Scrutiny on the Rise & Continuing

- Senator Baucus & Senator Grassley sent a letter to Secretary of the Treasury on May 25, 2007, encouraging a redesign Form 990 & specifically expressed concern with UBIT.
- Steve T. Miller, Commissioner, Tax Exempt and Government Entities Division, gave a testimony on July 24, 2007, before Oversight Subcommittee of the House Ways and Means Committee where he noted that a significant number of exempt organizations reported losses on Form 990-T.

Scrutiny on the Rise & Continuing

- In September 2008, IRS sent 400 questionnaires to colleges & universities asking about their unrelated business income (UBI), endowments, executive compensation & related organizations.
  - 16 of 33-page questionnaire focused on UBI & related organizations.
**Scrutiny on the Rise & Continuing**

- IRS college & university questionnaire focused on the following
  - Types of related organizations (taxable or exempt)
  - If organization has written policies which are designed to assure that transactions with related organizations are made at arm’s length
  - How organization determines pricing with related organizations
  - What types of revenue streams organization considers UBI
  - Expense allocation methods used

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**Polling Question #1**

- How does your organization currently determine pricing in its dealing with related entities?
  - A. Formal transfer pricing study
  - B. At cost
  - C. Structured to eliminate income of related entities
  - D. An estimate of what is believed to be fair market value
  - E. I do not know

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**Scrutiny on the Rise & Continuing**

- IRS Fiscal Year 2011 work plan
  - Controlling Organizations – Tax treatment of payments between controlled entities & their controlling tax-exempt parent organizations touches on several areas of tax law including unrelated business income, the allocation of income & deductions among taxpayers & transfer of property to controlled organizations
Scrutiny on the Rise & Continuing

- IRS Fiscal Year 2012 work plan
  - 990-T & UBIT — will be looking at organizations that reported unrelated business activities of Form 990 but have not filed a Form 990-T. In addition, IRS will analyze Form 990-T data to develop risk models that will help them identify organizations that consistently report significant gross receipts from unrelated business activities but declare no tax due
  - IRS will use this work in connection with a UBIT project

Scrutiny on the Rise & Continuing

Scrutiny on the Rise & Continuing
Polling Question #2

• Does your organization have formal written policies in place that document transactions with related entities?
  a. Yes
  b. No
  c. I don’t know

What is Transfer Pricing?

• Analyzes prices for transactions between related parties in different tax jurisdictions
  o Commonly seen with regard to cross-border international intercompany transactions
  o Has application to transactions between tax-exempt organizations & their related for-profit entities
• Transfer prices should be on an arm’s length basis
  o As if the related parties were unrelated

What is Transfer Pricing?

• Why would it apply to transactions that take place between tax-exempt organizations & their related for-profit entities?
  o For-profit entity is taxable & its taxable income could be affected by its dealings with its related tax-exempt organization – hence, amount of taxes it pays would be affected
Applicability

- We have been involved in transfer pricing reviews for the following types of exempt-organizations
  - Universities & colleges
  - Associations & other membership groups
  - Hospital systems
  - Insurance
  - Power cooperatives
  - Foundations
  - Religious organizations

Transfer Pricing Rules

- Relevant Rules/Regulations
  - Section 482 of Internal Revenue Code contains applicable rules & regulations by which to properly price activities that take place between tax-exempt organizations & their related for-profit entities

Examples of Relevant Transaction Types

- Sale of tangible goods
  - Sale of finished goods
  - Sale of raw materials & work in progress
  - Commission & purchasing agent services
  - Transfer of production machinery
Examples of Relevant Transaction Types

• Real life intercompany sale of goods example
  o Tax-exempt organization produces & sells religious literature to churches of a certain religious denomination. It also produces & sells religious literature to its taxable subsidiary that resells it to other religious denominations that are not core to its mission. Transfer price of literature must be determined between two entities.

Examples of Relevant Transaction Types

• Transfer of intangible property (IP)
  o Transfer of technology IP
    • Know-how
    • Patents
    • Processes
    • Formulations
    • Copyrights, etc.
  • Transfer of marketing IP
    • Trademarks
    • Trade names
    • Brand names
    • Reputation
    • Customer relationships
    • Customer lists
    • Sales force, etc.

Examples of Relevant Transaction Types

• Real life intercompany transfer of IP example
  o Tax-exempt association which produces research materials for its members has a taxable entity which provides consulting services to the members for a fee. Taxable entity utilizes know-how & proprietary information owned by tax-exempt organization to provide consulting services to its clients. An arm’s-length royalty should be paid by taxable entity to tax-exempt organization.
Examples of Relevant Transaction Types

• Provision of intercompany services
  o Management services
    ▪ Strategic management
    ▪ Finance
    ▪ IT
    ▪ HR
    ▪ Marketing
    ▪ Legal
    ▪ Administrative, etc.
  o Technical services
  o Development services
  o Manufacturing
  o Other

XYZ Tax Exempt Organization 1

XYZ Taxable Organization 1

XYZ Tax Exempt Organization 2

XYZ Taxable Organization 2

Examples of Relevant Transaction Types

• Real life intercompany provision of services example
  o Taxable insurance company creates an HMO which is housed in a tax-exempt entity. Taxable entity provides back office & other support services to tax-exempt HMO. Arm’s-length service fee should be paid by tax-exempt entity to taxable entity

Examples of Relevant Transaction Types

• Financing
  o Provision of intercompany loans
  o Guarantee fees by parent company
  o Cash pooling arrangements
  o Leasing of tangible property
Examples of Relevant Transaction Types

- Real life intercompany loan example
  - Tax-exempt U.S. university has loans to its for-profit campuses overseas. Foreign tax authorities want to ensure that rate of interest is arm’s-length

- Real life intercompany lease example
  - Taxable mortuary owns real estate that is used by its parent, which is a tax-exempt entity operating cemeteries. Lease of real estate has to be priced on arm’s-length basis

Polling Question #3

- Transfer pricing applies to the following types of activities that take place between related parties
  a. Goods
  b. Services
  c. Financing
  d. All of the above
  e. I don’t know

Other Uses of Transfer Pricing Rules

- Transfer pricing regulations are often used to determine profits related to Unrelated Business Income (UBI) & to determine fair market value (FMV)
  - Real life UBI & FMV example - Tax-exempt university receives a payment from a professional sports team to practice on its campus. Some of services can be classified as exempt activities while others are taxable. Transfer pricing rules can be used to first segment costs between taxable & non-taxable activities. They can then be used to determine FMV of taxable activities
Other Uses of Transfer Pricing Rules

- Real life FMV example - Tax-exempt entity (NFP 1) provides database research to another unrelated tax-exempt organization (NFP 2). NFP 2 requests that NFP 1 provide database research to its related taxable subsidiary (FP 1). NFP 1 will need to charge FP 1 the FMV of database services. NFP 1 does not currently charge any of its clients, which are all tax-exempt organizations, for database services it renders. Transfer pricing rules can be used to determine FMV of database services.

U.S. TP Documentation Rules - Overview

- Taxpayers must prepare documentation that is contemporaneous with filing of tax return
  - Burden of proof is on taxpayer
  - 10 principal documents must be satisfied
- TP documentation must be provided to IRS within 30 days of request for TP documentation by IRS
  - Agents are required to request documentation at opening conference of tax exam

TP Developments in the U.S.

- Transfer pricing is now the remit of the Large Business and International (LB&I) division
- LB&I is structured as a “national office” format & is responsible for
  - IRS’s International Tax Program
  - Administering U.S. tax treaty network
  - Developing international examiners, economists & other international tax specialists
Polling Question #4

- Internal Revenue Service will not levy transfer pricing penalties if the following is met
  A. Documentation existed when tax return was filed
  B. Can be provided to IRS within 30 days
  C. Has all of 10 principal documents
  D. All of the above
  E. I don’t know

IRS Enforcement Activities

- IRS has increased the number of taxpayer audits it conducts each year
- IRS has been focusing more on transfer pricing enforcement since 2010 (hiring TP economists & examiners)
- IRS interviewing individuals who prepared documentation
- Increase in IRS & Treasury staffing for transfer pricing cases (will hire 1,000 transfer pricing specialists)
- Impositions of transfer pricing related penalties
- Review of 990s

IRS Enforcement Activities

- IRS has indicated that it perceives that there are abuses by tax-exempt organizations in relation to their dealings with their for-profit entities
Real Life IRS Exam of Taxable Entity

• Tax-exempt hospital system has a for-profit pharmacy, which perpetually lost money. IRS exam team indicated that an “excessive” services fee from hospital to pharmacy was cause of losses. IRS adjusted pharmacy’s income, which resulted in a loss of all net operating loss carryforwards & an assessment of over a million dollars of taxes. Case had to be fought all the way to appeals level. Ultimately, taxpayer prevailed.

Considerations

• Services can trigger UBI or not be considered UBI
  o If services are an integral part of tax exempt organization’s exempt activities they are not considered UBI
• Need to consider if the costs will be transferred at cost or with a mark-up
  o Mark-up needs to be based upon comparables
  o Certain routine activities can be transferred at cost under cost safe harbor (Services Cost Method)
• Need to also consider if rents, royalties, interest & annuities are UBI to exempt entities

Avoidance of Penalties

• If adjustment is made to taxpayer’s transfer pricing arrangements, IRS can levy penalties if taxpayer did not maintain proper transfer pricing documentation
  o Having robust contemporaneous documentation in place allows taxpayer to avoid penalties
  o More importantly, it can mitigate against an adjustment to taxable income & imposition of interest
Benefits of Transfer Pricing Review

- Potential tax savings & penalty mitigation
  - Can potentially establish transfer pricing arrangements to move profit from taxable organization to tax-exempt organization resulting in a decreased tax liability
  - Avoidance of adjustments to taxable income, penalties & interest
- Safeguarding of tax-exempt status
- Avoidance of adverse publicity associated with a potential adjustment to the income of a related taxable entity
CPE Credit

- Up to 1 CPE credit will be awarded upon verification of participant attendance; however, credits may vary depending on state guidelines.

- For questions, complaints or comments regarding CPE credit, please email the BKD Learning & Development Department at training@bkd.com.