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Compliance & Completeness with the IRS

990 Reporting: What the IRS Looks for and How to Avoid Problems

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Dannible & McKee's Annual Nonprofit Conference

DoubleTree by Hilton ĕ East Syracuse, New York
Tuesday, January 9, 2018

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Circular 230

Any tax advice contained herein is not intended or written to be used, and cannot be used, for the purpose of avoiding penalties that may be imposed under the Internal Revenue Code or applicable state or local tax law provisions.

What are we Covering Today?

1. Reporting Obligations.
2. IRS Areas of Focus.
3. Common errors on Form 990.
4. Additional IRS filings.
5. Key Provisions in the Tax Cut and Jobs Act impacting Exempt Organizations.

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Annual Reporting Obligation

- Even though your organization may be exempt from Federal income tax, the Internal Revenue Code has reporting requirements to ensure the organization can continue to be recognized as tax-exempt.
- The type of form or notice required to be filed is determined by the public charity's gross receipts and the value of its assets.
- Public charities generally file either:
  - Form 990, Return of Organization Exempt from Income Tax;
  - Form 990- EZ, Short Form Return of Organization Exempt from Income Tax; or
  - Submit online Form 990-N, Electronic Notice (e-Postcard) for Tax-Exempt Organizations not Required to File Form 990 or 990-EZ.

Annual Reporting Obligation

- All tax-exempt organizations, except religious, certain government and certain political organizations, must file an annual return with the IRS and if they do not do so for three consecutive years, they automatically lose their exempt status.
- If an organization finds that its exempt status has been automatically revoked due to non-filing and it wants its tax-exempt status reinstated, it will need to reapply and pay the appropriate user fee.
- May request retroactive reinstatement if within certain time period.

Annual Reporting Obligation

- The IRS publishes a list of organizations that have had their Federal tax-exempt status automatically revoked for failing to file an annual information return or notice with the IRS for three consecutive years. This Automatic Revocation of Exemption List may be viewed and searched at: https://apps.irs.gov/app/eos/.
- The list gives the name, employer identification number (EIN), organization type, last known address the organization provided to the IRS, effective date of revocation and the date the organization was added to the list. For organizations that applied for and received reinstatement, the list gives the date of reinstatement. The IRS updates the list monthly.

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IRS Top 10 Areas of Focus

1. Independence of Governing Body.
2. Mission and Program Service Statements.
3. Compliance and Governance.
4. Compensation.
5. Public Charity Status.
6. Lobbying and Political Activities.
7. Foreign Activities.
8. Tax-Exempt Bonds.
9. Financial Information.
10. Related Party Transactions.

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IRS Guidelines for "Good Governance"

While the Code does not have specific requirements with respect to governance requirements, the IRS takes the position that without "good governance" a tax-exempt organization cannot operate consistently. The items the IRS looks at to determine "good governance" include:

- Mission statement;
- Organizational documents;
- Governing body;
- Financial statements and Form 990 reporting; and
- Transparency and accountability.

IRS Guidelines for "Good Governance"

- An active and engaged governing board.
- Adoption and implementation of policies relating to areas that can directly impact the organization's tax-exempt status.
- Ensuring financial resources are used to further exempt purposes and that funds are appropriately accounted.
- Encouraging transparency and accountability by making full and accurate information regarding mission, activities, finance and governance publicly available.

Mission Statement

- The exempt purpose should be embodied in a mission statement, which may be found in an organization’s bylaws and its articles of incorporation.
- Your mission statement should be revisited periodically to see if it still works for your organization. Many times, organizations "morph" as the realities of operating sink in, or as the external environment changes.
- It is also imperative that you consider the mission statement as part of any new planning you may do, such as putting together a strategic plan.

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Mission Statement

- Depending on the degree of changes, your original mission statement may need to be revised or even completely rewritten, depending on the circumstances.
- Amendments to an organization's mission statement will usually not jeopardize the organization's 501(c)(3) tax-exempt status, so long as the mission statement remains consistent with a tax-exempt purpose and the change is disclosed to the IRS on Form 990 or Form 990-EZ, along with the amended organizational document.
- If the organization is not required to file an annual return, it may report the change to the EO (exempt organizations) determinations office.

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Operation in Accord with Stated Exempt Purpose(s)

- If an organization stops doing all, or a significant amount of the exempt activities under the premise it was formed, the organization's original application (IRS Form 1023 series) could lose its exemption.

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Complete, Concise and Consistent 990

- A compete, concise and consistent 990 is the easiest way to remain off the Internal Revenue Service's radar.
- Compare your Form 990 to the prior year 990. If answers are different that those in prior year, verify that you have the correct response.
- Be sure that all applicable sections of the 990 are complete.
  - Part IV: Checklist of Required Schedules.
  - If a box is checked yes, the supporting schedule will have to be completed and attached to Form 990.

State of Program Service Accomplishments

- Part III of Form 990.
- Describes organization’s mission.
- Describes any changes in program services.
  - New services not reported in prior year.
  - Services no longer being conducted.
- Reports three largest program activities.
- Should equal Column B of the Statement of Revenue.

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Governance, Management and Disclosure

- Part VI of Form 990.
- The IRS focus on governance is supported by the inclusion of these questions. The IRS uses the responses to these questions to potentially identify noncompliant organization.
- The IRS is using more analytics in identifying audit targets and responding "no" to these questions may trigger further inquiry by the IRS.

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Governance and Management

- Distinguishes who is the governing body and who is independent.
- Discloses family or business relationship.
- Delegation of control to management company or other third-party.
- Significant changes to organizational documents.
- Significant diversion of assets.
- Who elects the board members.
- Document meeting and actions.
- Determination of compensation of officers/key employees.

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Disclosure

- Form 990 public inspection compliance.
- Review of 990 by board.
- Public disclosure of additional documents:
  - Governing documents;
  - Policies;
  - Financials.
- Contact information for who maintains books and records.

Policies

- Conflict of interest.
- Whistleblower.
- Document retention and destruction.
- Governance of chapters, affiliates and branches.
- Committee responsibility for compilations, review and audits.
- Governing body review of Form 990.
- Executive compensation.

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Compensation of Officers, Directors, Trustees, Key Employees, Highest Compensated Employees and Independent Contractors

- Part VII of Form 990.
- Calendar year compensation reported according to Box 1 or 5 of individual's Form W-2 and/or Box 7 of Form 1099.
- Does not have to agree to compensation reported in Part IX, Statement of Functional Expenses, which is reported based on the accounting method/fiscal year used for the organization.

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Statement of Revenue

- Part VIII of Form 990.
- Presents an organization's sources of revenue.
- Common issues:
  - Some direct expenses to be net with related revenue.
  - Improper reporting of fundraising activities.
  - Misclassification of types of revenue (4 columns).
  - Allocation of membership fees between contributions and program service fees.

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Statement of Functional Expenses

- Part IX of Form 990.
- Reports expenses in 4 columns: total expenses, program service expenses, management and general expenses and fundraising expenses.
- Common issues:
  - Reporting of contribution revenue and no fundraising expenses or special events.
  - No management and general expenses reported.
  - Improper allocation of specific costs or expenses (4 columns).

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Reconciliation of Net Assets

- Part XI of Form 990.
- Reconciles revenue and expenses.
- Certain activities to be excluded:
  - Unrealized gains/loss on investments.
  - Donated services.
  - Use of facilities.

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Schedule O, Supplemental Information

- Clarify anything reported in any section of Form 990 or Form 990-EZ.
- Report any additional information the organization would like to provide the IRS or users of the Form 990.
- Material changes to the organization's mission, purpose, by-laws or governing documents.

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Other IRS Filings and Compliance

- An organization may also be liable for reporting additional information and filing tax forms including, but not limited to unrelated business income tax, employment tax, excise taxes and certain state and local taxes.

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Other IRS Filings and Compliance

- Form 990-T, Exempt Organization Business Income Tax Return.
- Form 1098-C, Contributions of Motor Vehicles, Boats and Airplanes.
- FinCen114, Report of Foreign Bank and Financial Accounts.
- Form 1096, Annual Summary and Transmittal of U.S. Information Returns.
- Form W-3, Transmittal of Wage and Tax Statements.

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Form 990-T Exempt Organization Business Income Tax Return

- Tax on unrelated business income.
- Should agree with Part VIII, Column C.
- Gross income greater than $1,000.
- Quarterly estimated tax payments are required if tax is expected to be over $500.

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Unrelated Business Income (UBI)

Activity is unrelated business income if it meets three requirements:

1. It is a trade or business.
2. It is regularly carried on.
3. It is NOT substantially related to furthering the exempt purpose of the organization.

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Unrelated Business Income (UBI)

- Activity can potentially jeopardize an organization's tax-exempt status when there is too much income generated from activities that are unrelated to the exempt function of the organization.
- Also devoting a disproportionate amount of time to such endeavors could jeopardize the organization's status.
- No hard-fast rules in this area and the IRS evaluates unrelated income issues on a case-by-case basis.

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Unrelated Business Income (UBI)

Some of the most common UBI generating activities include:

- The sale of advertising space in weekly bulletins, magazines, journals or on the organization’s website;
- The sale of merchandise and publications when those items being sold do not have a substantial relationship to the exempt purpose of the organization;
- Provision of management or other similar services to other organizations; and
- Even some types of fundraising activities.

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Form 1098-C Contributions of Motor Vehicles, Boats and Airplanes

- Value of donation greater than $500.
- Separate form is required for each donation.
- When acknowledgement is required:
  - Name of charity;
  - Description of non-cash contribution; and
  - Statement that no good or services were provided by the charity or a good faith estimate of the value of good and/or services provided by the charity in return for the gift.

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FinCEN Form 114

- Aggregate value of foreign accounts over $10,000.
- Financial interest in foreign account.
- Signatory or other authority over foreign account.
- Required to be electronically filed by April 15th each year with a six-month extension.

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Form 1096 Annual Summary and Transmittal of U.S. Information Returns

- Summary of informational forms.
- Most common is Form 1099-MISC.
  - Reports payments greater than $600 for rents, services, prizes and awards.
  - Generally not required to be issued for payments to corporations, or nonprofit organizations or for payments for merchandise.
- Red flag - inconsistency with information reported on Form 990 (Part VII and Part IX).

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Form W-3 Transmittal of Tax and Wage Statement

- Reports totals for individual Form W-2s filed by the organization.
- Red flag - inconsistency with information reported on Form 990 (Part VII and Part IX).

Key Provisions in the Tax Cut and Jobs Act Impacting Exempt Organizations.

While there are significant changes that will impact business and individual taxes in the Tax Cut and Jobs Act there are several changes that will impact exempt organizations.

1. Excise tax on excess tax-exempt organization executive compensation.
2. Excise tax based on investment income of private colleges and universities.
3. UBTI separately computed for each trade or business activity.
4. Repeal of advance refunding bonds.
5. Credit bonds repealed.

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Excise Tax on Excess Tax-Exempt Organization Executive Compensation

Pre-Act law: There were reasonableness requirements and a prohibition against private inurement with respect to executive compensation for tax-exempt entities, but no excise tax tied to the amount of compensation paid.

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Excise Tax on Excess Tax-Exempt Organization Executive Compensation

New law: For tax years beginning after December 31, 2017, a tax-exempt organization is subject to a tax at the corporate tax rate (21 percent under the Act) on the sum of:

1. The remuneration (other than an excess parachute payment) in excess of $1 million paid to a covered employee by an applicable tax-exempt organization for a tax year; and
2. Any excess parachute payment (as newly defined) paid by the applicable tax-exempt organization to a covered employee.

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Excise Tax on Excess Tax-Exempt Organization Executive Compensation

- A covered employee is an employee (including any former employee) of an applicable tax-exempt organization if the employee is one of the five highest compensated employees of the organization for the tax year or was a covered employee of the organization (or a predecessor) for any preceding tax year beginning after December 31, 2016.
- Remuneration is treated as paid when there is no substantial risk of forfeiture of the rights to such remuneration.

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Excise Tax Based on Investment Income of Private Colleges and Universities

Pre-Act law: Private colleges and universities generally are treated as public charities rather than private foundations and thus are not subject to the private foundation excise tax on net investment income.

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Excise Tax Based on Investment Income of Private Colleges and Universities

New law: For tax years beginning after December 31, 2017, an excise tax equal to 1.4 percent is imposed on net investment income of certain private colleges and universities.

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Excise Tax Based on Investment Income of Private Colleges and Universities

- The tax applies only to private colleges and universities with at least 500 students, more than 50 percent of the students of which are located in the U.S., and with assets (other than those used directly in carrying out the institution's exempt purpose) of at least $500,000 per student.
- The number of students is based on the daily average number of full-time equivalent students (full-time students and part-time students on an equivalent basis). Net investment income is gross investment income minus expenses to produce the investment (but disallowing the use of accelerated depreciation methods or percentage depletion).

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UBTI Separately Computed for each Trade or Business Activity

Pre-Act law: A tax-exempt organization determines its unrelated business taxable income (UBTI) by subtracting, from its gross unrelated business income, deductions directly connected with the unrelated trade or business. Under regulations, in determining UBTI, an organization that operates multiple unrelated trades or businesses aggregates income from all such activities and subtracts from the aggregate gross income the aggregate of deductions. As a result, an organization may use a deduction from one unrelated trade or business to offset income from another, thereby reducing total unrelated business taxable income.

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UBTI Separately Computed for each Trade or Business Activity

New law: For tax years beginning after December 31, 2017 (subject to an exception for net operating losses (NOLs), arising in a tax year beginning before January 1, 2018, that are carried forward), losses from one unrelated trade or business may not be used to offset income derived from another unrelated trade or business. Gains and losses have to be calculated and applied separately.

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Repeal of Advance Refunding Bonds

Pre-Act law: The exclusion for income for interest on State and local bonds applies to refunding bonds, but there are limits on advance refunding bonds. A refunding bond is defined as any bond used to pay principal, interest, or redemption price on a prior bond issue (the refunded bond).

1. A current refunding occurs when the refunded bond is redeemed within 90 days of issuance of the refunding bonds.
2. Conversely, a bond is classified as an advance refunding if it is issued more than 90 days before the redemption of the refunded bond. Proceeds of advance refunding bonds are generally invested in an escrow account and held until a future date when the refunded bond may be redeemed.

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Repeal of Advance Refunding Bonds

New law: For advance refunding bonds issued after December 31, 2017, the exclusion from gross income for interest on a bond issued to advance refund another bond is repealed.

Credit Bonds Repealed

Pre-Act law: Tax-credit bonds provide tax credits to investors to replace a prescribed portion of the interest cost. The borrowing subsidy generally is measured by reference to the credit rate set by the Treasury Department. Current tax-credit bonds include qualified tax credit bonds, which have certain common general requirements, and include new clean renewable energy bonds, qualified energy conservation bonds, qualified zone academy bonds and qualified school construction bonds.

Credit Bonds Repealed

New law: For bonds issued after December 31, 2017, the authority to issue tax-credit bonds and direct-pay bonds is prospectively repealed.

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