

MP&S NONPROFIT AGENDAS MAY 2011: UBIT EXPENSE ALLOCATIONS DRAW SCRUTINY

AN IRS MAGNET: UBIT EXPENSE ALLOCATIONS DRAW SCRUTINY

The IRS is turning its attention to how nonprofit organizations calculate the tax they pay on unrelated business activities. The agency is concerned that many nonprofits may be improperly reporting losses related to these activities and thus may not be paying unrelated business income tax (UBIT).

The stepped-up focus on the reporting of unrelated business income comes in the wake of a recent IRS compliance study of 400 public and private colleges and universities. The agency collected statistical information to determine if it needed to look further into how the organizations allocated expenses. This resulted in 30 IRS audits.

When is unrelated business income taxable?

Let's say you've determined that an activity is unrelated to your exempt purpose. For example, your nonprofit's exempt purpose is to coordinate foster care, and you also run a coffee shop open to the general public to raise additional funds. The coffee shop would be unrelated to your exempt purpose. The excess of unrelated business income over the allowable deductions for that income results in UBIT. When reporting unrelated income, certain expenses — such as staff costs and coffee supplies — are allowed as deductions against that income. They're categorized as directly connected expenses and dual use expenses.

What are “directly connected” expenses?

Deductions incurred solely because of the unrelated business are known as *directly connected* expenses. These are expenses that wouldn't be incurred if the unrelated business didn't exist. In the above example, the costs of maintaining a building that's used solely for the coffee shop (the unrelated business) are a directly connected expense, as are the salaries of personnel employed full-time to operate the unrelated business.

What are “dual use” expenses?

If expenses are incurred both to carry on exempt functions and to conduct an unrelated business, they're known as *dual use* expenses. For example, a nonprofit's president is paid \$90,000 per year. If he devotes 90% of his time to the exempt activities of the nonprofit, but 10% of his time to an unrelated business, the organization can take a deduction of \$9,000 (10% of \$90,000) as a deductible expense of the unrelated activity on Form 990-T.

The allocation of dual use expenses is more complex in situations where the allocation isn't as apparent as in the example above. This is particularly true of the dual use of facilities. According to U.S. Treasury regulations, when facilities are used both to carry on exempt activities and to conduct unrelated business, the expenses, depreciation and anything attributable to such facilities “shall be allocated between the two uses on a reasonable basis.”

In such a situation, the nonprofit must first identify the expenses that are incurred for the dual purpose, such as repairs and maintenance, utilities and depreciation. There are then two methods that can be applied to allocate those expenses:

1. **The Rensselaer method.** This is a ratio based on the number of days that the facility is used for unrelated business (numerator) in relation to the total days used for all purposes (denominator) — for example, $64 \div 253$ (days). This method was named after the court case upon which it was based.
2. **The IRS method.** This is a ratio based on the number of days the facility is used for unrelated business (numerator) divided by the number of days the facility is available for use — for instance, $64 \div 365$ (days), or 17.5 % of the calendar year.

The Rensselaer method is more favorable for the nonprofit because more expense is allocated to the unrelated business.

Document, document, document

Whether you're deducting direct expenses or allocating dual use expenses, you must produce support for them. Use time sheets to document the percentage of an employee's salary allocable to unrelated business, and keep facility use records for facilities allocations. Document your reasoning behind *any* allocations.

In its college/university compliance study, the IRS found that only 16% to 19% of participants relied on the advice of independent accountants or counsel for allocations of expenses between unrelated and exempt activities. With heightened IRS scrutiny, this may be the time to revisit this issue with your accountant.

Why it matters

Here's the lowdown on what nonprofits have to face if they inaccurately report expenses related to unrelated business activities:

Accuracy-related penalties. The IRS may assess penalties for negligence or disregard of rules or regulations, or for a substantial understatement of income tax. The penalty is 20% of the underpaid tax.

Public access to Form 990-T, "Exempt Organization Business Income Tax Return." Since 2006, 501(c)(3) organizations have been required to make their Form 990-T available to the public. So expect the form — including allocations of expenses — to be scrutinized by the public just as Form 990 has been in the past.

FASB Interpretation No. 48 (FIN48). For nonprofits required to disclose uncertain tax positions on their financial statement footnotes, an incorrect or overly aggressive allocation of expenses to unrelated business income could result in a disclosure under the interpretation. This disclosure is required to be reported on Form 990.

BOARD DIVERSITY: GETTING THE RIGHT MIX

A nonprofit often begins with one person's passion. Soon family and friends are drawn into the picture, recruited as members of the board. As the organization grows, however, so does its need for board diversity.

Birds of a feather

In its infancy, a nonprofit may simply want to get the word out about its mission. So recruiting as many loved ones, friends and friends of friends as possible may be the most efficient approach. As time passes, however, the not-for-profit might find that it's represented solely by one race, sex, religion or economic class.

Such lack of diversity can signal an underlying problem: a disconnect from the community. A nonprofit should represent the population it serves as well as the community in which it operates.

A "healthy" diversity

What's considered "healthy" diversity will vary from organization to organization. But think of it like this: The more diverse your board is in attributes, the more diverse it will be in thoughts and ideas. This diversity can come in many forms — physical, emotional, societal and economic. The goal is to mirror the population you serve. Without this input, your mission might suffer.

If your bylaws limit the number of board members you can have at any given time, consider amending them to include the organization's commitment to board diversity. Careful expansion of the board to represent your community may certainly be worthwhile.

Your board's composition

The first step to a great mix is to ask board members to write their own profiles. In the instructions you give — or on the form you provide — include the attributes you consider important, such as particular demographic and skill sets. From this information, you'll be able to see what the board may lack.

Look at the group as a whole and assess where the organization lies on the diversity continuum. Imagine a scale from "1" to "5" with "5" displaying your organization's ideal diversity. Assess your members and give yourself a score. The diversity, or lack thereof, should be obvious. You may find, for example, that your board is underrepresented by females, persons of color, young adults or individuals with a financial background.

Next steps

Identifying that your board needs more diversity is easy. Figuring out what to do about it can be more difficult. Here are some ideas:

Start with current board members. Communicate the need for diversity to board members — if they haven't already vocalized the need themselves. Ask members to dip into their personal and professional networks to help find the right individual(s) for your organization.

Look to your community and the organizations that serve it. Your Chamber of Commerce might be a place to start, but there are many options. If your nonprofit lacks the perspective of young professionals, for example, contact a local "young professionals" group in your area or recent college graduates. Does your organization need diversity via a financial perspective? Express your need to a local CPA firm.

Consider a board placement service. Some communities have board training programs for professionals. At the completion of the program, the "graduates" are invited to meet and mingle with organizations seeking new board members. This is a great service for both the new board member and the not-for-profit. Professional associations also can be a good source. For example, some state CPA organizations help match accountants with organizations that need volunteers. You also could seek out a nonprofit consultant that can assist with board placement.

Go for it

Board diversity is on the front burner for many board presidents, concerned members and executive directors. With a little bit of work, an organization can achieve the diversity it desires.

WHAT YOU SHOULD KNOW ABOUT FISCAL SPONSORSHIP

The number of new fiscal sponsors has picked up since the turn of the millennium, and the figures continue to climb. So notes the online *Directory of Fiscal Sponsors*, which currently lists more than 175 sponsors that operate in nearly three-quarters of the states, Washington, D.C., and Ontario, Canada. Some 80 fiscal sponsors have formed since 2000 alone. Combined, the sponsors fund close to 10,000 projects that receive funding estimated at up to \$1 billion.

So, what do you need to know if your nonprofit is interested in becoming a fiscal sponsor? Or, if you know of a project that could use sponsorship, what basics should be considered?

Defining your terms

Fiscal sponsorship is a relationship in which a nonprofit with 501(c)(3) status sponsors a societal-minded project/group that doesn't have tax-exempt status. The fiscal sponsor is legally and financially responsible for the project. "Project" typically refers to either an ongoing group or a one-time project.

The fiscal sponsor is responsible for managing funds and acts as a "guardian" for the donations and grants the project receives. Donations are made to the sponsor, which qualifies the donors for a tax deduction. The sponsor employs the staff that works on the project and monitors activities to the same extent it monitors any of its other programs. It's the sponsor's responsibility to ensure that the project is within its mission and doesn't adversely affect its tax-exempt status.

Don't confuse being a *fiscal sponsor* with being a *fiscal agent*. Unlike a fiscal sponsor, a fiscal agent accepts donations and merely moves them on to the intended recipients. The IRS regards such donations as direct donations.

But a fiscal sponsor **is** legally responsible for the project and the funds. The sponsor doesn't merely receive the funds — it controls the project and accounts for the activity in its financial statements and on Form 990.

Identifying motives

Sponsorship allows an entity to fulfill a mission without going through the process of incorporating and applying for tax-exempt status. The sponsor can provide the back-office support that small nonprofits often lack.

Also, because donations to a 501(c)(3) organization are tax-deductible, the potential for donations is greater. And the sponsor may have much greater name recognition than the smaller or newer organization.

The sponsor benefits because the added project could bring additional recognition in the community for "doing more." This, in turn, might attract new funders.

The downside is that the sponsor may assume responsibilities that carry unanticipated risks or require additional infrastructure or cost not beneficial to the organization. The added responsibilities also might divert the sponsor from its primary programs and purpose.

Pinpointing candidates

Logical sponsoree candidates are new nonprofits who want to start operating, but have yet to receive 501(c)(3) status. So are very small groups that lack infrastructure. Sometimes even individuals are sponsored. For example, many arts organizations — Art Without Limits, Arts Engine Inc. and Intersection for the Arts, to name a few — sponsor the projects of individual artists.

Entities that have a similar mission and vision make the best match. And the sponsor should be financially strong enough to enable the sponsored nonprofit to run continuously without interruption. The sponsoring organization also should possess such traits as strong internal controls, written policies and procedures for administration and risk management, and enough staff to fulfill the agreed-upon services.

Where to start

Both organizations need to work out the terms of the relationship *before* getting started, such as who will have the authority to make decisions. You'll also need to determine how disbursing funds will be handled and who will take care of reporting requirements. An attorney and your CPA should be part of the team that helps you sort out these details, and weigh the pros and cons of this strategic move.

BE AWARE OF IRS REVOCATIONS FOR NONPROFITS

The U.S. Internal Revenue Service (IRS) is preparing to publish the Nonfiler Revocation List. This initial publication may include as many as 300,000 nonprofits whose tax-exempt status has been revoked for failure to file an annual information return.

With the implementation of the Pension Protection Act of 2006 (the Act), the IRS has the ability to revoke the tax exemption status of any nonprofit that were three or more years in arrears in filing their annual information return.

Prior to the passage of the Act, nonprofits with annual revenues of \$25,000 or less were exempt from filing an annual information return. However, with the new law, all nonprofits are required to do so. For nonprofit with annual revenues of \$25,000 or less the IRS created Form 990-N and the e-Postcard.

Some additional work for private foundations, donor-advised funds, federated giving campaigns, and other institutional funders: Publication of the Nonfiler Revocation List will add another requirement to private foundations, donor-advised funds, federated giving campaigns, and other institutional funders existing due diligence and decision-making procedures.

Such funders will need to confirm that a grantee or gift recipient does not appear in the Nonfiler Revocation List, in addition to verifying charitable status in IRS Publication 78 and establishing whether a grantee is a supporting organization in accordance with IRS Revenue Procedure 2009-32. Failure to do, as well as documenting that this additional research was performed may cause the IRS to disallow a payout as a charitable distribution and make your organization liable for excise taxes.

The Nonfiler Revocation List is published on the IRS website and will be updated monthly.

NEWS FOR NONPROFITS

IRS focuses on employment returns, Form 990 topics

The IRS's Exempt Organization (EO) Office says it plans to examine 500 employment tax returns during fiscal year 2011 — including Forms 940 and 941 — for information nonprofits report on worker classification, fringe benefits, officer compensation and employee expense reimbursement. Moreover, filing requirements are another area of focus this year.

Also underway is an EO Office initiative to audit nonprofits with high levels of fundraising expenses, unrelated trade or business activity with a low level of expenditures for program services, high officer compensation and low levels of program spending related to total revenue. The Office says it also will:

- Look for links between governance practices and tax compliance,
- Use information provided on the revised Form 990 to develop more audit areas, and
- Determine if nonprofits involved with foreclosure-assistance activities are fulfilling their tax-exempt purpose.

With the IRS magnifying glass on Form 990 — to provide insight on how tax-exempt organizations are operating and prioritizing projects — new regulations may be around the corner.

New rules for hospitals

The health care reform law imposes four additional requirements — including added reporting duties — that hospitals must meet to qualify as 501(c)(3) charitable organizations. IRS Notice 2010-39, *Request for Comments Regarding Additional Requirements for Tax-Exempt Hospitals*, explains the new requirements. Visit <http://www.irs.gov/pub/irs-drop/n-10-39.pdf> for a full description. Although this comment period is past, the document describes the new rules. Your tax advisor can guide you through the new processes.

Tougher disclosure requirements set for health care providers

Two Accounting Standards Updates revise reporting requirements for health care providers and attempt to provide more consistency in financial statements. ASU No. 2010-23, *Measuring Charity Care for*

Disclosure, requires that the measurement of any charity care that's provided be disclosed at its direct and indirect costs. The method used to determine the costs also must be disclosed. Health care providers don't recognize revenue for charity care in their financial statements, so no effect is expected on the primary financial statements — only on the disclosures.

ASU No. 2010-24, *Presentation of Insurance Claims and Related Insurance Recoveries*, clarifies the reporting of insurance claims for health care entities in an attempt to standardize reporting. The guidance prohibits a health care entity from netting insurance recoveries against a related claim liability. Instead the liability should be determined at the gross amount without any reduction for insurance recoveries. Both updates are effective for financial statement reporting years starting after Dec. 15, 2010.

SPOTLIGHT ON MP&S

MP&S PRACTICE LEADER COMMENTS ON THE GROWTH OF THE NONPROFIT SECTOR

The March 2011 issue of *Accounting Today* featured a special supplement that focused on the accounting industry. Mike McNee, Partner-in-Charge of the Nonprofit and Government Services Group and the Westchester Office of Marks Paneth & Shron LLP (MP&S), was asked to comment on the growth of the nonprofit sector as a specialized segment of the industry.

As the Big Four chose to reduce their focus on the nonprofit sector, this presented opportunities for mid-sized firms to expand the services they offer in this niche area. Mike noted that nonprofit clients now comprise nearly 10 percent of MP&S's entire practice. This increase has taken place over the last decade. Nonprofit and governmental entities are an important and valued service sector for MP&S.

The supplement also included *Accounting Today's* annual national ranking of the top 100 accounting firms. MP&S has risen to become the 30th largest accounting firm in the nation.

CASE STUDY: ASSESSING DAMAGES IN LOST WAGES CLAIM

When an employee is terminated, injured or for some other reason unable to work, what wages has he or she lost? What damages should be awarded? The question is central to thousands of personal injury claims each year. The answer is by no means straight forward.

Josefina Tranfa-Abboud, Director, Litigation and Corporate Financial Advisory Services, is often retained as a testifying economic expert in cases involving damages related to lost wages. At trial on a recent case, under direct examination she highlighted serious conceptual shortcomings in the plaintiff's economic expert's assumptions affecting the plaintiff's economic expert projections of lost wages. In a case study entitled "How Thoughtful Testimony from an Economic Expert Was Key in Multiple Million Dollar Lost Wages Suit," she discusses how the participation of an economic expert through economic damages analysis and testimony can make a decisive difference.

MP&S COMMENTARY AND PERSPECTIVES

Published Commentary and Perspectives from Marks Paneth & Shron Professionals contains selections of the firm's thought leadership output that were featured in leading journals, trade publications and/or our online library from the fourth quarter of 2009 through January 2011. The 20 articles in this compendium address such subjects as the new tax enforcement environment; valuation issues related to hedge fund dissolution; the boom in global start-ups and the importance of fresh-start reporting for companies emerging from bankruptcy. The collection is available in both print and electronically. Contact marketing@markspaneth.com to request a copy

MP&S FAST FACTS

- The 30th largest accounting firm in the nation and a leader in accounting and auditing (*Accounting Today*)
- The 13th largest accounting firm in the New York Area (*Crain's New York Business*)

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In addition, more information on the MP&S Nonprofit and Government Services Group can be found at www.markspaneth.com.

IRS CIRCULAR 230 DISCLOSURE

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