Association TRENDS

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And the horse you rode in on

Antitrust and membership restrictions

By Andrew E. Bigart and Rob Davis

The U.S. District Court for the Eastern District of Texas issued a decision involving the American Quarter Horse Association in 2013 that has some lessons for associations generally when it comes to antitrust risks for enforcing membership restrictions.

That decision, Abraham v. American Quarter Horse Association, No. 2:12-cv-00103-J (E.D. Tex.), highlights how association restrictions can sometimes run afoul of the antitrust laws, especially where the restrictions are intended to, or have the effect of, foreclosing a competitor's ability to compete in the market. In this regard, the case shines a light on the tightrope that associations walk when trying to balance membership and programmatic needs against the limits imposed by the antitrust laws.

In American Quarter Horse Association, the plaintiffs, who breed cloned horses, alleged that "Rule 227(a) of the American Quarter Horse Association Regulations, which prohibited the registration of any horses produced by the cloning process and their offspring, violates Sections 1 and 2 of the Sherman Act (15 U.S.C. §§ 1 and 2)...." Specifically, as explained by the court, the plaintiffs argued that elite Quarter Horse breeders controled the association's rules committee, and that "[t]hese breeders" opposed cloning and sought to exclude clones from the registry to "keep prices for their own horses high by avoiding competition...."

The plaintiffs in this case argued that the registry restriction "precluded competition" from cloned horses and "established unnecessary and insurmountable barriers to entry into the market." In terms of competitive harm, the plaintiffs alleged that most shows and races required horses to be registered with AQHA in order to compete. The court found, however, that "a factfinder could determine that the AQHA has monopoly power over the economically viable

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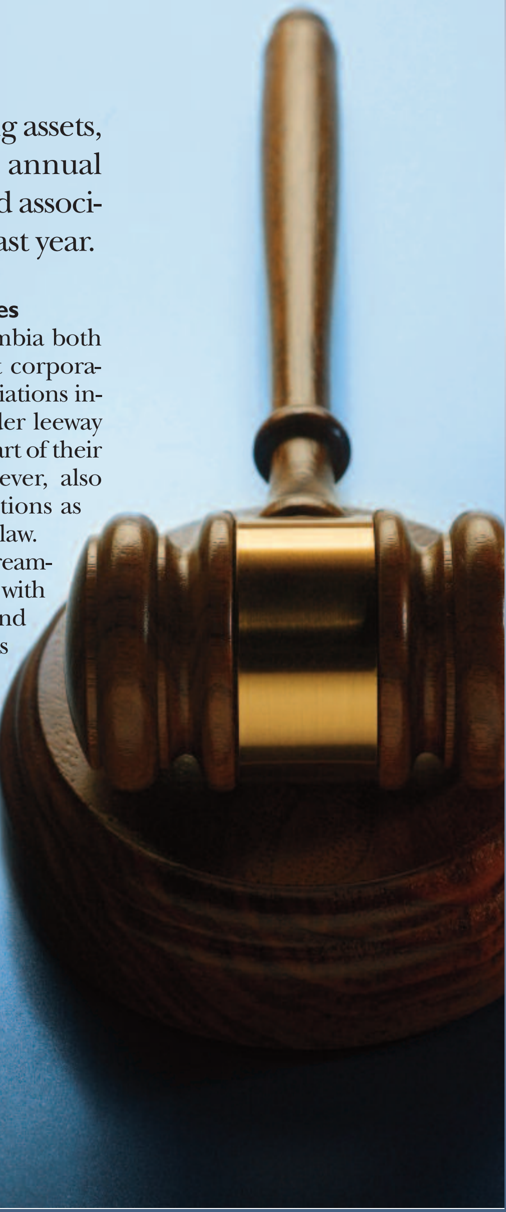
Top 5 Legal Issues of the Past Year

By George. E. Constantine

The IRS scandal, diverting assets, ethics and more – the annual list of issues that affected associations and nonprofits in the past year.



1. Nonprofit corporation law changes

New York and the District of Columbia both revised the laws governing nonprofit corporations in recent years. As a result, associations incorporated in those states have broader leeway to use electronic communications as part of their governance. The new statutes, however, also bring about new burdens for associations as well, particularly with New York's new law.

In New York, there has been some streamlining and modernization, doing away with the old Type A, B, C and D categories and allowing emails to be used for notices and in ballots. There are also a number of new burdens that nonprofits incorporated in New York will now face, including a prohibition on an employee serving as chair of the board and a mandatory requirement that each nonprofit corporation adopt conflicts of interest policies.

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DC's law has been in place and effective for a couple of years, though recently "technical corrections" were enacted to clean up a few errors from the initial statute. DC's law makes clear that member balloting can occur electronically and also provides for greater flexibility on a number of other matters that membership organizations face. The recordkeeping requirements in the new law are somewhat more burdensome than before, and the changes in the new law have made it more difficult for older corporations to continue to be covered under a pre-1962 corporate law.

2. IRS scandal and fallout for associations

The Exempt Organizations function of the Internal Revenue Service was the source of national news in May when it was reported that the IRS engaged in inappropriate flagging of conservative political groups when evaluating whether such entities qualified for tax-exempt status. While the focus of the scandal was largely on "tea party" and similar groups that would not traditionally be described as associations, the impact of the scandal has been broad, as numerous key IRS Exempt Organizations personnel have been replaced, and Congress has been scrutinizing closely all operations.

One potential positive result of all this scrutiny could be a focus on the immense backlog of exemption applications that the IRS currently has. In response to the issues that arose, the IRS has implemented a number of changes designed to streamline consideration of applications.

3. Association slapped over code of ethics provision

The Federal Trade Commission and the Music Teachers National Association entered a consent order after the FTC took issue with a code of ethics provision of MTNA. That provision (which MTNA maintained had not been enforced for a number of years) restricted members from soliciting clients from other music teachers. Under the consent order, the association was required to change its code of ethics, maintain an antitrust compliance program, and stop affiliating with any other group that MTNA knows to be restricting solicitation, advertising or price-related competition.

4.Tax reform plan takes aim at exempt organizations

U.S. House of Representatives Ways and Means Committee chairman Dave Camp recently released "The Tax Reform Act of 2014," a 979-page sweeping federal tax reform package that, among many other things, addresses a number of rules and laws applicable to tax-exempt organizations, and could impose significant new tax liabilities on nonprofits. While not expected to be voted on this year, many of the proposals could well find their way into law as part of any future federal tax legislation and many of the exempt organization-related proposals would fundamentally change the tax obligations of nonprofits.

The legislation proposes changes that impact both tax-exempt organizations and contributors to exempt organizations. The act would amend which activities and organizations are subject to unrelated business income tax, and would impose new excise taxes and modifications of current excise taxes on certain nonprofit organizations and activities.

Key aspects of the proposed legislation:

Royalty: Fees from the licensing of an organization's name or logo would be treated as expressly subject to UBIT.

Sponsorship: The act proposes to limit the ability of a tax-exempt organization to treat sponsorship payments as not subject to UBIT.

UBIT deductions: Requires tax-exempt organizations to compute UBIT separately for each unique activity that is subject to the tax. Thus, a tax-exempt organization would no longer be able to apply losses from one unrelated activity to offset gains from other such activities.

Changes to intermediate sanctions: Currently, if there are excessive benefits paid to certain insiders of section 501(c)(3) and 501(c)(4) organizations, an excise tax may be imposed on those individuals who so benefit as well as on those organization managers who approved those benefits. These provisions are often referred to as "intermediate sanctions." The act proposes sweeping new changes to the intermediate sanctions regime, including:

• Expanding the coverage of the provisions to apply also to 501(c)(5) and 501(c)(6) organizations;

• Adding a new excessive benefits excise tax, equal to 10 percent of the excess benefit, on the organization if certain minimum standards of due diligence or other procedures were not followed; and

• Doing away with the current law "rebuttable presumption of reasonableness," which gives a presumption that a transaction is not excessive if certain steps are followed.

Compensation tax: The legislation would impose an excise tax of 25 percent on executive compensation (including any parachute payments) over $1 million, to be paid by the organization. This excise tax would apply to any of the five-highest compensated employees of any tax-exempt organization.

5. Attention on diversion of assets

On Oct. 26, 2013, the Washington Post reported that from 2008 to 2012, more than 1,000 nonprofit organizations disclosed hundreds of millions in losses attributed to theft, fraud, embezzlement and other unauthorized uses of funds and organizational assets. According to a study cited by the Post, nonprofits and religious organizations suffer one-sixth of all major embezzlements, second only to the financial services industry.

While the numbers are shocking, this trend will not surprise those in the nonprofit world, who have long known that nonprofits are highly susceptible to fraud and embezzlement. Nonprofits are generally established for beneficial purposes and assume that their employees, especially senior management, share the organization's philanthropic mission. As such, nonprofits tend to be more trusting of their employees and have less stringent financial controls than their for-profit counterparts. Thus, they fall prey to embezzlement and other forms of employee fraud at an alarming rate.

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Quarter Horse market because its rules control not only market participation but whether, in turn, a horse is valuable or relatively worthless." The court also found that the question of the rule's alleged procompetitive benefits could "best be dealt with at trial." The jury, following trial, rendered a verdict against AQHA, concluding that the rule was exclusionary and not reasonably tailored to achieve AQHA's legitimate procompetitive goals.

In light of this decision, associations should review their current membership standards and the requirements for participating in an association-sponsored program (such as a certification or accreditation program) for compliance with the antitrust laws. This is particularly important for "dominant" associations or those that control access to a facility deemed (fairly or not) to be essential to competing in a market. Even smaller associations should be mindful of the potential impact of a rule limiting membership or program participation. No association – no matter its size – wants to end up with the fate of its membership or program standards in the hands of a jury.

Colleges and universities compliance project: Lessons for associations

The Internal Revenue Service recently completed its Nonprofit Colleges and Universities Compliance Project. The IRS had sent out an initial compliance questionnaire to more than 400 tax-exempt colleges and universities. Based on the responses, 34 colleges and universities were then selected for examination. The IRS has now completed 90 percent of these examinations. On April 25, 2013, the IRS released the Final Report on the project, summarizing the findings from the completed examinations and representing the culmination of almost five years of research and analysis.

Although the project has focused specifically on colleges and universities, the key points raised in the Final Report are applicable to all tax-exempt organizations and carry lessons for associations that are recognized as exempt under 501(c)(6) or 501(c)(3).

Unrelated business income findings

Unrelated business income arises when a tax-exempt organization regularly carries on a trade or business that is not substantially related to the tax-exempt purposes of the organization. The Internal Revenue Code imposes unrelated business income tax on an organization's UBI, reduced by the organization's related losses and deductions. The Final Report notes that 90 percent of the colleges and universities examined had misreported UBI on their Forms 990 and 990-T during the years under examination, and the resulting changes in the reporting of losses and net operating losses could result in more than $60 million in assessed federal taxes.

Other common findings among the examined colleges and universities included misallocation of expenses between activities related to tax-exempt purposes and those unrelated to such purposes; errors in computation of NOLs and the substantiation of such amounts; and misclassification of activities as related to the institution's tax-exempt purposes. It is interesting to note that the IRS identified numerous instances in which examined colleges and universities had reported net losses on activities "for which expenses had consistently exceeded UBI for many years." The IRS determined that these activities were not carried on with a profit motive and, as such, disallowed the NOLs that flowed from those activities.

Executive compensation and other compensation findings

With regard to executive compensation, the Final Report focuses on certain procedural shortcomings among many colleges and universities. As organizations described in § 501(c)(3) of the code, these colleges and universities are subject to the prohibition on "private inurement." As such, if an organization is deemed to make payments or engage in activities that improperly inure to the benefit of its "insiders," the IRS could seek to revoke the tax-exempt status of the organization. Alternatively, under Code § 4958 (also known as the "intermediate sanctions" rules), the IRS may impose punitive excise taxes on the insiders receiving undue benefit from their tax-exempt organizations, as well as a parallel excise tax on the organization's directors or managers that knowingly approved any "excess benefit transaction."

Organizations have an opportunity to lessen the exposure to excess benefit transactions if they follow a rebuttable presumption—have a disinterested decision-making body rely on valid comparability data to arrive at a compensation level for key officials and then have that decision-making body contemporaneously document its decision.

In the Final Report, the IRS found that 20 percent of the colleges and universities examined would not have successfully established the presumption that the compensation paid to key officials was reasonable. The key shortcomings included, for example, the use of comparability data that was derived, at least in part, from organizations that were not "similarly situated" to the institution in question (based on factors such as location, endowment size, revenues, total net assets, number of students, selectivity in admissions, and age of the institution); and the reliance on compensation studies that did not adequately document how and/or why certain comparability data was selected, and/or did not specify whether the amounts reported included salary only or also reflected other types of taxable and non-taxable compensation.

Employment and benefits developments: Same-sex couples

By Harry Atlas, Thora Johnson and Lisa Tavares

On Aug. 29, 2013, the Internal Revenue Service issued a Revenue Ruling answering many questions raised by the Supreme Court's ruling in United States v. Windsor earlier this summer. In Windsor, the court held that Section 3 of the Defense of Marriage Act, which defined marriage as a union between a man and a woman for federal law purposes, was unconstitutional because it denied same-sex couples equal protection under the law. The IRS's first formal response to the Windsor decision holds that for all federal tax purposes:

1. The term "marriage" includes a marriage between two individuals of the same sex, provided those individuals are lawfully married under state law (or the laws of a territory or foreign jurisdiction with the legal authority to sanction marriage);

2. A same-sex marriage sanctioned under the laws of the state or territory in which it was performed will be recognized, even if the married couple lives in a state that does not recognize same-sex marriage;

3. A same-sex (or opposite-sex) couple is not considered married by virtue of entering into a registered domestic partnership, civil union or other similar formal relationship recognized under state law (but not classified as a marriage under the laws of that state).

These general principles will apply for all tax purposes, including income, employment and estate taxes, on a prospective basis as of Sept. 16, 2013. The Revenue Ruling also permits affected same-sex couples to rely on its holdings with respect to original, amended, and adjusted tax returns (and claims for credits or refunds) for tax years still falling within the IRS's statute of limitations (generally, 2010, 2011 and 2012).

In a set of Frequently Asked Questions released contemporaneously with the Revenue Ruling, the IRS explicitly provides that qualified retirement plans "must treat a same-sex spouse as a spouse for purposes of satisfying the federal tax laws relating to qualified retirement plans." The FAQs specifically emphasize that this is the case even if the plan is operated by a nonprofit organization in a state that does not recognize same-sex marriage.

Beginning Sept. 16, 2013, plan sponsors must treat the same-sex spouse of any plan participant as that participant's spouse for all purposes under the plan. The new rule impacts, among other things, surviving spouse beneficiary provisions, qualified joint and survivor annuity and qualified pre-retirement survivor annuity requirements, required minimum distributions, hardship withdrawal rules and qualified domestic relations orders.

The IRS acknowledges that Revenue Ruling 2013-17 does not address the application of the Windsor decision to periods before Sept. 16 and states that it expects to issue future guidance for this purpose. This guidance also will include instructions to plan sponsors regarding required plan amendments and any necessary corrections relating to past plan operations.

The forthcoming employee plan guidance should also address health plans. The existing guidance, however, provides direction for plan sponsors who currently offer health coverage to same-sex couples.

DOJ rules on association joint purchasing plans

By Andrew E. Bigart, Lisa Jose Fales and Jeffrey S. Tenenbaum

In a recent DOJ Business Review Letter to STARS Alliance LLC, the DOJ reviewed a joint purchasing arrangement proposed by an association of several nuclear utility operators. As a starting point, the DOJ noted that the proposal likely qualified for the safety zone for collaborations that account for less than 20 percent of the relevant market. Nevertheless, the DOJ went on to conduct a rule of reason analysis to determine whether the anticompetitive effects outweighed the procompetitive benefits.

Starting with potential anticompetitive effects, the DOJ found that it was unlikely the arrangement would "restrict competition in either the upstream markets for goods and services or the downstream markets for electricity" because the STARS members were generally located in different geographic areas and did not compete against each other. At the same time, DOJ found that the arrangement had the potential for procompetitive benefits through increased efficiencies and lower costs.

Further, DOJ noted that STARS had implemented numerous safeguards to limit the potential for anticompetitive coordination among its members, including that the joint purchasing activities would be voluntary for members, that members would not discuss prices for procuring goods and services, and that STARS would require antitrust compliance training for its members.

This ruling confirms the general rule that, absent extraordinary circumstances, the enforcement agencies are unlikely to challenge an association joint purchasing program where members are not required to purchase a particular product or service, each member makes its own independent decision to participate, and there is significant competition in the relevant market.

Associations looking to implement a joint purchasing program should implement safeguards, as appropriate, to prevent members from sharing competitively sensitive information, such as downstream sale prices, the timing of price increases or purchase orders, and margins. Suggested precautionary measures include:

• Check your association's governing documents and evaluate its tax-exempt status to confirm that a joint purchasing program is a permissible association activity.

• Consult with antitrust counsel before establishing a joint purchasing program and periodically throughout the process to ensure compliance with antitrust laws.

• Monitor the buying group's market share in the input and output markets to stay within the safeguards set forth in the enforcement agencies' Antitrust Guidelines for Collaborations Among Competitors (e.g., 35 percent share for total purchases in the relevant input market and 20 percent share in the relevant output market).

• The association or an independent agent should handle joint buying activity and negotiate with suppliers on behalf of the purchasing group, or require each member to contract individually with the supplier offering a group discount.

• The program should not impose minimum purchasing requirements on members.

• Participation in the joint purchasing arrangement should be available to all association members and should not be limited by the size, type or location of a member.

• Joint purchasing should not be used to raise, lower or stabilize prices, or to boycott suppliers.

• Members should not share competitively sensitive information or enter into any agreement or understanding on prices or other competitive conduct in the downstream output market.

• Any meetings of a joint purchasing group should have an agenda and minutes. All discussions should be limited to the purposes of the joint purchasing group.

• Antitrust counsel should be present at all meetings where competitively sensitive information is discussed.

Brock R. Landry
202-344-4877
blandry@Venable.com

Jeffrey S. Tenenbaum
202-344-8138
jstenenbaum@Venable.com

Robert L. Waldman
410-244-7499
rlwaldman@Venable.com

George E. Constantine
202-344-4790
geconstantine@Venable.com

Ronald M. Jacobs
202-344-8215
rmjacobs@Venable.com

Thora A. Johnson
410-244-7747
tajohnson@Venable.com

Jonathan L. Pompan
202-344-4383
jlpompan@Venable.com

William N. Hall
202-344-4631
wnhall@Venable.com

Lisa M. Hix
202-344-4793
lmhix@Venable.com

Yosef Ziffer
410-244-7810
yziffer@Venable.com

Harry I. Atlas – 410-528-2848, hiatlas@Venable.com
Andrew E. Bigart – 202-344-4323, aebigart@Venable.com
Walter R. Calvert – 410-244-7726, wrcalvert@Venable.com
Robert P. Davis – 202-344-4514, rpdavis@Venable.com
Audra J. Heagney – 202.344.4281, ajheagney@Venable.com
Matthew T. Journy – 202-344-4589, mtjourny@Venable.com
Kristalyn J. Loson – 202-344-4522, kjloson@Venable.com
Alexandra Megaris – 212-370-6210, amegaris@Venable.com
Margaret Rohlfing – 202-344-4297, mcrohlfing@Venable.com
Janice M. Ryan – 202-344-4093, jryan@Venable.com
Davis V.R. Sherman – 410-244-7810, dvsherman@Venable.com