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A FIN 48 UPDATE FOR EXEMPT ORGANIZATIONS

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Like the redesigned Form 990, FIN 48 will cause organizations to take a closer look at their tax positions.

Two years ago, it appeared that all organizations would have to immediately adopt FIN 48, a major new accounting rule with respect to accounting for income taxes. On 2/1/08, however, the Financial Accounting Standards Board (FASB) deferred the effective date of FIN 48 for all organizations, except for public enterprises, to fiscal years beginning after 12/15/07.[1] Most tax-exempt organizations are not public enterprises and so were able to take advantage of this deferral. On 12/30/08, FASB again deferred the effective date of FIN 48 for nonpublic enterprises until fiscal years beginning after 12/15/08.[2] Finally, in 2009, the FASB staff clarified that all exempt organizations are subject to FIN 48 even if the only tax position in question is tax-exempt status itself, and that such entities must review other tax positions for their possible uncertainty as well.

FIN 48 provides a specific methodology to be followed in analyzing tax positions in order to create uniformity in accounting for income taxes. This uniformity allows investors, lenders, creditors, donors, and others to have a more accurate financial picture of an enterprise, thus promoting transparency. Greater transparency provides stakeholders the information needed to better allocate resources. FIN 48 is applicable to all enterprises using generally accepted accounting principles (GAAP) for financial accounting purposes, including all Section 501 and 401 entities. With certain Section 403(b) retirement plans now requiring audits, these entities also will be required to adopt FIN 48.[3]

FIN 48 is a two-step process—recognition and measurement. In step one, all tax positions or units of account are identified. The positions are then analyzed to determine their degree of certainty. If the position has a high degree of certainty, the basis for the certainty should be documented. If the position is uncertain, a determination based on the technical merits should be made as to whether it is more likely than not that the position would be sustained upon audit. If it is less likely than not that the position would be sustained, the amount of the potential liability should be measured—i.e., step two. If the aggregate of all uncertain tax positions is material, then there must be disclosure in the financial statements.

What is a tax position?

A tax position is a position taken on a tax return. It is also a decision to not file a tax return or not pay income taxes. A tax position can be the underreporting of taxable income that may result from underreporting income and/or overstating deductible expenses. Exemption itself is a tax position.[4]

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A tax position can occur at the state or local, federal, or international level. Like an IRS examination, the focus of FIN 48 is the open tax years of an organization—i.e., the potential liability of the organization, based on the technical merits of an issue, if it were audited. An organization must assume that all facts and circumstances would be known to taxing authorities and that the organization would be audited. One could consider FIN 48 adoption similar to a mock audit of the organization, but only in regard to taxes that are based on income.

The existence of a tax position is separate from the consideration of uncertainty about that position.

FIN 48 documentation objectives

The objective of FIN 48 documentation is for the organization to be able to present to its accountants auditable data that demonstrates the degree of certainty of tax positions and quantifies any uncertain tax positions so that a determination can be made as to whether there are material uncertain tax positions that must be disclosed on its financial statements.

The existence of a tax position is separate from the consideration of uncertainty about that position.[5] For example, an item of deduction is a tax position, but whether or not that item is properly and fully deductible may not be certain. Because exemption is a tax position, there should be documentation that establishes the level of certainty of that position. Documentation of exemption, for example, could include an affirmation that current activities are those that were stated on Form 1023 or 1024; the absence of private inurement and substantial private benefit, and a showing that unrelated activities are not substantial. If the organization is a Section 501(c)(3) public charity, it would include a statement that lobbying is insubstantial and there are no political activities. For a trade association, an affirmation would state that activities are primarily to promote the industry as a whole and not designed primarily to provide particular services to members.

Taking an inventory of tax positions could begin with reviewing Forms 990 and 990-T, financial statements, and tax returns of entities in the consolidated financial group. Also, opinions of tax advisors, private letter rulings, major contracts, joint venture agreements, and prior audit activity should be reviewed. However, even though an organization was previously audited and the activities remain the same, the organization should not assume that it has no uncertain tax positions for purposes of FIN 48. Prior audits will provide valuable information, but cannot be relied upon for several reasons. First, when the IRS conducts an examination, although the agent may request an enormous amount of information through the IDR (Information Document Request) process, the Service only gets the information it requests. There may be other issues about which it did not inquire. FIN 48 assumes that all relevant facts would be known.

Furthermore, the IRS may have conceded one issue in favor of pursuing another issue with a higher dollar amount. FIN 48 provides that each issue must stand on its own without regard to offsets.[6] The IRS also may have conceded an issue because at the time there were hazards of litigation. FIN 48 analysis should take into account litigation and legislation subsequent to the audit that would change the out-

[1] See FASB Staff Position (FSP) FAS 140-4 and FIN 46(R)-8 citing paragraph E1 of FASB Statement No. 132 (revised 2003), "Employers' Disclosures about Pensions and Other Postretirement Benefits," regarding nonpublic entities, including: "Any entity (enterprise) other than one (a) whose debt or equity securities trade in a public market either on a stock exchange (domestic or foreign) or in the over-the-counter market, including securities quoted only locally or regionally, (b) that is a conduit bond obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets), (c) that makes a filing with a regulatory agency in preparation for the sale of any class of debt or equity securities in a public market, or (d) that is controlled by an entity (enterprise) covered by (a), (b), or (c)." See also www.fasb.org/project/fin46randfas140_disclosure_requirements.shtml.

[2] If a tax-exempt organization is considered a public enterprise because it uses tax-exempt bonds that are offered to the public, and if it did not previously adopt FIN 48 and now finds that there were material uncertain tax positions, it appears that such an organization may be required to restate its financial statements for that prior fiscal year.

[3] A U.S. Department of Labor Notice issued 11/16/07 eliminated an exemption granted to Section 403(b) plans from the annual Form 5500 reporting requiring an independent audit for many plans. See Department of Labor Field Assistance Bulletin 2009-2.

[4] See FSP FIN 48-d, #17.

[5] See FSP FIN 48-d, #21.

[6] See FIN 48-7(c).

[7] See Portland Golf Club, 497 US 154, 5 AFTR2d 90-1162 (1990); Groetzinger, 480 US 23, 59 AFTR2d 87-532 (1987).

[8] See Form 14018 (9-2008), page 7

[9] Rev. Rul. 98-15, 1998-1 CB 718, points out in Butler, 36 TC 1097 (1961), *acq.* 1962- 2 CB 4, the court examined the relationship between a partner and a partnership for purposes of determining whether the partner was entitled to a business bad debt deduction for a loan he had made to the partnership that it could not repay. In holding that the partner was entitled to the bad debt deduction, the court noted that: "By reason of being a partner in a business, petitioner was individually engaged in business." Butler, 36 TC at 1106, citing Ward, 20 TC 332 (1953), *aff'd* 224 F.2d 547, 47 AFTR 1472 (CA-9, 1955).

[10] There also could be unrelated debt financed income if an organization incurs debt to purchase a partnership interest. See Reg. 1.514(c)-1(a)(2), Example 4, which provides that both debt incurred to acquire a partnership interest and debt incurred by the partnership to acquire property are included in calculating a tax-exempt partner's acquisition indebtedness.

come of a tax position. The IRS may also have not pursued an issue because at the time of the audit there was no net income being generated from the activity and, therefore, nothing to tax. Although the activity is still the same, there may now be substantial net income from the activity.

Finally, the IRS may have instructed an organization to take certain actions. For example, the organization might have been instructed to put a substantial unrelated activity into a taxable subsidiary. Although the organization may have transferred the activity on the books and legally to a taxable subsidiary, if the two organizations are operated as one entity—with identical board members, officers, and key employees and no separate board meetings or minutes—the degree of certainty of exemption could require further analysis.

Potential uncertain tax positions

Unrelated business taxable income is gross income derived from unrelated business activities less deductions "directly connected with" those activities. For an activity to be considered an unrelated trade or business it must be (1) a trade or business, (2) regularly carried on, and (3) not substantially related to exempt purposes, which is a facts-and-circumstances test. If there are losses from the activity on a continual basis, the IRS and the courts have taken the position that there is no profit motive and therefore the trade or business requirement has not been met.[7] If the trade or business test has not been met, it follows that the losses generated from that activity cannot be used to offset the unrelated business income from another activity.

If an organization is reviewing its tax positions and has been using losses from an unprofitable activity to offset other unrelated business income, the organization should document whether there may be some logical explanation for the activity to have generated a loss. In fact, the IRS provides some possible reasons in its recent College and University Survey[8] as follows:

- The business was in start-up phase.
- Actual costs were significantly greater than anticipated or budgeted.
- Competitive pressures prevented pricing to allow for full recovery of costs.
- There was less demand for the product or service than was projected.
- The business was in a business cycle downturn.
- The business was budgeted to operate at breakeven or a loss because doing so contributed to the organization's exempt mission.
- The business was in a winding-up phase.

Since the deduction is a tax position that is uncertain, it must be tested in order to determine if it is more likely than not that it would be sustained on audit. Note that if a net operating loss is generated in a prior year that is closed for assessment, it appears that the FIN 48 analysis should cover the basis of the deduction in the prior year.

Alternative investments

Exempt organizations frequently invest through partnerships or limited liability companies (LLCs), which for these investors constitute "alternative investments." An organization that has no uncertain tax positions relating to its activities may in fact have a multitude of uncertain tax positions from such alternative investments.

Many exempt organizations invest in partnerships through "blocker" corporations that generate no unrelated business income to the tax-exempt shareholders because they receive dividends. However, where an exempt organization invests directly in a partnership, or in an LLC treated as a partnership for tax purposes, there may be unrelated business income (UBI).

Section 512(c) provides that partnership income (whether or not actually distributed) is taxable as UBI if the activity of the partnership would have generated UBI if the organization had entered into the activity directly. The exempt partner is actually deemed to be involved in the trade or business of the partnership.[9]

Exemption itself is a tax position.

Partnerships and limited liability companies must provide investors with Forms K-1 that indicate the partner's distributive share of items such as income, loss, credit, and deductions. Exempt organizations that invest in partnerships should notify the partnership of their tax-exempt status so the partnership will furnish the partner with the information needed to determine whether there is unrelated business taxable income.

Debt financing is often the cause of unrelated business income from partnerships that invest in real estate.[10] Entities such as schools, universities, and pension trusts may be considered "qualified" organizations that may be eligible for an exception under Section 514(c)(9) to the unrelated debt-financed income rules. A determination should be made as to whether the exception applies and whether unrelated trade or business income and losses have been properly reported on Forms 990-T.

If the investment is in an oil or gas partnership, a determination must be made as to whether depletion has been properly reported. There is interplay between the net operating loss, charitable contributions, and depletion that may require calculations to be performed by an expert.

These examples only scratch the surface of the possible UBIT issues that arise with alternative investments, but they give a sense of the issues that must be examined. Various other rules could apply. For example, if an exempt organization partner owns more than 50% of the partnership interests, the partnership is required to report using the same tax year as that organization.[11] If the partnership is not reporting properly, this could result in an overstatement or understatement of taxable income.

State taxes

A tax-exempt organization may have uncertain state and local tax positions because it has operations in another state and has not appropriately filed for exemption or filed tax returns. Because an organization that is a partner in a partnership may be deemed to be in business in another state, a determination must be made regarding whether unrelated business income or loss should be reported in the jurisdictions where the partnership has nexus.

An organization may have a multitude of uncertain tax positions from 'alternative' investments.

Also, state rules differ greatly on how such income is reported. An apportionment/sourcing of income review would compare the state mandated rules for reporting K-1 type receipts and compare that to the manner in which the organization has reported such items to the states.

Foreign tax credits

A partnership may be located in a foreign country and may be required to pay taxes on the income earned in that country. The taxes may be imposed at different rates upon different types of income and the rates will vary depending upon the country imposing the tax. The Form K-1 will provide some indication of foreign taxes paid.

The question for the exempt organization investor is whether the tax paid is related to unrelated business income and whether the foreign taxes paid can be credited against the U.S. unrelated business income tax.[12]

Consolidated entities

Form 990, Schedule D, now requires that an organization provide its FIN 48 footnote.[13] FIN 48 provides that all organizations in a consolidated group covered under the audited financial statements must document uncertain tax positions. All uncertain tax positions must be aggregated to determine if the aggregate of such positions is material. Clearly, one organization that is part of the consolidated reporting group may have uncertain tax positions, whereas others in the group may have none. Also, several organizations in the group may have uncertain tax positions that are not in and of themselves material, but are material when aggregated with other entities in the group. The instructions to Schedule D address the situation as follows:

> Any portion of the FIN 48 footnote that addresses only the filing organization's liability must be provided verbatim. The filing organization may summarize that portion, if any, of the footnote that applies to the liability of multiple organizations including the organization (for example, as a member of a group with consolidated financial statements), to describe the filing organization's share of the liability.

Based on these instructions, it appears that if an organization has no uncertain tax positions that contributed to the FIN 48 disclosure, that organization would not disclose the FIN 48 footnote on its Form 990. If an organization in the consolidated group itself has material uncertain tax positions, that portion of the footnote must be stated verbatim. If an organization in the consolidated group contributed to the aggregate of the uncertain tax positions of the group, that entity would have to describe its share of the liability.

Taxable subsidiaries

If an exempt organization has a wholly owned taxable subsidiary, that entity will be part of the consolidated group and the adoption of FIN 48 will cover the subsidiary as well. There are many tax positions that are created by the relationships between taxable and tax-exempt entities. For example, Section 512(b)(13) may cause certain payments of rent, royalties, interest, or annuities to be taxable income to the exempt organization.

Furthermore, the question arises as to whether administrative or non-mission services provided

[11] See Section 706(b)(1)(B)(I).

[12] See Section 515.

[13] Page 4 of the Instructions to Schedule D of Form 990 states: "Every organization required to complete Part X must provide the text of the footnote to its financial statements, if applicable, regarding the organization's liability for uncertain tax positions under FIN 48."

[14] Reg. 1.482-1(i)(4) defines "controlled" to include any kind of control, direct or indirect, legally enforceable or not, however exercisable or exercised. This includes control resulting from the actions of two or more taxpayers acting in concert or with a common goal or purpose. It is the reality of the control that is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted.

[15] For a controlled taxpayer, Reg. 1.482-1(i)(9) defines "true taxable income" as the taxable income that would have resulted had it dealt with the other member or members of the group at arm's length.

by the exempt organization to a related taxable entity create unrelated business income. Many exempt organizations provide services to related entities at cost, so there may be no net unrelated business income. If the exempt organization makes a profit or has a loss on the services provided to the related entity, there may be uncertain tax positions. If the activity creates a loss, as stated previously, the activity may not be considered a trade or business and it is possible that the loss may not be available to offset income from another unrelated trade or business. If the activity creates a profit and is unrelated to the exempt purpose of the organization, the income from the activity may be subject to the unrelated business income tax. Finally, the relationship and activities between the organizations may create issues under Section 482.

Section 482 is an issue that typically arises in the context of a U.S. company shifting income to a foreign jurisdiction where tax rates may be lower. Where there are controlled entities[14] a taxable corporation may shift income to a tax-exempt organization and create a Section 482 issue as well. For example, if a taxable entity makes widgets that are related to the exempt purpose of an organization and sells the widgets to the exempt organization at cost, there is no net income to tax. If the exempt organization in turn sells the widgets that are related to its exempt purpose, because that activity is related to its exempt purpose, the gain again is not taxed. This scenario can create uncertain tax positions for both organizations; such as whether there should be a reallocation to clearly reflect true taxable income.[15]

Conclusion

FIN 48 provides an analytical framework by which an organization accounts for income taxes. This methodology is intended to promote transparency and must be adopted coincidentally with the new Form 990, which also serves the purpose of promoting transparency. Both the new Form 990 and FIN 48 will cause organizations to take a closer look at tax positions including whether net operating losses are properly used to offset unrelated business income from other activities, allocation of expenses, state tax issues, and issues that arise from alternative investments. ■

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