

The Nonprofit Advocate

Covering Legal Issues for Nonprofit Organizations



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In this issue

Recent Developments

- **IRS Sends Compliance Questionnaire to 400 Colleges and Universities**
- **Quick Hits**

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IRS Sends Compliance Questionnaire to 400 Colleges and Universities

Approximately 400 U.S. colleges and universities have been receiving compliance questionnaires from the Internal Revenue Service over the past few days as part of a focused effort to study key areas in the tax-exempt community. On October 1, the IRS announced plans to send the 33-page questionnaire to 400 public and private colleges of all sizes (for a sample copy of the form, visit www.irs.gov/pub/irs-tege/sample_cucp_questionnaire.pdf). The college and university questionnaire focuses on unrelated business income, endowments and executive compensation practices during the 2006 tax year. Questionnaires have been sent (and still may be in the process of being sent) to a cross-section of small, mid-sized and large private and public four-year institutions. The IRS hopes the information gathered will help it identify issues and areas that may need more scrutiny.

The IRS's targeting of colleges and universities is similar to that directed at hospitals just a few years ago. The focus follows several other initiatives that observers believe stem from congressional pressure, particularly from the Senate Finance Committee's Charles Grassley, R-Iowa, and the House Ways and Means Committee. The Senate committee's periodic hearings and Grassley's public statements about tax-exempt entities' lack of fiscal transparency likely have helped bring on this latest IRS scrutiny and the recent changes in reporting requirements for tax-exempt organizations.

Among other items, the questionnaire will gather information from the schools about how they report revenues and expenses from their trade or business

activities, classify their activities as exempt or taxable activities and calculate and report income or losses on taxable activities. The questionnaire also will gather information regarding how the organization invests and uses its endowment funds and determines compensation of certain highly paid individuals. This most recent IRS investigation of schools is viewed largely as yet another step along the path of increased disclosures for nonprofit organizations.

Endowment Funds

Twenty-eight questions included in the questionnaire relate to endowment funds and must be responded to by institutions which have held endowment funds or have had institutional foundations hold such funds. The questions regard whether the institution had an investment policy for the funds, the management of the investments and whether and what type of investment committee was involved. Information is requested related to the investment managers, including whether such entities or persons were internal, external or related parties and what types of compensation arrangements were involved. Additional questions ask about the types of investments in which funds are invested. The IRS also requests information on the institution's endowment assets per full-time equivalent student. Endowments must be broken down into charitable gift annuities, charitable remainder trusts and pooled income funds, and information must be provided on the distribution of such endowment funds.

Unrelated Business Income

Private nonprofit universities are subject to unrelated business income tax. One concern for the universities is questions related to activities that may generate so-called unrelated business income, which falls outside the primary charitable or educational mission. The IRS's definition of activities that produce unrelated business income is unclear, but the IRS could take the position that activities which consistently declare annual losses are actually nonbusiness activities because they are not intended to be profitable. The attention shown by the questionnaire to loss deductions may suggest a focus for future audits. One question in the questionnaire lists 47 activities which the IRS views as potential sources of unrelated business income, including the following: food service, golf courses, recreation and athletic facilities, catalog and internet sales and parking. The institution must disclose how income from each activity is treated and how management has operated such activities. Moreover, an explanation must be provided for any losses incurred. Joint venture activities must be disclosed, as well as the five largest revenue activities that have not been treated previously as unrelated business income.

Executive Compensation

Thirty-five questions relate to executive compensation, specifically on the six highest paid executives

and key employees. In addition to information on loans to executives, fringe benefits must be disclosed. Private institutions are required to disclose in further detail their compensation review, approval, policy and consulting procedures.

Compliance

While completion of the IRS's questionnaire is entirely voluntary, a failure to respond could raise a red audit flag. Many of the questions, such as those related to compensation, require interpretation and analysis of what the IRS is actually seeking. Schools should ensure that the data reported on the questionnaire is consistent with what the school previously reported on the Form 990-T business income tax return for tax-exempt organizations or on Form 990. The IRS expects to receive most of the responses within the next several months, analyze the results of the compliance questionnaire and conduct examinations of a sample of the organizations. The IRS then plans to issue a report on the higher education sector next year. Tax attorneys and their clients are expecting an onslaught of IRS examinations and audits once the IRS collects and analyzes the information. Universities and colleges likely will need to consult with outside advisors and will be called upon to expend effort and money in gathering information and presenting it in the required format.

Quick Hits

Broad Latitude in Nonprofit Hospitals' Determination of Community Benefit

According to a Government Accountability Office report, *Nonprofit Hospitals: Variation in Standards and Guidance Limits Comparison of How Hospitals Meet Community Benefit Requirements* (GAO-08-880), released October 14, the IRS's community benefit standard gives nonprofit hospitals broad latitude to determine what services and activities they provide to meet the agency's community benefit standard, while state requirements still vary substantially. The report said that while there is consensus about many activities hospitals undertake as charity care, consensus does not exist in other areas, such as the definition of patient bad debt. The GAO report indicates that the IRS needs a bright line test to be able to determine whether hospitals are meeting the standard necessary to maintain their tax exemption. States

have stepped in to try to define community benefit for their own purposes, which has caused a lot of variation from state to state. Among the standards and guidance used by nonprofit hospitals, consensus exists to define charity care, the unreimbursed cost of means-tested government health care programs such as Medicaid and many other activities that benefit the community as community benefit, the report stated. However, variations in the activities nonprofit hospitals define as community benefit currently lead to substantial differences in the amount of community benefits they report.

Grassley Favors Permission for Clergy To Endorse Political Candidates

According to a statement made on September 26 by Sen. Charles Grassley (R-Iowa), ranking member of the Senate Finance Committee and a leading watch-

dog of tax-exempt organizations in Congress, clergy members should be allowed to speak their minds on political issues. Grassley was referring to a recent initiative by the Alliance Defense Fund urging pastors to defy IRS rules and publicly endorse political candidates by name. The ADF, a conservative legal organization, enlisted 33 pastors to deliver sermons on September 28, and many of the sermons impliedly endorsed Republican presidential contender Sen. John McCain (R-Ariz.). Endorsing political candidates, explicitly or implicitly, currently is prohibited by IRS rules. ADF has said that it wants to prompt a Supreme Court challenge resulting from its actions in order to finally resolve free speech issues that have existed for churches since 1954. Grassley has supported legislation in the past that would overturn the IRS prohibition against endorsing political candidates. He said pastors have a right to challenge the restriction and provoke legal action against themselves as a way to get the law thrown out. Current law states that because of a church's tax-exempt status, a church leader cannot use church funds to help a candidate. However, according to Grassley, it should be permissible under the First Amendment for a preacher to say what he wants as long as it doesn't cost the organization any money. The ADF has pledged to defend any churches that end up in court as a result of the initiative.

Redesigned Form 990 Brings On Potential Revision of Penalty Provisions

The IRS stated on October 15 that it is considering increasing penalties for exempt organizations that fail to completely fill out the Form 990. The idea was introduced at a D.C. Bar Taxation Section Exempt Organizations Committee panel, during which Roger Colinvaux, a former Joint Committee on Taxation legislation counsel, said now that there is a new Form 990, there should be a new penalty structure to go along with it. According to Colinvaux, "once you've got a new form, the time to strike is right away, to follow up with significant enforcement efforts and send a signal to the sector that forms that are not completely filled out will not be tolerated." He suggested two possibilities: either making charity managers personally responsible for incomplete forms from the get-go or expanding the current rule that failure to file a form for three consecutive years leads to loss of tax exemption to cover forms that are incompletely filled out over that period. Currently, there is an organization-level penalty for failure to complete the form; managers, however, are given an

opportunity to respond to an IRS demand letter and rectify the situation before personal responsibility kicks in. Now that the Form 990 has been redesigned to capture more information about the exempt sector, there is a heightened expectation that the IRS will do something with the information. Among other things, the IRS likely will build compliance initiatives based on the information.

Questions on Nonprofit Governance Expanded to 20 on IRS New Form 990

The new Form 990 has expanded the questions on nonprofit governance from 3 to 20. According to an October 1 statement by advisers to the Tax Exempt and Government Entities, although there are technically only 20 questions, many of the governance questions have subquestions that increase the number to about 30. An IRS program is exploring whether charity boards are ready for the new form. The main areas the IRS will probe are charity board governing body and management, governance policies and disclosure. Questions include: the number of board members and whether they have voting authority; whether the board delegates management responsibilities to others; whether there have been significant changes in the organization's documents; whether members or stockholders elect board members; and whether their decisions are subject to approval by them. The IRS will continue to work on Form 990 in the area of nonprofit governance. The IRS also will conduct two related projects: (1) training IRS agents in the area of governance so they will be prepared to handle audits; and (2) designing an exam checklist that agents can use to identify whether good or bad compliance is related to governance. Last year, the IRS posted a preliminary discussion draft on good governance practices, but the IRS has moved away from recommended practices to general items that an organization and its governing body should consider.

Flexibility Provided In Computing Inventory Property Deductions

On October 3, the IRS issued Notice 2008-90, stating that until further guidance is issued, taxpayers can compute the deductible amount and the adjustment to cost of goods sold for contributions of inventory property under either Section 170(e)(3) or Section 170(e)(1). The IRS will not challenge a taxpayer's computation and adjustments under either code section or their corresponding Treasury regulations. The regulators are studying the computations involving

contributions of inventory property, as defined in Section 170(e)(3)(A) of the code. The IRS said it was aware that some taxpayers making qualified contributions may, because of the income limitation of Section 170(b)(2), prefer to apply the provisions of Section 170(e)(1) and Section 1.170A-1(c) of the regulations rather than the provisions of Section 170(e)(3) and Reg. Section 1.170A-4A(c). Section 170(e)(1) may be preferable to some corporations because there are different accounting rules for inventory property that apply if a contribution is made under 170(e)(3). In general, if a corporation makes a contribution under Section 170(e)(3), the corporation must reduce its cost of goods sold (COGS), usually by the basis or cost in the property. Some reduction in COGS is necessary to prevent double deductions. The IRS and Treasury are looking for comments on the computations and any other issues related to contributions of inventory by Jan. 26.

Implementation of FIN 48 Delayed for One Year For All Nonpublic Entities

On October 15, the Financial Accounting Standards Board (FASB) granted to all nonpublic entities a one-year deferral on implementing FIN 48 until fiscal years beginning after December 15, 2008. FASB previously had considered limiting the deferral to pass-through entities only. FASB's Statement of Financial Accounting Standards (SFAS) No. 109 (*Accounting for Income Taxes*) establishes financial accounting and reporting standards for the effects of income taxes that result from an enterprise's activities

during the current and preceding years. Standard No. 48 (FIN 48) (*Accounting for Uncertainty in Income Taxes*), clarifies the application of SFAS No. 109 by establishing a threshold condition that a tax position must meet for any part of the benefit of that position to be recognized in financial statements. Under FIN 48, tax benefits from uncertain tax positions that reduce an enterprise's current or future income tax liability are reported in its financial statements only to the extent each benefit is recognized and measured under a two-step process: (1) the enterprise must evaluate the technical merits, based on tax authorities, of each tax position to determine whether it is "more-likely-than-not" (i.e., more than 50 percent likely) that the position would be sustained upon examination by a tax authority that has full knowledge of all relevant information; and (2) if a tax position satisfies the more-likely-than-not threshold, the enterprise then must measure the amount of tax benefit from the position that can be recognized in the financial statements. Under a cumulative probability approach, an enterprise records in its financial statements the largest amount of tax benefit that is greater than 50 percent likely of being realized. FIN 48 also provides guidance on measurement, derecognition, classification and disclosure of tax positions. The Staff Position proposed on October 15 will have a 30-day comment period, after which time separate guidance will be issued dealing with passthroughs and existing disclosure requirements for nonpublic entities.

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