

Nonprofit Education Forum: Tax Hot Topics

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Presented by:

Amanda Williams, CPA

Jennifer Iwata, CPA

Cathy Hudak, CPA



Current Developments for Tax Exempt Organizations

As of April 2016

- ❖ 1,571,056 tax exempt organizations registered with the IRS
 - 1,097,689 Section 501(c)(3) public charities
 - 105,030 Section 501(c)(3) private foundations
 - 368,337 other tax-exempt organizations



IRS 2017 Exempt Org. Fiscal Year 2017 Work Plan

- ❖ EO Examinations, focusing on five issue areas:
 1. Exemption
 2. Protection of assets
 3. Tax Gap (employment and UBI)
 4. International spending
 5. Emerging issues
- ❖ IRS completing post-determination examinations of organizations filing for exemption on Form 1023/1024 and 1023EZ



IRS 2017 Exempt Org. Fiscal Year 2017 Work Plan

- ❖ IRS using data driven decisions in EO Exams.
- ❖ IRS plans to audit
 - 400 returns with high risk of private inurement and private benefit
 - 100 private foundation returns with anomalies
- ❖ EO Determinations
 - 93.6% approval rate



Department of the Treasury Priority Guidance Plan

- ❖ Plan updated 8-15-16
- ❖ 18 Tax Exempt Law Projects
 1. Political Campaign Activities
 2. Dual-use facilities method of allocating expenses (UBI)
 3. Update Rev. Proc 2011-33 for EO Select Check
 4. Grantor and Contributor reliance criteria



Department of the Treasury Priority Guidance Plan

- ❖ 18 Tax Exempt Law Projects (cont.)
 5. Reporting of contributions
 6. Supporting organizations additional guidance
 7. Update of Rev. Rul. 67-390 related to when org. needs new application for exemption as org. becomes new legal entity.
 8. Guidance on Private Foundation investment in partnerships with disqualified partners.



Department of the Treasury Priority Guidance Plan

- ❖ 18 Tax Exempt Law Projects (cont.)
 - 9. Proposed regulations on excise tax on donor-advised funds and fund management
 - 10. Regulations on church tax inquiries and examinations
 - 11. Regulations on ABLE programs
 - 12. Computation of UBI of voluntary employee's beneficiary associations
 - 13. Regulations on IRS authority to disclose exempt organization info to state officials.



Department of the Treasury Priority Guidance Plan

- ❖ 18 Tax Exempt Law Projects (cont.)
 - 14. Regulations on fractions rule
 - 15. Guidance to provide criteria for treating entity as integral part of state, local or tribal govt.
 - 16. Definition of “political subdivision”
 - 17. Notification requirement imposed on social welfare org
 - 18. Transition relief for qualified tuition programs concerning 1099-Q



Department of the Treasury Priority Guidance Plan

- ❖ 7 Charitable Giving Law Projects
 1. Record keeping, substantiation or appraisal requirements for cash and noncash contributions.
 2. Guidance on contributions of inventory
 3. Uniform basis of CRTs
 4. Contingencies of CRAT
 5. Charitable contributions of conservation easements
 6. Charitable contributions of water rights
 7. Irregularities in administration of split-interest charitable trusts.



501(c)(3) Organizations - Reason for Denial and Revocation

- ❖ Operating in substantially commercial manner
- ❖ Failure to operate primarily for exempt purposes
- ❖ Failure to provide records
- ❖ Inactivity
- ❖ Failure to file returns (3 consecutive years)
- ❖ Failure to maintain records
- ❖ Failure to serve charitable class



501(c)(3) Organizations - Reason for Denial and Revocation

- ❖ Operation of farmer's market
- ❖ Promotion of stock car racing
- ❖ Failure to meet organizational test
- ❖ Illegal distribution of Federally controlled substance
- ❖ Conduct of accountable care activates
- ❖ Failure to submit protest
- ❖ Conduct of fraud, insurance law violations, preying on elderly
- ❖ Operation of coffee shop in separate organization by Church
- ❖ Private inurement or private benefit.



501(c)(4) Social Welfare Org - Reason for Denial and Revocation

- ❖ Cannot qualify when primary activity requires participation in political campaigns.
- ❖ Needs to benefit community - benefiting interest of 4 individuals does not qualify
- ❖ “Popular and Lucrative” business
- ❖ Substantial nonexempt activity (too much business activity)



501(c)(6) Associations - Reason for Denial and Revocation

- ❖ Must promote a line of business/improve business conditions
- ❖ Principal activities cannot be performance of services for members
 - i.e. Farmers market since not aimed at overall betterment of conditions of farming industry, but provides venue to sell good which they could do themselves.
- ❖ Status revoked for particular services
 - Advertising, ACH and credit card processing, sale of GC



501(c)(7) Social Club - Reason for Denial and Revocation

- ❖ Excessive non member income
- ❖ Failure to keep records



Schedule B Disclosure Update

- ❖ Form 990, Schedule B lists donors to 501(c)(3) orgs' redaction by public charities for public disclosure
- ❖ CA and New York requesting un-redacted copies
- ❖ Courts ruled that submission of Schedule B to states chills exercise of donor's free speech (not needed by states).



Independent Contractor vs. Employee

- ❖ In 2016 one of focus areas of the IRS Exempt Organizations examinations was the tax gap, which includes issues related to employment tax
 - Worker Reclassification
 - Noncompliance with FICA, FUTA,
 - Backup withholding requirements



Independent Contractor vs. Employee

- ❖ Numerous administrative organizations each have a set of criteria/factors, that are often similar, used to evaluate independent contractor status
 - CA Employment Development Department - employment related taxes
 - CA Division of Labor Standards Enforcement - wage, hour and workers compensation insurance laws
 - Franchise Tax Board, Division of Workers' Compensation, and Contractors State Licensing Board



IRS Worker Classification

- ❖ Common law employees
 - Evidence falls into three categories:
 - Behavioral Control
 - Financial Control
 - Relationship of the party

- ❖ Statutory employees



Common Law Rules

- ❖ Behavioral Control - Does the business have the right to direct or control what work is accomplished and how the work is done, through instructions, training, or other means?
 - Instruction - Who determines the when, where, and how to do the work? Is the worker required to obtain approval before taking certain actions?
 - Training - Is training provided on how to do the job?
 - Business Identification - Is it necessary to be identified with the business to meet customer security concerns?



Common Law Rules

- ❖ Financial Control - Are the business aspects of the worker's job controlled by the organization?
 - Significant Investment - Who makes the investment in capital?
 - Reimbursed vs. Unreimbursed expenses - Who assumes responsibility for cost control?
 - Services Available to the Public
 - Calculation of Payment
 - Opportunity for Profit/Loss



Common Law Rules

- ❖ Relationship of the party - What do the parties understand their relationship to be?
 - Written Contracts - Is there an agreement to document parties intention?
 - Permanency of Relationship - Does the worker expect the relationship will continue indefinitely?
 - Regular Business Activity



Common Law Rules

❖ Important Points to Remember

- There is no magic number of criteria that must be reached related to relevant factors
- Factors merely point to the facts that can be used in evaluating the extent of the right to direct and control
- Evidence must be factual and well-documented



Statutory Workers

- ❖ Certain workers considered by statute to be employees. Varies by payroll tax statute
 - FITW lists corporate officers as statutory employees
 - FICA lists corporate officers, agent drivers distributing specified products/services, full-time traveling salespersons and life insurance agents, and homeworkers
 - FUTA generally agrees with FICA statute but full time life insurance agents and homeworkers are not statutory employees for FUTA
- ❖ Since each federal payroll tax statute has its own list of statutory employee occupations a worker can be considered a statutory employee for some purposes but not all of them
- ❖ Two statutory nonemployee occupations - qualified real estate agents and direct sellers



Dual Services

- ❖ Workers performing Dual Services
 - Potential audit risk issuing a w-2 and 1099-MISC to same worker
 - Acceptable if the business can show that the services fall into distinct categories.
 - The worker was an officer (statutory employee) and a director (independent contractor) - Rev Rul. 57-246
 - The worker was an officer (statutory employee) and an insurance salesman (independent contractor) Rev. Rul. 58-505



Independent Contractor vs. Employee

- ❖ Worker Classification Tax Audit Triggers:
 - Wage and hour, unemployment, or workers' compensation audits.
 - Worker complaints to wage and hour or unemployment agencies, labor unions, or the IRS.
 - Complaints from competitors or labor unions.
 - Unemployment claims from workers treated as independent contractors.
 - Using independent contractors who receive few Forms 1099-MISC.
 - Issuing a large number of Forms 1099-MISC relative to the number of Forms W-2 issued.



Independent Contractor vs. Employee

- ❖ Worker Classification Tax Audit Triggers (cont'd):
 - Discrepancies between Forms W-2, Form 940 (FUTA), and Forms 941 or 944 (FITW and FICA).
 - Filing Form 941 or 944 (FITW and FICA) but not Form 940 (FUTA).
 - Filing the state unemployment form but not Form 940 (FUTA).
 - Wages and labor costs deducted on the company's income tax return not reconciling to the Forms W-2 and Forms 1099.
 - A service company with substantial labor in cost of goods sold on a filed income tax return.
 - Payments to individuals listed as consulting fees or other deductions on a filed income tax return.



Independent Contractor vs. Employee

- ❖ Worker Classification Tax Audit Triggers (cont'd):
 - Issuing a Form 1099 and Form W-2 to the same worker in one year.
 - Issuing a Form 1099 to someone previously receiving a Form W-2, or vice versa.
 - Issuing a Form 1099-MISC to the same person for several years.
 - The worker or the employer filing Form SS-8 (Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding).
 - Worker filing Form 8919 (Uncollected Social Security and Medicare Tax on Wages).
 - Operating in targeted industries (e.g., trucking, janitorial, landscaping, construction, professional services, and healthcare).



Independent Contractor vs. Employee

- ❖ Section 530 Relief
 - Prevents the IRS from reclassifying workers treated as independent contractors to employee status if employer meets certain requirements
 - Criteria
 - ❖ Has the entity consistently treated the worker as an independent contractor
 - ❖ Have similar workers been treated the same
 - ❖ Has a reasonable basis for treatment as independent contractor
 - IRS court case or ruling
 - Previous IRS audit did not raise issue with treatment
 - Industry standard
 - Applies only for federal payroll tax purposes, not for state purposes



Independent Contractor vs. Employee

- ❖ What can you do?
 - Conduct a self-audit - use a checklist covering the factors that are looked at for classification, review service agreements and vendor files
 - Maintain independent contractor agreements - while not conclusive evidence supporting independent contractor status, it does help support the business's position showing the parties intention. Agreement should provide that worker uses their own equipment/tools, may perform services for other businesses, provides his or her own liability insurance, and is not eligible for employee benefits and has its own tax identification number
 - Conduct transaction at arms-length if leasing equipment, advancing funds, providing liability insurance to independent contractor
 - Maintain Appropriate Documentation - maintain vendor files that includes form w-9, 1099-Misc, and documentation of consideration of workers classification, backup withholding documentation, certificates of business and workers compensation insurance



Reportable Payments

- ❖ If business is making a reportable payment, it must obtain the appropriate form:
 - Form W-9
 - Form W-8/BEN/BEN-E/ECI
 - Form 8233
 - CA Form 590, 588, 589, 587 - as applicable
- ❖ Obtain prior to payment
- ❖ Business may be liable for tax it was required to withhold



Backup Withholding

- ❖ Business must withhold 28% on reportable payment if:
 - Payee does not furnish their taxpayer identification number (TIN)
 - The IRS informs you to impose backup withholding because the payee furnished an incorrect TIN



Nonresident Withholding

- ❖ Generally payments to foreign persons of amounts from US sources are subject to nonresident withholding. This includes
 - Payments to foreign independent contractors - sourced based on where services are performed
 - Royalties (patents, copyrights, etc.) - sourced based on where the property is used
 - Rents- sourced based on where the property is located



Nonresident Withholding

- ❖ Payee may be able to claim exemption from withholding under a tax treaty
 - Individual must complete Form 8233 to claim treaty benefits for personal services
 - Corporation would complete Form W-8BEN-E to claim treaty benefits



Reporting

- ❖ If they are not claiming tax treaty benefits, you should withhold at 30% for federal purposes
 - Withholding is required at time of payment. The timing of deposits of the amounts withheld depend on the amount of tax.
 - ❖ Undeposited tax withheld is \$2,000 or more at the end of any quarter-monthly (week) period: then you must deposit within 3 business days after the end of the period. A quarter-monthly period ends on the 7th, 15th, 22nd, and last day of the month.
 - ❖ Undeposited tax is at least \$200 but less than \$2,000 at the end of the month: then you must deposit the taxes within 15 days after the end of the month
 - ❖ Undeposited tax is less than \$200: then you may pay with Form 1042 or deposit by 3/15.
 - The Electronic Federal Tax Payment System (EFTPS) must be used to make payments.



Reporting

- ❖ California does not follow federal tax treaties. CA withholding is optional on the first \$1,500 in payments made during the year to the foreign person, then withholding is done at a rate of 7%
 - Form 592 and 592-V is used to remit withheld taxes. Remittance is due quarterly as follows 4/15, 6/15, 9/15, 1/15.



Reporting

- ❖ Year end reporting to taxing authority and copy to payee:
 - US Independent Contractors - Form 1099-Misc due January 31st
 - Foreign Persons - Form 1042/S/T due March 15th
 - CA Withholding for Nonresidents - Form 592-B due January 31st



Unrelated Business Income Tax

- ❖ Why would a tax-exempt entity pay tax?
- ❖ Rational for the UBI rules



Unrelated Business Income Tax

❖ UBI Decision Tree

- Is there a trade or business?
- Is the activity regularly carried?
- Is the activity “not substantially related” to the exempt purpose?
- Is the activity statutorily exempt from tax?
- What are the impact of unrelated activities on exempt status?



Unrelated Trade or Business

- ❖ Is There a Trade or Business?
 - Carried on for the production of income (profit motive)
 - Can be part of a larger activity
 - The deduction of ordinary and necessary expenses incurred can be deducted.



Unrelated Trade or Business

- ❖ Is It Regularly Carried on?
 - Looks at frequency and continuity of activity
 - Similar activities
 - Seasonal activities
 - One-time activities



Unrelated Trade or Business

- ❖ Is It Substantially Related?
 - Must contribute importantly and bear a substantial causal relationship to organization's exempt purpose
 - Must be related other than through the production of funds
 - Cannot be larger than is necessary to perform the exempt purpose
 - Dual use of assets or facilities



Activities Exempt from UBI Tax

- ❖ Business conducted by volunteers
- ❖ Convenience exception
- ❖ Sale of donated items
- ❖ Conventions and trade shows
- ❖ Provision of low-cost articles
- ❖ Qualified sponsorship payments
- ❖ Games of chance



Types of Income Excluded from the UBI Tax

- ❖ Interest, dividends and similar income
- ❖ Royalties
- ❖ Gains and losses from the sale of property
- ❖ Real Property Rental Income
 - Property cannot be debt financed
 - Cannot be from a controlled corporation
 - Cannot be calculated as a percentage of the lessee's net income
 - Personal property included cannot exceed 50% of the rent



Types of Income Included as UBI

UBI is income that is:

- ❖ From a trade or business
- ❖ Regularly carried on
- ❖ Not substantially related

Common UBI includes:

- ❖ Advertising
- ❖ Sale of products



Types of Income Included as UBI

- ❖ Internet activities
 - Links and banners
 - Website advertising
 - Website corporate sponsorships
 - Virtual trade shows
 - Online store fronts
- ❖ Debt financed property
- ❖ Controlled entities



Private Inurement

- ❖ Private Inurement - Tax-exempt organizations must be organized and operated so that no part of their net earnings accrue to the benefit of any private individual that has an interest in the activities of the organization
 - Can result in denial or revocation of exemptions



Private Inurement

- ❖ Private Inurement found:
 - Unreasonable compensation/fringe benefits
 - Improper personal use of organization assets
 - Forgiveness of debt of insiders
 - Personal expense paid by organization
 - Low-interest/unsecured loans to insiders
 - Transactions not conducted in arms-length manner
- ❖ Have guidelines and procedures in place to minimize the possibility of private inurement/benefit issues.



Private Benefit

- ❖ Broader in scope than private inurement. Private benefit encompasses not only benefits provided to insiders but also those to unrelated or disinterested persons.
- ❖ Providing public benefit often provides some benefit to private individuals, which is okay as long as mere by-product of public benefit and insubstantial in amount.



Form 990 Schedule L

- ❖ Transactions with Interested persons disclosed on schedule L
- ❖ For purposes of schedule L interested persons are:
 - Voting members of the governing board
 - Persons holding the power of president, CEO, COO, Treasurers and CFO's
 - A disqualified person's family member
 - A 35% controlled entity of a disqualified person and/or that person's family members
 - A donor or donor advisor to a donor advised fund
 - An investment advisor of a sponsoring organization
 - Other persons depending on facts and circumstances
 - Substantial contributor



Private Inurement

- ❖ Recent Developments:
 - **PLR 201615016** - Exempt application denied because private inurement found where nonprofit provided scholarships to students to attend a for-profit school, where the founder of both organizations was the same individual
 - **PLR 201627002** - Revocation of exemption because private inurement found from intermingling of personal expenses and exempt organization expenses. Organization unable to provide information as to the business purpose of the expense and no control over expense reimbursement.



Private Benefit

- ❖ Recent developments
 - **PLR 201640019** - Tax exemption under 501(c)(3) denied because of private benefit. Organization formed to help wrongfully convicted people. Funds were going to a specific individual.
 - **PLR 201617012** - 501(c)(3) Tax exemption of organization formed to provide training to softball/baseball umpires and to coordinate activities revoked because IRS determined organization was providing employment opportunities for members and serving private interest.



CA Attorney General Compliance

- ❖ The CA Attorney General (AG) has primary responsibility for regulating, enforcing and supervising organizations and individuals that administer and/or solicit charitable funds or assets in California. The CA AG has the duty to protect donors to charity, charities themselves and the beneficiaries of charities. The AG has broad authority under state statutes to regulate charitable organizations and trusts and to commence law enforcement investigations and legal actions to protect the public interest.



Raffles

- ❖ Charities and certain other private benefit organizations may conduct raffles to raise funds for beneficial or charitable purposes in CA.
- ❖ Must register with the AG office prior to conducting the raffle activity. Registration form should be filed at least 60 days prior to date of raffle. A confirmation letter must be received from Registry of Charitable Trusts prior to conducting activity.



Raffles

- ❖ The registration period is Sept 1 to Aug 31.
- ❖ A single aggregate report for all raffles held during the reporting year (9/1 to 8/31) is due on or before October 1st of each year (Form CT-NRP-2). If the raffle is held as part of a larger fundraiser, record must be maintained of raffle proceeds/expenses separately for reporting.



Raffles

❖ 90/10 rule

- Penal code section 320.5(b)(4)(A) states that 90% of the gross receipts generated by the sale of raffle tickets for any given draw are to be used by the eligible organization for charitable purposes.
- This means only 10% can be used for expenses or operating costs for conducting the raffle.
- 90/10 rule applies to 50/50 raffles. This makes 50/50 raffles therefore illegal in CA since 90% must be used for charitable purposes - except for an exception discussed next.
- Penal code 320.5 is a criminal statute. Violations could be forwarded for potential prosecution.



50/50 Raffles - Major League Sports Raffle Program

- ❖ The CA legislature enacted Senate Bill 549 which added section 320.6 to the Penal code. This authorizes major league sports franchises to conduct 50/50 charitable raffles at home game sporting events effective January 1, 2016.
 - Allows CA professional sports teams and associations to conduct these raffles, whereby 50% of the proceeds from the sale of raffle tickets go to the qualified eligible charity for that particular event and the other 50% goes to the winning ticket holder.



Games of Chance/ Charity Poker Night

- ❖ Eligible non profits are allowed to hold a charity poker night which needs to be approved by the Department of Justice Bureau of Gambling Control
- ❖ Need to register annually and pay registration fee of up to \$100
- ❖ Limits eligible organizations to one fundraiser event per calendar year.



Games of Chance/ Charity Poker Night

- ❖ Events are further limited to no more than 5 hours of duration and set a limit to four events per location unless pre-approved for "rural area"
- ❖ Prohibits cash prizes or wagers to be awarded to participants. Winners are entitled to donated prizes. Individual prizes must not exceed cash value of \$500 per individual and total prizes cannot exceed cash value of \$5,000 (gift cards are not considered cash and are ok)
- ❖ At least 90% of revenue has to go directly to the eligible nonprofit organization for exempt purpose.



Games of Chance/ Charity Poker Night

- ❖ Persons under 21 are not allowed to participate
- ❖ Records must be maintained and provided upon request to the Bureau of Gambling Control.



Backup Withholding

- ❖ All organizations must comply with any tax withholding requirements established by the IRS or CA Franchise Tax Board and any reporting requirements on monetary transactions imposed by state or Federal laws.



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Presenter's Contact Information



Amanda Williams, CPA
Senior Tax Manager
amanda@gilbertcpa.com



Jennifer Iwata, CPA
Senior Tax Manager
jiwata@gilbertcpa.com



Cathy Hudak, CPA
Senior Tax Manager
chudak@gilbertcpa.com

Office Tel. No. 916-646-6464

Relax
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Any Questions?



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CPAs and Advisors

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