

January 2009

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New Form 990 and Schedule K

The Internal Revenue Service (the “IRS” or the “Service”) has launched a new Form 990 that will necessitate any reporting nonprofit entity with outstanding bond issues to expend a great deal more time making the annual filing. Such a nonprofit corporation is likely to be required to complete new Schedule K, providing significant information about its bonds. The new initiative will almost certainly warrant numerous detailed discussions with the entity’s bond or tax counsel.

The Background

Under the Internal Revenue Code of 1986, as amended (the “Code”), and its predecessors, most nonprofit corporations intending to be exempt from income tax under Code Section 501(c)(3) are required to file an annual form (“Form 990”) with the IRS. With the introduction of a new proposed Form 990 in December 2007 and new Instructions issued in September 2008, the IRS has developed a large number of additional requirements for annual information from each filing nonprofit corporation.

The new requirements include providing facts about corporate governance, charity care and other activities of the entity.

This alert focuses on one entirely new category added this year — Schedule K to Form 990, which now requires facts about outstanding tax-exempt bonds benefiting the nonprofit.¹ Who has to file Schedule

¹ The new Form 990 and Schedule K are unclear about who has to file with respect to a bond issue. The key test (Question 24a in Part IV of the Form) uses the ambiguous phrase “did the organization have an issue ... outstanding.” The questions in the Form and the examples in the Instructions lead to the conclusion that the Service intends at least the 501(c)

K and an explanation of the requirements will be discussed. Differences between the requirements of Schedule K for filing for the 2008 fiscal year² and the 2009 fiscal year will be noted, and the different Schedule K filing requirements for refundings,³ as opposed to nonrefunding “new money” bonds, will be explained. Client alerts on other aspects of the new form will follow.

The Details

For reports on fiscal years beginning in 2008, nonprofit corporations and their counsel need to be particularly aware of several key points:

- Schedule K requires information only about bonds issued after 2002, but the tax definition of “issue date” is used. Therefore if certain post-2002 mode changes, liquidity replacements or document amendments on older issues have triggered a “reissuance,” even though the borrower may not have thought it was creating

(3) entity or entities owning bond-financed property must file. But that leaves the question as to whether a separate 501(c)(3) tenant of bond-financed property or other beneficiary of the financing needs to file. Prudence indicates such an entity probably should file Schedule K, with appropriate coordination of answers with the other entities noted in the response.

² For purposes of Form 990, a 2008 filing is any filing with respect to a fiscal year of the corporation which began in calendar 2008 (even if the form is filed in 2009 or later) and a 2009 filing is with respect to a fiscal year beginning in calendar 2009 (even if filed in 2010 or later).

³ A refunding is an issue proceeds of which are used to pay or provide for payments of principal or interest on a prior bond issue.

“new” bonds, there still would be a new “issue” to be reported on in its Schedule K.

- Schedule K calls for a listing of the “purpose” of each issue and great care should be taken to clearly define the “bond-financed property.” For Form 990 Schedule K filings after 2008, detailed questions on the use of proceeds and private business use with respect to such property are required to be answered.
- Consistency is crucial. No filing entity should want to change its project description for an issue contrary to a prior filing and a loose filing for 2008 may risk such changes on the 2009 Form 990 once the more difficult questions on Schedule K are faced. A significant portion of the requested information requires “legal” analysis or calls for categorizations of contracts with legal consequences.

Who Must File Form 990

Organizations that are exempt from income tax under Code Section 501(a) must file annual information return Form 990 unless they qualify for the small organization exception. The small organization exception will fit if the entity’s annual gross receipts (actual receipts without reduction for expenses) are

Form 990-EZ does *not* require completion of Schedule K on bonds.

less than \$1,000,000 and its total assets at the end of the fiscal year being reported on do not exceed \$2,500,000. If this exception is met, then the entity can choose to file the short form — Form 990-EZ. For purposes of this alert, use of the short form is preferred since completion of Form 990-EZ does *not* require completion of Schedule K even if there are significant post-2002 tax-exempt bonds outstanding.

Note that the maximum limits for the use of Form 990-EZ are set to reduce from \$1,000,000 and \$2,500,000 to \$500,000 and \$1,250,000, respectively, in 2009 and to \$200,000 and \$500,000, respectively, in 2010. Organizations with gross receipts of less than \$25,000, with certain exceptions, only have to file Form 990-N — a notice that neither the Form 990 nor Form 990-EZ is required. Given the reducing maximums for use of Form 990-EZ, in the future more nonprofits will be required to face the full panoply of Form 990 requirements, including Schedule K on bonds.

Bond Issues to Report

If a Form 990 is to be completed, then the filing organization will have to answer Question 24 in Part IV of the main form. This states:

- 24a Did the organization have a tax-exempt bond issue with an outstanding principal amount of more than \$100,000 as of the last day of the year, and that was issued after December 31, 2002? *If “Yes,” answer 24b-24d and complete Schedule K. If “No,” go to question 25.*
- b Did the organization invest any proceeds of tax-exempt bonds beyond a temporary period exception?
- c Did the organization maintain an escrow account other than a refunding escrow at any time during the year to defease any tax-exempt bonds?
- d Did the organization act as an “on behalf of” issuer for bonds outstanding at any time during the year?

Several points are worth noting about question 24:

- *Tax definition of “issue.”* As bond attorneys know, a single “issue” can be composed of bonds covered in multiple Form 8038s and issued over a long period of time.⁴ A single issue for tax purposes can also be only a portion of a large concurrent issuance.⁵ As a result of this legal complexity, the reporting nonprofit should make sure it reviews its files and consistently identifies the separate tax issues.
- *Issue Date.* A filing entity must know if any bonds have been “reissued.” Did, for example, the conversion of an issue from auction rate securities trigger a reissuance?

Has there been a “reissuance” forcing a new issue date and therefore required information?

If so, and the reissuance date was after December 31, 2002, an issue nominally dating from before 2003 must be reported on.⁶

- *“On behalf of” — 24d.* This question requires an affirmative answer by Rev. Rul. 63-20 corporations and other “on behalf of” issuers filing Form 990. Issues may be reported

⁴ For example, if some bonds of an issue are sold for delivery in a calendar quarter different than for the other bonds of the issue, two Form 8038s will be required.

⁵ For example, if a fixed rate issue is sold 15 days before a variable rate issue for the same borrower and both are closed on the same day, then there will be two issues for tax purposes, even if the borrower has only one set of documents to deal with.

⁶ This will not be an infrequent concern. With recent market upheavals, many nonprofits have changed the structure of existing issues (e.g., changing auction rate securities to variable rate demand bonds). This may or may not have been done with a “reissuance.” Frequently counsel assumes a reissuance does occur, treating the document changes as a current refunding — until now usually the only requirement triggered was the filing of another Form 8038. But now each of these transactions since 2003 will have to be analyzed to see if there was a new issue for tax purposes, with the result of a “yes” answer being inclusion of the issue on Schedule K.

both by an issuer and by a borrower. The parties should be sure they give consistent answers.

Filing Differences for Schedule K — '08 vs. '09

Of the four parts in Schedule K, only the first — identification of applicable bond issues — is required for 2008 fiscal year filings. However, great care should be taken even this year, notwithstanding that the more complicated parts of Schedule K are not due until later. Several of the determinations necessary to complete Part I with respect to each issue will be applicable in future years. In particular, each outstanding bond issue must be identified and its purpose stated. This term is used in Part III of Schedule K as the basis for several calculations and other requirements. Therefore, it would be unwise not to carefully review the property identification now even if the calculations are not due until another year.

Schedule K Highlights and Questions to Consider

With an affirmative answer to Question 24a, Schedule K must be completed — with information for each “issue” of bonds. All the Schedule’s sections are optional for 2008 but mandatory for filings thereafter.

Part I

| Part I Bond Issues (Required for 2008) | | | | | | |
|--|----------------|-------------|------------------|-----------------|----------------------------|-------------------|
| (A) Bond title | (B) Issue date | (C) CUSIP # | (D) Issue amount | (E) Issue price | (F) Description of purpose | (G) Interest rate |
| A | | | | | | |
| B | | | | | | |
| C | | | | | | |
| D | | | | | | |
| E | | | | | | |

Most of the questions in Part I are straightforward with answers that can be gleaned from the Form 8038 for the issue, however two are not.

- “Description of Purpose”: If there are multiple purposes, each should be set forth, unless separate purposes relate to a single project, in which case they should be aggregated. It is recommended that bond counsel be contacted on this point. Clearly if the contemporaneous tax documents at the time of issue identified separate purposes,

Clearly define “bond-financed property” for each issue — Schedule K questions focus on the use and financing of these assets only.

that categorization should be followed on Schedule K. Even if not, it may be desirable to have a more specific breakdown here in view of the calculations and other requirements imposed later in Schedule K — some of which are levied purpose by purpose.

- “On behalf of” issuer: According to the instructions for Schedule K, if the filing entity was such an issuer, then this

question should be noted as “yes.” If the filing entity was only the borrower of proceeds, then the answer should be noted as “no.”

Part II

| Part II Proceeds Allocation for 2008 | | | | | | | | | | |
|---|-----|----|-----|----|-----|----|-----|----|-----|----|
| | A | | B | | C | | D | | E | |
| 1 Total proceeds of issue | | | | | | | | | | |
| 2 Gross proceeds in reserve funds | | | | | | | | | | |
| 3 Proceeds in refunding or defeasance escrows | | | | | | | | | | |
| 4 Other escrow proceeds | | | | | | | | | | |
| 5 Insurance costs from proceeds | | | | | | | | | | |
| 6 Working capital expenditures from proceeds | | | | | | | | | | |
| 7 Other expenditures from proceeds | | | | | | | | | | |
| 8 Total of adjusted categories | | | | | | | | | | |
| 9 Were the bonds issued as part of a normal refunding issue? | Yes | No | Yes | No | Yes | No | Yes | No | Yes | No |
| 10 Were the bonds issued as part of an advance refunding issue? | | | | | | | | | | |
| 11 Has the final allocation of proceeds been made? | | | | | | | | | | |
| 12 Does the organization maintain adequate books and records to support the final allocation of proceeds? | | | | | | | | | | |

- For each issue there must be breakdown of the use of proceeds. Since the general instructions to Form 990 define “proceeds” to include investment proceeds, logically the sum of the answers 2 through 7 for each issue should equal the amount listed for the answer to question 1. However, the Instructions for question 3, regarding refunding of defeasance escrows, speak about the amount “deposited” into such an escrow.⁷ Under normal usage this ignores investment earnings. Since the defined term “proceeds” used in question 1 of Part II does not so exclude that subcategory, in many instances the total of lines 2 through 7 will not balance back to line one. It is suggested that in such a situation the discrepancy be noted and the difference explained. In addition, note that this breakdown of proceeds in Part II will usually *not* match the numbers in the issue’s Form 8038 since that form does not include any investment earnings.
- Final allocations should be made within five years and adequate books and records should be maintained supporting such allocation. Filing entities should be aware that answering these questions inappropriately may trigger an audit.

Part III

| Part III Private Business Use (Continued) | | | | | | | | | | |
|--|-----|----|-----|----|-----|----|-----|----|-----|----|
| | A | | B | | C | | D | | E | |
| 1a Are there any management or service contracts with respect to the bonded property which may result in private business use? | Yes | No | Yes | No | Yes | No | Yes | No | Yes | No |
| 1b Are there any research agreements with respect to the bonded property which may result in private business use? | | | | | | | | | | |
| 1c Does the organization routinely engage bond counsel or other outside counsel to review any management or service contracts or research agreements relating to the bonded property? | | | | | | | | | | |
| 2 Enter the percentage of bonded property used in a private business use by entities other than a section 501(c)(3) organization or a state or local government | | % | | % | | % | | % | | % |
| 3 Enter the percentage of bonded property used in a private business use as a result of unleased land or facilities activity carried on by your organization, another section 501(c)(3) organization, or a state or local government | | % | | % | | % | | % | | % |
| 4 Total of items 2 and 3 | | % | | % | | % | | % | | % |
| 5 Has the organization adopted management practices and procedures to ensure the post-issuance compliance of its tax-relevant bond liabilities? | | | | | | | | | | |

- This section includes the most detailed questions on new Schedule K. First, all such questions relate to the “property financed by the issue.” It is vitally important for the filing entity to remember this concept. The questions do *not* relate to the entire assets of the organization, or even

⁷ Note that both this question and question 24c in the main Form 990 talk about defeasance escrows. These are defined in the Form 990 Instructions as always being an escrow to the first call date on an issue. This may or may not be true! It is suggested all defeasance escrows be reported even if not to the first call date.

all the assets financed by all its bonds. The questions relate only to the assets financed by the particular issue. Second, absent any clear determination otherwise with advice of counsel, the answers to these questions should be consistent with the position taken by an organization's bond or tax counsel upon issuance.

- The questions on leases and other private uses of the bond-financed property arise from the limitations on such uses to the extent they do not fall into a permitted exclusion. The filing entity is asked to state if there are any such items extant that "may" result in private business use. If such a contract exists at all, a "yes" answer is to be given even if the corporation has determined that the contract fits an exception, meets a safe harbor or is otherwise not a problem for the issue.⁸
- Question 4 seeks the average percentage during the year⁹ for aggregate private business use for each issue. In determining this percentage, leases, management or service contracts or research agreements that do fit the public use exemption¹⁰ or the relevant safe harbors¹¹ are disregarded. If this number on any issue is above 5%, the filing entity should expect to be contacted by the Service. Then question 5 seeks a percentage of unrelated trade or business use by 501(c)(3) corporations (including the filer) or governmental units.¹²

Part IV

| Part IV Arbitrage (Optional for 2008) | | | | | | | | | | | | |
|---|----|-----|----|-----|----|-----|----|-----|----|-----|----|--|
| 1. Has a Form 8038-T, Arbitrage Rebate, Yield Reduction and Penalty in Lieu of Arbitrage Rebate, been filed with respect to the bond issue? | | | | | | | | | | | | |
| Yes | No | Yes | No | Yes | No | Yes | No | Yes | No | Yes | No | |
| | | | | | | | | | | | | |
| 2. Is the bond issue a variable rate issue? | | | | | | | | | | | | |
| | | | | | | | | | | | | |
| 3a. Has the organization or the governmental issuer identified a hedge with respect to the bond issue on its books and records? | | | | | | | | | | | | |
| b. Name of provider | | | | | | | | | | | | |
| c. Term of hedge | | | | | | | | | | | | |
| 3b. Were gross proceeds invested in a CDF? | | | | | | | | | | | | |
| b. Name of provider | | | | | | | | | | | | |
| c. Term of CDF | | | | | | | | | | | | |
| 4. Was the regulatory safe harbor for establishing the fair market value of the full subsidy? | | | | | | | | | | | | |
| | | | | | | | | | | | | |
| 5. Were any gross proceeds invested beyond an available temporary period? | | | | | | | | | | | | |
| | | | | | | | | | | | | |
| 6. Did the bond issue qualify for an exception to rebate? | | | | | | | | | | | | |
| | | | | | | | | | | | | |

- This section focuses on arbitrage — whether the issue is a variable issue, whether the rebate form has been filed (8038-T), whether there is a hedge (and if so, the term and the provider thereof) and whether there was or is a guaranteed investment contract (and if so, the name

⁸ See 2008 Schedule K (Form 990) Instructions, page 6 of 8.
⁹ The Instructions allow the filing entity to chose any year for each issue. Presumably, the "bond year" for the issue will be used. See 2008 Schedule K (Form 990) Instructions page 1 of 8.
¹⁰ Regulation Section 1.141-3(c).
¹¹ For management or service contracts, see Rev. Proc. 97-13. For research agreements, see Rev. Proc. 2007-47.
¹² Note this purportedly requires the filing entity to make a judgment as to whether another entity's use is unrelated or not.

and term of the provider and term thereof). The answers to these questions may change from year to year as investments are made. Note that an affirmative answer to question 5 will need to be discussed with counsel to make sure no other actions (such as yield reduction payments) are required.

Refunding Treatment for Schedule K

- Refunding issues need to be segregated into issues that refund bonds issued before 2003 or after December 31, 2002. If bonds being refunded were issued before 2003, then Part III of Schedule K does not need to be completed with respect to the refunding bonds or the bonds being refunded. However, if the bonds being refunded were issued in 2003 or later, then the answers to Part III must be provided. Logically these rules also apply for issues that refund a series of prior refunding issues, with the key question being whether the original issue was on or before December 31, 2002.
- If you are tasked with answering the questions to Part III with respect to a refunding issue, the analysis concerning the appropriate business use and other percentage questions will have to come from the project (or projects) that were financed by the prior issues. This can be an incredibly detailed analysis. Once again the necessity for identification of the "issuance date" of an issue is notably important and therefore, as mentioned above, the concept of "reissuance" and its relevance to the legal analysis is heightened.

Conclusion

It seems certain the IRS has put questions on Schedule K in part to identify potential audit targets and the filing entity should, absent a definite reason for other action, desire to treat its answers on Schedule K in the same manner as originally determined by its bond or tax counsel. Consistency with the determinations made upon issuance should be a strongly pursued goal. Great care should also be taken in identifying separate issues to report on. The purpose of each issue and the particular bond-financed property associated with each issue should be isolated for recordkeeping purposes. The "issue date" of each issue will become very important and each organization needs to make sure that any revisions to outstanding issues or other actions did not cause a "reissuance," triggering a new issue date for that issue.