

THE 2011 FORM 990: PART IV - SCHEDULE K

This Health Care Tax News article is Part IV in a series addressing recent changes to IRS Form 990 and its Instructions. The previous installments addressed changes to the [Core Form](#), [Schedule H](#) and [Schedule J](#).

As part of the January 21, 2012 release of the 2011 Form 990, the IRS also made updates to Schedule K, Supplemental Information on Tax-Exempt Bonds. These changes, to both the form itself and the related Instructions, provide both clarification to existing questions as well as additional inquiries for reporting organizations regarding the regularity of management and research contract reviews and the existence of post-issuance compliance procedures.

BACKGROUND

Schedule K is used by a reporting organization to report information regarding outstanding tax-exempt bonds, a term which is defined broadly to include a bond, note, loan or lease-purchase arrangement. An organization is required to complete Schedule K if it had any outstanding tax-exempt bond issues with outstanding principal amounts in excess of \$100,000 as of the last day of the organization's tax year that were issued after December 31, 2002.

CHANGES IN THE 2011 SCHEDULE K

Parts I and II:

While no changes were made to Parts I or II of the form, a change was made to the Instructions for Line 6 of Part II, which asks for the amount of proceeds held in a refunding escrow as of the end of the 12-month reporting period. Previously, the Schedule K Instructions provided that, unless the amount of bond proceeds held in a refunding escrow exceeded the amount of proceeds the organization anticipated for such use, as reported at the issue date of the bonds on IRS Form 8038, the amounts listed on the Form 8038 could simply be used for Schedule K purposes as well. In the 2011 Instructions, the IRS has deleted this reference to using the Form 8038 amounts. The practical result of this change is that reporting organizations will now need to report the actual amount of proceeds, including investment earnings, held in the escrow as of the filing date of the Schedule K, rather than the amount of proceeds anticipated for such use at the time the bonds were issued.

Part III:

Line 2 of Part III asks about any lease arrangements that may give rise to private use. While there are no changes to this question on the 2011 form, the related Instructions were revised to make clear that lease arrangements constituting unrelated trade or business activities of the lessor, or that are for an unrelated trade or business of a section 501(c)(3) organization lessee, may also result in private business use. This revision highlights that lease arrangements with another section 501(c)(3) entity may still give rise to private business use, despite the fact that both parties are qualified section 501(c)(3) entities, if the end user is engaged in an unrelated trade or business activity.

In earlier revisions to the Instructions for the 2010 Schedule K, the IRS made it clear that the existing question regarding whether the filing organization "routinely" engages bond counsel or other outside counsel to review any management or research contracts should be answered with respect to the tax year applicable to the filing. This change was notable because most reporting organizations seemed to be answering this question generally, relying heavily on a favorable definition of "routinely" in order to answer in the affirmative. The 2011 version of the form splits the old "Line 3c" into two new line items. The first (Line 3b) asks specifically whether management/service contracts have been reviewed. The second (Line 3d) asks about research arrangements. Instructions for both new questions retain the specific reference to the 12-month reporting period. The IRS is making it very clear that it is interested in knowing, for each tax year, whether a filing organization has had outside counsel review BOTH its management contracts AND its research agreements.

In the 2011 draft version of Schedule K, the IRS had deleted the original Line 7 of Part III, which asked whether an organization had adopted practices and procedures to ensure post-issuance compliance of its tax-exempt bonds. The IRS replaced the question with a new question specifically asking about the establishment of written procedures related to the remediation provisions in the regulations (established to provide organizations with a way to address violations of the tax rules) and further added a question to Part IV of the form asking specifically

about the existence of procedures to ensure compliance with the arbitrage restrictions under section 148. These questions were nearly identical to questions recently added to the Forms 8038 and 8038-G (filed for new bond issues upon issuance). When coupled with the new Schedule K changes, it is apparent that the IRS is attempting to obtain the same information for previously issued bonds. For reasons that the IRS has yet to explain, the final version of the 2011 Schedule K retains the previously existing Line 7, Part III question regarding the existence of post-issuance compliance procedures but expands the scope of "post-issuance compliance" to include private business use, arbitrage and "other applicable tax law."

Finally, the definitions section of the 2011 Instructions includes revised language under the "Special rules for refunding of pre-2003 issues," which makes it clear that an organization reporting a refunding bond issue that was issued after 2003 to refund a pre-2003 bond must still respond to the question on Line 7 of Part III (regarding the existence of post-issuance compliance procedures). The prior version of the Instructions permitted such a reporting organization to skip Part III in its entirety.

Part IV:

The final version of the 2011 Schedule K contains no revisions to Part IV. However, as previously stated, filing organizations should be aware that the Instructions to Part III now make it clear that the IRS wants to know whether an organization has adopted procedures to ensure compliance with the arbitrage rules of Internal Revenue Code Section 148.

Part V:

The IRS created a new section for Schedule K titled "Procedures To Undertake Corrective Action." The Instructions for the new Part V explain that the remediation provisions may not cover all violations, and in those cases, an organization may request a voluntary closing agreement under the Voluntary Closing Agreement Program ("VCAP"). Filers are asked whether the organization has established written procedures to ensure violations are timely identified and corrected through VCAP if self-remediation is not available under the regulations.

CONCLUSION

While the 2011 changes to Schedule K do not appear substantial, reporting organizations are cautioned to pay close attention to revisions to the 2011 Form 990's Instructions and to give some consideration to the potential motives behind the changes that were made. The IRS made several announcements in October 2011 as to its intent to audit certain bond issues based on reviews of Schedule K filings. The IRS will be devoting more resources to Schedule K than in past years and anticipates that it will be able to better target issuers for audit. The 2011 changes make clear that the IRS expects reporting organizations to establish practices and procedures to ensure post-issuance compliance of their tax-exempt bond liabilities. These procedures should apparently include, but should not be limited to, routine reviews of management and research contracts by outside counsel, and should ensure that any violations of the related tax law can be timely addressed under the remediation provision of the regulations or VCAP.

Should you need assistance with your organization's evaluation of the 2011 Schedule K or Form 990 in general, please contact Kendall A. Schnurpel at (317) 977-1480 or kschnurpel@hallrender.com, Jeffrey L. Carmichael at (317) 977-1443 or jcarmichael@hallrender.com or your regular Hall Render attorney.