

Preparing for Form 990: A Closer Look at Schedules H, J and K

By Anne McGeorge, CPA, and Michele Melchior, CPA

Understanding the complexities of the new Form 990 has proven to be a challenge for even the most sophisticated healthcare organizations. However, the new Form 990 is also an opportunity; with the proper attention, it can help tax-exempt organizations maintain their reputation, credibility, and goodwill. The revised form dramatically increases the amount and scope of information that is required to be reported. What follows are some important tips for hospitals about form requirements and deadlines: what the IRS is asking for and why.

Why is the IRS making all these changes?

The IRS's perception is that the previous version of the Form 990 did not keep pace with changes in the law and the increasing size, diversity, and complexity of the tax-exempt sector. Central to the changes in the new form is the perceived need for more transparency of tax-exempt health care organizations, particularly related to policies and practices surrounding governance, charity care, and compensation. Ultimately, the IRS is trying to obtain more detailed information from tax-exempt organizations. Since the forms are public documents, the end result is that the public has access to more information about the tax-exempt organization.

In addition to the core form, there are now 16 supplemental schedules. Hospitals potentially could have to file up to 15 of these, but more typically will have to complete 10 or 12. At this point, schedules H (hospitals), K (tax-exempt bonds) and J (compensation) are garnering the most attention, but hospitals also need to be

prepared to comply with many of the other schedules as well. In particular, schedule L (transactions with interested persons) contains many new definitions of transactions which will have to be explained and could create additional disclosure requirements with your board members and others. Organizations will find that they will need to complete schedule R (related organizations) as a first step since it will determine many other required disclosures. This schedule contains new definitions about who is considered related to your organization and the rules are different from previous schedules.

Who is looking at your Form 990?

The Form 990 is public information, so any Form 990 filed by a tax-exempt organization is available on www.guidestar.org to any interested party. Viewers can see compensation information, what the organization's governance practices are, where its money is coming from, where it is going to. Interested parties might include Congress, the IRS, the media, the general public, donors and potential donors, vendors, private foundations, state attorneys general, competitors, consumer groups and watchdog organizations, labor unions and other nonprofit organizations.

Schedule J: Compensation

Compensation is an area of particular focus for hospitals right now. The new form 990 covers compensation in several different areas beginning in the Governance and Policies section, continuing in the core form compensation section and culminating with Schedule J. The form delves deeper into the compensation of the

CEO, the CFO, board members and key employees, including a new definition of what constitutes a key employee, as well as other clarifications. This new definition of key employee will likely require additional people to be included.

In addition to disclosing compensation for all current and former officers, directors, trustees and key employees on the core form, the following individuals will also be disclosed on schedule J:

- Former officers, key employees and highly compensated employees to whom you (and all related organizations) provided more than \$100,000.
- Former directors or trustees to whom you (and all related organizations) provided more than \$10,000 (in that capacity).
- All individuals to whom you (and all related organizations) provided more than \$150,000.
- Any individual who was compensated by an unrelated organization for work they performed for your organization.

Consequently, knowing who your related organizations are will be important.

Schedule J starts with a check-the-box reporting format; new disclosures are required for the following:

- first-class or charter travel (including airplane or boat owned by the organization)
- travel for companions (not for a bona fide business purpose)
- tax indemnification and gross-up payments

- discretionary spending accounts
- housing allowance or personal residence
- payment for business use of personal residence
- health or social club dues or initiation fees (not including on-site facility)
- personal services (e.g., chef, chauffeur, maid, financial planner, nanny, physician, tax preparation)

If Schedule J is required, the compensation disclosure will require breaking down the executive's compensation into several buckets, including base compensation, bonus and incentive compensation and any other compensation included in Medicare wages. Further, deferred compensation and most non-taxable benefits must also be disclosed. Severance or change in control payments are disclosed as well as equity-based compensation arrangements. If compensation is based on either revenues or net earnings of the organization or related organizations, this too must be disclosed.

Schedule J also requires disclosure, through check boxes, of the processes used to establish compensation for the top executive, including:

- compensation committee
- independent consultant
- Forms 990 of other organizations
- written employment contract
- compensation survey or study
- approval by board or compensation committee

In addition, organizations must describe the process for determining the compensation of the CEO, other officers and key employees. While the classification of officer is determined by reference to state law, it always includes the organization's top management and financial officials. The form contains questions aimed at determining if the organization followed the 'rebuttable presumption' guidelines in setting the CEO's salary.

If the compensation is not established to the standard of rebuttable presumption (independent comparable data, properly approved and documented) and does not

meet fair market value, the organization risks running afoul of the Intermediate Sanctions rules with potential excess benefits. When that happens, the IRS can impose stiff penalties on the individual receiving the compensation as well as management and the board. This is not a new concept, but the IRS's questions related to compensation have become more pointed on this topic.

Schedule K: Tax-exempt bonds

Through Schedule K, the IRS wants to know if the appropriate tax rules are being followed after the issuance of tax-exempt bonds. The Schedule K changes are driven by the IRS's concern over organizations' noncompliance with recordkeeping and record-retention requirements relating to tax-exempt bonds issued by or for the benefit of tax-exempt organizations. It represents a substantial expansion of the IRS oversight in the tax-exempt bond area.

Previously, the IRS was focused on the time period leading up to and including the issuance of tax-exempt bonds, rather than post issuance. The new form encourages tax-exempt organizations to set up post-issuance compliance policies and procedures to ensure compliance with bond-related tax requirements. The detailed reporting requirements provide incentives for borrowers to be more rigorous in recordkeeping and post-issuance compliance monitoring.

Schedule K is divided into four parts: Part I—Bond Issues; Part II—Proceeds; Part III—Private Business Use; and Part IV—Arbitrage. Beginning in 2008, organizations are required to complete only Part I, which asks them to list the bonds and provide some information about them. This is fairly straightforward and can be found on your form 8038 prepared when the bonds were issued. Parts II through IV are optional for 2008. However, for years beginning in 2009, organizations will be required to list a significant amount of other information in those sections. In Part II—Proceeds, this includes stating how an organization used the proceeds of the bonds, how much is left and where it is invested until its planned use. While organizations should have this information, tracking it down may require some legwork, particularly

What should organizations do now?

Schedule H

- Even though the majority of the information is not required for 2008 returns, begin gathering the information now.
- Forms and instructions are available at www.irs.gov/charities.
- Develop internal processes to gather complete and accurate data.
- Consider assigning responsibility to a member of the management team and to a member of the board.
- Complete the form for 2008 (even if you don't send it to the IRS) and have management and board review it and discuss any 'gaps' in the information.

Schedule J

- Determine their related organizations/disregarded entities to identify the universe of individuals that must be considered.
- Prepare and review explanations of current compensation arrangements considering items that require specific disclosure.
- Educate the board and management regarding new expanded disclosures and identify any desired changes to arrangements.
- Determine/modify written policies regarding expense reimbursements and consider requiring substantiation prior to reimbursing or allowing the listed expenses.
- Review the process and data utilized to establish compensation for the CEO/executive director, in order to determine if any modifications are needed in order to comply with the rebuttable presumption instructions.

Schedule K

- Create post-issuance compliance practices and procedures for tax-exempt bond issues.
- Define facilities and equipment financed by tax-exempt bond proceeds.
- Trace and allocate tax-exempt bond proceeds.
- Identify and review documents related to tax-exempt bonds such as arbitrage certificates, management and service contracts, research agreements, etc.
- Confirm organization's compliance with arbitrage rebate and yield restriction regulations.

Complete the form for 2008 (even if you don't send it to the IRS) to assess the organization's gaps in the information.

if their record-keeping has not been organized in this way.

In Part III—Private Business Use, organizations are asked to provide information related to the private business use of the bond issues listed in Part I such as lease arrangements, management and service contracts, research agreements, and management practices and procedures in place to ensure compliance. In addition, the IRS wants organizations to calculate their percentage of private business use within one-tenth of one percent, a calculation most organizations don't have readily available. Most hospitals have been through this calculation at some time in order to ensure they have less than five percent private business use (a requirement needed to issue tax-exempt bonds); however, they likely have not annually, if ever, calculated it to such a precise percentage. Hospitals will need to consult with their tax advisers and legal counsel regarding how they are going to determine this percentage.

In Part IV—Arbitrage, organizations are asked to provide various information with respect to arbitrage for each bond issuance. These questions include asking if the organization filed for an arbitrage rebate, yield reduction and penalty in lieu of rebate, or qualified for an exception to rebate. It also asks if the bond issue is a variable rate issue. Other questions relate to hedge contracts and how the organization invested the proceeds.

Schedule H: Hospitals

Schedule H is a new form that is required for organizations that operate one or more state licensed, registered, or similarly recognized hospitals. In addition, organizations that own any part of a joint venture (treated as a partnership) that

operates a hospital (as defined above) will need to report their percentage of the activity on their Schedule H. This does not include entities taxed separately as corporations. All organizations required to file Schedule H, including those that operate multiple hospitals or file under a group exemption, will file only one Schedule H for their organization with all information combined.

For the first year (2008) the only information required is a listing of all licensed (or similarly recognized) healthcare facilities. This will require a simple inventory with name and address of each along with a short note of what the facility is, such as licensed hospital, 24-hour ER, children's hospital and so forth.

Beginning with the second year (2009), the remainder of the form will need to be completed. This is the long-anticipated section that deals with charity care and community benefits. Schedule H requests information related to charity care, including unreimbursed Medicaid, other unreimbursed costs and other forms of community benefit. All these are calculated at cost without the inclusion of bad debt or Medicare expenses. There is an opportunity to separately report bad debt and Medicare costs. The form asks hospitals to provide detailed explanations of their charity care policy, such as how it determines eligibility for charity care, and how it educates patients about their eligibility for assistance. A few of the questions are aimed at determining the hospital's budgeting policy for the provision of indigent care including what happens if the organization exceeds their budget for the year.

There is a separate section for the organization to use to calculate their cost of Community Building Activities.

Physical improvements for housing, environmental improvements, leadership development and other training are among the items calculated at cost.

If the hospital engaged in joint ventures with officers, directors, trustees or key employees who owned more than 10% of the venture, this will be listed in schedule H. The same listing is required if the more than 10% owner is an employed physician or physician with staff privileges if the venture provided management services or medical care used by the organization or if it owned or provided real property, tangible or intangible property used by the organization in its provision of medical care. Thus, ambulatory surgery centers or equipment leasing arrangements involving ownership by the organization and aforementioned individuals will require that these arrangements be disclosed.

Schedule H also includes a section for Supplemental Information. This section asks a series of open-ended questions which give hospitals an opportunity to include information about their local community, its needs, the hospital's activities, and anything else they'd like the public to know about their hospital and community benefits.

Getting Ready

Healthcare organizations will want to develop a strategy that involves the right people and process in order to ensure the most accurate Form 990 compliance. Management and the board of directors will also want to carefully review the information contained in the Form 990, keeping in mind the perspective of how it will be viewed by the public. Since the Form 990 is a public document, it's critical that it is not only accurate but reflects positively on the organization. **NP**

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