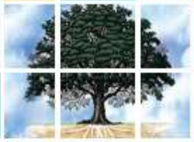

Developments in Nonprofit Taxation: What Every Organization Needs to Know to Effectively Manage Their Risks

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Agenda

- Colleges and Universities Compliance Project Final Report
- 2013 IRS Workplan Items
- Update on the Executive Pay Discussion
- IRS Notices
- Questions

Colleges and Universities Project Final Report

- Background
  - Project launched in 2008
  - Questionnaires distributed to 400 randomly-selected colleges and universities
  - 34 of 400 organizations selected for examination due to indications of potential noncompliance
  - Examinations focused on unrelated business income (UBI) and executive compensation
  - Interim report (May 2010) presented a preliminary overview of questionnaire responses
  - Final report (April 2013) provides additional analysis of the questionnaire responses and focuses on the examination results

- Underreporting of Unrelated Business Taxable Income (UBTI)
  - 34 examinations have resulted in:
    - Increases to UBTI for 90% of colleges and universities examined, totaling about $90 million
    - Disallowance of more than $170 million in losses and net operating losses (NOLs)
  - Primary reasons:
    - Disallowing expenses
    - Errors in computation or substantiation
    - Reclassifying exempt activities as unrelated

- Disallowing expenses
  - Lack of profit motive
    - 70% of examinees reported losses from activities that generated consistent losses for many years
    - Unrelated business income (UBI) must be generated by a "trade or business"
    - An activity qualifies as a trade or business <u>only if engaged in with the intent to make a profit</u>
    - **IRS: "A pattern of repeated losses is generally sufficient to show a lack of profit motive"**
    - Activities were disallowed as "unrelated" where the examinee failed to show a profit motive
    - More than $150 million of NOLs disallowed (from just the 34 examinations)

- Disallowing expenses
  - Improper expense allocation
    - Organizations may allocate expenses
    - Allocations must be done on a reasonable basis
    - Expenses offsetting UBI must be directly connected to UBI activities
    - Expense deductions were disallowed on more than 60% of Forms 990-T examined because of improper allocations between exempt and unrelated business activities

- Reclassifying activities as unrelated
  - Nearly 40% of examinees found to have misclassified certain activities as exempt (and not reportable on Form 990-T)
  - Fewer than 20% of such activities generated a loss
  - The IRS reclassified these activities as unrelated, resulting in nearly $4 million of additional UBI

- IRS next steps
  - IRS plans to focus on UBI more broadly, and especially on recurring losses, and allocation of expenses
  - Per the 2013 IRS workplan, IRS will examine a sample of organizations which reported substantial gross UBI for three consecutive tax years, but which reported no income tax due for any of those years

- Compensation
  - Examinations focused mainly on compliance with the Section 4958 Intermediate Sanctions provisions
  - Organizations may pay no more than reasonable compensation to their *disqualified persons*, *i.e.* officers, directors, trustees and key employees (ODTKEs)
  - Rebuttable presumption of reasonableness safe harbor (RPR), when:
    - Use of an independent body to set the compensation
    - Reliance on appropriate comparability data to set the compensation, and
    - Contemporaneous documentation

- IRS findings with compensation: *The Good*
  - Most examinees attempted to meet the rebuttable presumption standard
  - 94% of ODTKEs at examined institutions had compensation set using a procedure intended to satisfy RPR
  - Broad existence of compensation policies
  - Procedures designed to avoid conflicts of interest
    - Compensation setting for ODTKEs by the Board of Directors or by a compensation committee
    - Recusal by individuals from discussions about their compensation
  - Documentation of the basis for setting compensation

- IRS findings with compensation: *The Bad*
  - About 20% of examinees failed to meet the RPR standard because of problems with their comparability data, including:
    - Inclusion of institutions not similarly situated to the school relying on the data (location, endowment size, revenues, net assets and number of students)
    - The compensation studies failed to document the selection criteria for the schools included or explain why those schools were deemed comparable to the school relying on the study
    - The compensation studies failed to specify whether the data included just salary or included other forms of compensation

- IRS next steps regarding compensation setting
  - IRS plans to make tax-exempt organizations more aware of the importance of using appropriate comparability data when setting compensation
  - In other words…education and examinations

- Employment tax issues
  - IRS looked at employment tax returns at 11 organizations
  - All examinations resulted in adjustments to wages and assessment of tax. Reasons include:
    - Failure to include in income the value of personal use of automobiles, housing, social club memberships and travel
    - Misclassification of employees as independent contractors
    - Failure to withhold tax for wages paid to non-resident aliens
    - Failure to include in income the value of certain graduate tuition waivers and reimbursements
  - The results…
    - Wage adjustments of $36 million
    - Employment taxes and penalties of over $7 million

- Retirement plan issues
  - IRS looked at retirement plan reporting at 8 organizations
  - Examinations resulted in adjustments to wages and assessment of tax at 4 institutions. Reasons include:
    - Deferred compensation contributions 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
    - Loans from 403(b) plans exceeded limits
    - Deferrals for a 403(b) plan exceeded limits
    - Additions to a 403(b) plan exceeded limits
  - The results…
    - Wage adjustments of about $1 million
    - Taxes and penalties of over $200,000

Summary/Key Takeaways

- Read the IRS College and Universities Compliance Project Final Report
- Consider how the core issues relate to your organization: UBI, compensation, etc.
- Proactively conduct a risk assessment analysis focusing on the key issues raised in the IRS report
- Formulate a plan to address risks that you identify
- Report your risk assessment activities and mitigation plan to your audit committee

Other Matters

IRS Workplan

- Employment tax project
  - IRS has been conducting examinations of 6,000 companies over 3 years (including 500 tax-exempt organizations)
  - Focus has been on worker classification, employee expense reimbursement/accountable plan rules, withholding rules and fringe benefits
  - Final year of IRS-wide project

IRS Workplan

- 512(b)(13) study
  - This statute imposes tax on certain payments from controlled organizations to their parents
  - Pension Protection Act of 2006 (PPA) requires the Secretary of the Treasury to report on the administration of the statute and to provide recommendations to Congress
  - 3,000 check sheets completed upon closure of IRS examinations now being analyzed

Update on the Executive Pay Discussion

- March 2011: public uproar followed revelation of $11.3 million compensation package committed to departed Blue Cross Blue Shield of Massachusetts (Blue Cross) CEO

- Led to suspension of compensation to Board members by Blue Cross

- Triggered significant Attorney General (AG) and legislative activity

- Fast forward…
  - *The Boston Globe* reported on March 1, 2013 that Blue Cross had reinstated compensation for its Board members

Update on the Executive Pay Discussion

- Legislation under consideration in 2013:
  - HB 1714:
    - Would limit executive salaries of state funded nonprofits that receive 30% or greater of their annual budget from state funds
  - HB 1683:
    - Would prohibit public charities from compensating any independent officer, director or trustee
    - Would allow the AG to grant exemptions and approve compensation
  - SB 768:
    - Would prohibit public charities from compensating Board members
    - Would limit certain compensation of officers, directors, and directors acting in an executive capacity to $500,000
    - Charities seeking a waiver would be entitled to public hearing

IRS Notices for Missing Student TINs

- Observe response date
- Follow the instructions in the penalty notice
- If you disagree, enclose a signed statement explaining why you disagree
- Penalties may be waived for reasonable cause, but the organization must have acted in a responsible manner before and after the failure
- See IRS publication 1586 and Treasury Regulation § 1.6050S-1
- Describe your practices. Explain how you request TINs from students at least once per year (in conformity with the Regulation, as appropriate)
- Assure the IRS of compliance going forward

Questions?

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