



presents

Non-Profits and Unrelated Business Income Tax: Evaluating Non-Core Revenue Streams

Preparing for Tougher Scrutiny of UBI by the IRS and State Tax Agencies

A Live 100-Minute Audio Conference with Interactive Q&A

Today's panel features:

Brenda Blunt, Director, **CBIZ MHM**, Phoenix

Fred Rothman, Partner, Director of Tax Services, **Loeb & Troper**, New York

Charles "Chip" Watkins, Attorney, Watkins **Chamberlain & Bean**, Washington, D.C.

Tuesday, August 18, 2009

The conference begins at:

1 pm Eastern

12 pm Central

11 am Mountain

10 am Pacific

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Non-Profit And Unrelated Business Income Tax Teleconference

Aug. 18, 2009

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Changes In Form 990

Revised Form 990

- First revision since 1980
- Effective for tax years beginning in 2008
- Transition rules
 - 2008: EOs with gross receipts < \$1 million and total assets < \$2.5 million may file Form 990-EZ
 - 2009: EOs with gross receipts < \$500,000 and total assets < \$1.25 million may file Form 990-EZ
 - 2010: EOs with gross receipts < \$200,000 and total assets < \$500,000 may file Form 990-EZ

Revised Form 990 (Cont.)

“Core” Form 990

- 11 pages
- Glossary
- Financial summary
- Signature block
- Program service accomplishments
- Checklist of required schedules
- Other IRS filings
- Governance, management and disclosure

Revised Form 990 (Cont.)

- Compensation of officers, etc.
- Statement of revenue
- Statement of functional expenses
- Balance sheet
- Financial statements and reporting

Revised Form 990 (Cont.)

Schedules

- A – Public charity status
- B – Schedule of contributors
- C – Lobbying and political activity
- D – Supplemental financial information
- E – Schools
- F – Activities outside the U.S.
- G – Fundraising and gaming
- H – Hospitals

Revised Form 990 (Cont.)

Schedules (Cont.)

- I – Grants in the U.S.
- J – Compensation information
- K – Tax-exempt bonds
- L – Transactions with interested persons
- M – Non-cash contributions
- N – Liquidation, termination, etc.
- O – Supplemental information
- R – Related organizations and unrelated partnerships

Other Current Areas Of IRS Emphasis

Current UBIT Issues

Charitable remainder trusts – Investments in endowments

- Currently, the issue most frequently addressed in rulings
- Typical example: PLR 200922061
 - CRT assets are invested in unit investments in the endowment of the trustee/remainderman
 - Trust has contract rights only; no ownership in the endowment's assets
 - Trust has no right to direct investments or other endowment policies

Current UBIT Issues (Cont.)

Charitable remainder trusts – Investments in endowments (Cont.)

- Income paid to trust based on charity's authorized spending rate from endowment
- Income payments to trust are treated as ordinary income
- Redemption of units is treated as long- or short-term capital gain or loss
- IRS concluded that neither the charity nor the CRT would receive any UBI as a result of the arrangement. Charity received no compensation, and trust had no ownership of assets that might produce UBI in the endowment

Current UBIT Issues (Cont.)

Scientific research

- PLR 200905033:
 - Charity's conducted scientific research related to medical imaging, pursuant to an agreement with a commercial sponsor
 - Sponsor was entitled to use results for commercial applications
 - Charity was also entitled to use results for commercial applications
 - Charity published results of research within two months after completion

Current UBIT Issues (Cont.)

Scientific research (Cont.)

- IRS concluded that the research was not unrelated to the charity's exempt purpose. It was basic research conducted in the public interest

Current UBIT Issues (Cont.)

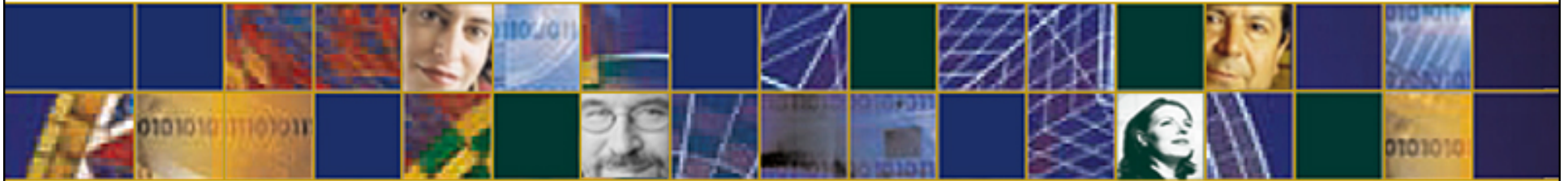
Colleges and universities compliance project

- 13 pages of questions about activities that might produce UBI
 - Related organizations and allocations
 - Transactions subject to §512(b)(13)
 - Advertising
 - Sponsorships
 - Facilities rental
 - Athletic facilities usage
 - Personal property rental
 - Catalog and bookstore sales

Current UBIT Issues (Cont.)

Colleges and universities compliance project (Cont.)

- Royalty arrangements
- Commercial research
- Hotel, conference center, restaurants, catering
- Parking lots
- Power generation
- Joint ventures
- Endowments
- Executive compensation



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Disclosure Rules

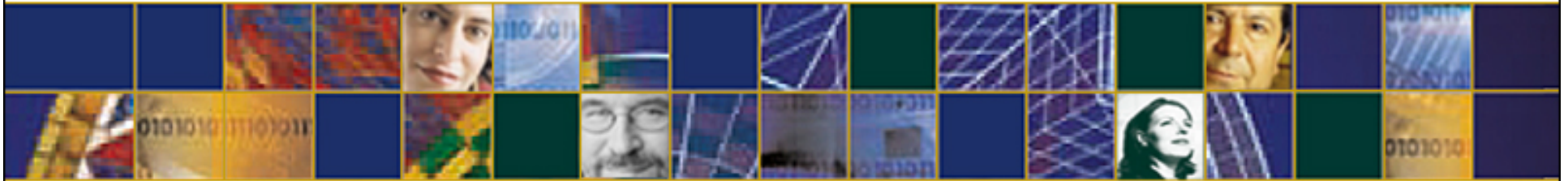
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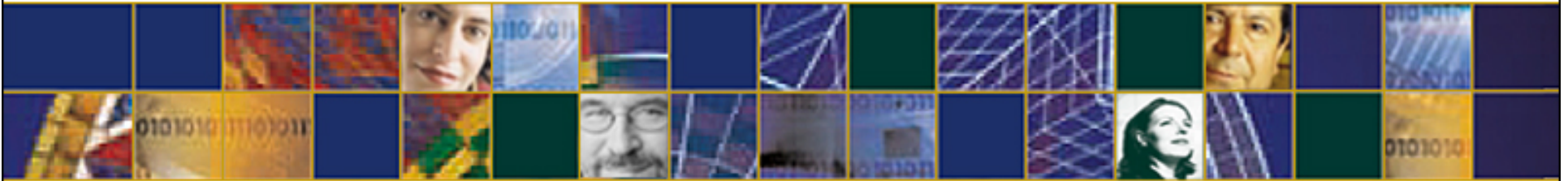
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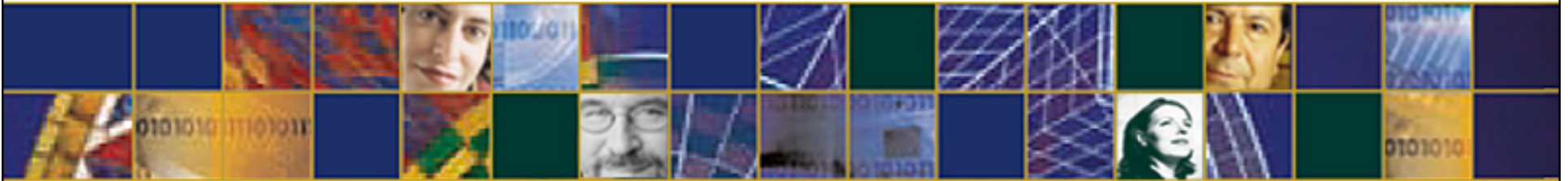
Pension Protection Act Of 2006

Although Form 990, 990-PF and related information returns have been subject to a variety of public disclosure rules for years, there has been resistance to making the 990-T a public document, as it might put charities at a competitive disadvantage with for-profit organizations whose income tax returns are not available to the public



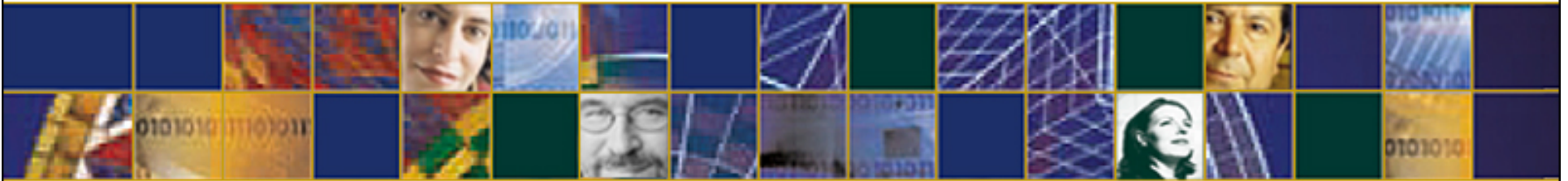
Pension Protection Act Of 2006 (Cont.)

The Pension Protection Act of 2006 amended IRC §6104(d)(1)(A)(ii) to require §501(c)(3) organizations to make their 990-T available for public disclosure for the first time



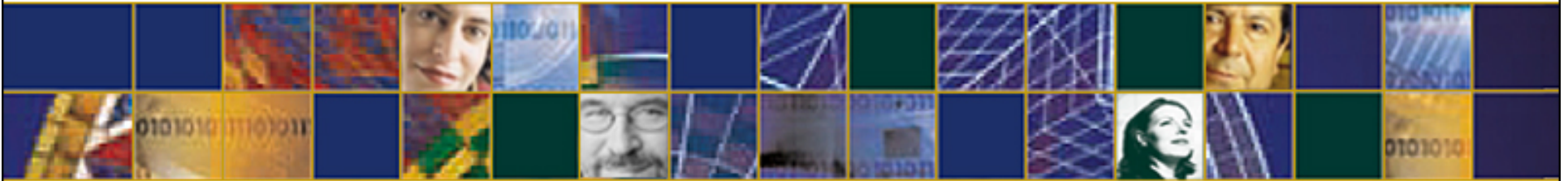
Pension Protection Act Of 2006 (Cont.)

- Effective for 990-T returns filed after August 17, 2006
- Original 990-T and amended 990-T returns remain subject to public inspection for three years from the due date of the return, including extensions



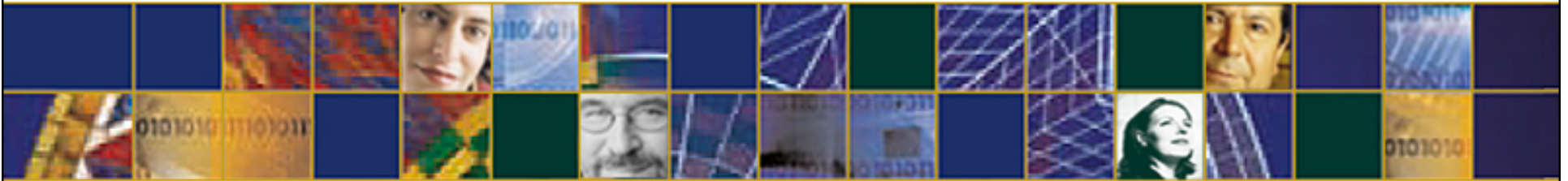
Pension Protection Act Of 2006 (Cont.)

- Applies to §501(c)(3) organizations that do not file a 990, such as churches
- Applies to state colleges and universities exempt under §115 *if they applied for exempt status under §501(c)(3)*
- Applies to private foundations exempt under §501(c)(3)



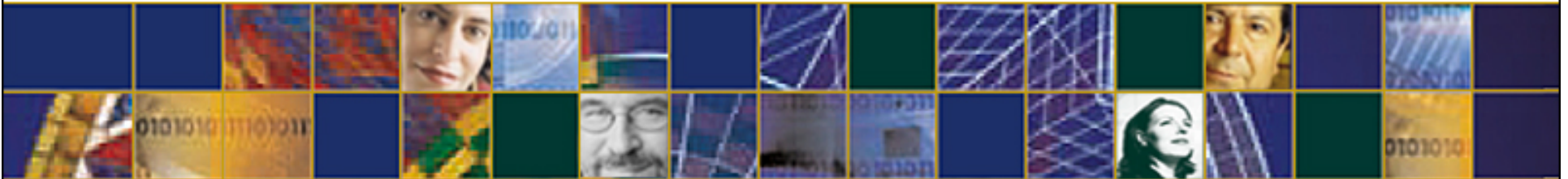
Pension Protection Act Of 2006 (Cont.)

- Applies to non-exempt private foundations and non-exempt charitable trusts described in I.R.C. §4947(a)(1)



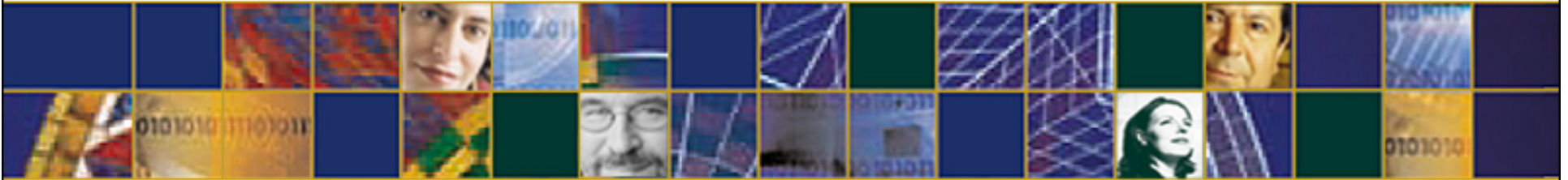
General Disclosure Rules

- Organization must provide a copy of their returns to anyone who requests a copy:
 - In person, during regular business hours at the organization's principal office and at each of its regional or district offices having at least three paid employees, the same day. Reg. 301-6104(d)-1(b)(4)



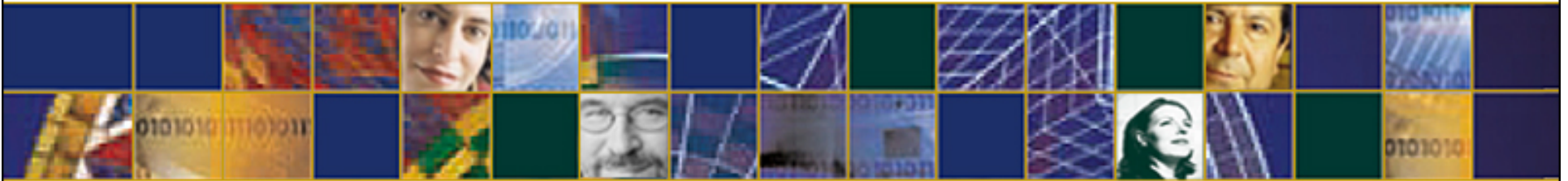
General Disclosure Rules (Cont.)

- Organization must provide a copy of their returns to anyone who requests a copy:
 - By mail, within 30 days of receiving a written request, or, if there is a charge, within 30 days of receiving payment. Reg. 301-6104(d)-1(b)(4)



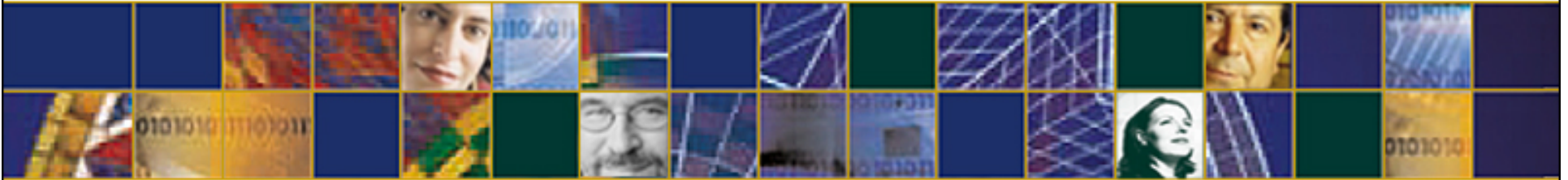
General Disclosure Rules (Cont.)

- Organizations may charge a reasonable fee defined as the amount the IRS charges for public inspection copies. See fee schedule in IRS Form 4506-A
- In lieu of providing a paper copy, an organization may make a readily accessible copy available on the Internet



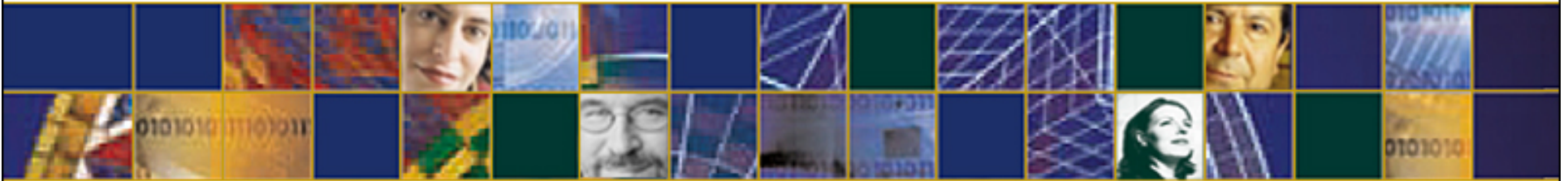
General Disclosure Rules (Cont.)

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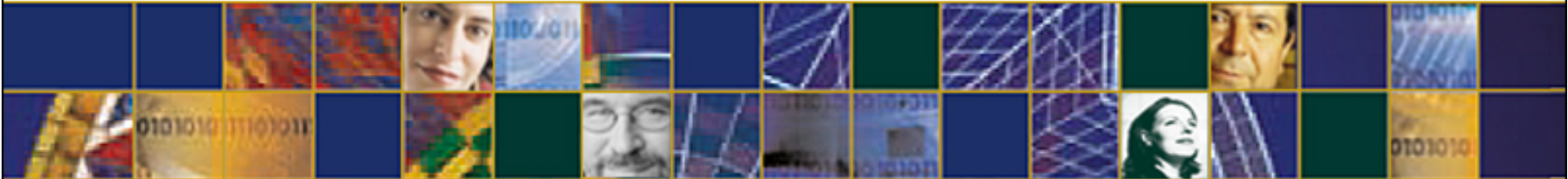
General Disclosure Rules (Cont.)

- Organizations need not comply with requests that are part of a harassment campaign
- Penalties apply to the person responsible for the failure to comply with these rules, at \$10/day up to \$10,000. Additional \$5,000 if willful violation



What Must Be Included?

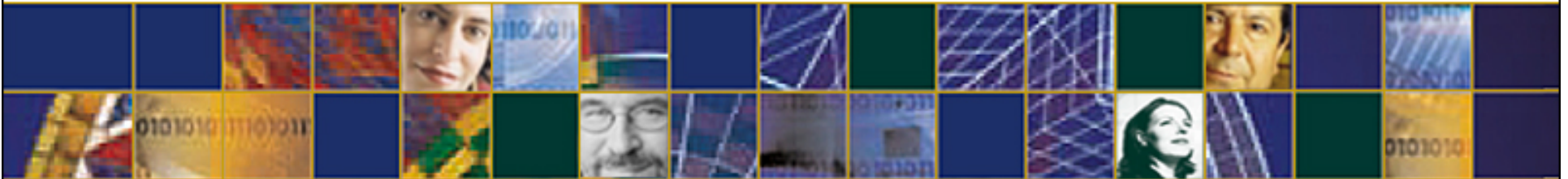
An exact copy of the Form 990-T including any schedules, attachments and supporting documents *that relate to the imposition of tax on the unrelated business income*



What Must Be Included? (Cont.)

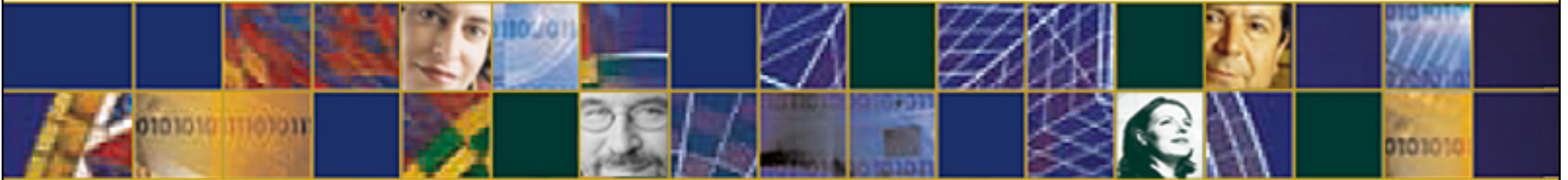
- Disclosure rules do not apply to 990-T returns that were filed solely to request the telephone excise tax refund

IRS Notice 2007-45



What Must Be Included? (Cont.)

- Disclosure rules do not apply to other forms that do not affect the imposition of tax on UBIT, including (Notice 2008-49):
 - Form 5471 (U. S. persons with respect to certain foreign corporations)
 - Form 8886 (reportable transaction disclosure statement)



What Must Be Included? (Cont.)

The organization may choose to attach certain forms to either the 990 or the 990-T. In those cases, the organization may strategically choose to attach the form to the 990-T, because of the non-disclosure guidance in Notice 2008-49 or because it is less frequently requested

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Joint Ventures And For-Profit Subsidiaries

- Joint ventures
 - “Look through” principle
 - Passive (investment) vs. active
 - Debt-financed

Joint Ventures And For-Profit Subsidiaries (Cont.)

- Joint ventures
 - Rev. Rul. 2004-51 – Ancillary joint ventures
 - LLC in which each party (not-for-profit and for-profit) each have a 50% share and equal representation on the board. The not-for-profit entity is a university and, as part of its educational programs, offers summer seminars. The activities of the LLC represent an insubstantial portion of the university's activities. Governing documents grant the university exclusive right to approve the curriculum, training materials and instructions; and to determine the standards for successful completion of the seminars. The for-profit had the exclusive right to select locations for video links and to approve other personnel (such as camera operators) necessary to conduct such video seminars. All other actions required mutual consent

Joint Ventures And For-Profit Subsidiaries (Cont.)

- Joint ventures (Cont.)
 - Rev. Rul. 2004-51 – Ancillary joint ventures (Cont.)
 - Because the activities the EO conducted through the LLC are not a substantial part of its activities, the EO's participation in the LLC will not affect its exempt status. Because activities are substantially related to EO's charitable purposes (education), it is not subject to UBIT on its distributive share of LLC's income
 - Ruling implies that, in other circumstances not presented in ruling, even if the activity is substantially related, such activity could result in loss of exempt status or unrelated business income, if the exempt organization cedes control to the for-profit with respect to the charitable aspects

Joint Ventures And For-Profit Subsidiaries (Cont.)

- For-profit subsidiaries
 - IRC Sect. 512(b)(13) requires control (direct or indirect) of more than 50% of stock, and with respect to partnerships or other entities, ownership of more than 50% of profits, capital or beneficial interest
 - If applicable, payment of annuities, interest, rent or royalty to tax-exempt organization is UBTI, to extent the payment reduces the net unrelated income or increases net loss
- Reporting on Form 990, Schedule R, Parts II and V
 - Part V-18 different described transactions
 - No minimum dollar thresholds

Joint Ventures And For-Profit Subsidiaries (Cont.)

- For-profit subsidiaries (Cont.)
 - Qualifying specified payments (QSPs) received or accrued from a controlled entity are included in an exempt organization's UBTI only to the extent they are excess payments. Extended through 2009
 - QSP is a specified payment made under a binding written contract in effect on Aug. 17, 2006, including renewals of such contracts under substantially similar terms
 - Excess payments are the portion of the QSPs received or accrued by the organization that exceeds the amount that would be been paid or accrued if the payment met the requirements prescribed by the anti-abuse reallocation rules of IRC Sect. 482

Joint Ventures And For-Profit Subsidiaries (Cont.)

- For-profit subsidiaries (Cont.)
 - Allocation of income, deductions and credits: Specified covered services (“SCS”)
 - IRS Announcement 2006-50 (July 31, 2006)
 - Issuance of temporary and proposed regulations under Sect. 482 with respect to intercompany services
 - Services cost method (“SCM”) will be considered to be the best method for purposes of Sect. 482, if the required conditions are met
 - SCM evaluates whether the price for covered services is arm’s length by reference to the total services costs with no mark-up

Joint Ventures And For-Profit Subsidiaries (Cont.)

- For-profit subsidiaries (Cont.)
 - Allocation of income
 - IRS Announcement 2006-50
 - Identified 48 activities that constitute specified covered services
 - Two categories of covered services eligible for SCM
 - **Specified covered services** – Support services of a type common across industry sectors that generally do not involve a significant arm's-length mark-up on total services costs
 - **Categories of services** – Payroll, premiums for unemployment, disability and worker's compensation, accounts receivable/accounts payable, general administrative, public relations, meeting coordination, accounting and auditing, tax, compliance, budgeting, treasury activities, statistical assistance, staffing, recruiting and related services, training services, benefit services, computer support, database administration, network and computer system administration, legal services, insurance claims management

Joint Ventures And For-Profit Subsidiaries (Cont.)

- For-profit subsidiaries (Cont.)
 - Allocation of Income
 - IRS Announcement 2006-50 (Cont.)
 - Two categories of covered services eligible for SCM (Cont.)
 - Low margin covered services that have a median comparable arm's-length mar-kup on total services costs of less than or equal to 7%
 - Rev. Proc. 2007-13 (Dec. 20, 2006): Broadened categories that constitute specified covered services included in Announcement 2006-50

Joint Ventures And For-Profit Subsidiaries (Cont.)

- For-profit subsidiaries (Cont.)
 - Penalty – A valuation misstatement penalty applies to excess QSPs that are included in UBTI. The penalty is 20% of the excess payment
 - Controlling organizations that must include QSPs in UBTI must also include on Form 990-T
 - Any interest, annuities, royalties or rents received from each controlled entity

Special Rule For Sect. 501(c)(2) Organizations [IRC Sect. 511(c)]

- If affiliated exempt organization and 501(c)(2) file a consolidated return, the 501(c)(2) is treated as if it were the affiliated exempt organization for purposes of UBI
- To be exempt from UBI, the 501(c)(2)'s activity has to be substantially related to the affiliated organization's exempt purpose

Special Rule For Sect. 501(c)(2) Organizations [IRC Sect. 511(c)] (Cont.)

- In TAM 9605001 (Feb. 2, 1996), a Sect. 501(c)(2) title-holding corporation filed a consolidated Form 990 with its parent, a Sect. 501(c)(8) fraternal organization
- Instructions for Form 990-T set forth procedure for filing consolidated return. Requires attachment of Form 851 (affiliation schedule), and for the first year, a consolidated return is filed, Form 1122 (authorization and consent of subsidiary corporation)

Debt-Financed Income – IRC Sect. 514

- Property held to produce income with respect to which there is acquisition indebtedness
- Acquisition indebtedness
 - Principal indebtedness incurred by the tax-exempt organization in acquiring or improving the property
 - Principal indebtedness incurred before the acquisition or improvement, if the indebtedness would not have been incurred but for the acquisition or improvement
 - Principal indebtedness incurred after the acquisition or improvement if the indebtedness would not have been incurred but for acquisition or improvement, and such incurrence was reasonably foreseeable when property acquired or improved

Debt-Financed Income – IRC Sect. 514 (Cont.)

- Property acquired subject to a mortgage is considered debt-financed, subject to certain exceptions
 - Property acquired subject to a mortgage not treated as debt-financed for ten (10) years following date of acquisition
 - If acquired by bequest or devise, or
 - If acquired by gift, if mortgage placed on property more than five (5) years before gift, and property held by donor more than five (5) years before gift

Debt-Financed Income – IRC Sect. 514 (Cont.)

- Property acquired subject to a mortgage is considered debt-financed, subject to certain exceptions (Cont.)
 - Ten (10) year rule not applicable if exempt organization assumes and agrees to pay the indebtedness or makes any payment for the equity owned by the decedent or donor
 - Extension, renewal or refinancing of pre-existing indebtedness is treated as a continuation, to the extent outstanding principal amount is not increased

Debt-Financed Income – IRC Sect. 514 (Cont.)

- Exclusions
 - Substantially related use (85% or more)
 - Subject to tax on unrelated business income
 - To extent income from property is derived from research activities performed by colleges, universities and hospitals; and by certain fundamental research organizations
 - Property to extent utilized in a business where the volunteer, thrift shop or convenience exception applies
 - Property owned by exempt holding company or other exempt organization and is used by related exempt organization for its exempt function

Debt-Financed Income – IRC Sect. 514 (Cont.)

- Exclusions (Cont.)
 - Subject to certain exceptions, debt incurred by qualified retirement plans to finance real estate investments
 - Charitable remainder trusts and charitable gift annuities
 - Neighborhood land rule
 - Exempts property located in the neighborhood of other property owned by the tax-exempt organization, which it plans to devote to exempt purposes within 10 years of acquisition. The exemption applies after the first five years of the 10-year period only if the organization satisfies the IRS that utilization for its exempt purposes before 10 years is reasonably certain. Churches are granted 15 years, and it is not required that property be in the neighborhood of the church

Debt-Financed Income – IRC Sect. 514 (Cont.)

- Exclusions (Cont.)
 - Neighborhood land rule (Cont.)
 - In the “neighborhood”: Contiguous with, or separated only by a road, street, or similar property
 - “In the neighborhood” if it is within 1 mile (not applicable to churches) and it is unreasonable under the specific circumstances to acquire contiguous property
 - LTR. Rul. 20082103b (5/23/08): Involved a church. IRS found acquisition furthered exempt purpose, construction would be concluded within 15 years, ruling request submitted within the five-year period, and church had taken sufficient actions to indicate intended use for exempt purpose was reasonably certain

Real Property Acquired By Qualified Organizations – Exception To Acquisition Indebtedness

- Qualified organizations – IRC Sect. 514(c)(9): Schools and their supporting organizations, trusts under IRC Sect. 401, Sect. 501(c)(25) organizations, retirement income accounts provided by churches
- If both tax-exempt and taxable partners exception applies if:
 - Tax-exempt entity cannot result in its having share of overall partnership income for any taxable year greater than its lowest share of losses
 - Each allocation must have substantial economic effect

Securities Trading

- Margin – Purchased securities constituted debt-financed property that produced income subject to UBIT. The Henry E. and Nancy Horton Bartels Trust f/b/o Cornell University et al v. U.S. U.S. Court of Claims, 2009-2 U.S.T.C. ¶ 50, 475 (July 1, 2009)
 - In the absence of “leverage,” trading securities by an organization for its own account (although constituting a trade or business that is regularly carried on) will not be subject to UBIT, since such securities do not constitute property includable in inventory or held primarily for sale to customers, and are excludable under IRC Sect. 512(b)(5). GCM 39597(2/4/87), GCM 39620 (4/13/87) and LTR 8922084 (3/10/89)

Computation Of Debt-Financed Income

- Unrelated debt-financed income =

$$\frac{\text{Average acquisition indebtedness}}{\text{Average adjusted basis}} \times \text{Gross income from debt-financed property}$$

- Average acquisition indebtedness = Average of first day in each calendar month
- Average adjusted basis = Adjusted basis of property for the first and last days of the year

Computation Of Debt-Financed Income (Cont.)

- Deduction allowed for debt-financed property
 - Average acquisition
indebtedness X Deductions directly
Average adjusted basis Related to property
or its income
- Subject to the modification provisions in Code Sect. 512(b)
- Only straight-line depreciation permitted

Computation Of Debt-Financed Income (Cont.)

- Gains or losses from the sale or other disposition of debt-financed property

Highest acquisition indebtedness of the property for
the 12-month period before disposition
Average adjusted basis of the property

Schedule K-1 Reporting

- Partner required to notify the partnership of its tax-exempt status
- Partnership to report any information needed to figure unrelated business taxable income
 - Problems arise with tiered partnerships and calculation of average debt-to-basis ratio
 - Need to ask questions

Form 990-T Disclosure

- Limited to 501(c)(3) organizations with respect to returns filed after Aug. 17, 2006
- Notice 2007-45 – Provided interim guidance
- Notice 2008-49 – Modified notice 2007-45 by providing that schedules, attachments and supporting documents that do not relate to the imposition of unrelated business income tax are not required to be made available for public inspection and copying. Such schedules and attachments include, but are not limited to, Form 5471 (information return of U.S. persons with respect to certain foreign corporations) and 8886 (reportable transaction disclosure)

FASB Interpretation No. 48 (FIN 48) – Accounting For Uncertainty In Income Taxes

- Effective for periods ending after Sept. 15, 2009, which means it applies to Sept. 30, 2009 year-end organizations
- Evaluation of a tax position in accordance with FIN 48 is a two-step process
 - First step is to determine whether it is more likely than not that a tax position will be sustained upon examination (including resolution of related appeals or litigation processes) based on the technical merits of the position
 - Second step is measurement. A tax position that meets the more-likely-than-not recognition threshold is measured to determine the amount of benefit to recognize in the financial statements

FASB Interpretation No. 48 (“FIN 48”) – Accounting For Uncertainty In Income Taxes (Cont.)

- Evaluation of a tax position in accordance with FIN 48 is a two-step process (Cont.)
 - Schedule D (supplemental financial statements) of Form 990 requires the inclusion of the FIN 48 footnote from an organization’s financial statements (Part XIV)

Impact On Non-Profit Organizations

- Interpretation is a consideration when there is uncertainty about:
 - Whether a particular type of tax is applicable to an entity at all
 - In what jurisdictions (federal, state, local and foreign) a tax return must be filed and taxes paid
 - Amounts of income potentially subject to tax
 - Amounts of deductible expenses, especially when allocations are involved
 - Whether tax-exempt organization does in fact qualify for tax-exempt status. If there is uncertainty about this position, then FIN 48 would apply to it. Circumstances that might raise questions about qualification for tax-exempt status include:

Impact On Non-profit Organizations (Cont.)

- Interpretation is a consideration when there is uncertainty about: (Cont.)
 - Private inurement (consider especially compensation of highly-paid people, insider transactions, etc.)
 - Excessive lobbying or political activity
 - Failure to meet the “organizational” and “operational” tests (in other words, failure to do what you told the IRS you would do when you applied for exemption status)
 - Having so much UBI (as a percentage of total income) that the IRS might assert you are really a business
 - Gross violations of other laws and regulations (e.g., repeated failure to file Form 990, discrimination, etc.)
- Tax on unrelated business income (UBI) – FIN 48 will usually need to be considered