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CliftonLarsonAllen

Nonprofit Executive Summit:

Bringing Nonprofit Leaders Together to Discuss Legal, Finance, Tax, and Operational Issues Impacting the Sector

September 26, 2013

Venable LLP

Washington, DC

Agenda

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1. Networking Breakfast — 8:00-8:30 am

2. Welcome — John P. Langan, CPA, Managing Partner, Public Sector Group, CliftonLarsonAllen
   Jeffrey S. Tenenbaum, Esq., Partner and Chair of the Nonprofit Organizations Practice, Venable LLP
   8:30-8:50 am

3. Keynote Introduction — Brian L. Schwalb, Partner and Vice Chairman, Venable LLP — 8:50-9:00 am

4. Keynote: *The Federal Tax Landscape for Nonprofits: View from the Hill*
   9:00-9:45 am

   Tiffany Smith, Esq., Tax Counsel, Majority Staff
   U.S. Senate Finance Committee

5. *Risk to Relevance: Protecting Your Nonprofit's Business Model* — 9:45-10:45 am

   The traditional nonprofit business model is being challenged by rapidly changing technology, social media, generational shifts in giving and membership, government travel and meeting restrictions, open access to data, increasing for-profit competition, advocacy platforms, and more. Join three industry professionals on the front lines of these changes to learn how they are adapting to this seismic shift in how nonprofits do business.

   - Moderator: John P. Langan, CPA, Managing Partner, Public Sector Group, CliftonLarsonAllen
     - Dr. Kevin M. Ross, President, Lynn University
     - Chris J. Brantley, Managing Director, IEEE-USA
     - Andrew Watt, FlnstF, President & CEO, Association of Fundraising Professionals

6. Networking/Cell Phone Break — 10:45-11:15 am

7. *In the Wake of the IRS Exempt Organizations Scandal, What Changes Are in Store for the Future and What Does It Mean for Your Nonprofit?* 11:15-12:15 pm

The ongoing crisis at the IRS Exempt Organizations Division – which started with improper scrutiny and delays of certain tax-exemption applications – has now expanded well beyond that. The fallout includes the replacement of every senior leader in the Division, while wreaking havoc on exemption application processing. Today, the crisis looks to have even broader ramifications. Learn what this means for all nonprofits, where is the IRS EO Division going to be focusing its efforts in the coming year, and what your organization can do to avoid being caught in the crossfire.

- Moderator: George E. Constantine, Esq., Partner and Co-Chair of the Regulatory Practice Group, Venable LLP
    - Matthew T. Journy, Esq., Associate, Venable LLP
    - John P. Langan, CPA, Managing Partner, Public Sector Group, CliftonLarsonAllen

8. Lunch 12:15-1:15 pm

9. *Effective Governance: Top Ten Tips for Ensuring the Success of Volunteer Leaders* 1:15-2:15 pm

Effective governance is at the heart of nonprofit efficiency and effectiveness in meeting organizational goals. Board dysfunction is the elephant in the room that cannot be ignored if nonprofits are to be successful in achieving their mission in an increasingly challenging environment. Explore best practices in nonprofit governance with two experienced consultants through their real-world experiences working with the best in breed and the also-rans.

- Moderator: Jeffrey S. Tenenbaum, Esq., Partner and Chair of the Nonprofit Organizations Practice, Venable LLP
    - Robert C. Harris, CAE, President & CEO, Non Profit Resource Center
    - Ben Aase, Principal, Public Sector Group, CliftonLarsonAllen

10. *Building and Protecting Your Nonprofit's Brand in Social Media: Managing the Legal Pitfalls* 2:15-3:15 pm

As virtually every nonprofit organization knows, social media can provide an excellent platform for promoting your organization's brand, promoting your industry, profession or cause, and engaging with the public, regulators and others. But there are also legal risks that need to be carefully considered and managed by nonprofits when engaging in social media usage. This interactive, advanced-level session will cover topics such as:

- What social media has to do with your brand and why this is important to the attorneys

- Protecting and enforcing your trademarks and copyrights - and avoiding infringing others' - in social media
- Common domain name pitfalls
- Dealing effectively with defamation
- Managing privacy issues and concerns
- Using social media to conduct raffles and other contests
- Legal issues to consider when creating a social media policy, both for your employees and for members, donors and others

- Armand J. (A.J.) Zottola, Esq., Partner, Venable LLP
- Mark A. Eich, CPA, CISA, Principal, Information Security Group, CliftonLarsonAllen

11. Networking/Cell Phone Break 3:15-3:30 pm

12. *International Opportunities and Pitfalls for Nonprofits* 3:30-4:30 pm

More often than not, global reach is the goal for many U.S.-based nonprofits. Yet, there is a minefield of thorny legal, financial, operational, and other issues that needs to be addressed to keep your organization out of trouble:

- Hosting meetings and other events overseas
- Hiring local representatives
- Affiliating with foreign entities
- Determining appropriate corporate and tax structures
- Considering foreign payment and dispute resolution options, and
- Analyzing U.S. export controls

What are the biggest pitfalls, what are best practices for dealing with them, and what are the key lessons learned by those who have succeeded and failed with international expansion?

- Jefforie A. Kvilhaug, CPA, Managing Partner, Global Services, CliftonLarsonAllen
- Carrie A. Kroll, Esq., Associate, Venable LLP

13. Networking Reception 4:30-5:30 pm

Presentations

Nonprofit Executive Summit:

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Thursday, September 26, 2013
Venable LLP
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- Keynote Address: The Federal Tax Landscape for Nonprofits: View from the Hill
- Risk to Relevance: Protecting Your Nonprofit's Business Model
- In the Wake of the IRS Exempt Organizations Scandal, What Changes Are in Store for the Future and What Does It Mean for Your Nonprofit?
- Effective Governance: Top Ten Tips for Ensuring the Success of Volunteer Leaders
- Building and Protecting Your Nonprofit’s Brand in Social Media: Managing the Legal Pitfalls
- International Opportunities and Pitfalls for Nonprofits

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Keynote Introduction:

Brian L. Schwalb

Partner and Vice Chairman, Venable LLP

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Keynote Address:

The Federal Tax Landscape for Nonprofits: View from the Hill

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The Federal Tax Landscape for Nonprofits: View from the Hill

KEYNOTE SPEAKER

Tiffany P. Smith

Tax Counsel

U.S. Senate Committee on Finance

Majority Staff

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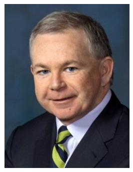
Panel 1:

Risk to Relevance: Protecting Your Nonprofit's Business Model

Risk to Relevance: Protecting Your Nonprofit's Business Model

PANELISTS



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Panel Discussion Areas

- Process and timeline for addressing key risks
- Engaging stakeholders in sustainability strategy
- Business model impact of technology/social media
- Government policy role in challenges/opportunities
- Impact of generational shifts in growth plans
- Current and planned strategic collaborations
- Changing methods of working with staff/boards

Panel Discussion Areas

- Tax exemption: Net benefit or burden?
- International expansion for growth and relevance
- Discounting as a slippery slope
- Accountability of program staff
- Perception of the sector - special interest/taxpayer ROI

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Panel 2:

In the Wake of the IRS Exempt Organizations Scandal, What Changes Are in Store for the Future and What Does It Mean for Your Nonprofit?

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In the Wake of the IRS Exempt Organizations Scandal, What Changes Are in Store for the Future and What Does It Mean for Your Nonprofit?

PANELISTS

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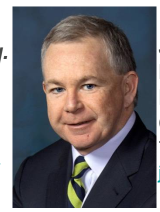

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Topics

- Recap of IRS Developments
- Review of Changes to Exempt Organizations as a Result
- What does this mean for you?
  - Short Term
  - Long Term
- Ongoing IRS Enforcement Initiatives
- Conclusion/Q&A

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Recent IRS Developments

- May 10, 2013 — Lois Lerner before ABA
- May 14, 2013 — TIGTA Report Released
- May 17, 2013 — Ways and Means Hearing
- May 21, 2013 — Senate Finance Committee Hearing
- Numerous ongoing hearings and high-level departures follow

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"Scandal" Summary

- Inappropriate criteria for scrutinizing applications ("tea party")
- Substantial delay in processing applications
- Issued inappropriate information requests
- Much debate over the political aspects
  - Were only conservative groups targeted?
  - How high up the chain did this go?
- Political aspects not our focus today
- Findings of report indicative of larger, ongoing IRS issues about responsiveness, resources

Who Is in Charge?

IRS Commissioner	
Out	In
Steven Miller	Joe Grant
Joe Grant	Danny Werfel
Danny Werfel	John Koskinen (Nominated)

OE/GE Commissioner/Director	
Out	In
?	Michael Julianelle
Lois Lerner (Suspended)	Kevin Corbin

Short-term Impact—Opportunities for Nonprofits

- New regime; renewed focus on timeliness
  - What about cases from the "old" regime?
  - What about other areas of exempt organizations (e.g., examinations)?
- Processes for expedited treatment and avoiding delay
  - 501(c)(4) special process
  - Declaratory judgment
- Self-certification — (c)(4), (c)(6)
- Opportunities for existing exempt organizations to take advantage of current disarray

Long-term Impact—From the Ashes

- Possible longer-term ramifications:
  - Streamlined application approval process
  - Interactive web-based Form 1023
  - More compliance projects to focus enforcement
  - Increased IRS and state coordination
  - Greater interest in self-determination (c)(4), (c)(6)
  - Potential increase in pursuit of declaratory judgment for delayed applications
- Impact of House and Senate tax reform initiatives

Areas of Scrutiny Not Changing

- UBI sources, income and expense allocation methods, and substantiation of related NOL's
- Executive Compensation approval and benchmarking
- Self-determination compliance (c)(4), (c)(6)
- Large Private Foundation compliance/excise tax
- Employment Taxes (NRP program)
- International Activities (discretion and control)
- Group Rulings/Exemptions/Filings
- Mortgage Foreclosure Assistance Groups
- Political Activities 1120-POL filing requirements

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Reference Materials

- TIGTA Report and related article "Tools for by-passing IRS Delays"
- IRS Initial Assessment and Plan of Action 6.24.13
- IRS Colleges and Universities Report and related article "A Wealth of Information"
- IRS TE/GE 2013 Work Plan

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Panel 3:

Effective Governance:

Top Ten Tips for Ensuring the Success of Volunteer Leaders

Effective Governance: Top Ten Tips for Ensuring the Success of Volunteer Leaders

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10 Pervasive Governance Myths

10 Governance Myths

1. You won't have to do anything when you get on the board.
2. We are non profit, our meetings and records are open to the public.
3. We can't make or save any money as an exempt organization.
4. Because we are volunteers they wouldn't evaluate our performance (or fire us.)
5. Micromanagement or snupervision is our job.

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10 Governance Myths

6. Working on a board is volunteer work—not corporate governance.
7. We should be a "working" board not a policy board right now.
8. I serve on a fundraising board, so governance rules don't really apply to my work.
9. Some members are micromanaging. I need more from the board—but not managers.
10. My board is not engaged.

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And 10 Tips for Ensuring Success

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10 Tips for Successful Governance

1. Assemble an appropriate board
2. Understand and talk about expectations
3. Focus on board chair/executive leader relationship

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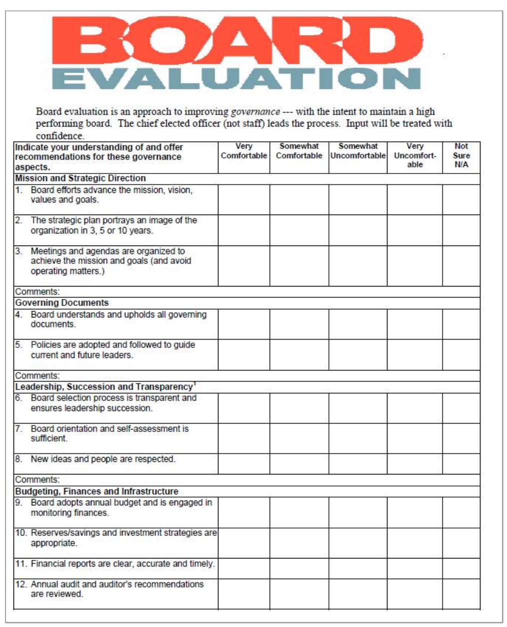
10 Tips for Successful Governance

4. Engender oversight, insight, and foresight
5. Seek ownership, not just stewardship
6. Conduct board and committee self-evaluations*



BOARD EVALUATION

Board evaluation is an approach to improving *governance* --- with the intent to maintain a high performing board. The chief elected officer (not staff) leads the process. Input will be treated with confidence.

Indicate your understanding of and offer recommendations for these governance aspects.	Very Comfortable	Somewhat Comfortable	Somewhat Uncomfortable	Very Uncomfort-able	Not Sure N/A
Mission and Strategic Direction					
1. Board efforts advance the mission, vision, values and goals.					
2. The strategic plan portrays an image of the organization in 3, 5 or 10 years.					
3. Meetings and agendas are organized to achieve the mission and goals (and avoid operating matters.)					
Comments:					
Governing Documents					
4. Board understands and upholds all governing documents.					
5. Policies are adopted and followed to guide current and future leaders.					
Comments:					
Leadership, Succession and Transparency[1]					
6. Board selection process is transparent and ensures leadership succession.					
7. Board orientation and self-assessment is sufficient.					
8. New ideas and people are respected.					
Comments:					
Budgeting, Finances and Infrastructure					
9. Board adopts annual budget and is engaged in monitoring finances.					
10. Reserves/savings and investment strategies are appropriate.					
11. Financial reports are clear, accurate and timely.					
12. Annual audit and auditor's recommendations are reviewed.					

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10 Tips for Successful Governance

7. Follow the governing documents (Duty of Obedience) – policies, bylaws, articles.
8. Avoid mission creep.*
9. Conduct an annual orientation.*
10. Teach risk management.

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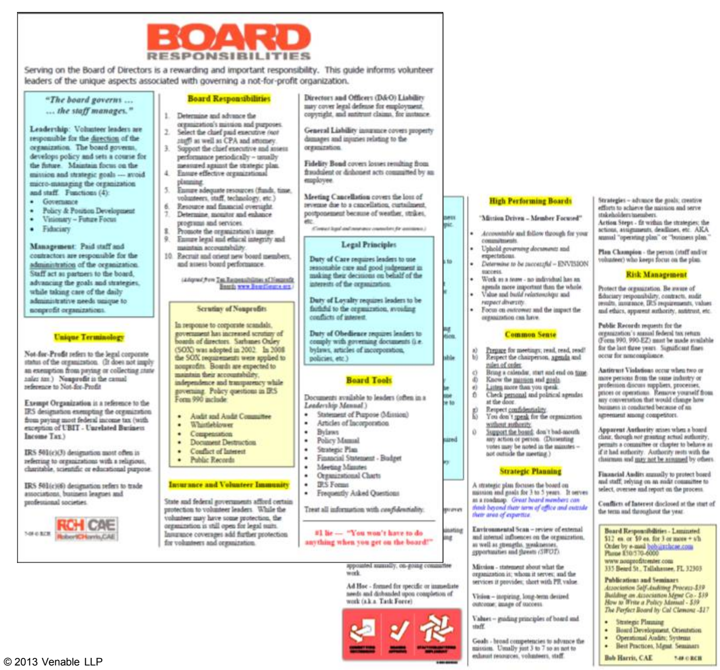
BOARD RESPONSIBILITIES

Serving on the Board of Directors is a rewarding and important responsibility. This guide informs volunteer leaders of the unique aspects associated with governing a not-for-profit organization.

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Plan on a Business Card

REALTORS

Strategic Plan 2013-17

Mission

The Bakersfield Association of REALTORS is the leading advocate of the Real Estate Industry, its Members, and the Consumers they serve.

Vision

Improving the real estate industry through professionalism and service.

Five Goals

I. Government Relations and the Voice of Real Estate

II. Professionalism and Standards

III. Community Service

IV. Member Value and Service

V. Association Leadership and Operations

Advocate
Educate
Engage
Serve
Lead

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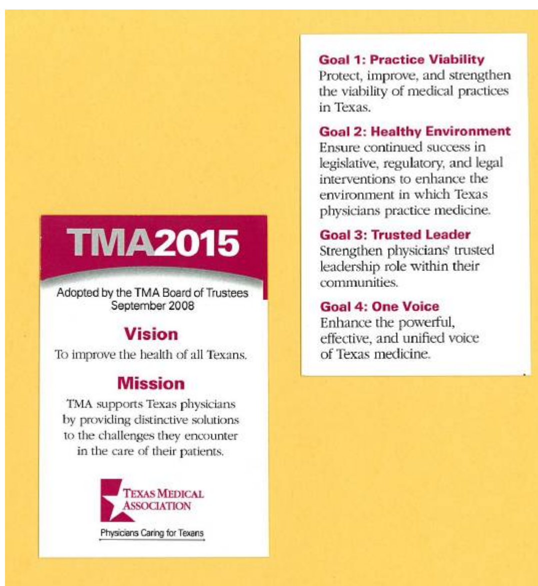

TMA2015

Adopted by the TMA Board of Trustees September 2008

Vision

To improve the health of all Texans.

Mission

TMA supports Texas physicians by providing distinctive solutions to the challenges they encounter in the care of their patients.

TEXAS MEDICAL ASSOCIATION

Physicians Caring for Texans

Goal 1: Practice Viability
Protect, improve, and strengthen the viability of medical practices in Texas.

Goal 2: Healthy Environment
Ensure continued success in legislative, regulatory, and legal interventions to enhance the environment in which Texas physicians practice medicine.

Goal 3: Trusted Leader
Strengthen physicians' trusted leadership role within their communities.

Goal 4: One Voice
Enhance the powerful, effective, and unified voice of Texas medicine.

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Panel 4:

Building and Protecting Your Nonprofit's Brand in Social Media: Managing the Legal Pitfalls

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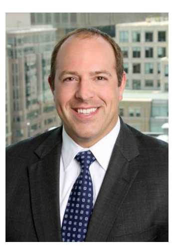
Building and Protecting Your Nonprofit's Brand in Social Media: Managing the Legal Pitfalls

PANELISTS



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Social Media – Everywhere

How Does Social Media Work for You?

- Promotion + advertising
- Cultivate a brand
- Community building
- Fundraising
- Recruitment

The best returns appear to come from diversifying across networks rather than focusing solely on the latest "it" platform?

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When Social Media Works Against You

- Defamation
- Others' intellectual property rights
  - Copyright
  - Trademark
  - Right of publicity/privacy
- Your intellectual property
  - Monitoring/enforcement
  - Contractors and work-for-hire
- Advertising/disclosures

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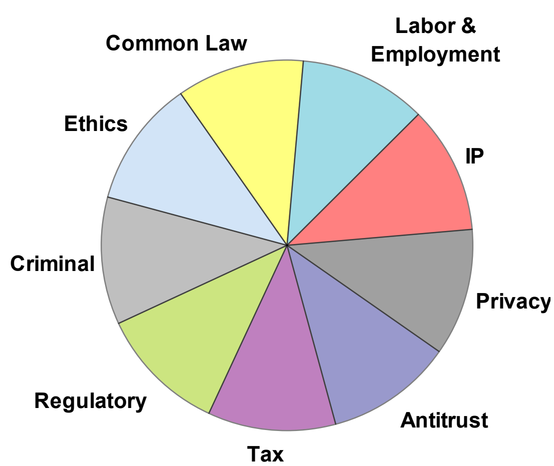
Laws – Evolving



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Defamation

- **Restatement (Second) of Torts Sec. 559**
  - Act of harming reputation of another through false statements to a third party.
  - Occurs when you have (a) false or defamatory statement concerning another person, (b) communication or publication to a third party, and (c) harm to third party
- **When might this arise?**
  - Offensive, negative user comments
  - Criticism, outlandish insults
  - Companies injured by anonymous speakers online can use discovery to learn the identities.
- **Possible with social media publication, display, or posting**
  - "Publisher Liability": Party who publishes the defamatory statement
  - "Distributor Liability": Party who repeats the defamatory statement with knowledge or reason to know its contents
- **Comments made by others can be attributed to the organization**

Defamation

- **How to Avoid?**
  - Federal Communications Decency Act of 1996 - § 230
    - Pattern behavior. Essentially, there is different treatment online
    - Only possible with information or content published or provided by another person
    - Immunity for interactive computer service if (a) voluntary, good faith action to restrict access or (b) enablement of technical means to restrict access. Won't be treated as publisher or distributor
  - Beware of informal nature of social media networks
  - Utilize disclaimers and terms of use
  - Enforce a takedown policy
  - Refrain from commenting on third-party posts
  - Remain mindful of trade secrets and confidentiality
  - Consider available screening capabilities for third-party hosts

Promotions and Contests

- Sweepstakes and contests are popular but heavily regulated
  - Including Terms and Conditions of social media sites
    - Facebook – may Promote, but cannot administer (collecting entries, notifying winners) without prior approval
- Requiring a donation to enter = Lottery under most state laws
  - Payment, chance, and prize
  - Registration is required
- Take away:
  - Many contests governed by state law
  - Control through Use Terms and limits on participation

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Intellectual Property: The Basics

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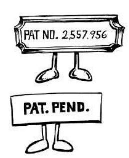

- Copyright
  - Protects creative expression fixed in any tangible or electronic medium, e.g., words, designs, audio-visual content, music
- Trademark
  - Trademarks protect against consumer confusion by protecting indicators of source, including company name, any logos, brands, product names, trade dress
- Patent
  - Protects inventive concepts

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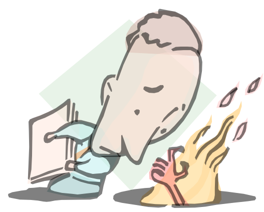
Why Does IP Ownership Matter?

- Only an IP owner intrinsically has the right to stop others' unauthorized use of that IP
- Only an IP owner has the right to profit from others' authorized use of that IP
- In some cases, others' unauthorized use of your IP may dilute the strength of your IP, e.g., trademarks

Even the best intentions can be spoiled!!



Trademarks

- Trademark issues are always possible when using third-party marks
- Safest course: Seek permission
- Don't be an imposter
- Fair use in trademark context is limited: Descriptive, nominative, and parody
- Be especially careful in commercial context. Commercial activities can include advertising, donation, membership, event, and program planning. (All social media?)
- Don't assume "Fair Use" because of non-profit or tax-exempt status
- Avoid using others' trademarks or in search terms, domain names, or user names
  - No DMCA-like immunity for trademark use, but many implement similar policies

Copyrights

- **Social media is essentially about the content and further communication and interaction between persons online**
- **Know the network operator rules of the road on re-posting, tweeting, pinning, etc., content created by another**
- **Legal framework**
  - Possible low level of creativity for copyright protection. What about a tweet?
  - Copyright protection is automatic upon creation
  - Exclusive rights: reproduction, distribution, public display, and public performance
- **Be mindful of copyright ownership**
  - Who owns work on social media?
  - Work-made-for-hire doctrine, written assignments of rights
- **Will the Digital Millennium Copyright Act protect you? Pattern behavior to take advantage of Sec. 512(c) Safe Harbor Provision**
  - Optional "safe harbor" for online service providers engaged in ... storage at the direction of a user
  - Must have: repeat infringer policy, no actual or "red flag" knowledge, or if knowledge, expeditious removal; no direct financial benefit + right and ability to control; takedown response; registered DMCA agent

The Pinterest Question: "But, What about Fair Use?"

(1) The purpose and nature of the use;

(2) The nature of the copyrighted work;

(3) The amount and substantiality of the portion used; and

(4) The effect of the use upon the potential market for or value of the copyrighted work.

"Our goal at Pinterest is to help people discover the things they love. Driving traffic to original content sources is fundamental to that goal."

– Pinterest.com

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Argh, so many Copyright Rules.

(Nope. Just 3.)

- Establish a DMCA policy that provides an e-mail address for complaints
  - Make sure someone checks it regularly
- If you did not draw it, film it, shoot it, or write it, do not post it without permission
- Find great, licensed content at CreativeCommons!
  - Stop using Google Images to create content. Please.

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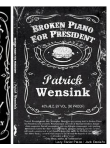
The Quiet Rights: Publicity and Invasion of Privacy

- Publicity: celebrities/privacy: the “hoi polloi”
- Triggered by commercial use, broadly interpreted
- Applies to uses on social media
- Layered underneath copyright protection
- Always get written releases from photo subjects, even if you have copyright permission to use the photo
- (We’ll talk about personal privacy and related trade practice later)

Protecting Your IP on Social Media

- Register, register, register (IP, Search, and Account)
- Monitor use by others and enforce rights via policy statements, DMCA, demand letters, and legal proceedings
  - BUT, be mindful that on social media, cease and desists go VIRAL! [World Nutella Day vs. Jack Daniels cover]



  - Balance IP protection with reputation protection. Many times, it's an innocent infringer
- Appropriate use of symbols – ©, ®, ™
- And, perhaps most importantly…

Obtaining Ownership of IP

- General rule: organizations own IP created by their employees, but not their contractors
  - BUT, employment status is not always clear and must be within the scope of employment
- Fix: all independent contractors and volunteers should sign a written work-made-for-hire agreement and copyright assignment
- A "work made for hire" is a work [that fits into one of nine enumerated categories and] . . . "if the parties expressly agree in . . . [writing] that the work shall be considered a work made for hire"

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Limit Apparent Authority and Protect Corporate Identity

- Limit individuals who have authority to speak on entity's behalf and then prohibit all others from claiming or implying authorization to speak on entity's behalf
  - Create process for gaining authorization to speak on entity's behalf
- Prohibit unauthorized individuals from using entity's intellectual property, logos, trademarks, and copyrights in any way or manner
- Prohibit employees and members from using entity's name in any online identity (e.g., username, screen name)

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Considerations for Developing a Social Media Policy

- Be clear
- Tailor to fit; don't use generic template
- Focus on planned online activities, both do's and don'ts. How will entity manage its presence (internally and externally). Try to maintain consistent approach across platforms and networks
- Distinguish between business use and personal use
- Don't ignore third-party social media network operator policies. Network operator policies provide limited protection, although they offer some enforcement mechanisms
- Involve multi-disciplinary team (HR, legal, marketing, and executive)
- Be consistent with other organizational policies and procedures (and require compliance with them)
- Consider level of monitoring
- Consider shelf-life of archived content
- Use appropriate disclaimers
- Communicate policy (notice and training)

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Catch-all Disclaimer

- Nothing in this policy is intended to interfere with or restrain any employee's exercise of his or her rights under Section 7 of the National Labor Relations Act.

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Information Security – the "Dark Side" of Social Media

- Over 1.2 billion Facebook users
- Creates a "target-rich environment" for hackers

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Malware

- Primary attack vector is malware injection
- Multiple different injection methods
  - Rogue links
  - Compromised ad sites
  - Ransomware
- McAfee: Koobface trojan up 3X in Q1 2013

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Malware Intent

- Steal passwords
- Log keystrokes
- Access company info
  - PFI
  - IP
- Corporate bank account takeover
  - ACH
  - Wires

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Key Defensive Measures

- User awareness
- AV meticulously updated
- Server/workstation patches meticulously updated
- Belt and suspenders approach

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Panel 5:

International Opportunities and Pitfalls for Nonprofits

International Opportunities and Pitfalls for Nonprofits

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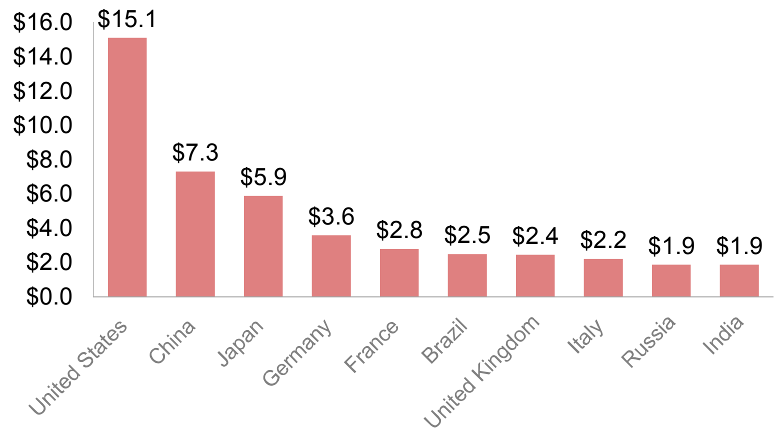
Why are we concerned about international opportunities anyway?

A quick overview of a couple trends…

Largest Global Economies in 2011

GDP in Trillions US $



Total Global GDP – 2011	**$69.98**

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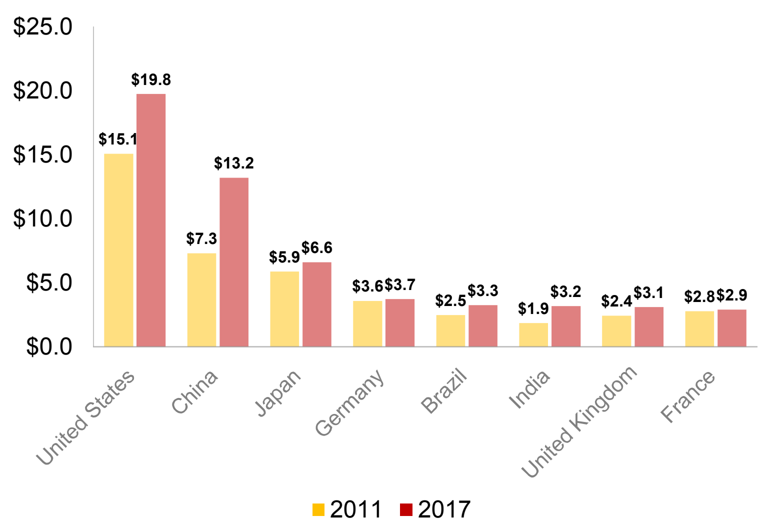
2011 and Projected 2017 GDP



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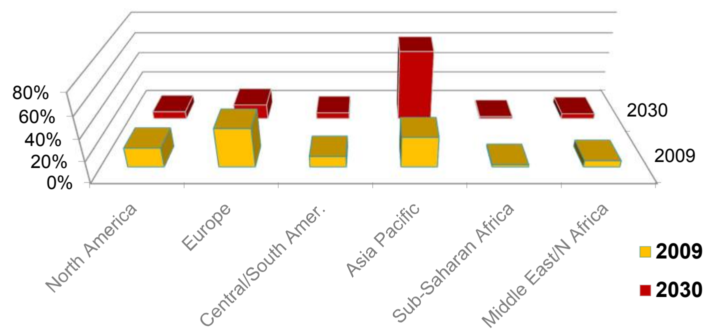
Global Middle Class by Region



Major shift in world middle class – and the disparity between classes

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Organization and legal considerations in a global environment

And a few lessons learned…

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Road Map to Successful and Compliant International Operations

- Identify Goals in the Foreign Market: What's next?
  Considerations in entering foreign market
- Form of Entity: What type of operation best meets your goals?
- Foreign Jurisdictions: What locale works for activities?
- Contracts: Essential provisions for protecting your interests
- How best to protect your Intellectual Property
- Insurance and Employment Issues
- U.S. and Foreign Tax and Informational Filings
- Accounting Issues
- Compliance: Anti-Corruption Laws and U.S. Export Controls and Economic Sanctions

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Goals in the Foreign Market

- Questions to ask?
  - What is your goal in the foreign jurisdiction?
    Identifying what you'd like to accomplish is the first priority. It will dictate almost all of the decisions that follow.
    - EXAMPLES: Trade fair; educational event; networking; formalize already ongoing work; partner with a similar org. to increase membership; gain access to market
  - Long term/Short term? Host of a one-time event or Establish a presence
  - Partner or independent?
  - Activities? Education; sales; fairs; membership dues; distribution of materials
- Answers will direct considerations as to type of organization or entity to establish abroad, if any

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Phased Approach

- Recommend: If you are starting out, may be wise to 'dip your toe in the water' first!
- Specific/Isolated Event v. Ongoing Presence
  - If your organization does not yet have an international presence:
    - Host a one-time conference
    - Use of Association Management Company or "Trade Fair Organizer"
  - Affiliation with a similarly-situated association (i.e., partner with a local association entity)
  - Joint Venture
  - Local office of a US nonprofit
  - Establish an "In-country Branch" (or Chapter)
  - Establish a nonprofit entity under local law

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Form of Entity: Organizational Options

Least Control **Least Risk**

Considerations:

Host Conference w/o Contracting w/ Local Entity — 1

Association Management Companies: — 2
- Careful agreement review: Know what and with whom you are contracting
- Revenue-producing event?
- Logistics
- Specific registration requirements? (e.g., bank accounts)

Affiliation with Similarly-Situated Entity — 3
- Due Diligence re: Organization/Association
- Agreement negotiations
- Under local laws, are you "Doing Business"?
- Use of IP

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Organizational Options (cont'd.)

Considerations (cont'd.):

Joint Venture

- Due diligence re: Organization/Association
- Agreement negotiations
- Under local laws, are you "Doing Business"?
- Use of IP
- Compliance with FCPA and other national anti-bribery legislation

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In-Country Branch v. Independently Incorporated Affiliate

- "Doing Business" under local laws
- Local employment and tax considerations
- Variation in nonprofit treatment under local law
- "Tax Exempt" registration requirements
- Foreign recordation of IP recommended

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Greatest Control **Greatest Risk**

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What Geographic Location Makes the Most Sense for Your Nonprofit?

- Factors to Consider in Choosing a Locale:
  - One-time event or establishing a presence? *Always the threshold question.*
  - Any onerous "registration" requirements?
  - Is it difficult, time-consuming, or expensive to set up a tax-exempt entity?
  - Repatriation or fundraising restrictions?
  - Any U.S. Tax Treaty with that country?
  - Any U.S. export controls or economic sanctions prohibiting transactions by U.S. persons in the country or with "nationals" of the country?
  - Is country high on Transparency International's "Corruption Index"?
  - Any U.S. national export initiatives? (e.g., green technology, energy projects, etc.)

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Make Your Contract Work for YOU

- Essential provisions for protecting your interests:
  - Careful review of any agreement or contract between your U.S.-based nonprofit and a foreign entity is key
- A few "sticky" provisions:
  - Dispute resolution: forum, place, and type (e.g., mediation, arbitration, litigation)
  - Governing law: *excluding a "conflicts of law provision"*
  - Language
  - Agency v. "Independent Contractor"
  - IP: Firm IP and copyright language
  - Termination provisions (always in writing)

➢ ***Always a country- and fact-specific analysis.***

Intellectual Property and "Confidential Information"

- Protecting your intellectual property:
  - IP includes: Logos, Trademarks, Patents
  - Depending on target country, IP rights and protection may be a high-risk issue
  - Is target country signatory to any International IP Conventions?
- Is your IP registered and recorded in the U.S.?
  - Consider registration of IP (or "international" version of IP) under local laws in target country
  - Differentiating between IP and "Confidential Information," i.e., business proprietary info (also requires contractual protections)

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Practical, real world financial and tax reporting

And a few lessons learned…

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Define Success (and Failure)

- Know what you want to get out of a foreign expansion (why are you really doing this?)
- Clearly define success for the organization and its stakeholders
- Understand stakeholder expectations, know what they will want to do if objectives are not met, or if timelines are delayed

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Consider Funding

- Educate stakeholders on the potential risks and rewards of expansion
- Determine cash needs for organizing, activities, and operating expenses
- Determine the timing of cash needs — all at once or over time
- Find out if there are minimum capitalization requirements and other local business start-up issues
- Identify primary and back-up funding sources (i.e., cash reserves, grants, donations, etc.)

Take a Realistic Look at People and Resources

- Analyze current employees and resources to determine if you have the depth to commit to an expansion
- Be realistic about the commitment of time
- Hire the people and acquire the resources you need
- Consider how outside stakeholders will figure into the picture
- No “Mickey Mouse” ears!!!

Determine Local Leadership

- Decide who will call the day-to-day shots in the local operation, what calls they can make, and which the U.S. organization retains
- Determine if leadership is available within the parent organization to relocate – integrate cultures
- Check out leadership resources in the local market
- Beware of differences in employment regulations – typically easy to hire and hard to fire
- Seek advice on important cultural differences and business customs
- Be cautious of communication barriers – again, no “Mickey Mouse” ears!!

Don’t Forget Foreign Reporting and Potential Taxes

- Is a *local* financial audit required:
  - U.S. GAAP?
  - Local GAAP?
  - IFRS?
- Should you require one anyway?
- Is a statutory audit required in the foreign jurisdiction?
- Can you get access to supporting documents, or do you need local representation for the parent organization?
- Who is the “client” of the foreign auditor?
- Understand the U.S. and foreign tax implications of your decisions – tax exemption requirements and restrictions apply to your non-U.S. operations as well

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Measure Performance

- Set financial targets for six months, one year, two years, and five years
- Have a plan if funding falls short and/or costs are higher than expected – typically costs 2-3X more than plan, and can take even more in time
- Determine who will measure results and how it will be done
- Develop processes and controls to ensure accuracy and completeness of information
- Determine your level of involvement with the local management team – you now OWN the outcomes, good and BAD!!!

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U.S. and Foreign Anti-Corruption Legislation

- **U.S. Foreign Corrupt Practices Act ("FCPA"):** U.S. law enacted by Congress in 1977 to halt rampant bribery of foreign government officials
- **Anti-Bribery Provisions**:
  - Prohibits paying of, offering, promising to pay (authorizing to pay or offering) money or "anything of value,"
  - With corrupt intent, directly or indirectly,
  - To a "foreign government official" or political party official,
  - For the purpose of (i) influencing an official act or decision; (ii) causing the official to fail to perform his lawful duty; or (iii) obtaining or retaining business or to secure any improper advantage.
- Certain limited exceptions and affirmative defenses exist

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U.S. and Foreign Anti-Corruption Legislation

- Applicability of the FCPA:
  - Current "red flag" countries
  - Nonprofits not exempt
  - Who is a "foreign official"?
  - "Agency" relationship with partners abroad → U.S.-based nonprofit or association can be held liable for the acts of partners abroad under FCPA
  - Provision of "samples" or other incentives
- Other national and international anti-bribery laws
  - Local laws
  - UK Bribery Act
  - OECD

Other U.S. Law Considerations

- U.S. export controls and economic sanctions
  - Controls on "exports" or releases of U.S.-origin goods, technology, and services to certain destinations, entities, and end users
  - Are you exporting computers, technology or other goods in support of your overseas venture? (Materials for a trade show; hand-carry items can be subject to controls)
- US Economic Sanctions ("OFAC")
  - U.S. sanctions are constantly changing and may affect ability to do business in certain countries and with nationals or entities based in those countries
    - Iran; Syria; Cuba; Sudan; North Korea
    - Other "targeted" sanctions
  - Comprehensive sanctions prohibit most transactions with entities, persons, or governmental entities in those countries
  - "Targeted" Sanctions: Specially Designated Persons
  - "Informational Materials" exemption
  - Transactional prohibitions

It can sound daunting…so a few suggestions

- Start early
- Be pragmatic – seek legal guidance where appropriate
- Have a plan that supports the "vision" – the devil is truly in the details
- Set up an advisory team, including advisors from outside the management of the organization, *with experience*
- Look to local counsel in the jurisdiction
- No substitute for trusted, local contacts – but a word of caution – "trust but verify"
- Assertive oversight
- Don't lose sight of the core mission

Upcoming Venable

Nonprofit Legal Events

October 7, 2013 – Association-Sponsored Market Research Programs: Common Pitfalls, Antitrust Risks, and Opportunities

October 24, 2013 – The IRS Final Report on Nonprofit Colleges and Universities: Lessons for All Tax-Exempt Organizations

November 14, 2013 – Donor Intent, Restricted Funds, and Gift Acceptance Policies: What Every Nonprofit Needs to Know to Effectively Accept and Utilize Contributions

December 5, 2013 – Work & Family: What Nonprofit Employers Should Know about Family-Oriented Employment Laws

Thank You!

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Additional Information

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nonprofit alert

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New York Legislature Passes Nonprofit Revitalization Act: Comprehensive, Significant Changes to New York Nonprofit Corporation Law on Horizon

The Nonprofit Revitalization Act, NY A8072 (the "Act"), a bill that makes comprehensive updates to the New York Not-for-Profit Corporation Law, as well as several other statutes related to nonprofits, recently passed both houses of New York's legislature unanimously. The Act is awaiting delivery to the Governor's office, at which time the Governor would have 10 days to take action or the bill would automatically become law, provided it is delivered before the end of the legislative session on December 31, 2013. The Act would be the first major revision to New York's nonprofit laws in over 40 years. Its provisions apply to nonprofits that are incorporated in New York, but one significant section – related to financial audits and financial reporting to the state – applies to all nonprofits that are registered in New York for charitable solicitation purposes.

If signed into law, most provisions of the new Act would be effective on July 1, 2014 (a couple of the provisions noted below would take effect in 2015, 2017, and 2021). The Act modernizes aspects of the current laws, including the incorporation of new technology options for holding meetings and taking action. The law also imposes standards for executive compensation and enhanced governance processes such as mandating that nonprofits of a certain size adopt conflict of interest and whistleblower policies, and it contains a new definition and approval process for related-party transactions. In addition, the law imposes new limitations and prohibitions on certain governance structures and practices, which may create significant challenges for particular organizations. Many nonprofits will find that they need to amend their governance documents, policies, and procedures – and, in some cases, significantly overhaul their governance structure – to comply with some of the detailed requirements of the Act.

The Act is based on recommendations from the Nonprofit Revitalization Group, convened by New York Attorney General Schneiderman, which recommended changes to cut red tape and eliminate outdated procedures to make it easier and more efficient for nonprofits incorporated in New York to operate. Some heralded these changes as welcome updates to create greater transparency in response to growing public mistrust of nonprofit governance. However, some of these changes may create practical challenges for many nonprofits that must now significantly revise their governance and oversight procedures in response.

Applicability

Generally, the Act only applies to nonprofits incorporated in New York. One section of the Act, however – relating to audit committees, related governance procedures, and financial reporting to the Attorney General – also applies to nonprofits which must register to conduct charitable solicitations in New York, regardless of where they are incorporated.

The major provisions of the Act are summarized below.

Elimination of Letter Types

One of the most substantial changes in the Act is the elimination of classification as Type A, Type B, Type C, and Type D. Nonprofits will instead now be classified as either "charitable" or "non-charitable." Existing organizations do not have to amend their governing documents to clarify whether the organization is "charitable" or "non-charitable." The Act provides that Type B and C entities, as well as Type D entities formed for a charitable purpose, will be deemed to be "charitable." Type A and all other Type D entities will be regarded as non-charitable.

Modernization and Streamlining of Nonprofit Governance Actions and Communication

Electronic Mail for Meeting Notice / Waiver of Notice / Unanimous Consent

The Act makes changes to reflect use of modern technology in governance. Prior to the Act, nonprofits were required to provide notice of member and director meetings by mail or in person. The Act now provides that notice, or waiver of notice, can be given by electronic communication such as e-mail. The Act also provides that electronic communication can be used by members to designate a proxy, and by directors and members to give unanimous written consent in lieu of an in-person meeting.

Video Conferencing for Board Meetings

Unless restricted by the corporation's certificate of incorporation or bylaws, the Act also allows members of the board to participate in a meeting of the board or any committee thereof through electronic video screen communication such as Skype, so long as all board members can hear each other at the same time and each director can participate in all matters before the board.

Enhanced Governance Procedures, Policies, and Prohibitions

Limitation on Employee Serving as Chair

In an effort to preserve the balance between the board and the executive staff of nonprofits, the Act contains an express prohibition on an employee serving as chair of the board or in an officer position with similar responsibilities. However, it should be noted that this prohibition would not extend to bona fide independent contractors. The Act provides that the board may appoint among its officers a chair or a president, or both. The prohibition on an employee serving as chair would presumably not apply to the president in an organization in which different individuals serve as chair and president.

The provision prohibiting employees serving as a chair has an effective date of January 1, 2015, one year later than the other provisions of the Act.

Compensation Approval

The Act provides that no person who may benefit from a compensation decision may be present at or otherwise participate in any board or committee deliberation or vote concerning that person's compensation, except that the board or committee may request that the person present information as background or answer questions at a board or committee meeting prior to the commencement of deliberations or voting thereon.

New Definition of "Independent Director"

The Act defines an "independent director" as an individual who meets all of the following criteria:

(1) has not been an employee of, or does not have a relative that was a key employee of, the corporation or an affiliate of the corporation in past three years;

(2) has not received, or does not have a relative that has received, $10,000 or more in direct compensation from the corporation or an affiliate in the last three years (other than expense reimbursement or reasonable compensation as a director);

(3) is not a current employee of or does not have substantial financial interest in an entity that made or received payments from the corporation or an affiliate of more than $25,000 or 2% of the corporation's gross revenue for property or services (whichever is less) in the last three years; and

(4) does not have a relative who is a current officer of or has a substantial interest in an entity making or receiving payments of a similar amount to the organization in the past three years.

The Act exempts payments of charitable contributions from the definition of payments, but does not contain an exemption for membership dues, which could trigger the "$25,000 or 2%" definition of independence and should be noted by an organization whose board consists of employees of member entities (which is common in trade associations as well as in other types of nonprofits).

This definition of independence particularly impacts audit oversight and administration of the organization's whistleblower and conflict of interest policies, as discussed below.

Mandatory Conflict of Interest Policy

The Act requires all nonprofits to adopt a conflict of interest policy covering directors, officers, and key employees. Some nonprofits may need to adopt a new conflict of interest policy, or update their current policy, to meet the new requirements. At a minimum, this policy must include (1) a definition of circumstances that constitute a conflict of interest, (2) procedures for disclosing a conflict to the audit committee or the board, (3) a requirement that the person with a conflict of interest not be present at or participate in board or committee deliberations or voting on the matter giving rise to such conflict, (4) a prohibition on any attempt by a conflicted person to influence board deliberations, (5) documentation procedures for detailing the existence and resolution of the conflict, and (6) procedures for disclosing and addressing related-party transactions. The Act provides that, prior to the initial election of any director, and annually thereafter, directors must complete, sign, and submit a written statement identifying any potential conflict, as defined in the Act. The board or designated audit committee of the board must oversee the adoption, implementation of, and compliance with any conflict of interest policy if this function is not otherwise performed by another committee of the board consisting solely of independent directors.

Related-Party Transaction Approval Process

In conjunction with the new conflict of interest policy requirement, the Act updates the definition of what constitutes a "related party," defined as (1) any director, officer, or key employee of the corporation or any affiliate of the corporation; (2) any relative of any director, officer, or key employee of the corporation or any affiliate of the corporation; or (3) any entity in which any individual described in (1) or (2) has a 35 percent or greater ownership or beneficial interest or, in the case of a partnership or professional corporation, a direct or indirect ownership interest in excess of five percent. A "related-party transaction" is defined as any transaction, agreement, or other arrangement in which a related party has a financial interest and in which the corporation or any affiliate of the corporation is a participant.

The Act prohibits all corporations from entering into any related-party transaction unless the transaction is fair, reasonable, and in the corporation's best interests. The Act contains additional requirements for charitable organizations (as opposed to non-charitable organizations, as defined by the Act) considering such transactions, including a requirement that the board consider alternative transactions to the extent available and approve the transaction by not less than a majority vote of the directors or committee members present at the meeting.

With regard to enforcement, the Act adds a provision allowing the New York Attorney General to bring an action to enjoin, void, or rescind any related-party transaction that is not reasonable and in the best interests of the corporation at the time such transaction was approved.

Mandatory Whistleblower Protection Policy

The Act also mandates that nonprofits with 20 or more employees and annual revenue in the prior fiscal year in excess of $1,000,000 institute a whistleblower protection policy. The whistleblower policy must protect from retaliation any director, officer, employee, or volunteer who in good faith reports an action or suspected action that is potentially illegal, fraudulent, or in violation of any adopted policy of the corporation. The policy must include procedures for reporting violations; a designated employee, officer, or director tasked with administering the policy and reporting to the audit committee or other committee of independent directors or, if there are no such committees, to the board; and a requirement that the policy is distributed to all directors, officers, employees, and volunteers.

Required Audit Procedures and Financial Reporting

Audit Committee and New Audit Procedures

One of the more significant changes in the Act relates to financial audits, including audit committees, governance procedures, and financial reporting to the Attorney General. The audit provisions apply not just to nonprofits incorporated in New York, but also to nonprofit organizations incorporated anywhere that are required to register under New York Executive Law Section 172 – the charitable solicitation registration statute – due to their charitable solicitation activities in New York.

The Act requires all organizations subject to registration for charitable solicitation in New York that are required to file an independent auditor's report with the Attorney General, pursuant to Section 172-b of the New York Executive Law (triggered by receipt of gross revenues above $500,000 in 2014; $750,000 in 2017; and $1,000,000 in 2021, as further explained below), to have a designated audit committee of the board comprised of independent directors responsible for retaining an independent auditor and reviewing the results of the audit. Alternatively, the delineated tasks must be performed by the independent directors on the board.

The audit committee of an organization with annual revenues (presumably meaning gross revenues) in excess of $1,000,000 that is required to file an independent certified public accountant's audit report with the Attorney General, pursuant to Section 172-b of the New York Executive Law, is subject to more extensive duties relating to the audit, including reviewing the scope and planning of the audit with the auditor prior to commencement of the audit, discussing any significant disagreements between the auditor and management after the audit, and annually considering the performance and independence of the independent auditor.

The audit committee also is charged with overseeing adoption, implementation, and compliance with the mandatory conflict of interest and whistleblower policies.

Raised Thresholds for Financial Reports

The Act raises the thresholds of revenues for which organizations conducting charitable solicitations in New York are required to file certain financial reports with the Attorney General. These threshold levels will become progressively higher on July 1, 2014; July 1, 2017; and July 1, 2021, respectively. Starting on July 1, 2014, organizations with gross revenues under $250,000 (previously $100,000) may file unaudited financial statements signed by the chief financial officer and president, or other authorized officer, under penalties of perjury. Organizations with gross revenues greater than $250,000 (previously $100,000) but less than $500,000 (previously $250,000) must file annual financial reports accompanied by an independent certified accountant's review report in accordance with "statements on standards for accounting and review services" issued by the American Institute of Certified Public Accountants. Organizations with gross revenues greater than $500,000 (previously $250,000) must file annual financial statements accompanied by an independent certified public accountant's audit report with an opinion that the financial statement and balance sheet fairly present the financial operations and position of the organization.

In 2017, these threshold levels are raised so that organizations with gross revenues under $250,000 will still file unaudited financial statements, but organizations with gross revenues between $250,000 and $750,000 must file annual financial statements with a CPA's review report, and organizations with gross revenues over $750,000 must filed annual financial statements with certified audit reports. In 2021, the threshold is increased to allow organizations with gross revenues between $250,000 and $1,000,000 to file annual financial statements with review reports and organizations with gross revenues over $1,000,000 to file annual financial statements with certified audit reports.

Interestingly, if the Attorney General is unsatisfied with the statements that are filed with a review report, the Attorney General can require an organization to have its financial statements audited; even if the organization's gross revenue is below the threshold limit. This could be an expensive endeavor for smaller organizations.

The requirement to file different types of financial reports is not new, and the three-step increase in revenue thresholds should relieve the burdens of filing audited financial statements or financial statements with review reports for some smaller nonprofits. However, the mandatory audit procedures and designated audit committee functions go well beyond what was previously required under New York law and are detailed in a nature that goes well beyond that of other states' requirements in the charitable solicitation area.

Simplification of Approval Process for Certain Transactions

Ability to Seek Consent of Attorney General as Opposed to New York Supreme Court for Certain Corporate Transactions

The Not-for-Profit Corporation Law previously required Type B, C, and D organizations to engage in a two-step process of 1) seeking approval of the New York Supreme Court, and 2) providing notice to the New York Attorney General, prior to engaging in certain fundamental transactions. The Act now provides a simplified process for "charitable" entities, whereby the organization can seek the approval of the Attorney General instead of initiating a court proceeding for transactions such as dissolution (sale, lease, exchange, or other disposition of substantially all assets); merger or consolidation; and change of purposes. The Attorney General has discretion whether to grant such action or to require the action to be submitted for the approval of the New York Supreme Court, and the nonprofit can appeal a denial by the Attorney General to the New York Supreme Court. The process for approval of non-charitable entities remains the same as under current law.

Notification Instead of Consent to New York Commissioner of Education

The Act also modifies a prior requirement for certain organizations with an educational purpose as defined by the New York Education Law (i.e., "colleges, universities, or other entities providing post-secondary education; nursery, elementary, secondary or charter schools; libraries, archives, or museums or historical societies with collections; and public television and radio shows") to seek the approval of the New York Commissioner of Education prior to incorporation. Under the new Act, out of the types of entities listed above, those that do not have as one of their purposes the operation of a "school, university, library, museum, or historical society" no longer have to receive prior approval.

Lowered Approval Requirements for Real Property Transactions

Previously, the New York Not-for-Profit Corporation Law required that two-thirds of the entire board approve any purchase of real property, for organizations with fewer than 21 directors. The Act lowers this threshold by requiring that only a simple majority of the board needs to authorize the purchase, sale, lease, exchange, or other disposition of real property, provided that the property to be acquired or disposed of does not constitute all, or substantially all, of the assets of the corporation. If the property does constitute all, or substantially all, of the corporation's assets, the approval of two-thirds of the entire board will continue to be required (unless there are 21 or more board members, in which case simple majority approval is sufficient). The Act also allows for the final determination as to the purchase, sale, lease, exchange, or other disposition of real property to be delegated to a committee authorized by the board, provided that the committee report any actions taken to the board by the next regularly scheduled board meeting.

Other

New Definition of "Entire Board"

The Act includes a new definition for the term "entire board" that clears up an ambiguity in the previous definition regarding the number of directors that must be counted for purposes of a quorum and board action when board size is provided as a range in the bylaws. Under the Act's new definition, if the board size is provided as a range between a minimum and maximum number, any reference to the "entire board" shall refer to the number of directors elected as of the most recent election. Meeting the "entire board" voting thresholds could be difficult for a board with vacant seats if there is a set number of directors provided for in the bylaws.

Removal of Requirement to Provide Residential Addresses of Board Members

The Act eliminates a provision in the section on membership access to records that required the corporation to provide the residential address of board members and officers to members upon request. Under the Act, a corporation may lawfully comply with a member request by providing a list of board members and officers without addresses.

Conclusion

The New York Nonprofit Revitalization Act will modernize the laws applicable to nonprofits incorporated in New York and enhance nonprofit governance and oversight. It also will establish new restrictions and requirements in the governance area that will require certain nonprofits to make significant – and, in some cases, challenging – changes to their governance structure. Notably, the financial audit provisions apply to all nonprofits required to register to solicit New York residents for charitable contributions, regardless of their state of incorporation. Presuming the Act is signed into law – which most expect it will be – many New York nonprofit corporations will need to adopt additional policies and procedures, and should carefully review their governance documents for compliance with the new law.

- The New York Nonprofit Revitalization Act, as passed by the New York legislature, is available at: http://assembly.state.ny.us/leg/?default_fld=&bn=A08072&term=&Summary=Y&Actions=Y&Text=Y.
- The New York Nonprofit Revitalization Group Report, on which much of the new law is based, is available at: http://www.ag.ny.gov/sites/default/files/press-releases/2012/NP%20Leadership%20Committee%20Report%20(2-16-12).pdf.

* * * * * *

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Tax-Exempt Financing for Tax-Exempt Organizations: Is Your Organization Eligible? Do the Benefits Outweigh the Costs? (Article)

Organizations qualified under Section 501(c)(3) of the Internal Revenue Code for exemption from federal income tax are eligible to borrow on a tax-exempt basis. If your organization is considering incurring debt, this article can assist in your evaluation of whether the more favorable interest rates provided by borrowing on a tax-exempt basis are worth the additional transactional costs and restrictions imposed by federal income tax law that comes along with tax-exempt debt.

From the outset, borrowing on a tax-exempt basis is more complicated than the typical bank loan. In order to qualify for tax-exemption, the debt must be issued by a government entity with the proceeds being re-loaned to the exempt organization. Typically, the issuer of the debt is a state or local government entity (known as the "Issuer") where the exempt organization and its proposed project are located. Such an arrangement is referred to as "conduit borrowing," with the government entity typically assuming no obligation on the debt. Rather, the government issuer serves as a mere conduit to pass the loan proceeds on to the true borrower, the 501(c)(3) conduit borrower, and to remit the debt service payments from that borrower to the lender(s).

Taxable or Tax-Exempt? Evaluating Costs. A starting point in the analysis of whether to borrow on a tax-exempt or a taxable basis is a comparison of the difference in interest rates that can be expected to be available to your organization. Generally speaking, the spread between tax-exempt and taxable interest rates is a function of the marginal tax rate on taxable interest income applicable to potential purchasers of the debt. Interest rates vary with a variety of factors, with principal considerations being the creditworthiness of the borrower (together with any parties that will guarantee or otherwise lend support to the borrower), what assets that borrower has available to pledge as collateral for the debt, and the term of the debt. Additional factors applicable to tax-exempt debt are the federal and state income tax rates that a debt holder foresees as being applicable to it over the term of the debt.

To be weighed against the potential interest rate savings realized by a 501(c)(3) conduit borrower are the additional costs of issuing tax-exempt debt over those typically incurred in connection with the issuance of taxable debt (e.g., a conventional bank loan). As discussed further below, these costs include conduit issuer fees, the bank application, loan fees or an underwriter's commission, various legal counsel costs, fees associated with retaining a trustee (if needed), and costs for drafting and printing offering documents in the case of a public offering of the debt. These transaction costs are a significant obstacle for transactions under $5,000,000 and remain a factor for larger transactions. A financial advisor can assist in quantifying the potential interest rate savings versus the various transaction costs and provide advice on the overall cost savings potential of pursuing tax-exempt financing.

Less quantifiable costs and burdens of tax-exempt financing are the ongoing compliance with federal income tax law requirements (discussed below). There also may be ongoing reporting requirements for the benefit of your lenders, but these will generally be the same whether the debt is tax-exempt or taxable.

Financing Structure. The debt issued by the conduit government issuer will typically be in the form of a bond or bonds, although other financing labels and structures also are used (e.g., tax-exempt leases). The simplest tax-exempt financing structures are bank placements. Here, the transaction resembles a conventional taxable bank loan in many respects. The structure is relatively simple because there is only one holder of the debt instrument – the bank – and it can exercise all administrative, oversight, and enforcement functions present in a lending transaction. Bank placements are frequently more cost-effective than other structures when the transaction size is below roughly $10 million.

In contrast, tax-exempt debt may be marketed to multiple bondholders in an effort to obtain a better interest rate via either a public offering or a private placement. Either approach is more complex than a direct bank placement because the debt is being sold to multiple bondholders and typically requires additional participants and documents. Because there will be multiple bondholders who are passive lenders, a bond trustee (usually the trust department of a bank) is needed to represent the interest of those multiple bondholders and to take on their collective responsibility for administering the bond terms. The bond trustee typically acts under a trust indenture (sometimes called a bond resolution), which spells out bondholder rights and establishes a framework for administration, oversight, and enforcement of the terms.

Marketing the bonds to multiple bondholders requires underwriting or placement agent services, usually provided by an investment bank. The bonds will be sold pursuant to a securities offering prospectus, usually called an “Official Statement” for a public offering or a “Private Placement Memorandum” for a private placement. The underwriter or placement agent carries out its responsibilities under a bond purchase agreement or private placement agreement. Official Statements and Private Placement Memoranda are expensive to draft, because they require collective effort from lawyers for the issuer, the underwriter or placement agent, and the borrower, and are typically accompanied by legal opinions as to accuracy and compliance with securities laws. Drafting the portions of the Official Statement describing the borrower and its operations and finances is particularly time-intensive for the borrower’s lawyers and accountants in a first-time borrowing, and is a significant part of the transaction costs associated with the issuance of tax-exempt debt in the form of bonds offered to the public. Private Placement Memoranda are used when the bonds are sold only to sophisticated investors, and can be cheaper to draft because they provide a more cursory description of the bonds, the borrower, and the transaction.

Credit Enhancements. Achieving the lowest possible debt service costs for tax-exempt debt may be aided by obtaining a credit rating for the debt from one or more of the national credit rating agencies (including Standard & Poor’s, Moody’s, and Fitch) if that rating will help the underwriters obtain a lower interest rate from the purchasers of the bonds. Borrowers with weak credit ratings can sometimes achieve debt service savings by paying for credit enhancement in the form of a bond insurance policy or backing by a letter of credit issued by a financial institution. Credit enhancement lifts the rating on the bonds, thereby enabling a lower interest rate, in return for payment of the insurance premium or letter of credit fees. Determining whether credit enhancement strategies are cost-effective is usually the job of the underwriters and/or the borrower’s financial advisor.

The Typical Process. Most borrowers need committed financing sometime between the start of the project design phase and the start of construction. A tax-exempt financing transaction commonly requires a three-to-six month timeline, so financing activity should begin six to nine months ahead of the day when borrowed funds will be needed. However, before taking any action in connection with a tax-exempt financing, the borrower’s finance personnel should obtain preliminary approval from the organization’s board of directors or trustees, the finance committee of such a board, or other body or officer with authority to initiate a borrowing on behalf of the organization. Federal income tax law generally requires that the borrower declare its intent to finance costs in a written declaration before actually spending money when any such spending will occur in advance of actual debt issuance. Most borrowers incur significant project costs well ahead of closing on their financing and reimburse themselves from bond proceeds at closing. Accordingly, as soon as the borrower commits itself to the funding of a project with tax-exempt debt, it should adopt a “declaration of intent” by resolution or other official action.

After completing its internal approval processes, a borrower’s next step is to identify and make application to the appropriate conduit issuer. Often, borrowers have a choice of either local governments or specialized state bond lending authorities that could serve as the government issuer. However, there may be political and policy factors at play in the choice, and borrower’s counsel is usually best situated to advise the borrower on the choice of issuer.

At this stage, the borrower is likely to be negotiating the basic financial terms of the loan transaction with the bank, the underwriter, or the private placement agent. Here again, it is critical to involve experienced borrower’s counsel in the basic negotiation of terms. The issuer chosen by the borrower often wants to see a term sheet and a list of parties as part of the application process.

Once the issuer has been selected, the borrower must obtain and complete whatever form of application and questionnaire may be required by the issuer and its counsel. This is also the stage when the rough calendar for the bond transaction is laid out. Issuers often require a general application to establish eligibility for the issuer’s program and a separate tax diligence questionnaire to support the crucial opinion on the tax-exempt status of the debt. Once the application process is complete, the conduit issuer will then satisfy the "TEFRA" notice, hearing, and approval process required by federal income tax law by means of publishing a notice of the proposed financing, followed by (a) the holding of a public hearing permitting public comment on the proposed financing, and (b) formal approval of the financing by a publicly elected official of the issuer following that hearing. Issuers have varying rules, procedures, and schedules for finance team meetings, public hearings, and formal approvals.

The Finance Team. A variety of professionals will typically be engaged in connection with the issuance of the conduit debt on behalf of the borrower. The conduit issuer will have personnel responsible for assisting with the issuance process and will have retained outside counsel to represent it in connection with the issuance ("bond counsel" and/or "issuer's counsel").

In the case of a private placement of tax-exempt debt with a single bank being the sole lender, that bank will usually retain its own internal or external counsel ("bank counsel"). Alternatively, if the debt is to be publicly offered with the assistance of an underwriter, the underwriter will typically retain its own counsel ("underwriter's counsel") to assist in the negotiation of the bond purchase document and the offering statements for the sale of the bonds to the public. Occasionally, the parties may consent to have a single counsel represent two of the parties, so as to reduce the overall counsel fees and create efficiencies in the issuance process. For example, a single counsel might serve as bond counsel to the issuer and as counsel to the borrower. In such a situation, the issuer would still typically have its own "issuer's counsel" retained for a much more limited role than that performed by bond counsel.

The borrower will retain its own legal counsel ("borrower's counsel"). The borrower's counsel must be familiar with the unique aspects of the tax-exempt financing process and be capable of giving the opinions required to support the tax-exempt status of the debt. If real estate and construction will be financed, then borrower's counsel will need competency in these areas as well.

Frequently, the borrower will engage a financial advisor. If involved, an underwriter may be a source of financial advice; however, an underwriter's advice may be accompanied by a disclaimer of fiduciary responsibility to the borrower. This is why many borrowers retain their own financial advisor, whose compensation does not depend on effectuating the transaction. If interest rate swaps or hedges will be used, the borrower may be able to rely on its financial advisor to serve as swap advisor or, depending on the competencies of the financial advisor, may need to retain a separate swap advisor. The conduit issuer also may have its own financial advisor.

The role of the borrower's accountant will depend on the financing structure chosen. A simple loan structure may only require copies of the audited financial statements. Bonds sold in a public offering will be accompanied by the borrower's audited financial statements with the consent of the auditor and appropriate diligence procedures. Auditors also may consult on financial covenant and feasibility issues. Additionally, the borrower's accountant may assist the borrower with tax-related calculations and certifications necessary to support the borrower's tax compliance certificate as required by bond counsel.

Opinions. The market requires that tax-exempt bonds be accompanied by an opinion of bond counsel supporting the tax-exempt status of the interest payable on the bond and assuring that the bond was properly issued. Bond counsel typically requires and relies upon the borrower's counsel for an opinion as to the borrower's tax-exempt status, among other things. Depending on the nature of the project and the structure of the transaction, there may be other important opinions about regulatory compliance, securities disclosure, and the like. Each party's counsel will generally issue an opinion as to the authority of the party that it represents to undertake the transaction, the validity of the approvals of that party to enter into the transaction, and other relevant matters. Each counsel will impose its own diligence and certification requirements on the parties to the transaction as it deems necessary to support the rendering of its opinion.

Sale and Closing. For a private placement, the sale and closing are typically combined as one event. A term sheet or letter committing the parties to the terms of the financing may be agreed to in advance.

For publicly sold bonds, the sale and closing components are two distinct events typically separated by one or two weeks. All parties work together to prepare the primary document, the Official Statement, which details the terms of and security for the bonds and is used by the underwriters to market the bonds to potential purchasers. Of primary concern to the borrower will be the portion of the Official Statement (typically titled as "Appendix A") describing the borrower, its purposes, and its financial condition in detail, so as to give the potential lenders the facts necessary to evaluate the ability of the borrower to repay its debts. After a period of marketing using the Preliminary Official Statement, together with any other strategies that the underwriters believe will advance the sale of the bonds, the underwriters will formally conduct the sale of the bonds on a date established in the offering materials.

Once the pricing and any other open terms of the bonds are finalized by completion of the sale, the final form of documents, incorporating the interest rates and other terms of the debt resulting from the sale of the debt, will be prepared for signing on the closing date. Subsequently, on the closing date, all of the bond documents will be completed and signed. Most importantly for the borrower, the funding will occur such that net bond proceeds after payment of issuance costs are available for the use of the borrower.

Federal Tax Law Requirements. Federal income tax law imposes a variety of requirements as conditions to the exempt status of the interest payable on tax-exempt debt. The following is an overview of several of the more significant of those requirements of federal income tax law. Additional requirements, beyond those discussed here, will apply depending on the nature of the borrower and its project. Various exceptions and unique rules apply in connection with each of these requirements.

All property to be financed with tax-exempt debt must be owned by a tax-exempt 501(c)(3) organization. Alternatively, the financed assets may be held by a wholly owned limited liability company or other entity which is “disregarded” as an entity separate from its sole member for federal income tax purposes (in other words, for federal income tax purposes, the two entities are viewed as one (the sole member)). At least 95% of the financed property must be used by the borrower in fulfillment of its tax-exempt purposes. The 95% requirement leaves a 5% allowance (often referred to as the “private business use allowance”) that must cover (i) issuance costs funded from debt proceeds, and (ii) any uses of bond proceeds either in an unrelated trade or business activity of the borrower or by third parties that are not themselves tax-exempt 501(c)(3) organizations.

Typical uses that may give rise to private business use subject to the 5% limitation include any unrelated trade or business activity of the borrower (regardless of whether that activity is operated at a loss), together with leases of unneeded space in a financed facility to a private business, and the retention of private managers to operate food service facilities, gift shops, bookstores, or the like. When a potentially prohibited private use is a result of a management and other professional service contract involving bond-financed facilities, relief from “private business use” status may be found in IRS rules that provide “safe harbor” guidelines. These guidelines provide combinations of compensation, term, and termination provisions, which, if complied with, ensure that private business use will not be considered to result from such management and service contracts.

No more than 2% of the debt proceeds can be used to pay the transaction costs incurred in connection with issuing the bonds. As noted, such “issuance costs” also count against the 5% allowance for private business use. If issuance costs exceed the 2% limit, then the borrower will need to fund them out of its own equity or take on a separate, taxable borrowing (often called a “taxable tail”) to fund the excess together with any other costs of the project not qualifying for inclusion in the sizing of the 501(c)(3) bonds. Many borrowers elect to pay all costs of issuance with equity to preserve the full 5% allowance for private business use. Such an approach can be valuable for preserving flexibility for future unexpected private business uses involving the bond financed project that may arise.

Post-Issuance Compliance. The various requirements of federal income tax law generally must be satisfied both at the time of initial issuance of the 501(c)(3) bonds and so long as any portion of the debt is outstanding. Both the conduit governmental issuer and the borrower should adopt written procedures detailing how and by whom such post-issuance compliance will be conducted.

For 501(c)(3) organizations benefitting from outstanding tax-exempt debt, an additional Form 990 schedule must be filed annually so long as the debt is outstanding – Schedule K, Supplemental Information on Tax-Exempt Bonds. The information required to be reported on Schedule K includes detailed listings of uses of proceeds, statistics on private business use, and arbitrage compliance facts. While some borrowers may have staff members that are comfortable completing the return on their own, others will need the assistance of outside advisors to ensure proper understanding of the questions being asked and accurate completion of the responses.

Weighing the Alternatives. Historically, 501(c)(3) organizations have found the benefits of tax-exempt debt to outweigh its costs and burdens. In the current economic environment, with interest rates at historically low levels, the valuation requires close scrutiny, as the margin of savings between taxable and tax-exempt interest rates may not merit the additional costs and burdens of pursuing tax-exempt debt, particularly for smaller borrowings. The services of a financial advisor, either through the borrower’s regular banking relationship manager or a professional dedicated to advising in this area, can be invaluable in assisting with this evaluation. The borrower’s legal counsel also may have expertise in tax-exempt finance and be a vital member of the team tasked with evaluating the financing options available to 501(c)(3) organizations.

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An editor from *EO Tax Journal* praised the article, saying “the folks at Venable law firm have put together what I think is a very sensible discussion of tax-exempt bonds for section 501(c)(3) organizations.”

This article is not intended to provide legal advice or opinion and should not be relied on as such. Legal advice can only be provided in response to a specific fact situation.

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April 2012

Top Ten Compensable Time Issues for Non-Exempt Employees

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Wage and hour lawsuits outpace all other types of employment litigation, and federal and state labor departments continue vigorous enforcement in this area. Under the Fair Labor Standards Act ("FLSA"), employees are categorized as either exempt or non-exempt. Exempt employees are paid a salary for all hours worked and do not receive overtime pay. Exempt employees must meet certain criteria under the FLSA to qualify as exempt based on the primary duties of the employee's job and they must be paid on a salary basis. Non-exempt employees are generally paid on an hourly basis. They must be paid for all hours worked in a workweek and receive overtime pay if they work over forty hours in a workweek. So, in order to calculate the amount of money a non-exempt employee should receive, an employer must determine the number of hours of work or "compensable time." Compensable time or working time is defined as any time the employer permits or allows an employee to perform the activity. This includes all time worked while at the office, work performed at home, and even work that is performed before the regular workday begins.

It is critical for employers to ensure that their non-exempt employees are properly compensated for all hours worked, including all overtime hours worked. The top ten list below highlights some of the common pitfalls for employers, and addresses areas of confusion under the FLSA's complex rules on compensable time for non-exempt employees.

1. Waiting Time

If a non-exempt employee is not performing work during a regular workday, but is waiting for an assignment, such time must be considered compensable time because the employee is not free to leave. For example, an administrative assistant who is reading a romance novel while waiting for an assignment must still be compensated for that time since the employee is being required to wait. If, on the other hand, the employee is told that he or she can leave and come back in two hours, that time is not compensable waiting time because the employee is free to use the time for his or her own purposes.

2. Seminars, Lectures, and Training Programs

Many non-exempt employees attend lectures, seminars, and training programs outside the office. Attendance at lectures, meetings, training programs, and similar activities is not considered compensable time only if *all* of the following criteria are met:

- Attendance is outside the employee's regular working hours,
- Attendance is voluntary,
- The course, lecture, or meeting is not directly related to the employee's job, AND
- The employee does not perform any productive work during such attendance.

Training is considered related to the employee's job if it is designed to help the employee handle his or her job more effectively and it is related to the job. If it is training for another job or a new or additional skill, then it is not job-related even if the course incidentally improves skills in doing the regular work. For example, an IT employee who takes classes toward an accounting degree may incidentally improve his or her organizational skills but that training is not job-related.

When employees attend independent trainings, courses, and college after hours, and it is not required by the employer, such time is not compensable time. Even if the employer pays or reimburses the employee for part of the tuition through an employee benefit plan, the time spent at the course is not compensable time. Similarly, if an employer offers a lecture or training session for the benefit of employees, voluntary attendance outside of work hours is not hours worked, even it if it is job-related or paid for by the employer. For example, an employer may offer all employees an opportunity to hear an author to speak about a new book about improving management skills. If it is during work hours, the time at the session is compensable time. If the speaker event is outside of regular hours, and is completely voluntary, it is not compensable time.

3. “Off-the-Clock Time”

A non-exempt employee must be compensated for all hours worked in a workweek. This includes work performed that may be outside the employee’s regular workday. For example, a non-exempt employee may report to the office 30 minutes early each day due to a commuter bus schedule. If the employee begins working prior to the start of the regular workday, that time must be counted as compensable time, even if the employee does not record the time on the time sheet. The same requirement applies to the non-exempt employee who brings work home or responds to emails from home before or after the regular workday.

Non-exempt employees should be instructed not to perform work beyond their regular work schedule unless they receive prior approval from their supervisor. If an employee fails to obtain approval but performs work, he or she must still be compensated for that time, but the employer may address the situation as a disciplinary matter. Employers should carefully consider work schedules for non-exempt employees, and establish policies and train supervisors regarding off-the-clock work to avoid potential violations of overtime requirements.

4. Attendance at Receptions, Dinners, and Other Social Events

Many employers sponsor or host receptions, dinners, happy hours, and other social events. If a non-exempt employee is required to attend a reception, dinner, happy hour, or other social event, that time is treated as compensable time, even if the employee is not performing work that he or she usually performs in the office. Again, it is important to clearly communicate to non-exempt employees what is required and what is not required. In addition, supervisors should be trained not to pressure non-exempt employees to attend an event that is not mandatory.

5. Volunteer Activities

Employers may offer “volunteering” or “team building” opportunities. If such activity is mandatory for non-exempt employees, it must be counted as compensable time even if the activities are held on the weekend outside normal working hours. Or, if the employer requires all non-exempt employees to “volunteer” two hours at a book drive, that is compensable time.

If, however, a non-exempt employee volunteers to work at the employer’s annual dinner outside regular work hours and is not performing work regularly performed by the employee, that can be considered volunteering and does not need to be compensated. For example, a research assistant volunteers to be a greeter at an event on Saturday night, and is not required to volunteer, that is not compensable time. If the volunteering occurs during regular working hours, it is considered compensable time.

6. Travel as a Passenger during Non-Shift Hours Where No Work Is Performed

As a general rule, an employee who travels from home before his or her regular workday and returns home at the end of the workday is engaged in ordinary home-to-work travel which is a normal incident of employment and is not compensable.

Oftentimes, employees are asked to travel longer distances to attend conferences or other out-of-town events. However, if all of the following conditions are met, even this longer form of travel to a different city is not considered compensable time: the employee is a passenger on an airplane, train, boat, or automobile; the travel is during non-shift hours; AND no work is performed during the travel.

For example, an employee who takes a four-hour plane trip to a week-long conference during non-shift hours but performs no work on the plane need not be compensated for this travel time.

7. Travel as a Passenger during Shift Hours

On the other hand, if an employee travels to an out-of-town conference during shift hours, that employee must be compensated for the commuting time to the conference which exceeds that employee’s regular commute, whether or not he or she performed any work during the commute.

For example, an employee whose regular commuting time is 30 minutes, and who takes a three- hour train ride for a one-day trip to another city during regular shift hours and performs no work on the train, must be compensated for the two-and-a-half hours which are not part of regular commute.

8. Work Performed while Commuting

One frequent area of confusion stems from situations where an employee performs work during his or her commute. As a general rule, any work which an employee is required to perform while commuting must be counted as hours worked and compensated accordingly. For example, time spent by an employee writing a report is work time, even if it happens to occur while the employee is riding on a bus (or other mode of transportation) to or from work.

It is important for employers to clearly communicate to non-exempt employees when work is and is not required to be performed. Moreover, supervisors should be trained not to give non-exempt employees work to do once the employee's shift ends which must be completed by the beginning of his or her shift the next morning.

9. Interns

Whether an employer must compensate interns for time worked is an often misunderstood topic. Unpaid internships in the public sector and for nonprofit organizations, where the intern volunteers without expectation of compensation, are generally permissible. Importantly, an intern who receives academic credit from his or her educational institution for completion of an internship with an employer will easily qualify as an intern/trainee.

On the other hand, examples of when an intern will not be considered an intern/trainee include: (1) where the intern is used to substitute for regular workers or to supplement the employer's workforce; (2) where, but for the intern, the employer would have hired additional employees or asked its existing staff to work additional hours; and (3) where the intern is engaged in the employer's routine operations and/or the employer is dependent on the intern's work.

10. Time Waiting for/Receiving Medical Attention

Time spent waiting for and receiving medical attention on the premises or at the direction of an employer during an employee's normal working hours on days when he or she is working constitutes hours worked and must be compensated.

For example, if a teacher's assistant feels dizzy during regular shift hours and her supervisor instructs her to lay down for 15 minutes in the employee lounge, this time must be compensated.

Conclusion

Of course, this top ten list only highlights some of the most common issues. Employers must first make sure employees are properly classified as exempt or non-exempt. Remember that not everyone who is paid a salary is exempt. For non-exempt employees, employers should carefully track hours worked. It is the employer's responsibility to keep records of hours worked and wages paid to employees. If the records do not exist, there is a presumption that the employee's assertions are correct. Also, train supervisors to be familiar with overtime requirements for non-exempt employees and to closely monitor hours worked by non-exempt employees. Employers are encouraged to establish clear policies about non-exempt employees working from home or working while traveling, coming in early and staying late, and working beyond their regular schedule to avoid some of the common pitfalls.

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January 10, 2012

Pitfalls for Nonprofits that Receive Federal Funds: Lessons Learned from ACORN

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On the heels of an embezzlement scandal, in September 2009, allegations of voter registration fraud and other questionable behavior by employees of the Association of Community Organizations for Reform Now ("ACORN" or the "Organization") surfaced following the release of several undercover videos. The alleged conduct of ACORN employees gained national attention, led to federal legislation prohibiting the distribution of federal funds to the Organization, and ultimately led to the Organization's bankruptcy and dissolution in 2010. The downfall of ACORN serves as an important lesson to all nonprofit organizations.

ACORN and Its Downfall

Founded in 1970, ACORN, a tax-exempt nonprofit organization, was a collection of community-based organizations that advocated for low- and moderate-income families on issues ranging from affordable housing to neighborhood safety, as well as other social issues. At its peak, ACORN reportedly had over 500,000 members across more than 1,200 neighborhood chapters spread throughout more than 100 North and South American cities. As ACORN grew it was not without issues, especially in its later years, when its founder's brother embezzled funds and allegations arose that the Organization allowed tax-deductible charitable contributions to be used for political purposes.

In the wake of the release of several videos in September 2009 that depicted conservative activists eliciting damaging responses from ACORN employees, a nationwide controversy erupted over, among other things, taxpayer funding of such an organization. Due to the groundswell of public sentiment and fueled by election-year politics, in a fiscal year 2010 appropriations bill, Congress prohibited the awarding of federal funds to ACORN and ACORN-related organizations. As it turned out, after Congress took action, the videos were discovered to have been "heavily edited," and were ultimately discredited.

Not surprisingly, in the wake of the federal prohibition, grant money from state agencies and private donations dwindled. As a result, it took only a little more than year after the by-then discredited videos were made public for the Organization to file for bankruptcy, effectively shutting down the 40-year-old organization.

GAO's Review of the Agency Response to the Defunding of ACORN

As part of the Consolidated Appropriations Act of 2010, Congress directed the Government Accountability Office ("GAO") to conduct a review and issue a report on the federal funding to ACORN and related organizations. The GAO issued a preliminary report on June 14, 2010 that addressed three topics:

- From fiscal years 2005 through 2009, how much funding did federal agencies award to ACORN or any potentially related organizations, and what was the purpose of the funding?
- To what extent did federal agencies' monitoring of ACORN or potentially related organizations' use of federal funding detect issues identified by inspector general and internal audits?
- What federal investigations or prosecutions were conducted of ACORN or potentially related organizations from fiscal years 2005 through 2009, and what were the nature and results of these investigations and prosecutions?

The GAO issued a final report in June 2011, which includes the final results of these objectives as well as results of a fourth objective, which Congress had subsequently requested – How have federal agencies subject to fiscal year 2010 provisions barring the distribution of appropriated funds to ACORN or its affiliates, subsidiaries, or allied organizations implemented those provisions?

In sum, with respect to each topic, the GAO made the following findings:

Topic of Inquiry	Findings
From fiscal years 2005 through 2009, how much funding did federal agencies award to ACORN or any potentially related organizations, and what was the purpose of the funding?	During fiscal years 2005 through 2009, ACORN or potentially related organizations received more than \$44.6 million in federal grant funds, primarily for housing-related purposes. These funds were awarded by 17 federal agencies, most predominantly the U.S. Department of Housing and Urban Development, as well as the federally chartered nonprofit Neighborhood Reinvestment Corporation (a.k.a. NeighborWorks America). With respect to sub-awards during the fiscal years 2005 through 2009 time period, the GAO identified \$3.8 million awarded to ACORN or potentially related organizations.[1]
To what extent did federal agencies' monitoring of ACORN or potentially related organizations' use of federal funding detect issues identified by inspector general and internal audits?	The determination to monitor ACORN awards was primarily based on: 1) the award amount; and 2) the agency's available resources. The form of monitoring ranged from reviewing progress reports to conducting site visits. Agencies monitoring these awards generally did not detect issues identified by inspectors general or internal audits.[2]
What federal investigations or prosecutions were conducted of ACORN or potentially related organizations from fiscal years 2005 through 2009, and what were the nature and results of these investigations and prosecutions?	The allegations of voter registration fraud and wage violations resulted in 22 investigations carried out by three agencies – the U.S. Department of Justice ("DOJ"), the Federal Election Commission ("FEC"), and the U.S. Department of Labor ("DOL"). Most of the cases were closed without prosecution. The DOJ investigated eight matters and one case resulted in a guilty plea by eight defendants. The FEC investigated five matters and one case resulted in a conciliation agreement with a penalty. The DOL investigated eight wage and hour disputes and a delinquent reporting matter, all of which resulted in corrective action with applicable requirements.
How have federal agencies subject to fiscal year 2010 provisions barring the distribution of appropriated funds to ACORN or its affiliates, subsidiaries, or allied organizations implemented those provisions?	The fiscal year 2010 federal funding restriction of ACORN was applicable to 27 of the 31 federal agencies. Of the 27 agencies, each agency (all 27) took some measure of action to ensure compliance with the funding restriction. Most agencies alerted staff via email, written memoranda or oral communications. Some agencies alerted awardees of the restriction. Finally, two agencies – Housing and Urban Development and the National Science Foundation – provided employees with guidance on the restriction.

Lessons Learned

While the ACORN matter involved just a few employees of a multi-national organization and a "sting" operation, the conduct of these individuals and the subsequent groundswell of public sentiment, coupled with the political climate, caused irreparable harm to the already embattled organization. Therefore, while a few employees do not speak for a nonprofit organization, in today's around-the-clock news cycle environment, where each federal dollar is closely scrutinized, they can certainly lead to its demise. As a result, it is important for nonprofits funded, even in part, through taxpayer dollars to be mindful not only of inappropriate conduct and bad press, but the mechanisms available to the federal government to take action, and of course, the tools available to such organizations to mitigate such action.

In the past, the federal government primarily relied upon the Executive Branch's prosecutorial powers to punish bad actors and unscrupulous organizations. However, the ACORN case is particularly telling as it shows Congress's inclination to punish for perceived violations of law. This includes the severe action of imposing statutory funding restrictions, as well as consistent efforts to impose mandatory suspension/debarment actions for certain misconduct. As a result, nonprofit organizations need to prepare themselves for not only criminal and civil defense, as well as heightened congressional scrutiny.

No nonprofit is immune from individual employees making bad decisions. Organizations must prepare themselves to be able to address and mitigate governmental action on all fronts. Many nonprofits believe they are prepared or have adequately protected themselves after the fact by hiring well-known defense counsel. While experienced counsel can be useful, there is much an organization can do preemptively to curb misconduct and also assist and better enable the organization's counsel to defend the organization should a situation arise.

Essential to every nonprofit organization should be an appropriate compliance and ethics program suitable to the size and sophistication of the organization. Often times, such programs may be viewed as cumbersome or burdensome, however, such programs can be creatively crafted to fit within existing practices or require only minor adjustments. At a minimum, these programs should include (to varying degrees of particularity and complexity depending on the organization):

- Documented policies and procedures, including codes of ethics and conduct, organizational conflict of interest policies, as well as appropriate program- and funding-specific policies and procedures;
- Training that educates and emphasizes employees on the organization's policies and procedures and to advise employees of who to contact with questions or concerns;
- Internal monitoring to ensure the organization's policies and procedures are effective in advising and assisting employees in conducting their business appropriately;
- Channels for employees and others to report potential issues;
- A crisis communication plan; and
- An individual appointed with overall responsibility for ensuring the adequacy of the compliance and ethics program, including ensuring that the policies, procedures, training and monitoring functions are adequate and to conduct and/or oversee investigations of potential issues.

Having a suitably tailored compliance and ethics program in place can help provide a nonprofit with a defense that it did as much as could reasonably be expected of the organization and that the organization itself, notwithstanding a few bad actors, is a reputable and responsible steward of taxpayer dollars.

* * * * * *

[1] While $3.8 million is not insignificant, the GAO noted that the number was perhaps larger than that during the time period under review because agencies were not required to collect information on sub-awards until after October 1, 2010.

[2] In only one case was an issue discovered by an inspector general also detected by the agency's monitoring processes. In this case, the agency recommended ACORN for suspension and debarment.

* * * * * *

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Understanding Force Majeure Clauses

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The aftermath of recent large-scale disasters like the terrorist attacks of September 11, 2001 and the storm and flood damage caused by Hurricane Katrina in 2005 have reinforced the importance of carefully planning for the unexpected when negotiating meeting contracts. If disaster strikes, will you be able to cancel your meeting without liability for cancellation fees? Will you be able to go ahead with the meeting, despite reduced attendance, without liability for attrition damages? A key tool in managing the risk of such challenging circumstances is the force majeure clause.

A “force majeure” clause (French for “superior force”) is a contract provision that relieves the parties from performing their contractual obligations when certain circumstances beyond their control arise, making performance inadvisable, commercially impracticable, illegal, or impossible. In the absence of a force majeure clause, parties to a contract are left to the mercy of the narrow common law contract doctrines of “impracticability” and “frustration of purpose,” which rarely result in excuse of performance. Instead of relying on the common law, meeting planners can better achieve flexibility during times of crisis through a carefully negotiated force majeure clause. Whether negotiating with or without the assistance of legal counsel, the following key elements of a force majeure clause should be addressed:

Anticipate and Specify Force Majeure Events.

Determining which types of circumstances will be covered by the force majeure clause is essential. Provisions often cover natural disasters like hurricanes, floods, earthquakes, and weather disturbances sometimes referred to as “acts of God.” Other covered events may include war, terrorism or threats of terrorism, civil disorder, labor strikes or disruptions, fire, disease or medical epidemics or outbreaks, and curtailment of transportation facilities preventing or delaying attendance by at least twenty-five percent of meeting participants.

Courts tend to interpret force majeure clauses narrowly; that is, only the events listed and events similar to those listed will be covered. For example, while acts of terrorism might be a specified force majeure event, it does not necessarily follow that a court would also excuse a party’s performance based on “threats” of terrorism. Thus, it is especially important to specify any types of circumstances that you anticipate could prevent or impede your meeting from being held.

To the extent possible, take into consideration the location of the meeting and any special needs or responsibilities of your organization and the meeting participants. What types of weather-related incidents are common for the meeting location? If there are major disruptions to transportation systems, will your participants be prevented from attending? What percentage of reduced attendance would make continuing with the meeting inadvisable? Asking and answering these types of questions will help you anticipate and specify the most critical force majeure events for your meeting. Even so, not all potential events can be specified or anticipated in the contract. A concluding catch-all phrase should be appended to the list, such as “and any other events, including emergencies or non emergencies,” to cover other unforeseeable events.

Beware of Restrictive Language.

It is common to find boilerplate force majeure language in meeting contracts limiting excuse of the parties’ performance obligations only when it would be “impossible” to perform due to the unexpected circumstances. Impossibility is a high threshold; many circumstances will make holding a meeting inadvisable, even though it would still be possible to do so. For greater flexibility, consider instead excusing performance when it would be “inadvisable, commercially impracticable, illegal, or impossible” to perform.

Additionally, even if you have negotiated a specified list of force majeure events, be sure to carefully read the language that comes before and after the list. Language appended after a comma can significantly alter the scope of the force majeure clause. For example, adding the words “or any other emergency beyond the parties’ control” to the end of a list of specified force majeure events serves to narrow the scope of triggering events only to “emergencies.” With such language, non-emergency circumstances making it inadvisable to hold a meeting would not be covered.

Consider Excusing Underperformance Due to Force Majeure.

Although a force majeure clause should always allow for complete cancellation of a meeting without penalty, cancellation will not always be the meeting planner’s preferred course of action. There may be circumstances in which going ahead with the meeting is preferred, despite the fact that the force majeure event will likely result in lower-than-expected attendance. However, groups that fail to meet minimum room or food and beverage commitments will often risk incurring significant attrition fees. To help make going-forward a viable option in such circumstances, the force majeure clause should be drafted to excuse liability associated not just with nonperformance (i.e. cancellation) but also with underperformance (i.e. failure to meet minimum guarantees).

A carefully negotiated force majeure clause is an important tool for reducing the risk of liability associated with cancelling or scaling back a planned meeting in response to a disaster. When significant resources are on the line, meeting planners should consider seeking advice of legal counsel prior to signing contracts, and should also consider obtaining meeting insurance. Taking appropriate precautions at the outset can provide reassurance that, even in the worst of circumstances, you will have the flexibility to make the best decision for your meeting.

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TOOLS FOR BYPASSING IRS DELAYS IN EO APPLICATIONS

Organizations and their representatives missed opportunities to mitigate the consequences of the IRS' delays and requests for inappropriate information.

Recently, the IRS admitted that it employed inappropriate criteria to select certain applications for recognition of tax-exempt status for additional review. Just a few days after this admission, on May 14, 2013, the Treasury Inspector General for Tax Administration (TIGTA) issued a report (the "TIGTA Report"),[1] concluding that, due to ineffective management, the Service: (1) developed inappropriate criteria to identify applications for additional review, (2) substantially delayed processing certain applications, and (3) issued unnecessary information requests as a result of such criteria and delays. Further, the TIGTA Report noted that the specialists charged with reviewing the selected applications "lacked knowledge" about the permissible activities of tax-exempt organizations described in Sections 501(c)(3) and (c)(4).[2] Predictably, in the aftermath of the TIGTA Report's publication, Congress and many sectors of the media have continued to rehash the particulars of this "scandal," looking to assign blame and find deeper connections between the Service's inappropriate criteria and other parts of the federal government, including the White House.

The purpose of this article is not to add to the noise surrounding the scandal. It will neither identify the parties at fault nor find the link between President Obama and the IRS selection of Tea Party organizations for additional scrutiny. It will not join the chorus of voices on either side of the aisle nor will it analyze who bears ultimate responsibility for the Service's internal structure and process. Rather, recognizing that the Service's inappropriate administration of tax-exemption qualification matters is not limited to the 296 completed applications reviewed under this program, and will not be entirely eliminated in the future, this article will discuss how organizations subject to extended IRS reviews can substantially mitigate the adverse effects of inappropriate enforcement efforts by the Service. Insofar as mismanagement, significant delays, and misinformed determinations specialists are potential issues in any IRS enforcement effort, practitioners must be equipped to combat the organizational ineffectiveness and bureaucratic inefficiency that can otherwise result in harm to clients applying for recognition of tax-exempt status.

Using the TIGTA Report as a point of departure, the discussion below identifies specific issues in the Service's review of requests for recognition of tax-exempt status and lists many of the common harms that can result from the Service's inappropriate actions. In that context, it then discusses proactive measures available to would-be tax-exempt organizations to help them mitigate the harms caused by inappropriate IRS delays or inquiries.

Issues identified in the TIGTA Report

Notwithstanding the general media attention devoted to the Service's use of inappropriate criteria to select organizations for additional review, other issues highlighted in the TIGTA Report should generate greater concern on account of their potential to cause substantial harm to organizations. Indeed, the Code limits the extent to which organizations described in Sections 501(c)(3) and (c)(4) may engage in lobbying activities and intervene in political campaigns. As such, it is a legitimate function of the Service to exercise additional scrutiny when information within an application, including the organization's name, indicates that the subject organization may be engaged in an inappropriate amount of political campaign activity. Of the issues noted by the TIGTA Report, the mere existence of additional review prior to approval was not highlighted as an issue of concern. In fact, while it determined that 91 out of 296 completed applications did not indicate significant political intervention,[3] the TIGTA Report estimated that an additional 185 applications should have been identified by the IRS for additional review, but were not.[4] Thus, although the TIGTA Report noted that the method used by the IRS gave "the appearance that the IRS is not impartial in conducting its mission,"[5] mere identification of organizations meriting further review is not unusual or particularly remarkable. Rather, the greatest harm arose from ineffective management and a determinations unit whose specialists lacked sufficient knowledge. This resulted in the Service's failure to make determinations on cases for, in some cases, more than two years, as well as its request for inappropriate information in its review of these entities.

The IRS took too long

The cover letter to the TIGTA Report noted that "many organizations had not received an approval or denial letter for more than two years after they submitted their applications. Some cases have been open during two election cycles (2010 and 2012)."[6] This is substantially longer than the Service's stated goal "of processing applications within 121 days."[7] In fact, through its review of these applications for tax-exempt status, the Service failed to close more than half of the cases identified for additional review.

Through this exemption application review program, the Service identified 296 complete applications for additional review because the applications indicated that the organization may be engaged in an impermissible amount of political activity.[8] Of the 296 organizations identified, 108 (approximately 36%) received a determination letter recognizing tax-exempt status.[9] In addition to the 108 examinations that were closed upon the recognition of tax-exempt status, 28 organizations withdrew their applications. Finally, as of the close of the TIGTA investigation, 160 cases (approximately 54%) remained open and had been open between 206 and 1,138 calendar days, with the average length of time being 574 days as of 12/17/12.[10]

The Service did not explain why it failed to close more than half of the cases that it identified for additional review. It is notable, however, that the Service failed to issue a single adverse determination to any organization whose application was identified for additional review. Moreover, the TIGTA Report makes no reference to any proposed adverse determinations, written protests, or any other actions by the Appeals Division. This suggests that not only did the Service fail to issue final adverse determination letters, but it failed to even issue any proposed adverse determination letters. What makes the absence of any adverse or proposed adverse determination letters so troubling is the fact that these cases were identified for additional review because the Service's initial review indicated a significant risk that these organizations should not be recognized as exempt under either Section 501(c)(3) or (c)(4). In other words, the Service failed to even propose the issuance of a single adverse determination after spending an average of 574 days on cases that were identified because of a substantial risk that the applicants would not satisfy the requirements for tax-exempt status. That leaves observers to draw their own conclusions, three of which are: (1) the "cynical supposition" that the Service's administration of these cases was so inept that it incorrectly identified almost 300 organizations as demonstrating a substantial likelihood of failing to qualify for tax-exempt status, only to conclude that the organizations are, in fact, exempt; (2) the "conspiracy theorist's supposition" that the Service deliberately delayed the issuance of any determinations, adverse or otherwise, for some unknown, nefarious reason; and (3) the authors' supposition that the Service, unsure of about the litigating hazards of its position relating to proposed adverse determinations, deliberately added layer after layer of administrative review so as to avoid having to issue any ruling to these organizations.

There is no evidence to support any of the suggested suppositions. The first and second are hopefully, and likely, incorrect. With respect to the third possibility, however, this would not be the first time that the Service decided to confront uncertainty in litigation by adding multiple layers of administrative review and substantial delay in the hopes that an organization awaiting a determination letter or subject to a proposed revocation letter simply goes away. Recently, in the credit counseling compliance project, several organizations waited so long-nearly a decade-to receive a final determination letter relating to their examination that they actually filed a petition for a declaratory judgment in the Tax Court prior to receiving a final adverse determination letter. Additionally, when one considers the many errors identified in the TIGTA Report-inappropriate selection of organizations for additional review, the request of unnecessary and inappropriate data regarding the political activities of individuals working with these organizations, and the improper disclosure of taxpayer information-it is not inconceivable that the Service was more than a little concerned about the litigating hazards created by its review of these applications.

Unnecessary and inappropriate information

The issues relating to the Service's review of these organizations were not limited to delays of time. Its actions during that review were equally problematic. The report noted a "lack of management review, at all levels" and also that the "Determinations Unit specialists lacked knowledge" about permissible activities for tax-exempt entities described in Sections 501(c)(3) and (c)(4).[11] As a result of this lack of management review and knowledgeable Determinations Unit specialists, the TIGTA Report counted 98 organizations that received inappropriate and unnecessary requests for additional information.[12] Specifically, the TIGTA Report noted that the Service's requests for additional information included seven questions that were not necessary to make a determination of an organization's tax-exempt status, including:

- The names of donors.
- A list of all issues important to the organization and the organization's position regarding such issues.
- The roles and activities of the audience and participants other than members in a particular activity, and the type of conversations and discussions members and participants had during the activity.
- Whether an officer, director, etc., has run or will run for public office.
- The political affiliation of any officer, director, speaker, candidates supported, etc., and, their relationship with an identified political party.
- Information regarding employment, other than for the organization, including hours worked.
- Information regarding activities of other organizations, not just the relationship of such organizations to the applicant.

Consequences of the inappropriate actions

Tax advisors, beyond providing technical expertise, strive to position clients to realize their business, programmatic, and operational goals. Since "timing is everything," they risk angering and alienating clients if the time and logistical complexities of legal or regulatory requirements prevent those clients from achieving their desired outcomes. This phenomenon manifests itself regularly when clients must be informed that their applications for recognition of tax-exempt status will likely take six to 12 months, if not longer, to be processed by the IRS.[13] Moreover, on top of the standard processing delays that have become the "new normal" at the IRS, the further delays caused by the questioning tactics identified in the TIGTA Report added further insult to injury. Far beyond the universe of potential Section 501(c)(3) and (c)(4) organizations, many constituencies suffer as a result of the Service's present inability to process exemption applications expeditiously.

The delays and inappropriate information requests had a unique effect on three groups: (1) the organizations under review that applied for Section 501(c)(3) status, (2) the organizations that applied for Section 501(c)(4) status, and (3) the contributors to and officers of these organizations.

Applying for Section 501(c)(3) status

For an organization applying for recognition of tax-exempt status under Section 501(c)(3), protracted delays in IRS review can prevent the organization from timely commencing its operations and, in some instances, jeopardize the organization's long-term viability.

As a practical matter, many new organizations awaiting confirmation of tax-exempt status commence fundraising activities even while their applications are pending. When engaging individual or corporate donors, the applicant organization can often provide sufficient comfort that its tax-exempt status will eventually be recognized. So long as an organization has applied for tax-exempt status within 27 months following the month of its formation, assuming that the IRS ultimately grants recognition of exemption, such recognition will apply retroactively to the organization's date of incorporation. More often than not, this information satisfies individual or corporate donors and such donors willingly take the small "leap of faith" that the IRS will, in fact, issue a favorable determination letter. Thus, the donors make contributions and claim charitable deductions, and in hindsight it eventually becomes clear that such contributions were made to a charitable organization exempt under Section 501(c)(3).

This approach, however, does not typically succeed with potential donations from private foundations (PFs) or donor-advised funds (DAFs). PFs and DAFs are subject to rules that prohibit taxable expenditures, and grants to organizations that are not classified under Section 501(c)(3) count as taxable expenditures unless the grantor (i.e., the PF or sponsoring organization that houses the DAF, as the case may be) exercises expenditure responsibility over those grants. Generally, as a matter of practice, PFs and sponsoring organizations simply refuse to award grants until a grantee demonstrates that the IRS has recognized it as a Section 501(c)(3) organization (and, in the case of PF grantors, as a public charity). Thus, newly-formed organizations may encounter increased difficulty in generating donations from otherwise-willing donors. This is particularly true as DAFs grow in popularity and more potential donors establish DAFs and choose to conduct their charitable giving through those vehicles.

For organizations whose early-stage operations require such grants-whether to hire staff, conduct programs, acquire charitable-use assets, or procure work space-the prolonged delay in receiving an IRS determination letter can severely handicap their development. Moreover, for publicly visible organizations whose creation and expected operations are well known to the communities they purport to serve, the ongoing delay as a result of IRS refusals to issue a determination letter can deteriorate public confidence and threaten the entity's viability.

In addition to initial inability to obtain adequate funding, prolonged delay in receiving a determination letter can also curtail the organization's ability to engage in certain activities and/or subject the organization to potential liabilities from which it would otherwise be protected. For example, many states impose their own registration requirements on new charities. This can be a requirement for procuring state-level tax-exemption, conducting fundraising activity, or transacting purchases free of sales tax. In many cases, as part of its registration process, a state will require the applicant organization to produce a copy of an IRS determination letter. Thus, if the IRS review process stretches over many months or years, the organization may be forced to delay its fundraising (or, alternatively, conduct fundraising in violation of state requirements), just as it must pay thousands of dollars in sales tax in connection with necessary purchases, transactions, and the like.

Similarly, several states have for years prohibited organizations from engaging in credit counseling activities within the state unless the organization was recognized as exempt under Section 501(c)(3). Recognition of exemption under Section 501(c)(3) protects organizations from lawsuits for violation of the Credit Repair Organizations Act,[14] which provides a private right of action for violations of its provisions. Thus, during an extended delay in reviewing an organization's application for recognition of tax-exempt status, an organization may be unable to participate in the very activities for which it was organized or may be subject to laws from which it would otherwise be exempt.

Finally, organizations victimized by unduly delayed IRS reviews stand to incur tens of thousands of dollars, if not more, in increased legal and other professional expenses. This is particularly true in circumstances like those considered in the TIGTA Report-multiple Service reviews of an application and requests for a substantial amount of additional information that may be inappropriate and unnecessary to determine the organization's tax-exempt status. In such situations, tax advisors spend significant time challenging IRS agents in response to unwarranted requests and in addressing lengthy lists of questions and demands for additional information. The applicant organization often feels that it has no choice but to incur these costs, because it sees no other option but to adhere to the Service's demands. For many new organizations, the resulting bills can throw yet another wrench into the process of beginning operations on solid financial footing.

Applying for Section 501(c)(4) status

Many of the problems listed above for potential Section 501(c)(3) organizations may also be encountered by newly-formed Section 501(c)(4) entities. For instance, the professional expenses and problems related to unnecessary requests for information affect organizations seeking recognition of exempt status under either Section 501(c)(3) or (c)(4). Moreover, while Section 501(c)(4) organizations do not seek to secure tax-deductible charitable contributions from donors, they may nevertheless encounter political donors or contractors that insist on verifying the organization's tax-exempt status prior to making a contribution or entering into a contract. This is a very important consideration for donors in light of the Supreme Court's decision in *Citizens United v. F.E.C.*,558 US 310, 175 L Ed 2d 753 (2010), and the role of Section 501(c)(4) entities in campaign financing. For these reasons, some of the organizations whose applications were identified for additional review, and whose determination was delayed by two election cycles, quite possibly had filed their applications with the specific purpose of addressing the concerns of potential donors. As such, new Section 501(c)(4) organizations may find themselves every bit as hamstrung in commencing operations as their Section 501(c)(3) counterparts that rely on grants from PFs or DAFs.

The common denominator in these situations? Undue delay on the part of the IRS causes real economic harm to the very organizations that, as a matter of policy, Congress has determined to be socially beneficial and therefore deserving of tax-exempt status. As a result, in its role as gatekeeper to ensure that fraudulent organizations do not inappropriately procure tax-exempt status for unsanctioned purposes, the IRS has instead effectively prevented individuals, families, and communities from accessing the benefits of organizations that seek tax-exempt status legitimately.

Finally, as the TIGTA Report noted, the "Determinations Unit specialists lacked knowledge of what activities were allowed by I.R.C. 501(c)(3) and I.R.C. 501(c)(4) tax-exempt organizations."[15] As such, the individuals charged with reviewing and making determinations of the exempt status of these applicants lacked a sufficient understanding of the law. This resulted in the Service's request for inappropriate and unnecessary information, which in turn increased the expense, delay, and adverse impact of the additional review. Additionally, by subjecting themselves to the extended review by individuals lacking sufficient knowledge of Section 501(c)(4), any of these organizations that satisfied the requirements for recognition of tax-exempt status were at risk of receiving a proposed adverse determination simply as a result of the reviewer's lack of adequate knowledge about the acceptable activities of organizations described in Section 501(c)(4).

Contributors and organization officers

In addition to the applicant organizations themselves, the contributors to, as well as the directors and officers of, such organizations likewise suffered adverse effects from the Service's requests for additional information. The focus of the additional information requests noted in the TIGTA report was on the identities of these individuals, as well as their political leanings and activities. The additional information requested by the Service focused on private information and, by virtue of including it in the administrative record for a tax-exempt organization, made such information publicly available. Thus, the Service's actions could have resulted in inappropriately publicizing the private speech and beliefs of individual citizens, simply on account of such individuals' association with an organization applying for recognition of exemption.

By exposing the private beliefs and activities of individual citizens to the public record, the Service's actions, intentionally or unintentionally, risked creating a "chilling effect" on the free speech of individuals whose private views became public. This is especially true with respect to donors to the Section 501(c)(4) applicants. With the recent changes to the legal landscape for organizations that engage in political activities, resulting in the rise of "super PACs," a primary appeal of making contributions to Section 501(c)(4) organizations was the anonymity that such contributions afforded donors. As such, it is reasonable to assume that a significant portion of the donors to Section 501(c)(4) organizations made contributions to those particular organizations specifically because they wanted to contribute to a cause in which they believe, but without being publicly linked to that cause. By effectively forcing organizations to publicly disclose the names of such donors, the Service eliminated the benefit of anonymity, which may in turn discourage individuals from fully participating in the political process in the future. Regardless of whether one believes that individuals or organizations should be able to make indirect anonymous contributions to political campaigns through Section 501(c)(4) organizations, the law currently allows such activity. The Service's directive, as provided by the Code, is to enforce the law. Thus, by requesting and disclosing certain taxpayer information which identified the political beliefs and identities of individual citizens, the Service abused its authority.

What was done to mitigate organizational harm?

The TIGTA Report notes that, as of 12/17/12, 160 of the 296 identified organizations had yet to receive any determination from the Service, notwithstanding that the *average* delay had reached 574 days. Of the cases that remained open, 70 organizations applied for recognition of exempt status under Section 501(c)(3) and 90 organizations applied for recognition of Section 501(c)(4) status. However, despite the long delay and availability of other remedies, it appears as though few, if any, of these organizations took any action to expedite or remove the review of these applications from the Service's purview.

The TIGTA Report noted that, as of 5/31/12, the declaratory relief provided by Section 7428 was available to 32 of the organizations selected for review-approximately 46% of open Section 501(c)(3) cases-because those cases "were open more than 270 calendar days, and the organizations had responded timely to all requests for additional information."[16] Additionally, as of 12/17/12, only 3 of the 260 cases had been open for less than 271 days.[17] Thus, notwithstanding the fact that requests for more than 95% of the organizations seeking exemption under Section 501(c)(3) had been open for more than 270 days without a determination from the IRS, the TIGTA Report noted that "none of these organizations had sued the IRS, even though they had the legal right."[18]

As discussed below, the right to seek a declaratory judgment relating to tax-exempt status is reserved for organizations that apply for tax-exempt status under Section 501(c)(3). That being said, a different potential remedy remained available to organizations that applied for recognition of exempt status under Section 501(c)(4) -the fact that organizations described in Section 501(c)(4) are not actually required to file an application seeking recognition of tax-exempt status. Such organizations can simply self-certify that they do in fact qualify for such tax-exempt status. As such, any organization that had applied for tax-exemption under Section 501(c)(4) could have withdrawn its application and avoided the risk and expense associated with the Service's extremely long and burdensome review. However, despite the ease of such an action, the TIGTA Report noted that 90 organizations continued to wait on the Service for more than 200 days, with some waiting more than 1,100 days. Only 28 organizations opted to withdraw their application from IRS review.[19]

Finally, the TIGTA Report noted that 98 organizations received information requests that sought "irrelevant (unnecessary) information because of a lack of managerial review."[20] While 27 of these organizations were subsequently informed by the Service that they need not respond to such information requests, at least 71 organizations were required to respond. Also, while the TIGTA Report does not indicate what portion of the organizations provided the requested information, it appears that many organizations did so.[21] The TIGTA Report does not contain a record of any organizations expressly refusing to provide such information.

Based on the information provided in the TIGTA report, it appears that these organizations failed to take any significant action to curtail the extended IRS review of their applications or avoid responding to the overbroad and inappropriate information requests.

Was there any advantage to enduring the review?

With so many organizations enduring the Service's extended review of their applications for exempt status, it is important to ask why these organizations subjected themselves to that review and whether there were any potential benefits from doing so. The authors are not aware of any advantages of undergoing a prolonged IRS review. First, there is no tax or other advantage to being "under IRS review" as opposed to being recognized as exempt.[22] Second, after more than a year in a state of limbo without any correspondence from the IRS, the organizations should have begun to wonder whether the Service would provide an unbiased review of their applications. In fact, the TIGTA investigation arose because several organizations complained to members of Congress about the Service's biased treatment. Thus, if these organizations were already questioning whether the IRS was biased, it may have been in their best interest to remove their cases from the Service's review by seeking a declaratory judgment from a less biased judge or by self-certifying their Section 501(c)(4) status.

Another consideration for organizations that applied for Section 501(c)(3) status should have been the impact of removing the case from the Service's review. By forcing the issue before a court of applicable jurisdiction, these organizations could have brought public attention to their plight long before the TIGTA Report was published in June 2013. Also, this could have worked as a diversion in the review of their cases. The mere fact that these organizations were selected for review is an indication of the existence of some questions regarding their qualification for tax-exempt status. By bringing a case to court after such an extended period of inaction, the initial question that would be presented to the court would relate to the Service's unexplained delays, rather than any questions pertaining to the organization's qualification for tax-exempt status. This would have put the Service in the position of needing to justify its substantial delays in a public forum, which would have accomplished one of two things. The more likely result is that the IRS would have been prompted to settle the case to avoid the public embarrassment that has unfolded in the aftermath of the TIGTA Report. Alternatively, litigation would have brought public attention to the Service's practices years before the TIGTA Report was published.

What could have been done?

As representatives of tax-exempt organizations, advisors' responsibilities exceed merely navigating the IRS administrative process and responding to requests for information when the IRS eventually reviews an application. Rather, they are responsible for achieving the results that best serve the clients' interests. As such, to the extent that additional avenues-inside the IRS and out-provide possible means to achieve the desired results in an effective and efficient manner, advisors should at a minimum present those options to clients for their consideration. Moreover, clients must be given the information and context necessary for them to make an informed decision on whether to pursue such options, particularly when they represent a departure from common practice.

Declaratory judgment

Once it became clear that the IRS review of applications of Section 501(c)(3) organizations was not going to be approved under the standard process, organizations confident of their position should have considered seeking a declaratory judgment.

Under Section 7428, the United States Tax Court, the United States District Court for the District of Columbia, and the United States Court of Federal Claims have concurrent jurisdiction to issue a declaratory judgment in the case of an actual controversy with respect to a determination or the Service's failure to make a determination regarding the initial qualification of an organization described in Section 501(c)(3). It is important to note that this remedy is available for Section 501(c)(3) organizations only; it is not available to other types of exempt organizations, including those described in Section 501(c)(4).

To meet the jurisdictional requirements necessary to obtain a declaratory judgment, Section 7428(a) provides that there must be "(1) an actual controversy (2) involving a determination or a failure to make a determination by the Secretary (3) with respect to an organization's initial or continuing qualification or classification as an exempt organization."[23] Additionally, Section 7428(b) provides that a declaratory judgment shall not be issued unless the court "determines that the organization involved has exhausted administrative remedies available to it within the Internal Revenue Service."

Actual controversy. Generally, courts have interpreted the "actual controversy" requirement to mean that "the power to issue declaratory judgments does not extend to advisory opinions on abstract or hypothetical facts, which do not involve any case or controversy."[24] As such, courts have determined that they lack jurisdiction over cases in which the Service has "not spoken finally with regard to [the] petitioner's status";[25] and that they do not have jurisdiction over cases in which the Service merely threatens revocation if an organization engages in a particular activity in the future.[26] Finally, the courts have ruled that the scope of their jurisdiction to issue declaratory judgments is limited to controversies related to initial or continuing classification "with respect to exempt status, the private foundation status or the private operating foundation status (as defined in 4942(j)(3)) of an organization."[27] As such, courts have determined that they lack jurisdiction over questions of donor deductibility of charitable contributions.[28]

With respect to the organizations discussed in the TIGTA Report, the issue under consideration within the IRS was whether the organizations were exempt under Section 501(c)(3). Thus, any dispute over such matters would constitute a controversy over which the courts have jurisdiction pursuant to Section 7428 .

Failure to make a determination. Under Section 7428(a)(2), in order for a court to have jurisdiction to make a declaratory judgment due to the Service's failure to make a determination, an organization must first make a request for such a determination. Generally, this is done by submitting a Form 1023, "Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code ."

Courts considering this issue have noted that neither the statute nor the regulations defines either a "failure to make a determination" or a "request for a determination."[29] However, courts considering whether a request for a determination was made have all recognized that the filing of a substantially complete application within the meaning of Regs. 601.201(n)(7)(iv)(a) and (b) is a "request for a determination."[30] When considering whether the Service has failed to make a determination, the courts have looked to the legislative history of Section 7428, which provides that the courts will have jurisdictional authority over an issue where the Service has failed to act on a request for a determination.[31]

In the present situation, the reason for the substantial delays was the Service's identification of each of these entities based on the information provided in the Form 1023. As such, it is clear that the organizations in question made a "request for determination." Moreover, the TIGTA Report noted that the Service had failed to act with respect to any of these requests for a determination since the Service failed to make a determination with respect to these organizations.

Exhaustion of administrative remedies. An organization is deemed to have exhausted its administrative remedies as of the earlier of: (1) the notice of a final determination or (2) the expiration of the 270-day period after filing its application for recognition of tax-exempt status. Specifically, Section 7428(b)(2) provides that an organization "shall be deemed to have exhausted its administrative remedies with respect to a failure by the Secretary to make a determination with respect to such issue at the expiration of 270 days after the date on which the request for such determination was made if the organization has taken, in a timely manner, all reasonable steps to secure such determination." In *BBS Associates*, 74 TC 1118, 2 EBC 2413 (1980), noting the Service's failure to issue a determination of tax-exempt status after 21 months, the court concluded that the applicant organization had exhausted its administrative remedies after an "inordinately long delay by the [Service] in processing the petitioner's application and arriving at a final determination."[32]

Although the 270-day period creates a presumption that an organization has exhausted its administrative remedies, the expiration of 270 days alone does not satisfy the jurisdictional requirements for a declaratory judgment.[33] An organization must have also taken, "in a timely manner, all reasonable steps to secure a ruling or determination."[34] When determining whether an organization has exhausted its administrative remedies under this standard, the courts have looked to the legislative history, one court noting that the purpose of this requirement is "to provide the Court with a full and complete administrative record on which to base its decision."[35] Moreover, the legislative history provides that an organization will not have exhausted its administrative remedies "if the organization fails to comply with a *reasonable* request by the Service to supply the necessary information on which to make a determination."[36] However, these additional requirements have not been read to require organizations that have not received a determination within 270 days to wait to file a petition for declaratory judgment until they have had the opportunity to exhaust all administrative remedies within the Service.

In *Gladstone Foundation*, 77 TC 221, 226 (1981), the court noted that Section 7428 "was intended to provide a remedy for hardships caused by undue administrative delays."[37] As such, in considering cases where 270 days have lapsed, courts have not looked to whether organizations have exhausted every potential administrative remedy. Rather, courts have looked to whether the organization "has taken timely, reasonable steps to secure a determination."[38] Thus, in the present situation, as of the publication of the TIGTA Report, the organizations discussed in the report likely would have been deemed to have exhausted their administrative remedies as of the expiration of 270 days, even though the organizations whose exemption was under consideration within the Service had not completed all available administrative processes within the Service.

Self-certification

Section 7428 does not apply to Section 501(c)(4) entities[39], and therefore its provisions do not extend to any entity that has submitted a submitted Form 1024 for recognition of exemption under Section 501(c)(4) (or any other 501(c) classification[40]). As such, organizations that file a Form 1024 are not permitted to seek a declaratory judgment in situations where the IRS refuses to issue a determination. Nevertheless, while a declaratory judgment is not available to such organizations, there are other options to avoid unreasonable IRS demands or delays. In particular, Section 501(c)(4) organizations can make use of the fact that they generally are not required to seek an IRS determination on their tax-exempt status, and need not await a formal IRS determination at all. Such organizations can instead "self-certify" as tax-exempt.

Section 508(a) requires most organizations seeking treatment as Section 501(c)(3) organizations to notify the Service of their intent to be treated as exempt by filing a Form 1023. However, Section 508(a) does not extend to other types of Section 501(c) tax-exempt entities. Therefore most such organizations may, of their own volition, determine that they meet the applicable parameters of a desired category of tax-exemption and conduct their business accordingly.[41] Indeed, the Internal Revenue Manual states that actual tax-exempt status arises as a matter of law; an IRS determination letter merely provides formal recognition of such status.[42] Thus, while Section 501(c)(4) organizations must file an annual Form 990 information return, they need not formally apply for tax-exempt status by submitting Form 1024. Nevertheless, many organizations opt to file Form 1024 in any event, whether for "peace of mind," to avoid future IRS allegation of taxable status, or to demonstrate formal IRS recognition for other purposes (*e.g.*, as a condition of obtaining state-level exemption, or to satisfy the needs of a potential contributor or contract-party).

Organizations subject to lengthy IRS delays or inappropriate questioning in response to a Form 1024 submission could opt to rely on self-certification and withdraw their previously submitted applications. Doing so would effectively end the IRS review, thus saving the financial and human resources that would otherwise be devoted to responding to the Service's inquiries. Similarly, to the extent that the IRS poses questions that may involve sensitive information, such as the identities of certain individuals as well as their political leanings and political activities, withdrawal of the application allows the organization to ensure that such information remains confidential and does not become inappropriately disclosed and thereby part of a publicly disclosed record. Of greatest importance, cancelling the organization's request for recognition of exemption avoids the risk that an under-informed determinations specialist, perhaps one not adequately familiar with the rules governing Section 501(c)(4) organizations, will incorrectly issue an adverse determination letter, refusing to recognize the organization's tax-exempt status.

Notwithstanding these potential benefits, the organization should confer with counsel to ensure that a decision to terminate a request for recognition of exemption will not unwittingly subject it to other, undesired consequences. For example, if state-level income tax exemption requires the organization to produce a copy of a favorable IRS determination letter, the potential state-level tax exposure may mandate that the organization proceed with its request for federal recognition. Similarly, depending on the organization's business model and expected sources of revenues, a favorable IRS determination letter may prove necessary.

However, once it became clear that the IRS review of applications of Section 501(c)(4) organizations were not going to be reviewed under the standard process for review of Forms 1024, organizations that were not seeking a determination letter to satisfy a donor or contractor requirement should have evaluated their reasons for filing a Form 1024 and considered whether it was in their best interest to withdraw their applications and self-certify their status as Section 501(c)(4) organizations. In the face of a prolonged IRS review, such as the one to which that the applicants at issue were subjected, self-certification offers distinct advantages.

Refuse to provide inappropriate information

When dealing with requests for information related to applications for tax-exempt status, advisors must remain knowledgeable and aware of: (1) the type of information that the IRS needs in order to make the requested determination, and (2) the purpose for which additional information is being requested. As such, upon receiving a request for information that the IRS does not need in order to make a determination, or whose purpose appears unclear, advisors should ask the IRS for clarity about the function of the requested information. In some instances, it may be appropriate to protect clients' interests by advising them not to provide such information.

The mere fact that the IRS requests information does not mandate that such information be shared. In some instances, the intended information is not clearly represented by the request and a discussion with the IRS may provide insight into the actual information desired or the previously unknown reason that the information is requested. Alternatively, after informing the IRS that a particular request is inappropriate, the IRS may choose to withdraw its request. By limiting the scope of information provided to the IRS, attorneys can help clients protect donors and other key individuals, as well as limit the likelihood that the IRS will rely on inappropriate information to make an adverse determination.

In the case of Section 501(c)(3) applicants, the refusal to provide information requested by the Service may raise concerns related to whether such a refusal may prevent an organization from obtaining a declaratory judgment under Section 7428 . However, though organizations are required to exhaust their administrative remedies, the legislative history and cases interpreting this statute are in agreement that the exhaustion of administrative remedies only requires organizations "to comply with a *reasonable* request by the Service to supply the *necessary* information on which to make a determination."[43] Therefore, the exhaustion of administrative remedies standard does not require organizations to respond to requests that are neither reasonable nor necessary, such as those discussed in the TIGTA Report.

Aftermath

In the aftermath of the Service's review of these issues, two significant developments have occurred. First, the IRS responded to criticism over its handling of certain Section 501(c)(4) cases by creating a process for expedited treatment of the organizations subject to this review program. Second, several of the organizations have acted on the TIGTA Report's advice and brought cases seeking a declaratory judgment, as well as other relief, in district courts throughout the country.

IRS response

In response to the well-publicized mishandling of Form 1024 applications, the IRS has recently offered a streamlined "hybrid" approach, combining the self-certification model with a formal recognition of tax-exempt status. For organizations whose applications had, as of 5/28/13, been pending for more than 120 days, so long as these applications do not raise questions of private inurement, the IRS has issued or will issue Letter 5228[44], which invites the applicant organizations to "self-certify" and make the following representations under penalties of perjury:

- The organization devotes 60% or more of its spending and time to activities that promote "social welfare" within the meaning of Section 501(c)(4).
- The organization devotes less than 40% of its spending and time to political campaign intervention.
- The organization certifies that the above-stated percentage threshold apply for past, present, and anticipated future activities of the organization.

If an organization is able and willing to make these representations, it may return the appropriate signed pages to the IRS. The IRS has committed to issue a favorable determination letter within two weeks of receiving the signed representations. Organizations desiring to take advantage of this expedited process must return their signed representations within 45 days. That being said, this expedited process is optional, and organizations may choose to continue seeking recognition of tax-exemption under their previously submitted Form 1024 through normal processes.

Tax litigation

One purpose of this article is to explain that more should have been done by organizations and their representatives to obtain a quicker determination from the IRS, including seeking a declaratory judgment from a court of appropriate jurisdiction. As such, it may be surprising that the authors do not believe that the majority of claims that have been filed to date as a result of this exemption application review program are viable cases. Nevertheless, based on an analysis as to whether a court will have jurisdiction over the issues raised in the complaints that have been filed since the publication of the TIGTA Report, it appears that many of the claims may not prove successful.

Since the TIGTA Report was published, three cases have been filed by organizations seeking declaratory, injunctive, and other relief resulting from the Service's review of applications identified for additional review. *NorCal Tea Party Patriots v. IRS, et al.* ("*NorCal Tea Party*")[45] is a class action filed in the U.S. District Court for the Southern District of Ohio seeking monetary damages resulting from the prolonged IRS review of the exemption applications. *True the Vote, Inc. v. IRS, et al.* ("*True the Vote*")[46] was filed in the U.S. District Court for the District of Columbia seeking declaratory, injunctive, and monetary relief. Also filed in the U.S. District Court for the District of Columbia was *Linchpins of Liberty, et al, v. U.S., et al.* ("*Linchpins of Liberty*")[47], which seeks declaratory, injunctive, and monetary relief on behalf of 25 organizations that were subject to the Service's prolonged examination of their applications for tax-exempt status.[48]

Filed on a behalf of a single organization that made a request for tax-exempt status that was not acted on, the *True the Vote* case provides the closest example of a traditional suit for declaratory judgment. The case was filed in a court of appropriate jurisdiction, the U.S. District Court for the District of Columbia, and the claim for relief expressly seeks a declaration that the organization qualifies both as an organization described in Section 501(c)(3) and as a public charity described in Sections 509(a)(1) and 170(b)(1)(A)(vi). In addition to declaratory relief, the complaint filed by True the Vote seeks: (1) a declaration that the Service's policies were unconstitutional, (2) a permanent injunction prohibiting IRS enforcement using similar policies, (3) a permanent injunction prohibiting the Service from illegally inspecting True the Vote's return information, (4) an order that the Service must implement the recommendations of the TIGTA Report, (5) damages for each unauthorized inspection of True the Vote's return information, (6) actual and punitive damages related to True the Vote's expenses related to the Service's review of its Form 1023, and (7) reasonable attorney fees.

The *Linchpins of Liberty* case represents a far less traditional request for declaratory judgment. First, it was filed on behalf of 25 organizations, two of which applied for recognition of Section 501(c)(3) status while 23 applied for recognition of Section 501(c)(4) status. Second, the grounds for the declaratory relief are primarily focused on the Service's alleged violations of the plaintiffs' constitutional rights-specifically the First and Fifth Amendments-though the complaint does seek Section 7428 declaratory relief as well. In addition to the declaratory relief and constitutional issues, the plaintiffs requested a declaration that the Service violated the Administrative Procedures Act (APA)[49] as well as an injunction that permanently prohibits the Service from unlawfully targeting the plaintiffs and compelling the Service to recognize the plaintiffs' tax-exempt status. Also, similar to the complaint in *True the Vote*, the complaint in the *Linchpins of Liberty* case seeks damages for the unauthorized inspection of return information, actual and punitive damages related to the Service's prolonged review of the plaintiffs' applications for tax-exempt status, and reasonable attorney fees. Finally, the *Linchpins of Liberty* complaint demands a jury trial.

Taken separately, with respect to the declaratory and injunctive relief requested, a court is far more likely to have the jurisdictional authority over the *True the Vote* case than over the *Linchpins of Liberty* case, because the *True the Vote* complaint is related to a single organization entitled to the declaratory relief requested pursuant to statutory authority, Section 7428 . On the other hand, the *Linchpins of Liberty* complaint includes only two organizations that are entitled to the statutory relief provided by Section 7428, and 23 organizations that fail to qualify for such relief because they sought recognition of exempt status under Section 501(c)(4), not Section 501(c)(3). Additionally, because of the multitude of plaintiffs and myriad issues raised in the *Linchpins of Liberty* complaint, the complaint is unable to clearly demonstrate the court's jurisdiction over the two plaintiffs who would otherwise be entitled to the declaratory relief. Taken together, these cases present a variety of interesting though ultimately untenable arguments seeking declaratory and other relief, including: (1) a declaration and injunction based on violations of the plaintiffs' constitutional rights, (2) a declaration and injunction based on violations of the APA, (3) declaratory relief sought by organizations that applied for recognition of Section 501(c)(4) status, and (4) a request for a jury trial.

Declaratory and injunctive relief based on violations of constitutional rights

The constitutional violations raised in these complaints include violations of the Free Speech Clause of the First Amendment, violations of the Due Process Clause of the Fifth Amendment, and violations of the right to free association implicit in the First and Fifth Amendments. Courts have considered these issues before, ruling that the

Service's denial of exemption does not violate these rights and, in light of the limitations of the Anti-Injunction Act (AIA)[50] and the Declaratory Judgment Act (DJA)[51], the court lacks authority to enjoin the Service from enforcement of the Code pursuant to such claims.

First, the specific issue of whether denial of tax-exempt status was a violation of First or Fifth Amendments was considered by the D.C. Circuit in *Taxation with Representation of Washington v. Blumenthal*, 48 AFTR 2d 81-5244, 81-1 USTC ¶9329 (D.C. Cir., 1981). In *Taxation with Representation*, the court rejected the argument that the failure to grant an organization's tax-exempt status violated either the First or Fifth Amendments. With respect to the First Amendment, the court noted that it was bound by a prior decision in which it cited the Supreme Court's decision in *Cammarano*, 3 AFTR 2d 697, 358 US 498, 3 L Ed 2d 462, 59-1 USTC ¶9262, 1959-1 CB 666 (1959)[52], holding that the taxpayers were "not being denied a tax deduction because they engage in constitutionally protected activities, but are simply being required to pay for those activities entirely out of their own pockets as everyone else engaging in similar activities is required to do."[53]

Second, the relief requested with respect to each of these counts is a declaratory judgment regarding the rights of the parties. However, in its 1974 decision in *"Americans United," Inc.*, 33 AFTR 2d 74-1289, 416 US 752, 40 L Ed 2d 518, 74-1 USTC ¶9439, 1974-2 CB 401 (1974), the U.S. Supreme Court considered very similar arguments and expressly determined that it lacked the jurisdictional authority to grant such declaratory relief. Specifically, the Court ruled that such relief was prohibited by the DJA, which generally authorizes suits for declaratory judgment in cases of actual controversy "except with respect to federal taxes,"[54] and the AIA, which generally provides that "no suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court by any person, whether or not such person is the person against whom such tax was assessed."[55] Based on these provisions, the Court expressly determined that it lacked the jurisdictional authority to grant the requested relief, even though the it included a lengthy discussion about the harm to which the plaintiffs were subjected, going so far as to suggest that Congress act to permit such suits. Shortly thereafter, Congress passed Section 7428 to provide an express exception to the DJA in cases of an actual controversy relating to an organization's initial or continuing qualification for tax-exempt status under Section 501(c)(3). Therefore, based on the Supreme Court's express ruling in *"Americans United," Inc.*, it is clear that the courts lack jurisdiction to grant the requested declaratory and injunctive relief granted in the present cases.

Declaratory and injunctive relief based on violation of the APA

Obtaining declaratory and injunctive relief based on violations of the APA is also problematic. The relief sought includes a declaration of the rights of the parties and a permanent injunction that: (1) prohibits the IRS from future enforcement and (2) mandates that the IRS immediately recognize as exempt plaintiffs that are not currently recognized as exempt.

Generally, the APA provides that a "person suffering legal wrong because of agency action, or adversely affected or aggrieved by agency action within the meaning of a relevant statute, is entitled to judicial review thereof," and allows courts to issue an injunction against a federal regulatory agency where there is a violation of an agency's published administrative procedures that causes irreparable harm to a taxpayer.[56] However, section 702(2) provides that the APA does not confer authority to grant relief if any other statute "expressly or impliedly forbids the relief which is sought."

The situation presented here is similar to the situation that the Supreme Court considered in *Bob Jones University v. Simon*, 33 AFTR 2d 74-1279, 416 US 725, 40 L Ed 2d 496, 74-1 USTC ¶9438, 1974-1 CB 354 (1974). In *Bob Jones University*, the Supreme Court ruled that a suit seeking an injunction pertaining to an organization's tax-exempt status "falls squarely within the literal scope of the AIA."[57] Thus, courts will generally lack the authority to issue such an injunction unless one of the express exceptions to the AIA is met. As the claims asserted in the *Linchpins of Liberty* case were not made pursuant to one of the express exceptions to the AIA, similar to *Bob Jones University*, it is unlikely that the plaintiffs will be able to obtain the requested injunctive relief.

There is one non-statutory exception to the AIA prohibition. In *Enochs v. Williams Packing & Navigation Co.*, 9 AFTR 2d 1594, 370 US 1, 8 L Ed 2d 292, 62-2 USTC ¶9545, 1962-2 CB 349 (1962), the Supreme Court ruled that, if one of the express statutory exceptions did not apply, courts lack the authority to issue an injunction unless the taxpayer can show both that: (1) the proposed government action will cause irreparable injury "such as the ruination of the taxpayer's enterprise," and (2) "it is clear that under no circumstances could the government ultimately prevail."[58] The *Linchpins of Liberty* complaint does not appear to satisfy this "extraordinary circumstances" exception created by the Supreme Court in *Williams Packing & Navigation*. Therefore, the court will most likely lack the authority to grant the injunctive relief requested under the APA.

Declaratory relief requested by Section 501(c)(4) applicants

In the *Linchpins of Liberty* case, 23 of the 25 plaintiffs fail to meet these requirements. Only two of the plaintiffs applied for recognition of Section 501(c)(3) status; the others applied for recognition of Section 501(c)(4) status. As such, as discussed above, all but two of the plaintiffs in this suit are not entitled to the requested relief under Section 7428 .

Request for a jury trial

The *Linchpins of Liberty* complaint requested a jury trial. However, pursuant to *Synanon Church*, 51 AFTR 2d 83-979, 557 F Supp. 1329, 83-1 USTC ¶9230 (DC D.C., 1983), a jury trial is not permitted in declaratory judgment cases brought under Section 7428 .

To summarize, the *True the Vote* and *Linchpins of Liberty* cases raise many interesting questions related to the Service's review of applications identified for additional review. However, due to the courts' limited authority to enjoin the Service under the AIA or to issue declaratory judgments against the Service under the DJA, it is unlikely that a court will consider the merits of many of the issues raised in these cases.

Conclusion

During the Service's review of the exemption applications of organizations deemed to be at risk of engaging in impermissible political activities, the organizations and their representatives could have better availed themselves of methods to mitigate the consequences of the Service's substantial delays and requests for inappropriate information. While it may be too late to undo harm that has already befallen those organizations, a better understanding of non-traditional options available to tax-exempt organizations can be used by future applicants to avoid falling prey to similar circumstances.

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[1] Treasury Inspector General for Tax Administration, "Inappropriate Criteria Were Used to Identify Tax-Exempt Applications for Review," (5/14/13), Reference Number 2013-10-053 ("TIGTA Report"), available at www.treasury.gov/tigta/auditreports/2013reports/201310053fr.pdf.

[2] TIGTA Report, *supra* note 1 at 18.

[3] TIGTA Report, *supra* note 1 at 10.

[4] TIGTA Report, *supra* note 1 at 9. It appears as though 19 of these organizations were recognized as exempt under Section 501(c)(3) and 89 were recognized as exempt under Section 501(c)(4).

[5] TIGTA Report, *supra* note 1 at 6.

[6] TIGTA Report, *supra* note 1 at 11.

[7] TIGTA Report, *supra* note 1 at 1.

[8] TIGTA Report, *supra* note 1 Report at 10.

[9] TIGTA Report, *supra* note 1 at 14.

[10] TIGTA Report, *supra* note 1 at 11.

[11] TIGTA Report, *supra* note 1 at 18.

[12] TIGTA Report, *supra* note 1 at 20.

[13] www.irs.gov/Charities-&-Non-Profits/Where-Is-My-Exemption-Application.

[14] 15 U.S.C. 1679 *et seq.*

[15] TIGTA Report, *supra* note 1 at 18.

[16] TIGTA Report, *supra* note 1 at 16.

[17] TIGTA Report, *supra* note 1 at 15.

[18] TIGTA Report, *supra* note 1 at 16.

[19] The TIGTA Report does not indicate the portion, if any, of the 28 withdrawn applications that were applications for recognition of tax-exempt status under Section 501(c)(4). Additionally, the report does not provide any information related to the reason such applications were withdrawn.

[20] TIGTA Report, *supra* note 1 at 18.

[21] It is clear that some of the organizations responded to the unnecessary requests because the TIGTA Report noted that "EO function officials informed us that they decided to destroy all donor lists that were sent in for potential political cases that the IRS determined it should not have requested." TIGTA Report, *supra* note 1 at 19.

[22] It is notable that there may be several advantages to being a taxable organization as opposed to being an exempt organization, including a lack of operational oversight by the IRS and the freedom to engage in a variety of activities that are impermissible for tax-exempt organizations. However, such advantages are not relevant here because each of the organizations in question applied for recognition of tax-exempt status. As such, the comparison at issue is not between a taxable organization and an exempt organization; rather, it is the comparison between an organization recognized as exempt and one that is seeking recognition of that status.

[23] Gladstone Foundation, 77 TC 221, 226 (1981).

[24] AHW Corp., 79 TC 390, 396 (1982) (holding that the court lacked jurisdiction to issue a declaratory judgment with respect to whether an organization recognized as exempt could engage in a particular activity without jeopardizing its exempt status).

[25] *Id.* at 393.

[26] See New Community Senior Citizen Housing Corp., 72 TC 372 (1979); AHW Corp., *supra* note 24; Urantia Foundation, 50 AFTR 2d 82-5465, 684 F2d 521, 82-2 USTC ¶9512 (CA-7, 1982).

[27] CREATE, Inc., 47 AFTR 2d 81-641, 634 F2d 803, 81-1 USTC ¶9152 (CA-5, 1981).

[28] *Id.*

[29] Anclote Psychiatric Ctr., 98 TC 374, 377.

[30] See N.Y. County Health Services Review Org., 45 AFTR 2d 80-1552, 80-1 USTC ¶9398, 80-1553 (D.C. Cir., 1980) (holding that "[u]ntil such time as the Service either rules on plaintiff's Form 1023 request for determination, or fails to act on such a request within 270 days of its filing, this Court lacks subject matter jurisdiction"); B.H.W. Anesthesia Foundation, 72 TC 681 (1979); Natl Paralegal Inst. Coalition, TC Memo 2005-293, RIA TC Memo ¶2005-293, 90 CCH TCM 623 (2005).

[31] Staff of the Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1976* (hereinafter, "the Blue Book"), page 405.

[32] BBS Associates, 74 TC 1118, 2 EBC 2413, 1122 (1980).

[33] See Prince Corp., 67 TC 318, 1 EBC 1229 (1976) (interpreting Section 7476, the employee-plan counterpart to Section 7428, rejecting the petitioner's argument that the Code creates a per se test for exhaustion of administrative remedies based on the mere lapse of 270 days); Clawson, TC Memo 1993-174, RIA TC Memo ¶93174, 17 EBC 1193, 65 CCH TCM 2452, (holding that even when the Service made an adverse determination, the court lacked jurisdiction to issue a declaratory judgment because the taxpayer did not exhaust its administrative remedies because it failed to protest the proposed revocation); Natl Paralegal Inst. Coalition, *supra* note 30 (holding that the "exhaustion of administrative remedies is predicated on the filing of a 'substantially completed' application" and that where an organization fails to file a completed application or take any steps to perfect the incomplete application, the organization has not exhausted its administrative remedies); McManus, 93 TC 79 (1989) (holding that even when the Service made an adverse determination, the court lacked jurisdiction to issue a declaratory judgment if the taxpayer did not take any steps to obtain a favorable ruling).

[34] Reg. 601.201(n)(7)(v)(b).

[35] Gladstone Foundation, *supra* note 23.

[36] The Blue Book at 405 (emphasis added); see also Animal Protection Inst., 42 AFTR2d 78-5850 (Ct. Cl. 1978) (noting that the exhaustion of administrative remedies only required that organizations supply "any *reasonable* information requested by the Service").

[37] Gladstone Foundation, *supra* note 23 at 236.

[38] Anclote Psychiatric Ctr., *supra* note 29 at 382; see also Gladstone Foundation, *supra* note 23 at 235 (stating that an organization "may be deemed to have exhausted its administrative remedies due to [the Service's] purported failure to process its request expeditiously"); Prince Corp., *supra* note 33 at 328 (holding that "[a]fter 270 days have passed a petitioner need only demonstrate that progress is severely hampered due to causes beyond its control").

[39] See Christian Coalition of Florida, Inc., 108 AFTR 2011-7157 (CA-11, 2011) (holding that the court lacked jurisdiction to issue a declaratory judgment under Section 7428 to an organization seeking Section 501(c)(4) status because "it is clear that Congress has granted organizations claiming 501(c)(4) tax-exempt status fewer avenues for judicial relief than those organizations seeking 501(c)(3) status").

[40] For purposes of this discussion, the authors will focus on Section 501(c)(4) organizations.

[41] Notwithstanding this general rule, based on sections other than Section 508, certain other types of tax-exempt entities may not self-certify. Such organizations include Section 501(c)(4) credit-counseling agencies, as well as organizations seeking exemption under Sections 501(c)(9), (c)(17), and (c)(20).

42 IRM 7.25.1.1(1). In this regard, note that both Form 1023 and Form 1024 are titled "Application for *Recognition* of Exemption" (emphasis added).

43 The Blue Book at 405 (emphasis added), See also Animal Protection Inst., Inc., *supra* note 36 (noting that the exhaustion of administrative remedies only required that organizations supply "any *reasonable* information requested by the Service").

44 Available at www.irs.gov/pub/irs-tege/letter5228.pdf.

45 NorCal Tea Party Patriots, number 1:2013cv00341, 5/20/13, available at http://dockets.justia.com/docket/ohio/ohsdce/1:2013cv00341/163188/.

46 True the Vote, Inc., number 1:2013cv00734, 5/21/13, available at http://dockets.justia.com/docket/district-of-columbia/dcdce/1:2013cv00734/160085/.

47 Linchpins of Liberty, number 1:2013cv00777, 5/29/13, available at http://dockets.justia.com/docket/district-of-columbia/dcdce/1:2013cv00777/160174/.

48 The discussion of these cases will focus on the *True the Vote* and *Linchpins of Liberty*. While the *NorCal Tea Party* case presents a variety of unique issues and questions that warrant discussion and analysis, such questions are unrelated to the exemption issues involved with the Service's review of tax-exemption applications that are the focus of this article. The *NorCal Tea Party* class action suit does not seek declaratory relief related to its qualification for tax-exempt status and was filed in a court that lacks jurisdictional authority to grant such declaratory relief. As such, it involves issues that are beyond the scope of this article. Additionally, the discussion of the *True the Vote* and *Linchpins of Liberty* cases will be limited to the declaratory and injunctive relief requested in these complaints because the request for monetary relief also is beyond the scope of this article.

49 5 U.S.C. section 551 *et seq.*

50 Section 7421.

51 28 U.S.C. Section 2201.

52 Cited in "American United," Inc., 31 AFTR 2d 73-582, 477 F2d 1169, 73-1 USTC ¶9165 (D.C. Cir., 1973), *rev'd on other grounds* 33 AFTR 2d 74-1289, 416 US 752, 40 L Ed 2d 518, 74-1 USTC ¶9439, 1974-2 CB 401 (1974).

53 Cammarano, 3 AFTR 2d 697, 358 US 498, 3 L Ed 2d 462, 59-1 USTC ¶9262, 1959-1 CB 666 (1959).

54 28 U.S.C. Section 2201.

55 Section 7421.

56 5 U.S.C. Section 702.

57 Bob Jones University v. Simon, 33 AFTR 2d 74-1279, 416 US 725, 40 L Ed 2d 496, 74-1 USTC ¶9438, 1974-1 CB 354 (1974).

58 Enochs v. Williams Packing & Navigation Co., 9 AFTR 2d 1594, 370 US 1, 8 L Ed 2d 292, 62-2 USTC ¶9545, 1962-2 CB 349 (1962).

International Financial Reporting Standards

Implications For Nonprofits

IFRS and Nonprofits - General

- International Financial Reporting Standards (IFRS) issued by International Accounting Standards Board (IASB), the successor to the International Accounting Standards Committee (IASC) who issued 41 International Accounting Standards (IAS) from 1973 to 2001. IAS are often colloquially referred to as IFRS as well
- IASB took over from IASC in 2001, and has so far issued 13 IFRS
- IFRS have been adopted (partially, entirely, or converged to) by more than 120 countries around the world. EU countries have adopted them in their entirety (2005) , others have made a point to adopt them partially like Canada's "for-profit" entities adoption (2011), and others made conversion efforts like Australia's "Australian equivalents to IFRS' (A-IFRS)"(2006) or like Chine who has been piecemeal converging with a vague plan to eliminate differences in the future. India announced full adoption in 2012, the project failed and was deferred for the future. Japan has scheduled full adoption for 2015. In the US, SEC revised expected timeline to 2015 for public companies. Private and nonprofit even later

IFRS and Nonprofits - General

- IFRS are principle-based and seek to avoid industry specific guidance (with the exception of some IAS i.e. agriculture) by contrast to US GAAP that is more rule-based and often industry specific. Heavier dependence on professional judgment
- In 2009, IASB issued IFRS for Small and Medium-sized Entities (SMEs) which provide less complex accounting framework for entities meeting certain eligibility criteria around the concept "public accountability" (roughly publicly traded or holding assets in fiduciary capacity).
- There are no Nonprofit IFRS, The vast majority of Nonprofit entities will fall under IFRS SME framework
- Overall US GAAP and IFRS best known differences relate to leases, inventories, consolidations/combinations, financial instruments and fair value measurement, certain revenue recognition, accounting policy etc.

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IFRS and Nonprofits – Financial Reporting

- Basic financial statements under IFRS:
  - SFP
  - Statement of Comprehensive Income or SOA with stand-alone SOCI
  - Statement of Changes in Equity, but combination with SOA allowed
  - SCF
  - Notes to the Financial Statements
- For the nonprofit industry the principal difference results from the fact that and international accounting standards have no equivalent guidance to FAS 116 & 117's "fund" accounting concepts
- International accounting standards do not address temporary or permanently restricted donations or net asset classes, nor does IFRS offer any specific not-for-profit guidance
- Much of the information that US nonprofits convey through their basic financial statements regarding net asset classes and restrictions are presented in footnote disclosures

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IFRS and Nonprofits – Revenue Recognition

- In exchange transactions differences tend to be industry specific for instance software revenue recognition and transactions with multiple deliverables especially on construction-type contracts. The IFRS principle driving revrec is not realization/earning of revenue but the probability that the economic benefit associated with the transaction will flow in AND it can be measured reliably. IFRS favors the percentage of completion method adopting it generically for sales of services. Overall, IFRS may be different from GAAP in the timing of revrec of exchange transactions we typically see in a nonprofit (dues, events, publications, etc) but differences are not deemed fundamental
- In contributory transactions, revrec under IFRS is significantly different from US GAAP, and due to lack of industry-specific guidance practices are not consistent. In general, the recognition of promises to give is a lot stricter than what we know in the US. Pledges in most cases are not recognized at all unless they are legally enforceable. Restricted donations are recognized with a footnote discussing the restriction, but in several countries they result in a deferred revenue or similar liability
- Government grants are treated similarly to US (receivable if not collected, deferred revenue if collected)

IFRS and Nonprofits – Other Areas

- Inventory: Under IFRS LIFO is not allowed and inventory impairments can be reversed under certain circumstances
- Even though for full IFRS goodwill and indefinite-lived assets must ne tested for impairment as in US GAAP, under IFRS SME they are amortized over 10yrs
- Investments in affiliates are allowed to be accounted for under the cost method (equity method permissible)
- Research and development costs are all expensed
- Borrowing costs can be expensed and not capitalized/amortized
- Financial Instruments under IFRS follow classifications similar to the US for-profit rules (assets held for trading or designated at fair value, with changes in fair value reported in earnings; held-to-maturity investments; available-for-sale financial assets; and loans and receivables). Differences exist in IFRS allowing more extensive recognition of debt instruments at amortized cost, the impairment model, loans and receivables can be carried in amortized costs but under conditions in FMV. In accounting for derivatives differences are subtle and relate to recognition and measurement of FMV

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Nonprofits: How to Manage Increased IRS Scrutiny of International Activities

by Patrick Speltz

With the IRS' increased attention to the international activities of nonprofits, it is now more important than ever for your organization to understand its operations and reporting obligations. Noncompliance in this area may lead to significant penalties, including loss of tax-exempt status. Today's atmosphere of increased scrutiny may have implications for nonprofits across the United States.

In its *2011 Annual Report and 2012 Work Plan*, the IRS Exempt Organizations Division says it will be focusing on whether assets of exempt organizations that are dedicated for international charitable purposes are being diverted for noncharitable purposes. Particular attention will be given to large private foundations, but any other organization reporting ownership of a foreign bank account or foreign activities is subject to scrutiny. According to the IRS work plan, key monitoring areas will include:

- Books and records, to ensure assets are used for charitable purposes
- Compliance with all filing requirements

The difficulty in assessing the risk of noncompliance lies in determining when and if an organization has met various thresholds for filing. Identifying the reporting requirements can be a challenge, but understanding the basic activities that may trigger IRS scrutiny is the foundation for full and timely compliance.

What activities may require reporting?

Activities requiring reporting and disclosure range from grant making to investments in foreign organizations. Although not all-inclusive, the following examples illustrate activities requiring some level of reporting:

- Financial interest in, or signature authority on, a foreign bank account
- Maintaining offices, employees, or agents outside of the United States
- Aggregate revenues or expenses of $10,000 or more from grant making, business, investment, or program services outside of the United States
- Foreign investments valued at $100,000 or more
- $5,000 or more of grants or assistance to:
  - Any organization/entity outside of the United States
  - A domestic organization/entity for the purpose of engaging in activities outside of the United States
  - Any individual outside of the United States
  - A domestic individual for the purpose of engaging in an activity outside of the United States
- Certain transfers of cash or property to, or equity interest in, a foreign organization

In addition to these examples, most of which relate to financial transactions, a nonprofit may have a filing requirement if it has operations held in, or related to, a boycotting country. According to the IRS, an organization has operations in a boycotting country "if you have an operation that is carried out, in whole or in part, in a boycotting country, either for or with the government, a company, or a national of a boycotting country."

To mitigate an organization's risk of noncompliance, it must have a clear understanding of the foreign activities that can trigger reporting requirements. To do so, it should:

- Establish monitoring processes for tracking foreign activities
- Educate personnel on the types of activities that may result in a reporting requirement

U.S.-based charities and foundations make significant contributions to good work carried out throughout the world. Compliance with IRS rules and reporting requirements is an important step toward ensuring the helping hand remains extended to those in need.

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COLLEGES AND UNIVERSITIES COMPLIANCE PROJECT
FINAL REPORT

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IRS EXEMPT ORGANIZATIONS
COLLEGES AND UNIVERSITIES COMPLIANCE PROJECT

Executive Summary of Final Report
(posted *April 25, 2013,* revised with highlighted changes on *May 2, 2013)*

The IRS is nearing the end of its multi-year project on tax-exempt colleges and universities. The Colleges and Universities Compliance Project was launched in 2008 with the distribution of detailed questionnaires to 400 randomly-selected colleges and universities. The IRS selected 34 of the 400 for examination because their questionnaire responses and Form 990 reporting indicated potential noncompliance in the areas of unrelated business income and executive compensation.

As exams were getting underway, the IRS released an Interim Report, presenting a preliminary overview of questionnaire responses. Now, with more than 90 percent of examinations completed, this Final Report provides additional analysis of the questionnaire responses and focuses on the examination results. Because colleges and universities were not randomly selected for examination, no assumptions should be drawn about the UBI and compensation practices of other colleges and universities based on the examination results.

Examination Highlights

Underreporting of Unrelated Business Taxable Income (UBTI)

Unrelated business income (UBI) is the income from a trade or business regularly conducted by an exempt organization and not substantially related to its exempt purpose. Unrelated business taxable income (UBTI) is the UBI that is taxable after deducting expenses directly connected to the trade or business. Because UBTI is calculated by totaling the UBI from all activities and subtracting the total allowable deductions, losses from one activity can offset profits from another. Examinations have resulted in:

- Increases to UBTI for 90% of colleges and universities examined totaling about $90 million;
- Over 180 changes to the amounts of UBTI reported by colleges and universities on Form 990-T; and
- Disallowance of more than $170 million in losses and Net Operating Losses (NOLs, i.e., losses reported in one year that are used to offset profits in other years), which could amount to more than $60 million in assessed taxes.

The primary reasons for increases to UBTI in the completed exams were:

- *Disallowing expenses that were not connected to unrelated business activities:* The IRS found that examined colleges and universities were reporting certain losses as connected to unrelated business activities when they were not. The misreporting occurred in two ways:

- *Lack of profit motive*: The IRS found that organizations were claiming losses from activities that did not qualify as a trade or business. Nearly 70 percent of examined colleges and universities reported losses from activities for which expenses had consistently exceeded UBI for many years. UBI must be generated by a "trade or business." An activity qualifies as a "trade or business" only if, among other things, the taxpayer engaged in the activity with the intent to make a profit. A pattern of recurring losses indicates a lack of profit motive. The IRS disallowed reporting of activities for which the taxpayer failed to show a profit motive. Those losses no longer offset profits from other activities in the current year or in future years, with more than $150 million of NOLs disallowed.

- *Improper expense allocation:* The IRS also found that on nearly 60% of the Form 990-Ts we examined, colleges and universities had misallocated expenses to offset UBI for specific activities. Organizations may allocate expenses that are used to carry on both exempt and unrelated business activities, but they must do so on a reasonable basis and the expenses offsetting UBI must be directly connected to the UBI activities. In many cases, the IRS found that claimed expenses, which generated losses, were not connected to the unrelated business activity.

- *Errors in computation or substantiation:* The IRS checked the calculations for all NOLs reported on returns under exam and found that NOLs were either improperly calculated or unsubstantiated on more than a third of returns. As a result, the IRS disallowed nearly $19 million in NOLs.

- *Reclassifying exempt activities as unrelated*: The IRS determined that nearly 40 percent of colleges and universities examined had misclassified certain activities as exempt or otherwise not reportable on Form 990-T. Fewer than 20 percent of these activities generated a loss. The examinations resulted in the reclassification of nearly $4 million in income as unrelated, subjecting those activities to tax.

Examinations resulted in more than 180 changes to UBTI reported for specific activities by colleges and universities. More than 30 different activities were connected to the changes. The majority of these adjustments came from the following activities:

- Fitness, recreation centers and sports camps
- Advertising
- Facility rentals
- Arenas, and
- Golf

Compensation and Comparability Data

The executive compensation component of the examinations focused mainly on compliance with section 4958 of the Code, which provides that organizations may pay no more than reasonable compensation to their disqualified persons. Section 4958 applies to private, but not public, colleges and universities, and imposes an excise tax on disqualified persons who received payment of unreasonable compensation and on those persons who approved it. At the private colleges and universities examined, the officers, directors, trustees and key employees (ODTKEs) were disqualified persons subject to the reasonable compensation requirements of section 4958.

An organization may shift the burden of proving unreasonable compensation to the IRS by following the three steps of the rebuttable presumption process:

- Using an independent body to review and determine the amount of compensation;
- Relying on appropriate comparability data to set the compensation amount; and
- Contemporaneously documenting the compensation-setting process.

Although most private colleges and universities examined attempted to meet the rebuttable presumption standard, about 20% of them failed to do so because of problems with their comparability data including:

- Institutions that were not similarly situated to the school relying on the data, based on at least one of the following factors: location, endowment size, revenues, total net assets, number of students, and selectivity;
- Compensation studies neither documented the selection criteria for the schools included nor explained why those schools were deemed comparable to the school relying on the study.
- Compensation surveys that did not specify whether amounts reported included only salary or included total other types of compensation, as required by section 4958.

Compensation Amounts

<u>**Officers, Directors, Trustees and Key Employees (ODTKEs)**</u>

With few exceptions, each college or university examined identified its "top management official," who was usually the president, as its highest paid ODTKE. Overall, the average and median base salary and total compensation for the top management official of the colleges and universities examined, both public and private, were as follows:

- Average base salary: $452,883; median base salary, $376,018.
- Average total compensation: $623,267; median total compensation, $499,527.

Highly Compensated Non-ODTKEs

Although examinations focused on ODTKEs, the IRS also looked at compensation levels for most highly compensated non-ODTKEs. The most highly-paid non-ODTKEs fell primarily into one of five categories: Sports Coaches, Investment Managers, Head of Departments, Faculty and Administrative/Managerial. As shown below, Sports Coaches and Investment Managers received the highest average compensation at the colleges and universities examined.

Position	Average compensation
Investment Managers	$894,214
Sports Coaches	$884,746

Compensation amounts for non-ODTKEs in the remaining categories differed based on whether or not the non-ODTKE was a medical doctor. The second column below excludes the compensation paid to medical doctors, who comprise 30% of the ODTKEs reported in the first column. The most highly-paid non-ODTKE positions were as follows:

Position	Average compensation	Average compensation (excluding M.D.s)
Heads of departments	$753,738	$279,770
Faculty	$575,632	$215,854
Administrative/Managerial	$462,872	$381,745

Employment Tax and Retirement Plans

In addition to examining Forms 990 and 990-T focusing on UBI and compensation, the IRS also reviewed employment tax and employee plan returns. These reviews covered employment tax and employee plan issues for all employees, not just for ODKTEs and the highest-paid non-ODTKEs.

Employment Tax Issues

- The IRS looked at employment tax returns at about a third of the colleges and universities examined.
- All of the completed exams have resulted in adjustments in wages, and leading to assessment of tax and, in some cases, penalties.
- Wage adjustments total about $36 million, while taxes and penalties amount to over $7 million.

Retirement Plan Issues

- The IRS looked at retirement plan reporting at about a quarter of the colleges and universities we examined, and found problems at about half. These examinations have resulted in increases in wages of more than $1 million and the assessment of more than $200,000 in taxes and penalties.

Next Steps

The examinations of college and universities identified some significant issues with respect to both UBI and compensation that may well be present elsewhere across the tax-exempt sector. As a result, the IRS plans to look at UBI reporting more broadly, especially at recurring losses and the allocation of expenses, and to ensure, through education and examinations, that tax-exempt organizations are aware of the importance of using appropriate comparability data when setting compensation.

INTRODUCTION

This is the Final Report of the Colleges and Universities Compliance Project. The Exempt Organizations Division of the Internal Revenue Service (IRS) Tax Exempt and Government Entities Division launched the project in 2008 so that the IRS and other stakeholders could better understand tax-exempt colleges and universities and their practices involving endowments, executive compensation and unrelated business activities. This report is based on the responses to Questionnaires the IRS sent to a sample of 400 colleges and universities and on the results of examinations of 34 colleges and universities.

The IRS presented a preliminary look at project results in May, 2010, with the release of an interim report summarizing how small, medium and large institutions responded to much of the Questionnaire.[1] The Final Report provides a comprehensive view of what the IRS has learned from both Questionnaire responses and examinations. The report presents new information based on deeper statistical analysis of data presented in the Interim Report and on analysis of those Questionnaire responses that were not included in the Interim Report. Schools are not categorized by size in much of the Final Report. Instead, the analysis represents the colleges and universities sector as a whole, and as categorized by whether an institution is public or private, regardless of size. The Final Report also includes findings from the examinations of colleges and universities. In addition, appendices to the Final Report incorporate the Interim Report and the Questionnaire so that readers will be able to access all information on the project in one location.

I. Key Differences Between the Interim Report and the Final Report

A. Examinations

Based on the responses to the Questionnaires and information on the Form 990, EO opened examinations of 34 colleges and universities. The examinations were designed to focus on unrelated business income and executive compensation. When the Interim Report was published, examinations were in their early stages. Now, with nearly all examinations closed, the Final Report includes a summary of what the IRS has learned from the examinations of colleges and universities.

B. Additional Data Analysis

The Interim Report described how three groups—small, medium and large colleges and universities—responded to much of the Questionnaire. To provide a more

[1] Interim Report on the IRS Exempt Organizations Colleges and Universities Compliance Project, May, 2010. See Appendix B.

comprehensive picture of the sector, for the Final Report, the IRS weighted data included in the Interim Report so that many of the findings could be extrapolated to apply to all tax-exempt colleges and universities and to private and public institutions as well. In addition to describing results in terms of the entire college and university sector (as opposed to small and medium and large schools within the sector), the Final Report incorporates information gathered from review of narrative responses to certain questions[2] that were not included in the Interim Report. It also includes, where possible, data generated through further analysis of questions that were included in the Interim Report.[3] Additional Data Analysis is in Appendix C.

C. Systems

The Interim Report did not include a discussion of responses submitted by colleges and universities that responded on a system-wide basis (rather than on a campus-only basis). The Questionnaire allowed system-wide reporting if (1) it was consistent with reporting on Forms 990 and 990-T and (2) the same method was used for all parts of the Questionnaire.[4] Information on the six systems that reported for 16 colleges and universities is included in Appendix D.

II. Limitations of the Data

This report presents a broad picture of what is happening in the tax-exempt colleges and universities sector based on information gathered from Questionnaire responses and examinations. In presenting this information, the IRS has been careful to point out its limits. For example, in the Interim Report, the data applies only to categories of universities based on their size—small, medium, or large--but cannot be used to draw conclusions about all colleges and universities or the typical college or university. Building on what was included in the Interim Report, much of the data in the Additional Data Analysis has been weighted so that it can be extrapolated to give a sense of the characteristics, activities and tax reporting of colleges and universities overall—and of public and private colleges and universities overall—regardless of size.

Some of the data in the Additional Data Analysis, however, has not been weighted to produce one overall result. Much of the compensation data, for example, applies to

[2] This includes Questions 21, 24, 25, 29, 57, 76 and 79. The IRS reviewed narrative responses to all questions and, where possible, presented a summary of those responses in the Additional Data Analysis.

[3] This includes Questions 17, 23, 27, 56, 60 and 80.

[4] This issue and several others related to completion of the Questionnaire (including an extension of time for completion) were addressed in “Questions and Answers,” which is included at the end of the Questionnaire in Appendix A.

individuals within colleges and universities. Weighting of the college and university responses produced meaningful results at the entity level, but not when broken down to data about individuals within entities. Similarly, narrative responses included a great deal of variation. The integrity of those responses could be maintained when summarized by size of school, but would have been lost if weighted and extrapolated across size-based categories to "average" narrative responses. Therefore, the report notes when data applies to all colleges and universities (or to public or private colleges and universities) and when it can only be applied to the schools that fall within the small, medium and large size-based categories. In addition, the IRS did not confirm the accuracy of answers to Questionnaires. The IRS analyzed and reported whatever the respondents reported and did not reconcile Questionnaire responses against Form 990 reporting or examination findings. Agents did, of course, use Questionnaire responses to help inform their examinations, although most Questionnaire data reflects the 2006 tax year, and examinations represent a range of tax years primarily from 2006 to 2008.

EXAMINATION RESULTS

I. Background

Examinations focused on compliance with the tax rules concerning unrelated business income (UBI) and compensation.

In selecting colleges and universities for examination, the IRS first reviewed Questionnaire responses to identify those respondents having the greatest potential for compliance issues with respect to UBI or compensation. The IRS then evaluated Form 990 reporting to further inform its selection process. In the end, the IRS chose 34 colleges and universities for examination, about equally divided between private and public institutions.[5] About two thirds were large, with 15,000 or more students.

Examinations covered all returns related to the college or university under exam, including Forms 990 and 990-T and employee plans returns, excise tax returns and employment tax returns. EO drew on expertise from across the IRS to support the examinations. Federal, State and Local Governments (FSLG) participated in the examination of employment tax issues at state colleges and universities. Large Business and International (LB&I) supported the examinations by providing Computer Audit Specialists trained to handle the volume and complexity of accounting records produced by automated data processing systems. LB&I also provided Engineers to offer expert valuation of compensation at private colleges and universities. Finally, Wage and Investment (W&I) provided Employment Tax Specialists for selected private college and university examinations. On all issues, EO Examinations teams worked closely with Chief Counsel and with EO Rulings and Agreements staff.

Reporting the results of these examinations involves descriptions of the practices of the 34 selected colleges and universities with respect to UBI and compensation. These institutions were selected for examination because their returns and questionnaires indicated potential noncompliance in these areas. They are not a representative sample of all colleges and universities, and readers should not make assumptions about the UBI and compensation practices of other colleges and universities based on these examination results.

II. Unrelated Business Income

As tax-exempt organizations, colleges and universities are not taxed on income from activities that are substantially related to their exempt purpose even if the activity is a trade or business. To be substantially related, activities must contribute importantly to the accomplishment of an organization's exempt purposes.

[5] 41 percent of 990-Ts examined reported UBI on a system-wide basis.

A college or university is subject to tax on income from an unrelated trade or business.[6] A trade or business is unrelated if it is not substantially related to the accomplishment of an organization's exempt purposes, even if funds from the business are used to support those purposes.[7]

Not all unrelated business income (UBI), however, is subject to tax. The law provides various exceptions and modifications to the calculation of unrelated business income tax (UBIT). Section 512 of the Code sets forth the rules for determining whether UBI is taxed, excluding income from certain types of activities[8] and also permitting all deductions directly connected with the unrelated trade or business. (Unrelated Business Taxable Income (UBTI) is the amount of UBI that is taxable after deducting expenses directly connected to the trade or business.

Many organizations generate UBI but pay no tax on that income.[9] The amount of UBI that goes untaxed each year is significant. In the examinations of colleges and universities, the IRS focused on how organizations report their business activities including the characterization of activities as exempt or unrelated, the methodology for allocating expenses, the significance of recurring losses on specific activities, the calculation of net operating losses (NOLs) and the application of exceptions and modifications. The IRS looked at these issues, and others, as they applied to a wide variety of activities including advertising and exclusive provider arrangements, sports management agreements, facility rentals, arenas, food service, golf courses, hotels, recreation centers and programs, parking lots, commercial research, and bookstores.

A. Activities and Changes to UBTI

The exams of 90 percent of colleges and universities ended with increases to UBTI. This includes more than 180 adjustments totaling about $90 million.

The activities below, in order of frequency, were connected to more than half of the adjustments:

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[6] The unrelated business income tax applies to organizations that are exempt from income tax under section 501(a), which includes private colleges and universities. Section 511(a)(2)(B) provides that the tax applies to any state college or university or any corporation wholly owned by a state college or university.

[7] I.R.C. §513(a).

[8] I.R.C. §512(b). For example, dividends, interest, certain investment income, royalties, certain rental income, certain income from research activities, and gains or losses from the disposition of property are excluded when computing unrelated business taxable income (UBTI).

[9] Jael Jackson, "Unrelated Business Income Tax Returns, 2008," SoI Bulletin, Winter 2012. After reducing their gross unrelated business income by allowable deductions, only about half of all organizations that were required to file Form 990-T for Tax Year 2008 reported unrelated business income tax liability.

- Fitness and recreation centers and sports camps;
- Advertising ;
- Facility rentals;
- Arenas; and
- Golf courses.

Adjustments to UBTI generated by these activities affected a significant number of colleges and universities examined.

- Advertising and Facility Rentals resulted in changes in UBTI for nearly half of colleges and universities examined; and
- Fitness and recreation centers and sports camps, Arenas, and Golf courses resulted in UBTI adjustments for about a third of colleges and universities examined;

The IRS disallowed losses on 75 percent of returns examined. In total, the IRS disallowed more than $170 million in losses and Net Operating Losses (NOLs), which could amount to more than $60 million in assessed taxes. If an organization cannot use all of its losses to offset gains in a single tax year, it receives NOLs. It may carry over these NOLs for use going back two years and going forward for 20 years.

B. Reasons for adjustments

1. Misclassification as a Trade or Business: Lack of Profit Motive

A taxpayer can only generate UBI from a "trade or business." An activity qualifies as a "trade or business" if, among other things, the taxpayer engaged in the activity with the intention of making a profit. A pattern of repeated losses is generally sufficient to show a lack of profit motive. Continuous losses sustained beyond the period which is necessary to bring the operation to profitable status that are not due to customary business risks or reverses indicate that the activity is not operated as a trade or business being engaged in for profit. When income is attributable to an activity lacking a profit motive, a loss from the activity cannot be claimed on Form 990-T.

The most common reason, by far, for disallowance of losses and NOLs in the college and university exams was that claimed losses were connected with an activity for which the school lacked a profit motive, as evidenced by years of sustained losses. The IRS disallowed losses and NOLs for lack of profit motive at 70 percent of colleges and universities examined. These disallowances amounted to more than $150 million of the total losses and NOLs disallowed in the college and university exams.

Losses from a single activity can offset gains from other activities both in the year of the loss and in future and past years. UBTI is determined by subtracting from gross UBI all deductions directly connected with the unrelated trade or business.[10] If an organization carries on multiple unrelated business activities, its UBTI is the aggregate of its gross income from such activities minus the aggregate deductions.[11] An unrelated business activity that generates sufficient deductions may operate at a loss, which offsets not only the income from that activity but also gains from other unrelated business activities.

2. Misallocation of expenses

When a trade or business activity serves both exempt and unrelated purposes, the income and expenses from the activity must be allocated between the two on a reasonable basis.[12] Allocated expenses must have a proximate and primary relationship to the activities to which they are attributed. Only the expenses allocated to an unrelated trade or business are allowable as a deduction against UBI. Expenses attributable to accomplishing an organization's exempt purpose may not be deducted because the organization is already exempt from paying tax on related income.

Expense deductions were disallowed on more than 60 percent of Form 990-Ts examined because they were based on improper allocations between exempt and unrelated business activities.

3. Errors in computation or substantiation

The IRS checked the calculations for all NOLs reported on returns under exam and found that on more than a third of returns examined NOLs were either improperly calculated or unsubstantiated. As a result, the IRS disallowed more than $19 million in NOLs.

4. Misclassification of Related Activities

The IRS looked at activities that were not reported on Form 990-T to determine whether they were properly omitted. Activities that are substantially related to an organization's exempt purpose are not reported on Form 990-T. Likewise, certain income is specifically excluded from Form 990-T reporting. When activities are not reported on Form 990-T, they are effectively treated as if they are related activities. Income from related activities is not subject to tax.

At more than 40 percent of colleges and universities examined, activities that were effectively treated as related were determined, upon examination, to be unrelated activities that should have been reported on Form 990-T, and were subject to tax. These adjustments totaled nearly $4 million. Less than 20 percent of these activities generated a loss.

[10] IRC § 512(a).

[11] Treas. Reg. § 1.512(a)–1(a).

[12] Treas. Reg. § 1.512(a)–1(c).

5. Review of UBI Reporting

The IRS was interested in whether colleges and universities sought advice or review beyond their own professional staffs on UBI-related matters.

The IRS found that about 20 percent of colleges and universities examined sought outside advice about the tax treatment of specific potentially unrelated business activities. In about 40 percent of those cases where an institution had obtained an outside opinion, the IRS did not agree with the opinion when the issue came up on examination. For example, based on outside advice, the college or university might have treated an activity as related to its exempt purpose, but the examination resulted in reclassifying that activity as unrelated.

Of Form 990-Ts filed with the IRS by examined colleges and universities:

- 13 percent were reviewed by outside counsel before they were filed with the IRS.
- 57 percent were reviewed by independent accountants before they were filed with the IRS.
- Half of Form 990-Ts were reviewed before filing by the board of directors or a board committee.

III. Compensation

The executive compensation component of the examinations focused on compliance with Section 4958 of the Code, which applies to organizations exempt from tax under section 501(a) and described under sections 501(c)(3) or 501(c)(4). This includes the private colleges and universities selected for exam. Section 4958 generally does not apply to public colleges and universities,[13] and they are not included in the Examinations section on Reasonableness of Compensation.[14]

[13] The income of public colleges and universities is generally exempt under section 115 because they are considered governmental units or affiliates. Some of these organizations still seek IRS recognition that they are also exempt under section 501(c)(3). In that case, they are exempted from section 4958 because they are not required to file an annual return because of their status as a governmental unit or affiliate. Treas. Reg. § 53.4958-2(a)(2)(ii).

[14] However, the IRS did gather information about compensation amounts and practices at public colleges and universities, so they are included in the other three sections: Compensation Amounts, Compensation-Related Adjustments and How Compensation Was Determined.

Section 4958 imposes an excise tax on compensation that constitutes an excess benefit transaction. An excess benefit transaction occurs when a disqualified person[15] receives more than reasonable compensation for services rendered to the organization. This report uses the terms, "Officers, Directors, Trustees and Key Employees," or "ODTKEs" to describe disqualified persons at the private colleges and universities examined. Reasonable compensation is understood to be the amount that would ordinarily be paid for like services by a like enterprise under like circumstances. In determining the reasonableness of compensation, all items of compensation are taken into account.[16]

The regulations under section 4958 set forth a process by which organizations can obtain a rebuttable presumption that compensation paid is reasonable.[17] In previous studies,[18] the IRS focused on the process by which organizations set compensation to see whether they were following practices that were consistent with meeting the rebuttable presumption of reasonableness.

During the examinations of colleges and universities, the IRS also enlisted the aid of LB&I Engineers to look behind the process and evaluate the comparability data relied upon in establishing the rebuttable presumption.

[15] Section 4958(f)(1) defines disqualified person, in part, as any person who was in a position to exercise substantial influence over the affairs of an applicable tax-exempt organization. Any person who holds any of the following powers, responsibilities, or interests is in a position to exercise substantial influence over the affairs of an applicable tax-exempt organization: (1) Voting members of the governing body; (2) Presidents, chief executive officers, or chief operating officers; (3) Treasurers and chief financial officers.

[16] Treas. Reg. § 53.4958-4. These include: All forms of cash and non-cash compensation, including salary, fees, bonuses, severance payments, and deferred and noncash compensation; The payment of liability insurance premiums, or the payment or reimbursement by the organization of taxes or certain expenses under section 4958, unless excludable from income as a de minimis fringe benefit ; All other compensatory benefits, whether or not included in gross income for income tax purposes; Taxable and nontaxable fringe benefits, except fringe benefits described in section 132; and Foregone interest on loans.

[17] Section 53.4958-6 of the regulations details this three-part process: (1) an independent body to review and establish the amount of compensation in advance of actual payment, (2) use of permissible comparability data to establish the compensation, and (3) contemporaneous documentation of the process used to establish the compensation amount. Compensation set pursuant to a process that satisfies these requirements is presumed to be reasonable in amount, and the IRS has the burden of proving that the compensation is excessive under section 4958. If the requirements are not met, the organization has the burden of proving reasonableness.

[18] In 2007, the IRS released a report on the Executive Compensation Compliance Initiative, and in 2009, the IRS released a report on the Hospital Compliance Project which included examinations of 20 hospitals focusing on executive compensation.

The sections below discuss what the IRS has learned about the amounts of compensation paid by the colleges and universities examined, the process by which those compensation amounts were determined, and whether those amounts were reasonable.

A. Compensation Amounts

1. Compensation paid to top management officials

The IRS looked at the compensation paid to Officers, Directors, Trustees and Key Employees (ODTKEs) at both public and private colleges and universities. With very few exceptions, the highest paid ODTKE at the colleges and universities examined was the individual identified as the institution's "top management official." In 80 percent of cases, that individual was described as the president or chancellor.

Average and median base salaries for the top management official of the colleges and universities examined were as follows:

Top Management Official – Base Salary		
	Mean	Median
Large	$461,332	$386,503
Medium	$419,925	$392,000
Small	$459,085	$294,479
Overall	$452,883	$376,018

Average and median total compensation for the top management official of the colleges and universities examined were as follows:

Top Management Official – Total Compensation		
	Mean	Median
Large	$661,706	$502,000
Medium	$551,656	$519,226
Small	$573,156	$379,029
Overall	$623,267	$499,527

2. Compensation paid to non-ODTKEs

The examinations also looked at amounts paid to highly-compensated individuals who are not ODTKEs. These non-ODTKES, by definition, are not disqualified persons covered by section 4958.

The information below describes the compensation for the individuals who were among the six highest-paid non-ODTKEs at each of the colleges and universities with closed examinations. (In other words, the numbers below represent about 180 individual non-ODTKEs employed by public and private colleges and universities.)

In order of highest to lowest average compensation by position:[19]

- Investment Managers
  - Investment Managers earned the highest average compensation, $894,214, with median compensation of $838,508.
  - 2 percent of the highest paid non-ODTKEs served primarily as Investment Managers.

- Sports Coaches
  - Sports Coaches earned the second highest average compensation, $884,746, with median compensation of $523,906.
  - 20 percent of the highest paid non-ODTKEs served primarily as Sports Coaches.

- Heads of departments
  - Heads of departments earned the third highest average compensation, $753,738, with median compensation of $654,451.
  - 16 percent of the highest paid non-ODTKEs served primarily as Heads of Departments.

- Faculty
  - Faculty earned the fourth highest average compensation, $575,632, with a median of $340,153.
  - 34 percent of the highest paid non-ODTKEs served primarily as Faculty (instructional and research).

- Other
  - Individuals in Other positions earned the fifth highest average compensation, $539,240, with median compensation of $476,665.

[19] Positions were counted in one of six categories: Faculty (Instructional and Research), Heads of Departments, Sports Coach, Administrative/Managerial, Investment Manager, and Other.

  - About 6 percent of the highest paid non-ODTKEs served primarily in a category of position other than the categories listed above.

- Administrative/Managerial
  - Individuals in Administrative/Managerial positions earned the sixth highest average compensation, $462,872, with median compensation of $356,522.
  - 23 percent of the highest paid non-ODTKEs served primarily in Administrative/Managerial positions.

3. Impact of medical school positions

Some of the examinations covered undergraduate schools, graduate schools and professional schools. About 30 percent of the individuals who were reported as one of the six highest-paid non-ODTKEs were medical school faculty. They are included in three categories above: Faculty, Heads of Departments and Administrative/Managerial. Removing those individuals from the calculation substantially decreases the average, median and highest compensation amounts for each position.

- Heads of departments (not including department heads at medical schools)
  - Heads of departments earn average compensation of $279,770, with median compensation of $233,130.

- Faculty (not including medical school faculty)
  - Faculty earns average compensation of $215,854, with a median of $163,176.

- Administrative/Managerial (not including medical school positions)
  - Individuals in Administrative/Managerial positions earn average compensation of $381,745, with median compensation of $322,816.

4. Other compensation

About 2 percent of non-ODTKEs (in the Faculty and Heads of Departments categories) received compensation from a related organization averaging $86,432.

About 11 percent of non-ODTKEs received compensation averaging $207,257 that was reported as NCAA Athletic Income.[20] Most of these non-ODTKEs were Sports Coaches. About half of Sports Coaches received NCAA income, averaging $209,426, with median compensation of $15,550.

[20] For an explanation of NCAA Athletic Income, see Appendix C: Additional Data Analysis, Section V.C.

B. Compensation-Related Adjustments

Under section 4958, total compensation includes all items of compensation to determine reasonableness. The IRS examined compensation by looking at the gross income of individuals, generally assuming that all compensation in whatever form is taxable unless subject to a specific exception in the tax laws. This involved, among other things, analyzing whether fringe benefits and deferred compensation were properly excluded from wages. A wage adjustment could trigger a variety of taxes and penalties – for the individual liable for greater taxable income, for the institution liable for additional employment taxes and potentially for the individual and the institution should the adjustments resulted in an excess benefit transaction under section 4958.

The adjustments described below are not limited to ODTKEs and the highest-paid non-ODTKEs. The employment tax examinations covered all employees on payroll.

1. Wage adjustments

The IRS opened employment tax exams at 11 of the colleges and universities examined. All of the completed exams resulted in adjustments, amounting to increases in taxable wages of $35,540,808.98 and generating $7,076,387.22 in employment taxes (federal withholding, Social Security and Medicare) and $167,242.90 in penalties.

Wages were adjusted for a number of reasons:

- failure to include in income the value of the personal use of automobiles, housing, social club memberships and travel;[21]
- misclassification of employees as independent contractors;[22]
- failure to withhold taxes for wages paid to non-resident aliens;[23] and
- failure to include in income the value of certain graduate tuition waivers and reimbursements.[24]

[21] Inclusion of these amounts in the income of the disqualified persons who received these benefits did not result in excess benefit transactions. The benefits were not automatic excess benefit transactions under section 4958(c)(1)(A) because they were described in employment agreements, and the amounts involved did not render the disqualified persons' total compensation amounts unreasonable.

[22] When making payments to an employee (unlike when making payments to an independent contractor), an employer generally must withhold income taxes, withhold and pay Social Security and Medicare taxes, and pay unemployment tax on wages paid to an employee.

[23] Non-resident aliens are generally liable for Social Security and Medicare taxes on wages paid to them for services performed by them in the United States.

[24] In general, the tuition reduction benefit of section 117(d)(1) of the Code is limited to education below the graduate level, unless graduate students are engaged in teaching or research activities at an educational organization described in section 170(b)(1)(A)(ii).

2. Deferred compensation-related adjustments

The IRS opened retirement plan examinations at eight of the colleges and universities examined and found compliance issues at about half. Examinations resulted in deferred compensation-related wage adjustments on Forms 941 and 1040 of $1,115,007.00 generating $201,298.00 in taxes and $12,036.74 in penalties.

Wages were adjusted primarily for the following reasons:

- contributions that had to be taken into income in current years because the payments were not conditioned upon the future performance of substantial services sufficient to convey a substantial risk of forfeiture under section IRC 457(f)(3)(B).
- loans from 403(b) plans exceeded IRC 72(p) limits so that deemed distributions were included in gross income.
- deferrals for a 403(b) plan exceeded IRC 402(g) limits.
- additions to a 403(b) plan exceeded IRC 415(c) limits.

3. How Compensation Was Determined

Examinations looked at the process by which private colleges and universities set compensation. To a large extent, these institutions followed practices in setting compensation that are consistent with meeting the rebuttable presumption of reasonableness. In fact, the compensation of 94 percent of ODTKEs at examined colleges and universities was set using a procedure intended to satisfy the rebuttable presumption of section 4958.

Nearly two thirds had formal compensation policies in place that applied to at least one ODTKE in the years under examination. Of those ODTKEs who were not subject to a formal policy during the exam years, over half were covered by such a policy in subsequent years.[25]

Either the board of directors or the compensation committee of the board set compensation levels for each ODTKE. Compensation was set according to procedures designed to avoid conflicts of interest. The compensation of each ODTKE was approved in advance by individuals who did not have a conflict of interest. In almost every case, individuals recused themselves from discussions about their compensation. In nearly every case, the college or university documented the basis for setting compensation before the person received the compensation. Even when the engineers found the initial contract exception applied to compensation at examined colleges and universities, the

[25] Most examinations were for tax years ending in 2006, 2007 and 2008. The 2008 Form 990, Return of Organization Exempt From Income Tax, due in 2009, was the first time organizations were required to report information to the IRS about their compensation practices and policies.

institutions followed procedures that were consistent with the rebuttable presumption – i.e., they relied on comparability data to set the compensation level.[26]

About half of colleges and universities used an outside compensation consultant to assist with setting compensation levels, and about half did not. Current surveys of position-specific compensation paid by colleges and universities were the most commonly used tool for determining comparable compensation for each position, whether or not a compensation consultant was employed.

C. Reasonableness of compensation

LB&I Engineers evaluated compensation paid to ODTKEs at private colleges and universities under examination to evaluate whether compensation was reasonable within the meaning of section 4958. The Engineers issued reports scrutinizing the determinations involved in establishing the rebuttable presumption. They asked whether comparability data was truly comparable – specifically, was it based on similarly situated institutions and functionally comparable positions? Once they established comparable data, they determined where the compensation fell within the range of compensation (i.e., at which percentile).

1. Observations on weaknesses in comparability data

The engineers identified a number of weaknesses in the comparability data relied on by colleges and universities to establish the rebuttable presumption.

- About 20 percent of the private colleges and universities included institutions in their data set that were not similarly situated.[27] Engineers looked to factors such as: type (e.g., private or public; liberal arts, research university, etc.), size of undergraduate enrollment, faculty size, location (urban, rural, suburban; region of the US), endowment size, tuition and cost to attend, selectivity (SAT ranges, etc.) and age of the institution (year founded). The engineers found institutions were not comparable based on at least one of the following factors: location, endowment size, revenues, total net assets, number of students, and selectivity.

[26] Treas. Reg. § 53.4958- 4(a). Under the initial contract exception, compensation is not subject to section 4958 as long as it involves fixed payments made pursuant to that initial contract entered into before the individual became a disqualified person.

[27] Treas. Reg. § 53.4958-6(c)(2). An authorized body that has appropriate data as to comparability if, given the knowledge and expertise of its members, it has information sufficient to determine whether, the compensation arrangement in its entirety is reasonable. In the case of compensation, relevant information includes, but is not limited to, compensation levels paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions; the availability of similar services in the geographic area of the applicable tax-exempt organization; current compensation surveys compiled by independent firms; and actual written offers from similar institutions competing for the similar services.

- Compensation studies provided by the colleges and universities often did not document the selection criteria for the schools in the surveys provided and did not offer an explanation as to why those schools were deemed comparable to the school relying on the study and under examination.
- Many colleges and universities relied on a compensation survey compiled by an independent firm in which their compensation data was included. However, the survey itself was not limited to schools that were sufficiently similar to all be comparable to each other. Some used the survey results without any adjustment; others removed schools that they determined were not sufficiently comparable.
- Compensation surveys relied on for comparability data often did not specify whether amounts reported included only salary or included other types of compensation to equal total compensation, as required by section 4958.

The selection of schools used for comparison determines whether total compensation appears to be high or low. The same compensation amount might be in the 25th percentile among one set of schools, but in the 90th percentile among another. For most positions for which engineers modified the list of comparable schools, the compensation was pegged at a higher percentile in the comparable data sets created by the engineers than in the data relied upon by the examined college or university.

2. Other observations

Organizations are permitted to use amounts paid by taxable organizations as comparable data. The colleges and universities examined, however, did not rely on compensation paid by taxable organizations to set compensation. Some compensation consultants did provide for-profit comparability data alongside comparable data for exempt colleges and universities to further inform the compensation-setting body, but not to set compensation.

Moreover, only for one position, that of the chief investment officer did some institutions look to other types of exempt organizations for comparability data. Some examined colleges and universities with very large endowments relied on a survey that included compensation for the chief investment officer position at both colleges and universities and private foundations with similarly sized endowments.

After engineers either accepted the comparability data presented or established alternative comparability data, they determined where compensation paid by the examined organization fell within the range of compensation paid by colleges and universities in the comparable data set for each position. The compensation for most positions analyzed was set in the range of the 75th percentile. Moreover, compensation set at or above the 90th percentile was much more common than compensation set in the range of the 50th percentile among the examined colleges and universities.

III. Outcomes of examinations

A. Written Advisories

The IRS issued written advisories to 24 institutions on a number of activities that could result in tax liability in the future. These advisories involved issues such as improper tracking of member types, characterization of income and expenses as related or unrelated, depreciation, attribution of expenses that are not primarily and proximately related to income and continuing losses that may indicate a lack of profit motive. They applied to activities including art galleries, hotels, conference centers, radio stations, parking lots, arenas and recreation centers.

B. Closures

Examinations have been closed at 31 of the 34 schools involving 117 separate Form 990-series returns, and the overwhelming majority of examinations closed with adjustments to returns.

SUMMARY OF ADDITIONAL DATA ANALYSIS

For the Final Report we have, where appropriate, weighted the Questionnaire responses to allow for the extrapolation of information from those organizations surveyed to all tax-exempt colleges and universities. This means that many of the findings apply not only to the particular respondents, but to the tax-exempt college and university sector as a whole.

In this section, we have summarized some of the questionnaire findings to present an overall picture of both the sector and the respondents. More detailed results and a greater discussion of the weighting of responses are available in Appendix C: Additional Data Analysis.

I. Organization Information

- The average college and university in the fall of 2006:
  - enrolled 3,800 full-time equivalent students.
  - employed 1,700 individuals, including 200 full-time faculty members, 200 part-time adjunct faculty members, 600 students and 750 staff.
  - had a student-faculty ratio of 13:1.
  - charged annual in-state tuition of $12,600 and out-of-state tuition of $14,800.
  - had gross assets of $361 million and net assets of $245 million.
  - had gross revenue of $141 million and total expenses of $121 million with excess revenue of $20 million.
  - maintained some form of off-site learning, with 63 percent conducting distance learning activities and 37 percent conducting educational programs outside the United States. Only 2 percent maintained offices, campuses and/or employees in at least five countries outside the United States.
  - had endowment funds.

II. Unrelated Business Activities

- About 60 percent of all colleges and universities had, at some point, filed a Form 990-T, with public institutions more likely than private to have filed.
- The activities most frequently reported on Form 990-T were Facility Rental (14 percent), Advertising (11 percent) and Recreation Center Usage (9 percent).
- All colleges and universities engaged in activities that they did not report on Form 990-T. Of the three most frequently reported activities (whether or not reported on Form 990-T):

  - 63 percent of colleges and universities engaged in Facility Rental with 14 percent reporting it on Form 990-T;
  - 54 percent engaged in Bookstore with 7 percent reporting it; and
  - 48 percent engaged in Food Service with 2 percent reporting it.
- The following shows by activity, the percentage of public and private colleges and universities engaged in that activity compared to the percentage reporting that activity on Form 990-T:
  - Public
    - Facility rental, 82 percent engaged with 53 percent reporting.
    - Food services, 64 percent engaged with 5 percent reporting.
    - Bookstore, 60 percent engaged with 12 percent reporting.
  - Private
    - Facility rental, 57 percent engaged with 11 percent reporting.
    - Bookstore, 52 percent engaged with 5 percent reporting.
    - Food services, 42 percent engaged with 1 percent reporting.

III. Endowment Funds

- 89 percent of all colleges and universities had endowment funds. 83 percent had endowment funds in their own name.
- 57 percent had another organization hold or maintain endowment funds on their behalf.
- 75 percent had an investment committee that oversaw investment of endowment funds, with an average of eight people on the investment committee.
- 64 percent engaged an outside consultant for investment guidance.
- 93 percent of the investment committees approved the selection of external parties used to manage the investments of endowment funds, while 83 percent approved investment-guidance recommendations made by outside consultants.
- For the fiscal year ending in 2006:
  - the average amount of endowment assets per full-time equivalent student was $53,656;
  - the average year-end fair market value of all endowment assets was $167 million;[28]

[28] This reflects questionnaire responses. As a result, the total endowment figure is less than the sum of the term, quasi and true endowment figures below.

- the average year-end fair market value of quasi endowments (i.e. unrestricted gifts) was $56 million;
- the average year-end fair market value of term endowments (i.e. those that can be spent after a term has passed) was $81 million; and
- the average year-end fair market value of true endowments (i.e. those where only the return on principal can be spent) was $82 million.

- 79 percent of investment committees or boards adopted a target spending rate for all endowments, which averaged 5 percent. 90 percent of those that adopted a target spending rate met the adopted rate.
- Of total endowment distribution, 56 percent were made for scholarships, awards, grants and/or loans in the amount of $3 million. 29 percent of total endowment distributions were made for general university operations in the amount of $3 million.
- 98 percent monitored endowment distributions to ensure that they were used for the donor's intended purpose(s). 86 percent monitored the distributions through reports; 54 percent monitored through financial audits on distributions.

IV. Compensation Practices

- Executive Compensation
  - 35 percent had a formal written compensation policy that governed compensation of at least some officers, directors, trustees, or key employees.
  - 21 percent reported that they hired an outside executive compensation consultant to provide comparable compensation data to determine the compensation of officers, directors, trustees, or key employees. Of those, 37 percent had the executive compensation consultant provide other services.
- Compensation for officers was approved by:
  - Board of directors (66 percent)
  - Officers (31 percent)
  - Other individuals (21 percent)
  - Compensation committee (20 percent)
- Compensation for directors was approved by:
  - Other individuals (17 percent)
  - Board of directors (15 percent)
  - Officers (12 percent)
  - Compensation committee (3 percent)

- Compensation for key employees was approved by:
  - Officers (54 percent)
  - Board of directors (26 percent)
  - Other individuals (22 percent)
  - Compensation committee (11 percent)

V. Compensation Amounts

- The responses for compensation amounts were not weighted. As such, the information discussed below does not apply to colleges and universities overall.
- The information below describes the compensation for the group of individuals listed among the highest-paid officers, directors, trustees, and key employees (ODTKEs):
  - For each position — CEO/Chancellor/President, Executive Director, CFO, Treasurer/Vice President, and Dean — the average compensation paid by large colleges and universities was more than twice that paid by small, with the compensation paid by medium institutions falling in the middle. For example, average compensation for CEO/Chancellor/President was as follows:
    - Small: $197,952
    - Medium: $294,798
    - Large: $399,723
  - The total average compensation of the highest paid ODTKEs ranged from a low of $109,746 to a high of $399,723.
- The information below describes the compensation for the group of individuals listed among the six highest-paid non-ODTKEs:
  - The total average compensation of the highest paid non-ODTKEs ranged from a low of $90,651 to a high of $832,677.
  - Of the highest paid non-ODTKEs, Sports Coaches had the highest average and median compensation across all sizes of colleges and universities.
  - Of the highest-paid non-ODTKEs at colleges and universities in each of the size categories:
    - Small
      - 55 percent served primarily as Faculty (instructional and research) with average compensation of $129,663 and median compensation of $86,183;
      - 24 percent served primarily as Administrative/Managerial with average compensation of $90,651 and median compensation of $85,174;

- 17 percent served primarily as Head of Department with average compensation of $150,664 and median compensation of $94,068; and
- Fewer than 1 percent served primarily as Sports Coach with average compensation of $216,678 and median compensation of $95,162.

▪ Medium

- 51 percent served primarily as Faculty (instructional and research) with average compensation of $185,529 and median compensation of $141,842;
- 21 percent served primarily as Head of Department with average compensation of $187,944 and median compensation of $141,712;
- 16 percent served primarily as Administrative/Managerial with average compensation of $173,117 and median compensation of $145,794; and
- 6 percent served primarily as Sports Coach with average compensation of $326,802 and median compensation of $196,341.

▪ Large

- 44 percent served primarily as Faculty (instructional and research) with average compensation of $346,490 and median compensation of $229,994;
- 18 percent served primarily as Sports Coach with average compensation of $832,677 and median compensation of $485,781;
- 16 percent served primarily as Head of Department with average compensation of $316,188 and median compensation of $205,363; and
- 11 percent served primarily as Administrative/Managerial with average compensation of $217,131 and median compensation of $174,273.

APPENDIX D: SYSTEMS

I. Introduction

Campuses of a university system were permitted to respond to the Questionnaire on a system-wide basis, rather than on a campus-only basis, if (1) system-wide reporting was consistent with reporting on Forms 990 and 990-T, and (2) the same method was used for all parts of the Questionnaire. Sixteen of the 400 colleges and universities that received a Questionnaire responded on a system-wide basis, identifying themselves as part of a total of six different systems.[29]

While the campuses were permitted to respond as systems, the sample and the Questionnaire were designed with campuses as the intended unit of analysis. Therefore, information provided on a system-wide basis was not included in the statistical analysis of survey responses presented in the Additional Data Analysis in Appendix C.

Readers should be careful not to draw conclusions regarding the information presented on systems in this Appendix D. The campuses that responded on a system-wide basis are not representative of the broader population of system-wide schools in the country. Furthermore, while respondents were instructed to answer all questions as systems if they answered any as systems, it is possible that respondents answered some questions for their individual campuses. The Questionnaire was written for individual campuses, and respondents may have answered some questions accordingly. As such, the information presented in this section cannot be used to draw conclusions for all university systems. This information is included for informational purposes only.

Unlike the presentation of information in the Additional Data Analysis, the discussion of the systems' responses includes limited raw data. A separate statistical analysis of systems' responses was not possible for the reasons discussed above. For most questions, narrative explanations are provided, but some could not be addressed because they would have required potentially misleading reporting of dollar figures.[30]

[29] The Interim Report reported that 11 campuses responded as part of a system. Further review indicates that 16 responded as part of a system.

[30] The following questions are not discussed with respect to systems: Questions 11 -12 (tuition), 13 (financial data), 17 (compensation), 46-67 (value of endowments and target spending rates), 48-50 (types of endowment funds), 75-94 (compensation policies and practices).

II. Organization Information

A. *General Observations of Systems*

1. Overview

- The six systems discussed in this appendix consist of both private and public institutions.
- On average, the six systems had over 43,000 Full Time Equivalent (FTE) students with over 4,800 full-time faculty members, reporting an average student to faculty ratio of 19:1.

2. Conflict of Interest Policy and Public Disclosure of Audited Financial Statements (Questions 8 – 10)

- All systems had a written conflict of interest policy that governs members of their top management officials or ruling body, while most had one in place for their full-time faculty.
- All systems also made their audited financial statements available to the public.

3. International and Other Activities (Questions 14 – 16)

- All systems conducted long distance learning activities and most conduced educational programs outside of the United States.
- About half maintained some sort of international physical presence in the way of offices, campuses and/or employees in at least five countries outside the United States...

4. Related Organizations (Questions 18 – 19)

- All systems had at least one related organization, the most common of which was a tax-exempt organization.
- Roughly half of the systems reported at least one related organization that was taxable as a corporation or trust.
- Most of the systems had written policies, or some other process, in place to assure that transactions with non-501(c)(3) related organizations (whether taxable or exempt) are made at arm's length for any arrangement that deals with the provision of goods or services, lending money, property rental, and transfers of assets. In the other arrangements, only some of the systems established an arm's length process.

5. Controlling Organizations (Questions 20 and 22)

- Most systems defined themselves as a controlling organization within the meaning of IRC § 512(b) (13). Those systems that identified themselves as controlling organizations each controlled an average of about two entities.

III. ACTIVITIES

A. *General Observations of Systems*

1. Participation in Activities (Question 23)

- Of the potential activities, all systems universally engaged in only two activities: facility rental and food services.
- More than half of the systems also reported engaging in the following additional activities: advertising, particularly printed publications and tv/radio broadcasting; corporate sponsorships; certain royalties; patents, copyrights and trade names or trade secrets; parking lot commissions; bookstores; and activities other than those enumerated in the Questionnaire.

2. Unrelated Business Income Treatment (Questions 26 – 27)

- Half of all systems reported the following as unrelated business income activities: advertising, facility rentals, partnership allocations, bookstores and activities other than those enumerated in the Questionnaire.

3. Expense Allocations and Use of Outside Counsel (Questions 28, 30 and 31)

- Most systems indicated they had both direct and indirect expenses, with the direct expenses significantly outweighing the indirect expenses.
- Inter-company expenses, i.e., expenses paid or accrued to related organizations, accounted for a very small percentage of total expenses.
- Many of the systems relied on the advice of independent accountants or counsel for certain unrelated business issues for the 2006 tax year, particularly to determine whether activities were unrelated or exempt.

IV. ENDOWMENT FUNDS

A. *General Observations of Systems*

1. Endowment Funds and Management by Other Organizations (Questions 32 – 33)

- All six systems reported having endowment funds.
- Over half reported that they had another organization or institution that managed or maintained the endowment funds on their behalf.

2. Investment Policy and Fund Managers (Questions 34 – 35)

- All systems maintained an investment policy for endowment funds.
- All systems hired external party managers.
- For systems that indicated more than one type of fund manager type, in-house managers were the next commonly used type of fund manager.

3. Investment Committees, External Managers, Internal Managers and External Consultants (Questions 36 – 41)

- All systems had an investment committee that oversaw the investment of endowment funds.
- The average number of individual members on an investment committee overseeing the endowment funds was nine (the median number was twelve).
- The investment committees for most of the systems approved the selection of external investment managers for their endowment funds.
- The investment committees of all systems approved investment guidance recommendations made by outside consultants.
- The average number of staff individuals whose primary responsibility was investment management of endowments was five (the median was three).
- All systems engaged outside consultant for investment guidance.

4. Compensation to Fund Managers (Questions 42 – 45)

- Of the respondents that used internal investment managers, the primary source of compensation was wages or salary. Performance-based compensation was the next most common form.
- All systems compensated their external investment managers on asset-based fees. The next common forms of compensation included mutual fund fees and performance-based fees.

5. Value of Endowments and Target Spending Rate (Questions 46 – 47)

- At least half of the systems have a committee of the board or full board review and approve compensation for both their internal and external investment managers.
- All six systems had their investment committees adopt a target spending rate for all endowments, which averaged 4.0% with a median of 4.5%.

6. Life Income Funds (Question 51)

- Over half of the systems held in their endowments one or more of the listed life income funds (charitable gift annuities, charitable remainder trust and pooled income).
- Of those who responded to the second half of Q 51 in providing a percentage, those endowments consisted of small percentages of each type of life income fund.

7. Foreign Investments (Question 52)

- Many of the systems made foreign investments through an investment entity, which was most commonly formed as a corporation or partnership.

8. Investments (Questions 53 – 55)

- Every system invested in one or more type of equity and fixed income funds.
    - Only U.S. equity funds were in the investment portfolio of all six systems.

    - Systems invested in both U.S. and non-U.S. equity and fixed income funds.
- Many systems' endowments also invested in alternative funds, such as private equity, hedge funds and venture capital funds. They also invested in real estate.
- Half of the systems held cash in their total investment pool.
- For all systems, the primary investment objective for their investment portfolio for the next five year period is a total real return (net of investment management fees) of 5% - 10%.
- A third of the systems reported that the board committee members of placed restrictions on the purchases or sales of certain securities due to particular donor restrictions or special requests.

9. Distributions from Endowments (Questions 56 – 59)

- All six systems distributed endowment funds for two categories: (1) scholarships, awards, grants and/or loans, and (2) general education support and/or libraries.
- All systems reported monitoring endowment distributions to ensure that the funds were used for the donor's intended purpose(s).
    - In order of common usage, the systems monitored the distributions with reports (monthly, quarterly or annual) and financial audits on distributions.
    - About half of the systems marked "other," and added such ways as campus departments and post-audit review procedures.
- All systems had a policy on disbursements made from endowments that were not used in the fiscal year of disbursement.
    - All reported applying undistributed amounts to the following year.
- Half also reported returning amounts to their endowment funds.
- Many of the systems also made distributions from endowments for the other categories, including: research, general university operations, chair positions and/or professorships, and other areas.

V. COMPENSATION

A. General Observations of Systems

1. Compensation of Highest Paid Employees (Other than Officers, Directors, Trustees, or Key Employees) (Question 17)

- Every system employed athletic coaches.
- Half of the systems reported that at least one of its five most highly paid employees received NCAA income.

2. Executive Compensation Amounts and Types of Remuneration (Questions 60 – 61)

- Very few systems reported that their highest-paid ODTKEs received compensation from related organizations.
- All six systems reported paying their highest paid individuals a base salary and providing contributions to employee benefit plans, such as health benefit.
- The next most common types of remuneration for these employees were contributions to life, disability and/or long-term care insurance, and providing housing and utilities.
- Half of the systems also paid a bonus, permitted personal use of the organization-owned or leased vehicles, and checked the box indicating other compensation (not otherwise classified).
- Systems also reported providing personal travel for the highly paid employee or a spouse, personal services (e.g. housekeeper, lawn service, etc.), expense reimbursements, health/social dues, other incentives or executive fringe benefits.
- Both employee and employer contributions are made to various deferred compensation plans.
  - Employees in most systems participate and contribute to deferred compensation plans under IRC 401(a), IRC 403(b), IRC 457(b).
  - Most systems also contribute to an IRC 401(a) plan.
  - A few systems also made contributions to IRC 403(b) and IRC 457(f) plans.

3. Executive Loans/Extensions of Credit (Questions 62 – 74)

- None of the systems provided loans or extended credit to their highest paid employees, including family members.

VI. GOVERNANCE

A. General Observations of Systems

1. Written Policies

- All systems reported having conflict of interest policies covering members of the ruling body and top management officials. Many also reported having conflict of interest policies covering full-time faculty.
- The number of systems that reported having conflict of interest policies or a statute in place to ensure specific transactions with related entities are made at arm's length varied.
  - Most of the systems had written policies or some kind of process in place to assure that transactions with non-501(c)(3) related organizations (taxable or exempt) are made at arm's length in arrangements that deal with the provision of goods or services, lending money, property rental, and transfers of assets.
  - In the other arrangements, only some of the systems established an arm's length process.
- All six systems maintain an investment policy for endowment funds.
- All systems reported having a formal written policy that governed compensation of at least some of their officers, directors, trustees or key employees.
- Same respondents also reported having a written employment or independent contractor agreement with at least one of the six highest paid ODTKEs.
- None of the respondents reported providing executive loans to any of the six highest paid ODTKEs.

2. Public Disclosure of Financial Statements

- All six systems also make their audited financial statements currently available to the public.

3. Use of Outside Advisers

- Many of the systems relied on the advice of independent accountants or counsel for certain unrelated business issues for the 2006 tax year, particularly to determine whether activities were unrelated or exempt.
- All systems reported use of an external party to manage investments in the endowment fund, as well as for investment guidance.

4. Endowment Funds

- All systems had an investment committee to oversee their endowment fund.
- The average number of members on an investment committee that oversaw the endowment funds was nine (median number is 12).
- Investment committees of most of the systems approved the selection of external investment managers for their endowment funds.
- Investment committees of all systems approved investment guidance recommendations made by outside consultants.
- The average number of staff individuals whose primary responsibility was investment management of endowments was five (median is three).
- All systems engaged outside consultant for investment guidance.
- Some systems reported that the board or a committee placed restrictions on the purchase or sale of securities because of particular donor restrictions or requests.
- All systems reported monitoring endowment distributions to ensure that the funds were used for the donor's intended purpose(s).

5. Compensation

- Most systems reported that the board of directors or a compensation committee set compensation and that they used a process intended to satisfy the rebuttable presumption.
- All private systems also reported that the compensation of at least one of the six highest paid ODTKEs was approved by the board of directors or by another authorized governing body that did not have a conflict of interest.
- These same systems also reported that executives recused themselves from approving and voting on their own compensation.
- These systems also reported documenting the basis for setting the compensation of at least one of their six highest paid ODTKEs, as well as using an independent compensation comparability survey.

IRS EXEMPT ORGANIZATIONS

FY 2012 ANNUAL REPORT & FY 2013 WORKPLAN

LETTER FROM THE DIRECTOR

Greetings,

FY 2012 was another busy year for Exempt Organizations (EO) — full of projects, legislation implementation, compliance, determinations and outreach work. In FY 2013, we will be moving to the next steps in much of that work, as well as beginning some new efforts.

We appreciate the exempt sector's interest in EO's annual reports and workplans, and we strive to make them as informative as possible. Although past workplans have given you a general description of our projects, we haven't provided much information about what we do behind the scenes to prepare for and implement them. I believe that has created a mismatch between your expectations of when a project will be completed and our reality of what it takes to execute and finalize a project. So, beginning with the FY 2012 Annual Report and FY 2013 Workplan, we will work to provide you with a clearer picture of the many elements that make up a project and give you a better sense of which elements we will be taking on within a particular fiscal year. We believe this approach will enable us to provide you with better, more timely information about ongoing projects.

Many of EO's projects are complex and require sophisticated planning and execution, so they rarely fit conveniently into a fiscal or calendar year and may go through several phases over their lifetimes. Phases can include:

- Project planning
- Questionnaire development
- Statistical sample design
- Specialized training for our revenue agents
- Focused data gathering — both internally and externally
- Data analysis and issue identification
- Examinations

Add to that the fact that the work on a particular project must accommodate other ongoing priority work assigned to staff. Coordination among the various offices that have pieces of the projects — Rulings and Agreements, Review of Operations, EO Compliance Unit, Determinations, Research, and Customer Education and Outreach — is sometimes challenging.

Despite the challenges, EO is committed to looking for ways to increase transparency about the status and findings of our projects by providing a clearer picture of our fiscal year goals and reporting on interim findings where possible. We hope this approach will provide the sector with a better understanding of how EO balances targeted projects with the overall compliance, determinations, guidance and education activities our stakeholders expect from us.

Sincerely,

Lois G. Lerner
Director, Exempt Organizations

CONTENTS

SPOTLIGHTS

Organizational Information

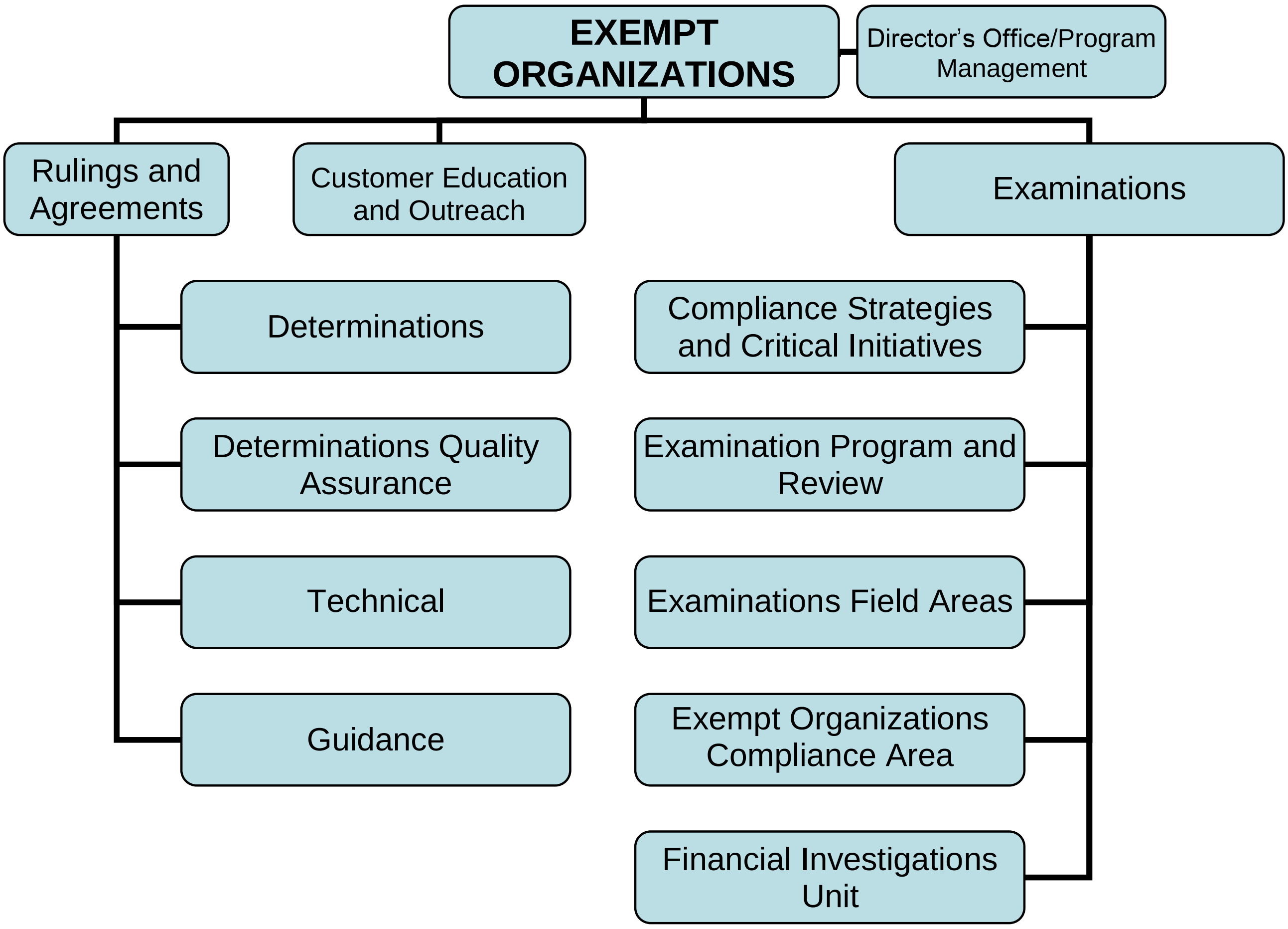
Exempt Organizations Staffing

Exempt Organizations (EO) is organized by three functional areas: Rulings and Agreements, Examinations, and Customer Education and Outreach.

Figure A: Employees over a 3-year period

	Rulings and Agreements	Examinations	Customer Education and Outreach	Director's Office/Program Management	Total
2010	337	538	13	12	900
2011	332	531	12	14	889
2012	335	516	12	13	876

Figure B: Organizational chart



GLOSSARY

Compliance Strategies and Critical Initiatives (CSCI)
Identifies areas of noncompliance and develops strategies to improve compliance through examinations, compliance checks, educational programs and other activities that may not involve the examination of books and records.

Customer Education and Outreach (CE&O)
Develops and delivers programs and products designed to help exempt organizations understand their tax responsibilities. Supports the development of internal and external communications, forms and publications and external education and outreach efforts.

Determinations
Processes applications for tax exempt status under IRC 501(a) and IRC 521, along with certain other requests. This includes reviewing applications, determining whether the information provided by the applicant meets legal requirements, and issuing determination letters.

Determinations Quality Assurance
Provides technical and procedural accuracy reviews of determination cases, provides feedback to determination groups on quality of work products and errors, and provides technical assistance to managers and employees.

Examinations
Analyzes the operation and finances of exempt organizations through examinations (audits). Exam agents propose tax assessments or changes to exempt status when necessary, as well as advise organizations about how to comply with the law in the future.

Examinations Field Areas
Exam managers and agents are situated in five geographical areas:

- Great Lakes: Illinois, Indiana, Iowa, Kentucky, Michigan, Minnesota, Nebraska, North Dakota, South Dakota, Wisconsin
- Gulf Coast: Alabama, Arkansas, Florida, Georgia, Kansas, Louisiana, Mississippi, Missouri, Oklahoma, Tennessee, Texas
- Mid-Atlantic: Delaware, Maryland, North Carolina, Ohio, Pennsylvania, South Carolina, Virginia, West Virginia, Washington, DC
- Northeast: Connecticut, Maine, Massachusetts, New Hampshire, New Jersey, New York, Rhode Island, Vermont
- Pacific Coast: Alaska, Arizona, California, Colorado, Hawaii, Idaho, Montana, Oregon, Nevada, New Mexico, Utah, Washington, Wyoming

Examinations Program and Review (EPR)
Responsible for EO Examinations program planning, monitoring and analysis; work plan; training plan development and monitoring; reports and briefings; workload studies; case selection, building and delivery; processing claims; screening and classifying all referrals; performing technical and procedural accuracy reviews of field examination cases; providing feedback to examination groups on quality of work products and errors; and providing technical assistance to managers and employees.

Exempt Organizations (EO)
IRS division responsible for oversight of the large and diverse sector of nonprofits — charities, foundations, churches and others — that are exempt from federal income tax. EO works to increase the sector's understanding of compliance requirements for federal tax-exempt status and promotes transparency, accountability and effective governance throughout the tax-exempt sector.

Exempt Organizations Compliance Area (EOCA)
Brings organizations into compliance using compliance checks, questionnaires and correspondence examinations. EOCA's Review of Operations (ROO) also conducts non-contact compliance reviews of exempt organizations' operations and activities to ensure they are operating in accordance with their exempt purposes. Where appropriate, they may refer organizations for examination.

Financial Investigations Unit (FIU)
Staffed with fraud specialists, forensic accountants and agents with expertise in identifying fraud and tracking foreign grant activities, FIU detects and deters fraudulent transactions in the exempt organization community by examining organizations identified as potentially involved in fraud. Additionally, the staff works jointly with law enforcement agencies, such as the Joint Terrorism Task Force and the Criminal Investigation Division, to support criminal investigations and expert testimony at trials.

Guidance
Provides formal and informal guidance that explains how certain laws, such as regulations, revenue rulings, revenue procedures, notices and announcements, may apply to exempt organizations.

Director's Office/Program Management
Supports the Director, EO and all of EO's functional areas, tracks EO's budget, monitors hiring and promotions, measures and reports EO's performance and performance goals internally, and helps ensure that EO is responsive to the needs of TE/GE HQ and the Commissioner.

Rulings and Agreements (R&A)
Composed of Determinations, Determinations Quality Assurance, EO Technical and EO Guidance. R&A processes applications for tax exemption and provides direction through private letter rulings, technical advice memoranda and formal and informal guidance; responds to taxpayer and Congressional correspondence, and supports EO Examinations initiatives with technical advice and the development of questionnaires, checksheets and reports.

Technical
Provides direction through private letter rulings and technical advice memoranda and processes complex applications for exemption.

Examinations

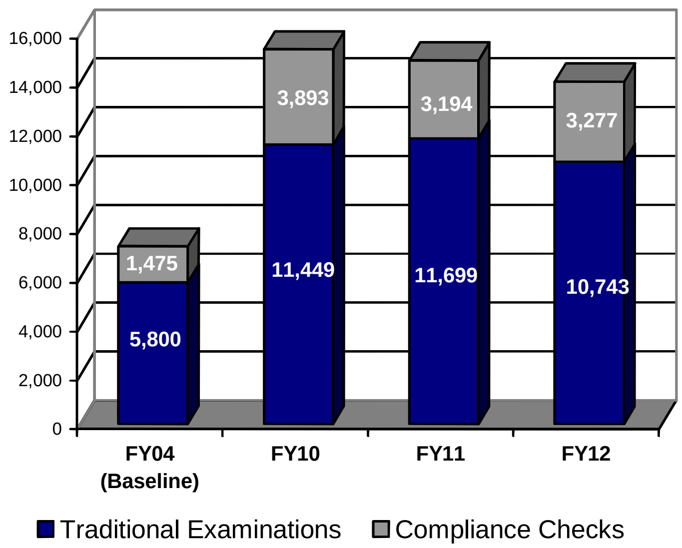
EO Examinations enforcement activities in FY 2012 included both compliance checks and traditional examinations. EO uses these techniques to maximize its reach as well as focus on specific issues.

In a typical compliance check, we contact an individual organization by letter when we discover an apparent error on a return. We also use compliance check questionnaires to study specific parts of the tax-exempt community or specific cross-sector practices. We request completion of the questionnaires by organizations matching the profile we want to learn about.

Traditional examinations, also known as audits, are authorized under § 7602 of the Internal Revenue Code. For exempt organizations, an examination determines an organization's continued qualification for tax-exempt status. We conduct two different types of examinations: field and correspondence.

In a field examination, the EO revenue agent performs the work at the organization's place of business. In a correspondence examination, an organization mails documents to the IRS office where the EO agent is located. Over three-fourths of the traditional examinations completed in FY 2012 were field exams.

Figure C: Total number of returns



Examinations

Since the redesigned Form 990 was introduced, EO Examinations has used the form's expanded data to better identify patterns of noncompliance, understand the causes and target potential offenders. The effectiveness of this process relies, however, on accurate reporting by Form 990 filers. Inaccurate or incomplete reporting may give the appearance of noncompliance, and that may lead us to examine an organization unnecessarily – something you and we want to avoid.

EO believes that education and compliance go hand in hand. In FY 2013, Examinations will work with EO Customer Education and Outreach to expand our efforts to help organizations understand clearly what is expected of them to keep their tax-exempt status.

Nanette Downing
Director, EO Examinations

Rulings and Agreements

One of the offices in EO Rulings and Agreements (R&A) is EO Technical. EO Technical is located in Washington, DC and is staffed by roughly 40 tax law specialists. Traditionally, EO Technical has been thought of as the function within EO that is responsible for private letter rulings (PLRs) and technical advice memoranda (TAMs). In the present workplace, however, EO Technical does many things in addition to those two activities.

EO Technical provides critical technical assistance to other parts of EO. EO Technical is actively involved in compliance projects. It works with EO Exam to develop questionnaires and checksheets, and it drafts reports on the results of compliance projects. EO Technical also works closely with EO Customer Education and Outreach (CE&O). It conducts technical review of all publications, IRS website material and outreach materials like scripts for webinars, workshops and presentations. A number of EO Technical's tax law specialists participate in the outreach events CE&O organizes throughout the country.

EO Technical works with EO Guidance to respond to correspondence from exempt organizations, the general public and members of Congress. In FY 2012, EO Technical/EO Guidance received over 300 pieces of general correspondence and almost 400 pieces of correspondence from members of Congress. EO Technical also works with EO Guidance to revise related EO chapters within the Internal Revenue Manual.

EO Technical provides technical assistance to EO Determinations as well as works applications itself. Certain applications for recognition of exemption, including cases where there is not well-established precedent that thus require interpretation of the tax law, are handled by EO Technical. Applications now compose more than 30 percent of EO Technical's total workload. By contrast, PLRs and TAMs combined compose roughly 15 percent of EO Technical's total workload.

As EO Technical's responsibilities have grown, we have looked for ways to better meet these competing demands. For example, over the last several years, EO Technical has implemented a number of measures to reduce the time it takes to process PLRs, TAMs and applications.

Those efforts are beginning to have an impact. In FY 2012, EO Technical reduced the number of its cases that are over two years old by more than 50 percent. EO Technical is committed to continuing to build on these improvements to make the PLR and application process as efficient as possible for taxpayers.

Holly Paz
Director, EO Rulings and Agreements

Customer Education and Outreach

In FY 2012, EO's Customer Education and Outreach (CE&O) office explored new ways to deliver programs and products virtually, which cut costs and broadened our audience. CE&O piloted a virtual workshop on a popular presentation topic that had been delivered previously by live speakers and was in high demand. CE&O's presentation, entitled *What You Need to Know About Automatic Revocation of Exemption,* was originally created in response to a request for a speaker for a series of events for tax practitioners in California. The presentation was delivered virtually, and an IRS speaker was available via speakerphone for live Q&A.

After its initial success in California, CE&O used the presentation at multiple other events for the remainder of the year, including briefings for congressional staffers in Texas, Georgia and New York. It has been used as both a stand-alone topic and integrated into larger presentations.

Figure D: Stakeholders reached through EO's education and outreach efforts

Outreach Efforts	FY 2010	FY 2011	FY 2012
EO Update subscribers	130,176	183,516	189,578
Attendees at speeches, tax forums, webinars, and workshops	32,111	41,252	30,688
IRS.gov/charities website views	5,333,380	5,242,943	4,827,351

EO maintained its core educational activities and continued to focus on new ways to engage and educate internal and external stakeholders. In FY 2012, EO's Customer Education and Outreach office:

- Offered 35 full-length and three shorter sessions of our day-long introductory workshops for small and medium-sized tax exempt organizations, in collaboration with 29 academic hosts in 34 cities in 18 states
- Supported the production and delivery of a writing course for EO Examinations Revenue Agents called *Express Yourself*
- Produced three webinars and three phone forums on select topics of interest to tax-exempt organizations and tax practitioners
- Issued 20 editions of the *EO Update* e-newsletter to help keep the tax-exempt sector informed about IRS policies and developments

In FY 2013, CE&O plans to build on the great success we had last year with stakeholder partnerships and virtual presentations. Traditionally, we've sent IRS experts to speak to groups around the country. Because our travel budget is limited, we will focus our in-person outreach on larger groups. Technology and virtual content are going to help us fill the gap with smaller organizations.

Like the example cited on the top left of this page, we're going to deliver more of our speakers' materials virtually, with an EO expert on the phone live to answer questions for participants.

We're more interested than ever in building stakeholder partnerships. Adding more virtual offerings is going to let us extend our reach — without the cost of an airplane ticket.

Melaney Partner
Director, EO Customer Education and Outreach

Federal-State Coordination

The Internal Revenue Code allows the IRS to disclose certain information about exempt organizations to state charity regulators that meet specified disclosure eligibility requirements. State charity regulators also provide information to the IRS about potential tax law violations occurring in their jurisdictions. This two-way exchange benefits both Exempt Organizations (EO) and state enforcement authorities.

EO has seen an increase in the number of referrals from state charity regulators and tax agencies of more than 70 percent over the past six years. In FY 2011 alone, the IRS received 104 referrals from state officials from 19 different states. Many of the common issues that are referred to the IRS involve:

- Private benefit and inurement
- Nonfilers
- Political activities by § 501(c)(3) organizations
- Employment tax issues
- Organizations not operated as required by their exempt status

At present, eight state tax and charity agencies in seven different states have met the disclosure eligibility requirements for IRS information sharing. In FY 2011, EO made approximately 27,000 disclosures to these eight agencies. The information included proposed and final revocations of tax exemption for § 501(c)(3) organizations, proposed and final notices of deficiency for Chapter 42 excise taxes for these organizations, approved § 501(c)(3) exempt organization applications, as well as proposed and final denials of these applications.

AFFORDABLE CARE ACT

In coordination with the Department of the Treasury and IRS Chief Counsel, Exempt Organizations (EO) continued in FY 2012 to implement the provisions of the Affordable Care Act of 2010 (ACA) that affect charitable hospitals, exempt organizations as small employers, and the tax practitioner community.

EO's activities in FY 2012 included:

- Continuing to revise Form 990, Form 990 Schedule H, and their instructions to enable hospital organizations to report whether and how they are complying with new requirements for tax-exempt hospitals.

- Issuing proposed regulations on new requirements for charitable hospitals under § 501(r). The proposed regulations address financial assistance policies, limitations on charges, and billing and collection requirements.

- Reviewing comments received in response to Notice 2011-52 and working on guidance regarding the community health needs assessment requirements under § 501(r), which are effective for tax years beginning after March 23, 2012.

- Continuing to conduct the statutorily required community benefit reviews. In FY 2012, EO reviewed the community benefit activities of hospital organizations. EO will continue to use the information gathered from the reviews for research, reporting and compliance purposes, as well as to identify areas where additional guidance, education or Form 990 changes are needed.

- Educating tax-exempt employers about the ACA's Small Business Health Care Tax Credit.

- Providing information (Fact Sheet 2011-11) for tax-exempt organizations participating in the Medicare Shared Savings Program (MSSP) through an Accountable Care Organization. The ACA established the MSSP, which encourages ACOs to facilitate cooperation among providers to improve the quality of care provided to Medicare beneficiaries and reduce unnecessary costs.

- Processing applications from organizations under new § 501(c)(29), which provides for exemption for Cooperative Health Insurance Issuers that meet certain requirements.

- Soliciting public comment on IRS proposals and providing outreach and education to improve exempt entities' understanding of the changes and new requirements.

As we move forward, the IRS will continue to work closely with the tax-exempt health care sector as we fully implement the ACA. EO will use the information gathered under new ACA requirements to further its research and risk modeling, which improves transparency and compliance.

GOVERNANCE

Based on comments in the 2008 report on governance by the Advisory Committee to TE/GE (ACT), EO undertook a study of the impact of various governance practices of public charities selected for audit.

Governance Study—Preliminary Results

EO has completed its analysis of 1,300 checksheets from 501(c)(3) organizations, and has produced preliminary findings. Because this analysis included only public charities that already had been selected for examination based on other criteria, the results are not statistically representative of the overall population. They do, however, provide an interesting starting point and offer some insight into which governance practices might be useful indicators of tax compliance.

The presence of the following factors was associated with compliance for the group that we reviewed:

- Have a written mission statement
- Always use comparability data when making compensation decisions
- Have controls in place to ensure the proper use of charitable assets
- Provide for Form 990 review by the entire board of directors before filing

On the other hand, the factor of having control of the organization concentrated in one individual, or in a small, select group of individuals, was associated with noncompliance.

In light of the initial findings, in FY 2013, EO will examine a statistical sample of 501(c)(3) and 501 (c)(4) organizations using a checksheet to gather information on their governance practices. As we continue our work in this area, we will look at whether other factors or practices are relevant.

Significant Diversion of Assets

In addition to the governance checksheet study, EO also looked at the tax filings and publicly available online information of 285 organizations that reported a significant diversion of assets on their 2009 Forms 990.

To learn more about whether and how governance practices may have contributed to these significant diversions of assets, in FY 2013, EO will conduct examinations that will include a review of governance practices, both before and after the diversion event. We are hopeful that the exams will generate relevant information on how organizations can avoid these events, as well as help EO refine our indicators of potential noncompliance to better target our examinations resources.

PLAIN LANGUAGE

Exempt Organizations (EO) has joined the rest of the IRS in encouraging plain writing among its employees, not only to meet the requirements of plain language legislation passed by Congress, but because clear communications obviously are a win-win for tax-exempt organizations and the IRS alike.

EO Examinations led EO's efforts. Examinations' customer satisfaction surveys as well as input from employees cited the need for better communications, including written products, yet EO had no program in place.

Seeing this need as an opportunity, EO designed a plain-writing course that combines virtual instruction and interactive, personalized coaching and delivered it over the past year to a pilot group of 300 EO Examinations revenue agents around the country. The voluntary course proved to be so popular and helpful that it will be extended in FY 2013 to tax law specialists in Rulings and Agreements.

The course, called *Express Yourself*, is a back-to-basics refresher on fundamentals like avoiding wordiness, writing for the reader, using strong, active verbs, and being careful to observe the rules of grammar. A separate session focuses on more formal technical writing required of agents and other specialists, such as taxpayer correspondence, requests for documents and final reports. The course's core curriculum was recorded by the IRS's former Chief of Congressional Correspondence, an experienced trainer. During breaks between those segments, coaches from Appeals, Counsel, EO Rulings and Agreements, and EO Customer Education and Outreach summarize and discuss points and help participants understand how plain writing is relevant to their daily work. The coaches also review homework assignments in a series of separate online sessions.

In addition to *Express Yourself*, EO participates in an ongoing, IRS-wide plain-writing working group that is establishing standards and guides across the IRS.

REVIEW OF OPERATIONS

In 2005, Exempt Organizations (EO) created the Review of Operations (ROO) to follow up on organizations after the IRS has approved them for exemption and determine whether they are complying with their tax requirements. These randomly selected follow-ups gave EO a less intrusive way to determine whether newly approved tax-exempt organizations — many of them start-ups — were engaged in activities that matched their stated tax-exempt purpose.

The ROO's efforts do not involve direct contact with the taxpayer. Decisions are based on the review of applications for exemption, other IRS information and information available from public sources, such as Internet searches.

In the ensuing years, the ROO has been a proven success, growing in scope and in the value it adds to EO's Determinations and Examinations work.

Among its expanded duties, the ROO:

- Follows up on organizations that were approved for exempt status by Determinations but that a specialist felt might bear another look in a year or two
- Checks to make sure an organization denied exempt status by the IRS is not holding itself out as exempt anyway
- Ensures that organizations are complying with the terms of closing agreements with the IRS
- Conducts specialized reviews that might focus on a particular issue or piece of legislation (such as community benefit reviews of hospitals under the Affordable Care Act)
- Uses its information-gathering abilities to greatly improve case selection for compliance projects and individual audits

Based on its success, the ROO has grown from an original staff of 14 to approximately 40 employees operating in two offices in Dallas and one in Atlanta. Together, they make Examinations and Determinations more effective and efficient and give meaning to a governing principle of IRS Exempt Organizations: trust, but verify.

AUTOMATIC REVOCATION AND REINSTATEMENT

The Pension Protection Act of 2006 (PPA) required small organizations, which had never before been required to file a return, to begin filing an annual notice with the IRS and also mandated that any organization—large or small—that failed to file a required return or notice for three consecutive years would lose its federal tax exemption by operation of law. As soon as the PPA was passed, EO began working to facilitate filing and prepare for the automatic revocations to come. Because the new law required small organizations to file an annual notice electronically, EO coordinated with other IRS offices to develop a new form, the 990-N, as well as an infrastructure for filing. Faced with the challenge of reaching hundreds of thousands of small organizations that had never before been required to file, EO engaged in an unprecedented effort to spread the word about the new filing requirements and the consequence of automatic revocation for failure to file for three consecutive years.

The PPA also required the IRS to publish and maintain a list of automatically revoked organizations. Since the list was first posted in mid-2011, EO has continued to respond to the challenges associated with automatic revocation and the needs of tax-exempt organizations and their stakeholders. Currently, more than 450,000 organizations have lost their exempt status, but only a little over 30,000 have come in for reinstatement. Because many revoked organizations are small and have limited resources, the IRS offered transitional relief, including a reduced filing fee and automatic retroactive reinstatement, to qualifying organizations applying through December 31, 2012. Recently, the IRS extended the filing date for transitional relief until February 1, 2013, for small automatically revoked organizations affected by Hurricane Sandy.

Of the more than 30,000 automatically revoked organizations that have submitted reinstatement applications to EO Determinations, some qualify for automatic retroactive reinstatement under the transitional relief. Others that seek retroactive reinstatement—that is, back to the date of revocation—must show reasonable cause for their failure to file in addition to providing other specified information.

EO continues to look for ways to better inform organizations and the public about automatic revocation and reinstatement. In January 2012, EO launched Exempt Organizations Select Check, which is an on-line, one-stop search tool that allows users to select an exempt organization and find out whether it has been automatically revoked, is eligible to receive deductible contributions or has filed a Form 990-N (e-Postcard) annual electronic notice. In March 2013, EO will begin providing more current information about automatic revocations by including organizations on the Automatic Revocation List within a month of their effective date of revocation. Previously, organizations did not appear on the List until six months after revocation. Because of this change, the number of organizations added to the List in March, 2013, will appear higher than in other months because it includes a catch-up period of about seven months.

DETERMINATIONS

Exempt Organizations (EO) Determinations consistently receives approximately 60,000 new applications for exemption every year. As the complexity of the applications and concerns about potential abuse have increased over the last several years, EO Determinations has implemented a number of improvements to the application process. Rather than assigning all cases to a revenue agent for development, we put in place a screening system to fast track applications that are substantially complete and require little or no further development. Technical screening is conducted as a first step in all cases by EO Determinations' most experienced revenue agents who review the applications and separate them into four categories:

- Substantially complete applications that do not require additional information (determination letter usually received within approximately 90 days)
- Applications that are not substantially complete (letter advising that the case was closed without action usually received within approximately 60 days)
- Applications where minor additional information is needed (request for additional information usually received within approximately 120 days)
- Applications that must be assigned to an agent for further development to determine whether requirements for tax-exempt status are met ("full development")

In FY 2012, 70 percent of all application cases were reviewed and closed within approximately 120 days during technical screening (i.e., cases in the first three categories above). Applications that cannot be completed through technical screening are sent to unassigned inventory, where they are held pending availability of a revenue agent with the appropriate grade level and experience for the issues involved in the matter. Certain applications, including cases where issues cannot be resolved by established precedent and thus require interpretation of the tax law, are reserved to be handled by EO Technical in Washington, DC. Those applications often take longer to process given the novel and complex issues involved.

In order to give applicants a sense of how long the wait could be before their application is assigned to a reviewer, we post on our website the submission date of full development applications currently being assigned. This date only applies to full development applications. In an abundance of caution, the date given on the website is the date of the oldest application awaiting assignment. Most applications requiring full development are assigned well before that date. The average wait time for full development applications at this time is roughly five months from the date we receive the application. We know the web page has created some confusion, so we are in the process of revising both the webpage and letters to applicants to provide better information on wait times.

EO Determinations understands the importance of processing exemption applications quickly, accurately, and consistently. We are continually refining the determinations process to better achieve these goals.

FY 2013 WORKPLAN
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FY 2013 WORKPLAN

This workplan highlights where Exempt Organizations (EO) is deploying resources in FY 2013. These projects are in addition to our day-to-day determinations and examinations responsibilities.

As stated in the Letter From the Director, EO plans to deliver timely information about ongoing projects, as well as updates on projects when they start or close. This year, we present the FY 2013 Workplan in two main categories:

- *Completed projects*
- *Ongoing projects*

We hope that this organization of our workplan highlights the status of each project and helps keep the tax-exempt community better informed about our efforts.

I. COMPLETED PROJECTS

As we mentioned in our FY 2011 Workplan, when projects conclude, we incorporate the applicable processes and procedures they generated into our day-to-day work.

Public Charity Status

In 2008, the IRS eliminated the advance ruling process for organizations seeking tax-exempt status as publicly supported charities. Under an advance ruling, a § 501(c)(3) organization received public charity status for a five-year period but then had to file Form 8734, *Support Schedule for Advance Ruling Period*, to demonstrate that it had met the public support test. With the elimination of the advance ruling period, organizations no longer have to file this separate "look back" report, and the IRS monitors an organization's public charity status after the first five years based on the public support data reported on Schedule A of Form 990.

Some organizations were still in their advance ruling period when the process was eliminated. The IRS looked at a statistically valid sample of the Schedules A filed by 400 of these organizations to determine whether they had properly computed their public support percentage. These compliance reviews showed that a high percentage of organizations reported correctly on Schedule A. EO will continue to monitor § 501(c)(3) organizations' qualification for public charity status as part of its regular, on-going assessment of Form 990 data.

Intermittent Non-Filers

In FY 2012, as one piece of our comprehensive non-filer program, EO completed compliance checks on about 240 organizations that had not filed a Form 990 or 990-EZ for tax year 2009. These organizations had filed for prior years, so we inquired about the failure to file.

These contacts resulted in submission of over 230 delinquent Form 990 or 990-EZ returns. We also found that a small number of contacted organizations had filed correctly, but their returns had not been fully processed prior to the mailing of the compliance contact letters.

In FY 2012, EO started an additional 300 compliance checks on non-filers for tax year 2010, as this effort has now become a part of our regular work.

Community Foundations

Community foundations began as a small group of charitable trusts established at local banks or trust companies to benefit residents through scholarship or other similar grantmaking programs. Over the past decade, there has been a significant increase in the number, size and complexity of community foundations and their grantmaking and other operations, including in some cases, related donor-advised funds.

EO sent questionnaires to approximately 3,700 organizations asking for information on their demographics, revenues, assets, investments, grantmaking and relationships. Over 3,500 organizations responded. Based on questionnaire responses and other research such as reviews of websites, EO corrected Master File community foundation designations for about 800 organizations.

Using questionnaire responses and information on the Form 990, EO selected certain community foundations for examination. The IRS was particularly interested in those organizations where donors appeared to exercise significant control over investment and grantmaking decisions. Although most of the examined organizations satisfied the regulations governing community foundations, the IRS found that some were potentially mischaracterizing fees earned from providing administrative, clerical, or grant-related services to unrelated organizations as related income.

"Mutual" Organizations Exempt under § 501(c)(12)

Organizations exempt under § 501(c)(12) include benevolent life insurance associations of a purely local character, mutual ditch or irrigation companies, or cooperative telephone companies. These organizations must collect at least 85 percent of their income from members for the sole purpose of meeting losses and expenses, with any excess being returned to members or retained for future losses and expenses. The results of the member-income "test" determine the organization's yearly filing requirement: Form 990 for the years in which it meets the 85 percent member-income test (income is tax-exempt), Form 1120 for the years it does not (income is taxable).

Based on Form 990-reported membership income percentages, EO sent compliance check questionnaires to a group of § 501(c)(12) organizations. Using the questionnaire responses and filed Form 990 information, EO selected about half of these organizations for examinations, all of which are now complete.

One-fourth of the examined organizations either failed the member-income test or were not being operated as a mutual entity or cooperative. EO procured the required tax forms or proposed revocation of exempt status as appropriate.

EO agents found that some of the other organizations had miscalculated and misreported their membership income percentages. In light of the high level of incorrect reporting, EO Customer Education and Outreach will work with IRS Forms and Publications to provide additional education on proper § 501(c)(12) membership income reporting in FY 2013.

EO Examinations Resource Pages on IRS.gov

In response to taxpayer requests for readily available information about the EO examination process, EO Examinations worked closely with Customer Education and Outreach in FY 2012 to centralize information about the examination process on IRS.gov. These new pages provide updated information to help familiarize organizations with what they need to know to help them prepare for an audit. Many of the pages have been simplified to make the reader's experience easier and clearer. At-your-fingertips information now includes:

- Many reasons an organization might be selected for review
- The distinctions among various types of review, including field audits, correspondence audits and non-audits, such as compliance checks
- What to expect during an examination, from initial contact to closing letter
- Taxpayer rights, including appeals
- Fast Track Settlement, a quicker way to resolve disputes

Several pages also have new links to additional information for ease of navigation.

II. ONGOING WORK

This section includes the status of projects started in previous years and, where possible, findings to date.

§ 512(b)(13) Study

The Pension Protection Act of 2006 (PPA) made numerous changes to the provisions of the Internal Revenue Code affecting exempt organizations. The § 512(b)(13) study is in response to a provision of the PPA that amended the law with respect to the unrelated business taxable income of an exempt organization and payments received from controlled entities. The provision also directed the Secretary of the Treasury to report on the administration of the new statute and to provide recommendations related to the tax treatment of payments between controlled entries and their parent exempt organizations. The Department of the Treasury asked EO to draft the report.

To gather basic data, we developed a § 512(b)(13) checksheet to be used in examinations. During the last two years, EO revenue agents completed about 3,000 checksheets, and we have now begun to analyze them.

National Research Program (NRP)

FY 2013 is the third and final year of this IRS-wide research project on employment tax compliance.

EO revenue agents have examined employment tax forms filed by exempt organizations for the tax years 2008, 2009 and 2010. To date, the agents have closed approximately 6,500 returns from almost 2,000 organizations and individuals. In FY 2013, EO will complete approximately 2,500 remaining returns and provide the data to the IRS-wide NRP project for further processing.

International Activities of Charities

EO is interested in ensuring that assets and income of domestic charities are not diverted to non-charitable purposes when the funds are sent abroad, as well as whether U.S. charities comply with regulations on recordkeeping and reporting when they operate or donate funds overseas.

In FY 2012, EO completed examinations of a sample of organizations that reported a foreign bank account on their Form 990s.

The results of the exams showed four problem areas:

- Failure to file the required Report of Foreign Bank and Financial Accounts (FBARs)
- Inadequate recordkeeping
- Lack of discretion and control over funds sent abroad
- Failure to file employment tax returns (or filing incorrect returns)

In FY 2013, we will shift our focus to examinations of organizations with high amounts of foreign grant expenditures.

This past year, EO also continued a project to determine levels of tax compliance by large private foundations, based on assets and revenues, with both § 501(c)(3) requirements and the specialized rules for private foundations. Many of the selected entities had foreign investments or made grants overseas.

About half of the examinations closed to date resulted in additional taxes or penalties. Adjustments to date included:

- Excise taxes on net investment income
- Taxes on unrelated business income
- Taxes on certain expenditures that are taxable when made by private foundations
- Employment taxes

In FY 2013, EO will complete examination of the remaining returns.

Finally, EO continued examinations of charities that participate in “Gifts-in-Kind” programs in which charities send non-cash items to other domestic or foreign organizations. In conducting these examinations, EO has coordinated with foreign regulators regarding organizations under their jurisdiction.

EO revoked the § 501(c)(3) exempt status of two organizations due to excessive private benefit and insufficient charitable activity. In other cases, EO noted the following problem areas:

- Poor recordkeeping of the gifts-in-kind
- Inaccurate reporting of this activity on Forms 990
- Inadequate discretion and control over the final disposition of the items

EO expects the remainder of the open cases in this project to close in late FY 2013. Additionally, more cases are being reviewed for potential examinations, with specific emphasis on organizations with limited charitable activity and excessive compensation.

State-Sponsored Workers Compensation Organizations

EO reviewed the activities of a number of state-sponsored groups that provide workers compensation insurance and claim tax-exempt status under § 501(c)(27). Together with TE/GE Research and the Government Entities division, we developed a questionnaire and sent it to approximately 40 organizations to determine whether they are meeting the criteria for exemption, are correctly classified as exempt, and are paying any employment taxes due. Based on our review of questionnaire responses, EO will refer some organizations to Government Entities, Large Business and International, or Small Business/Self Employed divisions for examination.

Group Rulings

In FY 2012, EO developed the Group Rulings Questionnaire for completion by a broad cross-section of central organizations holding group rulings. The impetus for this questionnaire was the 2011 report on group exemptions by the Advisory Committee to TE/GE (ACT), together with the large number of subordinates whose exemption was automatically revoked for failing to file a Form 990-series return for three consecutive years. EO hopes to learn about the relationship between central organizations and their subordinates and the ways in which central organizations and their subordinates satisfy their filing requirements.

In early FY 2013, EO mailed the comprehensive questionnaire to over 2,000 randomly selected central organizations. Recipients of the questionnaire are able to complete and submit responses online. EO anticipates that this new online system will shorten and improve the experience for respondents, as well as speed up data collection and analysis. EO also updated the IRS website with new information links about group rulings and a reference copy of the questionnaire.

Mortgage Foreclosure Assistance

In FY 2012, EO began a project focusing on organizations that offer or propose to offer foreclosure assistance activities. As mortgage foreclosures have risen over the past several years, EO has seen an increase in the number of organizations that claim to help individuals facing foreclosure. However, the activities of many of these organizations closely resemble those that EO looked at several years ago — noncompliant organizations that claimed to offer credit counseling support.

EO reviewed approximately 115 exemption applications from new organizations planning to offer mortgage foreclosure assistance programs. In follow-up letters, EO asked these organizations to show specifically how their proposed activities would meet § 501(c)(3) requirements.

Almost half of the applicants either did not respond to EO's questions or withdrew their applications after receiving EO's inquiries. About one-third of the applicants responded to the questions, met the requirements and were approved.

EO proposed or finalized denial of recognition of exemption for some applicants because their proposed activities either:

- Were not charitable
- Were commercial in nature
- Provided financial benefits to related businesses
- Appeared to attempt to take advantage of homeowners

In addition to reviewing applications, EO has also identified about 280 existing exempt organizations that appear to be providing mortgage foreclosure services. In FY 2013, we will conduct compliance reviews of these organizations and, where appropriate, recommend examinations.

Form 990-N Misfilers

The Pension Protection Act of 2006 (PPA) significantly impacted exempt organizations' annual reporting in two ways. First, it required most small exempt organizations to begin filing Form 990-N, the *e-Postcard.* Second, it mandated automatic revocation of exempt status of any organization failing to meet its annual filing requirement for three consecutive years.

Once the Form 990-N filing system was up and running, EO began monitoring to make sure that only eligible organizations were using it. Since filing began in 2008, we have determined that:

- Several hundred organizations submitted Form 990-N for tax years where other available information indicates they did not meet the Form 990-N filing criteria because they were too large.

- Several hundred apparent supporting organizations filed Form 990-N even though PPA required most such entities to file a Form 990 or 990-EZ.

- Over 1,000 organizations "dual-filed" both Form 990-N and another Form 990-series return for the same tax year.

We conducted compliance checks with the first two groups to obtain further detail on their eligibility to file Form 990-N. Over 200 organizations who filed the Form 990-N also provided information to the IRS indicating they were not eligible to file that form. In this circumstance the returns were not treated as valid filings and therefore, they will be notified that they automatically lost their exempt status, as mandated by law. Another 200 organizations did not provide sufficient information in their compliance check responses to make a determination that they have correctly filed. We will examine these organizations in FY 2013 and will contact the "dual-filing" organizations to determine their future filing requirements.

§ 501(c)(4),(5) & (6) "Self Declarers"

In FY 2012, EO developed a project focusing on § 501(c)(4),(5) & (6) organizations. These entities, which include social welfare organizations; labor, agricultural and horticultural groups; and trade associations, can declare themselves tax-exempt without seeking a determination from the IRS. EO wants to learn more about whether such organizations have classified themselves correctly and are complying with applicable rules.

In FY 2013, EO will send a questionnaire to organizations that "self-declared" by filing Form 990 for tax year 2010 or 2011. As in the Group Rulings questionnaire, recipients will be asked to complete the questionnaire online and submit it electronically. EO will analyze the responses and determine next steps.

Colleges and Universities

During FY 2012, EO completed a significant number of examinations in this project, and has begun to draft a final report. In FY 2013, EO will complete the report, which will include results from the examinations as well as additional analysis of the data from questionnaire responses previously received from almost 400 institutions.

EO Services and Assistance (EOSA)

EO launched the EOSA research project to better understand how small tax-exempt organizations receive tax-related information. The IRS started the project by gathering information from these organizations through a series of focus groups and a telephone survey. Drawing on what we have learned from the focus groups and surveys, EO is considering the most cost-effective ways to tailor its outreach efforts to meet the needs of these small organizations. In FY 2013, EO will develop communications materials and methods to implement the lessons learned.

Using Form 990 Information in Compliance Efforts

In 2008, the IRS released a new version of the Form 990 designed to promote transparency and improve compliance. The form requires filing organizations to supply more in-depth information than previous versions. We are using this information to develop potential indicators of noncompliance for use in our examination process. Once developed, these potential indicators must be tested, and we are in the early stages of that process.

As we examine organizations selected through this data-driven approach, we find that the Form 990 responses of some organizations do not always accurately reflect their activities. If those organizations had been more careful in completing their returns, they might not have been identified by our indicators or selected for examination. Because of the new ways we are analyzing return data and selecting cases, it is more important than ever that organizations follow instructions, compute properly and report accurately on their Forms 990. The bottom-line message to organizations and practitioners alike: The IRS uses the Form 990 responses to select returns for examination, so a complete and accurate return is in your best interest.

The following are compliance projects worked in FY 2012 that drew on data from the Form 990 and tested the indicators of potential noncompliance.

- Charitable Spending Initiative

In this long-range study, EO is using data from filed Forms 990 to focus on the sources and uses of funds in the charitable sector and their relationship to charitable accomplishments. We selected for examination a group of about 170 small organizations reporting high expenses in certain categories on their Forms 990 — for example, relatively large fund-raising amounts when compared with the expenditures for the organization's charitable programs.

Some of the results of this project illustrate the inaccurate Form 990 reporting noted earlier. In about one-third of the completed examinations, the reported high expense ratios turned out to be lower after examiners completed a full review of books and records.

More than 150 examinations have been completed and the remainder will close in early FY 2013. EO revoked the exempt status of four organizations due to either very little (or no) charitable activity or inurement to an officer. In other cases closed so far, EO has assessed tax on the unrelated business income of three organizations and secured or adjusted close to 100 employment tax returns.

In FY 2013, EO will use lessons learned during the exams of small organizations as well as similar criteria to identify a group of medium to large organizations to examine. We also will focus on organizations reporting substantial income from fundraising, but little or no fundraising expenses.

- Compensation Transparency

In this new approach to our ongoing interest in compensation, EO has focused on organizations reporting high annual gross receipts with very low total compensation to all officers, directors, trustees and key employees. EO's concern is whether some organizations may be circumventing the goal of transparency by hiding compensation levels.

The EO Review of Operations (ROO), using the Internet and internal sources, gathered information on a random sample of 200 organizations — a mix of "stand-alone" organizations and those reporting a formal relationship with one or more related organizations. Examinations will begin in FY 2013.

- Political Activity

In FY 2012, EO combined what it had learned from past projects on political activities with new information gleaned from the redesigned Form 990. Using the Form 990 data, EO developed indicators of potential noncompliance that allow us to better focus our resources. These indicators are now being tested and applied along two tracks:

- Based on current Form 990 data, the potential indicators of noncompliance have been used to identify organizations engaging in possible impermissible campaign intervention. Thus far, we have identified approximately 300 cases. This information, along with any other relevant public information, is sent to a committee of career civil servants for evaluation. Based on its review, the committee determines whether an examination of a particular organization is warranted.
- When EO receives referrals from outside sources alleging political campaign intervention, that information is also evaluated by a committee of career civil servants. After review, this group selects the cases that will be referred for examination. We also test the referral against our indicators of potential noncompliance as a way to refine and improve our criteria.

In FY 2013, EO will continue to work on cases that come through these two tracks. In addition, as a regular part of our political activity review, we will determine whether organizations are required to file Form 1120-POL under § 527(f), and if so, whether they have filed. We will use the results of the reviews, as well as other data analytics, to further refine our indicators of potential noncompliance.

- Form 990-T and Unrelated Business Income (UBI)

In FY 2012, EO completed compliance checks of 400 organizations that had reported taxable UBI activities on their Forms 990 but had not filed Form 990-T, *Exempt Organization Business Income Tax Return*. This work resulted in EO securing about 140 delinquent returns and more than $260,000 in tax payments.

In about one-quarter of the cases, inaccurate reporting on their returns resulted in organizations being examined for UBI issues. Examiners determined that if the organizations had reported correctly, they would not have been examined.

In FY 2013, EO will examine a statistically valid sample of organizations reporting substantial gross UBI for three consecutive tax years, but reporting no income tax due for any of those years. EO's concern is whether these organizations are accurately reporting their sources of UBI and correctly allocating and deducting expenses associated with it.

Interactive Form 1023

In its 2012 report, the ACT recommended that the IRS move towards an interactive, electronically-filed Form 1023, *Application for Recognition of Exemption*. As an interim step towards this recommendation, as well as a response to stakeholder and employee feedback, EO is developing an interactive, educational version of the Form 1023.

The interactive Form 1023 will feature pop-up text boxes for each line of the form that provide instructions and relevant links to online information at IRS.gov and StayExempt.irs.gov. EO hopes that this form will help § 501(c)(3) applicants file a complete and accurate application for exemption and improve the quality and consistency of exemption applications. EO plans to make this product available to the public in FY 2013.

Referral Selection Research Project

One way EO has traditionally identified organizations for examination is through referrals. Referrals are allegations of potential tax law violations that come from the public, Congress, other government agencies and also from within the IRS. Each referral that comes to EO is first routed to an experienced agent for preliminary research. In some cases, the agent then determines whether the referral has identified a potential violation of tax law and an examination is warranted. For certain issues, EO has established committees of experienced agents to consider whether referred organizations should be examined. If a referral raises one of those issues, the agent sends the referral on to the appropriate committee for consideration.

Because referred organizations constitute just one part of the EO Examinations workload, they must be balanced against other examination priorities. With referral cases, as in other parts of its work, EO has been developing tools using Form 990 data to facilitate more effective use of resources. In FY13, EO will begin a project testing the impact of using Form 990 data analytics to prioritize assignment of referral cases selected for examination. Based on the results, EO will continue to refine its selection of referred organizations for examination.

Legal Risks for Associations in Social Media

Legal Risks for Associations in Social Media - 4/9/2013 -

Check out this list of legal issues to consider when using social networking sites to create, manage, and sponsor content.

By A.J. Zottola

Incorporating the use of social media and online networking sites into an association's larger communication, membership, or marketing strategies raises a number of potential legal risks and liability issues for the association. The following is a non-exhaustive list of legal issues to consider.

1. It's more public than you think. An association should always be careful about what it posts, and assume that greater (not lesser) publication or disclosure is possible.

2. Avoid use of material obtained without permission, and provide proper attribution for content taken from other sources. Given the ease with which content and material can be obtained or posted online, even within social networking sites, avoiding copyright infringement will always remain a concern for associations.

3. Be careful with allowing others to post content. When managing an online social network that enables the posting of content by a third party (e.g., a member), such content functionality can give rise to liability for copyright infringement, torts, or defamation.Avoid encouragement of unauthorized use or copying of third-party content, and where possible, seek the consent of the author, owner, or subject before reproduction or use.

4. Know your identity and role. Monitor your interactions with other users, and be sure you can verify your association's own posted material from messages or material from other sources.

5. Pattern behavior to take advantage of potential immunity. The federal Digital Millennium Copyright Act of 1998 lays out certain safe harbors for Internet service providers that could provide protection from copyright infringement claims. Similarly, the federal Communications Decency Act of 1996 offers safe-harbor protection for providers or users of interactive computer services from civil liability for defamation, invasion of privacy, negligence, and trespass claims.

6. Consider hyperlinks to third-party sites. Although mere linking may not suffice to find copyright or trademark liability, an association should never frame, deep link to, or incorporate any third-party content without permission when it links to other sites or pages.

7. Don't misuse trademarks. Third-party trademarks should be used by an association in its online social media (with permission when possible), and with extra caution when use is in a commercial context.

8. Be careful with sweepstakes. An association should always seek legal counsel before implementing an online sweepstakes or contest through a social network.There are numerous state laws and regulations that govern online contests, lotteries, and sweepstakes.

9. Watch what you say when you market. An association should be careful with any practice that is really advertising in disguise.There are federal and state rules and guidelines to be mindful of in this area.

10. Don't ignore the rights of privacy or publicity. Privacy considerations, particularly with respect to children under the age of 13, still apply to social networking sites.

11. Be careful when sending unsolicited communications. Even inside a social networking site, email and other forms of viral campaigns (particularly for commercial messages) can remain subject to laws governing unsolicited email such as the federal CAN-SPAM Act of 2003.

12. Monitor blogs and other instant communication forums. Govern with clear policies regarding appropriate content, and use such policies to help manage the association's responsibility and potential liability.Every association needs a clearly stated take-down policy.

13. Protect your intellectual property and use proprietary notices. Consider use of a ™, ®, and/or © symbol in connection with more prominent placements of intellectual property. Otherwise, provide notices and conditions for any use of intellectual property by other users within an online social network.

14. Guard against antitrust risks. Social networking sites and related media can make it easy for members to let their guard down and share information that could lead to a violation of antitrust laws. Remind members that they may not communicate via association-sponsored social networking to make an anti-competitive agreement or even to share competitively sensitive information.

15. Don't ignore employer/employee considerations. An association should define its role and the expectations it has for its employees' behavior when they are using social networking sites for association business purposes.

A.J. Zottola is a partner at Venable LLP in its Technology Transactions & Outsourcing Practice Group.This article is not intended to provide legal advice or opinion and should not be relied on as such. Legal advice can only be provided in response to specific fact situations.

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April 2013

Information Security Implications for Business Agreements

This alert was also published in Law360 on April 22, 2013.

On February 12, 2013, President Obama signed an Executive Order ("Order") that outlined a voluntary cybersecurity framework ("Framework") designed to help protect the nation's critical infrastructure, which is generally defined as those systems or assets, whether physical or virtual, which are so vital to the United States that their incapacitation or destruction would harm public health or safety, economic security, or national security. The Department of Homeland Security has already designated the following 16 economic sectors as home to the U.S. critical infrastructure: information technology services, energy, telecommunications, banking and financial services, chemicals, manufacturing, transportation, emergency services, food and agriculture, healthcare and public health, the defense industrial base, government and commercial facilities, nuclear reactors, materials and waste, and water and wastewater systems. The Framework may therefore apply to countless companies of all sizes across a wide variety of critical infrastructure industries.

More generally, the Order has important implications for any private sector business because information security has rapidly become a hot button issue in this age of growing economic espionage, intellectual property and trade secret theft, and sensitivity to customer privacy. An increasing number of companies have recently reported data security breaches. Even a single security incident may lead to regulatory penalties, shareholder or customer class-action lawsuits, loss of customers to competitors, and irreparable damage to a company's brand or reputation. A company's best defense against any of these potential pitfalls is to take the steps necessary to sufficiently protect all proprietary and customer data.

Information Security Through Contract Drafting

Private sector businesses should now ensure that their agreements contain terms that effectively control access to and use and disclosure of their confidential or nonpublic intellectual property assets, such as patents, copyrights, and trade secrets ("Intangible Assets") and, separately, the personally identifiable information they store or otherwise retain ("Customer PII"). In an effort to minimize the likelihood of data breaches and the increasing number of data security obligations, businesses should even strive to consider safeguarding any Customer PII they are not presently obligated to protect under the patchwork of industry-specific privacy and information security laws, such as the Gramm-Leach-Bliley Act or the Health Insurance Portability and Accountability Act. What follows is a list of suggested concepts that should be incorporated, as applicable, into business agreements with counterparties who may have access to Intangible Assets or Customer PII (collectively, "Company Information").

- ***Confidentiality.*** Establish permitted uses and disclosures of Company Information by service providers, contractors, subcontractors or other venders, or counterparties to transfer, sale, merger or acquisition transactions (together, "Business Counterparties"), and provide that such parties cannot use or further disclose Company Information except as permitted or required by the contract or law.

- ***Risk identification and assessment.*** Consider requiring Business Counterparties to use commercially reasonable efforts to (i) identify and assess reasonably foreseeable threats to the security of Company Information and the likelihood of harm and potential damage flowing from such threats; (ii) classify data according to type or sensitivity; and (iii) gauge the need to adjust security protocols to address new threats or handling and storage deficiencies.

- ***Safeguards.*** Provide that Business Counterparties must implement technical, administrative, and physical safeguards to prevent unauthorized access to or use or disclosure of Company Information. Examples of such safeguards include (i) compartmentalizing Company Information on a business-need-to-know basis; (ii) encrypting stored and transmitted Company Information; (iii) limiting access to Company Information through passwords, network firewalls, and locking up hardcopy records; (iv) auditing security protocols on a regular basis; and (v) requiring employee information security training.

- ***Incident response and breach notification.*** Require Business Counterparties to report any unauthorized access, use, or disclosure of Company Information within a specified time frame, and provide that they must follow baseline breach notification procedures, including (i) a prompt investigation into the compromised information by designated individuals or groups; (ii) obligations to report (or assist with reporting) breaches to required regulators and law enforcement authorities within a specified time frame; (iii) mitigation procedures designed to limit the dissemination of stolen Company Information; (iv) and obligations to promptly notify affected individuals under certain circumstances.
- ***Customer Privacy.*** Consider inclusion of provisions in privacy policies and agreements with customers which (i) explain the company's practices regarding the collection, use and disclosure of Customer PII in business transactions; (ii) give customers the right to control certain or all secondary uses of their PII, and to access and contest the accuracy of their PII; (iii) explain or reference the procedures designed to ensure the integrity and accuracy of Customer PII; and (iv) describe how customers may seek information.
- ***Restrictive Covenants.*** Require employees to sign enforceable nondisclosure or noncompete agreements to protect Intangible Assets and, in particular, Customer PII from being misappropriated upon resignation.
- ***Terms of Employment.*** Require employees to execute written agreements that establish clear policies regarding downloading Company Information onto external devices, the ownership and control of Company Information, including, without limitation, work-related social media accounts and Company Information loaded onto external devices, and the return or destruction of data upon resignation.
- ***Downstream obligations – subcontractors.*** Require a Business Counterparty to ensure that any subcontractor it may engage on its behalf that will have access to Company Information agrees to the same restrictions and conditions that apply to the Business Counterparty with respect to such information.
- ***Termination rights.*** Retain a right to terminate any contract with a Business Counterparty that violates a material term of its agreement relating to Company Information.
- ***Data access by Business Counterparties.*** Draft provisions that clearly describe the Business Counterparty's rights to access Company Information during the arrangement and, in particular, in the event of litigation.
- ***Data destruction or return.*** After contract termination, require Business Counterparties to return or destroy all data received from the company, or created by the Business Counterparty on behalf of the company.

If you have any questions, please contact the authors or a member of the **Corporate** or **Technology Transactions and Outsourcing Group**.

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Online Social Media Legal Risks for Associations

Incorporating the use of social media and online networking sites into an association's larger communication, membership, or marketing strategies raises a number of potential legal risks and liability issues for the association. The following is a non-exhaustive list of legal issues to consider in connection with using social networking sites to create, manage, and/or sponsor content.

1. It's more public than you think. An association should always be careful about what it posts and assume that greater (not less) publication or disclosure is possible.

2. Avoid use of material obtained without permission and provide proper attribution for content taken from other sources. Given the ease with which content and material can be obtained or posted online, even within social networking sites, avoiding copyright infringement will always remain a concern for associations.

3. Be careful with allowing others to post content. When managing an online social network that enables the posting of content by a third party (*e.g.*, a member), such content functionality can give rise to liability for copyright infringement, torts, or defamation. Avoid encouragement of unauthorized use or copying of third-party content, and where possible, seek the consent of the author, owner, or subject before reproduction or use.

4. Know your identity and role. Monitor your interactions with other users and be sure you can verify your association's own posted material from messages or material from other sources.

5. Pattern behavior to take advantage of potential immunity. The federal Digital Millennium Copyright Act of 1998 lays out certain safe harbors for "Internet service providers" that could provide protection from copyright infringement claims, and the federal Communications Decency Act of 1996 offers safe harbor protection for providers or users of interactive computer services from civil liability for defamation, invasion of privacy, negligence, and trespass claims.

6. Consider hyperlinks to third-party sites. Although mere linking may not suffice to find copyright or trademark liability, an association should never frame, deep link to, or incorporate any third-party content without permission when it links to other sites or pages.

7. Don't misuse trademarks. Third-party trademarks should be used by an association in its online social media with permission when possible and with extra caution when use is in a commercial context.

8. Be careful with sweepstakes. An association should always seek legal counsel before implementing an online sweepstakes or contest through an online social network. There are numerous state laws and regulations that govern online contests, lotteries and sweepstakes.

9. Watch what you say when you market. An association should be careful with any practice that is really advertising in disguise. There are federal and state rules and guidelines to be mindful of in this area.

10. Don't ignore the rights of privacy or publicity. Privacy considerations, particularly with respect to children under the age of 13, still apply to social networking sites.

11. Be careful when sending unsolicited communications. Even inside a social networking site, email and other forms of viral campaigns, particularly for commercial messages, can remain subject to laws governing unsolicited e-mail such as the federal CAN-SPAM Act of 2003.

12. Monitor blogs and other instant communication forums. Govern with clear policies regarding appropriate content and use such policies to help manage the association's responsibility and potential liability. A clear take-down policy also should exist.

13. Protect your intellectual property and use proprietary notices. Consider use of a ™, ® and/or

© symbol in connection with more prominent placements of intellectual property and otherwise provide notices and conditions for any use of intellectual property by other users within an online social network.

14. Guard against antitrust risks. Social networking sites and related media can make it easy for members to let their guard down and share information that could lead to a violation of the antitrust laws. Remind members that they may not communicate via association-sponsored social networking to make an anti-competitive agreement or even to share competitively sensitive information.

15. Don't ignore employer/employee considerations. An association should define its role, as well as the expectations it has for its employees' behavior when they are using social networking sites for association business purposes.

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