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NONPROFITSTANDARD

IRS CHANGES POSITION ON WHO MUST APPROVE GOVERNANCE POLICIES

By Laura Kalick, JD, LLM in Tax

AS YOU KNOW, THE FORM 990 REQUESTS INFORMATION ABOUT WHETHER AN ORGANIZATION HAS ADOPTED VARIOUS POLICIES, INCLUDING CONFLICT OF INTEREST, COMPENSATION REVIEW, DOCUMENT RETENTION, ETC.

These questions were introduced for the first time when the Form 990 was revised. At the time, the addition of the questions was very controversial and some still take the position that the IRS does not have the statutory authority to ask the questions. On the other hand, the IRS believes that it does have the authority to ask the questions because it is the IRS's responsibility to see that the tax laws are properly administered.

Instructions to the 2008 and 2009 Forms 990 allowed an organization to state affirmatively that it had adopted the various policies if as of the last day of the organization's tax year the policy was in place. Then the IRS changed the instructions for the 2010 Form 990 to provide that an organization could answer the question "Yes" but "only if the organization's governing board (not a department or committee) adopted the policy by the end of its tax year."

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GOVERNANCE POLICIES

Now the IRS has announced that full board approval will not be required, but rather, the IRS will instead allow a committee of the full board to adopt the policy if it is done by the end of its tax year. The IRS indicated that this change would be effective for tax years 2010 and beyond, and that the instructions will be revised for the 2011 Form 990.

How did we get to this point and what effect do these questions and instructions have on exempt organizations? Does the fact that an organization has policies necessarily mean that the organization is well governed or are there other factors that are more important? Why would it be necessary for the full board to approve adoption of a policy if a committee with delegated authority had approved the policy? Does the fact that an organization has a conflict of interest policy mean that all conflicts are disclosed and the policy is enforced?

The IRS takes the position that a well-governed organization is more likely to be tax compliant. In an attempt to prove their hypothesis, the IRS has trained its agents on governance issues and provided a check sheet [for 501(c)(3) entities] with questions in order to show that there is a correlation between a poorly governed organization and numerous infractions of the tax laws. The check sheet[1] contains various questions, including whether the organization has a written mission statement that articulates its current §501(c)(3) purpose(s); how often the full board met during the year under examination and whether the number of meetings met or exceeded the number of meeting requirements set forth in the organization's bylaws, etc.

Although the basic premise that a well-governed organization is more likely to be more tax compliant may have some merit, as was pointed out by the Advisory Committee on Tax Exempt and Government Entities (ACT)[2], it is the practices of an organization, not necessarily the policies of an organization, that will show whether an organization is well governed. The executive summary of the report states:

Effective governance practices among these organizations will vary depending on numerous factors, including size, sophistication, location, available resources, and activities. Moreover, while we may all agree that governance matters, it is not at all clear that requiring specific governance practices results in greater compliance with the tax laws. In fact, superior board governance may have much more to do with the values, active engagement, and accountability of those in charge than with the adoption of procedures and policies.

▶CONCLUSION

With the exception of document retention and whistleblower policies that Sarbanes-Oxley mandates for nonprofit organizations as well as taxable corporations, none of these other policies are required by the Federal law. In fact, the IRS cannot deny an organization exemption if it does not have a conflict of interest policy or a broad based independent board in the absence of a showing of private inurement. However, IRS will make it difficult to obtain the exemption and if an organization appears to be at risk for the possibility of providing insiders unreasonable compensation or other private inurement, agents are told to mark the case for future referral.[3] Likewise, although the IRS may request information regarding whether an organization has a conflict of interest policy or various other policies, the fact that the organization does not have the policies cannot be the basis for revocation of exemption. However, the presence of the policies does provide a framework for an organization in which to operate. One size does not fit all and organizations should adopt the policies that are appropriate for them and should use the policies as guidance in operating an effective, ethical organization.

INSTITUTE PROFESSIONAL PROFILE

MEET LAURA KALICK

Laura Kalick is the national tax consulting director in BDO's Institute for Nonprofit Excellence℠. Based in the Bethesda office, she has more than 35 years of experience in both private and government practice that includes working with the IRS National Office, the U.S. Senate, and large accounting firms, as well as practicing law.

Laura works with a diverse group of complex exempt organizations including large charities, trade associations, healthcare organizations, foundations and social welfare organizations. Laura's experience covers transactions and contracts between tax-exempt organizations and taxable entities, private inurement, private benefit, intermediate sanctions, unrelated business income and allocation of expenses, private business use of tax-exempt bonds, lobbying and political activity, public charity status, and compensation arrangements. Laura also works with tax-exempt clients on filing applications for exemption, ASC 740-10 (FIN 48) documentation, IRS audits and the new Form 990.

Laura is a frequent speaker and author on many of these topics. She is also a member of many professional associations including the American Bar Association where she is the co-chair of the Unrelated Business Income Tax Subcommittee.

Laura has a B.A. degree from the University of Michigan, a J.D. from George Washington University and a LLM in Taxation from Georgetown University.

[1] http://www.irs.gov/pub/irs-tege/governance_check_sheet.pdf (Form 14114 (12-2009) Catalog Number 54282M)

[2] The Internal Revenue Service's Advisory Committee on Tax Exempt and Government Entities (ACT) is a group of outside professionals and practitioners who advise the IRS on various matters in order to improve the IRS. See http://www.irs.gov/pub/irs-tege/executive_summary_actgovernancerept.pdf (June 11, 2008) THE APPROPRIATE ROLE OF THE INTERNAL REVENUE SERVICE WITH RESPECT TO TAX-EXEMPT ORGANIZATION GOOD GOVERNANCE ISSUES

[3] See Internal Revenue Manual 7.20.4.6 (11-01-2004) Board Expansion

For more information, contact Laura Kalick, national director, Nonprofit Tax Consulting, at lkalick@bdo.com.

PRIVATE FOUNDATION FOREIGN GIVING

By R. Michael Sorrells, CPA

Grant making private foundations (PFs) are required to make a minimum amount of qualified distributions annually. This minimum is based upon a percentage of the PF's investments, subject to a few modifications. Failure to make the amount of required minimum distributions annually can result in excise taxes and could even lead to loss of exempt status. Additionally, non-qualifying grants or contributions may be considered taxable expenditures and are subject to an excise tax of 20% (for the organization) and an additional 5% tax on PF officers or managers *personally*, if they knowingly approve such distributions.

During the process of preparing Form 990-PF returns at year-end, we have discovered many instances where PFs had made grants to foreign organizations which were not "qualified distributions." These PFs had the very unpleasant experience of paying an unplanned and often significant excise tax on taxable expenditures and also finding out that their charitable distributions were less than required. It is essential for PF managers and officers who approve grants to know the basics of which foreign distributions are eligible for qualifying distribution treatment and when "expenditure responsibility" must be exercised (see discussion of expenditure responsibility below).

▶THE GENERAL RULE

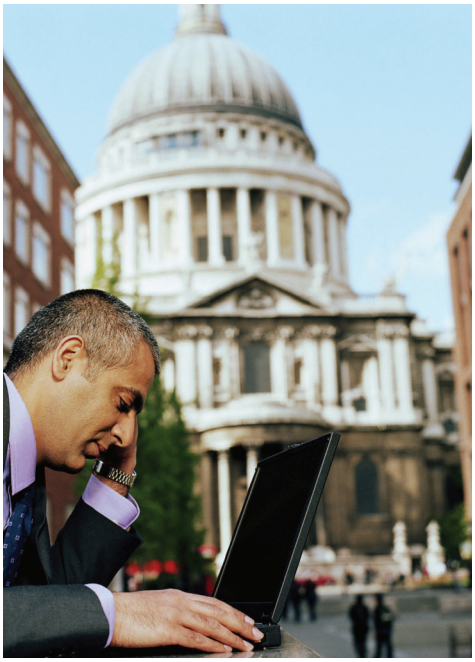
Grant making private foundations can make qualifying distributions to most 501(c)(3) *public* charities. Public charity status can be determined by consulting IRS Publication 78 (searchable on the IRS website at www.irs.gov/charities/article/0,,id=96136,00.html). Some foreign organizations have obtained a determination from the IRS that they are a 501(c)(3) charity and should be listed in Publication 78 or they can provide a copy of their determination letter. In that case, a distribution is a qualifying distribution and the PF should not have to exercise expenditure responsibility. However, the majority of foreign organizations will not be listed in Publication 78. For these organizations, distributions may still qualify under certain conditions as discussed below.

▶EQUIVALENCY LETTER

One option for the PF that wishes to fund international activities directly is to make a determination that the foreign organization it wishes to support is essentially the equivalent of a U.S. 501(c)(3) public charity. This may be done by seeking an opinion of counsel or by having the potential foreign grantee fill out an affidavit. The affidavit is designed to elicit all the information about the foreign grantee that would enable the IRS to determine whether it would be granted tax-exempt, public charity status if it were to apply. The information required is fairly extensive and includes financials for the current and previous years, governing documents, details about the board of directors, descriptions of programs and activities, etc. The affidavit must be completed in English and supporting documentation, such as the potential grantee's articles of organization and bylaws, must be translated into English. IRS Revenue Procedure 92-94 describes the affidavit requirements.

▶EXPENDITURE RESPONSIBILITY

A grant or contribution to a foreign charity can be allowed if there is a truly charitable purpose to the grant (e.g., an educational program) and expenditure responsibility is exercised. Expenditure responsibility entails a written commitment to utilize the grant only for the specified charitable purposes, provision of full periodic written reports on the use of grant funds and project progress, maintenance of records for funds received and expended, and agreement to return any funds not utilized for the charitable purpose once the project is completed. This is only a general description; see IRC Regulation 53-4945-5(b)(1) for full details. It is important that expenditure responsibility be carefully and fully implemented and monitored precisely as the regulations require.



In determining whether to exercise expenditure responsibility or do an equivalency determination, PFs should consider that the latter requires more investigation and work upfront, while the former requires more ongoing attention. If the potential grantee cannot provide the information necessary for the equivalency determination, the PF will have no choice but to exercise expenditure responsibility.

▶TAX TREATIES

Lastly, a tax treaty with a foreign country may establish that a charity is the equivalent of a U.S. 501(c)(3) public charity. For example, it appears that if Mexican organizations are charities under Mexican law that they are presumed to be public charities under the U.S.-Mexican tax treaty. Therefore, grants to those organizations can be qualifying distributions and should not be considered taxable expenditures, despite the fact that there has been no expenditure responsibility exercised. Article 22 of the United States-Mexico Income Tax Convention states in part that "[i]f the Contracting States agree that a provision of Mexican law provides standards

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for organizations authorized to receive deductible contributions that are essentially equivalent to the standards of United States law for public charities ... an organization determined by Mexican authorities to meet such standards shall be treated, for purposes of grants by United States private foundations and public charities, as a public charity under United States law."

On the other hand, for Canadian charities, the tax treaty is quite different. The U.S. presumes, in the absence of certain financial information, that all Canadian registered charities are private foundations. Grants from private foundations to other private foundations are typically not qualified expenditures. However, Canadian charities that have submitted the proper information will be listed on Publication 78 and are eligible for qualified distribution treatment. Therefore, the Canadian organization must have either a Publication 78 listing, an equivalency opinion or there must be expenditure responsibility exercised in order for distributions to be qualified.

There may be relief in other tax treaties for distributions from PFs. We recommend consulting with an expert in this area if a treaty is to be relied upon.

▶CONCLUSION

The laws and regulations concerning qualifying distributions from PFs are a complex area. PFs should be very careful and exercise due diligence prior to making distributions to foreign organizations, as the penalties are severe for doing otherwise. Policies should be implemented to assure that the rules are complied with and that documentation of the process for each grant is part of the organization's records.

For more information, contact Michael Sorrells, national director, Nonprofit Tax Services, at msorrells@bdo.com.

UPDATES FROM THE IRS

By Laura Kalick, JD, LLM in Tax

The following discusses a few recent issues that have been addressed by the IRS that tax-exempt organizations should be aware of.

Booster Club Dues and Non-Exempt Activity

An organization may conduct a fundraising campaign to raise funds for a particular activity that will be undertaken by the members; for example, a trip for children. One division of the IRS has indicated that if an individual makes a contribution that will be credited for the account of their child's trip, and the amount in excess of the benefit received by the child was given with a charitable donative intent, that it may be possible to deduct the amount in excess as a charitable contribution.

This practice, however, raised some concerns with the IRS Director of Exempt Organizations, Ms. Lois Lerner, as to whether such practices could have an adverse effect on the exempt status of a 501(c)(3) organization because it was more than a mere incidental private benefit, but rather, was intentional and, if substantial, could threaten exempt status. She also indicated that such a practice could result in income to the individual who raised the funds. Finally, although not mentioned in the June 27, 2011 communication from the IRS, it is possible that crediting the account of individuals with the amounts that they raised could turn an activity into an unrelated trade or business if it is regularly carried on. Many organizations conduct fundraising activities on a regular basis (such as car washes with volunteers) and these activities are not deemed to be subject to unrelated trade or business income tax because of the so-called volunteer labor exception, i.e., substantially all the work is conducted by persons who are not compensated. If the volunteer gets a credit into his or her account for labor, then it may constitute compensation. These rules are complex and if an organization has any concerns, it should consult with its tax advisor.

Gift Tax Consequences of Contributions to IRC 501(c)(4) Social Welfare Organizations

We had previously reported that the IRS was considering imposing the gift tax on contributions to IRC Section 501(c)(4) social welfare organizations. This type of organization can engage in political activity as long as it is not their primary purpose. Although 501(c)(4) organizations must reveal their contributors to the IRS, this is not public information, whereas political organizations do have to make information about their donors public. The IRS has now indicated that it has closed the cases where it was investigating the imposition of the gift tax and will not pursue the matter further. However, Revenue Ruling 82-216 is still on its books and that ruling states, "The Service continues to maintain that gratuitous transfers to persons other than organizations described in section 527(e) of the Code are subject to the gift tax absent any specific statute to the contrary, even though the transfers may be motivated by a desire to advance the donor's own social, political or charitable goals. " It appears that further clarification may be necessary.

Schedule H of Form 990

On July 5, 2011, the IRS issued Announcement 2011-37 that provides that Part V, Section B ("Part V.B") of Schedule H, *Hospitals*, of the 2010 Form 990, *Return of Organization Exempt From Income Tax*, will be optional for the 2010 tax year. The questions asked on Schedule H require information relating to the new IRC Section 501(r) tax-exempt hospital requirements enacted by the Patient Protection and Affordable Care Act in 2010.

For more information, contact Laura Kalick, national director, Nonprofit Tax Consulting, at lkalick@bdo.com.

EXECUTIVE COMPENSATION: IS IT REASONABLE?

By Mike Conover

THERE SEEMS TO BE NO END TO THE STORIES OF SENSATIONAL EXECUTIVE PAY PRACTICES EXPOSED IN TAX-EXEMPT ORGANIZATIONS.

Rarely is much attention given to the specifics of the organization or the qualifications required of the executive in question. The focus of the story usually rests on the paradox of "not-for-profit" versus an allegedly "outrageous" amount of compensation. As predictable as these stories might appear, they are especially disturbing during difficult economic times. And unfortunately, the stories not only taint the organization who is the subject of the article, but the entire tax-exempt community.

Not all of the bad examples spotlighted in the press are simply misunderstood organizations and the dedicated souls that manage them. There are unfortunately some bad apples where abuse has occurred. However, there are also some unusual situations where one-of-a-kind or particularly complex organizations or highly specialized positions simply defy a simple explanation of the compensation arrangements in use. These organizations would be well-advised to pay particular attention to the practices used to govern their compensation arrangements. The remainder of this article offers some thoughts on how these organizations might address these issues.

The overriding principle in executive compensation for tax-exempt organizations is reasonableness. The term "executive compensation" used throughout this article includes the aggregate of all pay, benefits and any perquisites offered to the organization's policymaking executives. Reasonableness can be assessed from several perspectives, including the following:

- Compensation is set at levels and structured in a manner required to attract, engage and retain qualified personnel needed to fulfill the organization's mission and should not enrich or inure any individual(s).
- Compensation deliberations and decision making is performed by objective and independent members of the organization's governing body and should not involve the executive(s) in question.
- Information and/or professional advice about compensation levels and methods offered by other organizations that compete for comparable executive resources is an essential requirement for sound decision making. These decisions should not be based on unsupported hunches or flattering comparisons.
- Adequate documentation of deliberations and decisions made about executive compensation must be kept to support the rationale for compensation levels and methods. An organization should not rely on individuals' recollections or after-the-fact expression of intentions.

The IRS Intermediate Sanctions offer a "presumption of reasonableness" to those tax-exempt organizations adopting the required practices to ensure that "reasonableness" characterizes the organization's executive compensation practices. All organizations, especially the unusual and/or unique ones, should pay particular attention to ensure that these practices are effectively implemented and well-suited to their own unique context. Failure to do so inevitably leads to embarrassment or penalties when compensation practices are exposed or challenged.

The recommended practices associated with the Intermediate Sanctions are outlined in the next section of this article. We have highlighted some points that are

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particularly applicable to unusual and/or unique organizations. Note that while an organization may not choose to follow all the suggestions, we have noted that there is at least one required item for each of the three major practices to secure the presumption of reasonableness.

▶GOVERNANCE

There is a requirement that the organization rely on its independent board members (or designated committee of independent board members) to be formally charged with oversight responsibility for executive compensation arrangements. It would be difficult to overemphasize the importance of this group in an organization's efforts to comply with the Intermediate Sanctions and address the needs of an unusual organization or executive position.

The requirement for a group with the independence and freedom from conflict of interest is nearly self-evident insofar as reasonable executive compensation decision making is concerned. This body can oversee the organization's compensation practices in an objective manner to ensure decisions are made in the best interests of the organization and with complete propriety in terms of the executive(s) in question. Ideally, at least one member of the group should have experience with compensation matters and be able to provide helpful background information on a topic under consideration or identify the need to call in outside expertise.

The unique and/or unusual situation will gain a particular benefit from members that are thoroughly familiar with the organization and/or position(s) in question. This allows members to understand, consider and decide compensation issues in the context of the organization's special issues. This is especially important for identifying relevant benchmarks for comparisons in the external marketplace that warrant consideration as comparable in some critical characteristic or competing for similar executive expertise. Knowledgeable board members can examine relevant external market data, even from sectors that are not directly comparable to the organization and/or position at hand, and use it as a context for good decision making.

A good compensation governance process would typically have many of the following types of formally adopted policy documents:

- Designation of a responsible party is required and should include the list of independent board and/or committee members currently responsible for oversight and/or governance of executive compensation.
- Formal criteria for determining the independence of the responsible party.
- Conflict of interest policy.
- Specific charter for the group and/or committee charged with responsibility for setting executive compensation including:
  - Roles and authorities for board, committee and management
  - Schedule of meeting(s) for compensation matters and decision making

▶RELEVANT EXTERNAL INFORMATION

There is a requirement that information about methods and levels of compensation offered by other organizations competing for comparable executive resources is provided to the organization's board or committee charged with responsibility for executive compensation. The primary characteristic sought for this type of external information is that it is reasonable and relevant to the organization and position(s) in question. It need not be limited to tax-exempt organizations or just the most directly comparable organizations, though one would certainly expect them to be represented. In some cases, it might be necessary to incorporate information from multiple sources, where no one source is completely comparable to the organization in question, to arrive at an overall consensus of executive compensation in the competitive market.

The key point here, particularly for the unique and/or unusual organization, is that there must be a reasonable basis for the data selected and an explanation of its significance from the standpoint of the context of the organization's decision making. The relevance of the information needs to be established ideally, on a business need basis. As mentioned previously, knowledgeable board members can play a critical role to ensure that efforts to fulfill this requirement are as effective as possible by identifying, evaluating and determining information sources.

Relevant external information would typically include at least one (required) or more of the following sources:

- Published compensation surveys from industry groups, and trade or professional

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EXECUTIVE COMPENSATION

organizations that report on pay practices in organizations and/or positions accompanied by a documented explanation of their relevance addressing such questions as "Why was this particular source used?", etc.

- Form 990's from peer and/or competitor organizations and the criteria used to select them.
- Consultant studies performed by qualified professionals to evaluate the organization's executive compensation program.

▶DOCUMENTATION

This final requirement involves the maintenance of a thorough and timely record of board deliberations and decisions regarding executive compensation. Of course, this documentation supplies much of the support required to demonstrate the organization's efforts to comply with the two previously described requirements. It details when, how and what has been done (as well as by whom) to arrive at the organization's executive compensation decisions.

This information documents not only the organization's efforts to promote compliance with the Intermediate Sanctions, but also serves as a means for ensuring continuity and consistency in the organization's executive compensation practices over time. With records of past deliberations and decisions and possibly other policy-related information, the organization's executive compensation practices are not redefined every time the board meets or there is a change in the membership of the responsible committee or group. Ideally, it is a clear record of the organization's efforts to ensure its compensation decisions are reasonable and that sincere efforts have been made to comply with the Intermediate Sanctions and standards of good practice.

The importance of this requirement, especially for the unique and/or unusual organization, ought to be obvious. All documentation maintained about the organization's executive compensation practices represent an excellent opportunity to detail the particulars associated with the efforts to: involve the appropriate individuals in the governance process; establish a reasonable basis for evaluating competitive practices; and the rationale for deciding the organization's executive pay practices. The more unusual the organization, the more unique the position, or the greater the compensation, the more important it is for excellent documentation.

Examples of the types of documentation that would typically support an executive compensation program include one or more of the following:

- Minutes of meetings are required to satisfy the Intermediate Sanctions' presumption of reasonableness.
  - The minutes should be detailed and include dates, people participating in the meeting, reports and documents used, summaries of topics considered, deliberations, decisions made and the rationale for them.
  - The minutes must be prepared on a timely basis which is defined as the earlier of the next meeting date or 60 days, whichever comes first.
- Compensation policy statement or program description containing the following items:
  - Overall compensation philosophy that describes the role of compensation in the management and operation of the organization.
  - Guiding principles that govern the design and administration of the executive compensation program.
  - Calendar showing the schedule of compensation program activities and decisions (e.g. goal setting, performance evaluation, review of competitive data, salary review, etc.).

In summary, there are a couple of final points that need to be made. First, to take advantage of the Intermediate Sanction's presumption of reasonableness, each of the three broad requirements we have covered here must be addressed. Failure to satisfy any one of them puts the burden of proof back on the organization to establish that executive compensation practices are reasonable. It is not too difficult to imagine that responding to a challenge with hastily produced documentation after the fact puts an organization, especially a unique and/or unusual one, at a considerable disadvantage when trying to justify current practices even if they are subsequently found reasonable. Most would agree, it is much better to have a well-documented program that could be readily understood by any outsider offered the opportunity to review it.

One might ask the following question while reviewing the overall program: "Is there anything here that might be difficult to explain to a supporter and/or sponsor of our organization?"

Finally, it would be a good idea for board members to familiarize themselves with the full range of compensation offered to the organization's policy making positions (e.g. salary, bonus/incentive, benefits – particularly any special retirement or deferred compensation arrangements, perquisites such as automobiles/auto allowances, first class travel, club memberships, etc.). One might ask the following question while reviewing the overall program: "Is there anything here that might be difficult to explain to a supporter and/or sponsor of our organization?"
Any aspect of the organization's current compensation practice that seems unusual or out of character for the organization should be reviewed to ensure all the requirements outlined here have been met.

For more information, contact Michael Conover, senior director, Specialized Tax Services – Compensation and Benefits, at wconover@bdo.com.

AICPA COMMENTS ON REVISED FORM 990

By Joyce Underwood, CPA

In June 2011, the IRS released Announcement 2011-36 requesting public comments on transitional issues and frequently asked questions involving the redesigned Form 990. On August 9th the AICPA released its comments developed by their Exempt Organizations Tax Technical Resource Panel and approved by their Tax Executive Committee in a letter to Stephen Clarke of the IRS. A summary of the areas commented on are as follows:

- Activity codes for Activities on Part III
- Reporting compensation to management companies and leasing companies owned or controlled by officers, directors, trustees or key employees
- Thresholds for reporting compensation to key employees, highest compensated employees, independent contractors, and former officers, directors, trustees, and key employees
- Reporting revenue from governmental units
- Net asset reconciliation
- Reporting on audited financial statements
- Names and Employer Identification Numbers (EINs) of foreign grantees
- Indirect foreign expenditures
- Reporting bank deposits as loans or business transactions on Schedule L
- Reporting of component parts of community trusts on Form 990-series returns
- Scope of related organization reporting on Schedule R

Complete details on the AICPA comments can be found both on the IRS and AICPA websites under "Announcement 2011-36."

Additionally, the AICPA released a separate letter to Ms. Lois Lerner, the IRS Director of Exempt Organizations, which provides the AICPA's current year comments on Form 990 and its instructions. These comments were developed by an AICPA Task Force of practitioners serving tax-exempt organizations and approved by the AICPA's Exempt Organizations Tax Technical Resource Panel. As such, they are based on hands-on practitioner experiences and describe issues seen in the real world application of the new form. AICPA comments are in the form of a table with issue areas referencing the IRS form or schedule section and line number. Each weights the items by their importance and urgency, and describes the issue and a potential suggested resolution. Items addressed include straightforward matters such as uncertainty of the inclusion of unpaid board members under the definition of total number of "volunteers" on Part I, line 6, to more complex matters requiring theoretical analysis such as disclosures regarding significant dispositions of assets, relationships, and policy matters. Some questions also focus on issues arising from differences between financial statement and tax reporting of contributions, fundraising, and expenses, and the desire to include nonmonetary items in disclosures.

It is expected that the IRS will take into consideration comments from the AICPA and others responding to IRS Announcement 2011-36, as well as other public and private comments such as the IRS letter to Ms. Lerner when considering future revisions and guidance on the Form 990. All comments under Announcement 2011-36 were due to the IRS on or before August 1, 2011, and will be open for public inspection.

IRS Releases New Form 8940, Request for Miscellaneous Determinations

By Joyce Underwood, CPA

The IRS has released a new form to facilitate requests for determinations regarding certain activities and events (other than initial exemption applications). In the past if an organization wanted an affirmative opinion on a situation, the organization would request an advance ruling from the IRS to preapprove the facts and consequences. This opinion was obtained by submitting a written request including all the information under the specific regulations necessary to make a determination on the status. Each request under the new form is subject to a user fee as currently outlined under Revenue Procedure 2011-8. The fees currently range from $400 - $1,000. The one-page form is accompanied by instructions that specify what information needs to be submitted to support each of the nine types of requests that may be submitted. The information is similar to what was previously required when an advance determination request was made. The new format is expected to facilitate the request process. Organizations simultaneously requesting tax exemption and either an advance approval of scholarship procedures or an exception from filing Form 990 should include their request with their Form 1023, Application for Exemption, rather than filing Form 8940. Form 8940 can be used to make requests for the following nine determinations:

- advance approval of certain private foundation set-asides;
- advance approval of private foundation voter registration activities;
- advance approval of private foundation scholarship procedures;
- exemption from Form 990 filing requirements;
- advance determination that a potential grant or contribution is an unusual grant that can be excluded from certain public support calculations;
- change in (or initial determination of) the type of a Section 509(a)(3) supporting organization;
- reclassification of foundation status, including a voluntary request from a public charity for private foundation status;
- termination of private foundation status under Section 507(b)(1)(B) (advance ruling request); and
- termination of private foundation status under Section 507(b)(1)(B) (60-month period ended).

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NAVIGATING THROUGH THE ACCOUNTING FOR JOINT ACTIVITIES

By Lee Klumpp, CPA

Many nonprofit organizations solicit contributions to support their mission through a variety of fundraising activities, including the following:

- Direct mail
- Telephone solicitation
- Door-to-door canvassing
- Telethons
- Television and radio spots
- Special events and others

Sometimes these fundraising activities include components that would otherwise be associated with programmatic or supporting service activities, but in fact support fundraising activities.

An example is a mailer that educates the recipient about your organization's mission and/or programmatic activity and on the back of the mailer there is a request for a donation (those little check-boxes that encourage a $25, $50, or $100 pledge). That mailer is possibly a joint activity. Other joint activities might include special fundraising events that also function as membership drives and serve an educational purpose or raise awareness. These activities are referred to as joint activities because they serve more than one purpose and as a result, costs (also referred to as joint costs) can be allocated to these various activities.

The Financial Accounting Standards Board's Accounting Standards Codification (FASB ASC) 958-720 "*Accounting for Costs of Activities that Include Fundraising*" establishes financial accounting standards for accounting for costs related to joint activities and the required financial statement disclosures. This standard includes three criteria that are to be used to determine whether or not an activity qualifies as a joint activity. The three criteria that must be met are purpose, audience, and content. The management of a nonprofit organization must be able to demonstrate that the three criteria are met for the activity to qualify as a joint activity. If all three criteria are not met, the cost of the joint activity defaults to fundraising expense, even if the costs are otherwise identifiable as program costs.

A description of the three criteria is as follows:

A. PURPOSE

The purpose of the activity must be to carry out a program and/or management purpose. The organization should examine tangible evidence of intent (e.g., agreements, policies or other written guidance) to ensure that: (1) the organization intended to engage the audience in a call to action to help accomplish the organization's mission, and (2) the majority of compensation of any party performing any part of the joint activity is not based on the contributions raised.

B. AUDIENCE

The audience should be appropriate with respect to the action being requested. If the target audience includes prior donors, or is otherwise selected based on its ability or likelihood to contribute, a rebuttable presumption exists that the audience criterion is not met. This presumption can be overcome if it can be shown that the audience was selected because it has a reasonable potential to use the call to action or it has the ability to carry out the call to action.

C. CONTENT

The content criterion is met if the joint activity actually supports program or management functions. For example, a mailing supports program functions by asking the recipient to take specific action that will help accomplish the entity's mission (e.g., a mailing by a cancer organization advising the recipient on actions s/he can take to prevent cancer). Although the content criterion overlaps to some extent with the purpose criterion, the purpose criterion focuses on intention, while the content criterion looks at execution. This criterion can also be met if the joint activity fulfills one or more of the organization's management and general responsibilities.

An important part of the purpose and content criteria is that the activity must include a "*call to action*" on the part of the recipient, other than just making a contribution. This call to action is required in order to permit the organization to allocate the costs of the joint activity. Calls to action might include requests for those receiving to: communicate with public officials about some issue, volunteer to help some other organization, change one's personal behavior in some beneficial way, participate in a scientific research study, or attend an academic educational program.

Nonprofit organizations often fail to find creative and meaningful ways to engage the audience through a call to action. In the current economic times with many organizations competing for the same resources, they must make a concerted effort to get people involved in assisting the organization in fulfilling its mission as well as consider a donation.

Once an organization has determined that an activity meets all the required criteria discussed above, it needs to establish the methodology for allocating the costs of the joint activity.

The accounting for joint activities impacts an organization's expense ratio between program, management and general, and fundraising. These percentages are monitored by many stakeholders including the following:

- Donors
- Charity watchdogs
- Boards of Directors
- Senior management
- Corporate funders and sponsors
- Regulators (i.e. the Internal Revenue Service, Congress and its committees, and various federal agencies)

Regulators, watchdogs, and others acting in the interest of donors and the general public are concerned that organizations use the expense allocation of joint activities to overstate the program portion of their activity, thus misleading donors and the general public into believing that the organization is providing more program services to recipients than they really are.

Nonprofit organizations must apply a systematic and rational allocation methodology for the allocation of joint costs as documented in ASC 958-720. Although there are several possible allocation methodologies, the most frequently used

▶ Read more on next page

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ACCOUNTING FOR JOINT ACTIVITIES

allocation methodology is the physical units methodology. Under this methodology, the unit of measure typically used is the lines included in a direct mail piece, television script, or other joint activity). Each joint activity engaged in must be separately analyzed. For example, if an organization undertakes a direct mail campaign over the course of their fiscal year that includes ten mailings, all ten mailings must be analyzed separately. It is not appropriate to analyze one activity (e.g., one direct mail piece), and attribute the allocation percentages based on the line count analysis of this one piece to all of the other mail pieces. It is also not appropriate to use a general estimated percentage (e.g., 60% program, 40% fundraising) based on past analysis, estimates, or some other unverifiable method of allocation.

An organization must be careful that their analysis of program activities is not overstated. One issue is the categorization of educational material as program expenses when it does not have a call to action that requires the recipient to take any specific action. Such an allocation is prohibited under FASB ASC 958-720. For example, a statement that an organization's mission is to fund research on a specific disease, and a descriptive summary of the types of disease research that the organization has helped undertake educates the audience about the nonprofit organization's cause, but does not engage them in any particular action, other than perhaps leading to a request for a donation to further support their research. While the language itself may not directly be a request for funds, it also does not ask the audience to take any specific action that furthers the organization's mission. As such, these costs must be allocated to fundraising. There is an exception in the guidance when educational language may have an implicit call for a specific action. For example, activities that educate the audience about environmental problems caused by not recycling implicitly call for that audience to engage in recycling. In this case, the educational language may be categorized as a program expense.

An organization should make sure that they have accounted for the total cost of all joint activities. An organization should ensure they include all cost components of the joint activity, such as envelopes, letters, an action insert, a premium item (e.g., greeting cards, address labels, etc.), and a business reply envelope.

Once established, the process should be used by an organization to analyze whether a joint activity meets all the criteria and if so, the cost allocation performed should result in a reasonable allocation and be applied consistently.

For more information, contact Lee Klumpp, director, at lklumpp@bdo.com.

ITEMS OF NOTE....

2011 Yellow Book

The Government Accountability Office (GAO) released an interim version of an update to *Government Auditing Standards* (also referred to as the Yellow Book) titled, "*2011 Internet Version of Government Auditing Standards*" (2011 interim revision), which is available on the Yellow Book section of the GAO website at http://www.gao.gov/govaud/iv2011gagas.pdf.

The 2011 interim revision states that the effective date for financial audits and attestation engagements is for periods ending on or after December 15, 2012. It is effective for performance audits for periods beginning on or after December 15, 2011. Early implementation is not permitted.

The GAO has stated on its website that the 2011 interim revision is the intended content for the final 2011 revision of the standards. However, because of the linkage between the AICPA's auditing standards and *Government Auditing Standards*, the GAO is issuing the new standards in an interim "Internet" format only until such time that the AICPA Auditing Standards Board (ASB) completes its clarity revisions to the AICPA's auditing standards. The GAO is monitoring the ASB's progress on the clarity project and once it is complete, the GAO is planning to formally issue the final 2011 revision. It is expected that the final issuance will occur before the end of 2011.

Basis of Presentation of the Schedule of Expenditures of Federal Awards

At a recent meeting with numerous Inspector General (IG) representatives, there was a discussion led by a representative of the AICPA's Government Audit Quality Center (GAQC) regarding a practice issue that had recently come up and had been a finding in a Quality Control Review (QCR) by a Federal Agency regarding the basis of accounting to be used by an entity that was acting as a pass-through of federal awards. The QCR finding issued by the Federal Agency related to an audit of an entity that had made pass-through awards (sub-awards) to subrecipients and prepared its Schedule of Expenditures of Federal Awards (SEFA) on the accrual basis of accounting. The QCR finding asserted that the cash basis of accounting was required for the pass-through entity's SEFA and cited paragraph 12.20 of the AICPA's *Government Auditing Standards* and Circular A-133 Audits Audit Guide to support this position. That paragraph states that "With respect to federal awards passed through to subrecipients, the activity that requires the pass-through entity to comply with laws, regulations, and the provisions of contracts or grant agreements is the **disbursement of funds** to subrecipients."

Based on this guidance, the reviewing Federal Agency took the position that a payable to a subrecipient should not be considered an expenditure until funds are actually disbursed (i.e. essentially requiring that a cash basis of accounting be used). In the GAQC's discussion with the broader IG community attending the meeting, the IG community stated that in their view, as long as the SEFA is clear about the basis of accounting used to prepare the SEFA, that the use of something other than the cash basis of accounting is acceptable for pass-through entities. The IG community noted that the main emphasis should be on ensuring that the notes to the SEFA be clear about the basis of accounting used to prepare the SEFA and that the SEFA be presented on the basis disclosed.

BDO INSTITUTE FOR NONPROFIT EXCELLENCE℠ IN THE NEWS

Members of the Institute are requested to speak on a regular basis at various conferences due to their recognized experience in the industry. The following is a list of some of the upcoming events where you can hear BDO Institute professionals speaking. In addition, to these external venues, BDO will be offering both live local seminars, as well as webinars on such topics as nonprofit tax and accounting updates, international accounting and business issues, disaster recovery and preparedness and insurance needs, executive compensation, and employee benefit plan issues. Please check BDO's website at www.bdo.com for upcoming local events and webinars.

▶OCTOBER

Laura Kalick will be presenting a session entitled "New UBIT Concerns for Hospitals and Healthcare Organizations" at the American Health Lawyers Association 2011 Tax Issues for Healthcare Organizations program in Arlington, Virginia on October 3.

Lee Klumpp will be presenting an eight-hour course entitled "Top Twelve Governmental and Nonprofit Accounting and Auditing Issues Facing CPAs" for the Arizona Society of CPAs on October 3 in Phoenix, Arizona. He will also be presenting this course to the Kentucky Society of CPAs on October 19 in Louisville, Kentucky.

Dick Larkin will be presenting a webinar discussing nonprofit financial statements at the Evangelical Council for Financial Accountability on October 13.

Mike Sorrells will be teaching a course on Form 990 for the Maryland Association of Certified Public Accountants entitled "Form 990: AICPA's Answers to Unlocking the Tax Complexities" in Columbia, Maryland on October 17.

Lee will be presenting two all-day courses for the Illinois Society of CPAs in Chicago, Illinois. He will present "Applying A-133 to Nonprofit and Governmental Organizations" on October 25 and "Audits of HUD-Assisted Projects" on October 26.

Laura will be presenting a webinar entitled "Nonprofit Political Structure: 501(c)(3) Organizations: Keeping Your Tax-Exempt Status Intact" through Columbia Books and Information Services on October 27 from 2–3:30 p.m. EST.

Lee will be presenting two all-day courses for the Missouri Society of CPAs in St. Louis, Missouri. He will present "The 2011 Revised Yellow Book: *Government Auditing Standards*" on October 27 and "Running a Nonprofit Like a For-Profit Business" on October 28.

▶NOVEMBER

Laura will be presenting a webinar entitled "Nonprofit Political Structure: 501(c)(4) & 501(c)(6) Organizations: How Can You Advocate?" through Columbia Books and Information Services on November 1 from 2–3:30 p.m. EST.

Dick will be presenting a one-day course entitled "Accounting Principles and Practice for Not-for-Profit Organizations" for Foxmoor Continuing Education (formerly known as PESI Law & Accounting) in Las Vegas, Nevada on November 3.

Lee will present an all-day course for the Rhode Island Society of CPAs entitled "Fair Value Accounting: A Critical Skill for All CPAs" on November 7 in Providence, Rhode Island. He will also present this course to the Kentucky Society of CPAs on November 10 in Louisville, Kentucky.

Laura will be presenting a live webcast through Knowledge Congress entitled "New Tax Rules for Tax-Exempt Hospitals and Accountable Care Organizations" on November 10 from 12–2 p.m. EST.

Dick will be presenting his current update at the Virginia Society of CPA's 41st Annual Virginia Accounting & Auditing Conference in Virginia Beach, Virginia on November 17 and 18.

▶DECEMBER

Lee will be presenting three separate all-day sessions for the Virginia Society of CPAs in Richmond, Virginia. He will present "The 2011 Revised Yellow Book: *Government Auditing Standards*" on December 7; "Applying A-133 to Nonprofit and Governmental Organizations" on December 8; and "Accounting and Reporting Practices of Nonprofit Organizations" on December 9.

Mike will be presenting two sessions at the Greater Washington Society of CPAs (GWSCPA) Nonprofit Symposium being held in Washington D.C. on December 14 and 15. He will be presenting "Tax Implications for Alternative Investments" and "The 990 Preparation and Organizational Review Process."

Dick and **Lee** will be co-presenting a session entitled "Accounting and Auditing Update" at the GWSCPA Nonprofit Symposium.

▶JANUARY

Cindy Bertrand, a partner in BDO's La Jolla, California office, will be presenting a seminar entitled "Guarding Your Assets: Everything you Need to Know about Finance" at the University of San Diego's 8th Annual Nonprofit Governance Symposium being held on January 6 – 7, 2012.

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BDO NONPROFIT & EDUCATION PRACTICE

For 100 years, BDO has provided services to the nonprofit 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 nonprofit sector, BDO's team of professionals offers the hands-on experience and technical skill to serve the distinctive needs of our nonprofit 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 nonprofit organization.

In addition, BDO's Institute for Nonprofit Excellence℠ (the Institute) has the skills and knowledge to provide high quality services and meet the needs of the nation's nonprofit 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 nonprofit accounting and business management.

ABOUT BDO

BDO is the brand name for BDO USA, LLP, a U.S. professional services firm providing assurance, tax, financial advisory and consulting services to a wide range of publicly traded and privately held companies. For 100 years, BDO has provided quality service through the active involvement of experienced and committed professionals. The firm serves clients through 41 offices and more than 400 independent alliance firm locations nationwide. As an independent Member Firm of BDO International Limited, BDO serves multinational clients through a global network of 1,082 offices in 119 countries.

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