information frequently omitted included interest rates, amount of the original loan, loan repayments, and collateral. Some of the loans mad up a very large amount of the organization's total assets. There were very substantial loans to insiders and lots of undocumented loans. In fact, based on what we were seeing regarding loans, we started a new phase of the compensation initiative at the end of March , dedicated solely to loans. This new phase involves 200 compliance check letters and 50 examinations.

h. We're seeing the practice of spreading compensation of officers and other insiders among several affiliated organizations, for-profits or management companies with only a small amount reported on any one return. Question 75 on Form 990 is the Service's attempt to collect information on compensation paid by related organizations.

i. Confusion as to how, when and how much deferred compensation to report. Deferred compensation is to be reported as accrued. There is an element of double counting there, so in a footnote, or schedules or notes to the 990, you should indicate if amounts paid in a particular year have already been reported as accrued. Also, amounts need to be reported even if not vested or if subject to a substantial risk of

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forfeiture. Fringe benefits were found that were not considered and reported as part of compensation, such as personal free use of a car, apartment, cell phone, etc.

j. Legal protection.

(1) Every board should consider meeting the requirements of the rebuttable presumption of reasonableness. In order for the rebuttable presumption to be met, compensation must be set in advance by disinterested board members on the basis of appropriate comparability data and the decision musts be appropriately and timely documented.

(2) All economic benefits to officers, directors and key employees should be reported timely on Form 990.

(3) Avoiding automatic excess benefit transactions. Every form of compensation needs to be reported timely as compensation.

(4) Executive compensation matters must be disclosed to the full board.

k. What constitutes a conflict of interest? The part of the definition that most frequently generates questions is the fourth one – whether there is a conflict of interest if the member has a material financial interest affected by the compensation arrangement.

Not every relationship will always result in a conflict of interest. A relationship that generates a conflict of interest for one purpose may not generate a conflict of interest for another purpose. For example, if a member of a board is a partner in a law firm, he would have a conflict of interest for purposes of negotiating a retainer between the exempt organization and that law firm. On the other hand, he will not or likely will not have a conflict of interest for purposes of discussing a contract with a construction company unless he has shares in that construction company or has a similar financial interest in it.

What do you do if a conflict of interest exists? A board member with a conflict of interest can recuse himself from decision -making. The organization can end the business relationship with the business in which the member has a financial interest. Or, the organization can re-evaluate the terms of its business relationship with that business. The organization may use an RFP process to generate disinterested bids or hire a consultant to examine the terms of the relationship to make sure that they are fair and reasonable.

l. Determining reasonable compensation is not an exact science. The key is comparing duties and responsibilities, not the title. Compensation must be commensurate with the number of hours per week, or some other unit of time, devoted to the job. Compensation for the final year of service is not comparable automatically to compensation for other years of service because final years frequently involve additional payments such as severance.

Comparisons need to be based on entities of similar size. Indicators of size include budget, revenues (gross revenue or net revenue), number of employees, number of persons served by the organization during a specific period of time and whether the organization is stand alone or part of a group.

It is relevant that other enterprises compete for the services of the executive in setting compensation.

You can use only for-profit comparables but you may not be able to use the rebuttable presumption of reasonableness. The regulations reference compensation levels at both taxable and tax-exempt entities, and the use of the word both suggests that for-profits alone aren't going to qualify. Also, if you rely on just for-profit data, you will likely draw increased scrutiny from the IRS.

What constitutes like circumstances? A compensation package that consists of just base salary is obviously not comparable to a compensation package that also includes various perks and benefits. While there is no prohibition on revenue based compensation, such an arrangement will likely receive more scrutiny.

It's important for the organization to use comparables from the same geographic area. The regulations do not specify how many comparables you need to consider. However, if you are a small organization trying to meet the requirements of the rebuttable presumption of reasonableness you have to use at least three.

A small organization that wants to bring in a top notch person to grow its activities, and to recruit such a person initially requires that the organization compensate this person out of the range of what would be comparable for organizations of similar size. Of course, the organization aspires to be bigger – that's why it is bringing in this individual. There's nothing inherently wrong with this, but the organization needs to document its decisions and reasoning.

A word of caution on compensation surveys. Having a survey is not necessarily a magic bullet for compliance with the requirements for the rebuttable presumption. A compensation survey does not absolve the organization from showing that the entities in the survey constitute like-enterprises and provide like-services. When relying on surveys, make sure that it has the supporting data that shows that both the enterprises listed in the surveys are indeed comparable and the jobs listed in the survey are comparable.

9. Legislative Tax Proposals. IRS tax proposals include: Proposed excise tax on termination of exempt status; tax 100% of non-profit income from participation in the tax shelter schemes; intermediate sanctions extended to both public and private foundations; proposed use of excise tax to fun IRS enforcement.

10. Conversion of Non-Profit to For-Profit.

a. Conversion in Place. Conversions usually entail changing an organization's legal form under state law and its federal tax status. A conversion in place usually involves an amendment to the corporation's articles of incorporation to delete the non-profit limitations on purpose and powers and add broader, more permissive for-profit purposes and powers. Conversions in place are typically favored by organizations that are not significantly dependent on fixed assets, such as real property. A conversion in place does not disturb existing contractual relationships and other agreements. This arrangement contrasts with other forms of conversions, like asset sales, which often required the converting entity to assign contracts and other rights.

b. Asset Sales. In this structure, a non-profit seller agrees to sell some or all of its assets to the purchaser, and the purchaser specifically agrees to assume all, some, or none of the liabilities of the seller. An asset sale requires the for-profit purchaser to obtain appropriate state and local licenses, and the for-profit purchaser will not automatically succeed to contracts by operation of law. Some contracts may have restrictions on or require consents to their assignability. Asset purchases and sales are the typical structure for acquisition of schools and non-profit hospitals by for-profit companies. The selling organization retains responsibility for paying the claims of creditors; funding pension plan; severance, and other employee costs; and similar matters.

c. Mergers. In these instances, the non-profit corporation mergers with and into a for-profit corporation, and the for-profit corporation is the survivor. The disappearing non-profit corporation's members, if eligible, receive stock of the surviving corporation, or cash or other merger consideration, depending on the structure of the transaction.

d. Drop Down Conversion. A drop down conversion involves the transfer of some or all of the operating assets and liabilities of the organization to a wholly or partially owned subsidiary in exchange for stock and/or notes. This is typically used when an organization wants to convert some or all of its assets into a for-profit mode in order to obtain access to capital.

e. Partial Conversions. Partial conversions are generally structured using some form of joint venture. A joint venture may be formed by two unrelated entities. Some of these joint ventures are designed to combine the resources of the two venturers to create a new entity, or they are used to combine all of the operations and related activities of both venturers in a particular market.

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f. Conversion Considerations. Transactions were frequently structured as fairly primitive leveraged buyouts. A new corporation would be formed and the original owner of the hospital or school would agree to sell the assets of the hospital or school to the new corporation. Because the potentially large amounts of consideration being paid in connection with conversions, and the inherent imprecision of valuations, the retention of some form of equity in the converted entity by the converting organization or its successor can serve as an important hedge against the possibility that the valuation is incorrect or incapable of being determined with complete precision as of the date of conversion. From a fiduciary point of view, however, an evaluation must be made as to the risks associated with retaining a substantial amount of the conversion consideration in the form of equity in the converted organization, because it cannot always be assumed that the value will always increase or increase exponentially.

g. Charitable Trust Law Considerations. Regardless of the form of the conversion, a non-profit corporation's articles of incorporation or state law will require that its assets be irrevocably dedicated to charitable or other non-profit purposes. Because of this so-called non-distribution constraint, state charitable trust law typically requires that the fair market value of the non-profit corporation's assets be used for charitable purposes or for other purposes consistent with the converting organization's historic non-profit purposes. Many states require that the state attorney general be notified of a proposed transfer of all or substantially all of a non-profit corporation's assets, and certain types of transactions, such as mergers, may actually require the approval of the attorney general or another state regulator.

h. Federal Tax Considerations. The most significant tax issue affecting conversions from non-profit, tax-exempt status to for-profit, taxable status is the general requirement that the transferring or selling organization must receive the full fair market value of the transferred assets, regardless of the form that the conversion takes. As a general rule for federal tax purposes, an organization's tax-exempt status would not be adversely affected simply because it changes the means by which it carries out its charitable purposes. For example, a tax-exempt hospital that was formed and has historically operated for the purpose of promoting health and that has operated hospitals as a means of carrying out that charitable purpose would not lose its exemption simply because it sells its assets to a for-profit purchaser or engages in another form of conversion transaction. Continued exemption would be predicated on that organization's continuing to conduct programs or activities that further an exempt purpose or function.

The principal risk to tax exemption arises because of the prohibition against the inurement of net earnings that has always applied to Section 501(c)93) organizations and that was made applicable to Section 501(c)(4) organizations in 1996. Section 4958 now poses penalty excise taxes on persons who receive excessive benefits directly or indirectly from a Section 501(c)(3) or Section 501(c)(4) organization, the Service and the courts generally took the position that the prohibition against inurement of net earnings was absolute in that virtually any amount of inurement. An Organization's net earnings could inure to the benefit of a private shareholder or individual or other insider was if the organization sold or transferred assets to that individual, or to an organization owned or controlled by that individual, for less than the assets' fair market value.

(1) In Anclote Psychiatric Center, Inc. v. Commissioner, it was alleged that a tax-exempt psychiatric hospital's net earnings inure to the benefit of private shareholders or individuals as a result of the sale of its assets to a corporation formed by its board of directors for an amount that allegedly was less than its fair market value. The tax-exempt organization sold the hospital assets to its directors for $6,318,000, including assumed liabilities of $1,818,000. Two years later, the corporation owned by the board of directors sold the hospital to an unrelated third party for $29,518,000. The Tax Court, after evaluating the evidence concerning valuation, concluded that the Service satisfied its burden of proving that the sale of the hospital to the corporation formed by its directors resulted in prohibited inurement and that, as a result, the hospital lost its Section 501(c)(3) exempt status.

(2) In Caracci v. Commissioner, a case decided under the intermediate sanctions regime, the Tax Court concluded that the three Section 501(c)(3) home health agencies sold their assets to corporations controlled by insiders for amounts that, in the aggregate, were approximately $5,164,000

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below their fair market values. The Tax Court upheld the imposition of the first-tier excise taxes on the disqualified persons who were the recipients of the excess benefits, as well as the excise tax on the organization managers who participated in approving the excess benefit transactions The Tax Court declined to revoke the tax-exempt status of the three selling Section 501(c)(3) organizations.

When the conversion is structured as a sale of assets, the selling organization remains in existence and thus can continue to use the proceeds from the conversion transaction in furtherance of charitable purposes. As an alternative, a new organization can be created.

When a Section 501(c)(3) organization converts from non-profit to for-profit status in a transaction, such as an assets sale, that allows the organization to continue in existence, the organization must be concerned with the question of whether or when it will become a private foundation. In most instances, a hospital or HMO that sells its assets will have several options with regard to its future public charity status. In fact, unless the organization transfers its assets, including conversion consideration, to a newly formed organization, the organization will, in most instances, be able to continue to qualify as a public charity for at least some period following the sale of assets and the discontinuation of the hospital or HMO operations.

First, the organization may continue to be classified as a hospital described in Sections 509(a)(1) and 170(b)(1)(A)(iii) because it continues to carry on other functions, such as operating outpatient clinics, that are of the type that would allow it to be classified as a Section 170(b)(1)(A)(iii) hospital.

If the organization will cease conducting activities that will allow it to be classified as a Section 170(b)(1)(A)(iii) hospital, the organization will have three other options available for continuing to qualify as a public charity. First, if the organization continues or puts in place a fundraising program that can reasonably be expected to be successful, the organization may be able to be classified as a publicly supported organization described in Sections 509(a)(1) and 170(b)(1)(A)(vi).

Second, if the organization does not have sufficient public support to enable it to be entitled to the additional Section 170(b)(1)(A)(vi) classification, it nonetheless will be entitled to the additional classification as a Section 509(a0(2) organization. The Service has issued private letter rulings in which it concluded that a hospital was entitled to the additional classification as a Section 509(a)(2) organization on the basis of its sources of support from government programs, particularly Medicare and Medicaid. After the organization sells assets, it will be able to continue to be classified as a Section 509(a)(2) organization until either it fails to satisfy the one-third-of-support test or its investment income and net after-tax unrelated business income (UBI) exceeds the one-third-of-support limitation.

11. Joint Ventures Between Tax-Exempt and For-Profit Organizations.

a. Revenue Ruling 98-15.

(1) This Ruling announces a substantial clarification of the IRS's position. The Ruling describes two factual situations in which an otherwise charitable hospital forms a limited liability company with a proprietary firm, and transfers virtually all of its operating assets to the LLC. The Revenue Ruling sets out for the first time a clear and analytical basis for determining whether a charitable organization's participation in a joint venture will adversely affect its tax-exempt status.

(2)The Ruling does not prescribe specific requirements, but allows much room for drawing emphasis by comparing the facts of Situation 1 (in which the organization's participation in the joint venture did not adversely affect its tax-exempt status), with those of Situation 2 (in which the organization's participation did adversely affect exempt status).

Consider these key differences between Situation 1 and Situation 2.

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- Composition of the Board. In Situation 1, the exempt organization selected 3 members of a 5 member governing board. In Situation 2, the exempt organization selected 3 members of a 6 member governing board.

- Powers of the Board. Under both situations, majority approval was necessary for specified major operating decisions. However, in Situation 1, a greater number of operating decisions required board approval than in Situation 2. Substantially more control was placed in the hands of an exempt organization controlled board in Situation 1.

- Stated Purpose. In Situation 1, the governing documents provided that the LLC would operate in a manner in furtherance of charitable purposes. In Situation 2, however, the stated purpose was merely the provision of healthcare services.

- Management Company. In Situation 1, the management company was unrelated to either party, whereas in Situation 2, the management company was a wholly-owned subsidiary of the taxable member. The management contracts in both situations were for initial five year terms with two additional five year renewal options; in Situation 1, renewal was by mutual consent while in Situation 2, the management company had sole discretion to renew. "Evergreen" clauses would appear to be a negative factor.

- LLC Management. Situation 2 specified that the chief executive officer and the chief financial officer of the LLC would be selected by the for-profit corporation, subject to the exempt organization's approval. Further, the selected officers were prior employees of the taxable member.

b. Redlands Surgical Services. 113 T.C. No. 3 (7-19-99). A non-profit organization ("NPO"), which was a subsidiary of a public charity that operated hospitals, did not qualify for exemption under the following circumstances. NPO participated as a co-general partner in a general partnership ("GP") that owned and operated an ambulatory surgery center. The other co-general partner was a for-profit entity. Neither the general partnership agreement nor any of the binding commitments relating to the operation of the surgery center established any express or implied obligation that charitable purposes be advanced over non-charitable objectives. Under the general partnership agreement, although BPO appointed half of the managing directors and could veto actions proposed by the directors, it could not initiate action without the consent of the for-profit entity's managing director appointees; (ii) all of the partners of the operating partnership except BPO were for-profit interests not motivated or constrained by charitable objectives; and (iii) the operating partnership was locked into a management contract with a for-profit affiliate of the for-profit co-general partner. This revenue-based compensation structure provided an incentive to maximize profits and the entire arrangement provided market advantages and competitive benefits to all of the for-profit entities involved in it.

c. St. David's Health Care System. D.C. Tex., 2002 - 1 USTC § 50, 452 Vac., and remanded; CA-5, 2003-2 USTC § 50 713, 349 F.3d 232. St. David's and HCA each appointed one-half (½) of the partnership's board of governors. No measure could pass the board without a majority of the representatives both St. David and HCA. St. David's and HCA each had the power to unilaterally remove the partnership's Chief Executive Officer. St. David's could dissolve the partnership if it received legal advice that their participation in the partnership would hinder its tax-exempt status. The partnership agreement provided that "the Manager shall cause the Facilities to conduct the business operations of the Partnership in such a manner as to satisfy the community benefits standard generally required of hospitals under Section 501(c)(3) of the Code . . ." The Management Services agreement provided that if Galen took any action with a "material probability of adversely affecting" St. David's tax-exempt status, St. David's could terminate the Agreement through its representatives on the governing board. The District Court for the Western District of Texas granted summary judgment in favor of St. David's.

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The jury found that St. David's proved by a preponderance of the evidence that it was entitled to a tax exemption for 1996.

d. Rev. Rul. 2004-51, 2004-22 IRB. An exempt education organization's exempt status wasn't jeopardized by its 50-50 ownership interest in an LLC with a for-profit partner, even though it conducted a portion of its activities through the LLC.

e. Additional guidance is available in several PLRs issued in recent years. See 200436022; 200325003; 200304041; 200206058 and 200118054.

f. Low Income Housing Tax Credit Limited Partnership. An April 25, 2006 Memorandum for Manager, EO Determinations provides criteria for processing applications for recognition of exemption under section 501(c)(3) or (c)(4) of the Internal Revenue Code where the applicant proposed to further its purposes by participating, as a general partner, in a section 42 low income housing tax credit (LIHTC) limited partnership:

(1) The applicant must describe its proposed activities, including identifying the specific proposed housing project to be operated by the limited partnership and explain how it will accomplish its charitable purposes, consistent with the safe harbor or the facts and circumstances test set forth in Rev. Proc. 96-32 , 1996-1 C.B. 717. This requirement requires that proposed activities be described in sufficient detail to permit a conclusion that an organization qualifies for the exemption claimed.

(2) The applicant is not required to provide a final limited partnership (LP) agreement. However, written representations will be required as discussed below.

The formative documents will require that charitable purposes be advanced as follows:

(i) The LP or LLC will operate housing that it owns in a manner that furthers charitable purposes by providing decent, safe, sanitary and affordable housing for low income persons and families.

(ii) In the event of a conflict between the obligations of the applicant (in its capacity as general partner or managing member) to operate the LP or LLC in a manner consistent with such charitable purpose and any duty to maximize profits for the limited partners or other members, the charitable purposes contained in the LP agreement or the LLC governing documents will prevail.

(3) Adopt a conflict of interest policy.

(4) The applicant:

(i) must provide an independent Phase I environmental report on the proposed project and exercise due diligence to minimize any risk;

(ii) will require the LP or LLC to enter into a fixed price construction contract wit a contractor that is bonded or that provides a performance letter of credit or adequate personal guarantee.

(iii) to the extent the agreement requires the general partner to provide an operating deficit guarantee, the agreement must limit the general partner's liability in one or more of the following ways:

(5) The agreement must limit the payments to the investors in the event of a reduction in the amount of tax credits received.

(6) The applicant must secure a right of first refusal to acquire the project at the end of the LIHTC compliance period.

(7) The repurchase price may not exceed the amount of capital contributions.

(8) If the formative documents provide that the applicant must obtain the consent of the limited partners or the investor members with respect to certain matters that do not involve day to day operations, including, but not limited to, the following:

(i) sale or refinancing of the LIHTC project;

(ii) admission of a new partner or member;

(iii) acquisition of additional property;

(iv) transfer of the applicant's interest in the limited partnership or limited liability company;

(v) borrowing substantial additional funds;

(vi) entering into contracts with affiliated entities;

(vii) amendment of the limited partnership agreement or operating agreement;

(viii) change of accountant or property manager; and/or

(ix) approval of annual budget, then such consent shall not be unreasonable withheld.

(9) Consent may be withheld if one or more of the above actions would likely be inconsistent with preserving the housing as a low-income housing project.

(10) Any right of the limited partner(s) or other member(s) to remove the applicant as general partner should only be for cause as set forth in the agreement.

12. Instrumentalities of Government.

a. A wholly owned state or municipal instrumentality that is a separate entity may qualify for tax exemption as a charitable entity if it is a *clear counterpart* of a charitable, educational, religious, or like organization. Based on the scope of the organization's purposes and powers, a state or municipality itself, exempt under IRC § 103, cannot qualify as a charitable organization, inasmuch as its purposes are not exclusively those inherent in charities, nor can an integral component of the state or municipality. An instrumentality meeting the *counterpart* requirement, such as a school, college, university, or hospital, can be deemed a charitable organization.

b. Four (4) IRS rulings draw the contrast:

- A public housing authority was denied tax exemption as a charitable organization.
- The organization had the power to determine the tax rate necessary to support its operations within specified maximum and minimum rates; since the organization lacked the power to impose or levy taxes, the power was deemed not regulatory or enforcement in nature.
- Likewise, the IRS held that an industrial commission established by a state legislature to study the problems of industrial life in a geographic area are qualified as a charitable donee.
- A committee, created by joint resolution of a state legislature, established to receive and expend contributions to provide state units for a parade incident to a presidential inauguration, was ruled to be a political subdivision.

c. The following factors are taken into consideration: (I) whether it is used for a governmental purpose and performs a governmental function; (ii) whether performance of its function is on behalf of one or more states or political subdivisions; (iii) whether there are nay private interests involved, or whether the states or political subdivision involved have the powers and interests of an owner; (iv) whether control and supervision is vested in public authority or authorities; (v) if express or implied statutory or other authority is necessary for the creation and/or use of such an instrumentality and whether such authority exists; and (vi) the degree of financial autonomy and the source of its operating expenses.

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(1) A political subdivision has been delegated the right to exercise part of the sovereign government power of the governmental unit of which it is a division. Rev. Rul. 74-15, 1974-1 C.B. 126.

(2) A federal court of appeals held that a *political subdivision* is any division of any state that has been delegated the right to exercise part of the sovereign power of the state.

(3) States, Political Subdivisions, Instrumentalities, and Integral Parts. The states, the District of Columbia, and U.S. territories are, in a loose sense of the term, tax-exempt entities. This tax exemption is a consequence of the doctrine of intergovernmental immunity – the doctrine implicit in the U.S. Constitution that the federal government will not tax the states. This tax exemption extends not only to the states as such but to component parts thereof: political subdivisions, instrumentalities, agencies, and the like. The general principle is that the "United States may not tax instrumentalities which a state may employ in the discharge of her essential governmental duties. The Court ruled that Congress could tax any "source of revenue by whomsoever earned and not uniquely capable of being earned only by a State."

(4) The term political subdivision connotes a jurisdictional or geographical component of a state, such as counties, cities, and sewer districts. Any division of a state made by the proper authorities thereof, acting within their constitutional powers, for the purpose of carrying out a portion of these functions of the state that by long usage and the inherent necessities of government have always been regarded as public. The tax exemption derives in part from the constitutional immunity accorded the revenue of integral units of states. The IRS, however, asserted that a state university cannot qualify as a political subdivision because if fails to possess a substantial right to exercise the power to tax, the power of eminent domain, or the police power.

d. **INSERT RE SUPPORTING ORG**

e. Native American Tribes. Native American Tribes generally are not taxable entities for federal income tax purposes. These tribes generally have governing instruments, a council, operational rules, a formal membership arrangement, and various governmental powers, such as the rights to levy taxes, enact ordinances, and maintain a police force. Thus, any income earned by this type of corporation, regardless of the location of the business activities that produced the income, is not subject to federal income tax.

C. State Attorney General Action.

The one arm of state government which has generally been effective in non-profit regulation is the state attorney general's office ("AG"). In most states, the AG's office is charged with the responsibility of protecting the public's interest in exempt organizations. Some AGs both in respond to requests and initiate actions against charitable entities for alleged wrongdoings. In many States the AG is required to receive notice of all probate or trust proceedings in which a charity is named to receive a benefit. In such proceedings they question fees and expenses and oversee the payment of the benefit to the charity. The primary focus of the AG action is regulation of charitable solicitation. Some states are expanding filing requirements and reviewing filings and court proceedings.

1. Oklahoma AG:

a. Hinton Economic Development Authority. Seven people, including four town trustees, are accused of conspiring to personally profit by publicly funding a failed cocoa butter plant near Hinton. The investigation centers around four trustees for the town of Hinton, who allegedly created HEDA and two other entities, LGX and Hinton Enterprises, for the purpose of routing public money allotted to construct the plant back to their own pockets. Each are accused of one count of conspiracy against the state and one count of embezzlement by public officer. The indictment alleges they knew that the public funds could result in personal profit, and they conspired to set up the fictitious companies in an attempt to hide the money until they could line their pockets. Also indicted for his role in the scheme is the HEDA attorney.

b. Rural Development Foundation. The AG, and possibly the IRS, is aware of a news report concerning activities of Kiamichi Economic Development, Inc. and the Rural Development Foundation in

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connection with payment to a public official of funds coming to a McAlester dog food company through earmarked appropriations.

c. Fraudulent Charitable Solicitations. An Oklahoma couple has been charged with 30 counts of charity fraud that may have netted more than $230,000 from their scheme. Investigators believe the Andersons made as many as 4,600 successful, but fraudulent, solicitations to Oklahoma businesses on behalf of charities the couple was not affiliated with. It appears the Andersons would find businesses that were willing to donate to charitable organizations, and then they solicited those businesses numerous times for different charities. The state's complaint alleges 30 instances where eyewitnesses either confirmed the couple fraudulently solicited businesses or deposited the money – a total of $1,875 – into their own accounts. The solicitations may have been in small amounts in an attempt to fly under the radar, but their repeated solicitation raised suspicions among donors and bank employees and are backed by eyewitness accounts of these individuals soliciting money and depositing it into their own bank accounts. The charities used in their bogus solicitations included the Oklahoma Veterans Association, the Blind Children's Learning Center, the Oklahoma University Youth Center, the Veterans of Foreign Wars, the Norman University Lion's Club, the Lion's Club and the OKC Beep Ball Bombers. If convicted, they could face up to five years imprisonment and $10,000 fine for each count.

d. Mobile Phone Donation Cases – State of Oklahoma v. Domingo A. Frias-Bayan, Save a Life, Give Me a Phone Foundation, et al.; Case No. CJ-2005-2840; District Court of Oklahoma County; and State of Oklahoma v. Domingo Antonio Friar-Bayan and Hether Friar-Bayan; Case No. CF-2005-1847; District Court of Oklahoma County. AG sued promoters of the foundation that solicited and received donations of over 100,000 used cell phones for the benefit of battered women alleging donated phones were sold for a profit and little, if any, money went to benefit battered women. Women who sought help were required to work soliciting donations.

The criminal case alleges violation of 22 O.S. § 2001 § 1405, the Oklahoma Corrupt Organizations Prevention Act (similar to federal RICO) for racketeering and Oklahoma Solicitation of Charitable Contributions Act, Oklahoma Securities Act and Offering Forged or False Instrument for Record. Hether Friar-Bayan pled guilty to all 11 counts and was sentenced to 7 years and to pay an $11,000 fine. Domingo is in jail and awaiting trial.

e. In re National Benevolent Association; Christian Church (Disciples of Christ) et al.; Case No. 04-50948-RBK; U.S. Bankruptcy Court, Western District of Texas, San Antonio Division. Case involved bankruptcy of a large national organization that managed retirement facilities - one of which was Oklahoma Christian Home ("OCH"), organization received charitable donations to care for residents in the home. AG filed a "Cy Pres" claim on funds held by the Association for OCH and delivered funds to local charity to administer for original purpose of providing care for residents who could no longer pay..

f. Sarkeys v. Independent Sch. Dist. No. 40, Etc. – 592 P. 2d 529. A class action on behalf of the Independent School District No. 40 and all of the beneficiaries of Sarkeys Foundation was brought against Sarkeys, Inc., Sarkeys Foundation, Sabine Corporation and the Board of Trustees of Sarkeys Foundation. Sabine Corporation entered into contracts for the purchase of 81.8% of Sarkeys, Inc. stock from the Sarkeys Foundation. It was contended that the sale to Sarkeys, Inc. by the Foundation constituted an act of indirect self-dealing. The Attorney General of the State of Oklahoma intervened. A Joint Application for Approval of Compromise Settlement was filed by the Class, the Attorney General, the individual and corporate defendants, the Trustee of Sarkeys Foundation, and the Co-Receivers of Sarkeys Foundation. The court heard and considered testimony and evidence offered in support of the Joint Application of Settlement. The court entered its Journal Entry of Judgment approving the settlement agreement entered into by the parties. The Attorney General exercised his duty of parens patriae, and intervened in the action involving the charitable trust, Sarkeys Foundation. He had the authority to conduct the litigation. The Attorney General's power are as broad as the common law, unless restricted or modified by statute. The authority of the Attorney General to settle or compromise the litigation in question, in the absence of fraud or collusion is exclusive. The court found $14,500,000 to be paid to Sarkeys Foundation under the terms

of the settlement agreement to be fair and adequate in relation to the appraised value of the assets and liabilities of Sarkeys, Inc.

2. New York AG. Eliot Spitzer has received significant press coverage for the enforcement efforts of the New York AG's office.

3. Pennsylvania AG:

a. AG brought suit in 2002 to block the sale of Hershey Foods by the Hershey Trust Company and the Milton Hershey School.

b. In 2000, AG, as a party to the proposed transaction involving two non-profit health care organizations, insisted the two organizations more fairly negotiate the transaction to minimize future disputes and to achieve a fair division of charitable assets.

c. In Estate of McCahan, the Pennsylvania AG, acting on behalf of charitable remaindermen of two charitable remainder trusts, sued the trustees – alleging that investment in tax-exempt bonds impermissibly favored the income beneficiaries over the remaindermen.

4. Illinois AG. Brought suit against private foundation and related investment company for loss of over $50 million of foundation funds through speculative investments. Suit seeks to recover investment management fees, salary paid to foundation founder's wife and funds converted by managers, losses as a result of breach of fiduciary duties. Illinois AG maintains a data base containing all filings by private foundation and CRTs – 990s, copies of audit.

D. State Sunshine Laws.

State sunshine laws (such as Oklahoma's Open Records and Open Meetings Acts discussed at I.C.4, above), require the meetings and records of state and local government be open and accessible to the general public. The courts have traditionally held that most charities are private non-profit entities and are not subject to state sunshine laws. However, with the increasing involvement of private non-profits directly and indirectly in public projects or traditionally governmental functions, some non-profits are finding themselves subject to these laws.

1. In Colorado, for example, an independent non-profit corporation was created to redevelop the 4700-acre site of Denver's former airport. The development corporation solicited bids from real estate firms seeking to become partners in the project. The Denver Post filed an Open Records Act request to see the real estate developers' bid proposals.

The Colorado Court of Appeals held that, although the development corporation was a private entity not usually subject to the Colorado Open Records Act, the City of Denver retained substantial control over the project because it provided funds to the corporation and appointed its board. In addition, Denver would receive the proceeds if the corporation opted to sell any portion of the land it owned. Therefore, the court concluded, the development company was a "political subdivision" of the state and was required to comply with Colorado's Open Records Act.

2. A Minnesota state court found that the Minnesota Partnership for Action Against Tobacco, a private non-profit organization formed as part of the state's $6 billion settlement with tobacco makers, was subject to Minnesota's Open Records and Open Meetings Act because of the amount of "public money" it received and the "importance" of its mission.

3. The Missouri sunshine law references "quasi-public governmental bodies." These are defined as organizations performing a public function, carrying out activities through contracts with public bodies, or receiving direct appropriations from public bodies.

4. In North Carolina, the state court of appeals held that an organization that began as a public body but then became a private non-profit organization was obligated to comply with North Carolina's sunshine laws. In addition, if the private organization was formed by a public body or agency and the initial board of directors was selected by the public agency, North Carolina's Open Meeting and Open Records laws likely apply, even if the board becomes self-perpetuating. The Georgia legislature specifically amended Georgia's Open Records and Open Meetings Acts to expand its coverage to apply to private charitable organizations which succeeded to the operation of county public hospitals.

5. In Iowa, a private not-for-profit corporation, which operated as a foundation that solicited and managed private gifts for exclusive benefit of a public university, performed a government function by virtue of its service agreement with the university, making the corporation's records "public records" for purposes of a state's Freedom of Information Act; the corporation's activities advanced the university's institutional goals; fund raising and management were vital functions of a modern university; and the university, with express approval of the board of regents, had contracted away those functions.

6. Clearly, the trend is away from protecting private non-profit organizations that contract with public agencies or perform normally (or previously) public functions. Every non-profit organization must be aware of this trend and consider whether its participation in joint ventures with public agencies, the performance of previously public functions or the acceptance of direct appropriations from state or local government will subject some or all of the organization's books, records, and meetings to disclosure. Gannon V. Board of Regents - 2005 WL 263892 (Iowa).

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