

## 29<sup>th</sup> Annual Law and Higher Education Conference

Life's a beach and then  
you're taxed!



Sheraton Sand Key  
Clearwater Beach, Florida  
February 16 – 20, 2008

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## Protecting 501(c)(3) Status: Common Pitfalls in Managing Nonprofits

Holiday Hart McKiernan  
Senior Vice President and General Counsel  
Lumina Foundation

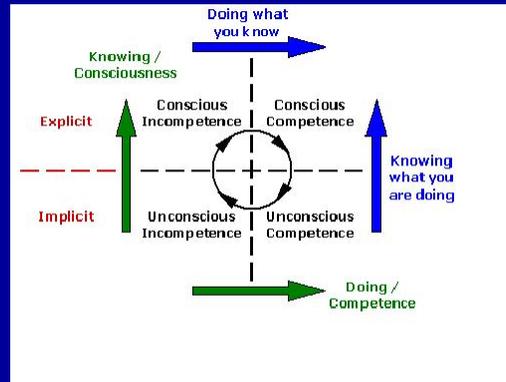
Darryll K. Jones  
Professor of Law  
Stetson University School of Law

February 19, 2008



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## The biggest danger to 501(c)(3) status is **lack of awareness**



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## Developing and Fine Tuning the 501(c)(3) Radar

We will strive to raise “big picture” awareness so that participants develop a “501(c)(3) radar.”

In matters financial – raising and spending money — and political, college and university administrators need to turn on and correctly tune their tax radars.



Example: Temple University's Tax Radar  
(in need of fine tuning?)



### Donor cancels Islamic chair for Temple

**The group offering a \$1.5 million deal had been probed for terrorism. Trustees and others raised concerns.**

By Kathy Boccella  
Inquirer Staff Writer  
January 5, 2008

Last spring, an Islamic group came to Temple University with an extremely generous offer: \$1.5 million for an endowed chair in Islamic studies to honor religion professor Mahmoud Ayoub. But after months of talks, the deal fell apart when trustees and others raised concerns about the donor, the International Institute of Islamic Thought (IIIT), a nonprofit research organization that was included in a government probe into funding of suspected terrorists. "They did not want a chair of Islamic studies funded by a Muslim organization," said Ayoub, a blind, 69-year-old Islamic and interreligious scholar who was to be the first occupant of the chair. "That is really a sad thing, because part of the chair's mandate was to encourage and engage in interfaith dialogue with Jews and Christians and others."

See 501(p).

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## Our Roadmap: Where we are going today

1. An overview of the new IRS Form 990 and the implications for substantive decision making.
2. Hot compliance issues, including all the usual suspects – executive compensation, political activity, ubit.
3. Legislative initiatives, including Senator Grassley's continuing scrutiny on exempt organizations.
4. Good governance.

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# PART I

## THE NEW IRS FORM 990

Form 990 (2005)		Page 6		
Part V-A Current Officers, Directors, Trustees, and Key Employees (continued)		Yes	No	
75a Enter the total number of officers, directors, and trustees permitted to vote on organization business at board meetings				
b Are any officers, directors, trustees, or key employees listed in Form 990, Part V-A, or highest compensated employees listed in Schedule A, Part I, or highest compensated professional and other independent contractors listed in Schedule A, Part II-A or II-B, related to each other through family or business relationships? If "Yes," attach a statement that identifies the individuals and explains the relationship(s)		75b		
c Do any officers, directors, trustees, or key employees listed in Form 990, Part V-A, or highest compensated employees listed in Schedule A, Part I, or highest compensated professional and other independent contractors listed in Schedule A, Part II-A or II-B, receive compensation from any other organizations, whether tax exempt or taxable, that are related to this organization through common supervision or common control? Note. Related organizations include section 509(a)(3) supporting organizations. If "Yes," attach a statement that identifies the individuals, explains the relationship between this organization and the other organization(s), and describes the compensation arrangements, including amounts paid to each individual by each related organization.		75c		
d Does the organization have a written conflict of interest policy?		75d		
<b>Part V-B Former Officers, Directors, Trustees, and Key Employees That Received Compensation or Other Benefits</b> (If any former officer, director, trustee, or key employee received compensation or other benefits (described below) during the year, list that person below and enter the amount of compensation or other benefits in the appropriate column. See the instructions.)				
(A) Name and address	(B) Loans and Advances	(C) Compensation	(D) Contributions to employee benefit plans & deferred compensation plans	(E) Expense account and other allowances
.....				
.....				
.....				
.....				

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## The New Form 990

From Grassley's May 2007 letter to Treasury



The impetus for change:

“The IRS must particularly recognize that the Form 990 is not adequate to encompass vital information regarding major parts of the nonprofit sector – **especially hospitals and universities**. It is for that reason that we view it as vital that the IRS include for major subsectors of the charitable field, supplemental information requests. Large, complex institutions, such as hospitals and universities, require more detailed questions tailored to the specifics of their fields if transparency and openness are to have real value.”

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## Press [i.e., public] Perceptions

“Though 990’s are open to public scrutiny, they are rarely filed on time, and their information is presented with little or no elaboration or perspective. A prospective donor reading a charity’s 990 would have far more difficulty gauging performance than would an investor perusing a corporation’s 10K.”

Charles Storch, *New IRS Form May Shine Light on Tax Exempt Groups; Agency Aims to Make Trouble Hard to Find*, Chicago Tribune, June 15, 2007 at C1.

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## The Upshot

The intended consequence is that charitable fiduciaries must pay better attention to their activities in all respects.

How will the activity look on paper to an uninformed or malevolent observer?



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## Likely Readers (in addition to the IRS)

- Donors
- Reporters
- Competitors
- Watchdogs →
- Employees
- Faculty
- Students
- State Regulators



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## Goals of the redesign Pursuant to [IR 2007-117](#) (6.14.08)

- Enhancing **transparency** to provide the IRS and the public with a realistic picture of the organization;
- Promoting **compliance** by accurately reflecting the organization's operations so the IRS may efficiently assess the risk of noncompliance; and
- Minimizing the burden on filing organizations.

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## Significant Changes

- The current form consists of a 9-page core and two schedules (A and B).
- The 2008 form (to be filed beginning in 2009) consists of an [11 page core](#) and [16 schedules](#).

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## Substantive Concerns Underlying New Form 990

- Compensation
- Good Governance Practices
- Endowments

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## Schedules most applicable to colleges and universities

- Schedule A – Public charity status
- Schedule B – Contributions
- Schedule C – Political Activity
- Schedule D – **Donor Advised Funds**, Conservation Easements, Art and Historical Treasures, Endowments,
- Schedule G – Fundraising activity
- Schedule J – Compensation
- Schedule L – Insiders and Private Benefit

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## Practical Suggestions

1. Ideally, the 990 should be reviewed, (line by line before filing) by accountants, administrative affairs, general counsel, comptroller and media relations.
2. A presentation should be made to board's executive or finance committee

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## Required Reading



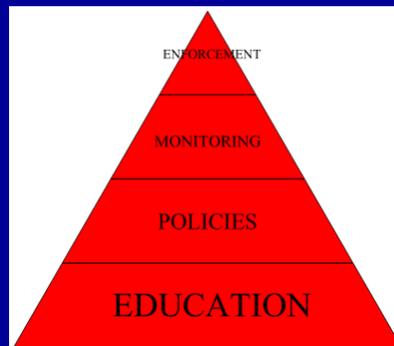
Read Peter Sword, [\*How to Read the IRS Form 990 and Find Out What it Means\*](#)

The latest version relates to IRS Form 990 (2005) but it is still good reading. A [125-page expanded version](#) (2003) is also available on-line.

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## Part II: Compliance Issues

- Athletics
- IRS Priorities
- Student FICA
- Executive Comp
- UBIT
- Political Activity
- Tax Shelters



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## Good News and Bad News

At a press briefing on the EO fiscal 2008 workplan that took place in Washington at the headquarters of the Tax-Exempt and Government Entities Division, Lerner said that although the Service will initiate a large college and university compliance initiative and will continue to keep an eye open for section 501(c)(3) organizations that engage in prohibited political activities, her division will start to pay more attention to non-501(c)(3) organizations.

---- Christopher Quay, *Workplan for Fiscal 2008 Addresses Universities, Non-501(c)(3) Orgs*, 59 Exempt Org. Tax Rev. 11 (January 8, 2008)

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## IRS 2007-08 Priorities

1. Final regulations under Internal Revenue Code sections 501(c)(3) and 4958 on revocation standards for organizations that engage in excess benefit transactions ([proposed regulations](#) were published September 9, 2005).
2. Proposed regulations on new requirements for supporting organizations added by the [Pension Protection Act of 2006](#).
3. Regulations regarding qualified tuition programs under section 529.
4. Final regulations on excise taxes on [prohibited tax shelter transactions](#) and related disclosure requirements.
5. Proposed regulations on new excise taxes on donor-advised funds, as added by the [Pension Protection Act of 2006](#).

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April 3, 2007

Dr. Peter R. Orszag  
Director  
Congressional Budget Office  
Ford House Office Building  
Second and D Streets, SW, Room 402  
Washington, DC 20515



Dear Dr. Orszag:

Educational institutions represent a large portion of the tax-exempt sector, and the commercialization of colleges and universities, particularly in the area of intercollegiate athletics, is an area of interest. I would like to gain a better understanding of the economic benefits received from the tax-exempt status of college athletics.

To accomplish this objective, I request the Congressional Budget Office to conduct a study of the following aspects of the tax-exempt status of college athletics:

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## Grassley's Queries

1. An analysis of what commercialization means in the context of nonprofit organizations and how it relates to the provision of social benefits that is a primary justification for nonprofit tax preferences;
2. A description of how commercialization varies across the spectrum of colleges and sports;
3. A discussion of the tax treatment of college athletic programs, including:

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4. The exemption from Federal income taxation and the operation of the unrelated business income tax;



corporate title sponsorship payments;

active royalty income;

charitable deductions for booster programs, including those made for the right to purchase tickets; and

the use of tax-exempt bonds to finance the construction and renovation of university athletic facilities.

A discussion of the economic effects of the tax treatment of college athletics;

5. A discussion of the distribution of tax benefits among the participants in college athletics including colleges, administrators, coaches, athletes, alumni, donors, and spectators;
6. Guidance as to what types of additional reporting by colleges and universities to the Internal Revenue Service and the public would provide useful information with respect to the economic benefits received from the tax-exempt status of college athletics.

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## The Student FICA Exception

United States v. Mount Sinai Medical Center of Florida, 486 F. 3d 1248 (11<sup>th</sup> Cir. 2007):

We reject the government's assertion that courts should defer to a "bright-line" rule that medical residents can never be exempted from FICA taxation as students. *See Apfel*, 151 F.3d at 748; *see also Ctr. for Family Med. v. United States*, 456 F. Supp. 2d 1115 (D.S.D. 2006) (holding that medical residents are not automatically ineligible for the student exemption); *Mayo Found.*, 282 F. Supp. at 1018 (same). Instead, a case-by-case analysis is necessary to determine whether a medical resident enrolled in a GMEP qualifies for a FICA tax exemption pursuant to the student exemption in § 3121(b)(10). Specifically, § 3121(b)(10) requires a determination as to whether Mount Sinai qualifies as a "school, college, or university," and whether the Mount Sinai residents qualify as "student[s]."

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## Restrictive Regulations Declared Invalid

Mayo Foundation v. United States, 503 F. Supp. 2d 1164 (D. Minn. 2007):

The [amended regulations](#) provide that an employee is a student if the services he or she performs are "incident to and for the purpose of pursuing a course of study" at the employer organization and the educational aspect of the relationship between the employer and employee predominates over the service aspect of the relationship. 26 C.F.R. § 31.3121(b)(10)-2(d)(3)(i). However, "an employee whose normal work schedule is 40 hours or more per week is considered a full-time employee" and therefore the services of a full-time employee are "not incident to and for the purpose of pursuing a course of study." 26 C.F.R. § 31.3121(b)(10)-2(d)(3)(iii).

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## Student FICA Exemption

"The Court finds that the full-time employee exception is invalid because it is inconsistent with the plain meaning of the statute and is arbitrary, capricious, and unreasonable." Mayo Foundation v. United States, 503 F. Supp. 2d 1164 (D. Minn. 2007):

For background, see Richard M. Weber, Jr. *The Student FICA Exception and Medical Residents*, 114 *Tax Notes* 453 (2007).

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# Executive Compensation

Bullet-Proofing a compensation arrangement: [The Case of United Way Atlanta.](#)

- Apply Treasury Regulation 53.4958-6 word for word!

- Get comparable data
- Eliminate conflicts of interest
- Document the decision



- **Get your PR people involved early** – see United Way documents (from the link above).

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# Political Activity

Read Rev. [Rul. 2007-41](#)

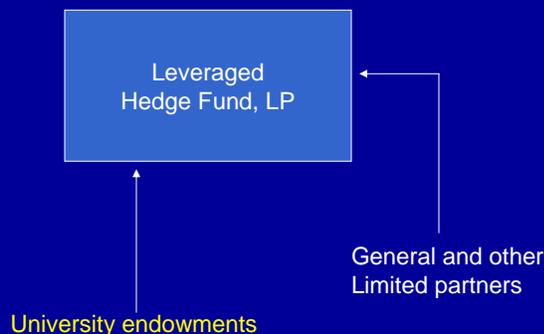
Get Steven Sholk, [A Guide to Election Year Activities to 501\(c\)\(3\) Organizations](#)

Lloyd Mayer, [What is This Lobbying We Are All So Worried About](#)

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# UBIT

- The Case of **Blocker Corporations**: Allocations of profit to the university LP would be subject to 35% taxation if the investment is debt financed because debt is attributed to the partners.



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## More than you want to know

Nonprofit organizations that invest directly in hedge funds face a problem, however, in structuring their investments in ways that do not create exposure to unrelated debt-financed income tax liabilities under the rules of §514. Hedge funds often make use of borrowed funds in some of their investment strategies, especially those involving arbitrage. And, because hedge funds are usually organized as limited partnerships, that borrowing may be imputed to their partners, including any charitable organizations that may be limited partners. If a hedge fund were organized as a corporation, it could freely use debt in pursuit of its investment strategies, and still pay dividends to charitable stockholders that would not be characterized as unrelated debt-financed income. However, operating through a corporate structure would generate income tax liabilities at the entity level that are otherwise completely avoidable and which would be unacceptable to the fund's nonexempt investors.

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## IRC 4965 Background Paper

1. An entity level tax for participation in a prohibited or listed transaction.
  - a. 100% of the net income from the transaction, or
  - b. 75% of proceeds from the participation in the transaction
  - c. UBIT applies if the transaction is listed or becomes prohibited after organization has already participated.
  - d. Disclosure mandates
  - e. \$20,000 manager penalty
  - f. Know or reason to know standard
  - g. Willful/reasonable cause exception

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## Important Resources

- The IRS Web Site has five documents to help tax administrators understand IRC 4956. These are “must reads:”
  - Proposed regulations
  - Final/Temporary Regulations re: return requirements
  - Temporary Regulations re: disclosure
  - Notice 2006-65 (general description of 4965)
  - Notice 2007-18

*See also, Darryll K. Jones, When Charity Aids Tax Shelters, 4 Florida Tax Review, 769 (2001)*

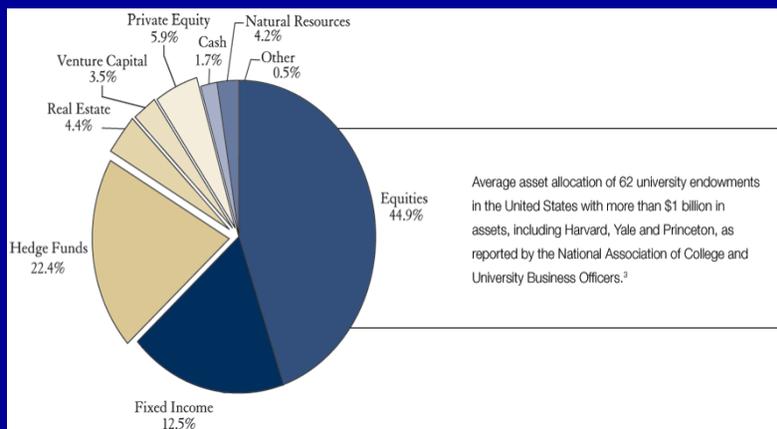
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## Part III

# ENDOWMENT PAYOUT ISSUES

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## Endowment Payout Issues



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# From Whence the Pressure?

Public charities, unlike private foundations are not subject to mandatory payouts. See IRC 4942 (regarding mandatory distributions for private foundations).

## Current Versus Future Charity

"The issue of foundation payout rates comes down to a tradeoff between charity for the current generation and charity for future generations./3/ The lower the payout rate, the greater the amount saved and invested, and hence the greater the amount that can be distributed to future generations./4/ Conversely, the higher the payout rate, the lower the amount available for future distribution.

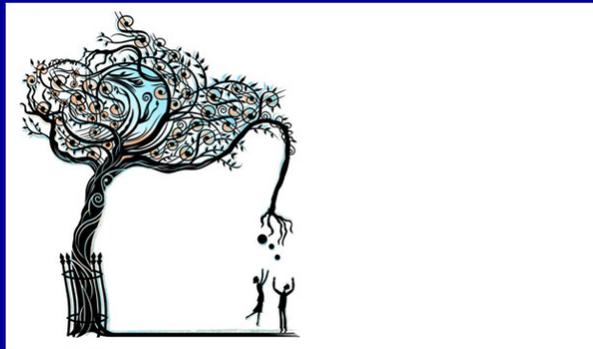
The arguments of those who advocate higher payout rates amount to arguments that foundations should provide more money to current charity and less to future charity. Foundations that resist higher payout rates are in effect arguing for more future charity at the expense of current charity."

Michael Klausner, *When Time Isn't Money: Foundation Payouts and The Time Value of Money*, 41 Exempt Organizations Tax Review, 421 (2003).

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## Press and Public Perceptions and Debate

Stephanie Strom, [How Long Should Gifts Just Grow](#), New York Times, November 12, 2007



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## Complaints re: Public Charity Endowment Payout

Endowments are currently earning high returns, with most of that return being used to increase the endowment rather than being spent. While the average return in 2006 was 15.3% the payout rate was 4.6%, weighted by institution. Educational institutions with large endowments earned the highest returns on average; payout rates were about the same across institutions with different endowment sizes. Again, while it is difficult to obtain institution level data, the three institutions with the largest endowments, Harvard, Yale, and Stanford, earned returns of around 20% (in 2004-2005) but paid out 4.5% (in 2003-2004). Out of the ten institutions with the largest endowments, only three paid out more than 5%, and out of eight private institutions, only one paid out more. Out of the top twenty, only five paid out more than 5%.

--- from [CRS Testimony](#) before the Senate Finance Committee, September 27, 2007

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## CRS Recommendations

There are a number of policy options that might be alternatives to a restriction of these offshore investments by educational institutions. Private foundations are required to payout a portion of their assets, and are subject to a minimum rate of 5%, which leads to an average payout of 7%. The overall payout ratio on educational institutions' endowments fall below this level. One option would be to require a payout rate; or to require a payout rate (or a higher rate) for institutions as long as their per student endowment is above a fixed amount. Alternatively, one could relate the payout rate to the earnings rate so as to preserve the real value of the endowment and perhaps some small growth, but not allow it to grow so rapidly. Another option, if the public policy concern is about affordable education, would be to impose a tax on the endowment for schools with tuition increases over a pre-determined threshold.

--- from CRS Testimony before the Senate Finance Committee, September 27, 2007

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## Harvard and Yale Initiatives

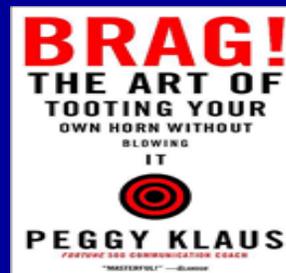
Two possible impacts of the big leaguers' decision to increase financial aid payouts from billion dollar endowments:

- a. Senator Grassley might be satisfied, as suggested in his [press release](#) (or maybe not – he still insists that Congress should “talk about” mandatory payouts).
- b. Schools with smaller schools may feel [greater pressure](#) to increase endowment payout.

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## Strategy to forestall mandatory endowment payouts

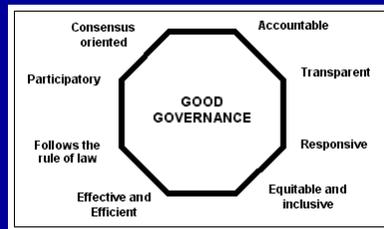
- Publicize financial aid spending!
- Publicize benefits of long term investments in terms of student benefit!
- Prove that colleges and universities are good stewards



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## Part IV

# Good Governance



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## Why?

- It is simply the right thing to do.
- It forestall outside regulation.
- It decreases the chance of legal liability.
- It leads to better use of scarce resources.
- Notorious cases taint the entire sector.
- Best Practices have become “quasi-law.”

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## Discussion Resources

1. The Panel on The [Nonprofit Sector Report](#)
2. IRS Good Governance [Discussion Draft](#)
3. BoardSource [Guide](#)

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We're Done!



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