Shannon & Associates LLP
Certified Public Accountants
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Not-For-Profit Advisor

COMMITTED TO YOUR SUCCESS

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AN IRS MAGNET - UBIT EXPENSE ALLOCATIONS DRAW SCRUTINY

The IRS is turning its attention to how nonprofit organizations calculate the tax they pay on unrelated business activities. The agency is concerned that many nonprofits may be improperly reporting losses related to these activities and thus may not be paying unrelated business income tax (UBIT).

The stepped-up focus on the reporting of unrelated business income comes in the wake of a recent IRS compliance study of 400 public and private colleges and universities. The agency collected statistical information to determine if it needed to look further into how the organizations allocated expenses. This resulted in 30 IRS audits.

When is unrelated business income taxable?

Let's say you've determined that an activity is unrelated to your exempt purpose. For example, your nonprofit's exempt purpose is to coordinate foster care, and you also run a coffee shop open to the general public to raise additional funds. The coffee shop would be unrelated to your exempt purpose. The excess of unrelated business income over the allowable deductions for that income results in UBIT. When reporting unrelated income, certain expenses — such as staff costs and coffee supplies — are allowed as deductions against that income. They're categorized as directly connected expenses and dual use expenses.

What are "directly connected" expenses?

Deductions incurred solely because of the unrelated business are known as directly connected expenses. These are expenses that wouldn't be incurred if the unrelated business didn't exist.

In the above example, the costs of maintaining a building that's used solely for the coffee shop (the unrelated business) are a directly connected expense, as are the salaries of personnel employed full-time to operate the unrelated business.

What are "dual use" expenses?

If expenses are incurred both to carry on exempt functions and to conduct an unrelated business, they're known as dual use expenses. For example, a nonprofit's president is paid $90,000 per year. If he devotes 90% of his time to the exempt activities of the nonprofit, but 10% of his time to an unrelated business, the organization can take a deduction of $9,000 (10% of $90,000) as a deductible expense of the unrelated activity on Form 990-T.

The allocation of dual use expenses is more complex in situations where the allocation isn't as apparent as in the example above. This is particularly true of the dual use of facilities. According to U.S. Treasury regulations, when facilities are used both to carry on exempt activities and to conduct unrelated business, the expenses, depreciation and anything attributable to such facilities "shall be allocated between the two uses on a reasonable basis."

In such a situation, the nonprofit must first identify the expenses that are incurred for the dual purpose, such as repairs and maintenance, utilities and depreciation.

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There are then two methods that can be applied to allocate those expenses:

1. The Rensselaer method. This is a ratio based on the number of days that the facility is used for unrelated business (numerator) in relation to the total days used for all purposes (denominator) — for example, 64 ÷ 253 (days). This method was named after the court case upon which it was based.

2. The IRS method. This is a ratio based on the number of days the facility is used for unrelated business (numerator) divided by the number of days the facility is available for use — for instance, 64 ÷ 365 (days), or 17.5 % of the calendar year.

Document, document, document

Whether you're deducting direct expenses or allocating dual use expenses, you must produce support for them. Use time sheets to document the percentage of an employee's salary allocatable to unrelated business, and keep facility use records for facilities allocations. Document your reasoning behind any allocations.

In its college/university compliance study, the IRS found that only 16% to 19% of participants relied on the advice of independent accountants or counsel for allocations of expenses between unrelated and exempt activities. With heightened IRS scrutiny, this may be the time to revisit this issue with your accountant.

SIDEBAR: WHY IT MATTERS

Here's the lowdown on what nonprofits have to face if they inaccurately report expenses related to unrelated business activities:

Accuracy-related penalties. The IRS may assess penalties for negligence or disregard of rules or regulations, or for a substantial understatement of income tax. The penalty is 20% of the underpaid tax.

Public access to Form 990-T, "Exempt Organization Business Income Tax Return." Since 2006, 501(c)(3) organizations have been required to make their Form 990-T available to the public. So expect the form — including allocations of expenses — to be scrutinized by the public just as Form 990 has been in the past.

FASB Interpretation No. 48 (FIN48). For nonprofits required to disclose uncertain tax positions on their financial statement footnotes, an incorrect or overly aggressive allocation of expenses to unrelated business income could result in a disclosure under the interpretation. This disclosure is required to be reported on Form 990.

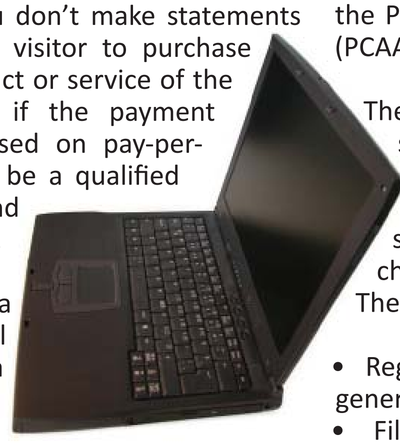
WHEN IS WEBSITE ACTIVITY UBI?

The Internet is a significant communication tool for your nonprofit. Through your website and emails, you can share with your public the organization's purpose, events and other important information. But while handy in disseminating information, the Internet also can create unrelated business income (UBI) and the tax liability that comes with it.

Website activities are subject to the same UBI rules as any other activities, so conducting an unrelated business activity over the Internet is subject to UBI tax as if it were done by any other method. Watch out for these activities:

Website advertising. Website advertising that's unrelated to your exempt purpose could be subject to tax. Banner advertising and graphic ads can be of concern. A moving banner or graphic ad is likely to be taxable if it promotes the goods or services of another.

Website sponsorship. A qualified sponsorship (a mere acknowledgment of the sponsor with no promotion of products or services) won't be subject to UBI tax. Your website, for example, can publish a listing of the sponsors of one of your activities. Or an outside party can sponsor all or part of your website as long as you don't make statements to induce the visitor to purchase or use a product or service of the sponsor. But, if the payment amount is based on pay-per-view, it won't be a qualified sponsorship and will be taxable.



Often, a nonprofit will provide a link from its website to a sponsor's site. Merely providing a link doesn't make the sponsorship payment taxable. If the sponsor's website contains an endorsement of its product or service by your organization, however, the sponsorship payment becomes taxable advertising.

Sequel to UPMIFA

The Uniform Law Commission, the organization that developed the Uniform Prudent Management of Institutional Funds Act (UPMIFA) in 2006, has proposed a new set of rules, the Protection of Charitable Assets Act (PCAA).

The purpose of the proposed act is to safeguard the role of the states in protecting charitable assets by further clarifying the role of the state attorney general, who is the charity "gatekeeper" in most states. The act would require charities to:

- Register with their state attorney general, and
- File a report with that office once a year.

Charities also would be directed to notify the state attorney general of certain events, including dissolution, disposition of assets, merger or transfer to another state.

AS BUSINESS FRAUD STATISTICS GROW, SHANNON & ASSOCIATES AFFILIATES WITH RED FLAG REPORTING

With a typical organization losing 5% of its revenue to fraud each year, it's no wonder that Shannon & Associates, one of the area's largest accounting firms, has affiliated its business with Red Flag Reporting services.

The *2012 Report to the Nations on Occupational Fraud and Abuse* by the Association of Certified Fraud Examiners (ACFE) reported an average loss due to fraud of $140,000 per victim, with more than 20% of victims losing at least $1,000,000. The result of these findings is a concerted effort on the part of Shannon & Associates with the education and training of their employees and clients on fraud prevention, detection, and proactive reporting.

"Unfortunately, we've seen a lot of vulnerability in clients who over-rely on audits and internal controls alone to protect themselves from fraud," states Certified Fraud Examiner and CPA Jessica Kinney of Shannon & Associates. "Businesses today need to focus on protecting their bottom line everywhere possible – not only on spreadsheets, but within their own work environments. Choosing to affiliate with Red Flag Reporting was an easy decision for us – as it is the most cost-effective anti-fraud solution and it's created for organizations of all sizes. It was the perfect fit into our portfolio because it was founded within our industry, by experts with the high standards similar our own," says Jessica.

Red Flag Reporting can help clients achieve 44% less loss from fraud (than those without). In fact, the national average for loss to fraud reported by companies without a hotline is $180,000.

Red Flag Reporting

Protecting Organizations and Their People

"Clients love it because it's a targeted, user-friendly and cost-effective solution to occupational fraud," says Raymond Dunkle, President of Red Flag Reporting. "At Red Flag Reporting, we see it as part of our job to protect a client's bottom line, and so we founded this turnkey program for our affiliated firms to be able to extend the protection to their clients as well. We're ecstatic to see the benefits of this proven system for fraud prevention being utilized by a firm with the stellar reputation that Shannon has."

Red Flag Reporting was created to educate and empower employees with the tools to detect and report unethical behavior. Because tips and complaints are proven to be the number one method of fraud protection (2012 ACFE Report to the Nations on Occupational Fraud and Abuse), the anonymity that hotlines like Red Flag Reporting provides has been shown to make employees feel both protected and alleviated from burden. By adding a new service to our portfolio, Shannon & Associates is now in a unique position to build value and protect our clients.

Red Flag Reporting is your hotline for:

- Fraudulent activity/theft
- Misconduct
- Safety violations
- Unethical behavior

Report concerns safely, securely and anonymously 24/7.

About Red Flag Reporting

Red Flag Reporting's mission is to protect organizations and their people from damages caused by financial fraud and employee misconduct. Developed by experienced fraud investigators and human resources consultants, Red Flag Reporting is a highly effective program to detect and stop costly problems such as embezzlement, false billing, misuse of appropriations and accounting irregularities. The program also addresses employee protection, raising red flags before a work condition leads to a litigious situation. For more information contact Certified Fraud Examiner, Jessica Kinney, CPA, CFE at 253-852-8500 or JKinney@Shannon-cpas.com.

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