NONPROFIT TAX HOT ITEMS: IRS ISSUES, FORM 990 AND LEGISLATION

MACPA Government and Not For Profit Conference
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Mike Sorrells, BDO USA, LLP
National Director Nonprofit Tax Services

Agenda

• Update on IRS Activity
• A Few Form 990 Items
• Overview of the Legislative Landscape
• Conclusions and Q&A
Background: Focus on Exempt Organizations

Events that have shaped the debate include:
- The College and University Compliance Program Final Report, especially with regard to UBIT and Compensation
- The 501(c)(4) political uproar
- Tax Reform Act of 2014 (TRA 2014)
- Treasury Inspector General for Tax Administration (TIGTA)-Payroll Report
- Changes in IRS Personnel and function locations
- GAO Report on Compliance


- IRS audited 0.7 percent of charities in 2013, compared to 0.81 percent in 2011. This compares to 2013 audit rates of 1 percent and 1.4 percent for individuals and corporations, respectively. Additionally, the IRS has faced $900 million in budget cuts since 2010, along with 10,000 fulltime employees—47 of whom came from the exempt-organizations (EO) division

- Exempt returns filed by charities alone have increased by 5 percent since 2011, according to the report. Keep in mind that this does not account for nonprofit advocacy groups and the other entities that can garner tax-exempt status, for which the EO division is also responsible for overseeing
IRS Initiatives

- UBIT
- Retroactive revocations still ongoing
- Proposed regulations under §501(c) relating to political campaign intervention
  - Qualified management contracts for tax exempt bond financed facilities would be able to include annual productivity award based on the quality of services provided under the management contract
- Final regulations just issued for hospitals under IRC section 501(r)—260 pages
- Priority Guidance projects: List includes methods of allocating expenses relating to dual use facilities. (No precise IRS guidelines other than “reasonable”)

Applications for Exemption and Reinstatement

  - Streamlined retroactive reinstatement process for small organizations
  - Retroactive reinstatement process (within 15 months of revocation)
  - Retroactive reinstatement process (application more than 15 months from revocation)
- Interactive version of Form 1023 Exemption Application
- Form 1023-EZ
  - Projected annual gross receipts of $50,000 or less
  - Total assets of $250,000 or less
  - $400 user fee
  - Prompt approval by IRS—we have seen these approvals in 2 weeks—helping IRS with its backlog of applications
Payroll Tax Compliance

Treasury Inspector General for Tax Administration (TIGTA) -- July 3, 2014

• Reviewed 25 exempt organizations and found failure to remit payroll and other taxes, including penalties and interest, totaling more than $25 million
• Overall, approximately $875 million of payroll and related tax debt from exempt organizations

Takeaways and Review

• Worker Classification Review
  • At stake—back pay, overtime, back taxes
  • Varying definitions among common, federal, state law
  • Common theme is control—behavioral and financial
• Also, Nonresident reporting—ongoing issue
• Payroll Tax will be a focus if audited by IRS
  • Be sure 1099s are filed for all applicable payees
  • Keep W-9 files for all vendors—without an EIN or SSN, IRS will assess backup withholding at 28%

IRS is Focused on UBIT

• Current IRS initiative to examine sample of organizations with substantial gross UBI but no taxable income for 3 years
• Results of IRS College and University Compliance Project (CUCP)
  • Disallowance of more than $170M in losses and NOLs due to:
    • Errors in computation or substantiation of NOLs
    • Lack of profit motive
    • Improper expense allocations
    • Unrelated activities classified as exempt or excluded
General Information on NOLs, Computation and Substantiation

NOLs in General:
• Can be carried back 2 years and forward 20
• IRS can go back to first year of NOL origination to disallow, but can only change tax liability for open tax years (generally last 3 years), i.e., cannot change liability in closed years even when the NOL is denied or decreased
• States generally follow Federal NOL rules

• Computation and Substantiation:
• Must carefully track and document origination and utilization
• Keep old returns and all calculations, allocations, memos, agreements, etc.

Lack of Profit Motive

To be an unrelated business, an activity must be:
• A trade or business, regularly carried on and unrelated to exempt purposes
• A profit motive is required for a trade or business and if continual losses, IRS says no profit motive
• For open years with continual losses, the IRS typically disallows the losses, resulting, of course, in much additional tax
• There may be extenuating circumstances for continual losses: business in start-up phase, actual costs significantly greater than anticipated or budgeted, business cycle downturn or in wind-up phase, alternative investment structured to not turn around for many years
• If organization is taking position that the activity will turn around, must document it carefully
Improper Expense Allocation

• No precise IRS guidelines other than “reasonable”
• Expenses must be deductible for tax purposes (e.g. 50% of meals and entertainment, etc.)—Nonqualified deferred compensation is NOT deductible for tax purposes
• Cannot use expenses from related activity to offset unrelated—often an issue with expenses that support both related and unrelated activities

THIS IS A PRIORITY GUIDANCE ITEM FOR IRS

Form 990

The Major Change!

• 2014 Schedule A (required for all public charities)
  • Added 5 pages all related to Sec. 509(a)(2) supporting organizations—instructions now 18 pages
  • Basically, IRS wants proof that supporting org meets the tests for this determination-- lots of data and descriptions involved
  • Type III organizations (both functionally integrated and non-functionally integrated) have heavy burden here—Type III non-functionally integrated must go through minimum distribution calc like private foundations
  • If you have a supporting organization, take a look at this now and decide how you will be responding
  • We suspect some supporting organizations my change to being a regular publicly supported charity
Form 990

Other Changes

• Compensation on Part VII and Schedule J
  • Instructions make clear that if deferred compensation is paid within 2 and 1/2 months after year end of the calendar year included in the 990 fiscal year, and is included on the W-2, it should not also be included in the other income or deferred comp columns (would be double reporting)
• Schedule L, Transactions With Interested Persons
  • For Parts II, III and IV, the definitions of “interested persons” is harmonized so that there are no longer separate definitions for each part (with a few twists for Part II)
  • Part IV, Business Transactions With Interested Persons, instructions say you don’t have to report transactions with publicly traded companies if in normal course of business, under normal terms
  • Instructions also harmonize “reasonable efforts” definition for all of Schedule L

Form 990

Not New- But Important

• Part IV, Line 5: “Did the organization become aware during the year of a significant diversion of the organization’s assets?
  • Not a new question but getting a lot of attention in the press, by the states and IRS (audit program)
  • Keep in mind:
    • “Significant” for most organizations is $250,000 or more
    • Can be diversion from a prior year of which you just became aware
    • Responsible for diversions of grant monies by grantees
    • Requires explanations in schedule O
Congressional Focus on Exempt Organizations

Triple Crown of Government Tax Subsidies for Exempt Organizations—Are they in Jeopardy?

- The cost to taxpayers of just hospital tax exemptions on the state, local and federal levels ranged from $12.6 to $20 billion in 2002 (GAO report)
- Triple crown of government tax subsidies:
  1. Charitable deductions for contributors
  2. Tax exemptions for related income, sales tax and property tax exemptions
  3. Use of tax exempt bond proceeds and the exclusion of income by the bondholders
Tax Legislation: Reform or Revenue or Both?

- Draft Tax Reform Act of 2014 (TRA 2014) introduced as HR 1
  - 30 hearings, 11 working groups and “scored” by the Joint Committee on Taxation (JCT)
- America Gives More Act of 2014
- President’s FY 2016 Budget Proposals
- House activity
- Senate activity

Legislative Highlights

- Unrelated business income tax
- Compensation of executives including expanding the reach of Intermediate Sanctions
- Tax Exempt Bonds
- Private Foundations
- Charitable Giving
TRA 2014
NOLs and Loss Proposals

- Under current law, losses from a particular trade or business are aggregated with profitable lines of business to determine if there is overall taxable income or a loss which becomes an NOL
- TRA 2014 eliminates the ability to aggregate losses from one trade or business with income from another trade or business
- A loss from a particular trade or business could only be carried forward or back to offset income from that same trade or business

TRA 2014--Other UBIT Proposals

- Corporate sponsorship:
  - Mention of a sponsor’s product lines is not excluded from being a “return benefit” and would become taxable UBI
- Name and logo royalties
  - Passive royalty income from use of organization’s name or logo (e.g., affinity cards and logo items) would be taxable
- Exclusion of research income from UBI modified to only allow exclusion for fundamental research with results freely available to the public -but other exclusions still remain
- Increase of specific deduction from $1,000 to $10,000 for most organizations
- New manager level penalty for underpayment of tax under IRC 6662
  - 5% of underpayment amount with $20K limit
  - Applies to manager “under duty to perform an act in respect of which the underpayment occurs”
TRA 2014--Nonprofit Compensation Under Fire

• Current law: The deduction allowed to publicly traded C corporations for compensation paid with respect to chief executive officers and certain highly paid officers is limited to no more than $1 million per year. Similarly, current law limits the deductibility of certain severance-pay arrangements (“parachute payments”).

• TRA 2014: A tax-exempt organization would be subject to a 25-percent excise tax on compensation in excess of $1 million paid to any of its five highest paid employees for the tax year. Tax would apply to all remuneration paid to a covered person for services, including cash and the cash value of all remuneration (including benefits) paid in a medium other than cash, except for payments to a tax-qualified retirement plan, and amounts that are excludable from the executive’s gross income.

• JCT estimate: increase revenues by $4.0 billion over 2014-2023.

TRA 2014--Intermediate Sanctions Proposals

• Imposes an excise tax of 10 percent on the tax-exempt organization when the excess-benefit excise tax is imposed on a disqualified person. The entity-level tax would be avoidable if the organization follows minimum standards of due diligence or other procedures to ensure that no excess benefit is provided by the organization to a disqualified person.

• Eliminates the rebuttable presumption of reasonableness that shifts the burden of proof to the IRS

• Managers would no longer be able to rely on the professional advice safe harbor under Treasury regulations. Thus, a manager’s reliance on professional advice, by itself, would not preclude the manager from being subject to the excise tax for participating in an excess-benefit transaction.

• JCT estimate: Negligible revenue effect over 2014-2023
TRA 2014: Excise Tax on Investment Income for Private Colleges and Universities

Certain private colleges and universities would be subject to
- 1% excise tax on net investment income
- provision would only apply to -
  - private colleges and universities
  - assets valued at the close of the preceding tax year
    - other than those used directly in carrying out the institution’s educational purposes
    - of at least $100,000 per full-time student
- State colleges and universities would not be subject to the provision
- JCT estimate: provision would increase revenues by $1.7 billion over 2014-2023

TRA 2014--Tax Exempt Private Activity Bonds

Current law: Interest on both governmental bonds and private activity bonds (PABs) is excluded from gross income (and thus exempt from tax)
- Governmental bonds typically are issued to finance projects that constitute public goods (e.g., roads, schools, and parks).
- PABs finance the activities of, or loans to, private parties, with indirect benefits accruing to the State or locality that issues the bond.

TRA 2014: Under the provisions, interest on newly issued PABs would be included in income and thus subject to tax.

JCT estimate: the provisions would increase revenues by $23.9 billion over 2014-2023.

Observation: Focus is on the individual bondholders as opposed to the tax exempt institutions in need of financing
President’s Proposals for Tax Exempt Bonds

- Expand the use of tax-exempt financing for infrastructure and research
- Repeal exempt financing of professional sports facilities on the basis that it transfers the benefits of exempt financing to private professional sports teams, rather than the general public.

Focus on Sports

- President’s Proposal for Tax exempt bonds
- Conservation easement deduction is enhanced under the President’s proposal, but would be denied for golf course and other recreational facilities
- TRA 2014--Repeal of tax-exempt status for professional sports leagues currently exempt under sec. 501(c)(6) of the Code
- Charitable giving proposals in TRA 2014 would eliminate deduction where the donor receives the right to purchase tickets at college and university athletic events.
Charitable Giving-TRA 2014 Draft

An individual’s contributions could be deducted only to the extent in which they exceed 2% of the individual’s AGI.
Deductions for most donations of real property would be limited to cost basis.
The 50% income-based (AGI) percentage limit for certain contributions would be reduced to 40%.
Individuals could make tax deductible contributions until April 15th and they would count as deductible in the previous tax year
Elimination of special rule for College Athletic Event Seating Rights

Charitable Giving Provisions Previously and Currently in Congress

February 2015 the House passed the America Gives More Act:
- Make permanent the IRA rollover to charities for individuals age 70 ½ or older of $100,000
- Qualified conservation easement deduction made permanent
- Contributions of food inventory deduction made permanent
- Reduce excise tax on investment income of private foundations to 1% for all

Included in TRA 2014 and also passed by the House last year was the provision for the extension of time to make deductible charitable contributions up until April 15th and count for the previous year.
Charitable Giving—President’s Proposals

• Phase out benefits for upper brackets
• Simplify the rules regarding AGI limitations on the maximum amount of charitable contribution deductions for a single year, regardless of whether contributions are made to public charities or private foundations, whether they are cash or property, and whether they are for the use of the organization
• Increase the carryforward period for an unused charitable deduction that is in excess of the limits from five years to fifteen years.

Private Foundations

TRA 2014--
• Self-dealing tax modifications
• Excise Tax on Failure to distribute funds from Donor Advised Funds
• Repeal of Type II and Type III Supporting Organizations
• Reduce 2% excise tax on investment income to 1%
  • This provision passed in the House
  • The President’s proposals would reduce the tax from 2% to 1.35% percent for all private foundations...except for some foundations that can currently pay 1%, this may be an increase

New bill in Senate ....
Pending Senate Legislation

- Require the IRS to give an exempt organization 65 days of notice before it has its exempt status revoked for failing to file information returns (Form 990 series);
- A bill to make certain agricultural research organizations public charities; and
- A bill to provide an exception to the private foundation excess business holding rules for certain philanthropic business holdings.

Pending House Legislation

*Gifts to Non-Charitable Organizations*

- We all know that gifts to non 501(c)(3) organizations (e.g., c4, c6 etc.) do not qualify for a charitable deduction but whether gifts over $14,000 are subject to the gift tax has never been made clear by Congress or the IRS
- The IRS has at various times threatened to apply the tax for gifts to c4, c5 and c6 organizations
- H.R. 1104, the Fair Treatment for All Donations Act, would permanently insure that such donations were not subject to the gift tax
Summary and Questions & Answers

There is a lot happening....stay tuned!