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New regulations affect reporting requirements

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On Sept. 8 of this year, the IRS issued final regulations to implement the "redesigned" Form 990, the annual return filed by most tax-exempt organizations (final regulations). These final regulations affect all tax-exempt organizations that are required to file the Form 990 and generally apply for tax years beginning on or after Jan. 1, 2008.

The proposed regulations, issued in 2008 (proposed regulations), were adopted without significant change. Nevertheless, the IRS addressed comments and made certain revisions. Specifically, the final regulations eliminate the advance ruling process for new exempt organizations, modify the "public support" computation period for publicly supported organizations and clarify which accounting methods are permissible for reporting purposes. This article examines certain aspects of the final regulations that may significantly impact tax-exempt entities.

Form 990 generally

Most organizations (other than churches) exempt from federal income tax under Section 501(a) of the Internal Revenue Code must file a Form 990 to report income, receipts, disbursements and other information required by the IRS. The IRS redesigned Form 990 in December 2007 (for use on or after the 2008 tax year).

Private foundation status and advance rulings

When an organization applies to the IRS for tax exemption, it also requests a "determination" of its status as a private foundation or public charity. Public charities generally include organizations that have broad public (financial) support and their supporting organizations. In the past, organizations seeking public charity status could request an "advance ruling" that addressed both the organization's tax exemption and public charity status.

The proposed regulations eliminated the advance ruling process and the final regulations maintained this change, providing instead that an organization would qualify for public charity status in its first five years if its exemption application demonstrates a reasonable expectation for required public support. While in some cases this change has led to stricter scrutiny by the IRS of the financial information in the exemption application, it eliminates the need for an organization to submit "proof" of public support to the IRS following the advance ruling period, instead relying on public support disclosures on future Form 990s.

Computation period for and failure to meet public support test

The final regulations adopted the change made by the proposed regulations to the public support computation period from a four-year period (comprised of the four years prior to the taxable year being tested) to a five-year period (ending with the taxable year being tested).

The proposed regulations also stated that an organization that satisfies a "public support" test (i.e., either the "one-third support" test or the "facts and circumstances" test) for a taxable year is treated as publicly supported for that taxable year and the following taxable year. Conversely, an organization that does not satisfy a public support test for a taxable year may be classified as a private foundation as of the first day of the next taxable year if it also fails to satisfy a public-support test for the succeeding tax year.

The IRS received one comment that organizations cannot always predict the amount of public support they will receive, and thus, organizations that fail a public support test for two consecutive years should be treated as private foundations at the beginning of the second test year only for limited purposes (termination of private foundation status and excise taxes on investment income), but not fully treated as private foundations until the beginning of the third consecutive taxable year. The IRS adopted this comment in the final regulations. This emphasizes the need for public charities to monitor and maintain their public support to comply with either "public support" test.

Method of accounting and multiyear grants

Previously, the IRS required Section 501(c)(3) organizations, including those using the accrual method, to use the cash method of accounting to report public support. Under the final regulations, an organization must compute and report public support on the Form 990 under the same accounting method used to keep its books.

The commenter suggested that accrual method organizations must include the present value of a multiyear grant as "support" in the year the grant commitment is received, and thus, would potentially deter substantial, multiyear grants because of the organization's concern of the effect on its public-support test. Instead, the commenter suggested that multiyear grants should accrue over the period to which they relate. The IRS did not include this suggestion in the final regulations. While acknowledging that multiyear grants may have a negative impact on the public support calculations for some accrual method organizations, the IRS said it believed that allowing an organization to use its "normal accounting method" to report public support is less cumbersome and provides greater transparency. The IRS also suggested that the longer, five-year testing period should mitigate the impact of recognizing a multiyear grant in a single year. Regardless, publicly supported organizations should review their accounting method in light of this change, particularly if they receive or anticipate multiyear grants.

The IRS also declined to adopt a comment that the "unusual grant" exclusion be expanded to include multiyear grants. Generally, the unusual grant exclusion applies to substantial contributions that are 1) attracted by the organization's publicly supported nature, 2) unusual or unexpected in their amount and 3) in an amount that would adversely affect the organization's public charity status. An "unusual grant" is excluded from "one-third support" test calculation. Citing the rationale that the public support tests are designed to ensure organizations are not funded by a small number of donors, the IRS did not believe that a large contribution from a single donor should be excluded simply because it is paid over multiple years. The final regulations do, however, continue to provide that all pertinent facts and circumstances will be considered with no single aspect being determinative.

Overall, the final regulations serve as a warning to "publicly supported" tax-exempt organizations to continuously monitor their sources of financial support to ensure compliance with the IRS' public-support tests.

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