2011 Higher Education Tax Update

MARCH 2011

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CapinCrouse LLP
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About the CapinCrouse Higher Ed Team

With more than 700 not-for-profit organizations and 1,500 tax clients, CapinCrouse is the country's leading accounting and advisory firm primarily serving the Christian not-for-profit community.

Since 1972, CapinCrouse has been serving not-for-profit entities by providing a full range of audit, review, tax, and advisory services.

We provide services to more than 50 institutions of higher education, including:

- Financial statement and A-133 single audits
- State financial aid attestation services
- Tax planning and assessments, including UBIT studies and tax compliance
- Accreditation assistance
- Monitoring reports
- Board and leadership training and support
- Leadership transition services
- Finance, accounting, and tax training
- Advisory services

CapinCrouse is dedicated to helping our clients operate with financial integrity so they can dedicate themselves to fulfilling their mission.

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INTRODUCTION

Welcome to the 2011 edition of CapinCrouse's annual tax update for institutions of higher education. In this edition of our Higher Education Tax Update, we provide you with articles entitled:

- Key 2010 Tax Law Provisions
- 2011: "The Year of the UBIT"
- Schedule K – Supplemental Information on Tax-Exempt Bonds
- We Don't Have to File Form 990…Do We?
- "De-listing" of Cell Phones

A lot went on in 2010, including health care reform, tax court decisions, and IRS announcements that directly affected institutions of all sizes. The big news — even bigger than health reform — was the release of the IRS's Interim Report on the College and University Compliance Project.

Participants in the Interim Report were broken down into three categories: under 5,000 students, between 5,000 and 15,000 students, and greater than 15,000 students. In the fall of 2010, CapinCrouse published its first annual College and University Tax Reporting Trends report. The participants in our report also fell into three categories, but with different metrics: under 700 students, between 700 and 1,700 students, and more than 1,700 students.

Generally, our annual tax update is aimed at higher education institutions with fewer than 5,000 students. Thus, our trends compared with those in the IRS's "small" institutions category. Overall, the institutions we surveyed performed better on items the IRS was looking at than the schools in their report. However, we found much room for improvement in reporting compensation amounts for officers, directors, trustees, and key employees. Improvement is also needed in reporting the number of independent voting members of boards.

We hope that the information in our Tax Reporting Trends report will help colleges and universities increase the readability of their Form 990s in the future. If you would like a copy of the 2010 report, please contact us at collegetax@capincrouse.com. The topics covered include compensation issues, separate foundations, volunteer reporting, unrelated business activities and FIN 48, at-risk organizations, functional expenses, transactions with interested parties, and Form 990 nuances such as Schedule M – Non-cash Contributions.

Finally, we invite you to participate in our 2011 Higher Education Tax Reporting Trends Report, which will be published in September. This report is designed to help accounting support professionals, board members, and others in leadership positions better understand the nuances of Form 990 and issues with unrelated business activities. It also provides crucial benchmarks against peer institutions. It only takes three minutes to participate by completing the online survey. See the box on page 12 for more information.

We received great feedback on our 2010 Tax Update and hope that the information in this update will provide you with valuable insight. If there are any topics you'd like to see covered in future editions, please e-mail us at collegetax@capincrouse.com.

We look forward to hearing from you throughout 2011, and hope that we can be of service with your audit, tax, and consulting needs.

Thank you!

—- The CapinCrouse Not-for-Profit Tax Team

KEY 2010 TAX LAW PROVISIONS

We'll start with a quick overview of some of the 2010 tax changes affecting colleges and universities. If you would like further information on any of these items, please contact us at collegetax@capincrouse.com.

Health Care Reform

It took Congress several thousand pages to define the Patient Protection and Affordable Care Act of 2010. Numerous provisions — many of them positive — went into effect in 2010. We'll cover several below.

Ultimately, the new Congress may change the effects of the original Affordable Care Act. In the meantime, you should have an understanding of the provisions taking effect in 2011:

- Standard definition of qualified medical expenses – This provision sets a common definition of qualified medical expenses for health savings accounts (HSAs), flexible spending accounts (FSAs), and health reimbursement accounts (HRAs). For these plans, "qualified medical expenses" are now the same as the definition used for the itemized deduction. The only difference is that over-the-counter medicines *with a prescription* still qualify as medical expenses for the plans. Beginning in 2011, non-prescription over-the-counter medicines are no longer reimbursed through HSA, FSA, and HRA plans. The change does not affect insulin — even if purchased without a prescription — or other health-care expenses such as medical devices, eye glasses, contact lenses, co-pays, and deductibles. The new standard applies only to purchases made on or after January 1, 2011, so claims for medications purchased without a prescription in 2010 can still be reimbursed in 2011, if allowed by the employer's plan.

- Increase in the additional tax for health account withdrawals – The penalty for HSA participants who reimburse themselves for non-qualified medical expenses before age 65 was raised from 10% to 20% in 2011. The additional tax for Archer MSA withdrawals not used for qualified medical expenses increased from 15% to 20%. You should take particular care in alerting your employees that non-prescription over-the-counter medicines are no longer qualified medical expenses as of December 31, 2010.

- Reporting health coverage costs on Form W-2 – Initially, the Affordable Care Act instituted a rule that employers must disclose the value of the health insurance coverage benefit they provide. This disclosure is to be made on each employee's annual Form W-2. (The IRS has modified the form to add a new box for reporting this amount.) The amount is not taxable and, ostensibly, is shown for information purposes only. In late 2010, the IRS announced that this provision would be optional for 2011 and mandatory for 2012.

Form 1099-MISC Reporting

Beginning in 2012 (reportable in January 2013), organizations will be required to file Form 1099-MISC for each payee that they pay more than $600 for goods, services, rents, and financial fees. This has caused a lot of public outcry. Congress had several opportunities to change or repeal this requirement in 2010 and failed to do so in all instances. IRS Commissioner Doug Shulman did qualify the filing requirement somewhat by stating that payments made via credit card would not be subject to 1099-MISC reporting under this provision.

We expect more to transpire on this issue in 2011. Your organization should closely monitor the status of this rule and ensure that you have systems in place to meet the requirements beginning on January 1, 2012.

Small Business Health Care Tax Credit

The small business health care tax credit could be one of the highlights of the tax year for smaller organizations. This 2010 provision helps small tax-exempt organizations and businesses afford the cost of covering employees. It is specifically targeted to employers with low- and moderate-income workers, and is designed to encourage small employers to maintain their health insurance coverage or offer it for the first time.

For employers with fewer than 25 full-time-equivalent employees and average annual salaries of less than $50,000, this credit can provide much-needed funding in the form of a credit against amounts paid for employee health costs. In general, the credit is available to small employers that pay at least half the cost of single coverage for their employees. The credit for qualifying non-profits equals up to 25% of premium costs in 2010 (rising to 35% in 2014) and phases out gradually for organizations with average wages between $25,000 and $50,000 and with the equivalent of 10 to 25 full-time workers. The credit is calculated on Form 8941 and the money from the credit is obtained by filing Form 990-T, whether you have unrelated business income or not.

The IRS has a great Q&A summary on this credit at http://www.irs.gov/newsroom/article/0,,id=220839,00.html.

Health Coverage for Older Children

Health coverage for an employee's children under age 27 is now generally tax-free to the employee. This expanded health care tax benefit applies to various workplace and retiree health plans. It allows employees with cafeteria plans — plans in which employees can choose from a menu of tax-free benefit options and cash or taxable benefits — to start making pre-tax contributions to pay for this expanded benefit. This also applies to self-employed individuals who qualify for the self-employed health insurance deduction on their federal income tax return. Because this provision is effective for plan years beginning after September 23, 2010, many people will not see a benefit from this change until later in 2011.

Early Retiree Health Benefit Reinsurance

The Affordable Care Act includes an oft-overlooked provision for reimbursement of early retiree health benefits. This is a temporary plan with limited funding.

For the purposes of this provision, "health benefits" are defined as "medical, surgical, hospital, prescription drug, and such other benefits as shall be determined by the Secretary of Health and Human Services." These can be self-funded or available through insurance.

"Early retirees" are defined as those age 55 and older who are not eligible for SSA, not an active employee of the employer maintaining or contributing to the maintenance of the plan, and enrolled for health benefits in a certified employment-based plan. In the regulation, spouses, surviving spouses, and dependents of such retirees are considered "early retirees." To qualify, organizations must file an application through the United States Department of Health and Human Services. Funds are limited and generally disbursed on a first-come, first-served basis. To qualify for "reinsurance" reimbursement, organizations must incur more than $15,000 in expenses for early retiree health benefits. Qualified employers may be reimbursed for 80% of the paid amounts between $15,000 and $90,000. For more information, see http://www.errp.gov.

Photo courtesy of Charleston Southern University

Appraiser's Signature on Form 8283

The IRS periodically releases Chief Counsel Advice Memos (CCAs), internal email messages to IRS offices in response to specific questions. CCAs can provide good insight into how the IRS views certain issues.

On June 18, 2010, the IRS released a CCA about non-cash contributions reported on Form 8283 (message CCA 201024065). The memo states that only the person who conducted the appraisal can sign as the appraiser on Form 8283 (Noncash Charitable Contributions):

> There is no exception for the referenced entities. If someone other than the person(s) who conducted the appraisal is signing the appraisal than the appraisal is not a qualified appraisal for purposes of section 170 and the claimed deduction may be disallowed. This is regardless of whether the person signing is or is not an appraiser. The person who signs the 8283 and the appraisal must be the appraiser who conducted the appraisal. Attaching a properly executed 8283 (i.e., "appraisal summary") is required to substantiate the contribution, so failure to do so should lead to disallowance of the deduction. However, we are not aware of any cases where the 8283 was not signed by the right person. Some Tax Court cases have taken the view that "substantial compliance" with certain substantiation requirements under the 170 regs is sufficient (e.g., Bond and Simmons). Both of those cases had to do with the appraisal itself, though — not the 8283. It is, therefore, uncertain how the Tax Court would resolve this issue. Furthermore, this creates a Circular 230 issue, as previously discussed, because the Service must be able to hold the appraiser responsible for any false or fraudulent overstatement in the appraisal.

IRS Increasing Audits of Exempt Organizations

Since 2008, the IRS has added over 100 employees to its Exempt Organizations Examinations Division, the group that handles audits of non-profits. In a report released in late 2010, the IRS showed that the number of not-for-profit audits increased from 7,861 in 2008 to 10,187 in 2009 — a leap of 30%. In 2010, the number of audits rose to 11,449, another 12% increase.

The Service will be looking at things like executive compensation, unrelated business activities, and loans to executives. More than 30 of the 400 colleges and universities included in the College & University Compliance Project have been audited to date.

Debt-Financed Income on Security Margin Sales

In a case that could have repercussions for many organizations, especially foundations and endowments, the Court of Appeals for the Federal Circuit found that a Cornell University trust was subject to unrelated business income tax under IRC §514 on income resulting from the sale of securities purchased on margin.

The trust stated that there was no unfair competition in connection with the transaction and that fact should override the statutory language of IRC §514. Further, it believed that the activity did not rise to the level of a trade or business. The court rejected the trust's arguments.

All organizations should review their investments for margin purchases, consult with their development teams and investment advisors regarding this issue, and consider new policies and procedures designed to communicate the taxes that may be levied when securities purchased on margin are sold.

Minor Changes to 2010 Form 990

Since the IRS issued the final draft of the 2008 Form 990, we have been requesting three changes. First, please give us line numbers on Form 990, Part VII, Section A where officers, directors, trustees, key employees, and highest compensated employees are listed. Next, it would be good to have some method — possibly checkboxes at the top of given sections — of alerting readers that explanations about that section are included on Schedule O. And, finally, please give us a "totals" line/box at the bottom of Schedule M (Non-cash Contributions) Column C, as the total of that column must equal Form 990, Part VIII, line 1g.

Well, two out of three isn't bad; they gave us all but the Schedule M total box for 2010. Other changes include:

- The Reconciliation of Net Assets was relocated to the Core Form on a new Part XI (Part XI moves to part XII)
- Form 990, Part VI, line 2 instructions now clarify that only business and family relationships between the organization's current (not former) directors, trustees, or key employees should be reported
- Part VI, Line 11 instructions now clarify that an organization should answer "No" if it redacted or removed any information (e.g., names and addresses of contributors listed on Schedule B) from the copy of its final Form 990 provided to its governing body members before filing the form
- Schedule J-2 was eliminated as a continuation for Part VII, Section A (you now use multiple Part VII pages)
- New narrative parts have been added to Schedules E, G, K, L, and R. These parts, rather than Schedule O, should now be used to supplement responses to questions on those schedules. Schedule O should be used only to supplement responses to questions on the Core Form 990
- Various verbiage changes were made throughout the form and schedules

2011: THE YEAR OF THE UBIT

Over the past few months, the CapinCrouse Tax Team has been privileged to conduct on-site Unrelated Business Activities Surveys at 12 institutions across the U.S. It has been a very educational process — for the colleges and for us!

At each school, the process entailed meeting with the accounting team to review the school's Form 990; discussing our hierarchy for unrelated business income (UBI) analysis; taking a tour of the campus; interviewing personnel from other departments such as athletics, radio stations, conferences, and book store operations; and completing our 144-question 740-B Checklist. It has been interesting to discover the similarities between the activities and operations of our higher education clients. Having said that, it is very clear that every school is unique and has its own set of challenges and opportunities when it comes to unrelated business income and expense.

As we suspected at the outset, institutions have a wide variety of activities that are at least technically unrelated to their exempt purpose. On the other hand, the field of higher education has a broad coverage area when it comes to what that exempt purpose may be. "Education" casts a wide net!

Common UBI sources at the institutions we've worked with include sponsor banners in the field house, ads in publications, office space rental to non-profits and other entities, conference rentals that include equipment and services, and the operation of parking lots during special events. Several schools also receive revenue from billboards they own, cell phone tower rentals, sale or rental of products produced in their education purpose, and investments that create UBI.

We continually talk with college and university accounting teams that are perplexed as to how the unrelated business rules apply to their institution's activities, and with good reason. Many IRS pronouncements and tax court decisions regarding unrelated business issues for exempt organizations have involved colleges and universities. While this gives us some foundational knowledge and written documentation to go by, this area is still very complicated and fraught with misinformation.

For the most part, tax law gives way to an "all facts and circumstances" approach that makes each institution unique when analyzing the taxability of its activities. For example, an activity that rises to the level of "convenience of the students" at one college may not at another, due to the availability of the service from other sources.

Every UBI presentation we've ever heard has included a tax-law-based, three-point premise to follow for UBIT analysis. We've all been taught that business income is generally subject to taxation if it falls into one of three categories: 1) trade or business, 2) regularly carried on, or 3) not part of the exempt purpose of the organization. However, our experience has shown that while this framework aligns with the tax code, it is incomplete and leads to confusion.

CapinCrouse has developed a step-by-step hierarchy that incorporates the three criteria above, but goes further to make the UBIT analysis process clearer and made a decision more complete. Historically, most not-for-profit organizations have looked at these three points and made a UBI determination without much research. Unfortunately, we've seen many instances of colleges and universities paying unnecessary taxes on activities they incorrectly deemed to be unrelated business activities.

Our hierarchy is summarized below. If you're interested in completing this process for your institution or simply want more information about it, we would love to talk with your accounting team. CapinCrouse will also be hosting training sessions on this important topic throughout 2011.

The TREE SAP Hierarchy

We joke that we use the acronym "TREE SAP" because UBIT is such a sticky issue! In actuality, it stands for:

- Trade or Business?
- Regularly Carried On?
- Exempt Purpose?
- Exploitation?*
- Specifically Excluded?
- A Profit Motive?
- Prepare Form 990-T!

Note that the first three items mirror the three-step test historically used in determining whether activities should be subject to UBIT and reported on Form 990-T.

Our seven-step analysis process is best used as a progression. Rather than stopping when the activity fails one of the tests, we recommend continuing through the first six items. This can be advantageous in determining and documenting that there are several reasons why a given activity is not an unrelated business. As with many areas of tax analysis, you should pay particular attention to three facets of your study: reasonableness, documentation, and "all facts and circumstances."

It is important to remember that the purpose of UBIT is to prevent non-profit organizations from unfairly competing with for-profit entities in activities that are taxable to the for-profits.

Trade or Business?

According to Treasury Regulation 1.513-1(b) (and Internal Revenue Code section 162), the term "trade or business" in the UBIT context "generally includes any activity carried on for the production of income from the sale of goods or performance of services." Several tax court cases, including *United States vs. American Bar Endowment* (1986), have affirmed that the existence of a profit motive is central to the determination that a particular activity is a trade or business. It should be mentioned that code section 513(c) sets forth the "fragmentation rule," which clarifies that a part of a business activity will not lose its identity as a trade or business simply because it is carried on within a larger group of similar activities, even if the larger group is related to an organization's exempt purposes. For example, the sale of advertising space in a college or university publication is treated as a separate activity that can produce UBI.

This determination seems easier than it typically turns out to be. Treasury Regulation 1.183-2(b) contains a list of factors that determine whether an activity is a trade or business:

1. Manner in which the taxpayer carries on the activity
2. The expertise of the taxpayer or his advisors
3. The time and effort expended by the taxpayer in carrying on the activity
4. Expectation that assets used in the activity may appreciate in value
5. The success of the taxpayer in carrying on other similar or dissimilar activities
6. The taxpayer's history of income or losses with respect to the activity
7. The amount of occasional profits, if any, which are earned
8. The financial status of the taxpayer
9. Elements of personal pleasure or recreation

It's probably obvious that these nine criteria are for discerning whether an activity is a business or hobby for individual or business tax purposes, but we can glean some of the philosophy the IRS uses when determining whether an activity is a business. Note that the IRS is using their "hobby loss" rule — if the activity generates a profit in three out of five years, it is a business — as they determine whether activities are subject to UBIT. In fact, almost every activity we analyze at colleges and universities rises to the level of being a trade or business.

Photo courtesy of Anderson University

Regularly Carried On?

This is one of the most controversial and confusing areas in all of U.S. tax law. The examples given in the code and regulations, along with tax court decisions, do not appear reasonable in many instances and are downright contradictory in others. Treasury Regulation 1.513-1(c)(1) says:

> In determining whether trade or business from which a particular amount of gross income derives is "regularly carried on," within the meaning of section 512, regard must be had to the frequency and continuity with which the activities productive of the income are conducted and the manner in which they are pursued. This requirement must be applied in light of the purpose of the unrelated business income tax to place exempt organization business activities upon the same tax basis as the nonexempt business endeavors with which they compete. Hence, for example, specific business activities of an exempt organization will ordinarily be deemed to be "regularly carried on" if they manifest a frequency and continuity, and are pursued in a manner, generally similar to comparable commercial activities of nonexempt organizations.

How clear is that?

Colleges and universities may conduct income-producing activities of a kind normally conducted year-round by nonexempt commercial organizations (for-profit companies), and not have the activities subject to UBIT. The regulations clarify that when the conduct of such activities by an exempt organization is over a short period (i.e. only a few weeks out of the year), the activity likely does not constitute the regular carrying on of trade or business.

For example, the regulations stipulate that the operation of a sandwich stand by a non-profit organization for only two weeks at a state fair would not be the regular conduct of trade or business. However, the conduct of year-round business activities for one day each week would constitute the regular carrying on of trade or business. Thus, the operation of a commercial parking lot on Saturday of each week would be the regular conduct of trade or business. In the case of activities that for-profit companies only engage in on a seasonal basis, the conduct of such activities by an exempt organization during a significant portion of the season ordinarily constitutes the regular conduct of trade or business.

As you can see, this area requires much analysis and can still be fraught with uncertainty. In practice, many business activities that appear to be unrelated are not regularly carried on when analyzed within the framework of the tax code.

Exempt Purpose?

The question here is whether an activity is "substantially related" to the organization's exempt purpose. Remember, generating revenue for use in the exempt functions of the organization does not necessarily make an activity related to its exempt purpose. A foundational principal of UBIT is that it is not how the revenues are used, but how they are obtained.

Whether an activity is "substantially related" is a factual question, based on the relationship between the activity and the accomplishment of the organization's exempt purposes. If it is an important contributor to or furthers the organization's exempt purposes through means other than the generation of revenue, the income produced will not be UBI. The exempt purpose of an organization is generally stated in its organizing documents, its Form 1023 (Application for Exempt Status), and on the annual Form 990 in Part I and Part III. Most colleges and universities will find that several of their "business" activities are not substantially related to the institution's exempt purpose.

Exploitation?*

Generally, the sale of items produced or developed in an exempt function activity is not subject to UBIT. One example set forth in tax law concerns the sale of furniture that has been rehabilitated by handicapped persons. However, this rule does not apply where the organization has exploited the exempt function activity beyond what is necessary to accomplish the intended purposes (see Form 990-T, Schedule I). This type of “exploitation” of an exempt function activity may be treated as an unrelated trade or business. For example, the regulations provide that the sale of milk or cream by an experimental dairy farm would not produce UBI, but the sale of ice cream or pastries produced with those products would.

We use a broader definition of the term “exploitation” in our TREE SAP Hierarchy. In this part of the analysis, the hierarchy includes unrelated business activities such as debt-financed rental income, advertising, rental of personal property, services, income from subchapter S corporations, and income from certain controlled corporations. We’ve found that almost every higher education institution engages in some of these activities.

Specifically Excluded?

Section 513 provides specific UBIT exclusions for income derived from certain types of activities. These specific exclusions include, but aren’t limited to:

- The “volunteer” exception
- The “thrift shop” exception
- A trade or business carried on for the “convenience” of members, students, patients, officers, or employees
- The “token” exception
- Real property rentals
- Royalties
- Qualified sponsorship payments
- Dividends
- Interest

There are qualifications and limits to many of these specific exceptions. One of the best summaries of these exceptions can be found under the heading of “Exclusion Codes” on page 53 of the 2007 Form 990 instructions at: http://www.irs.gov/pub/irs-prior/i990-ez--2007.pdf.

It should be noted that “qualified corporate sponsorship income” — as opposed to advertising income — is specifically excluded from unrelated business income tax. In addition, portions of corporate sponsorship income may need to be allocated as unrelated business income in situations where corporate sponsors receive certain perks. This issue requires in-depth analysis.

A Profit Motive?

As we noted earlier, several tax court cases, including *United States vs. American Bar Endowment* (1986), have affirmed that the existence of a profit motive is central to the determination that a particular activity is a trade or business. The question of whether an activity produces a profit generally comes down to the methods used to allocate expenses.

At this point in the process, we identify the direct expenses associated with the income from the unrelated business activity. Directly connected expenses are defined as “expenses which have a proximate and primary relationship to carrying on the unrelated trade or business.”

Then we look at the allocation of “indirect expenses.” For this process we look at allocable “departmental expenses” and allocable “overall expenses.” By thinking through all of the internal goods and services required to carry out the activity, we develop reasonable allocation percentages that can be applied to the identified costs. Remember, under Treasury Regulation 1.512(a)-1(c) the allocation must be “reasonable.”

We recommend analyzing these activities every six months for income less direct expenses, less allocable departmental expenses, and less allocable overall expenses. To accomplish this, we create a worksheet with columns for each activity and enter the applicable revenue and expense data. Documentation of the non-profitability of the activities can be key in demonstrating that the activities are not subject to UBIT.

Prepare Form 990-T!

Finally, if we progress all the way through the seven-point list and determine that a given activity is an unrelated business activity subject to tax, we file Form 990-T and, if applicable, pay the indicated taxes. Note that the instructions to Form 990-T state that any unrelated trade or business that shows gross revenue of $1,000 or more must be reported on Form 990-T. The key is whether the activity is a trade or business, and that is what the TREE SAP Hierarchy seeks to document. The preparation and filing of Form 990-T requires specific knowledge. The form is not laid out in an intuitive manner, and we advise following the instructions closely or working with a professional tax preparer.

Ultimately, 2011 could prove to be a watershed year with respect to the IRS providing information about unrelated business activities. As the Service completes audits on more than 30 of the institutions involved in the College and University Compliance Project, we expect technical advice memoranda and other communications regarding various unrelated business activities.

Later this year, CapinCrouse’s *2011 Higher Education Tax Report Trends* will cover any new developments in UBIT. (See page 12 for more information.) We will also offer live and web-based training on UBIT issues several times during the year. Check www.capincrouse.com for times, dates, and locations.

SCHEDULE K, SUPPLEMENTAL INFORMATION ON TAX-EXEMPT BONDS

As colleges and universities complete the “new” Form 990 for the second year, many are coming face-to-face with a somewhat daunting form called Schedule K, Supplemental Information on Tax-Exempt Bonds. On the 2008 Form 990, institutions required to file the schedule only needed to complete Part I, as the remainder was optional that year. Part I was fairly easy, requiring only a list of any tax-exempt bonds issued, along with some date and identification numbers. The full schedule is more complicated.

Fortunately, the IRS is very helpful in providing information on tax-exempt bonds. The IRS has posted a great deal of information on their website, including a "tax-exempt bond community" webpage at http://www.irs.gov/taxexemptbond/index.html.

Another great source of information on this topic is a 2007 paper from the Advisory Committee on Tax Exempt and Government Entities (ACT), titled "After The Bonds Are Issued: Then What?" This is a summary of the committee's sixth report of recommendations, dated June 17, 2007. It is designed to help borrowers and issuers develop policies, procedures, and systems to ensure bonds do not lose tax-exempt status for investors. You can download this informative paper at www.irs.gov/pub/irs-tege/bonds_act_0607.pdf.

The litmus test for filing Schedule K comes at Form 990, Part IV, line 24a, which asks: "Did the organization have a tax-exempt bond issue with an outstanding principal amount of more than $100,000 as of the last day of the year, that was issued after December 31, 2002?" If you answer "Yes," you must complete Schedule K.

The Form 990 glossary defines "tax-exempt bonds" as: "An obligation issued by or on behalf of a governmental issuer on which the interest paid is excluded from the holder's gross income under section 103. For this purpose, a bond can be any form of indebtedness under federal tax law, including a bond, note, loan, or lease-purchase agreement." Then, the glossary defines "government issuer" as: "A State or local governmental unit that issues a tax-exempt bond."

Note that the requirement to complete Schedule K depends upon having an outstanding tax-exempt bond issue, but with three qualifications:

1. The outstanding balance is greater than $100,000,
2. That balance exceeds $100,000 as of the last day of the institution's fiscal year, and
3. The bonds were issued after December 31, 2002.

Thus, outstanding bonds issued before December 31, 2002 are not required to be reported on Schedule K. This can be significant for some schools. There are special reporting requirements when pre-2003 bonds are "refunded," however, which we'll cover later in this section.

The instructions to Schedule K explain that the purpose is for an organization filing Form 990 to "provide certain information on their outstanding liabilities associated with tax-exempt bond issues." The instructions further note that:

If the organization has one or more related organizations (for example, parent and subsidiary relationship), it must complete Schedule K (Form 990) consistent with the filing(s) of its related organization(s). The same liability should not be reported by more than one of the related organizations. For example, if a parent organization issues a tax-exempt bond issue and loans or allocates that issue to a subsidiary organization, only one organization (either the parent or subsidiary) should report the liability on Form 990 and the Schedule K. Similarly, if a parent organization loans or allocates the proceeds of a tax-exempt bond issue to a group of subsidiary organizations, only one level (either the parent or the group of subsidiaries) should report the liability on Form 990 and the Schedule K. For this purpose, if the subsidiary organizations report the liability, each subsidiary should only report the amount it is loaned or allocated.

Schedule K contains four parts:

- Part I – Bond Issues
- Part II – Proceeds
- Part III – Private Business Use
- Part IV – Arbitrage

The real purpose of the schedule seems to be to provide a method for the IRS (and the public) to monitor the issuances of tax-exempt bonds by not-for-profit entities and track how the proceeds were used (Parts I and II of Schedule K). The answers to the questions on these two issues are generally not too cumbersome to obtain and report.

In Part III it appears that the IRS is taking the opportunity to begin tracking and analyzing two areas that have been somewhat off the radar in past years. First, the IRS asks about "private business use," which "means use of the proceeds of an issue by the organization or another section 501(c)(3) organization in an unrelated trade or business as defined by section 513. Private business use also generally includes any use by a nongovernmental person other than a section 501(c)(3) organization unless otherwise permitted through an exception or safe harbor provided under the regulations or a revenue procedure."

The private business use rules and regulations can be complex and are covered under Internal Revenue Code section 141 and its regulations. Ultimately, private business use cannot exceed 10% of the total use of a facility that was built with tax-exempt bond funds without endangering the investors' tax-exempt treatment of the interest on the bonds.

In Part IV, the IRS is looking at what it calls "arbitrage." This summary section looks at how the proceeds of the bond issue were used or invested and whether the issuer might be liable for penalties (reported on Form 8038-T).

In order to stay "within bounds" on any investment of bond proceeds, you should set up procedures regarding arbitrage.

We recommend that you consult with your bond counsel before making investments or setting up formal or informal funds with bond proceeds. Make sure you comply with "temporary period" guidelines for the expenditure of bond proceeds (typically three years for new money bonds). You should also set up procedures to ensure that any investments acquired with bond proceeds are obtained at fair market value. There are safe harbors in the Internal Revenue Code for several of these items.

Special Rules for Refunding of Pre-2003 Issues

There are special reporting requirements for bonds issued after December 31, 2002 to refund bonds issued before January 1, 2003. Such refunding bonds are subject to the generally applicable reporting requirements of Parts I, II, and IV. However, the organization does not need to complete Part III to report private business use information for the issue for such refunding bonds. These special rules do not apply to bonds issued after December 31, 2002 to refund bonds that were also issued after 2002.

Example 1: Refunding of pre-2003 bonds

Bonds issued in 1998 were current refunded in 2008. As of December 31, 2009, the last day of the organization's tax year, the refunding bonds had an outstanding principal amount exceeding $100,000. The organization must list the refunding bond issue in Part I for each year the outstanding principal amount exceeds $100,000 as of the last day of such year, and must provide all Part I, Part II, and Part IV information for such refunding issue. Because the refunded bonds were issued prior to 2003, the organization does not need to complete Part III for the refunding bond issue or the refunded bonds.

Example 2: Refunding of post-2002 bonds

Bonds issued in 2003 were current refunded in 2006. As of December 31, 2009, the last day of the organization's tax year, the refunding bonds had an outstanding principal amount exceeding $100,000. The organization must list the refunding bonds in Part I for each year the outstanding principal amount exceeds $100,000 as of the last day of the year, and must provide all Part I, Part II, Part III, and Part IV information for such refunding bonds.

Finally, the IRS instructions suggest that organizations:

> Use Schedule O (Form 990), Supplemental Information to Form 990, to provide additional information or comments relating to the information provided on this schedule. For example, use Schedule O (Form 990) to provide additional information or comments relating to the reporting of liabilities by related organizations. In addition, an organization can use Schedule O (Form 990) to describe certain assumptions which are used to complete Schedule K (Form 990) when the information provided is not fully supported by existing records.

Photo courtesy of Trevecca Nazarene University

We strongly recommend that Schedule O be used in almost all cases to clarify answers to the various items requested on Schedule K. Also, the schedule does not give your Form 990 readers a clear, definitive picture of the buildings and facilities your college has built with the bond proceeds. Schedule O can help you accomplish this.

WE DON'T HAVE TO FILE FORM 990 … DO WE?

Over the past 10 years or so, we've received a lot of correspondence that included the question above or one like it. The question of who is required to file Form 990 is ongoing. We had hoped that the IRS's recent release of a list of charities at risk of losing their exempt status would shed some light on this issue. Relatively few colleges and universities were included on that list, however, and the IRS stated that it may be incomplete.

Churches, associations of churches, and their integrated auxiliaries, including seminaries, are exempt by law from filing the Form 990 series of returns. If any of these entities have unrelated business income of more than $1,000 in a given year, however, they may be required to file Form 990-T.

Many colleges and universities we speak with do not file Form 990 because they consider themselves an integrated auxiliary of a church or of an association or denomination of churches. In some cases, the college has a determination letter from the Service stating that they are not required to file Form 990 — a good item to have in your files!

In Treasury Regulation 1.6033-2(h), the IRS defines an "integrated auxiliary" as an organization that is:

1. Described both in sections 501(c)(3) and 509(a)(1), (2), or (3);
2. Affiliated with a church or a convention or association of churches; and
3. Internally supported.

We'll discuss affiliation and internal support below.

Affiliation

The regulation states that:

> …an organization is affiliated with a church or a convention or association of churches if the organization is covered by a group exemption letter issued under applicable administrative procedures to a church or a convention or association of churches; the organization is operated, supervised, or controlled by or in connection with (as defined in §1.509(a)-4) a church or a convention or association of churches; or relevant facts and circumstances show that it is so affiliated.

The section goes on to say that "relevant facts and circumstances" include the following factors:

- The organization's enabling instrument (corporate charter, trust instrument, articles of association, constitution, or similar document) or by-laws affirm that the organization shares common religious doctrines, principles, disciplines, or practices with a church or a convention or association of churches;
- A church or a convention or association of churches has the authority to appoint or remove, or to control the appointment or removal of, at least one of the organization's officers or directors;
- The corporate name of the organization indicates an institutional relationship with a church or a convention or association of churches;
- The organization reports at least annually on its financial and general operations to a church or a convention or association of churches;
- An institutional relationship between the organization and a church or a convention or association of churches is affirmed by the church, or convention or association of churches, or a designee thereof; and
- In the event of dissolution, the organization's assets are required to be distributed to a church or a convention or association of churches, or to an affiliate thereof.

However, the absence of one or more of the above factors does not necessarily preclude classification of an organization as affiliated with a church or a convention or association of churches.

Internally Supported

An organization is considered to be "internally supported" unless it both:

- Offers admissions, goods, services, or facilities for sale, other than on an incidental basis, to the general public (except goods, services, or facilities sold at a nominal charge or for an insubstantial portion of the cost); *and*
- Normally receives more than 50% of its support from a combination of governmental sources, public solicitation of contributions, and receipts from the sale of admissions, goods, performance of services, or furnishing of facilities in activities that are not unrelated trades or businesses.

Now, the "internally supported" clause would cause many higher education institutions to fail the integrated auxiliary test if it weren't for an exception built into the tax law (Regulation 1.6033-2(h)(1)(v)). This exception states that "men's and women's organizations, *seminaries*, mission societies, and youth groups that satisfy numbers 1 and 2 above, are considered integrated auxiliaries of a church regardless of whether such an organization meets the internal support requirement (number 3 above)" (emphasis ours).

While that is helpful, you should be aware that the IRS's definition of "seminary," taken from examples throughout the Internal Revenue Code and Treasury Regulations, seems to mirror what most of us would typically consider a convent or monastery. A vow of poverty is usually mentioned.

Group Exemption Letter

Organizations affiliated with a church or association of churches are generally covered by a group exemption letter that applies to the whole church or association. Among the colleges and universities we've talked with, most who do not file a Form 990 are covered by a group ruling.

The IRS is putting a great deal of effort into reviewing the group exemption process, however. In fact, the original draft of the new Form 990 eliminated the concept of group exemptions. It was added back in after public comments on the draft.

Since the Pension Protection Act of 2006, there has been some concern that colleges and universities covered under a group ruling for a church or association or convention of churches may need to file Form 990. This is because the parent organization does not file a "group" Form 990 that includes the financial data for the subordinate college or university. If your team has concerns about this issue, you should review IRS Publication 4573, Group Exemptions.

Pros and Cons of Voluntarily Filing Form 990

We receive many questions about whether an integrated church auxiliary should file Form 990 when the church does not. Organizations can voluntarily file Form 990, and many do. Even if your college or university is not required to file the return, there may be reason to do so. We've put together the pros and cons of voluntary filing.

Pros:

1. Proactive protection if IRS decides to ask churches and church-related entities for Form 990.
2. Protection if IRS decides that you should have been filing. (We have been unofficially told by IRS representatives that no college should be exempt from filing Form 990. Filing the form —even voluntarily — ensures that the IRS will not be able to revoke your exempt status due to non-filing.)
3. Voluntary filing could be viewed positively by funding sources (foundations) because many funders and constituents expect to see Form 990 and the information therein.
4. Being transparent and informing the public about what you do and your good practices can be good PR. Voluntarily filing Form 990 shows the world that you will go the extra mile to be transparent.
5. Completing the return may prompt your organization to improve processes and adopt best practices.
6. Form 990 provides the governing board with a broad, comprehensive summary of the issues the IRS and your constituents are looking for.

Cons:

1. Filing Form 990 results in the public disclosure of information that could be used to criticize your institution.
2. Completing the form requires expertise, time, and energy that you may not be prepared for.

Ultimately, we expect to receive clearer guidance on this issue as the IRS revokes the exempt status of some organizations in 2011. We would love to talk with you and your team about Form 990 filing requirements, and we will continue to engage colleges, consultants, and the IRS in this conversation as it develops. We will let you know what we discover.

"DE-LISTING" OF CELL PHONES

Beginning in 1982, mobile phones were considered "listed property" under Internal Revenue Code section 280F. This meant that for cell phone costs to be reimbursable or deductible, heightened substantiation requirements had to be met.

For several years, the IRS has been examining substantiation at universities and other organizations. In most cases, the IRS has assessed additional taxes and penalties when employers were not getting a complete, itemized cell phone bill stating — for each and every call — the business purpose, who was called, when the call was made, etc. Further, the Service required the inclusion of all or part of the value of the cell phone billings in employees' Form W-2 as wages.

Many of us broke out in spontaneous cheering when President Obama signed the Small Business Jobs Act into law on September 27, 2010. This law includes a provision that makes cell phones and similar telecommunications equipment no longer subject to the listed property (and stricter substantiation) rules, effective January 1, 2010. The buzz was that Congress intended for cell phones, PDAs, and similar devices to be treated just like the phones employees have had on their desks for decades. Once the cheering died down, however, we were left pondering what the change really meant.

For a fringe benefit such as an employer-provided cell phone to be excluded from the employee's gross income, it must qualify as a working condition fringe benefit under Code section 132. For an employer-provided cell phone (or similar telecommunications device) to be considered a working condition fringe benefit, the employee must be able to show that he or she would have been able to deduct all or part of the phone bill as an employee business expense under I.R.C. section 162(a). (Also see the instructions for Form 2106.) To take that deduction, the employee would have to substantiate the business use of the phone.

We have talked to several organizations that are taking the position that their employer-provided cell phones are a working condition fringe benefit. These organizations have developed a substantiation methodology and chosen not to include the full value of the cell phone billings in employees' W-2s for 2010.

Now that it appears the line-by-line substantiation requirements for listed property no longer apply, the question becomes: What level of substantiation is now required? The short answer is that we are awaiting IRS guidance. However, we can look at an IRS proposal about cell phone substantiation that surfaced in 2009 and get a feel for what they might say.

In Notice 2009-46, the IRS requested public comment on four substantiation methods that could simplify the cell phone substantiation requirement. The proposed methods were as follows:

1. The full amount of an employee's use of an employer-provided cell phone would be deemed to be for business purposes if the employee demonstrated with proper records that he or she had available, and used, a non-employer-provided cell phone for personal purposes during work hours.
2. The IRS would specify that a de minimis amount of personal use would be disregarded in determining the amount of personal use of an employer-provided cell phone. For example, the Service may define a particular number of minutes, percentage of total use, or use for certain personal purposes as "minimal."
3. The IRS could create a safe harbor provision whereby a certain percentage (e.g., 75%) of each employee's use of a phone would be treated as nontaxable business use.

The remainder would be treated as taxable personal use (and included in wages on Form W-2).

4. The IRS could establish a plan that allows employers to use statistical sampling techniques to measure the percentage of an employee's personal use of an employer-provided cell phone and multiply the percentage times the value of the total usage. This might entail taking three-months' worth of use by each employee or all employees and measuring business and personal use to determine the percentage.

The IRS closed the comment period in late 2009. In early 2010, they announced that they would await Congress' action on cell phones. Now that Congress and the President have acted, it seems to be back to the IRS to define substantiation standards for cell phones. So, as with many tax issues in play today, we are in a wait-and-see situation. If the IRS releases guidance in 2011, we will let you know.

These articles are intended to provide accurate and authoritative information regarding the tax issues covered. They are provided with the understanding that the authors are not engaged in rendering specific accounting or tax advice. If tax or other expert assistance is required, the services of competent professionals should be obtained.

LEARN MORE AT OUR COMPLIMENTARY WEBCASTS

CapinCrouse regularly offers webcasts on current tax issues for colleges and universities. You can learn more and register for these informative sessions at www.capincrouse.com/events/webcasts/.

And as always, please do not hesitate to contact us with questions or if you'd like to discuss any of the issues raised here and how they affect your organization. We are here to help you!

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2011 HIGHER EDUCATION TAX REPORTING TRENDS

Our 2010 "Trends" project saw 79 higher education institutions participate – and we are hoping for even broader participation in 2011. Published in the fall each year, this report can provide great benchmarking data and valuable editorial information about how colleges are handling myriad tax issues. "Trends 2010" reported on such issues as separate supporting foundations; FIN 48 (Topic 740) and UBIT; organizations at-risk of losing their exempt status; executive compensation issues; functional expense categorical comparisons; volunteer reporting; transactions with interested parties; and Schedule M reporting.

If you would like a copy of the "Trends 2010" report, please email us at collegetax@capincrouse.com.

As we prepare for "2011 Trends", we would love for you to participate! It should only take about 3-4 minutes of your time. For 2011, we ask you about activities your institutions engages in such as:

- Cell phone tower rental income
- Sponsor banners in your sports complexes
- Presidential housing
- College radio stations
- State license plates
- Functional expense allocations
- State higher education tax credits

All responses will be held in strict confidence. You can access the quick questionnaire at www.capincrouse.com. If you have any questions, please email us at collegetax@capincrouse.com. Thanks in advance for participating!

About CapinCrouse

With more than 700 not-for-profit organizations and 1,500 tax clients, CapinCrouse is the country's leading accounting and advisory firm primarily serving the Christian not-for-profit community.

Since 1972, CapinCrouse has been serving not-for-profit entities including megachurches, institutions of higher education and secondary schools, and international missions agencies by providing a full range of audit, review, tax, and advisory services.

CapinCrouse is dedicated to helping our clients operate with financial integrity so they can dedicate themselves to fulfilling their mission.

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