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Non-Profit Challenges With Alternative Investments and Restricted Funds

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WEDNESDAY, SEPTEMBER 7, 2011

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

Michael Sorrells, National Director of Non-Profit Tax Services, **BDO USA**, Bethesda, Md.

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JULY 2011
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THE NEWSLETTER OF THE BDO NONPROFIT & EDUCATION PRACTICE

NONPROFIT STANDARD

BUYER BEWARE: ALTERNATIVE INVESTMENT COMPLIANCE AND TAX ISSUES

By R. Michael Sorrells, CPA

With the promise of greater investment yields, many nonprofit organizations are jumping on the bandwagon and investing in an array of alternative investments, many of which derive income from offshore sources. Such investments include partnerships, limited liability companies (LLCs), hedge funds, funds-of-funds and other similar entities.

Alternative investments can lead to both unrelated business income tax (UBIT) and significant additional filing requirements even when there is no tax liability. These additional filing requirements have to be taken very seriously as there are significant penalties for not filing.

▶TAXATION

Any investment (not related to the organization's exempt purpose) that is purchased with borrowed funds may be subject to the debt-financed income rules. Under these rules, passive income that is normally excluded from UBIT (such as interest, dividends, royalties and rent) becomes at least partially taxable if there is acquisition debt on the part of the nonprofit organization. Acquisition debt can occur if the organization borrows to make the investment or, in the case of a pass-through entity, if the "fund" has borrowed to purchase an income-producing asset (most commonly real property). This is true regardless of whether the income is foreign or domestic.

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BUYER BEWARE

Many alternative investment funds are organized as U.S. partnerships or LLCs. Thus, the partnership or LLC pass-through income is taxed at the organization level (on its distributive share as reported on Form K-1) and not at the partnership or LLC level. If the partnership has borrowed funds to finance its operations, it will likely generate debt-financed UBIT as discussed above. Any K-1s from U.S. partnerships or LLCs should be carefully analyzed to ascertain if UBIT is being passed through to the partner or member. UBIT is required to be reported to nonprofit partners or members, but sometimes the partnership return preparer is not aware of the UBIT rules or does not even realize that the partner or member is a tax-exempt organization (there is a box on the K-1 which should identify what kind of organization the partner or member is; if it says anything other than tax-exempt organization, careful scrutiny is required to determine if there is UBIT). Partnerships and LLCs may also have UBIT sourced from states other than the nonprofit's state of domicile, which may require filing income tax returns and payment of tax to multiple jurisdictions *(see the article entitled "State Tax Liability for Alternative Investments" on page 3).*

Some funds are structured as corporations which then invest in domestic or foreign partnerships. Corporations pay dividends to investors and do not pass through items of income with various characteristics as partnerships and LLCs do. Dividend income is not generally taxable to nonprofit organizations and the debt-finance income rules do not come into play unless the nonprofit has borrowed to make the investment. Typically, many funds invest in foreign partnerships but through the intermediary of a foreign corporation which effectively blocks the UBI from passing directly through to the nonprofit investor (all income is nontaxable dividends).

Some foreign corporations are classified under U.S. law as passive foreign investment companies (PFICs). This is generally the case when 75% or more of the gross income is passive or, if the average percentage of assets held by the corporation which produces passive income is 50% or more. PFICs may generate taxable income to for-profit investors but generally not to nonprofits unless the income is unrelated business income (which it generally is not, since it is usually dividends or capital gains) or if the organization borrowed funds for the investment.

If foreign partnerships are invested in directly, the income is recognized in the year the partnership earns it. The fact that a nonprofit invested in a foreign partnership does not receive a K-1 does not excuse the organization from reporting any income whether or not it is distributed. Such income may or may not be UBIT, depending upon its characteristics.

▶POSSIBLE REQUIRED FORMS

Whether or not tax is generated by the alternative investment, there may be an onerous burden for the organization in terms of additional forms that generally are required to be attached to Form 990 or 990-T. There are very significant penalties for not filing these forms (**$10,000 to $100,000 per form**). Not filing most of these forms leaves the statute of limitations open for any year the form was not filed, so a non-compliant organization may be subject to these penalties (with interest added) if the IRS discovers the omission. The IRS is currently stepping up enforcement of these filing rules which in prior years were not such a high priority. Additionally, for 2010, the Form 990 Schedule F has been modified to ask specifically if the organization is liable for filing these forms. K-1 footnotes will usually contain significant information about many of these filings related to pass-through investments.

For organizations who are remiss in filing these forms, there is an **Offshore Voluntary Disclosure Initiative** available until August 31, 2011 for filing prior-year forms that were omitted. For most tax-exempt entities, there should be no penalties involved with filings under this program (although the work involved in gathering the information and preparing the filings may be extensive).

Some of the Forms That May Be Required:

- **Form 926:** generally required for investments of $100,000 or more in a foreign corporation, even if done through a partnership or LLC.
- **Form 8865:** generally required for purchase or sale of investments in foreign partnerships of $100,000 or more.
- **Form 5471:** may be required if the organization owns 10% or more of a foreign corporation (directly or indirectly).
- **Form 8621:** may be required for investments in PFICs.
- **Form TD F90-22.1 Report of Foreign Bank Accounts (FBAR):** required for organizations and their officials with signatory authority. Even if the organization does not directly have a foreign account, it may be required if it controls an entity which has such an account. Unlike the above forms, the FBAR is not filed as an attachment to the 990 or 990-T. It is a separate filing due annually on June 30th.

▶CONCLUSIONS

The tax and reporting rules related to alternative investments are extremely complex. Organizations that are contemplating alternative investments should consider the tax consequences and reporting burdens of the specific investment carefully before making the investments. Organizations already invested in alternatives should take a careful look at their investments to determine if they have an unreported tax liability and to determine if all required filings were properly prepared and filed. This will generally require the assistance of tax professionals with expertise in international tax issues. If the required forms have not been filed, nonprofits should consider filing under the Offshore Voluntary Disclosure Initiative before it is too late.

For more information, contact Michael Sorrells, national director, Nonprofit Tax Services, at msorrells@bdo.com.

STATE TAX LIABILITY FOR ALTERNATIVE INVESTMENTS

What you can do if you did not pay state taxes

By Laura Kalick, JD, LLM in Tax

Nonprofit organizations that have adopted Accounting Standards Codification (ASC) 740-10 (FIN 48) have gone through the exercise of determining whether there are any material uncertain tax positions. This analysis should have been performed for all income tax positions at the federal, international, and state and local levels. The identification of tax positions should have taken into account all the open tax years, i.e., those years that would be subject to assessment by the taxing authorities. In general, for federal income tax purposes, the government has three years from the date a tax return is filed to go back to assess taxes. Otherwise, there is a statute of limitations on going back further unless there is a material understatement of tax liability, i.e., greater than a 25% understatement.

Most organizations have filed Forms 990 and 990-T and information and tax returns in their state of domicile. Also, most organizations are in compliance with state filings in states where they have a physical location and employees and it is clear that there is nexus in the state, i.e., that there are enough points of contact with the state that the state can claim jurisdiction over taxing the entity. On the other hand, organizations may not have been aware of state filing requirements that have arisen because of an ownership interest in a partnership or alternative investment that has activities and property in another state. *If an organization never filed a state tax return where one was required there is no statute of limitations on how many years the state can go back to assess taxes.* Also, if the state were to pursue the organization, in addition to the back taxes, there could also be significant interest and penalties.

Whether or not there is nexus through a partnership interest is not always clear cut and different states have different rules. If an alternative investment reports on a K-1 that there is unrelated trade or business income or loss in a particular state, an exempt organization should look into its reporting responsibilities. This is true both when there is net income and if there is a net loss. If an organization never files a tax return, then a loss in one year cannot be used to offset income in another year.

An organization that has not filed a tax return that it should have filed may have to establish a reserve to take into account the liability. The reserve should take into account all the income earned when the organization held the investment and the interest and penalties associated with that liability. If the organization continues to not file returns, the reserve will keep growing. If the organization decides to rectify the situation by just filing returns in the future or even files returns for the last three years, this may be a serious "red flag" because now the state knows of the organization's existence and may pursue previous years and the related interest and penalties.

If there is potential liability in just one state, an organization could consider contacting that state in order to determine what the state will find acceptable. Their representative could even contact the state on a no-name basis. However, the potential problem is that unless the state has a written procedure indicating how many years' returns will be required, the amount of interest and whether penalties will be imposed, the organization is at the mercy of the state. Also, if there are multiple states where there is potential liability, contacting the states and getting an agreement can be a full-time job.

Fortunately, there is an alternative to continually carrying a reserve or revealing yourself to the taxing authorities and begging for mercy.

▶MULTISTATE VOLUNTARY DISCLOSURE PROGRAM

The Multistate Tax Commission (MTC), an intergovernmental state tax agency working on behalf of states and taxpayers to administer the tax laws equitably and efficiently, has established a Multistate Voluntary Disclosure (MVD) Program that allows a tax non-filer with potential liability in multiple states (including DC) to negotiate a settlement agreement regarding back liability on favorable terms through a single point of contact and a single, uniform procedure. The procedure does not determine whether nexus exists with respect to an organization, but the parties set that issue aside and come to an agreement for past non-filing and agree that filing will occur in the future.

The MTC does not charge for their services. An organization or its representative can have the MTC approach all the participating states on a no-name basis to reach an agreement. The agreement usually includes that the organization files and pays back tax and interest with respect to the prior periods or "lookback period;" the state(s) waives all penalty and tax prior to the lookback period and the organization will continue to file with the state(s) unless its nexus status changes. The identity of the organization is only revealed to the state(s) after a legally binding voluntary disclosure contract has come into force. The program is not available if the organization has already made "contact" with a state. "Contact" includes filing a return, paying a tax, and receiving an inquiry from the state regarding the type of tax at issue. So this means that an organization must come forward before it is too late.

All but six states participate in the MVD Program. For a full list of the states, see http://www.mtc.gov/Default.aspx.

BDO has assisted organizations in navigating through the MVD Program. Please contact Laura Kalick if you need further information or assistance.

For more information, contact Laura Kalick, national director, Nonprofit Tax Consulting, at lkalick@bdo.com.