

## 2010 Nonprofit Update Nonprofit Tax Update

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July 22, 2010  
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### Introduction

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- o Federal tax issues as they relate to nonprofit organizations
- o New rules that apply to nonprofits
- o Existing rules that apply in new contexts

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### Intermediate Sanctions Developments

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- o Overview
  - Section 4958 imposes a series of excise taxes on "excess benefit transactions"
  - Tax-exempt organization provides an economic benefit to a disqualified person which exceeds the value of the consideration provided by the disqualified person
  - Example: Payment of excessive compensation

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**Intermediate Sanctions Developments**

- Excise taxes are levied on both the disqualified person and any organizational manager who knowingly approves the transaction
  - Members of a compensation committee or board who approve the compensation arrangement

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**Intermediate Sanctions Developments**

- What is compensation?
  - Salary, fees, bonuses, and severance
  - Deferred and noncash compensation
  - Premiums paid
  - Payments to welfare benefit plans, such as medical, dental, life insurance
  - Excludes working condition fringe benefits and de minimis fringe benefits

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**Intermediate Sanctions Developments**

- Rebuttable Presumption of Reasonableness
  - A compensation package will be presumed reasonable if 3 criteria are met:
    - Arrangement approved by independent body
    - Reliance upon appropriate comparability data
    - Adequate documentation of the basis for its determination

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**Intermediate Sanctions Developments**

- Effect of Rebuttable Presumption of Reasonableness
  - Unless the IRS introduces credible evidence to substantiate its claim that the challenged compensation is unreasonable, the taxpayer is under no obligation to prove that the challenged compensation is appropriate

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**Intermediate Sanctions Developments**

- Knowing participation in excess benefit transaction by organization manager
  - A manager's participation in a transaction will not be considered to have been "knowingly made" if the manager relies on the fact that the requirements giving rise to the rebuttable presumption of reasonableness were satisfied
  - In other words, the rebuttable presumption process protects the organization's management from potential excise taxation

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**Intermediate Sanctions Developments**

- The Chronicle of Philanthropy reports that 31% of nonprofit organizations gave a pay increase to their executive staff in 2010



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### Intermediate Sanctions Developments



- There may be challenges when increasing compensation in recessionary times
- The justification process should be thoughtful
- Follow rebuttable presumption

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### Economy and Unrelated Business Income

- Real estate and facilities owned by tax-exempt charitable organizations create challenges
  - Lease?
  - Sell?
- Unrelated business income is the income from a trade or business that is regularly carried on by an exempt organization and that is not substantially related to the performance by the organization of its exempt purpose or function

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### Economy and Unrelated Business Income - Leasing

- Leasing real estate—is the rental income taxable?
  - Passive income modifications (rents)
  - Real versus personal property
  - Providing services to occupant



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## Economy and Unrelated Business Income - Leasing

- Parking lots
  - Generally no UBI
  - If used by public, parking fees might be taxable
  - Lease parking lot to third party



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## Economy and Unrelated Business Income - Leasing

- Debt-Financed Income
  - If property on which there is debt outstanding is leased, the rental income may constitute unrelated debt-financed income subject to unrelated business income tax

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## Economy and Unrelated Business Income - Selling



- Generally, gain from the sale of real estate is excluded from UBI
- In the business of selling lots???
- Sale of property is big deal—proper corporate approval, absence of donor restrictions, proper documentation, etc.

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**A Word About Property Tax and Leasing Real Estate**

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- Consider whether leasing property puts property tax exemption at risk

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**A Word About Property Tax and Leasing Real Estate**

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- Appeal of Archdiocese of Philadelphia, 617 A.2d 821 (Pa. Commw. Ct. 1992)
  - Premises are not the source from which any income or revenue is derived by lessor
  - Nominal rent
  - Lessee recipient of lessor's charity

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**A Word About Property Tax and Leasing Real Estate**

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- Borough of Homestead v. St. Mary Magdalen Church, 798 A.2d 823 (Pa. Commw. Ct. 2002)
  - Fees charged were below market
  - Lessor subsidized
  - Lessor maintained active, daily possession of the property with some control over activities

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### A Word About Property Tax and Leasing Real Estate

- Factors
  - Amount of rent charged
  - Whether the activity of the lessee furthers the charitable work of the lessor
  - Amount of control lessor maintains over the property

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### Colleges and Universities



- Compliance check – interim report
- Sent to 400 public and private colleges and universities
- Focus:
  - UBI
  - Investment management and use of endowment funds
  - Executive compensation

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### Colleges and Universities

- Organizational Information / Demographics
  - Less than half of the organizations reporting income from controlled entities on the questionnaire indicated that they reported income from controlled entities on Form 990-T

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## Colleges and Universities

- Activities
  - Advertising
  - Facility rental
  - % of colleges and universities that indicated engaging in an activity was much higher than the % of organizations that reported including that activity on their Form 990-T

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## Colleges and Universities

- Endowment Funds
  - Majority of colleges and universities reported engaging in foreign investments
  - Many colleges and universities reported using investment entities to make foreign investments of endowment funds

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## Colleges and Universities

- Compensation
  - In small and medium organizations the highest paid employee (other than ODTKE) was most often a faculty member
  - In large organizations the highest paid employee (other than ODTKE) was most often a sports coach

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**Colleges and Universities**

- Compensation
  - More than half of the private organizations at all size levels reported using a procedure intended to satisfy the rebuttable presumption process for at least one of the six highest paid ODTKEs
  - Little reporting of initial contract exception

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**Colleges and Universities**

- Governance
  - 76% of small colleges and universities reported making their audited financial statements available to the public
  - 91% of medium organizations did so
  - 97% of large organizations did so

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**Colleges and Universities**

- Governance
  - Little reliance on outside advice on UBI issues
    - Whether business activities were related or unrelated
    - Allocation of expenses between related and unrelated activities
    - Intercompany pricing

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### Colleges and Universities

- What's next???
  - IRS opened 30 examinations
  - Data on governance practices and procedures will be collected and reviewed
  - Final report



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### Marcellus Shale and Tax Exemption

- Windfall sounds great, but is it really?
- Social clubs have special issues with regard to income from natural gas leasing arrangements



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### Marcellus Shale and Tax Exemption

- Social clubs are described in section 501(c)(7)
- Justification for exemption: individuals are in substantially the same position as if they had spent their after-tax income on pleasure or recreation without the intervening organization

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**Marcellus Shale and Tax Exemption**

- Income limitations—social clubs are allowed to receive up to 35% of their gross receipts, including investment income, from sources outside their membership without losing tax-exempt status
- “Unusual amounts of income” are not included in that 35%

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**Marcellus Shale and Tax Exemption**

- Social clubs have “an almost unique status” in that they alone among exempt organizations are taxed on passive income (dividends, rents and interest)
- Social clubs are among the many types of organizations now being compensated for the value of the gas trapped underneath their land

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**Marcellus Shale and Tax Exemption**

- Types of payments: lease “bonus” payments, delay rental payments, advance royalty payments, etc.
- Because of the unique UBI rules that apply to social clubs, any rent or royalty payments to the social club from natural gas leasing activities would most likely be taxable to the club
- If the numbers are large enough, the tax-exempt status of the club could be jeopardized

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**Marcellus Shale and Tax Exemption**

- An up front payment may also be characterized as a rent or royalty payment, and thus subject to the same income limitation and exemption issues
- Important to think through tax implications of natural gas leasing arrangements

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**New Tax Exemption Standards for Hospitals**

- Four new requirements under Section 501(r):
  - Community Health Needs Assessment
    - Requirement to conduct a community health needs assessment every 3 years
    - Adopt an implementation strategy to meet the community health needs identified
    - Form 990 disclosure
    - \$50,000 excise tax for noncompliance
    - Effective for tax years beginning on or after March 23, 2012

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**New Tax Exemption Standards for Hospitals**

- Four new requirements under Section 501(r):
  - Financial assistance policy
    - Hospitals must establish a financial assistance policy and a policy relating to the provision of emergency medical care
    - Effective immediately for tax years beginning after March 23, 2010

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**New Tax Exemption Standards for Hospitals**

- Four new requirements under Section 501(r):
  - Limitation on charges
    - Hospitals must limit amounts charged for emergency or other medically necessary care that is provided to individuals eligible for assistance under the hospital's financial assistance policy to not more than the amounts generally billed to insured individuals
    - Effective immediately for tax years beginning after March 23, 2010

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**New Tax Exemption Standards for Hospitals**

- Four new requirements under Section 501(r):
  - Billing and collection
    - Hospitals must forego extraordinary collection actions against an individual before it has made reasonable efforts to determine whether the individual is eligible for assistance under the hospital's financial assistance policy
    - Effective immediately for tax years beginning after March 23, 2010

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**L3C**

- Low-Profit Limited Liability Company
- More states are passing legislation
- IRS still analyzing

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## Nonprofit Governance

- The IRS believes a well-governed charity is more likely to obey the tax laws, safeguard charitable assets, and serve charitable interests than one with poor or lax governance
- Developed a check sheet
- Gathering data to gain a better understanding of the intersection between governance practices and tax compliance

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## Conclusion

- Charitable organizations . . .
  - Are subject to increasingly complex laws and rules
  - Are subject to increasing public scrutiny
  - Now have to deal with adverse recessionary impact
- Keep up on new rules and understand application of existing rules in new contexts

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## Questions

- Questions and discussion

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