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NONPROFITSTANDARD

BUYER BEWARE: ALTERNATIVE INVESTMENT COMPLIANCE AND TAX ISSUES

By R. Michael Sorrells, CPA

With the promise of greater investment yields, many nonprofit organizations are jumping on the bandwagon and investing in an array of alternative investments, many of which derive income from offshore sources. Such investments include partnerships, limited liability companies (LLCs), hedge funds, funds-of-funds and other similar entities.

Alternative investments can lead to both unrelated business income tax (UBIT) and significant additional filing requirements even when there is no tax liability. These additional filing requirements have to be taken very seriously as there are significant penalties for not filing.

▶TAXATION

Any investment (not related to the organization's exempt purpose) that is purchased with borrowed funds may be subject to the debt-financed income rules. Under these rules, passive income that is normally excluded from UBIT (such as interest, dividends, royalties and rent) becomes at least partially taxable if there is acquisition debt on the part of the nonprofit organization. Acquisition debt can occur if the organization borrows to make the investment or, in the case of a pass-through entity, if the "fund" has borrowed to purchase an income-producing asset (most commonly real property). This is true regardless of whether the income is foreign or domestic.

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BUYER BEWARE

Many alternative investment funds are organized as U.S. partnerships or LLCs. Thus, the partnership or LLC pass-through income is taxed at the organization level (on its distributive share as reported on Form K-1) and not at the partnership or LLC level. If the partnership has borrowed funds to finance its operations, it will likely generate debt-financed UBIT as discussed above. Any K-1s from U.S. partnerships or LLCs should be carefully analyzed to ascertain if UBIT is being passed through to the partner or member. UBIT is required to be reported to nonprofit partners or members, but sometimes the partnership return preparer is not aware of the UBIT rules or does not even realize that the partner or member is a tax-exempt organization (there is a box on the K-1 which should identify what kind of organization the partner or member is; if it says anything other than tax-exempt organization, careful scrutiny is required to determine if there is UBIT). Partnerships and LLCs may also have UBIT sourced from states other than the nonprofit's state of domicile, which may require filing income tax returns and payment of tax to multiple jurisdictions *(see the article entitled "State Tax Liability for Alternative Investments" on page 3)*.

Some funds are structured as corporations which then invest in domestic or foreign partnerships. Corporations pay dividends to investors and do not pass through items of income with various characteristics as partnerships and LLCs do. Dividend income is not generally taxable to nonprofit organizations and the debt-finance income rules do not come into play unless the nonprofit has borrowed to make the investment. Typically, many funds invest in foreign partnerships but through the intermediary of a foreign corporation which effectively blocks the UBI from passing directly through to the nonprofit investor (all income is nontaxable dividends).

Some foreign corporations are classified under U.S. law as passive foreign investment companies (PFICs). This is generally the case when 75% or more of the gross income is passive or, if the average percentage of assets held by the corporation which produces passive income is 50% or more. PFICs may generate taxable income to for-profit investors but generally not to nonprofits unless the income is unrelated business income (which it generally is not, since it is usually dividends or capital gains) or if the organization borrowed funds for the investment.

If foreign partnerships are invested in directly, the income is recognized in the year the partnership earns it. The fact that a nonprofit invested in a foreign partnership does not receive a K-1 does not excuse the organization from reporting any income whether or not it is distributed. Such income may or may not be UBIT, depending upon its characteristics.

▶POSSIBLE REQUIRED FORMS

Whether or not tax is generated by the alternative investment, there may be an onerous burden for the organization in terms of additional forms that generally are required to be attached to Form 990 or 990-T. There are very significant penalties for not filing these forms (**$10,000 to $100,000 per form**). Not filing most of these forms leaves the statute of limitations open for any year the form was not filed, so a non-compliant organization may be subject to these penalties (with interest added) if the IRS discovers the omission. The IRS is currently stepping up enforcement of these filing rules which in prior years were not such a high priority. Additionally, for 2010, the Form 990 Schedule F has been modified to ask specifically if the organization is liable for filing these forms. K-1 footnotes will usually contain significant information about many of these filings related to pass-through investments.

For organizations who are remiss in filing these forms, there is an **Offshore Voluntary Disclosure Initiative** available until August 31, 2011 for filing prior-year forms that were omitted. For most tax-exempt entities, there should be no penalties involved with filings under this program (although the work involved in gathering the information and preparing the filings may be extensive).

Some of the Forms That May Be Required:

- **Form 926:** generally required for investments of $100,000 or more in a foreign corporation, even if done through a partnership or LLC.
- **Form 8865:** generally required for purchase or sale of investments in foreign partnerships of $100,000 or more.
- **Form 5471:** may be required if the organization owns 10% or more of a foreign corporation (directly or indirectly).
- **Form 8621:** may be required for investments in PFICs.
- **Form TD F90-22.1 Report of Foreign Bank Accounts (FBAR):** required for organizations and their officials with signatory authority. Even if the organization does not directly have a foreign account, it may be required if it controls an entity which has such an account. Unlike the above forms, the FBAR is not filed as an attachment to the 990 or 990-T. It is a separate filing due annually on June 30th.

▶CONCLUSIONS

The tax and reporting rules related to alternative investments are extremely complex. Organizations that are contemplating alternative investments should consider the tax consequences and reporting burdens of the specific investment carefully before making the investments. Organizations already invested in alternatives should take a careful look at their investments to determine if they have an unreported tax liability and to determine if all required filings were properly prepared and filed. This will generally require the assistance of tax professionals with expertise in international tax issues. If the required forms have not been filed, nonprofits should consider filing under the Offshore Voluntary Disclosure Initiative before it is too late.

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

STATE TAX LIABILITY FOR ALTERNATIVE INVESTMENTS

What you can do if you did not pay state taxes

By Laura Kalick, JD, LLM in Tax

Nonprofit organizations that have adopted Accounting Standards Codification (ASC) 740-10 (FIN 48) have gone through the exercise of determining whether there are any material uncertain tax positions. This analysis should have been performed for all income tax positions at the federal, international, and state and local levels. The identification of tax positions should have taken into account all the open tax years, i.e., those years that would be subject to assessment by the taxing authorities. In general, for federal income tax purposes, the government has three years from the date a tax return is filed to go back to assess taxes. Otherwise, there is a statute of limitations on going back further unless there is a material understatement of tax liability, i.e., greater than a 25% understatement.

Most organizations have filed Forms 990 and 990-T and information and tax returns in their state of domicile. Also, most organizations are in compliance with state filings in states where they have a physical location and employees and it is clear that there is nexus in the state, i.e., that there are enough points of contact with the state that the state can claim jurisdiction over taxing the entity. On the other hand, organizations may not have been aware of state filing requirements that have arisen because of an ownership interest in a partnership or alternative investment that has activities and property in another state. *If an organization never filed a state tax return where one was required there is no statute of limitations on how many years the state can go back to assess taxes.* Also, if the state were to pursue the organization, in addition to the back taxes, there could also be significant interest and penalties.

Whether or not there is nexus through a partnership interest is not always clear cut and different states have different rules. If an alternative investment reports on a K-1 that there is unrelated trade or business income or loss in a particular state, an exempt organization should look into its reporting responsibilities. This is true both when there is net income and if there is a net loss. If an organization never files a tax return, then a loss in one year cannot be used to offset income in another year.

An organization that has not filed a tax return that it should have filed may have to establish a reserve to take into account the liability. The reserve should take into account all the income earned when the organization held the investment and the interest and penalties associated with that liability. If the organization continues to not file returns, the reserve will keep growing. If the organization decides to rectify the situation by just filing returns in the future or even files returns for the last three years, this may be a serious "red flag" because now the state knows of the organization's existence and may pursue previous years and the related interest and penalties.

If there is potential liability in just one state, an organization could consider contacting that state in order to determine what the state will find acceptable. Their representative could even contact the state on a no-name basis. However, the potential problem is that unless the state has a written procedure indicating how many years' returns will be required, the amount of interest and whether penalties will be imposed, the organization is at the mercy of the state. Also, if there are multiple states where there is potential liability, contacting the states and getting an agreement can be a full-time job.

Fortunately, there is an alternative to continually carrying a reserve or revealing yourself to the taxing authorities and begging for mercy.

▶MULTISTATE VOLUNTARY DISCLOSURE PROGRAM

The Multistate Tax Commission (MTC), an intergovernmental state tax agency working on behalf of states and taxpayers to administer the tax laws equitably and efficiently, has established a Multistate Voluntary Disclosure (MVD) Program that allows a tax non-filer with potential liability in multiple states (including DC) to negotiate a settlement agreement regarding back liability on favorable terms through a single point of contact and a single, uniform procedure. The procedure does not determine whether nexus exists with respect to an organization, but the parties set that issue aside and come to an agreement for past non-filing and agree that filing will occur in the future.

The MTC does not charge for their services. An organization or its representative can have the MTC approach all the participating states on a no-name basis to reach an agreement. The agreement usually includes that the organization files and pays back tax and interest with respect to the prior periods or "lookback period;" the state(s) waives all penalty and tax prior to the lookback period and the organization will continue to file with the state(s) unless its nexus status changes. The identity of the organization is only revealed to the state(s) after a legally binding voluntary disclosure contract has come into force. The program is not available if the organization has already made "contact" with a state. "Contact" includes filing a return, paying a tax, and receiving an inquiry from the state regarding the type of tax at issue. So this means that an organization must come forward before it is too late.

All but six states participate in the MVD Program. For a full list of the states, see http://www.mtc.gov/Default.aspx.

BDO has assisted organizations in navigating through the MVD Program. Please contact Laura Kalick if you need further information or assistance.

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

NONPROFIT BOARD MEMBERS: PAID OR VOLUNTEER?

By Mike Conover

The propriety of pay for board members serving tax-exempt organizations is in the news again. While not a new topic (it has been raised at any number of points in past years), the sentiments of some opposed to the practice has intensified. Undoubtedly, the financial turmoil of recent years, the gloomy economy and the predictable appearance of excesses in executive pay, in for-profits and nonprofits alike, have all contributed to this opposition. The outcry from the public has, in at least one recent instance in Massachusetts, prompted pending legislation to prohibit the practice of compensating board members altogether.

This article explores the topic of compensation for board members of nonprofit organizations from a few different perspectives. The intent is to discuss some of the background factors associated with the topic and acquaint readers with some criteria that may be useful for a thoughtful, rather than a reflexive, decision about volunteer versus paid board members.

The general public's frequent and interchangeable use of the "nonprofit" designation with the "tax-exempt" designation gets things started on the wrong foot. All types of exempt organizations are then thought of as "charitable" and operating under an assumed "vow of poverty" versus being only a description of their tax status. It leads to suspicions about pay for any full-time staff member that makes more than $____ (note: the reader is free to insert the number of their choice here). Still worse, it can produce outrage over board members getting anything more than a nice lunch and reimbursement of parking fees for their service.

Increased disclosure requirements for nonprofit organizations and continued media publicity of compensation levels have also played a part in the current situation. They have contributed to greater public awareness of pay levels, but not necessarily any understanding of the subject. To further complicate matters, media coverage often comes about in adverse circumstances. An organization's disappointing performance, discovery of a significant irregularity, departure of an executive or some combination of these events often gets the organization's board members (and their compensation) in the spotlight.

Public outrage predictably prompts a reflexive reaction from legislators and regulators. Eager to get out in front of the issue with constituents, these individuals quickly demonstrate determination to "do something" about the problem by proposing new laws and regulations that will "fix" it. Like the many constraints imposed on pay in the for-profit sector following the recent financial crisis, the nonprofit sector has experienced similar instances of increased disclosure requirements and regulation (i.e. Intermediate Sanctions, new Form 990, etc.). Massachusetts is now proposing legislation that would prohibit pay for board members in any exempt organization unless the state's Attorney General can be convinced with "sound justification" of the need for it.

In light of current circumstances, what should a nonprofit organization that pays its board members (or wants to) do? Opponents of the practice point out that a board member should serve out of a sense of community service or the mission of the organization in question. They cite statistics that show only a small percentage of exempt organizations offer board members pay. Some go on to explain that volunteer status ensures the board member's independence and ability to govern objectively because no pay is at stake. The case for, or against, board member pay in an exempt organization rests squarely on the strength of the business need for it. The fact that a particular organization always has paid board members or never has really falls short of the requirement for deciding the question one way or another. The explanation that "everyone else does it/doesn't do it" may be slightly more persuasive, but still falls short of a satisfactory answer.

Information from surveys or public filings about the prevalence of pay for nonprofit organization board members shows that only a small percentage of ALL nonprofit organizations do so. However, looking more closely at certain types and sizes of nonprofit organizations reveals the practice is far more prevalent and a growing one. As an example, more than 50% of large independent foundations (and many smaller ones) are offering pay to some or all of their board members. Other types of exempt organizations (i.e., some associations/trade groups, specialized service organizations, etc.) also have some instances of pay for board members.

The organizations offering pay for board members frequently cite several factors as the basis for doing so. At the top of the list in most cases is the need to attract, engage and retain outside expertise that is essential to fulfilling the mission of the organization. The expectations and the exposure for individuals serving on boards have increased significantly in recent years. Organizations committed to complex mission issues, stewarding

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NONPROFIT BOARDS

substantial financial resources and/or having complex structures cannot necessarily expect to obtain the outside expertise they require for board members from volunteers.

For example, a large private foundation may determine it is in the best interest of perpetuating its donor's bequest to secure significant involvement from a particular type of individual to serve as a board member. An individual with the required experience/expertise may be supportive of the organization's mission but unable to devote what is required on a strictly volunteer basis.

In other instances, nonprofit organizations may have an ample supply of qualified individuals willing to serve on a volunteer basis. It is interesting to note that these volunteer situations sometimes present their own set of challenges. There are, of course, those individuals who work tirelessly as volunteer board members and others who simply join the board for little more than "yearbook credit." Sometimes, no-show volunteers seriously impede an organization's ability to secure the outside expertise and independent advice it requires.

The answer to the question "Board pay or not?" seems, therefore, to lie in each exempt organization's commitment to a process that will define or affirm its own basis for the answer to this question. I would suggest the following steps as a way to arrive at the answer:

1. Develop a clear understanding of the specific role of a board member in the organization. This should be as specific as possible in terms of the experience and expertise sought, time commitment required, responsibilities/accountabilities, etc.
2. Evaluate the impact that compensation can/should play in retaining and engaging qualified individuals to fill the specified role.
   a. Outside advisors/consultants can provide helpful information on competitive practices – prevalence and levels of pay for board members in similar situations
   b. Input from significant stakeholders committed to the organization's mission
3. Based on steps #1 & #2, develop a formal policy stating the organization's policy for a paid or volunteer board and, if board pay is adopted, a detailed description of the process that will be used to govern and administer board pay.
4. Keep the documentation associated with all the preceding steps and contemporaneous minutes of all meetings held to discuss and decide the organization's position on pay for board members.
5. On a regular basis, every two or three years, review the board pay policy and practices adopted to ensure they continue to be fully supportive of the organization's needs.

The process outlined above follows the guidelines offered in the IRS Intermediate Sanctions in order to afford an organization the "presumption of reasonableness" available to those that comply with the process. These steps would appear to offer a nonprofit organization a path to determining the right course for it to follow in terms of the board member pay question. The information produced can also be extremely useful in communicating the organization's board pay policy. It works far better than a board member confronted with a street corner interview or telephone call from a reporter trying to develop a policy on the spot.

In many respects, the Intermediate Sanctions may be all the legislation/regulation needed to address the question of board pay for exempt organizations.

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

INSTITUTE PROFESSIONAL PROFILE

MEET MIKE CONOVER

Mike Conover is a senior director in BDO's Compensation and Benefits Practice. Based in our Boston office, he has more than 25 years of consulting experience, a significant portion of it devoted to work with a wide variety of nonprofit organizations. Mike's client experience includes service to hospitals, health plans, foundations, professional & trade associations, higher education institutions, private secondary schools and a variety of highly specialized organizations in the nonprofit sector.

The focus of Mike's consulting work is compensation and related human resource issues. Much of his work with nonprofit organizations is related to work with the boards of organizations on matters such as executive compensation, pay program governance & administration and IRS Intermediate Sanctions. His experience encompasses all aspects of compensation including competitive assessments, plan audits, plan design, board compensation, executive employment and severance arrangements, succession plans and performance management programs.

Mike is a frequent speaker and author on compensation. He is a former member of the board of directors of a successful internet company and was an elected town official for more than 10 years.

Mike has a B.A. degree in Psychology from Drew University in Madison, New Jersey.

INCENTIVES AND DISINCENTIVES FOR CONTRIBUTIONS

By Laura Kalick, JD, LLM in Tax

WHEN A GIFT IS MADE TO A 501(c)(3) ORGANIZATION, THE DONOR IS ALLOWED A CHARITABLE CONTRIBUTION DEDUCTION. THE CHARITABLE CONTRIBUTION DEDUCTION IS A MAJOR INCENTIVE FOR CHARITABLE GIVING AND IS A SIGNIFICANT SOURCE OF FUNDING FOR CHARITABLE ORGANIZATIONS.

In fact, the Congressional Budget Office (CBO) recently issued a report called *Options for Changing the Tax Treatment of Charitable Giving* (see http://www.cbo.gov/ftpdocs/121xx/doc12167/CharitableContributions.pdf) which compared various options including deductions and credits for all taxpayers with and without floors. The study found that if the current deduction was converted to a 15 percent nonrefundable credit for all filers with a two percent of Adjusted Gross Income floor, that contributions to charities (measured in 2006 dollars) would be reduced by $10 billion and at the same time, the tax subsidy by the Federal government would be reduced by $24.6 billion, a significant impact.

Other nonprofit organizations do not have the benefit of the charitable contribution deduction in building up their coffers. And although trade associations that are exempt from tax under IRC Section 501(c)(6) may benefit by the business expense deduction their members may take for paying dues that are considered ordinary and necessary business expenses, the portion of dues expended for lobbying or political activities cannot be deducted. An organization can either notify its members as to the portion of dues that is spent on lobbying or political activity or pay a "proxy tax" on that amount.

IRC 501(c)(4) organizations can lobby to an unlimited degree and can engage in political activities as long as that is not their primary purpose. It may be hard to make the case that a social welfare organization that is exempt under IRC 501(c)(4) is engaging in activities that would allow a donor to deduct a contribution or dues to the organization as an ordinary and necessary business expense. And clearly, a contribution to such an organization does not qualify for the charitable contribution deduction. Not only that, contributors to social welfare organizations may have to pay a gift tax on those contributions.

The IRS has a gift tax noncompliance project where they are reviewing donations to 501(c)(4) organizations. Although donors have annual gift tax exclusions and a lifetime exemption amount, in order to qualify for the exclusion or exemption, the individual must file a gift tax return.

In a separate initiative, the IRS is reviewing the activities of 501(c)(4) organizations in order to determine if those organizations are primarily involved in political activities and/or engaged in prohibited private benefit, both of which could cause the organizations to lose their tax-exempt status.

We will have to watch these IRS initiatives to see their future impact on nonprofit organizations.

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

ISSUES IN CHARITABLE GIVING

By Paul E. Hammerschmidt, CPA, MS (Taxation) and Christina K. Patten

Some issues in charitable giving are outlined as follows:

▶PARTIAL INTERESTS

Over the years some taxpayers have wanted to have their cake and eat it too. They've wanted to make a charitable contribution and still retain property rights that would entitle them to use the property. Taxpayers are subject to a significant number of restrictions that must be complied with before they are entitled to an income tax deduction for gifts of property to a charity. One of these restrictions generally provides that a taxpayer cannot take a charitable contribution deduction for a partial interest in property, i.e., a gift of less than his or her entire interest in the property [IRC Section 170(f)(3)(A)].

▶FREE USE OF PROPERTY

Under this rule, taxpayers who permit a charity to use their property without a charge (or a minimal charge) are not entitled to a charitable contribution deduction because they are deemed to have made a contribution of a partial interest in property, which is a nonqualifying contribution. For example, a taxpayer who allows a charity to use space in an office building without charge cannot deduct the rental value of that property. Similarly, a generous donor that allows the charity to auction off the use of their vacation home for a week or two receives no deduction for the fair rental value of that property. In addition, the property owner is deemed to have personally used the property during this period for purposes of the restriction on the rental expenses being claimed if personal use exceeds the greater of 14 days or 10% of the number of days the home is rented at fair rental value.

▶RECENT GIFT TO MIT FROM BOSE FOUNDER

In April 2011, Amar Bose, founder of audio technology company Bose Corp., donated most of the privately held firm's stock to Massachusetts Institute of Technology (MIT). MIT will receive annual cash dividends on the shares when paid by Bose Corp. and use the payments "to sustain and advance MIT's education and research mission." Gift restrictions prevent MIT from selling the shares which don't carry voting rights in the company. MIT is also barred from participating in management and governance of Bose Corp.

While all the details of the gift are not yet available to the public, the concern among some professionals is that the restriction on MIT's ability to transfer the stock represents a contribution of a partial interest only and therefore is not deductible as a charitable contribution.

▶FRACTIONAL INTEREST GIFTS

An exception to the partial interest rule is for contributions of an undivided portion of a taxpayer's entire interest in property. Regulations provide that a contribution of an undivided interest will only qualify for a charitable contribution deduction where the charity is given the right, as a tenant in common with the donor, to possession, dominion, and control of the property contributed for the portion of each year that is equal to the organization's undivided interest in the property [IRS Reg 1.170A-7(b)(1)]. For example, if a taxpayer owns 100 acres of land and makes a contribution of 50 acres to a charitable organization, the charitable contribution is allowed as a deduction under Section 170.

This tenants-in-common interest was affirmed by the court (Winokur v. Commissioner, 90 TC 733, 4/21/1988). For example, a donor with a substantial art collection may be entitled to a charitable contribution deduction by donating a 10% interest of the collection in year one and an additional 10% in year two. The charity would have the right to possess the entire artwork collection for a number of days proportionate to its ownership interest. Gifts of art or other collectibles have been the most common types of fractional interest gifts. The rules for fractional interest gifts are somewhat complex and include limitations of the income tax deduction available for gifts of artwork.

▶VALUE OF TIME OR SERVICES

A contributor cannot deduct the value of his or her time or services to a charity. No deduction is allowed for the value of income lost while working an as unpaid volunteer for the charity. A board member or attorney working pro bono, for example, may not deduct the value of their time in connection with services to a charity. These individuals are, however, entitled to a deduction for out-of-pocket expenses they incur in connection with their volunteer efforts for the charity. These expenses would be deductible by the volunteer as charitable contributions.

▶OUT-OF-POCKET EXPENSES INCURRED BY VOLUNTEERS

A practical problem that has been presented by the statutory provisions relates to out-of-pocket expenses incurred by a taxpayer who does volunteer work for a charity. These expenses have always been deductible as contributions. These may include travel and transportation expenses. The problem is that the charity typically does not know about them.

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CHARITABLE GIVING

The IRS Regulations provide that the substantiation requirements will be met if the taxpayer:

- Has adequate records to substantiate the amount of the expenses, and
- Obtains a statement from the donee organization describing the services that the taxpayer provided and indicating whether any goods or services were given in consideration (and, if so, their value). [Reg. 1.170A-13(f)(10)].

This means that a volunteer will have to provide the charity with a statement of the services performed so the charity can then acknowledge those services. The charity need not be advised of the amount of the expenses, but it must be informed of the nature of the work done by the taxpayer that required the expenditure (i.e., preparing letters, attending board meetings, entertaining prospective donors). This may seem like unnecessary paperwork but, unfortunately, it will be required if out-of-pocket expenses are to be deducted by the volunteer.

Also, note that a volunteer cannot deduct payments for child care expenses as a charitable contribution, even if they are necessary to free the volunteer to do the work for the organization.

For more information, contact Paul E. Hammerschmidt, director, at phammerschmidt@bdo.com or Christina K. Patten, associate, at cpatten@bdo.com.

FASB ASU 2011-04 AND ITS EFFECTS ON NONPROFIT ORGANIZATIONS

By Dick Larkin, CPA

Accounting Standards Update (ASU) 2011-04, *Fair Value Measurement: Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS* was issued to further conform the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) standards relating to fair value measurements. The IASB standards are referred to as International Financial Reporting Standards (IFRS). The principal remaining differences between the two sets of standards involve some terminology, and references to other standards, and matters that do not affect nonprofit organizations.

The following is not a complete summary of ASU 2011-04; rather, it lists those parts of the ASU that are specific to non-public entities – which include most nonprofit organizations. [Reminder: Some nonprofits are considered public entities, if they have conduit debt outstanding in the hands of the general public. See FASB Staff Position 126-1 (codified in Accounting Standards Codification (ASC) 825-10-50).]

ASU 2011-04 exempts non-public entities from the following requirements of ASU 2010-06, *Fair Value Measurements and Disclosures: Improving Disclosures about Fair Value Measurements:*

- A reporting entity should disclose separately the amounts of significant transfers in and out of Level 1 and Level 2 fair value measurements, and describe the reasons for the transfers; and
- From the following proposed requirements included in a draft ASU issued in June 2010 (which is the draft that was issued as ASU 2011-04), there are additional required disclosures, including:
  - Measurement uncertainty inherent in Level 3 inputs;
  - Categorization by input level of assets not reported at fair value (FV), but whose FVs are disclosed in notes (i.e., the disclosures that may be required by Statement of Financial Accounting Standards (SFAS) No. 107 (codified in ASC 825-10-50) for non-SFAS 124 (codified in ASC 958-320) securities).

The other proposed requirements in the June 2010 draft ASU are retained, including:

- Make terminology and clarifying changes to further converge U.S. and International accounting standards
- Clarify that the "highest and best use" concept would only apply to non-financial assets
- Provide guidance on measuring FV of an instrument classified in equity (not normally applicable to nonprofits)
- Provide additional flexibility for measuring FV of assets and liabilities managed in a portfolio on the basis of the entity's net exposure to a particular market risk (interest rate, currency, price) or credit risk of a counterparty
- Expand the prohibition against applying blockage factors at all input levels; and
- Require additional disclosures, including if an asset that is valued using a highest and best use basis, but is not actually being used that way.

ASU 2011-04 will become effective for annual periods beginning after December 15, 2011 - essentially for calendar 2012. Early adoption for annual periods is not permitted.

For more information, contact Dick Larkin, director, BDO Institute for Nonprofit Excellence℠, at dlarkin@bdo.com.

2011 OMB CIRCULAR A-133 COMPLIANCE SUPPLEMENT ISSUED

By Tammy Ricciardella, CPA

ON JUNE 1, THE OFFICE OF MANAGEMENT AND BUDGET (OMB) ISSUED THE 2011 *CIRCULAR A-133 COMPLIANCE SUPPLEMENT* (THE SUPPLEMENT) DATED MARCH 2011.

The Supplement is available on OMB's website at http://www.whitehouse.gov/omb/circulars/a133_compliance_supplement_2011 in both pdf and Word format. The full version of the Supplement is over 1,500 pages in length. You can download the entire Supplement or sections of the Supplement from the website. The Supplement is applicable to audits of fiscal years that begin after June 30, 2010 and supersedes the 2010 Supplement.

As in the past years, Appendix V lists the changes from the previous Supplement. There were 19 new programs added to the Supplement and five new programs added to the Student Financial Aid Cluster. There is also a summary of specific changes to programs listed by Catalog of Federal Domestic Assistance (CFDA) number. Throughout the Supplement, items that pertain to funds received under the American Recovery and Reinvestment Act (ARRA) are identified in boldface print.

The following is a summary of some of the major changes from the 2010 Supplement.

New Requirements for the Federal Funding Accountability and Transparency Act (FFATA) of 2006 and subsequent 2008 amendments

One of the most significant changes to the Supplement is in Part 3, Compliance Requirements, for both Reporting and Subrecipient Monitoring. These sections have been modified to include the new compliance requirements and suggested audit procedures relating to FFATA. FFATA put into place a new federal reporting system for direct recipients of non-ARRA funds that requires the reporting of certain subawards. Under FFATA, a subaward is defined as a legal instrument to provide support for the performance of any portion of the substantive project or program for which a recipient received a grant or cooperative agreement award and that is awarded to an eligible subrecipient.

For grants and cooperative agreements, the effective date of FFATA was October 1, 2010, for all discretionary and mandatory awards equal to or exceeding $25,000 with a new Federal Assistance Identification Number (FAIN) made on or after that date. A recipient must report each obligating action of $25,000 in Federal funds for any subawards. The reporting is made to the FFATA Subaward Reporting System (FSRS) and is required to include the date of the subaward, subaward amount, subaward number and other details. The auditor will be selecting a sample of recipient payments for first-tier subawards to determine that all amounts reported are supported by documentation and to determine that the filing was completed in a timely basis.

Comparison of ARRA and FFATA Requirements

The Reporting compliance requirement section in Part 3 also includes a new table that helps auditors distinguish for purposes of the OMB Circular A-133 audit the reporting requirements that apply to reporting by

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recipients under ARRA and those that apply to reporting under FFATA.

Part 4 Applicability of FFATA Reporting

There is a new section entitled Subaward Reporting under the Transparency Act that is now included in each program and cluster in Part 4. This new section notes whether FFATA reporting is "applicable" or "not applicable." There are several reasons why FFATA reporting may not be applicable to a program and/or cluster, such as: (1) there are no subawards under the program, (2) the program is exempt because it is ARRA-funded, or (3) the program is not a grant or cooperative agreement. If you have programs or clusters with both ARRA and non-ARRA funding, the FFATA reporting only applies to the non-ARRA funds.

Clarification Regarding ARRA Section 1512 Reporting

The Reporting section in Part 3 has been updated to clarify the requirements of the quarterly reporting requirement under Section 1512 of ARRA (Section 1512 reporting). OMB has clarified in the Supplement that when recipients do not have the actual expenditure amounts for the quarter within the 10 days allowed, they must use the "best available data" for the full quarter which can include estimates. So, if a recipient has two months of finalized data and the third month can only be estimated due to the timing of the reporting, this final month can be reported based on estimates. However, the recipient should have a process in place to review the reports they submitted and compare the estimated amounts to the actual finalized results, to determine if there are any material differences that would require that the report be corrected during the continuous correction period. If there are no material differences between the estimates used on the report submitted and the actual finalized results, the recipient does not have to correct a submitted report.

This clarification states that the "lag" method being used by some entities is not acceptable and if used would be considered a compliance finding. OMB did state that the finding would not be considered a material weakness or affect the compliance opinion and would not have questioned costs associated with the finding. The "lag" method is where a recipient is using the finalized financial data from two months of the quarter but due to not having the final month closed due to the timing, they used the last month of the previous quarter.

Clarification of Buy American Act Requirements

The Procurement and Suspension and Debarment compliance requirement in Part 3 has been modified to include additional information related to international agreements and the Buy American Act. Entities with funds that are used for purchases of iron, steel and other manufactured goods should review these clarifications.

Update to Subrecipient Monitoring

The Subrecipient Monitoring compliance requirements in Part 3 have been updated to add the requirement that non-ARRA first-tier subrecipients must obtain DUNS numbers as part of eligibility for a subaward. The update also clarifies that for ARRA awards, a subrecipient is not required to be registered in the Central Contracting Registration (CCR) at the time of the award.

Contacts for A-133 Audits

A table has been added to the Supplement that provides programmatic contact information for programs by CFDA number to obtain specific information about a federal program or its programmatic requirements. OMB notes that these are program contacts and they are not familiar with the nuances of A-133, so only programmatic questions should be posed to these individuals.

Disaster Waivers

Appendix VI provides updated information on the waivers and special provisions granted by Federal agencies. Many of the waivers and/or special provisions are directed toward recipients affected by Hurricanes Katrina and Rita in 2005.

Exclusion of Certain ARRA Programs from the Single Audit Requirement

Included in Appendix VII of the Supplement is a list of ARRA-funded programs that are not covered by the Single Audit requirements, and therefore, are not required to be included in the Schedule of Expenditures of Federal Awards (SEFA) or in the determination of major programs. This appendix has also been updated to include a list of ARRA programs that are not covered in Parts 4 and 5 of the Supplement but that are potentially subject to an A-133 audit.

ARRA Findings Requirements

Included in Appendix VII to the Supplement is a paragraph that notes that the details of findings reported for ARRA funds must include explicit identification of the applicable ARRA programs that are affected by the finding.

Appendix VII Reminders

Appendix VII continues to follow the same guidance introduced in the 2010 Supplement regarding the effect of ARRA expenditures on the major program determination process and the fact that ARRA funds need to be separately identified in the SEFA and on the Data Collection Form. In addition, the clarification remains that an entity cannot be a low-risk auditee if they have not submitted their A-133 reporting package to the Federal Audit Clearinghouse within the nine-month time period. The OMB guidance that recommends that agencies not grant extensions to grantees is repeated again.

It is recommended that organizations review the 2011 Supplement for a full list of changes that may affect them and ensure they have complied with all the applicable compliance requirements.

For more information, contact Tammy Ricciardella, director, at tricciardella@bdo.com.

IRS TARGETING FRINGE BENEFITS FOR INTERMEDIATE SANCTIONS

By R. Michael Sorrells, CPA

According to an IRS tax-exempt official at a recent nonprofit conference, fringe benefits are the most common area in which the IRS is imposing intermediate sanctions under IRC Section 4958. This code section, which applies to 501(c)(3) public charities and 501(c)(4) social welfare organizations, can lead to very expensive excise taxes for organization executives and even members of the governing body in certain situations.

▶TWO WAYS FRINGE BENEFITS CAN LEAD TO INTERMEDIATE SANCTIONS

First, when determining if compensation is reasonable and establishing the "rebuttable presumption of reasonableness" under the IRC Section 4858 regulations, an organization must take into consideration the value of fringe benefits when calculating the total value of executive compensation. When fringe benefits are not added into the total compensation, then compensation may exceed a reasonable level and the rebuttable presumption may not be legitimate because it is not truly based on the total compensation package.

Secondly, the IRS can impose intermediate sanctions on "automatic" excess benefits. Automatic excess benefits are any compensation amounts which the executive receives that are not reported on either the organization's 990, the employee's W-2 or otherwise documented as approved compensation, i.e., in board minutes or the individual's employment contract. Thus, it is vitally important to account for and properly report all fringe benefits.

The IRS is currently conducting a three-year examination program in the area of employment taxes with some 500 exempt organizations being examined. Proper recording of fringe benefits is certainly going to be an area of interest in these examinations and automatic excess benefits could clearly be a target for improper recording.

Also, organizations should be very careful about their accountable expense reimbursement plans. Lack of proper documentation (receipts and expense reports) can cause a reimbursement to be considered a taxable fringe benefit. Periodic board reviews of CEO expense reimbursements can help assure that both expenses and reimbursements are appropriate.

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

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.

AUGUST

Lee Klumpp will be presenting an 8-hour course entitled "The 2011 Revised Yellow Book: Government Auditing Standards" for the Wisconsin Society of CPAs on August 22 in Brookfield, Wisconsin. Lee will also be presenting a course titled "Fraud in the Governmental and Not-for-Profit Environments: What a Steal!" on August 23 in Brookfield, Wisconsin.

SEPTEMBER

On September 7, **Lee** will be presenting an 8-hour course titled "Top Twelve Governmental and Nonprofit Accounting and Auditing Issues Facing CPAs" for the Maryland Association of CPAs in Columbia, Maryland.

Dick Larkin and **Lee Klumpp** will be presenting an all-day course entitled "Accounting Principles and Practices for Not-for-Profit Organizations" through PESI Law & Accounting in King of Prussia, Pennsylvania on September 16.

Lee will be conducting two sessions at the Wisconsin Society of CPAs Not-for-Profit Conference on September 19 in Waukesha, Wisconsin. Lee's sessions are "Advanced Nonprofit Accounting" and "Finance and Fundraising: Playing in the Same Sandbox."

Dick will be presenting his nonprofit accounting and auditing update at the 41st Annual Virginia Accounting & Auditing Conference in Roanoke, Virginia on September 26 and 27.

Dick will be conducting an all-day course titled "Accounting and Audit Update" for the Tennessee Society of CPAs in Memphis, Tennessee on September 29.

OCTOBER

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

Dick will be presenting his current update on nonprofit accounting and auditing issues at the VSCPA conference in Virginia Beach, Virginia on October 17 and 18.

Mike Sorrells will be teaching a course on Form 990 for the Maryland Association of Certified Public Accountants in Columbia, Maryland on October 17.

GIFTS OF PROPERTY AND IRS FORMS 8282 AND 8283

By Sandra Feinsmith, CPA

HAVE YOU RECEIVED A PHONE CALL FROM A DONOR REQUESTING THAT YOUR ORGANIZATION VALUE, COMPLETE AND SEND THEM FORM 8283 FOR THEIR NONCASH CONTRIBUTIONS TO SUBMIT WITH THEIR TAX RETURNS?

Perhaps a donor asked why you sent them a Form 8282 for property that they donated to the organization two years ago that the organization has since sold. Many nonprofit organizations receive questions regarding both the donor's and organization's responsibilities for the completion and filing requirements regarding Forms 8282 and 8283. In this article, we will give a brief overview of Section B of Form 8283 which is the section that is applicable to donee organizations and triggers the filing requirements for Form 8282. We will then discuss the donee organization's responsibilities regarding donors and filing Form 8282.

▶FORM 8283

Form 8283, *Noncash Charitable Contributions*, is required to be completed when partnerships or individuals claim a noncash charitable contribution deduction in excess of $500 on their respective tax returns or when a corporation claims a charitable deduction for a gift of property when the deduction is in excess of $5,000. However, Form 8283 is only required to be *submitted* to the donee organization for signature when the donation is greater than $5,000 and it consists of property other than publicly traded securities. It is the responsibility of the donor to complete all applicable sections of this form except for the Appraiser and Donee Acknowledgment sections. The form must be filed with the entity or individual's tax return for the year the property was contributed and first claimed as a deduction.

Section B, Part I, *Information on Donated Property* of Form 8283 is required to be completed by the donor for noncash charitable contributions in excess of $5,000. In addition, except for certain types of donated property, the donor is required to obtain a written appraisal from an independent appraiser. In certain instances, the donor will be required to attach the written appraisal to their tax return. Types of property included in this section and subject to appraisal include artwork, collectibles, real estate, qualified conservation contributions, equipment and nonpublicly traded securities. Information to be included in this section is a description of the property, an appraisal of fair market value (if appraisal was required), the date acquired by the donor, the donor's cost or adjusted basis, and the amount claimed as a deduction.

Section B, Part II is the *Donor Statement*. This section is to be completed by the donor for each item included in Section B, Part I that has an appraised value of $500 or less. It is important that the donor clearly identifies these types of items for the donee organization in Part II because the donee is then not required to file Form 8282, *Donee Information Return* (see below) for any items valued at $500 or less.

Section B, Part III of Form 8283 is the *Declaration of Appraiser*. This is the section that is completed by the appraiser of the property. The appraiser declares in this section that they are not a party to the transaction and meet the requirements to be considered a qualified appraiser.

Part IV of Form 8283 is the *Donee Acknowledgement*. As mentioned earlier, this is the section of the form that the donee nonprofit organization is required to complete and return to the donor. Please note that the donor is only required to complete Part I of Section B regarding the name, identifying number, and description of the donated property and Part II of Section B, if applicable, before submitting the form to the donee organization.

The purpose of this section of the form is to document (1) that the organization acknowledges that it is a qualified organization under the Internal Revenue Code and, (2) the date the property was received by the organization. The form must be signed by an official of the organization authorized to sign the tax returns of the organization. After the organization signs and returns the form to the donor, the donor must complete the form with all required information, including the appraised amount and then provide a copy back to the donee organization for their records.

There are two additional items to note regarding the donee acknowledgement section of Form 8283. If the organization expects that any donated tangible personal property will be used in a purpose unrelated to the organization's function or mission at the time of the donation, the organization should check the "yes" box in Part IV. In addition, the charitable organization is required to affirm that if the organization (or a successor donee organization) disposes of the property within three years after the date the original donee received it, the organization must file Form 8282, *Donee Information Return* with the IRS and send a copy to the donor. As a result

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GIFTS OF PROPERTY AND IRS FORMS 8282 AND 8283

of the sale or disposition of the property by the donee organization, a donor's charitable contribution deduction may be limited or subject to rules regarding recapture of donation amount.

▶FORM 8282

As briefly discussed above, Form 8282, *Donee Information Return*, is required to be completed by a donee or successor donee charitable organization that sells or disposes of tangible personal property within three years of the receipt of the donation by the organization. This includes any donated property (other than money or publicly traded securities) if the claimed donation value exceeds $5,000 per item or group of similar items donated by the donor to one or more donee organizations. This is the property listed in Section B on Form 8283.

There are two exceptions where organizations do not need to file Form 8282:

1. Items are valued at $500 or less. The information to determine this comes from Section B, Part II of the donor's original Form 8283.

2. Items that have been distributed or used for the organization's charitable purpose. If the organization used or distributed the item, without receiving consideration in fulfilling the organization's exempt purpose, then no reporting on Form 8282 is required. The IRS instructions give the example of a charity relief organization distributing medical supplies in assisting disaster relief victims.

   Normally, organizations are required to file Form 8282 with the IRS and donor within 125 days after the disposition of the property.

   At a minimum, organizations are required to provide the organization's name, address and employer identification number (EIN), and complete at least Part III, columns 1, 2, 3 and 4 and Part IV. The other portions of Form 8282 are not required to be completed if the organization does not have the information.

There are two types of penalties associated with Form 8282:

1. The first penalty is the failure to file penalty. This penalty can be assessed when the organization fails to file the form by its due date, fails to include all required information or includes incorrect information on the form. The penalty is $50 per form.

2. The second penalty is the fraudulent identification of exempt use property. The organization can be assessed this penalty if in Part III of Form 8282 it stated that tangible personal property donated to the organization was sold, disposed of or exchanged or was used in a way that was related to the exempt purpose of the organization when it fact it had knowledge that it was not intended for this purpose. In this situation, the organization could be assessed a $10,000 penalty.

There are also other information requirements that organizations should be aware of regarding Form 8282:

1. If property is transferred to another charitable organization within the three-year period of the date of donation, the organization must provide the following information to the successor donee:
   - The name, address and EIN of the organization.
   - Copy of Section B of Form 8283 received from the donor or preceding donee. The instructions define a preceding donee as the organization or person who gave the donated property to the organization.
   - Copy of the Form 8282 within 15 days after the organization files it with the IRS.

2. Successor donees to whom property was transferred to from the donee organization are required to provide their name, address and EIN to the organization within 15 days of the later of:
   - The date the organization transferred the property, or
   - The date the successor donee received a copy of Section B Form 8283.

Please note that the organization is required to give a copy of Form 8282 to the original donor of the property as well as keeping a copy of Section B of Form 8283 in their records.

▶SUMMARY

To summarize, there are a number of suggested processes and procedures organizations should adopt to assist with the disclosure and recordkeeping requirements regarding Forms 8282 and 8283:

1. Develop and institute noncash donation acceptance and procedure policies, particularly for tangible personal property items valued at over $5,000. For example, include sections documenting the process of acceptance of noncash donations over $5,000, the organization's requirements regarding the donor and Form 8283, the exempt use of donated property, the holding period of property before selling or disposing of it, and the Form 8282 itself.
2. Educate donors regarding their responsibility for the completion of Form 8283 so that there are no surprises for either the organization or the donor.
3. If the donor has questions regarding the deductibility of the donation, direct the donor to consult with their tax advisor.
4. Consult with your tax advisor early in the process regarding any Form 8283 or 8282 questions or filing requirements.

For more information, contact Sandra Feinsmith, tax senior manager, at sfeinsmith@bdo.com.

NEW GASB PRONOUNCEMENTS

By Patricia Duperron, CPA

The following pronouncements from the Governmental Accounting Standards Board (GASB) will be effective for reporting governmental financial statements in upcoming years:

GASB Statement No. 59, *Financial Instruments Omnibus*, amends the reporting and disclosure requirements of certain financial instruments and external investment pools for which significant issues have been identified in practice. GASB Statements No. 25 and 43 are amended to remove the fair value exemption for unallocated insurance contracts. These were previously reported using a cost-based measure but are now required to be reported at fair value.

Statement No. 59 also amends Statement No. 31 to indicate that a Rule 2a7-like pool is an external investment pool that is not registered with the Securities and Exchange Commission (SEC). Statement No. 31 provided an exception to fair value reporting when the pool had a policy that it would operate in a manner consistent with SEC Rule 2a7. This clarifies that pools must meet all SEC requirements except for filing with the SEC.

Statement No. 59 amends Statement No. 40 to indicate that interest rate risk information should be disclosed only for bond mutual funds and external investment pools and not mutual funds that hold both equity and debt securities. Because interest rate risk is not applicable to equity investments, some governments looked through the fund at the individual investments and this was not the intent of Statement No. 40.

Statement No. 59 amends Statement No. 53 by stating that nonperformance penalty provisions are not derivatives because they do not meet the net settlement criteria and also to provide that certain financial guarantees would no longer be exempt from Statement No. 53. This pronouncement is effective for years ending June 30, 2011.

GASB Statement No. 60, *Accounting and Financial Reporting for Service Concession Arrangements,* addresses issues related to service concession arrangements (SCAs), which are a type of public-private or public-public partnership. An SCA is an arrangement between a transferor (a government) and an operator (governmental or nongovernmental entity) in which the transferor conveys to an operator the right and related obligation to provide services through the use of infrastructure or another public asset in exchange for significant consideration and the operator collects and is compensated by fees from third parties. Examples include toll roads, convention facilities, and parking garages.

The accounting for these SCAs depends on whether the transferor retains control over the facility or not. If control is maintained, the transferor continues to report the facility as its capital asset. If a new facility is created, it is reported by the transferor at fair value along with a corresponding liability that is amortized over the term of the agreement.

If the transferor doesn't meet the control criteria, it will derecognize the facility and report a residual interest based on book value of the facility.

For governments that operate the facility, an intangible asset will be reported and amortized over the term of the agreement. The pronouncement is effective for years ending June 30, 2012.

GASB Statement No. 61, *The Financial Reporting Entity: Omnibus,* amends GASB Statements No. 14 and 34 regarding the assessment of potential component units to be included in the reporting entity. Certain organizations are required to be included as component units because they are fiscally dependent on the primary government. Statement No. 61 now requires a financial benefit or burden to also be present between the primary government and the potential component for it to be included in the reporting entity. An organization's fiscal dependency does not necessarily imply that there is a financial benefit or burden to the primary government. The potential for dual inclusion may exist, as an organization may be fiscally dependent on more than one government. The inclusion of this second test could cause some current component units to be disassociated with the primary government.

For organizations that do not meet the financial accountability criteria for inclusion as component units, but are included because it was determined that it would be misleading to exclude them, this Statement clarifies the manner in which that determination should be made and the types of relationships that generally should be considered in making the determination.

Statement No. 61 also changes and adds new criteria for determining whether a component unit should be blended or discretely presented. The new criteria were added to eliminate a current practice of "off-balance sheet" financing. For example, a government hit their debt limit so a separate commission was established to renovate a government-owned building. The commission bought the building, renovated it and leased it back to the government. The renovations were funded with debt guaranteed by the lease. The commission would not be considered a blended component unit under the old rules. The new rules specify that when a component unit has outstanding debt (including leases) that will be repaid by the primary government, it must be included as a blended component unit. Statement No. 61 will be effective for the year ending June 30, 2013.

GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements,* incorporates into the GASB's authoritative literature certain accounting and reporting guidance that is included in the following original pronouncements (excludes subsequent amendments). These pronouncements, issued on or before November 30, 1989, do not conflict

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NEW GASB PRONOUNCEMENTS

with or contradict the following GASB pronouncements:

1. FASB Statements and Interpretations (through FAS 102 and FIN 38)
2. Accounting Principles Board Opinions (through APB Opinion 31)
3. Accounting Research Bulletins (through ARB 51)

Statement No. 62 also eliminates the election provided in paragraph 7 of GASB Statement No. 20 for enterprise funds and business-type activities to apply post-November 30, 1989 FASB Statements and Interpretations that do not conflict with or contradict GASB pronouncements. In practice, this option was seldom elected. However, those entities can continue to apply, as other accounting literature, post-November 30, 1989 FASB pronouncements that do not conflict with or contradict GASB pronouncements. This pronouncement will be effective for years ending December 31, 2012.

▶PROPOSED GASB TOPICS

GASB Proposed Statement *(Exposure Draft) Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position* will change the financial statement presentation by including two new concepts that were introduced in GASB Concept Statement No. 4. Deferred outflows are consumptions of net assets that are applicable to a future reporting period. Deferred inflows are acquisition of net assets that are applicable to a future reporting period. This does not include items like prepaid rent or deferred revenue because net assets have not been consumed or acquired. Deferred outflows should be reported in financial statements in a separate section following assets. Deferred inflows should be reported in a separate section following liabilities. This pronouncement will be effective for years ending June 30, 2012.

GASB has issued ***Preliminary Views, Pension Accounting and Financial Reporting by Employers.*** The significant change when this pronouncement is issued will be the requirement to record the unfunded pension obligation in the government-wide financial statements. Currently, this amount is not recorded in the financial statements but is only disclosed in the footnotes. However, the liabilities for unfunded pension and other post-employment obligations are recorded by private companies and nonprofits and the governmental employer is responsible for the obligation to the extent that sufficient assets have not been set aside in a pension plan. The numbers currently being reported for these amounts are quite large, making this a very controversial subject for local governments that are already struggling.

For more information, contact Patricia Duperron, director, at pduperron@bdo.com.

OTHER ITEMS TO NOTE....

Schedule H - Hospitals

The IRS has just issued Announcement 2011-37, which indicates that Part V, Section B (Part V.B) of Schedule H, Hospitals, of the 2010 Form 990, Return of Organization Exempt From Income Tax, is optional for the 2010 tax year. This announcement came after protest from many groups regarding the issuance of the new schedule provisions before the IRS had even issued draft regulations on the new requirements. It is important to note that even though the particular section of the form will be optional, hospitals must still be in compliance with the new requirements.

Charitable Contributions and the FCPA

The U.S. Foreign Corrupt Practices Act (FCPA) prohibits making any "payment" to a foreign official for the purpose of obtaining or retaining business for or with, or directing business to any person. This applies not only to business transactions, but also to charitable contributions or grants made outside the United States by persons who are subject to U.S. jurisdiction. Issues may arise if a foreign official has a direct or indirect financial interest or other interest in a charitable donation or has requested that the donation be made to a particular charity. Entities must be careful when a charitable contribution or grant is provided to ensure that there is no direct or indirect benefit received by a foreign official in return, so as to insure there is no violation of the FCPA. Organizations should implement an appropriate review procedure for charitable contributions and grants to avoid any undue risk.

Loss of Tax Exemption

As discussed in the December 2010 *Nonprofit Standard* article, "Preserving and Restoring Exempt Status," on June 8, 2011 the IRS released the list of organizations that have automatically lost their tax-exempt status because they did not file legally required annual reports for three consecutive years (IR-2011-63). They also issued the expected final guidance on how organizations can apply for reinstatement of their tax-exempt status, including retroactive reinstatement; how to apply transition relief for certain small tax-exempt organizations; and how contributors may rely on Publication 78 or on the IRS Business Master File extract for purposes of deducting contributions and making grants.

Certain Financial Professionals Have FBAR Deadline Extended

The IRS and the Financial Crimes Enforcement Network (FinCEN) announced on May 31 that a small subset of individuals with only signature authority required to file the Report of Foreign Bank and Financial Accounts (FBARs) will receive a one-year extension beyond the upcoming filing date of June 30, 2011. In February 2011, FinCEN published a "Final Rule" that amended the Bank Secrecy Act (BSA) regulations and addressed the scope of the persons that are required to file reports of foreign financial accounts. Due to the many questions regarding exceptions under the Final Rule, the extension was put in place to allow these questions to be resolved. Notice 2011-1 extends the deadline until June 30, 2012 for an employee or officer of a covered entity [§1010.350(f)(2)(i)-(v)] who 1) has signature or other authority over and no financial interest in a foreign financial account of another entity more than 50 percent owned, directly or indirectly, by the entity (a "controlled person"); and 2) who has signature or other authority over and no financial interest in a foreign financial account of the entity or another controlled person of the entity. Frequent updates, clarifications and changes to FBAR requirements are expected up through the June 30 deadline. Please consult your tax advisor.

GAMBLING WITH YOUR TAX EXEMPTION?

IRS Guide Highlights Important Exempt Issues

By Joyce Underwood, CPA

GAMING CAN HAVE AN IMPACT ON AN ORGANIZATION'S EXEMPT STATUS AND REQUIRES SPECIAL RECORDKEEPING AND REPORTING FOR THE UNIQUE ACTIVITIES THAT SURROUND THESE EVENTS INCLUDING INCOME, EMPLOYMENT AND EXCISE TAXES.

Gaming has become more visible with the addition of Schedule G in the revised Form 990. IRS updated its Publication 3079, *Tax-Exempt Organizations and Gaming*, late last year to provide current guidance. Gaming is often added to facilitate socializing and fundraising amongst a group with a common interest and is frequently included at exempt organizations' fundraising special events.

▶EXEMPTION ISSUES

Although a gaming activity may provide funds to pay expenses associated with the conduct of exempt activities, gaming itself often doesn't further an exempt purpose. A Section 501(c)(3) organization is organized for a certain exempt purpose and should not devote a substantial amount of its resources to an unrelated activity. A charity conducting gaming as an insubstantial part of its activities will not ordinarily jeopardize its tax-exempt status but may be subject to the tax on unrelated business income. Additionally, public charities often must meet a public support test to avoid classification as a private foundation. If the organization receives too much of their financial support from a limited number of sources or from an unrelated trade or business such as gaming they may fail the "public support" test and be classified as a private foundation.

Other nonprofits may also jeopardize their exemption status if gaming becomes the organization's primary activity. Gaming income may be subject to tax on unrelated business income. For example, social clubs and fraternal organizations may engage in gaming involving only members without jeopardizing their exempt status. Because gaming is recreational and social, the income a Section 501(c)(7) social club receives from gaming activities limited only to its members is considered exempt function income and is not subject to tax. On the other hand, if income received from gaming activities is open to nonmembers and is part of the social club's gross income, then it is subject to unrelated business income (UBI) tax. Social clubs endanger their exempt status when receipts from nonmembers become substantial.

▶UBI TAX ISSUES

There are three conditions that define gaming as a primary activity of an unrelated trade or business:

1. Gaming is generally considered a "trade or business" if it generates revenue.
2. Gaming is considered "regularly carried on" if it is conducted with a frequency and continuity similar to comparable activities of a non-exempt organization and if pursued in a manner similar to commercial gaming activities, but can exclude those that occur only occasionally or sporadically.
3. Gaming is not per se an exempt activity, although it sometimes can be one where the exempt function includes social or recreational activities.

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GAMBLING WITH YOUR TAX EXEMPTION?

Publication 3079 provides a handy flow chart to assist with the determination. Even if the gaming activity is taxable UBI, there are certain exemptions outlined in Publication 3079. These exemptions include certain bingo games; activities conducted with substantially all volunteer labor; qualified public entertainment activities; and games of chance conducted in North Dakota. (This excludes social clubs, as they are taxed on all nonmember income.)

▶RECORDKEEPING AND REPORTING ISSUES

Organizations that conduct gaming activities must maintain records of gross receipts from gaming, prize payouts, and other related disbursements to substantiate information submitted on the exempt organization returns. Records are kept under the same statute of limitation rules that govern other businesses. Because gaming can generate substantial income, often in cash, close control and oversight of the operations is needed, and care should be taken to ensure funds are not diverted to individuals or private interests. Segregation of duties and internal controls are important. State and local laws may require their own specific recordkeeping, reporting and internal control requirements, as well.

▶GAMING ACTIVITY WORKERS

Many states and localities require that exempt organizations use all (or substantially all) volunteer labor to conduct their games in order to qualify for a license. Care should be taken to ensure if a worker is compensated that they are classified appropriately as an employee, contractor or volunteer. Volunteers recognized with awards or gifts of non-cash items of nominal value, such as turkeys or hams around the holidays, would not constitute taxable wages. However, cash items, including gift certificates as well as any other taxable fringe benefit, would be a payment of taxable compensation, and if a volunteer is subject to the organization's right to direct and control, the amounts are wages. All pay that you give to an employee for services performed is considered wages and is subject to federal employment taxes unless an exception applies. The pay may be in cash or in other forms. It includes salaries, bonuses, commissions and fringe benefits. Payments in kind may be in the form of goods, lodging, food, clothing, or services. Generally, the fair market value of such payments at the time that they are provided is subject to employment taxes. This excludes expense reimbursements under an accountable plan. Tips that gaming activity workers receive from players, whether cash or non-cash, are taxable income.

▶WITHHOLDING AND ANNUAL REPORTING

If your organization's gaming workers are employees, you are responsible for withholding and paying employment taxes and filing and furnishing the required employment tax forms and information returns. An employee who receives tips should keep a daily tip record so that he or she can accurately report tips to the employer and on his or her tax return. If your organization employs independent contractors, it does not have to withhold or pay taxes unless required under backup withholding. Use Form 1099-MISC to report payments to independent contractors, including fees, salaries, commissions, prizes, and awards for services performed as a nonemployee. If you pay the winner or winners of a game more than a certain amount, you must report the amount and information about the winners to the IRS on Form W-2G. The threshold amount at which winnings become reportable often depends on the type of game involved. In determining whether the threshold is met, you may reduce the winnings by the amount of the wager. Generally you must withhold income tax from a payment of winnings when the proceeds from the wager are more than $5,000. There are also wagering and occupational excise taxes that may apply.

▶TAX RETURN

Subject to certain thresholds, your annual Form 990 will require you to complete and attach Schedule G, Supplemental Information Regarding Fundraising or Gaming Activities, which includes the following reporting:

1. Gross revenues from bingo, pull-tabs/instant bingo, and other types of gaming;
2. Cash and non-cash prizes paid for each type of gaming;
3. Rent or costs of facilities and other direct gaming expenses;
4. Percentage of your organization's games operated in your own facilities and in outside facilities;
5. Percentage of volunteer labor for each type of gaming;
6. States in which you operated gaming activities and the states in which your organization holds gaming licenses;
7. Revocation, suspension or termination of any of your organization's gaming licenses;
8. Amount of mandatory charitable distributions from gaming proceeds required under state law, or the amount of proceeds spent on your organization's own exempt activities;
9. Names and addresses of the gaming manager and the person who prepares your gaming/special events books and records; and
10. Information about third parties with which your organization has contracts to receive gaming revenue.

▶STATES

There are also many state and local gaming licensing requirements for which an organization should contact the appropriate agencies. Gaming may be legal or illegal.

For more information, please contact Joyce Underwood, director, at junderwood@bdo.com.

NONPROFIT EXPENSE ALLOCATION

By Lee Klumpp, CPA

Over the past fifteen years, there has been more pressure on nonprofits to conform to the expectation set by stakeholders to keep overhead expenses (supporting services activities) down and therefore maximize the use of unrestricted and temporarily restricted funds that can be used on programmatic activities.

The Internal Revenue Service (IRS) requires that nonprofit organizations allocate their expenses on their Form 990 into three categories: Program, Management/General, and Fundraising. However, generally accepted accounting principles allow for costs to be allocated by program service and supporting service categories with multiple functional areas in each category.

The vast majority of nonprofit organizations allocate costs directly to the function, which is the simplest and most transparent technique. A few use indirect cost allocation methodologies for some or all of their expenditures by entering all their expenses into one or more cost center or categories (know as an overhead pool), and then reversing out the expenses based on an allocation methodology to other functional categories.

The main reason for wanting to understand a nonprofit organization's expense structure is to understand the cost related to the activities that allow the nonprofit organization to carry out its mission. Each nonprofit organization is very different in how it accomplishes its mission and performs it programmatic and supporting services activities. In some cases these differences are cultural and in other cases they are structural related to how the nonprofit organization was originally set up and formed. Additionally, over the past ten years, there has been push back from many funders on paying for supporting services. In some cases, some funders have either paid for a very small percentage of supporting services or not paid for supporting services at all. Not recapturing the cost related to supporting programmatic services can be shortsighted and can in some cases

cripple nonprofit organizations and make them not only inefficient but ineffective. The reason for this is that it is hard to raise funds that are unrestricted and can be used for general operating activity. If all funds raised are applied directly to programmatic activities, it will still have to be determined as to where the funds will come from for the childrens' after school program supplies; facility management (including janitorial work, repairs and maintenance); and the accounting and reporting of the program to funders. Supporting programmatic activities is important, but a certain amount of supporting services are required for an organization to be in good operating order.

▶FUNCTIONAL EXPENSE CATEGORIES

Programmatic Activities

The number of functional reporting categories for programmatic services varies by nonprofit organization according to the nature of the services rendered by the nonprofit. There is no specific limit to how many categories a nonprofit can have. A nonprofit may only have one functional classification and that may adequately portray their programmatic activities. However, in most cases, a nonprofit will have several separate and identifiable programmatic services that relate to its mission, goals and objectives of the nonprofit. The reason for functional reporting is to provide funders and other readers of the financial statements information on how funds have been expended to provide services to participants or beneficiaries.

A nonprofit organization may also have various kinds of supporting service activities, such as management and general, fundraising, and membership development. A single functional reporting classification is usually not adequate to portray each kind of supporting service that a nonprofit may have. A nonprofit organization will have at least management and general and fundraising supporting services but it may have others depending on how the nonprofit organization's structure is set up. It would be extremely rare for a nonprofit organization not to have fundraising expenses. Some nonprofits show disaggregated information for each kind of supporting service. For example, fundraising expenses and the corresponding support that is obtained may be reported separately for each kind of fundraising activity undertaken, either on the face of a statement of activities or in the notes to the financial statements.

Management and General Activities

Management and general activities are activities that are not identifiable with a single programmatic or supporting service (i.e., fundraising, or membership-development activity) but that are indispensable to the conduct of the nonprofit organization's activities, mission and existence. These activities include such services as oversight,

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NONPROFIT EXPENSE ALLOCATION

business management, general recordkeeping, budgeting and financing; soliciting funds other than contributions, such as exchange transactions and government contracts; disseminating information to inform the public of the nonprofit's stewardship of contributed funds; announcements regarding appointments and the annual report; and all management and administration activities except for direct conduct of program services or fundraising activities.

The costs of oversight and management usually include the salaries and expenses of the governing board, the CEO of the nonprofit organization, and the supporting staff. If staff spends a portion of their time directly supervising programmatic services or categories of other supporting services, a certain portion of their salaries and related benefit expenses should be allocated among those functions. There should never be an occasion where management and general activities are not included on the statement of activities because there are certain costs that are incurred for a nonprofit organization just to turn on the lights and open the doors every day.

Fundraising Activities

Fundraising activities are those that are undertaken to induce potential donors to contribute money, securities, services, materials, facilities, time, or other assets. The financial statements of a nonprofit organization should disclose total fundraising expenses on the statement of activities or in the footnotes to the financial statements.

Financial Accounting Standards Board Accounting Standards Codification (FASB ASC) 958-720-45 provides a further description of fundraising activities, which includes publicizing and conducting fundraising campaigns; maintaining donor mailing lists; conducting special fundraising events; preparing and distributing fundraising manuals, instructions, and other materials; and conducting other activities involved with soliciting contributions from individuals, foundations, government agencies, and others. Fundraising activities include soliciting contributions of services from individuals, regardless of whether those services meet the recognition criteria for contributions in the "Contributions Received" subsection of FASB ASC 958-605-25.

Membership-Development Activities

Membership-development activities include soliciting for prospective members and membership dues, membership relations, and similar activities.

▶ALLOCATION OF EXPENSES

Some expenses are directly related to and can be assigned to a single program, service or supporting activity. Other expenses relate to more than one program or supporting activity, or to a combination of programs and supporting services. These expenses should be allocated among the appropriate functions. Examples include a direct mail solicitation that combines fundraising with program activities, salaries of persons who perform more than one kind of service, and the rental of a building used for various programs and supporting activities.

Direct Identification vs. Allocation Methods

Direct identification of a specific expense is the preferable method of charging expenses to various functions. For example, travel costs incurred in connection with a programmatic activity should be assigned to that program. If direct identification is impossible or impracticable, then an allocation is appropriate. Expense allocation techniques are utilized by all types of entities, nonprofit and for-profit alike. The reasonable allocation of expenses among a nonprofit's functions may be made on a variety of bases. Objective methods of allocating expenses are preferable to subjective methods. The allocation may be based on related financial and/or nonfinancial data. Additionally, you may find that the guidance found in the U.S. Office of Management and Budget Circular A-122 may also be helpful in developing a methodology for your nonprofit organization to use in allocating expenses.

One misconception that lots of nonprofit organizations have is that occupying and maintaining a building is not a separate supporting service activity; however, FASB ASC 954-720-45-25 specifically states that it is. Additionally, expenses associated with occupying and maintaining a building, such as depreciation, utilities, maintenance, and insurance, may be allocated among the nonprofit organization's functions based on the square footage of space occupied to each programmatic and supporting service activity. If floor plans are not available and the measurement of the occupied space is impractical, an estimate of the relative portion of the building occupied by each function may be made. These costs may also be allocated based on the distribution of personnel costs or head counts.

Per FASB ASC 958-720-45-24, interest costs, including interest on a building's mortgage, should be allocated to specific programs or supporting services to the extent possible. Interest costs that cannot be allocated should be reported as part of the management and general function.

A nonprofit organization should evaluate its expense allocation methods on a periodic basis to ensure that the assumptions used are still relevant and appropriate. The evaluation may include, for example, a review of the time records or activity reports of key personnel, the use of space, and the consumption of supplies and postage. The expense allocation methods should be reviewed by management and revised when necessary to reflect significant changes in the nature or level of the organization's current activities.

As you can see, there are many options for functional expense allocation and reporting and there is no single answer on what is appropriate for all organizations. Each organization should review their costs and activities to establish a functional reporting process that is transparent and that is based on a sound reporting methodology. It is critical that expense allocation methodologies represent the activities of your organization, result in fair and reasonable allocations and be applied on a consistent basis.

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BDO NONPROFIT & EDUCATION PRACTICE

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