Skadden

NONPROFIT NOTES

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INSIDE

IRS Employment Tax Initiative Includes Audits of Exempt Organizations

In 2010, the IRS began a National Research Program on employment taxes. This project, which is expected to last through 2012, will involve employment tax audits of 6,000 randomly selected employers, including 1,500 exempt organizations. Though exempt organizations do not have to pay income taxes, they do not enjoy exemption from certain employment tax requirements, such as Federal Insurance Contribution Act (FICA) and income tax withholding requirements.

According to the IRS, employment tax misreporting constitutes a sizable part of the tax gap — close to $54 billion per year. (The "tax gap" refers to the IRS' measurement of the extent to which taxpayers fail to file their tax returns and pay the correct tax on time.) For this reason, the IRS has implemented this study to, among other things, measure compliance and improve the IRS' ability to detect and reduce noncompliance.

IRS agents deployed under the National Research Program have been instructed to focus their examinations on certain specific areas of interest, including the following:

Worker Classification

The IRS is looking at whether organizations have properly classified workers as employees or as independent contractors. Employers, including tax-exempt organizations, generally are not required to withhold and pay over employment taxes on payments to independent contractors. Therefore, if an organization improperly classifies a worker as an independent contractor as opposed to an employee, it may be liable for failure to withhold employment taxes, plus interest and penalties, if the independent contractor is later reclassified as an employee.

Notably, President Barack Obama and certain members of Congress also are concerned about the misclassification of employees. President Obama's fiscal 2012 budget includes $46 million for enforcement efforts. In addition, this proposal, as well as legislation expected to be reintroduced in the 112th Congress, would prospectively repeal Section 530 of the Internal Revenue Act of 1978, a provision that has hindered the IRS' enforcement efforts in certain worker classification cases.

Many states, including New York, have been stepping up their enforcement efforts as well. Formed in 2007, New York's multiagency Joint Enforcement Task Force on Worker Misclassification has been counteracting worker misclassification through enforcement and other efforts.

Benefits

The IRS also is interested in whether organizations are properly valuing and including taxable fringe benefits in wages. Fringe benefits that often

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arise as issues during audits include an employer's treatment of car and housing allowances, spousal travel, personal travel during business trips, holiday gifts, employers' payments for relocation and education expenses, among others things. Any benefits that are treated improperly for tax purposes could result in additional income tax to the worker as well as related tax obligations for the organization.

Also, if an organization does not properly substantiate benefits as either compensation (through contemporaneous documentation) or reimbursement in accordance with an accountable plan,[1] the benefits could be deemed automatic excess benefits (whether or not the benefits were reasonable) under the IRS' intermediate sanctions rules.[2] Under these rules, applicable to public charities described in Section 501(c)(3) of the Internal Revenue Code and to Section 501(c)(4) organizations, the worker is required to repay the organization for any excess benefits, and could be liable to the IRS for penalties and interest on the excess benefit amount. In some cases, an organization manager could be penalized as well.

Executive Compensation

Another key topic in audits of exempt organizations is the reasonableness of executive compensation.

Compensation includes not only base salary and cash compensation, but fringe benefits as well. Excessive compensation could trigger excise taxes under the intermediate sanctions rules.

Other Areas of Interest

The IRS advised that the National Research Program also may include reviews of nonfiling employers. Such examinations may look at whether nonfiling employers are not filing tax returns even when required, and whether they are in compliance with rules requiring backup withholding on payments to independent contractors.

Steps Nonprofits Can Take

The following are a few steps an exempt organization can take to reduce its risk of liability in the event it is chosen for an audit.

1. Review existing procedures to ensure that employees and independent contractors have been appropriately classified, and that the organization's documentation and reporting regarding such workers are consistent with such classification.

2. Review benefit arrangements to confirm that benefits are being treated properly, and that they are otherwise current and consistent with IRS guidelines.

3. Review or develop expense reimbursement policies and procedures to ensure that the organization's reimbursement and allowance procedures meet the requirements of accountable plans.

1 If you would like more information on the rules regarding accountable plans, please contact us.

2 If you would like more information on the intermediate sanctions rules, please contact us.

IRS Exempt Organizations Division Will Continue Study on Charitable Spending

During the IRS 2009 fiscal year, the Exempt Organizations Division began a long-range compliance project known as its Charitable Spending Initiative. The Charitable Spending Initiative is designed to examine whether charitable organizations generally are conducting charitable activities commensurate in scope with their financial resources. Organizations selected for examination in this study include:

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(i) organizations with high levels of fundraising expenses; (ii) organizations reporting unrelated trade or business activities with relatively low levels of program service expenditures; (iii) organizations with high ratios of officer compensation in comparison to program service expenditures; and (iv) organizations with low levels of program service expenditures in comparison with total revenue. This initiative is one of the EO Division's projects aimed at addressing possible areas of noncompliance with the tax laws governing exempt organizations. The EO Division began its examinations of organizations selected for review in connection with this study during fiscal year 2010 and has indicated that these examinations will continue during fiscal year 2011, which ends on September 30, 2011.

Supporting Organizations: A Useful Planning Tool

Every 501(c)(3) organization is further classified as either a private foundation or a public charity. Private foundations typically have a single major source of funding (usually gifts from one family or corporation rather than funding from many sources). A public charity is deemed as such because of the organization's: (i) character and purpose (churches, hospitals, schools, etc.); (ii) sources of support — either contribution revenue or income derived from the conduct of the organization's charitable activities; or (iii) relationship to another organization or organizations that the organization supports. This third type of public charity is known as a supporting organization.

Supporting organizations do not need to satisfy a numeric public support test to qualify as public charities. Rather, they typically qualify as public charities by virtue of being organized and operated exclusively for the benefit of one or more of the types of public charities described above. There are three levels of relationship available to a supporting organization, known as "types": Type I is akin to a parent-subsidiary relationship; Type II is more like a brother-sister corporate rela-

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tionship; and Type III is the loosest connection, where the supporting organization is merely "operated in connection with" the supported organization.

A supporting organization also may be created to support a 501(c)(4) social welfare organization, a 501(c)(5) labor organization or a 501(c)(6) trade association, so long as the supporting organization supports only the charitable activities of these types of organizations.

The supporting organization vehicle affords individuals the more favorable tax deductibility and generally is subject to the rules governing public charities, rather than the more constrictive rules applicable to private foundations; at the same time, the organization need not meet a public support test and offers the benefits of a legally separate entity. In this way, the supporting organization vehicle can work much like a subsidiary — as a means of isolating assets or activities for liability or other purposes. Supporting organization subsidiaries often are used as fundraising arms for large entities such as universities with substantial development activities.

Supporting organizations also can be a useful tool when a new organization is needed that will be affiliated with an existing organization. If a single donor wishes to support a public charity or charities or even a particular class of public charities, using a supporting organization allows the donor to take advantage of the more favorable public charity status rather than form a private foundation.

Another way in which supporting organizations can be useful is as a tool for avoiding defaulting into the less favorable private foundation category. When the sources of support of one of a network of affiliated organizations dry up such that the organization no longer satisfies the numeric public support tests, the organization generally will default into private foundation status. Such an organization can instead convert into a supporting organization of one of its affiliates to avoid this outcome.

While the supporting organization vehicle can be very useful, it is important to be aware that the Pension Protection Act of 2006 contained a number of provisions that adversely affect supporting organizations. For example, supporting organizations are now prohibited from paying any form of compensation to major contributors and their relatives. Most supporting organizations also are restricted from accepting contributions from persons who directly or indirectly control the entity that the organization supports. Finally, Type III supporting organizations — those most loosely bound to the organization that they support — have been studied heavily by the Internal Revenue Service as potentially suspect charities and, as a result, many have had their tax exemptions revoked by the IRS or have ceased activities voluntarily.

Private Operating Foundations: An Attractive Alternative

Private operating foundations have become increasingly popular charitable vehicles in the past 10 years, reflecting a growing desire for philanthropists to be actively involved in their charitable activities.

A private operating foundation (POF) is a hybrid of a public charity and the more traditional private non-operating foundation. A POF must meet minimum annual expenditure requirements by sponsoring and conducting its own programs, rather than merely making grants to other organizations. Although grants to other organizations are permitted, they only count toward satisfaction of the POF expenditure requirements if the POF maintains a significant level of involvement in the grants, *e.g.*, through POF staff members conducting activities on-site with a grantee.

Expenditures to acquire or maintain assets used directly in the conduct of the POF's exempt activities, such as the operating assets of a museum, public park or historic site, meet the POF requirements. In addition, administrative expenses (such as staff salaries and traveling expenses) and other operating costs necessary to conduct the POF's exempt activities are satisfactory distributions if reasonable in amount.

POFs are subject to many of the same rules as non-operating foundations, but there are significant advantages to the POF form in terms of income tax deductions. Cash contributions to POFs may be deducted up to 50 percent of the donor's adjusted gross income, while cash contributions to private foundations are limited to 30 percent of adjusted gross income. There also are deductibility advantages for donations to POFs of other property, such as qualified appreciated stock and long-term capital gain property (including artwork). In both cases, donors may deduct contributions of such property to a POF up to 30 percent of the donor's adjusted gross income, while such donations to private foundations are limited to 20 percent of adjusted gross income. In addition, for gifts of long-term capital gain property, the deductible value of the gift, if made to a POF, will be the fair market value of the property, whereas the deductible value of such a gift, other than qualified appreciated stock, made to a private foundation will be reduced by the gain on such property.

POFs are used increasingly for the donation of artwork to be publicly displayed either at a museum operated directly by the POF or by loaning the artwork to other existing venues. A POF formed for the purpose of providing art for display to the general public that owns only the displayed works easily will satisfy the numeric POF tests without doing more;

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all of the organization's assets would be used to directly accomplish its charitable purpose. A POF that loans art to another institution may treat as qualifying distributions amounts paid by the POF to maintain the space, install the exhibitions and maintain the art.

Collectors must understand, however, that once a work has been contributed to a POF, the gift is irrevocable and the collector may no longer display the art for his or her personal benefit. The IRS has strict rules in this regard, prohibiting donors from displaying artwork in their homes between displays or exhibits elsewhere.

Changing Tax Classification

The IRS issued in January 2011 Revenue Procedure 2011-10 updating the IRS procedures for issuing determinations on changes to an organization's classification under Section 501(c)(3) of the Internal Revenue Code. The revenue procedure provides organizations with clear guidance regarding how and under what circumstances to request a change in tax classification from one category — private foundation, private operating foundation or public charity — to another, or from one type of public charity to another. The revenue procedure also provides guidance for a supporting organization that wishes to change from one type to another or to request a determination that indicates whether it is a Type I, II or III supporting organization. Type III supporting organizations also may request a determination of "functionally integrated" status, a designation that avoids the more restrictive rules applicable to nonfunctionally integrated Type III supporting organizations.

The revenue procedure also provides a method for a public charity that miscalculated its public support percentage and, mistakenly thinking it had failed its public support test, erroneously began filing private foundation returns with the IRS. Now, instead of having to follow the burdensome private foundation termination procedure, such an organization may simply apply to be correctly categorized once again as a public charity provided that it has continuously met the public support tests during the relevant periods.

ECFA to Spearhead Commission on Accountability and Policy for Religious Organizations

The Evangelical Council for Financial Accountability (ECFA) has announced its formation of an independent commission that will address a number of tax and policy issues involving religious organizations. Founded in 1979, ECFA provides accreditation to religious organizations that demonstrate compliance with ECFA standards pertaining to financial accountability, fundraising and board governance.

The commission was formed in January 2011, shortly after U.S. Senate Finance Committee member Charles Grassley issued a staff report on his three-year inquiry into the financial practices of certain high-profile Christian ministries. After releasing his findings, Sen. Grassley asked ECFA to lead an independent, national endeavor to examine and offer input on major accountability and policy issues affecting religious organizations.

At Sen. Grassley's request, ECFA created the Commission on Accountability and Policy for Religious Organizations, which will address a number of issues that could potentially affect all houses of worship and clergy members in the United States, as well as most nonprofits. These issues include, among others:

- whether churches and certain church-related organizations, which are currently exempt from filing the Form 990 annual information return, should be required to file such form, or whether it would be advisable to limit this exemption to churches that are accountable to another body, such as a denominational organization or an accreditation agency like ECFA;
- whether legislation should be enacted to reduce abuses of the clergy housing allowance exclusion;
- whether legislation should be enacted to remove or modify the current prohibition against political campaign intervention by churches and other nonprofits;
- whether excise taxes should be imposed on nonprofit organizations that engage in excess benefit transactions (currently, such penalties are only imposed on nonprofit leaders that engage in such transactions);
- whether current laws restricting the IRS' ability to audit church leaders should be repealed in order to improve the enforceability of current law;
- whether the government should repeal current law providing, if certain procedures are followed, a "rebuttable presumption" of reasonableness for transactions between nonprofits and their leaders, and whether such protection should be replaced by other provisions, such as "minimum standards of due diligence"; and
- whether legislation should be enacted to clarify the taxability of "love offerings" received by some clergy.

On April 13, 2011, ECFA publicly announced its naming of 15 members to the commission, which includes leaders from a variety of Christian organizations from across the nation and other experts.

The commission began work on April 11, 2011, with a teleconference, followed by a meeting on May 19, 2011. The commission will hold quarterly meetings for up to approximately three years.

> The new commission will address issues that could potentially affect all U.S. houses of worship and clergy members — as well as most nonprofits.

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Members of the commission, ECFA staff and their legal counsel will receive input from Sen. Grassley and his staff; the IRS and Treasury Department; a panel of legal experts; a panel of religious sector representatives; a panel of nonprofit sector representatives; position papers; an ECFA member survey; and the general public. The commission, in turn, plans to provide regular updates to Sen. Grassley, ECFA's governing board and the general public. The commission expects to ultimately issue a report to Sen. Grassley by the end of 2013.

The panel of religious sector representatives will include individuals representing various faith groups, including, but not necessarily limited to, Protestant Christianity, Roman Catholicism, Judaism and Islam. The commission expects to place particular emphasis on engaging leaders representing large segments of their respective faith groups.

The Delaware General Assembly Provides 'Translation' for Nonprofit Nonstock Corporations

Unlike New York, Delaware does not have a separate law for nonprofit organizations. The application of the Delaware General Corporate Law (the DGCL) to nonstock corporations always has raised questions of statutory interpretation. Striving to fill in gaps and address incongruities when applying the DGCL to nonstock corporations, the Delaware legislature crafted Section 114 to "translate" the existing code. This new section became effective as of August 2010. Section 114 declares that all references to "stockholders" in the DGCL now also refer to "members" of a nonstock corporation. Broadly, Section 114(a) states that the entire DGCL will apply to nonstock corporations — except as carved out in Sections 114(b) and 114(c). The amendments to Section 114 define "nonstock corporation," "non-profit nonstock corporation" and "charitable nonstock corporation" — the latter two are each a subset of the former. A charitable nonstock corporation is any nonprofit nonstock corporation that is exempt from taxation under Section 501(c)(3) of the United States Internal Revenue Code.

The 2010 amendments provide a number of provisions specifically applicable to nonstock corporations as follows:

- Nonstock corporations are expressly required to have members, but failing to have members does not forfeit otherwise valid corporate acts;
- If a nonstock corporation fails to state the conditions of membership in its certificate of incorporation or bylaws, its members will be considered those who elected the governing body;
- Unless otherwise provided in the certificate of incorporation, the bylaws or by resolution, the record date for determining the members of a nonstock corporation entitled to vote at a meeting of the members will be the date of the meeting itself;
- Nonstock corporations may effect a short-form merger with a subsidiary, provided the nonstock parent corporation survives the merger; and
- Where only the governing body of a nonstock corporation is entitled to vote on a merger, only a single majority vote is required to authorize the merger. Previously, both a majority vote of the governing body and a vote of two-thirds of all members of the governing body were required in all situations.

In Addition

Charitable nonstock corporations are specifically prohibited from merging or consolidating if doing so would cost them their Section 501(c)(3) status.

ATTORNEY CONTACTS

New York

Daniel L. Kurtz | Partner
212.735.3390
daniel.kurtz@skadden.com

Sarah E. Paul | Of Counsel
212.735.2480
sarah.e.paul@skadden.com

Coleen M. McGrath | Associate
212.735.2486
coleen.mcgrath@skadden.com

J.J. Harwayne Leitner | Associate
212.735.2273
jj.leitner@skadden.com

Vivienne C. LaBorde | Associate
212.735.3332
vivienne.laborde@skadden.com

David J. O'Connell | Associate
212.735.2002
david.oconnell@skadden.com

Washington, D.C.

Fred T. Goldberg, Jr. | Partner
202.371.7110
fred.goldberg@skadden.com

Emily M. Lam | Counsel
202.371.7115
emily.lam@skadden.com