TAX RED FLAGS FOR AUDITORS AND FINANCIAL MANAGERS:
KNOW WHEN YOU NEED AN EXPERT

MACPA GOVERNMENT AND NOT-FOR-PROFIT CONFERENCE
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Agenda

• Identify situations and activities that can have potentially adverse tax consequences to your organization

• Understand what the tax preparer needs to know

• Stimulate conversations between management, auditors, and tax personnel that will serve and protect your organization
CAUTION

THIS SIGN HAS

SHARP EDGES

DO NOT TOUCH THE EDGES OF THIS SIGN

ALSO, THE BRIDGE IS OUT AHEAD
New Programs
Discontinued Programs

What to Look For:

• The organization has undertaken a new programmatic activity
• The organization has discontinued an existing programmatic activity

Why it Matters:

Both significant new and discontinued programs must be disclosed on the tax return. Organizations that undertake significant programs that are inconsistent with their mission may jeopardize their tax-exempt status.
Independent Contractors

What to Look For:

Workers classified as independent contractors who: appear to have set working hours, receive significant training, follow specific instructions, are paid based on time instead of by the job, aren’t working for any other employer, and who can be fired even if the job specifications are met.

Why it Matters:

To determine whether an employment relationship exists between the individual and the organization for federal employment tax purposes. When the organization has the right to control and direct not only what is done but how it is done, the relationship may be that of employer and employee. Penalties for worker misclassification are severe. This is an area examined in every IRS audit!
Compensation/Bonuses

What to Look For:

- Executives holding positions for which they are not qualified
- Accomplishments and results do not justify the compensation/bonus
- Compensation seems significantly larger than comparable organizations
- Compensation is not set by independent, disinterested persons
- Individual’s hours do not justify the compensation

Why it Matters:

Intermediate sanctions exist to curb inurement to disqualified persons (c3 and c4 only) who have substantial influence over the organization. In extreme cases, tax-exempt status can be revoked. An excess benefit transaction occurs when the economic benefit provided by the organization exceeds the value of the consideration received.
Rebuttable Presumption of Reasonableness

What to Look For:

- Compensation for officers and key employees is NOT determined by independent members of the governing body or compensation committee
- Compensation levels are being set without regarding to comparability data for similar positions at similar organizations
- Organization is not documenting the decision-making process

Why it Matters:

If these procedures are followed, the compensation will be presumed to be reasonable under the excess benefit rules. Excise taxes can then be imposed only if the IRS develops sufficient contrary evidence to rebut the organization's evidence (the burden of proof shifts to the IRS to prove that the compensation is unreasonable).
Executive Privileges

What to Look For:

First Class/Charter travel, travel for companions, housing allowances, expense reimbursements without an accountable plan, club dues, use of personal residence, company car, chauffeur, tax return preparation, personal trainer, personal advisor, babysitter, pet sitter, chef, concierge

Why it Matters:

An economic benefit that should be treated as compensation but is not is an automatic excess benefit transaction and can subject the executive to excise taxes. Organizations must be careful to report the taxable portion of fringe benefits in the recipient's W-2, and include all elements of reportable compensation on Form 990.
Out-of-State Activity

What to Look For:

- Employees who regularly work from home in another state
- Inventory or other property located in another state
- Regular and systematic travel into another state
- Attending trade shows in another state
- Speaking engagements in another state
- Fundraising Activity in another state

Why it Matters:

Can create nexus for:

- Payroll and unemployment taxes
- Charitable solicitation registration
- Unrelated business income tax
- Property Tax
- Sales and Use Tax
Grantmaking/Programmatic/Investment Activity in Foreign Countries

What to Look For:

- Grants, assistance, investments, fundraising, unrelated trades or businesses, programmatic activities, or maintaining offices, employees, or agents outside of the USA

Why it Matters:

- Revenue, expenses, and investments related to activities in foreign countries must be reported on Form 990. Additional filing requirements exist when an organization has signature authority over any financial account in a foreign country, transferred property to, or held a substantial interest in a foreign corporation, trust, or partnership. Potentially severe penalties for non-filing.
Income From Debt financed property

What to Look For:

• Rental income from property subject to a mortgage
• Margin-financed securities and other leveraged Investments

Why it Matters:

Although there are many exceptions, income from debt-financed property is subject to unrelated business income tax. To the extent that a tax-exempt organization borrows money to purchase property that generates income, the IRS seeks to treat the activity as an unrelated trade or business, even when it is passive in nature.
Joint Ventures

What to Look For:

The nonprofit organization is the General Partner in a partnership in which individuals or commercial entities are limited partners.

Why it Matters:

Exempt status is jeopardized unless the activity furthers the exempt purpose and the partnership agreement allows the general partner to act exclusively in the interests of the exempt purpose. The nonprofit must be in control of the venture, and must explicitly put the mission ahead of profitability.
Alternative Investments

What to Look For:

Partnership investments, investments in S Corporations, hedge funds, private equity funds, real estate funds, venture capital funds, commodity funds, offshore fund vehicles, funds of funds, bank common/collective trust funds

Why it Matters:

Although passive income is generally exempt from income tax, investments may generate UBI if they engage in activities unrelated to the exempt purpose or generate income from debt-financed property. However, the entire share of S Corporation income is UBI to most tax-exempt entities. Alternative investments often generate additional tax filings. K-1’s from partnerships and LLC’s should disclose UBI amounts.
Mailing List Rental

What to Look For:

• Sale or rental of mailing lists to nonprofit or commercial organizations
• Any services provided along with the mailing list

Why it Matters:

• The rental or exchange of mailing lists between exempt organizations is not taxable. However, if the Organization provides any additional services, the payment may be treated as an unrelated trade or business.
Extremely Large Donations

What to Look For:

• An unusually large grant given to a public charity, so large that it constitutes a significant amount of the organization’s support over the last 5 years.

Why it Matters:

• Unusual and unexpected large donations can cause a public charity to be reclassified as a private foundation. By examining specific criteria, an unusual grant may be able to be excluded from the calculation of public support.
Gift Shops

What to Look For:

• Gift shop that sells stuffed animals, coin banks, toys, film, bottled water, candy bars, art items, post cards, newspapers, aspirin, batteries, souvenirs, coffee mugs, t-shirts, caps and jewelry items
• Sales of inventory through the website

Why it Matters:

Each and every item of inventory should be carefully evaluated to determine if it is educational/mission related, trivial/utilitarian in nature, or meets one of the available exceptions (convenience of the visitors, etc.). Otherwise, such sales may be UBI.
Noncash Donations

What to Look For:

• “In-kind” donations of goods such as shares of stock, works of art, or cans of soup

• “In-kind” donations of services such as pro bono legal services, free advertising space or air time, free use of facilities

Why it Matters:

While noncash items are included in revenue and expenses on Form 990, in-kind services and use of facilities are excluded.
Vehicle Donations

What to Look For:

The organization receives a contribution of a motor vehicle, boat, or airplane

Why it Matters:

A charitable donee organization must file Form 1098-C (Contribution of Motor Vehicles, Boats, and Airplanes) for each qualified vehicle with a claimed value of more than $500 received as a contribution with the IRS with a copy to the donor no later than 30 days after the date a vehicle is sold in an arm's-length transaction to an unrelated party or is transferred to a needy individual for significantly below fair market value in furtherance of the donee's charitable purpose. Certain penalties are imposed for filing a false or fraudulent Form 1098-C.
Resale of Noncash Donations

What to Look For:

• An organization disposes of donated tangible personal property within 3 years
• Does not apply to donations of publicly traded securities

Why it Matters:

An organization that sells or otherwise disposes of donated property within three years after the donor's contribution of such property generally must file Form 8282 (Donee Information Return) with the IRS and provide a copy to the donor. Failure can result in penalties.
Conventions/Trade Shows

What to Look For:

The organization conducts a trade show where vendors exhibit their products and services and promote public interest in the industry.

Why it Matters:

Income from such activity is excluded from UBI only when the activity is carried on by a qualifying organization in conjunction with a qualified convention or trade show. The purpose of the activity should be educating members, promoting products and services of the industry, or educating persons attending the show concerning new developments or products and services related to the exempt activities.
Advertising/Sponsorships

What to Look For:

Corporate donations that oblige the nonprofit to provide anything in return, including acknowledgement of the gift

Why it Matters:

While return benefits, most frequently advertising, may be taxable, a qualified sponsorship payment is not. To qualify as a sponsorship, there must be no arrangement or expectation of a substantial return benefit to the donor. Mere acknowledgement is not a return benefit.
Exclusive Provider Arrangements

What to Look For:

An arrangement limiting the sale, distribution, availability, or use of competing products, services or facilities

Why it Matters:

Such payments are not qualified sponsorship payments, and may under some circumstances be unrelated business income.
Travel Tours

What to Look For:
Organization offers or promotes tours, vacations, or cruises to various travel destinations, whether for educational or recreational purposes.

Why it Matters:
Revenue may be UBI unless the tour is related to the organization’s mission, contains significant educational value, and is led by qualified instructors. The IRS will focus on the types of activities scheduled and the time devoted to such activities. Contemporaneous written documentation must be maintained, showing the development of the itinerary and the actual conduct of the tour.
Parking Lots

What to Look For:

Organization operates a parking lot or garage, renting spaces to customers and the general public.

Organization generates revenue by making its parking facilities available to outside organizations during special occasions.

Why it Matters:

Revenue will generally be UBI unless the facilities are for the convenience of the organization’s members, patients, visitors, etc. or are not regularly carried on.
Games of Chance

What to Look For:

Organization conducts a sweepstakes, raffle, or lottery where participants purchase chances to win.
Organization operates a ‘casino night,’ bingo, instant bingo, slot machines, or video games with a gambling theme.

Why it Matters:

Games of chance are generally taxable. Exceptions include charitable bingo, unpaid volunteer staffing, and being in North Dakota. Additional tax forms may be required to report winnings, and significant disclosures are required on Form 990.
In addition, states closely regulate gaming activity, and the IRS and state regulators can and do share information.
Research

What to Look For:

Organization earns income from fundamental research, testing, experimental construction/production, or inspection of materials and products

Why it Matters:

Research income is generally taxable, unless:

- The organization is a college, university, or hospital,
- The results are made freely available to the general public, or
- It is performed for a federal, state, or local government or agency
Fundraising Events

What to Look For:

Golf tournaments, galas, banquets, dances, auctions, concerts, carnivals

Why it Matters:

In order to be excluded from UBI, fundraising events must not be regularly carried on, or they must be mission-related. Organizations must carefully track the expenses and the fair market value associated with each event, and provide quid pro quo acknowledgements to the donors. Affects the public support test. Penalties up to $5,000 per event can be imposed for failure to provide written substantiation.
Membership Dues

What to Look For:

The organization has ‘membership’ dues, which may include benefits such as free or reduced admission or parking, restaurant and gift shop discounts, stroller rental discounts, low-cost items, members-only events, advance purchase of special event tickets, newsletters, or private use of facilities.

Why it Matters:

Complex rules exist regarding the charitable donation portion of membership dues, affecting the public support test. Significant benefits create an exchange transaction, and can result in UBI.
Contractual Obligations

What to Look For:

Contracts or other agreements that obligate the nonprofit to perform certain acts or services in exchange for payment. For example, in exchange for a large donation, the nonprofit agrees to encourage its members to use the donor’s goods and services, send out letters or emails to its members, monitor and report on results, etc.

Why it Matters:

Services provided by an exempt organization to a donor can result in a substantial return benefit to the donor without advancing the mission. The organization should make a good-faith estimate of the fair market value of the services it is providing, and consider whether that portion of the payment is exempt-function income or UBI.
Transactions With a Controlled Subsidiary

What to Look For:

Interest, annuities, royalties, and rents (but not dividends) paid by a controlled organization to a tax-exempt controlling organization

Why it Matters:

Although these amounts are usually considered passive income to the controlling organization and therefore not UBI, a special exception applies which can create UBI. To the extent these transfers reduce the taxable income of the controlled subsidiary, the exempt controlling organization must treat them as UBI.
Recreational Facilities

What to Look For:

- Income from recreational facilities earned from outsiders, alumni, volunteers, family members, or anyone other than directors and employees.
- Facilities used for charitable purposes, but also used for unrelated purposes.

Why it Matters:

- Income from recreational facilities used by faculty, employees, patients, etc can possibly be excluded as a convenience to the members
- However, in the absence of a suitable exception, the income described above could be UBI.
Business Transactions With Insiders

What to Look For:

- Transactions between the organization and its officers, directors, trustees, key employees, highest paid employees, or disqualified persons, including loans to or from the organization, grants to the individual or the individual’s family, or business transactions with the individual or businesses they own

- Family or business relationships among officers, directors, trustees, and key employees

Why it Matters:

The organization must disclose certain transactions and arrangements between the organization and its interested persons, or amongst those interested persons. Specific attention is given to excess benefit transactions.
Lobbying

What to Look For:

Organization attempts to influence how a legislator votes on a specific legislative proposals, attempts to influence the general public with respect to legislation or ballot issues, or directly communicates with certain executive branch officials in an attempt to influence official actions on legislation.

Why it Matters:

• Private foundations are prohibited from lobbying.
• Public charities may engage in ‘insubstantial’ amounts of lobbying before facing loss of exempt status.
• Other exempt organizations may conduct unlimited lobbying, but dues may be disallowed to the extent they are spent on lobbying activities.
Political Activity

What to Look For:

Organization promotes, attacks, supports, or opposes a candidate for public office, or attempts to influence the nomination, election, or appointment of any person to public office.

Organization website contains links to sites containing campaign information.

Why it Matters:

- Strictly prohibited for all 501(c)(3) organizations, resulting in possible loss of exempt status.
- Other exempt organizations may conduct political activity as long as it is not the primary activity (generally considered to be 49.9% or less)
Donor Advised Funds

What to Look For:

Organization creates separately identifiable accounts, to which donors make contributions. The organization maintains legal ownership and control over the fund, however, the donor has advisory privileges on investments and distributions of the funds’ assets.

Why it Matters:

Detailed information must be submitted on Form 990 Schedule D. Payments from such a fund to a disqualified person are automatic excess benefit transactions. Excise taxes also exist against an advisor who receives a distribution and the fund manager who knowingly approved such a distribution, sponsoring organizations that make taxable distributions, and funds that maintain excess business holdings.
Mergers/Contractions

What to Look For:

- The organization is considering a dissolution, liquidation, termination, or merger into a successor organization.

Why it Matters:

An organization terminating or disposing of more than 25% of its net assets through sale, exchange, or disposition must provide details on Form 990 Schedule N.
Private Foundations
Self-Dealing

What to Look For:

The foundation has business dealings with a manager, director, or major donor, or a business of such a person, including rent, sales of goods and services, or loans.

Why it Matters:

Both direct and indirect dealings between a foundation and a disqualified person can subject the disqualified person to a 10% personal excise tax and the foundation manager who approved it to a 5% personal excise tax.
Private Foundations
Excess Business Holdings

What to Look For:

- Foundation owns over 20% of any corporation, partnership, joint venture, sole proprietorship, etc.
- Foundation owns less than 20% but more than 2% of the above, but in the aggregate ownership percentage with all disqualified persons is over 20%

Why it Matters:

- If a disqualified person purchased the excess holding, the Foundation has 90 days to dispose of it.
- If the Foundation purchased the excess holding, the Foundation must dispose of it immediately.
- If the excess holding was obtained by gift or bequest, the Foundation has 5 years to dispose of it.
Private Foundations
Jeopardizing Investments

What to Look For:

- Trading on margin
- Commodity Futures
- Oil and Gas speculation
- Puts, calls, straddles
- Warrants
- Short selling

Why it Matters:

If organization failed to exercise ordinary business care and prudence, there is an excise tax of 10% of the amount invested for even a portion of the year, imposed personally on foundation managers.
Private Foundations
Taxable Expenditures

What to Look For:

• Lobbying
• Political Activity
• Grants to individuals, commercial organizations, other private foundations, or organizations that are not qualified public charities

Why it Matters:

Excise tax of 20% on each transaction
Conclusion

Frequent communication is essential to:

• Provide seamless service

• Alert tax professionals to planning opportunities

• Assist organization with gathering additional required data and information

• Identify areas for improvement
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