2017 AJCU Finance Officers Conference

IRS/Tax Update
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**Agenda**

- Tax Reform - Areas to Watch
  - Charitable Contribution Deductions
  - Endowments
  - Unrelated Business Income

- The Greatest Tax Risks
  - Compensation & Benefits Reporting
  - Alternative Investments
  - International Activities
  - Tax-Exempt Bonds
  - IRS Changes/Activity
Tax Reform - Areas to Watch
Potential impact of tax reform on exempt organizations – watch list

• Proposed changes to personal income tax provisions could affect charitable giving.

• Recent proposals targeting university endowments could play a part in tax reform.

• Unrelated business income tax (UBIT) – change in corporate rates and AMT.

• Changes in foreign tax rates and repatriation could affect the tax efficiency of existing capital structures.

• Repeal and replacement of the ACA would affect employers.
### Legislative paths available for tax reform in 2017

<table>
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<th>Regular legislative process</th>
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| **Benefits** | Legislation can be enacted permanently  
| | No artificial restrictions on which measures can be included |
| **Limitations** | 60 votes needed at every step in the Senate (i.e., to begin debate, vote on amendments, vote on passage, to conference, etc). |

<table>
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<tr>
<th>Budget reconciliation process</th>
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| **Benefits** | Requires only simple majority vote at every step in the Senate (no filibuster allowed)  
| | Expedited consideration (time limits for amendments and overall debate) |
| **Limitations** | Legislation that increases the deficit outside of the budget window (typically 10 years) is subject to automatic sunset or other measures to avoid long term deficit effect  
| | 60-vote Senate super-majority required to waive deficit rule  
| | Senate rules also require reconciliation to be used only to enact measures that have a fiscal effect on the federal budget |
### Potential impact of tax reform on exempt organizations

<table>
<thead>
<tr>
<th>Subject Matter</th>
<th>Potential Change</th>
<th>Impact</th>
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<tbody>
<tr>
<td>Charitable contributions</td>
<td>Proposed changes to personal income tax provisions and the cap on the charitable deduction.</td>
<td>Changes could affect the amount of charitable donations a tax-exempt organization receives.</td>
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<tr>
<td>Endowments/investments</td>
<td>Excise tax of 1% on net investment income, minimum payout requirements, limiting charitable contribution deductions for gifts to endowments, and changing the tax rules relating to offshore investments</td>
<td>Proposals targeted to university endowments – decreases the projected earnings and challenges the efficiencies of investment strategies.</td>
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<tr>
<td>Unrelated business income</td>
<td>Proposals include determining UBI separately with respect to each unrelated trade or business and prohibiting a loss from one trade or business to offset the income from another.</td>
<td>Would require more complex tracking of activities and tax positions. May also have significant impact on annual tax due.</td>
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### Potential impact of tax reform on exempt organizations

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<td>Corporate tax rate</td>
<td>Reduction in top corporate Federal tax rate</td>
<td>Attribute planning and the potential impact on deferred taxes.</td>
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<td>Domestic accounting methods planning; accelerate deductions into higher rate years; defer revenue into lower rate years.</td>
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<td>Corresponding impact to the unrelated business income tax rate.</td>
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Potential impact of tax reform on exempt organizations

Charitable contributions in greater detail

• As individual tax rate decrease, the value of a charitable contribution deduction also decreases

• If the standard deduction is increased, this will decrease the number of individuals who will itemize deductions

• Proposed cap on itemized deductions reduces the tax impact of charitable contributions, or removes the impact completely if an individual’s state tax deduction is greater than the proposed threshold (President Trump’s proposal – itemized deductions capped at $100k for single/$200k for joint filers)

• Tax Policy Center* estimates that the Trump tax proposals would decrease individual giving by 4.5-9% ($13.5-26.1B) in 2017

• The Congressional Business Office estimates that estate tax repeal would decrease charitable contributions by 6-12%

*Source: Urban Institute, Brookings Institution
President Trump (also as a candidate) has made comments regarding endowment spending, the cost of education, and tax exempt status – including:

- Currently too much focus on “using the money to pay their administrators, to put donors' names on their buildings, or just store the money, keep it and invest it.”*

- "I'm going to work with Congress on reforms to make sure that if universities want access to all of these special federal tax breaks and tax dollars, paid for by you, that they are going to make good-faith efforts to reduce the cost of college and student debt and to spend their endowments on their students, rather than other things that don't matter....”*

- “...an education system, flush with cash, but which leaves our young and beautiful students deprived of knowledge,...”**

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*President Trump (at the time Presidential nominee), Campaign Speech - Chester, PA, September 22, 2016

**President Trump’s Inaugural Address, January 20, 2017
# College and University Endowments

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<tr>
<th><strong>CRS Report</strong></th>
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| December 2015, the Congressional Research Service (CRS) published a report describing possible changes to the Federal income tax treatment of college and university endowments. The report discusses four areas of possible tax reform:  
(1) imposing a minimum payout rate on endowments;  
(2) imposing a tax on endowments or endowment earnings;  
(3) limiting the charitable contribution deduction for certain gifts made to endowments; and  
(4) changing the tax treatment of certain offshore investment strategies that use ‘blocker corporations’ in connection with unrelated business income tax planning. |

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<th><strong>Endowment Inquiry</strong></th>
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<td>February 2016, Congress sent a letter to 56 private colleges and universities with endowments over $1B requesting information regarding categories of assets, endowment size and investment return, management costs, spending and use, financial aid to students, real property holdings and conflict of interest review.</td>
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<th><strong>Congressional Hearings</strong></th>
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<td>September 2016, the House Ways and Means Oversight Subcommittee held a hearing entitled “Back to School: Review of Tax-Exempt College and University Endowments” which discussed topics including increased tuition costs, student loan debt and the transparency of the higher education community in managing them.</td>
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*Provides interesting background and proposals*  
*Viewed as laying the groundwork for potential future legislation*  
*Focused on delivery of education-tax proposals discussed briefly*
In December 2016, Rep. Tom Reed (R-NY) proposed the “Reducing Excessive Debt and Unfair Costs of Education (REDUCE) Act”

- Institutions with endowments over $1B to spend 25% of investment gains to reduce the cost of education for the cost of attendance for students of middle and working class families

- Failure to reinvest would yield a 30% tax (with increases to 100%) and potential loss of an organization’s ability to receive charitable contribution deductions
Unrelated Business Taxable Income (UBTI) and the Corporate Tax Rate

• UBTI is detailed on the Form 990-T and taxed at the Federal corporate tax rate

• Proposed decrease of the corporate tax rate would adjust the tax rate for the Form 990-T, decreasing the tax liability for filing organizations

• Proposed repeal of the corporate alternative minimum tax would decrease the complexity of the Form 990-T

• For organizations currently in a positive alternative minimum taxable income position, repeal would decrease the tax liability for applicable organizations

• Proposed corporate tax changes are perceived as “taxpayer friendly”
The Greatest Tax Risks

- Compensation & Benefits Reporting
- Alternative Investments
- International Activities
- Tax-Exempt Bonds
- IRS Changes/Activity
Compensation & Benefits Reporting
**Compensation & Benefits Reporting – Why still important? Key Issues, Risk Factors, & Mitigating Risk**

**Form 990 Reporting**
- All cash & noncash payments or benefits
- Reported on Part VII & Schedule J
- Tie to Form W-2 or Form 1099

**Intermediate Sanctions**
- Are imposed on “disqualified persons” who receive an “excess benefit”
- Essentially an insider who receives a benefit (e.g. compensation) that exceeds FMV in exchange for the goods/services provided

**Rebuttable Presumption**
- Payment presumed to be reasonable under certain conditions:
  - Comparability data
  - Approval by authorized body, and
  - Contemporaneously documented
- Shifts the burden to the IRS to prove that compensation is unreasonable

**Mitigate Risk**
- Establish the rebuttable presumption for all disqualified persons annually
- Consider *all* compensation and benefits
- Establish a compensation committee that approves compensation of executives annually and reports to the Board
- Ensure all employee loans are treated properly for tax purposes and have the proper documentation/approval
Alternative Investments
Alternative Investments

Key Issues & Risk Factors - Alternative Investments

- Managing compliance
- Estimated payments – federal and state
- State tax obligations & state notices
- Tracking investments
- U.S. reporting of foreign transactions
- PTPs, Oil and Gas, & other complexities
Alternative Investments
Common U.S Reporting of Foreign Activities Overview

1. Form 926 & Form 5471
   • Certain direct and indirect transfers to and certain holdings in foreign corporations

2. Form 8865
   • Certain direct and indirect transfers to and certain holdings in foreign partnerships

3. Form 8621
   • Certain holdings in passive foreign investment companies

Penalties for Failure to File

• Forms 926 & 8865 (category 3 filer) – 10% of FMV of property transferred, limited to $100k per form
• Form 5471 - $10,000 per form
• Form 8865 - $10,000 per form
Alternative Investments -
Mitigate Risk - Monitoring within your Organization

1. Identify universe of alternative investments

2. Identify investments which will pass through UBTI & additional filing requirements (partnerships, LLCs, etc.)

3. Follow up with investment managers as often as necessary

4. Develop reliable methods of tracking
   - K-1 UBI workbook
   - Questionnaire
   - Partnership/K-1 checklists
Alternative Investments -
Mitigate Risk - Monitoring within your Organization

5. Have a method to identify direct transfers to foreign entities

6. Focus on the impact of AMT

7. Monitor UBI federal and state to anticipate estimated payments – and have a process to manage state notices

8. Remember UBI is not a bad thing – it just needs to be managed!
International Activities
International Activities

Key Issues to Consider

- Roles and Responsibilities
- Compliance
- Cost
- Safety & Security
- Policy considerations
- Tracking
- Reputation
- Social security
- Withholding obligations
- Export Controls
- Treaty relief
- Personal Income tax
- Corporate and Other Taxes
- Immigration
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International Activities

Tax Risk Factors

• Controls – How does an organization know what is happening abroad?

• Reporting obligations
  • Form 990, Schedule F
  • FBAR
  • Local country reporting requirements
  • CbyC reporting

• Impact on faculty and staff – individual tax reporting
International Activities

Mitigate Risk

Monitor International Presence

- Employees
- Conferences
- Educational Programs
- Investments
- Research

Ensure International Compliance

- Work Permits/Visas
- Payroll Tax issues
- Repatriation
- Withholding
- Permanent Establishment
Tax-Exempt Bonds
Tax-Exempt Bonds

Key Issues & Risk Factors

Post-Issuance Compliance
- Arbitrage calculations
- Allocation elections
- Documentation
- Tracking use of bond-financed space
- Compliance required on all bonds, not just on bonds reported on Schedule K

Form 990, Schedule K Reporting
- Outstanding principal amount in excess of $100,000
- Issued after 12/31/2002, including refunding issue

Private Business Use
- 5% limitation for private use
- Issuance costs are treated as private use
- Exclusions
  - Incidental use
  - Certain short term uses

Risk Factors
- Failure to comply with post issuance compliance could possibly result in remedial action or bonds becoming taxable
- May limit ability to secure future tax-exempt bond issues
- IRS Examinations
**Tax-Exempt Bonds**

*Actions to Mitigate Risk*

- Maintain a Document Retention Policy
  Retain documents for the life of the bond plus 3 years

- Perform an Annual Private Business Use Review

- Proactively Analyze Management Contracts & Leases for Private Use Implications

- Perform Arbitrage Calculations at the End of Every 5th Bond Year

- Timely File the Form 990 with Schedule K Completed

- Consider Equity Allocations at the Onset of Private Use, If Available
IRS Potential Changes/Activities
The IRS Today – Personnel and Funding

• Current IRS Commissioner John Koskinen’s five-year term is scheduled to expire in November 2017
• Current IRS funding is at its lowest level in 15 years (adjusted for inflation)
• FY16 funding bill set IRS budget at $11.2B, up from $10.9B in FY15, and down $1B from the FY10 budget
• IRS staffing has decreased 15,000 employees since FY10
  o Delays in exams and appeals cycle times
  o Examinations occur less frequently
  o Response to cybersecurity and identity theft threats has consumed IRS time and assets
Proposed Changes to the IRS

- The Trump Administration, and Secretary of the Treasury (when nominee) Steve Mnuchin have expressed concerns that the staffing level at the IRS is low “especially for an agency that collects revenue”
  - Increase staff – “We add people, we make money”*
  - Increase examinations and audits

Areas of interest with the IRS:

- Better trained workforce, and improved customer service
- Modernize internal information systems (cybersecurity)
- “Bring the IRS up to date” with technology*

*Bloomberg.com, Mnuchin Calls for Boosting IRS Despite House Plan to Streamline, January 19, 2017
Similar to 2016, the IRS will continue to focus on the following:

- **Tax Exemption** – Non-exempt activity & private inurement
- **Protection of Assets** – Self dealing, excess benefit transactions, & loans to disqualified persons
- **The Tax Gap** – Employment tax & UBTI
- **International Activities** – FBAR, overseas funds
- **Statistical sampling** - In the Tax-Exempt/Government Entities group work plan for FY17 the IRS indicated that they are using statistical sampling more heavily to evaluate overall compliance levels.
IRS examinations – Areas of actual recent focus

- **Diversion of assets** – a media article created focus resulting in multiple examinations
- **Compensation** – may be triggered by media reports, also may be triggered by worker classification matters, reviews might include fringe benefits and special pay plans like deferred compensation, severance, etc.
- **Form 990 inconsistencies** – can be triggered by missing/inconsistent information on the return
- **Tax-exempt bond** – post issuance compliance – focus on policies and procedures, and the tracking of private business use
- **Unrelated business income** – review activities that consistently generate NOLs, and also review the identification of income, and the allocation of expense (direct & indirect)
- **Pension and retirement plans** – review plan compliance, nondiscrimination rules, and annual contribution limits
Questions

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Thank you