New Developments on Federal Tax Matters Affecting Associations

Annual Association Law Symposium
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Today's Agenda

- State of IRS Exempt Organizations
- Congress and Association Tax Matters
- A Review of 2013's Big Developments
  - Unrelated Business Income
  - Compensation
  - Other Issues
    - Automatic Revocation
    - Self-Declarers
    - Group Exemptions
    - International Activities

State of IRS Exempt Organizations

- TIGTA Report—Political Activities and 501(c)(4)
  - Inappropriate criteria for review of exemption applications
  - Some debate over scope and partisan nature of problem
  - Takeaways
    - The long delays it takes IRS Determinations Unit to process applications;
    - Indecisiveness when difficult issues are presented

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State of IRS Exempt Organizations

- Congressional Scrutiny (post-scandal)
  - Issa and Camp—House Committees on Oversight and Government Reform, Ways and Means
  - Other hearings (e.g., tax reform)
- Personnel Changes (Miller, Lerner, Paz, others)
- What does this mean for associations and those who represent them?
  - Short-term:
    - Less scrutiny of (c)(4) political activities?
    - More timely consideration of applications?
  - Further down the road
    - Bright line tests for political activities?
    - Online application forms?

Legislative Developments

- Investigations (discussed earlier)
  - Any possible legislation related to the "scandal"?
  - Greater funding to improve timeliness?
- Substantive tax matters
  - Tax reform
  - Charitable deduction issues
  - Investment Income

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2013 Big Developments

- IRS Work Plan
  - FY 2012 Stats
  - Governance Study Results
  - Completed and Ongoing Projects
- Colleges and Universities Project
  - Unrelated Business Income
  - Compensation

2013 Big Developments

- IRS EO Work Plan—UBI
  - EO will continue on its Unrelated Business Income Project begun in 2012
- Statistics of Income
  - 2006 tax year, less than 50% of returns filed showed positive amounts of UBTI
  - This year IRS <u>will be examining a "statistically valid" sample of nonprofits that have reported "substantial" UBI for 3 consecutive years but have reported no income tax due</u>
  - We see a lot of organizations in exactly this situation
    - May be legitimate (e.g., LLC/LP investments and/or business activities that will eventually turn around)
    - May be result of aggressive expense allocations
    - May be caused by netting a perennial loss activity (that does not qualify as a trade or business) with other activities which do produce UBI
    - Sometimes, all of the above

2013 Big Developments

- IRS Colleges and Universities Compliance Project (CUCP)—UBI
  - The Project was begun in 2008 when the IRS sent a 33-page questionnaire to 400 colleges and universities that included public, private, small, large and medium sized institutions. An interim report was issued in 2010.
  - As a result of the answers to the questionnaire, IRS decided to examine 34 of the schools and waited until those examinations were completed to come out with the final report
  - April 25, 2013—IRS issued the CUCP Final Report
  - In addition to UBIT the Final Report also focused on a variety of compensation issues.
  - This is a good report to be familiar with: http://www.irs.gov/pub/irs-tege/CUCP_FinalRpt_042513.pdf

2013 Big Developments

- CUCP—UBI
  - Underreporting of UBTI resulted in an increase in UBTI for the schools totaling approximately $90 million in the aggregate and disallowance of more than $170 million in losses and net operating losses (NOLs)
  - Disallowance of losses due to lack of profit motive;
    - NOLS's disallowed
    - Offsetting against profitable activities not allowed
  - Improper expense allocations, such as where expenses for related activities were used to offset unrelated income or where an allocation of overhead to unrelated activities was unreasonable;
  - Errors in computations or substantiation of NOLs; and
  - Misclassification of an activity as exempt when it was really unrelated

2013 Big Developments

- UBI Expenses—Deductible and Profit Motive
  - Item must first be a deductible item under the IRC
  - If there are losses from the activity on a continual basis, the IRS and the courts have taken the position that there is no profit motive and therefore the trade or business requirement has not been met.
    - Portland Golf Club, 497 US 154(1990)
    - Groetzinger, 480 US 23(1987)
    - There may be a legitimate reason for the loss

2013 Big Developments

- Possible Reasons for UBI Losses

A = Business was in start-up phase
B = Actual costs were significantly greater than anticipated
C = Competitive pressures prevented pricing to cover costs
D = Less demand for product or service than was projected
E = Business was in business cycle downturn
F = Budgeted to operate at breakeven to further mission
G = Business was in winding-up phase
H = Other

2013 Big Developments

- Characterization of Expenses

  When looking at expenses to offset unrelated business income, the expenses should be put into three baskets:

  1. Expenses related solely to exempt activity, which cannot be used at all to offset UBI
  2. Expenses related solely to unrelated activity, which can be used in full (e.g., an individual whose only job is to procure advertising customers)
  3. Expenses involving related *and* unrelated activities (i.e., "dual use expenses")

2013 Big Developments

- Dual Use Facility Expense Allocations
  - Under IRS regulations, an organization is allowed to deduct an expense that is directly connected to an unrelated trade or business if it has a “proximate and primary relationship” to that unrelated trade or business.
  - Currently, regulations state that expense allocation between dual uses must be “reasonable.” But “reasonable” is open for interpretation and litigation. Though still controversial, several legal cases highlight the issue, including RPI v. Commissioner of Internal Revenue (1983/1984).
  - With the current lack of clarity, if and when this issue is brought to light during an audit, the organization and the IRS have to negotiate a settlement.

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2013 Big Developments

- Steps to Take
  - *Profit motive*. Document why the activity is generating losses (i.e. startup mode, meant to run a loss, etc.).
  - *Dual use of facilities expense allocations.* Review and document the methodology used in the calculation. Is it reasonable? Is it consistent with relevant tax court rulings and the IRS' interpretation?
  - *Documentation.* Keep good records in case the IRS comes knocking.

2013 Big Developments

- Statute of Limitations and UBI
  - In general, for federal income tax purposes, the government has three years from the date a tax return is filed to go back and assess taxes and otherwise, there is a statute of limitations on going back further unless there is a material understatement of tax liability, i.e., greater than a 25% understatement and then the statute of limitations is generally six years.
  - If an organization never filed a tax return, then there is no limitation on how far back the government can go to assess taxes, interest and penalties.
  - Net Operating Losses (NOL)—IRS can go back to the year that the NOL was generated to see if the losses were legitimate.

2013 Big Developments

- UBTI Focus: Sponsorship or Advertising
- Qualified Sponsorship Payment
  - No “substantial return benefit” –2% deminimus rule
  - Mere acknowledgement vs. advertising
    - Name, logo, address, etc.
    - No comparison or sales information
  - Does not matter whether sponsor takes a charitable or business deduction
  - Website click through okay
  - Think about tweets and other social media sites
  - – Safe harbor does not apply to periodicals nor to trade shows
  - – Payment may be exempt for other reason, e.g., royalty

2013 Big Developments

- Sponsorship or Advertising—Acknowledgments
  - Mere recognition of a sponsor
  - Logos and slogans that do not contain comparative and qualitative descriptions of the sponsor’s products, services, facilities, or company
  - Sponsor locations and telephone numbers
  - Value-neutral descriptions, including displays or visual depictions of a sponsor’s product line or services
  - Sponsor brand or trade names and product or service listings
  - Logos or slogans that are an established part of a sponsor’s identity are not considered to contain comparative or qualitative descriptions

2013 Big Developments

- Advertising
  - Subject to unrelated business income tax
  - “Any message or other programming which is broadcast, published, displayed or distributed in exchange for any remuneration, and which promotes or markets any company, service, facility or product.”
  - Endorsements are subject to UBIT

2013 Big Developments

- Compensation—Work Plan
  – EO has focused on organizations reporting high annual gross receipts with very low total compensation
  – 200 organizations selected for examination

2013 Big Developments

- Compensation—Colleges and Universities
  - Final report released April 2013
  - Compensation issues found
    - Comp of officers, directors, trustees, key employees (ODTKEs) at 94% of schools was set following procedures intended to meet rebuttable presumption in § 4958 regs
    - However, IRS concluded that 20% did not satisfy the regulatory standards—comparability data not from “similarly situated organizations”; compensation studies lacked necessary detail

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2013 Big Developments

- Compensation—Colleges and Universities Report (continued)
  - Non-ODTKE Compensation to heads of departments, coaches, etc., was a concern
  - While non-ODTKEs generally do not fall within *per se* disqualified person category, facts and circumstances might show otherwise
  - Also, private benefit could be an issue even in the absence of a disqualified person

2013 Big Developments

- Compensation—Takeaways and Practice Tips
  - May 2013—IRS announced more expansive project beginning in 2014 to investigate whether issues identified in Colleges report are present across a greater portion of the tax-exempt sector
  - Inurement, Intermediate Sanctions applicability
  - Rebuttable Presumption Steps:
    1. Advance approval by an independent Authorized Body
    2. Reliance on comparability data
    3. Concurrent documentation of terms and date approved

2013 Big Developments

- Compensation—Takeaways and Practice Tips (continued)
  - Review methods and policies for compensation
    - Establish and follow a formal policy that matches the rebuttable presumption of reasonableness
    - Review procedures for identifying comparable entities
  - Compensation consultants—while it is helpful to use such a consultant, associations should obtain detailed information about the origins of data used (e.g., Forms 990s? Other studies?) and about the comparable organizations selected (revenue, type of organization, etc.)

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2013 Big Developments

- Compensation—Takeaways and Practice Tips (continued)
  - Remember that Form 990 brings to the forefront compensation issues for all nonprofit organizations
  - Form 990 viewed by donors, members and the general public:
    - Scrutinized by the media
    - Reviewed by own executives
    - Reviewed by other organizations executives
    - Reviewed by the States
  - Schedule L—Transactions with Insiders and Excess benefit transactions

2013 Big Developments

- Other Important Work Plan Items
  - Automatic Revocation
  - Self Declarers
  - Group Rulings
  - International Activities

Conclusion

- Questions?

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