

THE NEWSLETTER OF THE BDO NONPROFIT INDUSTRY PRACTICE

# NONPROFIT **STANDARD**



## GOVERNANCE – STILL HIGH ON THE IRS RADAR SCREEN: AUDIT CHECKLIST ON GOVERNANCE NOW IN SERVICE

By R. Michael Sorrells, CPA

By now, it should come as no surprise that nonprofit governance is high on the list of IRS interest areas. This interest has, of course, been spurred on by Senate Finance Committee hearings and some highly publicized exempt organization governance failures which helped to put a black mark on the entire nonprofit sector. However, Congress was not able to (or chose not to) pass any legislation mandating particular governance structures or policies. A backdoor, friendlier approach was taken instead. In its major revision of the Form 990, the IRS now asks a significant number of questions about governance, policies and disclosures. Although almost all of these questions have no right or wrong answer legally, most organizations have strived to answer most in a way that

creates the best image of the organization as a well-governed entity. Since the Form 990 is a public document, this is probably a wise course of action. It is also easy to imagine that a lot of no answers to what are essentially best practice questions might encourage the IRS to send its auditors around.

As part of this new emphasis on good governance, the IRS has now mandated that a governance checklist be completed by its revenue agents as part of every examination of 501(c)(3) public charities (after September, 2009). The stated purpose of this checklist is to provide data for a long term study. Whether or not that study will lead to legislation or more detailed guidance is certainly subject to conjecture.

The checklist has 28 questions and a four-page set of instructions for the agent. While a lot of

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# FORM 990-T AND LOSSES: FROM THE IRS VIEWPOINT



By: **Sandra Feinsmith, CPA**

The IRS is taking a close look at tax exempt organizations that engage in unrelated business activity but rather than reporting taxable income, are instead reporting large loss carryforwards. The IRS has already begun to look at this issue with the release of its compliance questionnaire that was sent out to 400 colleges and universities. The IRS noted that many of the colleges and universities' Forms 990-T were showing large losses after expense allocations.

In this article, we will discuss three areas of particular interest to the IRS when looking at losses on Form 990-T:

1. Profit motive of the activity
2. Dual use facility expense allocations
3. Exploited activities

## ► PROFIT MOTIVE OF THE ACTIVITY

One of the areas that the IRS is looking at when examining the large losses is the profit motive of the activity. The "Profit Motive Test"

came from rulings and case law that occurred in the 1980s and 1990s. When applied, this test eliminates deductions for losses from activities that lack a profit motive.

IRS Code Section 512(a)(1) defines unrelated business taxable income as "gross income derived by an organization from any unrelated trade or business regularly carried on by it, less the deductions which are directly connected with the carrying on of such trade or business." This section of the Code allows organizations to offset the income and gains from one unrelated activity against the losses generated by another unrelated activity.

However, as noted in the definition, the losses must be generated by a trade or business, which is defined as an activity that is carried on for the production of income and has the other traits of a for profit organization. In other words, an organization must engage in the activity with the primary goal of generating a profit.

Organizations reporting large losses on their Form 990-T are at risk of IRS applying the profit motive test to their activities. This may result in the losses from the activity being

## BDO INSTITUTE FOR NONPROFIT EXCELLENCE IN THE NEWS...

*Members of the Institute are requested to speak on a regular basis due to their recognized leadership in the industry. The following is a list of some of the upcoming events where you can hear BDO Institute professionals speaking.*

**Lee Klumpp** will be the presenter for two separate eight-hour courses for the Georgia State Society of Certified Public Accountants. He will be presenting *Governmental and Nonprofit Annual Update*, discussing the latest accounting requirements for these entities on July 8th in Gainesville, Georgia, and on July 9th he will present *Nonprofit Accounting and Reporting: From Start to Finish*, discussing the basics on nonprofit accounting in Duluth, Georgia.

Lee will also present an eight-hour program in New York for the New York State Society of Certified Public Accountants, entitled *Audits of HUD-Assisted Projects*, that will discuss the requirements of HUD audits and the latest developments on August 13, 2010.

Lee will conduct an eight-hour course for the Maryland Society of Certified Public Accountants, entitled *Audits of 403(b) Plans: A Challenging New Area*, in Laurel, Maryland, on September 14th.

**Laura Kalick** will be speaking about ASC 740-10 (previously known as FIN 48) at the ASAE Legal Symposium on September 24, 2010.

**Mike Sorrells** will present *Update on Tax Issues Facing Nonprofit Organizations* at the Virginia Society of Certified Public Accountants (VSCPA) Accounting and Auditing Conference in Roanoke, Virginia, on September 27, 2010.

**Dick Larkin** will also be presenting *Nonprofit Accounting and Auditing Update* at the VSCPA's Accounting and Auditing Conference in Roanoke, Virginia, on September 28, 2010.

**Lee Klumpp** will present at the Greater Washington Society of Certified Public Accountants on September 29, 2010, on the topic of frequent frauds found in governments and not-for-profits.



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## IRS VIEWPOINT

disallowed due to the IRS assertion that the organization did not engage in the activity with the primary purpose of generating income or profit.

In looking at these losses, the IRS has adopted a facts and circumstances approach to determine whether or not an activity is a trade or business. Various areas that might indicate to the IRS that an activity does not have a profit motive include:

1. No formal business plan or contracts for the activity
2. Expenses almost always exceed any income from the activity
3. Many years of losses
4. No adjustments to cost, expenses or pricing to lower the losses

Another item to be aware of is the IRS treatment of offsetting losses from one set of unrelated activities against the income from other unrelated activities. It has been the IRS approach to look at each one of these activities as its own separate trade or business and make the determination on whether or not each one of these has or does not have a profit motive. Using this methodology, the IRS has taxed profitable activities while disallowing the ones with losses.

### ▶ DUAL USE OF FACILITIES

Another area of focus by the IRS regarding losses reported on Form 990-T involves the expense allocation and deductions for the dual use of facilities and personnel. Under IRS Regulations 1.512(a) – 1(a), an organization is allowed to deduct an expense that is directly connected to an unrelated trade or business if it has a “proximate and primary relationship” to that unrelated trade or business. The Regulations further discuss this relationship regarding expenses directly related to unrelated business activities and expenses from the dual use of facilities or personnel.

The Regulations state that the expense allocation between the dual uses must be “reasonable.” However, “reasonable” has been subject to interpretation and litigation. Some guidance may be found in *Rensselaer Polytechnic Institute (RPI) v. Commissioner of Internal Revenue (1983/1984)*. In this case, RPI interpreted “reasonable” to mean that fixed costs as well as depreciation and overhead expenses that could not be associated

directly with exempt student uses nor non-exempt commercial for-profit uses should be allocated based on percentage of total use, ignoring periods when the facility was idle. RPI prevailed. However, the Commissioner, to this day, contends that the basis of allocation should have been all time the facility was available for use, which would substantially reduce the amount of expenses and losses that could be used to offset unrelated business income.

With the lack of clarity on the issue, it is up to the organization and the IRS to come to some type of negotiated settlement on their own regarding such matters should the issue be brought to light during an audit.

### ▶ EXPLOITED ACTIVITIES

The third area of focus regarding loss reporting on Form 990-T involves the calculation and reporting of expenses from exploited exempt activities. These types of activities occur when an organization generates intangible assets in performance of its exempt activity that are exploited in a commercial manner and does not contribute to an organization's exempt purposes. Examples of these types of activities discussed in the IRS regulations include advertising income from an educational organization's journal or a scientific organization's endorsement of laboratory equipment.

For these types of activities, the IRS requires that organizations report and complete two separate calculations of net income from the activities – one from the taxable activity, and one from the exploited activity.

Under IRS Regulations 1.512(a) - 1(d), if the taxable activity has net income, any losses from the exploited activity can be used to offset the net income from the taxable activity to the extent of net income. The exploited activity is not allowed to create a net operating loss for the taxable activity. However, if the taxable activity shows a loss, that loss is what is required to be reported on Form 990-T.

The IRS is concerned that organizations are not observing the rules regarding the expense deduction limitations and are putting excess expenses on page 1 of Form 990-T under deductions not taken elsewhere on Form 990-T.

## DID YOU KNOW...

- The updated and much-improved Charities and Nonprofits section on the IRS website ([irs.gov](http://irs.gov)) is now the largest section on the website! It contains over 1,600 pages of information, most of which is quite useful.
- There are almost 1.6 million tax-exempt organizations in the US, including almost 1 million public charities. These nonprofits accounted for 8.1 percent of wages and salaries in 2006.
- Public charities reported over \$1.4 trillion in total revenues and nearly \$1.3 trillion in total expenses for 2007.
- Approximately 26.4 percent of Americans over the age of 16 volunteered through or for an organization in the year-ended September 2008.
- Across all sectors (including nonprofits), the IRS estimates there is a \$54 billion-tax shortfall in payroll tax collections between what was filed and what should have been filed if everyone had filed correctly. This is why the IRS is launching a multiyear Employment Tax Research Project which includes 500 nonprofit examinations each year.

### ▶ CONCLUSION

With the increasing scrutiny by the IRS in this area, organizations with unrelated business activities generating losses on their Form 990-T should look closely at the following areas:

- Look at each of your activities' profit motive. Document why the activity is generating losses (i.e. start up mode, meant to run a loss, etc.).
- For dual use of facilities expense allocations, look at and document the methodology used in the calculation. Is it reasonable? Is it consistent with relevant tax court rulings or the IRS's interpretation?
- For exploited exempt activities, make sure the organization is in compliance with the expense limitation rules.

For more information, contact Sandra Feinsmith, Senior Tax Manager, at [sfeinsmith@bdo.com](mailto:sfeinsmith@bdo.com).



# MANAGEMENT'S ROLE IN VALUING ALTERNATIVE INVESTMENTS WITH NAVs

By Tammy Ricciardella, CPA

Alternative investments held by nonprofit organizations present a challenge to management for many reasons. One of the most significant is the responsibility that management has to determine the fair value measurements for these investments and draft the required footnote disclosures. This process can be very challenging depending on the nature and number of the alternative investments held by an organization.

FASB issued Accounting Standards Update (ASU) 2009-12 entitled, "*Investments in Certain Assets That Calculate Net Asset Value per Share*," and a series of 10 AICPA questions and answers (TIS Sections 2220.18-27) that will make the process of valuing these assets somewhat easier in certain circumstances. ASU 2009-12 permits the use of net asset value (NAV) as a practical expedient that can be used to measure fair value in certain scenarios. In order to utilize NAV the alternative investment fund must comply with the FASB's standards for investment companies and the investor cannot have initiated plans to sell the investment in the near term at a price that will probably be different than the NAV.

This ASU was issued because some organizations were adjusting reported NAV for their assessment of liquidity and marketability. The ASU was issued to give you the option to use the NAV under certain conditions. However, all the other requirements related to understanding how the NAV was computed and the due diligence required to be performed by management are still required even if management determines that using the NAV is appropriate.

Management should obtain information from the fund manager as to how the funds they are invested in are valued. Management should understand the methods used by the fund manager to compute fair value. An understanding is necessary before management can evaluate whether this valuation is appropriate. Management must understand the reason alternative investments are being utilized in the portfolio, the underlying investments, and the method and significant assumptions used by the fund manager to value these underlying investments.

Steps that management should take to fulfill their responsibility regarding the valuation of alternative investments include:

- What is the NAV of each investment and as of what date was it computed? This

information is generally provided by the fund manager.

- Does the fund comply with the FASB standards for investment companies? Management needs to review the financial statements and auditor's opinion for the fund.
- If management determines that the fund complies with the FASB investment company standards, management needs to determine if there are any adjustments that need to be made to NAV because the NAV is not computed as of the entity's year end.
- If management determines that the fund does not comply with the FASB investment company standards, they need to ascertain if it is possible to adjust the NAV or if they must use alternative valuation methods.
- Management needs to determine if they have the ability to redeem the investment at NAV in the short term and what the entity's plans are for either holding or selling the investment. An alternative investment that can be redeemed at NAV in the short term may be classified as a level 2 investment in the footnote disclosures. However, if management has already initiated plans as of the measurement date to sell the alternative investment at a price that will differ from the NAV then they cannot use NAV to measure fair value.

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## MANAGEMENT'S ROLE

### Consideration of whether the fund complies with the investment company standards:

Generally those alternative investments that calculate NAV per share and report this information to their investors include, but are not limited to, hedge funds, private equity funds, real estate funds, venture capital funds, commodity funds and funds of funds. FASB ASC 820-10-35-59 permits the use of the NAV as a practical expedient if the NAV is calculated in a manner consistent with the measurement principles of Topic 946 as of the reporting entity's measurement date. How does management do this?

Management must independently evaluate the fair value measurement process utilized by the fund manager to calculate the NAV. This is a professional judgment and includes determining that the fund manager has an effective process and related internal controls in place to estimate fair value of the investments. The steps management uses may include various stages of due diligence which are designed to understand the fair value estimation process used by the fund. Other factors to consider are:

- The use of independent third party valuation experts by the fund;
- The portion of the underlying securities held by the fund that are traded on active markets;
- The professional reputation and standing of the fund's auditor and the qualifications, if any, of the auditor's report;
- Fund's history of significant adjustments to NAV;
- Findings in the fund's advisor or administrator report; and
- Comparison of historical realizations to the last reported value.

### Adjusting NAV When it is Not as of the Entity's Measurement Date:

NAV provided by the fund manager is not as of the entity's measurement date. Now what?

First, management may request that the fund manager provide a supplemental NAV calculation consistent with ASC 946 as of the measurement date. If this cannot be obtained, management needs to assess whether they should roll forward or back the NAV provided for such factors as:

- Additional investments or capital contributions that have occurred after the date of the reported NAV;
- Distributions or partial redemptions received by the entity since the reported NAV;
- Management has become aware of changes in the value of the underlying investments since the reported NAV;
- Market changes or other economic conditions that have changed that would affect the value of the portfolio after the reported NAV; and
- Changes that have occurred in the composition of the underlying investment portfolio of the fund after the reported NAV date.

### What if management determines that the NAV was not calculated in accordance with ASC 946?

In these cases, management should apply the general measurement principles of FASB ASC 820 instead of using the NAV provided. Often times this occurs when the funds appear to function in a manner similar to investment companies but they do not meet the definition of an investment company provided in FASB ASC 946-10-15-2 and the funds do not issue financial statements using measurement principles in FASB ASC 946. Management needs to determine whether they can obtain valid information from the fund that they can utilize to estimate fair value based on NAV or whether a fair value based NAV can be obtained from the fund. There are cases where management may be able to obtain data to estimate an adjustment that include the following situations:

- NAV is reported on a cash basis. Management could estimate fair value of each underlying investment by obtaining additional information from the investee manager.
- The NAV utilizes blockage discounts. Management could estimate the adjustment to NAV required to remove the blockage discount based on additional information from the investee manager.
- NAV is not adjusted for the impact of unrealized carried interest or incentive fees. Management could estimate the impact of these items and estimate the NAV.

## Electronic Filing of Form 5500s Now Required

Beginning January 2010, all Form 5500s *Annual Return/Report of Employee Benefit Plan*, except 2008 plan year filings, are now required to be submitted by the plan sponsor via the Department of Labor's ("DOL") new electronic filing system called EFAST2. Paper copies of the Form 5500, other than 2008 plan year filings, will not be accepted by the government.

Now that EFAST2 is up and running, each individual who signs a Form 5500 on behalf of the plan sponsor and/or the plan administrator will need to go to the DOL website and register for electronic signing credentials, which will enable the appropriate individual to electronically sign the Form 5500 and submit it through EFAST2. The DOL is planning to send post card notifications inviting Form 5500 signers to apply for their personal credentials but there is no need to wait. Form 5500 signers can log on today and get credentials at, <http://www.efast.dol.gov/portal/app/welcome?execution=e1s1>.

Instructional tutorials for EFAST2 are also available on the DOL website at, <http://www.efast.dol.gov/training/EFAST2%20Tutorial%20Menu.html>. Once there, click on "Register" for a demonstration of how to obtain signing credentials.

In cases where management finds that it is not practicable to calculate an adjusted NAV because sufficient information is not available or they are not in a position to reasonably evaluate the information that is available and estimate values in accordance with FASB ASC 946 then the entity cannot utilize the practical expedient. Management also has the option to elect not to utilize the practical expedient and apply the general measurement principles of FASB ASC 820 instead.

For more information, contact Tammy Ricciardella, Assurance Director, at [triciardella@bdo.com](mailto:triciardella@bdo.com).



# ACT RELEASES REPORT ON ONLINE TOOL FOR COMPENSATION

By Joyce Underwood, CPA

On June 9, 2010, the Internal Revenue Service's Advisory Committee on Tax Exempt and Government Entities (ACT) recommended that the IRS provide additional assistance to charities in setting executive compensation through their *Report of Recommendations, Exempt Organizations: Getting It Right – An Online Guide to Setting Executive Compensation for Charities*. ACT describes their creation as an online instructional tool in the form of a webinar or tutorial to provide "step-by-step, plain language advice for managers, boards and advisors of charities to assist them in a wide range of areas, including: developing internal procedures and compensation comparables, reporting salary information in their IRS Form 990 filings, and maintaining appropriate records necessary to meet the rebuttable presumption of reasonableness and comply with the regulations promulgated pursuant to Section 4958."

IRS, legislators and the public have shown a great deal of interest in recent years in compensation of executives for all types of entities, including exempt organizations. Newspapers often herald the outrageous news of the latest charity that appears to have excessive compensation and the new Form 990's expanded disclosures of compensation are expected to lead to even more scrutiny. Since Congress has granted the IRS tools to police the reasonableness of compensation through intermediate sanctions allowing application of excise taxes and the authority to invoke the private benefit or private inurement doctrines to revoke a charity's tax-exempt status, the Section 4958 sanctions address situations where compensation is deemed excessive and provide a structure for corrective action. They also provide procedures that taxpayers may follow to establish reasonable processes around compensation-setting practices. ACT's new tool is intended to better explain the rules and help organizations put into place appropriate measures to manage compensation.

It should be noted that recent IRS compliance studies on executive compensation, colleges and universities, and hospitals have provided IRS insight into the application of Section 4958. While in many instances the rules appear to have been followed, IRS wonders if the resulting compensation is truly appropriate as many organizations place compensation in the 90th percentile. Additionally, legislators have raised questions about the existing rules and have had such suggestions as to eliminate the safe harbor of the rebuttable presumption of reasonableness standard or to require detailed internal procedures and require compensation comparables to be disclosed as part of the Form 990 that is available for public inspection. No action has gone forward in these areas, but it is a subject that may see further attention. In the interim, IRS and the exempt organization community are working together to educate and improve communication in this area.

The June ACT report indicates the areas covered by this tool include the intermediate sanctions, revocation of tax-exemption, taxation of fringe benefits, and compensation-related disclosures required by the Form 990. Other areas addressed are compensation and audit issues relevant to churches and compensatory, below-market rate loans. With regard to the intermediate sanctions, it addresses the basic rules, the rebuttable presumption and automatic excess benefits. Because state law requirements for setting executive compensation have significant overlap with the federal tax law rules (particularly the requirements for satisfying the rebuttable presumption under the intermediate sanctions), the tool addresses the process for setting compensation from the governing board's standpoint and specific state law requirements. Also discussed are ten common pitfalls that organizations often encounter when setting executive compensation. This tool is designed to offer some best or preferred practices drawn from experts who regularly advise organizations on setting compensation.

## UPDATE ON CELL PHONES

On April 14, 2010, the House firmly passed H.R. 4994, the Taxpayer Assistance Act of 2010. The bill includes a provision that would ease the cumbersome cell phone recordkeeping requirements. Existing tax law treats cell phones as "listed property" and requires the value of an employer provided cell phone to be either included in an employee's income to the extent that the employee does not pay for the phone or excludes it as a working condition fringe benefit. To exclude the value of the business related use of a cell phone from taxable income employers and employees must substantiate the business use portion of the phones which can be time consuming and difficult. An exempt organization could have an excess benefit transaction if such income is not reported. If the bill becomes law, organizations would no longer have to keep detailed records substantiating the use of such phones. With the bill now passed by the House, it goes before the Senate, where it has been referred to the Senate Finance Committee which now needs to approve it before the full chamber considers it. If passed by the Senate it goes to the President for signature, who is expected to sign it. The new provision is expected to be retroactive to January 1, 2010.

ACT's tool uses an informal voice with an effort towards education and humor to encourage reception to this new application. IRS has not announced yet if it will implement this suggested tool. The report, along with screen samples from the tool, is available on the IRS website: <http://www.irs.gov/charities/article/0,,id=98353,00.html>

For more information, contact Joyce Underwood, Director, Nonprofit Tax Services, at [junderwood@bdo.com](mailto:junderwood@bdo.com).

# TAX REFORM MAY BE ON THE HORIZON FOR NONPROFIT ORGANIZATIONS

By Laura Kalick, JD and LLM in Tax

In the current economic climate, nonprofit organizations should watch for legislative initiatives that could have an impact on them. Since the government is looking for ways to raise revenue, it is possible that the government subsidy to tax exempt organizations could be cut back. The government subsidy consists of several elements. First, revenue of tax exempt organizations is generally exempt from tax to the extent it is received as a contribution, generated by a related activity or meets an exception or modification in the Internal Revenue Code that prevents it from being taxed. Investment income is for the most part not taxed, allowing nonprofit organizations to build substantial endowments. The government also subsidizes section 501(c)(3) organizations by allowing donors to take charitable deductions for gifts to these organizations. Section 501(c)(3) organizations also have the benefit of being able to obtain low rate financing through tax exempt bonds, the income on which is tax exempt to the holder of the bond. All of these provisions result in lost tax revenue to the Federal government.

## ► CHARITABLE GIVING

One legislative proposal that could surface is to cap the value of itemized deductions, including the charitable contribution deduction, to 28 percent. In addition, changes to income tax rates and estate tax rates can have an impact on charitable giving.<sup>1</sup> Other proposals could surface as the result of studies that are underway at IRS and other government agencies.

## ► IRS STUDIES

For example, the IRS had undertaken a study of the hospital industry that focused on compensation practices and also the provision

of charity care and community benefits. In part due to the hospital study, Congress just enacted new Internal Revenue Code section 501(r) that would require tax exempt hospitals to assess community needs every three years and certain other requirements in order to maintain 501(c)(3) tax status.<sup>2</sup>

IRS is now completing a compliance project on colleges and universities, one of the largest and most complex segments of the nonprofit industry and the results of the study may provide a framework for Congress to enact legislation for nonprofits in general. The IRS Exempt Organization Colleges and Universities Compliance Project Interim Report (Report) was issued May 7, 2010, with preliminary findings based on responses from a sampling of 400 small, medium and large colleges and universities in both the public and private sectors. The main areas of focus of the project are: compensation, endowments and investments, and unrelated business income. Some of the results were as follows:

## ► COMPENSATION

There have been concerns that nonprofit executives are receiving pay that is too high at the cost of the taxpayers. The Report indicated that compensation of the highest paid officer, director or key employee of large universities averaged \$428,000 per year and these persons were usually the president or chancellor of the college or university. Large universities' highest paid employees other than officers, directors and key employees averaged pay of \$798,000 per year and were either faculty members or sports coaches.

The Report found that more than half of the organizations reported using the rebuttable presumption<sup>3</sup> procedure to establish executive compensation. The rebuttable presumption shifts the burden of proof to IRS to prove that compensation is unreasonable if the organization is audited. The procedure requires that an independent governing

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body determine compensation based on comparable data and contemporaneously document the decision making process. For-profit comparables can be used as well as nonprofit data. Senator Grassley, ranking minority member of the U.S. Senate Finance Committee, had proposed an amendment to one of the iterations of the healthcare reform bill to eliminate the rebuttable presumption, but then withdrew the amendment. It is possible that such a proposal may surface again in the future because many think that the rebuttable presumption serves to increase compensation of nonprofit executives and at the same time to put IRS at an unfair disadvantage to enforce the tax laws.

## ► ENDOWMENTS

The IRS and Congress are concerned about how tax exempt organizations invest their endowments and also how they use their endowments. Are organizations just piling up money or are they actually using the money for exempt purposes? When the return on investments was much greater a few years ago, this was a much greater concern than it may be today. Also, the Report indicates that a large segment of the sampling of the colleges and universities have foreign investments and alternative investments in their portfolios, areas that Congress is looking into in general.

<sup>1</sup> See Congressional Research Service (CRS) Report, 'Tax Options for Financing Health Care Reform' (April 8, 2010), BNA Daily Tax Report & TaxCore and CRS Report, 'Charitable Contributions: The Itemized Deduction Cap and Other FY2011 Budget Options' (March 22, 2010)

<sup>2</sup> See the Patient Protection and Affordable Care Act, signed into law on March 23, 2010, Pub. L. No. 111-148 (the "Act")

<sup>3</sup> See IRC 4958, the Intermediate Sanctions provisions

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## TAX REFORM

As far as legislation in this area there had been rumor of requiring a minimum payout each year similar to private foundations. However, at this point it appears that such a proposal will not be forthcoming because it could have the adverse effect of establishing a ceiling rather than a floor on spending and it may be wiser to leave these financial decisions to the institutions themselves.

However, another aspect of the use of endowments has been raised and that is "indirect arbitrage," where colleges and universities borrow money at a low rate through the use of tax exempt bond proceeds and then earn money on endowments at a higher rate. If Congress somehow required organizations to use their own money and not borrow, this could reduce the number of outstanding tax exempt bonds, thus resulting in a revenue gain to the Federal government.<sup>4</sup>

### ▶ UNRELATED BUSINESS INCOME AND EXPENSES

Finally, the IRS College and University Questionnaire used in the compliance project asked numerous questions about activities of colleges and universities in four areas: advertising, corporate sponsorship, rentals and other. There were also numerous questions regarding expenses associated with these activities. The Report indicates that in many cases colleges and universities reported conducting an activity that was not reported on their Form 990-T and that this will be an area of further study. It has been reported that at least 30 schools that had participated in the survey are now under IRS audit.

The Report points out that many exempt organizations receive opinions from counsel to determine if an activity is related or unrelated. However, many organizations do not report net unrelated business income because of the expenses that they use to offset the income. The IRS Questionnaire asked questions about expenses from activities that generate losses year after year. IRS takes the position that in order for there to be an unrelated trade or business there must be a profit motive and if there are constant losses there may not be the requisite profit motive; therefore, expenses from loss activities may not be unrelated trade or business losses which could

## OMB 2010 COMPLIANCE SUPPLEMENT STATUS

By Tammy Ricciardella, CPA

The Office of Management and Budget (OMB), usually releases its annual edition of the OMB Circular A-133 Compliance Supplement (the Supplement) in the spring. The issuance of the 2010 Supplement has been delayed due to the inclusion of new programs and clusters and new guidance on The American Recovery and Reinvestment Act of 2009 (Recovery Act) requirements. In the interim, OMB has provided the AICPA's Governmental Audit Quality Center and certain other stakeholder groups with a draft version of the Supplement so both auditors and auditees can begin reviewing some of the significant changes that have been added in the Supplement. OMB has stressed that this document is a draft and that it is subject to change. The draft Supplement can be accessed at <http://www.aicpa.org/interestareas/governmentalauditquality/resources/pages/draft2010compliance-supplement.aspx>.

The draft 2010 Supplement includes the normal changes made by OMB each year related to new programs and required compliance procedures and are summarized as they have been in the past in Appendix V, *List of Changes*, for the 2010 Compliance Supplement. Many of the critical changes made in 2010 are summarized in Appendix VII, *Other OMB Circular Advisories*. These include changes to the major program determination process and other guidance both for situations where an auditee has expended funds relating to the Recovery Act and for other situations.

be used to offset other unrelated trade or business income. Although not necessarily on the immediate horizon, future legislative proposals could include bright line tests for the use of expenses from loss activities and also what constitutes a reasonable allocation for purposes of allocating expenses between related and unrelated uses.

### ▶ CONCLUSION

It is hard to predict how or whether Congress will legislate in the nonprofit arena. Various

In addition, OMB has recently issued a memorandum to federal agencies titled, M-10-14, *Updated Guidance on the American Recovery and Reinvestment Act* (the memo). This memo advises Federal agencies to no longer grant extension requests to auditees for late single audit filings with the Federal Audit Clearinghouse for fiscal years 2009 through 2011. Appendix VII of the draft 2010 Supplement emphasizes this guidance and explains that beginning with audits covered by the draft 2010 Supplement an auditee cannot be considered a low-risk auditee if either it's 2008 or 2009 single audit was submitted late. The current filing deadline is nine months after the entity's year end.

There is a placeholder in Part III of the draft 2010 Supplement that will be completed once audit procedures regarding Section 1512 reporting filed by auditees as required by the Recovery Act are finalized. At this point, we do know that the job information in the 1512 reporting will not be part of the A-133 audit. Audit procedures will be focused on the reporting of the Recovery Funds received and expended. The final requirements will be incorporated into the final version of the 2010 Supplement.

It is anticipated that the final Supplement will be issued by June 30th.

For more information, contact Tammy Ricciardella, Assurance Director, at [tricciardella@bdo.com](mailto:tricciardella@bdo.com).

government reports provide some insight as to what future action may be taken. In the meantime, affirmative action should be taken by organizations to be in compliance with the tax laws and maintain sound financial practices as the best defense against future actions.

For more information contact Laura Kalick, National Tax Consulting Director, at [lkalick@bdo.com](mailto:lkalick@bdo.com).

<sup>4</sup> See Tax Arbitrage by Colleges and Universities, April 2010, a CBO Study



# DOCUMENT CORRECTION PROGRAM FOR NON-QUALIFIED DEFERRED COMPENSATION SUBJECT TO IRC §409A

By **Derrick Neuhauser** and  
**Yolanda Scannicchio**

**M**any of our tax-exempt clients have long-standing executive directors that more than likely have Internal Revenue Code (IRC) Section (§) 457(f) plans, which allow tax-exempt organizations to provide nonqualified deferred compensation to a select group of management or highly compensated employees. IRC §457(f) and other non-qualified deferred compensation arrangements provided by both for-profit and tax-exempt organizations are subject to IRC §409A regulations. In Notice 2010-6, the Internal Revenue Service (IRS) announced a new document correction program for deferred compensation plans that are in violation of IRC §409A.

On April 10, 2007, the final regulations under IRC §409A were announced and a deadline of January 1, 2009, was set for operational and documentary compliance. The final regulations are applicable to both for-profit and nonprofit organizations. IRC §409A generally provides for the acceleration of the recognition of income and imposition of an excise tax on participants in deferred compensation programs in those cases where the participant is deemed to have the ability to control the timing of the receipt of the deferred compensation. The IRS, recognizing that compliance with IRC §409A could be complicated, provided taxpayers with the ability to correct certain types of operational failures in Notice 2008-113; however, that Notice did not give taxpayers the ability to correct failures in the underlying documents.

Although the nonprofit entity itself is not subject to IRC §409A, the officers of the organization are. Failure to comply could subject executives to immediate taxation, a 20 percent excise tax and interest penalties. As mentioned above, IRC §457(f) plans are regulated by IRC §409A. In addition, many nonprofit entities have other compensation arrangements that should be reviewed, such

as bonus and incentive plans where the bonus is paid in the year after it was earned, severance arrangements, Supplemental Employee Retirement Plans and arrangements that provide for "gross-up" payments.

Notice 2010-6 gives a taxpayer the ability to bring its underlying plan documents into compliance with IRC §409A by December 31, 2010, so long as any operational issues are also corrected under Notice 2008-113. If the terms of Notice 2010-6 are satisfied, the Service will not impose the sanctions contained in IRC §409A. However, in certain cases, compliance with Notice 2010-6 will result in a reduced level of income recognition and related excise tax.

It is possible for the definition of certain terms in a plan to conflict with the definition of those terms in IRC §409A. The Notice gives the plan the ability to amend those terms (the IRS uses as examples the terms "change in control," "disability," and "separation from service"), although some of the amendments can be made only on a prospective basis. The Notice also indicates that certain ambiguous plan terms which are often found in the discussion of distributions from the plan, such as "as soon as reasonably practicable," will not cause the plan to fail to satisfy IRC §409A's requirements if the plan, in operation, satisfies the terms of IRC §409A.

If a plan which fails to satisfy the requirements of IRC §409A is eligible for correction under Notice 2010-6, and the plan is corrected on or before December 31, 2010, the plan will be treated as having been corrected on January 1, 2009, and any requirement of income inclusion under IRC §409A as a condition of the relief will not apply. However, Notice 2010-6 also provides that this transition relief will apply only if any payment made before December 31, 2010, that would not have been made under the corrected provision, will be classified as an operational failure and thus subject to the provisions of Notice 2008-113. The benefits of Notice 2010-6 will

not be available to taxpayers that are under examination on an IRC §409A-related issue.

While many non-profit organizations have already undertaken plan reviews, there is value in making an additional review, particularly in light of the specific issues that have been addressed in Notice 2010-6. If violations are found, corrections can still be made before the end of this year to mitigate penalties.

*Please contact the Compensation and Benefits practice if you have further questions. Derrick Neuhauser, Senior Manager, dneuhauser@bdo.com, and Yolanda Scannicchio, yscannicchio@bdo.com.*

## FBAR (Foreign Bank Account Reporting)

Form TDF 90-22.1, Report of Foreign Bank Accounts, was due on June 30, 2010, for organizations and other entities which maintained foreign accounts during the year ended December 31, 2009. Persons with signing authority over such accounts have until June 30, 2011, to file the FBAR form for tax years ended December 31, 2010, and earlier. Organizations with foreign comingled funds that are mutual funds were required to file the FBAR form for the year ended December 31, 2009, and prior years by June 30, 2010. See the March 2010 *Nonprofit Standard* for more details. Organizations that missed the filing deadline should consult with their tax advisors.

# NONFINANCIAL ASSETS AND LIABILITIES – WHAT DO I NEED TO KNOW?

By Lee Klumpp, CPA

Now that we are in 2010 the deferral of applying Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 820, *Fair Value Measurements and Disclosures*, (formerly Statement of Financial Accounting Standards No. 157, *Fair Value Measurements*) for nonfinancial assets and nonfinancial liabilities in interim or annual financial statements has now expired and the guidance is now in effect. Nonprofit organizations are now required to reflect the fair value of nonfinancial assets and nonfinancial liabilities in their financial statements.

## ▶ WHAT DOES THIS REALLY MEAN?

As of December 31, 2009, nonprofit organizations may be required to disclose fair value measurement information in the financial statements for certain nonfinancial assets and liabilities, such as other real estate owned, goodwill or pension obligations.

For purposes of the application of ASC 820, nonfinancial assets and nonfinancial liabilities

include all assets and liabilities other than those meeting the definition of a financial asset or financial liability. Financial assets are defined as cash, evidence of an ownership interest in an entity, or a contract that conveys to one entity a right to do either of the following:

- Receive cash or another financial instrument from a second entity.
- Exchange other financial instruments on potentially favorable terms with the second entity.

Nonfinancial assets include land, buildings, equipment, use of facilities or utilities, materials and supplies, intangible assets or services. An example of a nonfinancial asset is when a nonprofit organization receives a donor contribution of an asset that does not have a readily marketable value and it meets the definition of a nonfinancial asset. An example would be when a donor contributes a building to a nonprofit organization to be used for the organization's program activities. The building does not have a readily determinable market value and; therefore, would require an appraisal to determine its fair value. The asset would then be recorded at fair value at the time of the contribution to organization.

A financial liability is defined as a contract that imposes on one entity an obligation to do either of the following:

- Deliver cash or another financial instrument to a second entity.
- Exchange other financial instruments on potentially unfavorable terms with the second entity.

Nonfinancial liabilities are generally not an issue for a nonprofit organization but an example of a nonfinancial liability would be if a nonprofit organization makes an unconditional promise to contribute land to another nonprofit organization and has not yet transferred title of the land at the statement of financial position date. The nonprofit organization would need to record a grants payable, which would be a nonfinancial liability.

The FASB has issued guidance noting that lease classifications and measurements are excluded from the provisions of ASC 820.

This standard will not really be an issue for most nonprofits unless your organization is entering into a merger or doing an acquisition, disposing of an activity or long-lived asset, or your organization has intangibles such as goodwill. If you have any of these activities you should consult with your financial advisor regarding the impact of this standard on your financial statements.

For more information contact Lee Klumpp, Senior Manager, at [lklumpp@bdo.com](mailto:lklumpp@bdo.com).

## ITEMS TO WATCH...

**Tax Legislation: Extenders** – extensions of expiring beneficial laws that impact exempt organizations are still pending. Charitable extenders potentially include provisions for:

- IRA contributions to charity,
- favorable basis adjustments for S-corporations making contributions of property,
- conservation contributions of real property,
- contributions of computer inventory,
- contributions of food inventory,
- contributions of book inventory to public schools, and
- extension of special rules for interest, rent, royalties, and annuities received by an exempt entity from a controlled entity.

The House passed "American Jobs and Closing Tax Loopholes Act" (H.R. 4213) that includes these provisions, but the Senate has yet to agree.

Time will tell if any will become law. If they do become law, the provisions would likely be retroactive to January 1, 2010.

### Congress Seeking to Reform Government Auditing

Illinois Congresswoman Melissa Bean (D) introduced H.R. 5018 (the Bill), the *Government Audit Reform Act*, which is to amend the Single Audit Act of 1984 to address issues related to the quality of single audits. This bill is co-sponsored by Texas Congressman Mike Conway (R).

This bill is based on the findings in the President's Council on Integrity and Efficiency's (PCIE) single audit sampling report in 2007. The report found that there were a significant amount of single audits that were performed that were unacceptable or had limited reliability.

The legislation would enact recommendations made by GAO in its report issued in response to the PCIE single audit sampling report to address problems with the single audit.

The Bill has been referred to the House Committee on Oversight and Government Reform, where it awaits action and deliberation.

### GAO to Release Exposure Draft on 2011 Revised Yellow Book

The Government Accountability Office (GAO) officials have announced that they plan to release an exposure draft on the 2011 revisions to the *Government Auditing Standards* (Yellow Book) sometime this summer, and plan to issue the final version by June 2011.

The proposed revised Yellow Book would include a principle-based approach to the independence standards and clarify continuing education requirements for those involved in Yellow Book engagements to ensure that those participating in such engagements be qualified and maintain professional competence. The GAO has also proposed expansion of its quality control and assurance requirements in the Yellow Book.

# IRS REVOKING EXEMPTIONS FOR NONFILING

May 17, 2010, marks the first date IRS can revoke exemptions for nonfiling—starting with calendar year organizations failing to file for 2007–2009. In 2006 The Pension Protection Act put into place law that requires the IRS to revoke organizations' tax exemptions for not filing. Intended to clear the rolls and get a more accurate summary of existing organizations by requiring all organizations to provide certain information to IRS to retain their exemption, most tax-exempt organizations, other than churches, must submit a yearly 990 filing with the IRS. If an organization does not file as required for three consecutive years, the law provides automatic loss of tax-exempt status. Loss of exempt status means an organization must file income tax

returns and pay income tax, and donations to 501(c)(3)s are no longer deductible by donors. A new application for exemption would need to be filed and it would apply from the date approved forward.

Despite an extraordinary outreach effort to the tax-exempt sector on the law's new filing requirements, which includes the new electronic Form 990-N e-Postcard for eligible small organizations, many of these smaller organizations are not aware or just learning of the deadline. Now that the May 17th filing deadline has passed, IRS indicates many small tax-exempt organizations have not filed the required information return in time. They have posted a notice that they want to reassure these small organizations

that the IRS will do what it can to help them avoid losing their tax-exempt status, and will be providing additional guidance in the near future on how it will help these organizations maintain their important tax-exempt status—even if they missed the May 17th deadline. The guidance will offer relief to these small organizations and provide them with the opportunity to keep their critical tax-exempt status intact. Internal Revenue Code Section 6033(j)(3) grants IRS the discretion to reinstate an organization's exempt status retroactively if they can show reasonable cause for not filing. Organizations that missed the deadline are urged to go ahead and file even though the May 17th deadline has passed.

## ▶CONTINUED FROM PAGE 1 AUDIT CHECKLIST

these questions mirror those already on the Form 990, some go a little deeper in detail and others are entirely new. Key questions and areas include:

- Does the organization have a written mission statement that reflects its *current* 501(c)(3) purpose? Agents are instructed to answer “no” if there is no mission statement or the mission statement is not aligned with the current activities of the organization.
- In addition to asking to whom the organization's articles and bylaws are provided and how large is the governing body, it asks if the bylaws have requirements as to the board's composition, duties, qualifications and voting rights.
- How often did a quorum of the board meet during the year and how often did the full board meet? It follows this by asking if the number of meetings met or exceeded the meeting requirements of the bylaws.
- With regard to compensation for officers, directors and key employees, the questions about advance approval and documentation by an independent authorized body and use of comparability mirror similar questions on the new Form 990. However, the checklist goes on to ask exactly what kinds

of organizations are used for comparison (exempts, government, for-profit, etc.)

- Does effective control of the organization rest with a single person or select few individuals? The agent instructions say that this should be answered “yes” if the board typically defers to a small group or an individual on the board—seemingly a subjective question for the agent to answer. As with the Form 990, disclosure of business and family relationships among board members is required.
- In addition to the now standard Form 990 question about having a written conflict of interest policy and whether annual disclosures are required, the checklist asks if the policy addresses recusals. If there were any actual conflicts disclosed, was the organization's policy adhered to?
- In the area of financial oversight, questions address policies and procedures to assure that assets are used consistent with the organization mission. How often did board members get written reports on financial activities and how often were finances discussed?
- Was an independent accountant's report issued and was it discussed by the board?

Was a management letter issued and was it reviewed by board or committee? Were any of the accountant's recommendations adopted?

- Is there is a document retention and destruction policy (same as the Form 990 question) and did the organization adhere to the policy?
- The checklist concludes by asking if the examination was hindered by a lack of necessary documentation.

**Conclusion:** This checklist provides excellent insight into what the IRS may consider as the most significant governance issues. It certainly delves much deeper than the Form 990 questions with which many organizations wrestled. Charities may wish to complete this checklist on their own as a self-assessment tool, to see how they might stack up in an audit situation. The complete checklist and agent instructions are available at <http://www.irs.gov/charities/article/0,,id=216068,00.html>.

For more information, contact Michael Sorrells, BDO National Director Nonprofit Tax Services, at [msorrells@bdo.com](mailto:msorrells@bdo.com).



## WEBINARS

The following schedule lists planned webinars that BDO will be hosting over the next few months. These webinars are free, CPE-qualified webcasts that are offered on various topics. As a recipient of the *Nonprofit Standard* you are also on the mailing list for the invitations to these webinars. As the date of each webinar approaches you will receive an invitation with further information on the webinar content and enrollment options.

**We hope you and your colleagues will plan on participating in many, if not all, of these sessions.**

### JULY 2010

July 7 / 12:30-2:00 ET

#### **Single Audit – How Will Your Organization Be Affected by the American Recovery and Reinvestment Act and the New Regulatory Requirements?**

CPE: 1.5 Governmental Accounting  
Specialization: Yellow Book

July 28 / 12:00-2:00 ET

#### **Fair Value Accounting for Nonprofits – What You Need To Know**

CPE: 2.0 Accounting  
Specialization: Yellow Book/Technical

### SEPTEMBER 2010

September 28 / 12:00-2:00 ET

#### **Nonprofit Mergers and Acquisitions – Applying the New Guidance**

CPE: 2.0 Accounting  
Specialization: Yellow Book/Technical

BDO also conducts various live seminars throughout the country on topics that are of specific interest to nonprofit organizations. These seminars are offered free of charge and are CPE-qualified. Contact your local office for seminars that are being conducted locally or check our website: [www.bdo.com/events](http://www.bdo.com/events) for further details.

## BDO NONPROFIT PRACTICE

For 100 years, BDO has provided services to the not-for-profit community. Through decades of working in this sector, we have developed a significant capability and fluency in the general and specific business issues that may face these organizations.

With more than 2,000 clients in the not-for-profit sector, BDO's team of professionals offers the hands-on experience and technical skill to serve the distinctive needs of our not-for-profit clients – and help them fulfill their missions. We supplement our technical approach by analyzing and advising our clients on the many elements of running a successful not-for-profit organization.

In addition, BDO's Institute for Nonprofit Excellence<sup>SM</sup> (the Institute) has the skills and knowledge to provide high quality services and meet the needs of the nation's not-for-profit sector. Based in our Greater Washington, DC Metro office, the Institute supports and collaborates with BDO offices around the country to develop innovative and practical accounting and operational strategies for the tax-exempt organizations they serve. The Institute also serves as a resource, studying and disseminating information pertaining to not-for-profit accounting and business management.

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**NOTE:** Due to the large number of current topics covered in this edition, the follow-up to the March 2010 article entitled "Effective Policies – Building the Foundation of Your Organization" will appear in the next issue of the *Nonprofit Standard*.