

2010 NONPROFIT UPDATE

Nonprofit Tax Update

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I. INTRODUCTION

This outline discusses various federal tax issues as they relate to nonprofit organizations. The outline is intended to provide an overview of the subjects presented and is not all inclusive. Nonprofit organizations continue to face an ever-changing regulatory environment. Additionally, as many nonprofit organizations continue to find new ways to address current economic conditions, many of the traditional rules applicable to such organizations will be encountered in new and different ways.

II. INTERMEDIATE SANCTIONS DEVELOPMENTS

A. OVERVIEW

1. Section 4958 of the Internal Revenue Code of 1986, as amended, imposes a series of excise taxes whenever an “excess benefit transaction” occurs. The term “excess benefit transaction” means any transaction in which certain tax-exempt organizations provide an economic benefit to a disqualified person, such as a chief executive officer, which exceeds the value of the consideration provided by the disqualified person.
2. A common example of an excess benefit transaction is the payment of unreasonable compensation to an executive of a charitable organization. The excise taxes imposed under Section 4958 are levied on both the disqualified person who engages in the excess benefit transaction (i.e., the executive officer receiving excess compensation), as well as any organizational manager who knowingly approves the transaction (i.e., members of a compensation committee or board who approve the compensation arrangement).
3. In the area of executive compensation, the Service, by regulation, has held that an executive’s compensation includes, but is not limited to, the following items:
 - a) All forms of cash and noncash compensation, including salary, fees, bonuses, and severance payments;

- b) All forms of deferred and noncash compensation, whether or not funded, and whether or not paid under a deferred compensation plan that is a qualified plan under section 401(a);
 - c) The amount of premiums paid for liability or any other insurance coverage, as well as certain payments or reimbursements by the organization for expenses, fees, or taxes;
 - d) All other compensatory benefits, whether or not included in income for tax purposes, including payments to welfare benefit plans on behalf of the persons being compensated, such as plans providing medical, dental, life insurance, severance pay, and disability benefits, and both taxable and nontaxable fringe benefits (other than working condition fringe benefits described in section 132(d) and de minimis fringe benefits described in section 132(e)); and
 - e) Any economic benefit provided by an applicable tax-exempt organization through another entity owned, controlled by or affiliated with the applicable tax-exempt organization, whether such other entity is taxable or tax-exempt.
4. As noted above, in determining the reasonableness of an executive's compensation package, it is the preferred practice of the Internal Revenue Service to compare an executive's compensation package with compensation packages provided by similar organizations to their similarly situated executives performing like services. Comparability data includes current compensation surveys compiled by independent consulting firms, and includes compensation paid by similarly situated organizations, both taxable and tax-exempt.
5. It is important to note that the provisions under Section 4958 provide positive guidance to exempt organizations in structuring their executive compensation packages. To the extent that a charitable organization complies with these affirmative provisions, a rebuttable presumption of reasonableness will arise. Under the current regulations of the Internal Revenue Service, a compensation package will be *presumed reasonable* if three criteria are met:

- a) The compensation arrangement must be approved by the organization's governing body, or a committee of the governing body, composed entirely of individuals who do not have a conflict of interest with respect to the arrangement.
 - b) The governing body or the committee must have obtained and relied upon appropriate comparability data.
 - c) The governing body or committee must adequately document the basis for its determination concurrently with making that determination. Documentation will be considered "concurrent" if it is prepared by the next meeting of the governing body which authorized the arrangement or 60 days after final approval of the transaction, whichever is later.
6. Once the presumption of reasonableness arises, the Internal Revenue Service has the primary burden of producing evidence that the compensation was, in fact, unreasonable. Moreover, if the rebuttable presumption of reasonableness is established under the Section 4958 safe harbor regulations, a different set of procedural rules govern any subsequent tax litigation. Specifically, unless the Internal Revenue Service 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.
 7. The final regulations issued by the Internal Revenue Service indicate that the safe harbor provisions also play an important role in determining whether a manager of an exempt organization "knowingly" participated in an excess benefits transaction and, therefore, is personally subject to the imposition of an excise tax. Specifically, 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. Thus, compliance with the safe harbor provisions not only gives rise to a rebuttable presumption, it protects the organization's management from potential excise taxation.

B. DEVELOPMENTS

1. The Chronicle of Philanthropy reports that 31 percent of nonprofit organizations gave a pay increase to their executive staff in 2010.

2. Nonprofit organizations may face challenges—both tax challenges and challenges related to public perception—when significantly increasing executive compensation in recessionary times. The justification process should be very thoughtful and based on a solid process that follows the rebuttable presumption of reasonableness.

III. ECONOMY AND UNRELATED BUSINESS INCOME

A. FEDERAL TAX

Real estate and facilities owned by tax-exempt charitable organizations create many challenges, especially in tough economic times. This discussion addresses such issues as considerations in leasing and selling real estate, tax implications from the generation of income from real estate, and key considerations related to holding vacant facilities and land.

1. Leasing Real Estate - Is the Rental Income Taxable?
 - a) Tax-exempt organizations may engage in income-producing activities unrelated to their tax-exempt purposes, as long as the unrelated activities are not a substantial part of the organization's activities.
 - b) The net income from such activities may be subject to unrelated business income tax.
 - c) 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.
 - d) There are certain passive income modifications to unrelated business income. For example, certain rents are excluded from unrelated business taxable income.
 - e) The rental exclusion generally applies to all rents from real property. Any rents attributable to personal property must constitute only an incidental amount of the total rent.
 - f) The Treasury Regulations provide that rents attributable to personal property generally are not an incidental amount of the total rents if such rents exceed 10 percent of the total rents from all leased property.
 - g) There are several exceptions to the rental exclusion:

- (1) The rental exclusion does not apply if more than 50 percent of the total rents are attributable to personal property.
 - (2) The rental exclusion does not apply if the determination of the amount of rents depends in whole or in part on the income or profits derived by any person from the property leased, other than an amount based on a fixed percentage or percentages of receipts or sales.
 - (3) The rental exclusion does not apply to payments for the use or occupancy of rooms and other space where services are also rendered to the occupant. Services that may affect rental exclusion:
 - ✓ Personnel for special events
 - ✓ Administrative services
 - ✓ Catering and beverage service
 - (4) Services that generally do not affect rental exclusion:
 - ✓ Furnishing of heat and light
 - ✓ Cleaning of public entrances, exits, stairways and lobbies
 - ✓ Collection of trash
- h) Parking lots – generally, income from a parking lot used by members and visitors of an exempt organization does not generate unrelated business taxable income. However, if an exempt organization operates a parking lot that is used by members of the general public, parking fees are taxable, as this activity is not substantially related to the organization’s exempt purpose. If the organization enters into a lease with a third party who operates the parking lot and pays fixed rent to the organization, such payments are not considered unrelated business income, as these payments constitute rent from real property.
- i) 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.

- j) An exempt organization that has \$1,000 or more of gross income from an unrelated business must file Form 990-T. An organization must pay estimated tax if it expects its tax for the year to be \$500 or more.

2. Selling Real Estate

- a) Generally gain from the sale of real estate is excluded from unrelated business taxable income.
- b) If property is subdivided or otherwise sold as a sufficiently large number of lots, however, the organization may be treated as being in the business of selling lots and thus subject to unrelated business taxable income.
- c) The disposal or sale of property should be undertaken carefully—among other things, proper corporate approval must be obtained with respect to the disposal or sale of property, the seller must confirm the absence of donor restrictions that may impede the sale or disposal, the seller may need to confirm the absence of historic landmark status, and proper real estate transfer documentation must be prepared.

B. PROPERTY TAX

Does Leasing Place Property Tax Exemption at Risk?

- 1. In Appeal of Archdiocese of Philadelphia, 617 A.2d 821 (Pa. Commw. Ct. 1992), the court denied a charitable exemption for certain real estate leased by the Archdiocese to the Delaware County Pro-Life Coalition. The court stated that to meet the requirements of the statute, the taxpayer needs to prove that (1) the premises are not the source from which any income or revenue is derived by the lessor; (2) any rent paid was merely nominal; and (3) the lessee was the recipient of the lessor's charity. Among other things, the court concluded that the lessee was not a recipient of the Archdiocese's charity, and rents were more than nominal, and the Archdiocese maintained only minimal, passive possession of the property.
- 2. In Borough of Homestead v. St. Mary Magdalen Church, 798 A.2d 823 (Pa. Commw. Ct. 2002), the court ruled that a job center operated by the Diocese of Pittsburgh was exempt from real estate tax, notwithstanding the fact that fees were received from for-profit and nonprofit licensees that occupied the center.

- a) By way of background, the Diocese had closed a high school in Homestead and converted the school into an office building known as the Bishop Boyle Center in which it operated a job center to assist displaced workers.
 - b) Licensees included for profit companies such as Giant Eagle, McDonald's and Lowes, who used the space to interview prospective employees, and nonprofit organizations such as Just Harvest and the Mon Valley Unemployed Committee.
 - c) The court concluded that the licensees were the recipients of the Diocese's bounty, and that income or revenue generated by the Bishop Boyle Center did not preclude tax exemption.
 - d) The court noted that the fees charged the licensees were below market value, and that the Diocese never derived net income or surplus revenue from the Bishop Boyle Center, but rather continued to subsidize the operation. Furthermore, the Diocese maintained active, daily possession of the property with some control over all activities on the property.
3. Bottom line – property tax exemption issues are complex. Factors to consider include the amount of rent charged, whether the activity of the lessee furthers the charitable work of the lessor, and the amount of control the lessor maintains over the property. Property tax exemption is not necessarily “all or nothing”—in other words, property tax exemption may be proportionately diminished.

C. CONCLUSION

While tough economic times may prompt charitable organizations to examine their real estate and facilities holdings more carefully, such examination may yield opportunities previously unforeseen. Opportunities that further the organization's charitable mission, and generate revenue as well, are certainly possible to discover and put into place. Because of tax and other legal implications involved in real estate holdings and transactions, however, care must be taken in structuring those opportunities to protect the interests of the organization.

IV. COLLEGES AND UNIVERSITIES

A. IRS COMPLIANCE PROJECT

1. On May 7, 2010, the IRS released an interim report summarizing responses to compliance questionnaires sent to 400 public and private colleges and universities in October 2008.
2. This compliance check of colleges and universities principally focused on the conduct and reporting of exempt or other activities that may generate unrelated business taxable income; investment, management, and use of endowment funds; and executive compensation practices.
3. What is a “compliance check”? – A compliance check is a review conducted by the IRS to determine adherence to certain requirements. A compliance check is also a tool to help educate organizations about their reporting requirements and to increase voluntary compliance. A compliance check is not a review of the organization’s books and records. Organizations may refuse to participate; however, the IRS has the option of opening a formal examination whether or not the organization agrees to participate.
4. The interim report contains preliminary information on the respondents’ organizational structures, demographics, exempt and unrelated business activities, endowments, executive compensation as well as governance practices.
 - a) Organizational Information/Demographics
 - (1) Less than half of the organizations reporting income from controlled entities on the questionnaire indicated that they reported income from controlled entities on their Form 990-T.
 - b) Activities
 - (1) The most frequently reported UBI activities were advertising and facility rental.
 - (2) In most cases, the percentage of colleges and universities that indicated engaging in an activity was much higher than the percentage of organizations that reported including that activity on their Form 990-T.

c) Endowment Funds

- (1) The majority of colleges and universities reported engaging in foreign investments.
- (2) Many colleges and universities reported using investment entities to make foreign investments of endowment funds.

d) Compensation

- (1) The reported compensation of the highest paid officer, director, trustee or key employee (ODTKE) was highest for the large colleges and universities—average approximately \$428,000; median \$361,000.
- (2) The reported compensation of the highest paid employee that was not an ODTKE was highest for the large colleges and universities—average approximately \$798,000; median \$352,000.
- (3) In small and medium organizations, the highest paid employee (other than an ODTKE) was most often a faculty member.
- (4) In the case of large organizations, the highest paid employee (other than an ODTKE) was most often a sports coach.
- (5) 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.
- (6) At all size levels, the use of comparability data to establish compensation was present less frequently than the other rebuttable presumption factors.
- (7) Initial contract exception—in the majority of cases, organizations reported that none of their six highest paid ODTKEs were disqualified persons immediately before entering into their compensation arrangements with the organization. However, relatively few organizations reported making fixed payments under the initial contract exception to any of their six highest paid ODTKEs.

e) Governance

- (1) Audited financial statements—76% of small colleges and universities reported making their audited financial statements available to the public, which 91% of medium organizations and nearly all (97%) of the large colleges and universities reported doing so.
- (2) More than 60% of the colleges and universities in each size category reported they did not rely on outside advice on unrelated business income issues, such as determining whether business activities were related or unrelated to the organization's exempt purpose, the allocation of expenses between related and unrelated business activities, and intercompany pricing between the organization and related entities.

B. WHAT'S NEXT?

1. The IRS has opened examinations of more than 30 organizations that were selected based on responses to the questionnaire.
2. These examinations focus primarily on unrelated business income (including expense allocation, losses, and debt-financed property issues) and executive compensation issues (including the use of the rebuttable presumption procedure, the initial contract exception, and comparability data by private colleges and universities).
3. The examinations will also include review of controlled entity issues.
4. Data on governance practices and procedures will be collected and reviewed.
5. A summary of findings and information learned from the examinations will be included in a final report.

V. MARCELLUS SHALE AND TAX EXEMPTION

A. OVERVIEW

The natural gas that is trapped underground has little or no value to landowners who do not have proper equipment and technology to extract it from the ground. Therefore, the landowner is compensated for the value of the gas through certain payments. While the thought of receiving a windfall of revenue from a natural gas leasing arrangement sounds

appealing at first, tax-exempt organizations need to be wary of possible inadvertent tax and other legal consequences of entering into such arrangements.

B. SOCIAL CLUBS

1. Tax-exempt social clubs must be especially careful when faced with the potential windfall from a Marcellus shale gas leasing arrangement. (*See, e.g., Gas Leases Can Blow Up Tax-Exempt Club*, Pennsylvania Institute of Certified Public Accountants, available online at www.picpa.org/Content/39999.aspx (April 2009).
2. The primary purpose of social clubs is to provide benefits to their members, typically in the form of access to social and recreational facilities such as club houses, golf courses, swimming pools, and hunting grounds.
3. Social clubs are exempt from federal tax under section 501(a) of the Internal Revenue Code of 1986, as amended, as organizations described in section 501(c)(7) thereof.
 - a) Justification for tax-exemption is that individuals are in substantially the same position as if they had spent their after-tax income on pleasure or recreation without the intervening organization.
 - b) A key aspect of the federal tax treatment of social clubs is the income limitation provisions. A social club will lose its federal tax exempt status if it regularly derives a substantial part of its income from nonmember sources.
 - c) Generally, social clubs are allowed to receive up to 35% of their gross receipts, including investment income, from sources outside their membership without losing their tax-exempt status.
 - d) “Unusual amounts of income” are not included in the gross receipts of a social club for purposes of the 35% test.
 - e) Social clubs have “an almost unique status” in that they alone among exempt organizations are taxed on passive income (dividends, rents, and interest).
 - f) Social clubs cannot have any part of their net earnings inure to their members.

4. Social clubs are among many types of organizations now being compensated for the value of the gas trapped underneath their land.
5. Landowners may be compensated through certain payments, which may take various forms—including lease “bonus” payments, delay rental payments, rental payments, advance royalty payments, and royalty payments.
6. Because of the unique unrelated business income 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 from the receipt of rent or royalty income from a natural gas leasing arrangement.
7. An upfront payment may also be characterized as a rent or royalty payment, and thus subject to the same income limitation and exemption issues referenced above.
8. One possible tax-planning strategy is having the natural gas rights appraised and establishing a separate taxable entity to which those rights are sold at fair market value.
 - a) The new entity would be the lessor in the lease arrangement going forward and would receipt payments from the gas company lessee.
 - b) The one-time influx of cash into the social club from the sale of the natural gas rights to the new entity should not be subject to the social club income limitations.
 - c) Note that the motive of the social club in purchasing the property in the first place is relevant.
9. The bottom line is that, to the extent an exempt organization has significant income from a lease related to Marcellus shale gas leasing activity, be aware of the possible effect of the income on the tax-exempt status of the organization.

C. OTHER TAX EXEMPTION AND LEGAL ISSUES

1. Unlike social clubs, section 501(c)(3) organizations may exclude certain types of income from UBTI including rents and royalties.
2. Keep property tax exemption issues, realty transfer tax issues, income tax issues, and the like in mind when dealing with natural gas leasing arrangements.

3. Organizations should realize the importance of having a fairly negotiated lease in place.

VI. MISCELLANEOUS

A. Section 501(r) – Tax Exemption Standards for Hospitals

1. Four new requirements—described below—for tax-exempt hospitals were added by new section 501(r) of the Internal Revenue Code of 1986, as amended, under the Patient Protection and Affordable Care Act (the “Affordable Care Act”) and the Health Care Education Affordability Reconciliation Act of 2010 (the “Reconciliation Act”).
 - a) Community Health Needs Assessment – Section 501(r)(3) requires a hospital to conduct a community health needs assessment every three years and adopt an implementation strategy to meet the community health needs identified through such assessment. Hospitals will be required to include in their Form 990 a description of how they are addressing the needs identified in each Community Health Needs Assessment and a description of any needs that are not being addressed, along with the reasons why the needs are not being addressed. A \$50,000 excise tax will be imposed on hospitals that fail to meet the Community Health Needs Assessment requirements. This requirement is effective for tax years beginning after March 23, 2012.
 - b) Financial Assistance Policy – Section 501(r)(4) requires a hospital to establish a financial assistance policy, and a policy relating to the provision of emergency medical care on a nondiscriminatory basis. The financial assistance policy must include:
 - (1) Eligibility criteria for financial assistance, and whether such assistance includes free or discounted care;
 - (2) The basis for calculating amounts charged to patients;
 - (3) The method for applying for financial assistance;

- (4) In the case of an organization which does not have a separate billing and collections policy, the actions the organization may take in the event of nonpayment, including collections action and reporting to credit agencies; and
- (5) Measures to widely publicize the policy within the community to be served.

This requirement is effective immediately—for tax years beginning after March 23, 2010.

- c) Limitation on Charges – Section 501(r)(5) requires hospitals to 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. This requirement is effective immediately—for tax years beginning after March 23, 2010.
 - d) Billing and Collection – Section 501(r)(6) requires hospitals to 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. This requirement is effective immediately—for tax years beginning after March 23, 2010.
2. July 22, 2010, is the deadline for submission of comments to the IRS regarding the need for guidance relating to the new exemption requirements, pursuant to IRS Notice 2010-39.

B. L3C – Low-Profit Limited Liability Company

1. The primary focus of the L3C—low-profit limited liability company—is not to make money, but to achieve socially beneficial aims, with profit making as a secondary goal.
2. Although L3Cs are created to advance charitable purposes, they are not charitable organizations. L3Cs are designed to facilitate program-related investments by private foundations.
3. Several states have passed L3C legislation, and L3C legislation is currently being considered in other jurisdictions as well.
4. The IRS, however, is still analyzing the L3C concept.

C. Nonprofit Governance

1. The IRS believes that 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.
2. As of December 2009, a check sheet is used by IRS Exempt Organization examination agents to capture data about governance practices and the related internal controls of organizations being examined. *See* <http://www.irs.gov/charities/article/0,,id=216068,00.html>.
3. The check sheet addresses the following topics:
 - a) Governing Body and Management
 - b) Compensation
 - c) Organizational Control
 - d) Conflict of Interest
 - e) Financial Oversight
 - f) Document Retention
4. The data will be included in a long-term study to gain a better understanding of the intersection between governance practices and tax compliance.

VII. CONCLUSION

When one combines the complex federal tax regulations that govern charitable and other nonprofit organizations, with the increasing public scrutiny experienced by the sector, with an adverse recessionary impact, the results can be far-reaching and unpredictable. Not only can new rules and regulations cause traps for unwary organizations, but existing rules and regulations interpreted in new contexts can have the same effect.

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