

# **EOTS NewsFlash**

## **Exempt Organizations Tax Services**

**July 31, 2012**

### *House Oversight Subcommittee tax-exempt hearing focuses on commercial activities, complex structures, and Form 990 redesign*

On July 25, 2012, the Oversight Subcommittee of the House Ways and Means Committee held a hearing entitled "Hearing on Public Charity Organizational Issues, Unrelated Business Income Tax, and the Revised Form 990." The hearing was intended to focus on issues of transparency and compliance efforts, organizational complexity, and commercial activities relating to public charities. The hearing turned out to be far-reaching and covered topics relevant to major parts of the exempt sector.

Steven T. Miller, the IRS Deputy Commissioner of Services and Enforcement, and former Commissioner of Tax Exempt and Government Entities, testified for about one hour on behalf of the Internal Revenue Service regarding challenges it faces in trying to serve the exempt sector through education and outreach, reviewing determination letter applications, as well as in assuring tax compliance by the sector.

Following him, a panel of practitioners and academic experts focused on public charities and issues in three specific areas: Form 990 redesign, complex structures, and unrelated business income. Many of the Members' questions raised concerns about the lack of clarity regarding political activity rules, and the IRS's administration of these rules for organizations seeking or claiming exemption as a social welfare organization under section 501(c)(4).

The second panel included (1) Eve Borenstein, Borenstein and McVeigh Law Office LLC (Minneapolis, Minnesota); (2) Thomas Hyatt, Partner, SNR Denton (Washington, DC); (3) John Columbo, Albert E. Jenner, Jr. Professor, University of Illinois College of Law (Champaign, Illinois); and (4) Donald Tobin, Associate Dean for Faculty and the Frank E. and Virginia H. Bazler Designated Professor in Business Law (Columbus, Ohio).

Highlights of their testimony is provided below.

## **Deputy Commissioner Miller's Testimony**

- IRS resources have been sufficient to achieve its balanced goals of providing education and outreach, reviewing and issuing determination letters, and conducting compliance programs. However, Deputy Commissioner Miller expressed concern that further budget and resource cutbacks could adversely affect IRS Exempt Organization's programs and result in longer than desirable response times for reviewing exempt applications, lower levels of audit and compliance coverage, and less education and outreach services.
- The two most difficult areas in administering the unrelated business income tax by the IRS are 1) determining whether an activity is substantially related to the organization's exempt activities, and 2) verifying expense allocations among taxable and exempt activities.
- The IRS is exploring whether to issue additional guidance regarding the conduct of political activities by section 501(c)(4) organizations seeking exemption, but no decisions have yet been made.
- The Form 990 has largely achieved what it set out to achieve, but there might be parts of the redesign that are more burdensome than they need to be. In particular, some of the Schedule R detail pertaining to related organizations, and the current Form 990 filing thresholds for gross receipts (less than \$200,000 annual gross receipts) and total assets (less than \$500,000 total assets), should be open for discussion and possible revision to consider ways to balance burden with transparency and compliance objectives.
- The IRS would like to do more to help smaller exempt organizations, including the development of an electronic interactive Form 1023 application and more website education materials regarding forming and operating a public charity.

## **Panel 2 - Expert Witnesses**

### **Form 990 Redesign (Eve Borenstein)**

- Overall, the Form 990 redesign was a major improvement over the prior form, and has achieved many of the transparency, accountability and compliance objectives that motivated the form's redesign.
- The redesigned form created a steep learning curve for most organizations and preparers, but four years into implementation of the form, organizations are starting to get comfortable with the new form.
- The IRS has done a good job of reviewing and taking public comments into the redesign implementation process.
- The fact the Form 990 is "more than just numbers" and requires considerable narrative disclosure of programs and activities means the organization must involve program and non-financial staff in the process.
- The form's public availability allows the IRS to leverage off of the general public as a reviewer of the sector and particular organizations.

- The redesigned form has provided the IRS better compliance data and caused many organizations to do a better job of focusing on compliance, reporting, governance, and charitable mandates.
- There are a few areas of the form that are overly burdensome relative to the benefits derived from the reported information, and the IRS should consider:
  - eliminating or streamlining Schedule F (activities outside the United States) and simplifying or making uniform the definitions for all parts of Schedule L (insider transactions);
  - eliminating the requirement for section 501(c)(3) and (c)(4) organizations to report functional expenses;
  - increasing the filing threshold so that organizations with gross receipts less than \$1 million and total assets less than \$3 million are able to file a short-form 990, which could consist of certain parts of the core Form 990 and a limited number of schedules; and
  - seeking public comments on the interaction of Schedules L (insider transactions) and R (related organizations) to reduce redundancies in reporting currently required.

### **Complex Structures (Thomas Hyatt)**

- Numerous factors drive complex structures, particularly in the health care and higher education areas. These include liability protection, regulatory compliance, improved governance, and protecting exempt status, by placing certain activities or assets in separate legal entities.
- Complex structures are not inherently bad, and oftentimes are extremely useful as they provide the exempt organization needed flexibility to achieve the various objectives described above and comply with various federal and state laws.
- Complex structures raise federal tax compliance issues that must be closely monitored by the IRS, including exempt purpose, inurement, private benefit, and unrelated business income, and therefore transparency regarding such structures is critical to sound tax administration and maintaining public confidence in the exempt sector.

### **Unrelated Business Income (Professor Columbo)**

- The unrelated business income tax ("UBIT") is extremely complicated and in many instances does not provide bright lines that the sector or the IRS may apply to determine compliance. In some instances, the regulations provide conflicting guidance regarding the extent to which an organization may engage in unrelated business income activities without jeopardizing its exempt status.
- Two key areas of complexity and uncertainty in the UBIT area include the "substantially related" test (which requires the activity be substantially

related to the organization's exempt purposes) and allocation of expenses among taxable and exempt activities.

- Professor Columbo recommended that Congress abandon the substantially related test and subject income earned by a public charity from all commercial activities to UBIT, regardless of whether the activity was substantially related to the organization's exempt purposes.
- He also recommended that the Congress or the IRS resurrect the commensurate in scope doctrine to make clear that as long as revenues from commercial activities are being used to conduct a substantial charitable program, the activity will be considered in furtherance of an exempt purpose and the organization's tax exempt status is not at risk.

### **Political Activities (Professor Donald Tobin)**

- Professor Tobin explained that public charities cannot engage in prohibited political activity, but can be associated or affiliated with a section 501(c)(4) organization that could in turn form a section 527 organization to conduct such activities, provided the public charity did not subsidize the political activity.
- He also made several recommendations regarding how to improve transparency regarding political activities conducted by social welfare organizations and IRS administration of the political activity rules, including:
  - Congress establishing a public complaint process involving a nonpartisan committee within the IRS to review the complaints;
  - Making audit results pertaining to exempt organization examinations available to the public; and
  - Make more uniform the disclosure rules regarding various types of exempt organizations with respect to these activities.
- Professor Tobin testified that the Form 990 Schedule R (related organizations) is critical to assuring that relationships among public charities, social welfare organizations, and others involved in political activities is disclosed to the IRS and the public.

The Subcommittee indicated that the hearing testimony will provide important information to the Subcommittee as it begins to consider changes that would help exempt organizations work most effectively to meet their goals, and as the Subcommittee considers overall tax reform.

Links:

Additional information, including a video of the hearing, is available on the [House Ways and Means Committee website](#).

Complete copies of panelist testimony are available on the House Ways and Means Committee website under [hearing title](#).

*For additional information, please contact a National Tax Services Exempt Organizations Tax Services Practice representative:*

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