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Mergers of Nonprofit Organizations

Article by Warren J. Casey

Over the past few years an increasing number of nonprofit organizations have considered the possibility of merging with another nonprofit organization. This is due both to the impact of the economic crisis on nonprofit organizations, which has greatly reduced public support and other revenues, and a growing trend toward consolidation of services.

So what does a "merger" mean, and how do you go about considering the possibility of a merger?

Here is a starting point:

1. "Mergers" Can Refer to Many Different Forms of Combinations. Mergers span a broad spectrum of alternatives. "Statutory mergers" are creatures of state corporate law, require specific corporate approvals and state filings, and result in the legal combination of two entities into one single surviving entity. On the other end of the spectrum are "collaborations" between organizations. Collaborations are mutual understandings between two or more organizations on how to join resources for a common goal. Between statutory mergers and collaborations are other potential alternatives, such as joint ventures or partnerships, which are documented in a written joint venture or partnership agreement, with a mutually agreed-upon organizational structure.

   The key is recognizing alternatives exist and one size need not fit all.

2. Due Diligence. When considering a combination of two organizations, the first step is due diligence. Initial due diligence, however, does not mean attorney or auditor review of legal contracts or financial statements. Rather, the first step is obtaining an in-depth understanding of each other's organization. How are they managed, how are they governed, what is their culture? What are their most significant outstanding issues, and how are they addressing those issues? What is the appetite for a merger or other collaboration among their governing body and within their staff? What are their financial resources, and how are they addressing any weakness or insufficiency of financial resources? What is their strategy for accomplishing their mission?

   These are just some of the initial due diligence questions, all of which need to be fully answered in order to better assess whether a merger or other collaboration is likely to lead to success.

   Once you are further along in the process and have reached a general meeting of minds, more traditional due diligence needs to proceed, and each organization needs to be willing and prepared to open the tent to the searching eyes of the other organization and its professionals.

   No one wants, or responds well to, surprises, and openness is key to any successful combination. When problems or

significant issues arise, it is far better to have them addressed early in the process when calm and reasoned thinking can find solutions, rather than late in the process, when such issues can potentially undo a proposed combination.

3. Confidentiality. Confidentiality between two organizations discussing a possible merger or collaboration is most important. Each organization needs to carefully guard not only the confidential information it provides to the other organization, but also the confidentiality of the very fact that discussions are occurring. In the very early stages, this is more easily accomplished than as time goes on and more individuals are added to the process, both from within each organization and outside the organizations.

   Organizations should assume that rumors or news of a potential merger or collaboration will occur, and both organizations need to be prepared and to coordinate how best to respond to and address such rumors or news, both with their own staff as well as with their outside constituencies and the general public.

4. What Will You Look Like? Certain fundamental questions need to be considered early on. What will the governing body of any combined organization look like, and who is to be included in a new or combined governing body? Who will be the top executive of the combined organization, and how will that person be chosen? What role will be assumed by the chief executive of the other organization, if any? Which organization will play a greater role in any combined organization, or is it meant to be a "combination of equals" (It seldom is)? What will the reaction of each organization's staff likely be when faced with the prospect of a collaboration? What will the combined staff look like, and are staff reductions likely? Is the organization prepared for the likelihood of losing good people who simply do not wish to be part of a combined organization?

   There are seldom any clear or easy answers to these fundamental questions. Further, the original plan with respect to one or more of these matters may and likely will change over time. However, being open and realistic about each of these areas is critical in the road to a successful collaboration.

5. Balance the Positive With the Negative. Nonprofit organizations are generally unlike private industry when it comes to mergers and collaborations. Private companies are often more willing and able to take the hard actions necessary to make a merger or similar combination successful. Very often private industry is also more adept and experienced at accomplishing mergers and acquisitions, generally with a closetful of past lessons and hard-earned experience in what not to do in future transactions. Private industry also generally has the human and capital resources available to approach and complete mergers, acquisitions and other combinations.

   The nonprofit sector, as a whole, is generally far less experienced in accomplishing mergers and other combinations and may tend to focus more on the potential significant benefits and positive results without equal weight being given to the problems and difficulties that inevitably accompany any significant combination. Going in with your eyes wide open is important.

6. Timing. Completing a merger or other collaboration takes considerable time, no matter what the desires of the parties. The thoughts, insight and sensitivities of each organization's governing body and staff need to be carefully addressed, and all of the structural aspects of any combination need to be fully thought out and mutually resolved, which generally takes more time than expected.

The best approach in considering any potential combination of organizations is to do all of your homework, particularly as to governance, staff and culture. Structure should then follow, not lead.

IRS Releases Report?On Underreporting Of Unrelated Business Taxable Income At Nonprofit Educational?Institutions

Article by Linda L. D'Onofrio

The Internal Revenue Service (IRS) recently released a report (Report) summarizing its findings after a multiyear compliance examination of tax-exempt colleges and universities following the distribution of detailed questionnaires to 400 randomly selected entities. As the Report outlines, the IRS chose 34 of the 400 for examination because of their responses and reporting on their Forms 990-T, which indicated potential noncompliance in the areas of unrelated business income and executive compensation.

The Report provides that the examinations uncovered substantial underreporting of unrelated business taxable income (UBTI). By way of background, unrelated business income (UBI) is income derived from a trade or business regularly conducted by an exempt organization that is not substantially related to its exempt purpose. UBTI is the UBI that is taxable after deducting expenses directly connected to the trade or business. Because UBTI is calculated by totaling the UBI from all activities and subtracting the total allowable deductions, losses from one activity can offset profits from another.

The Report outlines that the 34 examinations resulted in the following:

- An aggregate of $90 million of increases to UBTI for 90 percent of the entities;
- More than 180 changes to the amount of UBTI reported by the entities on their Forms 990-T; and
- Disallowance of more than $170 million in losses and net operating losses (NOLs) that could amount to more than $60 million in assessed taxes.

As the Report presents, the IRS found that the primary reasons for increases to UBTI in the completed examinations were:

- *Disallowance of expenses not connected to unrelated business activities:* The examined entities were reporting certain losses as being connected to unrelated business activities when, in fact, they were not. The Report notes that the misreporting occurred in two ways:
    - *Lack of profit motive:* Organizations were claiming losses from activities that did not qualify as a trade or business, and nearly 70 percent of the entities reported losses from activities for which expenses had consistently exceeded UBI for many years. The IRS noted that UBI must be generated by a "trade or business," i.e., an activity the taxpayer engages in with an intent to make a profit, and that a pattern of recurring losses indicates a lack of profit motive. The IRS disallowed reporting of activities for which the entity had failed to show a profit motive, which meant that those losses could no longer offset profits from other activities in the current year or future years, and so disallowed more than $150 million of NOLs.

- *Improper expense allocation:* The IRS also found that nearly 60 percent of the Forms 990-T examined demonstrated that the entities had misallocated expenses to offset UBI for specific activities where those expenses were not related to the unrelated business activity.

- *Errors in computation of substantiation:* The IRS found that, on more than one-third of the returns NOLs were either improperly calculated or were unsubstantiated, and so disallowed nearly $19 million in NOLs.
- *Reclassifying exempt activities as unrelated:* The IRS determined that nearly 40 percent of the entities examined had misclassified certain activities as exempt or as otherwise unreportable on their Forms 990-T. The IRS also found that fewer than 20 percent of those activities had generated a loss, and so reclassified nearly $4 million in income as unrelated, subjecting those activities to taxation.

The examinations resulted in more than 180 changes to UBTI reported for more than 30 different specific activities. The majority of the adjustments came from the following activities: fitness, recreation centers, and sports camps; advertising; facility rentals; arenas; and golf.

The Report continues with an extensive informative discussion of the IRS findings on compliance with executive compensation under Section 4958 of the Code.

Although the focus of the Report is on the IRS' study of colleges and universities, the principles and findings outlined in the report are relevant and instructive for all nonprofit organizations. We encourage you to read the Report, which can be found at http://www.irs.gov/pub/irs-tege/CUCP_FinalRpt_042513.pdf.

"Self-Declared" Exempt Organizations: Change Is in the Air

Article by Jennifer M. Pagnillo

Unlike Section 501(c)(3) organizations, which must apply to the IRS for recognition of tax-exempt status, Section 501(c)(4) social welfare organizations, Section 501(c)(6) business leagues and others are able either to apply to the IRS for a determination letter recognizing tax-exempt status or to "self-declare" tax-exempt status by conducting operations in a manner consistent with tax-exempt status.

Until recently, if a self-declared organization later applied for a determination letter from the IRS, it would usually receive a letter recognizing its tax-exempt status retroactively to the date of that organization's formation, regardless of the length of time between the date of its formation and the date of its application to the IRS.

However, on January 7, the IRS issued Revenue Procedure 2013-9, which provides, among other things, that a self-declared organization that applies for a formal determination letter more than 27 months after its formation will now normally receive a letter recognizing its tax-exempt status from the date of its application rather than from the date of its formation. This is similar to the rules that always applied to Section 501(c)(3) organizations, which allow for retroactive recognition of determination only if the organization applies within 27 months of its formation.

In addition, the IRS recently announced it is undertaking a voluntary compliance check of more than 1,300 self-declared organizations. Selected organizations will be asked to complete a questionnaire (Form 14449) designed to provide extensive information to the IRS as to the organization's operations. Completion of the questionnaire is voluntary, but the IRS may choose to open a formal audit investigation into any organization that refuses to participate. Of course, the IRS may open a

formal audit investigation in any event, based on the information disclosed by an organization that voluntarily completes the questionnaire.

The questionnaire requests information regarding revenues, expenses, activities (including political campaign activities), executive compensation and benefits. Perhaps most important, question 6 in Part I asks the organization to describe the reasons why it did not apply to the IRS for recognition of its tax exemption. The questionnaire can be found at http://www.irs.gov/pub/irs-tege/Form14449.pdf.

Of course, at this time there are ongoing congressional hearings to investigate the IRS' use of inappropriate criteria to delay the exemption applications of certain social welfare conservative groups (based on names such as "Tea Party" and "Patriot"), and it is unclear what impact this may have on the IRS' planned voluntary compliance check of self-declared organizations. As a result of this scandal, new leadership is in place at the IRS; acting IRS Commissioner Steven Miller has resigned and Lois Lerner (director of exempt organizations at the Internal Revenue Service) has been placed on administrative leave.

In addition, new regulations adopted on June 5 by New York State Attorney General Eric T. Schneiderman (which are effective immediately) now require certain disclosures by Section 501(c)(4) organizations and other nonprofits that are registered with the New York Attorney General under Article 7-A of the New York Executive Law and/or Article 8 of the New York Estates, Powers and Trusts Law.

These organizations (other than Section 501(c)(3) organizations) must now submit itemized schedules with their annual financial reports, disclosing the amount and the percentage of the organization's total expenses during the reporting period that are "election related expenditures" (those made for express election advocacy or election targeted issue advocacy, as defined in the regulations).

In addition, organizations that spend more than $10,000 per year on New York state and local elections must also disclose:

a. each expenditure of $50 or more made in connection with a New York state or local election (including the recipient's name, the date, the amount and the purpose); and

b. each contribution of $1,000 or more received from a single donor, including the donor's name, employer (if known), the amount and date of the contribution; provided, however, that this information need not be disclosed if:

    i. the contribution was made to a segregated fund that is not used for electioneering in New York; or

    ii. the organization or the donor applies for a waiver from the New York Attorney General after establishing that there is a reasonable likelihood that disclosure of donor's name will cause undue harm, threats, harassment or reprisals.

These itemized schedules will be made available to the public on the New York Attorney General's website.

AG Schneiderman explained the rationale for the new regulations in a statement, saying, "There is only one reason to funnel political spending through a 501(c)(4), and that is to hide who has bankrolled the effort. By shining a light on this dark corner of our political system, New York will serve as a model for other states, and for the federal government, to protect the integrity of nonprofits and our democracy."

New Regulations for Type III Supporting Organizations

Article by Brooke Pollak

Effective December 28, 2012, the Internal Revenue Service (IRS) issued final and temporary regulations regarding "Type III supporting organizations" under Internal Revenue Code ?509(a)(3)(B)(iii). "Supporting organizations" are entities that are not themselves publicly supported but rather have public charity status by virtue of supporting a public charity. Supporting organizations are further classified into "Types" (I, II or III) depending on the relationship between the supporting organization and its supported public charity. The Pension Protection Act of 2006 added provisions to the Internal Revenue Code intended to more tightly regulate supporting organizations because of actual and perceived abuses in the operation of Type III supporting organizations, those that have the loosest connection with their publicly supported charities (are operated "in connection with" a supported public charity).

In order to qualify as a supporting organization, an entity must meet an organizational test, an operational test, a disqualified person control test and a relationship test. The newly issued regulations focus mainly on the relationship test and clarify that Type III supporting organizations must meet (i) a notification requirement?-- requiring it to annually provide particular documents to its supported public charity; and (ii) a responsiveness test?-- requiring the supported public charity to have a significant voice in its operations. Type III supporting organizations are further classified into those that are functionally integrated (FI) and those that are non-functionally integrated (NFI) with their supported public charity.

To further determine whether a Type III supporting organization is FI or NFI, the entity must meet an integral part test, which is satisfied if substantially all of the entity's activities are "direct furtherance activities" (i.e., those that directly further the exempt purposes of the supported public charity and would be undertaken by it if not for the entity). Merely controlling the assets of a supported public charity, such as managing its endowment fund or fundraising, is not a direct furtherance activity (unless the entity is the parent of its supported public charity). Rather, running specific charitable programs on behalf of the supported public charity is a direct furtherance activity.

A Type III supporting organization that does not meet the integral part test is classified as NFI. NFI Type III supporting organizations are subject to a mandatory payout requirement (not unlike that required for private foundations), and they must annually distribute the greater of 85 percent of adjusted net income from the prior tax year or 3.5 percent of the fair market value of nonexempt-use assets. At least one-third of this distribution must be to one or more supported public charities that are "attentive" to the supporting organization, defined with respect to the amount of support received by them from the supporting organization.

The new regulations are complex, and the above is only a broad overview of some of the changes imposed. If you have any questions about how these regulations affect your organization, you should contact your tax advisor.

Updated I-9 Employment Eligibility Verification Form

Article by Daniel L. Schwartz and Basil C. Sitaras

All employers, including nonprofit organizations, are required to verify the identity and employment authorization of individuals hired to work in the United States, citizens and noncitizens alike, within three business days of the first date of active employment. An employer satisfies this requirement by completing Employment Eligibility Verification Form I-9 (Form I-9), as provided by the Department of Homeland Security's U.S. Citizenship and Immigration Services (USCIS). Earlier this year, USCIS published an updated Form I-9 that employers were required to use commencing on May 7, 2013. Prior versions of Form I-9 no longer can be used for new hires or necessary re-verifications, and failure to use the updated Form I-9 could subject an employer to monetary penalties. The new Form I-9 is available for free download here.?

In general, the updated Form I-9 contains several revisions that USCIS states are "designed to minimize errors in form completion." Such revisions include a) adding data fields; b) improving the form's instructions; and c) revising the layout of the form and expanding the core form from one to two pages.

The most common question we anticipate from the new Form I-9 is, "For whom do I need to complete this updated Form I-9?" As stated above, all employers must use the updated Form I-9 going forward for all new hires and re-verifications. Although the term "new hires" is self-explanatory, there may be some confusion regarding re-verifications. As a threshold matter, employees who are U.S. citizens never need re-verification. For all other employees, the employment authorization must be re-verified upon the expiration of their employment authorization and/or immigration status. Thus, while employers must remain cognizant of the expiration dates of these documents, they also should be careful not to seek or require unnecessary re-verifications, because such action could lead to claims of race or national origin discrimination.?

For further information, you may want to review the Notice from the Federal Register regarding the updated Form I-9 and USCIS' Guidance for Completing Form I-9.