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NONPROFIT STANDARD

PREDICTING THE IMPACT OF CHANGING TAX TREATMENT OF CHARITABLE CONTRIBUTIONS

By Joyce M. Underwood, CPA

Economic and political pressures are threatening the long-held tradition of taxpayers receiving tax benefits in exchange for supporting charitable organizations. Under recent tax reform initiatives the government is weighing the cost/benefit of tax deductions for charitable contributions by attempting to measure the impact these deductions have on overall tax revenue, the worthiness of donors in certain income classes receiving incentives for giving gifts, and the charitable benefits provided by charitable organizations.

Our government's support of tax deductions for contributions reduces government resources. So the true cost is hard to measure. Although tax deductions are a means to encourage charitable giving, they reduce government revenue and may benefit certain classes of taxpayers over others. In this difficult time it should not be forgotten, however, that charitable organizations are also in need of revenue as they serve vital public needs and in recent years have been strained by increased demand for services and decreased support from donors due to the tough economic challenges facing our country and the world. Charitable organizations reduce the burden of government by supporting those the government would need to support without charities' help, and also support needs that would not be met without public interest and support. Also, many argue that charitable

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PREDICTING THE IMPACT OF CHANGING TAX TREATMENT

organizations can respond more quickly and operate more effectively to address urgent public needs than the government can.

At a Senate Finance Committee public hearing in Washington, D.C., Oct. 18, lawmakers and witnesses proposed modifications to the deduction for charitable contributions as part of tax reform. Many testified to the impact such provisions would have on the government, the charitable community, and donors. In preparation for the hearing, *Joint Committee on Taxation (JCT), Present Law and Background Relating to the Federal Tax Treatment of Charitable Contributions (JCT-55-11) (the JCT Report)* was prepared. In light of the tax reform efforts, the report considers the interplay between charitable giving and federal revenues, and attempts to evaluate how the current system might be impacted by changes in the tax treatment of contributions. The 36-page JCT Report summarizes the history and evolution of the charitable deduction, started in 1917 when the government raised income taxes to fund World War I efforts and wanted to ensure individuals still had funds to support charities. Historically the viewpoint was that the support of charities decreased the need for government resources and could help avoid further tax increases. Thus the government support benefited both parties and was seen as beneficial by keeping tax rates reasonable.

The JCT Report provides background on the current law and evolution of the tax incentives around charitable contributions, including the impact of the charitable deduction on the income tax liabilities of individuals, corporations, trusts and estates. The rules are complex and not everyone enjoys the benefit of the tax deduction. Deductions also differ depending upon the type of organization and type of property given. It is reported that the cost to the federal government of the charitable deduction to the federal government is expected to be $38 billion in 2011, with more than $11 billion of the benefits of the deduction going to high-income households. The JCT estimates the impact on government revenues between 2010 and 2014 to be about $230 billion.

The JCT Report is not just a primer; it discusses economic behavior. After considering the financial incentives one must consider the personal incentives to giving. The tax deductibility of contributions reduces the economic cost to the donor, but there are a number of different rationales to support the deduction depending on one's view of the roles of charitable organizations and the benefits they provide to society as a whole, as well as the individuals' motivations for giving. The study speculates that some donors are motivated by the satisfaction of doing a good thing and helping others and that they do not benefit personally; and also that charitable gifts alleviate the burden on government. If the deduction incentive was not given, the government would have to provide the benefits at full cost rather than at the reduced incentive percentage. Also, there is thought to be a spillover from services provided to the public. For example, charities providing vaccinations provide direct benefits, but also benefit the general public by reducing the spread of disease to others not directly benefiting from the contributions.

The Congressional Budget Office (CBO) also released a study in May 2011 at the request of the House Budget Committee entitled *Options for Changing the Tax Treatment of Charitable Giving*. This study examines the patterns of individual charitable giving and how different tax treatment of contributions might affect the overall amount of donations, the cost to the government, and benefits provided to the different income groups. Motivations can be different and different income groups support different types of organizations. Low-earning individuals tend to support churches while high earning individuals tend to provide greater support of education and the arts.

Options for deduction floors, nonrefundable credits and fixed dollar percentage amounts are grouped into four categories by the study:

1. Retaining the current deduction for itemizers but adding a floor
2. Allowing all taxpayers to claim the deduction, with or without a floor
3. Replacing the deduction with a nonrefundable credit for all taxpayers, equal to 25 percent of a taxpayer's charitable donations, with or without a floor

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INSTITUTE PROFESSIONAL PROFILE

MEET JOYCE UNDERWOOD

Joyce Underwood is a director of Nonprofit Tax Services in BDO's Greater Washington, D.C. office and a member of BDO's Institute for Nonprofit Excellence℠. She provides technical and compliance support to BDO offices and clients throughout the country. With more than 25 years of experience in public accounting she has specialized in nonprofit tax services for the past 14 years.

Joyce's extensive experience includes all aspects of tax compliance and information reporting, as well as consulting, for a wide spectrum of national and regional nonprofit organizations, including large charities, trade associations, private foundations and social welfare organizations. With a background in tax, accounting and consulting, she teams regularly with other tax specialists regarding international tax, State and Local Taxation (SALT) and employee benefits issues, providing comprehensive services to nonprofit clients.

Joyce is a frequent author and speaker on tax issues affecting nonprofit organizations, and a member of the American Institute of Certified Public Accountants, the Greater Washington Society of Certified Public Accountants, and the Maryland Association of Certified Public Accountants.

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4. Replacing the deduction with a nonrefundable credit for all taxpayers, equal to 15 percent of a taxpayer's charitable donations, with or without a floor.

For each of the four categories, CBO analyzed two potential floors: a fixed dollar amount ($500 for single taxpayers and $1,000 for couples filing a joint return) and a percentage of income (2 percent of AGI). Only contributions in excess of the floor would be deductible or eligible for a credit. The analysis uses data for 2006, the most recent year for which the Internal Revenue Service's public-use sample of individual income tax returns is available. The tax treatment of charitable contributions is generally the same today as it was in 2006; however, because of rising incomes and contribution amounts, the options that include a fixed dollar floor would have a somewhat different impact today than presented here. [1]

The CBO report summarizes the impact of changes in the different categories, but the results do not reflect behavioral assumptions that are included in the JCT analysis. Thus, the CBO report is meant to highlight the general effects of the various approaches. The actual effects of a change would differ based upon the specific parameters of a policy.

Charitable organizations can reduce the burden of government. Incentives cost revenue, but motivate action. Shifting the incentives among income groups can result in different allocations of donations among types of charities.

So questions remain:

- Can we afford a reduction of donations from high earners?
- Will lower income earners respond to incentives?
- Can we truly measure the response to a major change in tax law in such a complex area?
- And, finally, is the government prepared to respond to the potential financial burden of providing social services presently borne by charities if government revenue increases at the expense of public support of charities?

All these questions remain unanswered at this point. It is therefore difficult to measure the true cost of government's support of tax deductions for contributions and the impact a major change would bring to the economy and budget.

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

[1] Congressional Budget Office (CBP) Summary – Options For Changing The Tax Treatment Of Charitable Giving

PAYROLL AUDIT UPDATE

By R. Michael Sorrells, CPA

We have previously written about the IRS Payroll Tax Examination program which began this year. (See the July 2011 *Nonprofit Standard.*) This program will select 2,000 entities for examination this year and the next two years as well. Of these 2,000, approximately 500 will be nonprofit organizations.

We have seen this program in action first hand at several organizations and have heard from other practitioners about how it is being manifested in many other instances. In addition to the special audit program, we have also seen payroll tax issues elevated to a new level of importance in all nonprofit examinations. This is an area where the IRS feels it can collect significant revenue, so it is being aggressive.

The IRS appears to be targeting a wide swath of nonprofits, from 501(c)(3) charities to 501(c)(7) country clubs, with an extensive range in size. As expected, the largest issue of interest to the IRS has been employee vs. independent contractor. Organizations under examination can expect to be required to provide substantiation for independent contractor status of everyone in that category. Foreign employees and proper withholding and filings seem to be the next most popular area of interest with lots of questions about visa/residency status and Form 942 filings and tax withholding. Non-filing of Form 1099 is also being examined carefully. The IRS will try to impose backup withholding taxes and penalties when Forms 1099 are not filed. We have seen and heard of proposed tax, penalty and interest amounts in seven-figure amounts for some larger organizations under audit.

For organizations that believe they may have misclassified a significant number of workers as independent contractors rather than as employees, consideration should be given to the recently announced Voluntary Classification Settlement Program (VCSP) as unveiled by the IRS in Announcement 2011-64 (http://www.irs.gov/irb/2011-41_IRB/ar14.html). Filing under this program is not penalty free, but penalties are greatly reduced when an organization participates in the program. Organizations considering this program should

carefully consult with their tax and legal advisors before embarking on this course as there may be many ramifications to consider when reclassifying persons to the employee status. This program is not available to organizations currently under examination.

As we have said previously, it is definitely time for organizations to self-assess their payroll tax situation. This is doubly true if there are significant independent contractors or non-U.S. persons being paid by the organization.

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THE AGE OF NONPROFIT MERGERS IS UPON US

By Adam B. Cole, CPA

Whether it is the result of declining public and private support, increased accountability or the need to expand the footprint of your mission in an era of funding changes; the age of nonprofit mergers seems to be upon us.

In the wake of significant changes with funding sources as a result of large deficits at the state and local government level, the funding mix for many nonprofits has been subject to severe reductions now, with more possible for the future.

Nonprofits are looking for ways to reduce costs, without reducing quality or jeopardizing the infrastructure. Transactions between two nonprofit organizations can be more complicated and move more slowly than transactions between two commercial organizations since, most of the time, cash does not exchange hands. Usually if an organization has excess cash to purchase the assets of another organization, the organization does not feel the need to merge. Rather it feels it is in a position of strength and can remain with the status quo. On the contrary, if the organization were open to a transaction, it could achieve some economies of scale with costs and potentially expand the footprint of its mission.

Nonprofit mergers can take on several different looks. There is the full takeover of another organization, which results in one organization ceasing to exist. The successor organization assumes all debts and potential unknown liabilities. Types of potential unknown liabilities that could be a potential risk to the successor organization include litigation, third-party reimbursement overpayments and asset remediation costs, such as environmental problems at a site.

An alternative to the full takeover is the affiliation. This has been the preferred avenue for many of our healthcare-related clients. The affiliation is achieved through a change in the composition of the board of the organization being taken over so there is a majority of board members from the successor organization and control is achieved. This can be accomplished in two ways. First, you can add enough board members from the successor organization to achieve control or in combination remove some existing board members to achieve control for the successor. An easier alternative would be to change the structure of the organization being taken over to a membership board and designating the successor organization as the sole member. This has been a more preferred vehicle of affiliation since it does not require any more involvement from existing volunteer board members. An additional benefit of this form of merger is that the liabilities remain at home and are not inherited by the successor organization. This transaction format is like a long–term engagement period that allows the successor organization time to uncover what is ailing the other organization without assuming all of the risk.

Either form of merger or affiliation will require proper due diligence on the part of both organizations. Some considerations for due diligence are as follows:

- Make sure both organizations have a common ground included in their missions.
- Understand the financial models and the burn rate of cash, both pre-merger and post-merger.
- Understand the comparison of compensation, benefits and union affiliations, if any, on the overall cost structure.
- Determine if you will gain leverage with both existing and future funding sources to negotiate reimbursement rates.
- Determine impact of any transaction on the debt covenants of both entities.
- Evaluate the timeliness of the final reports each month and annually.
- Determine if there are any conflicts between existing board members that may derail the transaction.

In my experience with nonprofits, I have noted that many mergers and affiliations have achieved success for the surviving organization. Many however have cost more than was originally anticipated. Much of that had to do with the length of the transition period before any revenue enhancement was achieved or expense efficiency materialized. Most of the time this was caused by the governing bodies not acting fast enough with tough decisions and being more concerned with perceptions outside the organization.

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THE CASE OF EXEMPT ORGANIZATIONS IN THE TAX REFORM DEBATE

By Laura Kalick, JD, LLM

Is the purpose of the tax system to raise revenue or provide incentives for certain social and economic behavior? Or is it a combination of those two principles? Congress is now asking this question, and numerous others, in light of the difficult debate over the budget and the deficit.

There are many points to consider: Do we raise tax rates, reduce or eliminate tax deductions, come up with new taxes or reduce spending? If Congress reduces the tax incentives for charitable giving, how much more revenue will the Treasury see and how will this impact charitable organizations? Or should certain tax-exempt organizations be obligated to meet additional requirements to maintain their status?

The states are grappling with these same questions. For example, the New York State Governor's Not-For-Profit Entities Task Force sent inquiries to charities regarding the compensation of executives to ensure "taxpayer dollars are used to serve and support the people of this state, not to pay for excessive salaries and compensation." The California Attorney General has sent similar inquiries. In addition, property tax exemptions are being challenged in many states, as well as in New York City. Although the city had not sent out renewal notices to properties receiving tax exemptions since 2007, it recently sent exemption renewal notices to more than 10,000 properties – exemptions that save organizations a total of $1.75 billion per year in property taxes, according to an article in the New York Nonprofit Press.

▶THE COST OF TAX EXEMPTION

Tax exemption at federal, state and local levels results in decreased tax revenues. On all levels, income related to tax-exempt purposes is not taxed, and some states, such as Pennsylvania and New Jersey, do not even tax unrelated trade or business income. Many states and localities provide sales, use and property tax exemptions for Internal Revenue Code (IRC) section 501(c)(3) organizations. The federal government also helps 501(c)(3) organizations by allowing them to use the proceeds of tax-exempt bonds, and by providing a charitable deduction for gifts made to such organizations.

▶LIMITING THE CHARITABLE CONTRIBUTION DEDUCTION

The history of the charitable deduction, outlined recently in a publication by the Congressional Joint Committee on Taxation, describes the several economic rationales for providing a tax incentive for charitable giving. The report distinguishes between gifts to hospitals or universities where the benefits are effectively directed to discrete beneficiaries rather than the public-at-large; charities that do benefit the public-at-large, such as museums; charities that provide goods and services the government would otherwise have to provide; and charities that provide spillover benefits to the general public, such as a charity that offers vaccinations to particular individuals, which could improve the health of the entire community.

The charitable contribution deduction acts as a major incentive for charitable giving, a fact confirmed by the Congressional Budget Office in a May 2011 report, which compared various options, including deductions and credits both with and without floors for all taxpayers. The study found that if the current deduction were converted to a 15 percent nonrefundable credit for all filers, with a 2 percent of adjusted gross income floor, contributions to charities would be reduced by $10 billion and the tax subsidy by the federal government would be reduced by $24.6 billion (measured in 2006 dollars). If proposals to scale back the tax benefit to donors are codified into law, nonprofit organizations could be forced to look to other sources for revenues and may have to reduce their expenditures to remain viable.

▶NEW REQUIREMENTS MAY SPARK A TREND

Recently enacted, IRC section 501(r) imposes specific requirements on hospitals in order for them to maintain their 501(c)(3) status. Under the new provision, hospitals must adopt a financial assistance policy, a charges policy and a billing and collection policy, as well as conduct a Community Health Needs Assessment (CHNA) at least every three years and adopt a strategy to meet the community needs identified through the assessment. If an organization fails to meet the CHNA requirement, then IRC section 4959 imposes a $50,000 excise tax for any taxable year for which such a failure occurs. The penalty tax

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NEW DISTRICT OF COLUMBIA NONPROFIT CORPORATION ACT

By R. Michael Sorrells, CPA

Effective Jan. 1, 2012 the District of Columbia (D.C.) is enacting a new Nonprofit Corporation Act (Chapter 4 of DC Code Title 29).

Included in its many provisions are changes in the following areas:

- Restrictions and approvals for mergers and sale of assets
- Religious corporation governance
- Provisions for member-governed corporations
- Emergency powers
- Board and member meetings
- Prohibition on most loans to officers/directors
- Board powers and removal of directors
- Amendment of articles and bylaws
- Dissolution
- Record keeping
- Transition for corporations in existence under old law

Organizations incorporated in D.C. or foreign organizations operating in D.C. should consult with legal counsel to determine how the new rules may apply to them and if changes to organizing documents or procedures are required.

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THE CASE OF EXEMPT ORGANIZATIONS

is in addition to loss of exemption for the hospital. These requirements replace the more vague community benefit standard in Rev. Rul. 69-545.

Sen. Charles Grassley (R-Iowa) played an instrumental role in changing tax-exempt hospital standards. Most recently, he has called for inquiry into the dollar value of tax exemption and, on a broader scale, into other tax-exempt organizations that provide services for a fee, such as universities, to determine a need for additional requirements to distinguish those organizations from for-profit organizations that provide the same services.

In addition to the fee-for-service organizations, Congress and the IRS are scrutinizing IRC section 501(c)(4), (5) and (6) organizations and their involvement in political activities. The standards for exemption for an IRC section 501(c)(4) social welfare organization, in particular, are quite amorphous. These types of organizations are not required to obtain a formal determination letter from the IRS in order to be exempt from taxation, although if an IRC section 501(c)(4) organization files a Form 990, the IRS will also send the organization a Form 1024 (Application for Exemption) to file. IRC section 501(c)(4) organizations can engage in political activity, although this cannot represent their primary purpose. Moreover, these organizations cannot provide more than an insubstantial private benefit.

Congress has asked the IRS to look into these types of organizations, including their political activities and whether there is private inurement and private benefit. The IRS has undertaken the project, and it is possible that some legislative changes in this area could result, along with the conclusion that these organizations can no longer proclaim they are tax exempt.

In addition to federal activities, many states are considering revising rules for property tax exemptions, reviewing the compensation practices of tax-exempt organizations and debating whether the community benefit provided (versus the private benefit) justifies exemption. The results of these inquiries, as well as other federal and state government studies and hearings, may provide the basis for future legislative initiatives.

▶FURTHER CONSIDERATIONS

Tax-exempt organizations play a vital role in our society and our economy – a role that has historically outweighed the government revenue lost by the various tax breaks provided to these organizations and the taxpayers that support them. Yet, it may be necessary to modify the tax laws so organizations are more accountable and can better justify the loss of revenue.

Rather than look at the charitable deduction as a government subsidy, Congress could view it as private funding for a public purpose, and could create different incentives for achieving that end.

But would it be more appropriate for these kinds of changes to be considered as part of a more comprehensive examination of our fiscal issues to avoid threatening nonprofit organizations' vital functions? Rather than look at the charitable deduction as a government subsidy, Congress could view it as private funding for a public purpose, and could create different incentives for achieving that end. Congress could even consider providing tax incentives encouraging the private funding of some important and necessary infrastructure projects, such as a quasi tax-exempt bond to fund these projects that would tax the income in the hands of U.S. bond holders at a preferential rate.

A focus on tax-exempt organizations has landed Congress in the middle of another debate: whether the tax system should be used to raise revenue or to encourage social and economic action. The laws may change to make organizations more accountable to justify the loss of revenue as a result of the favorable provisions, but hopefully these changes will not reduce incentives for charitable giving, which could result in the need for the government to provide services that were previously funded by private sources.

This article originally appeared in the November 2011 *Tax Stringer* and is reprinted with permission from the New York State Society of Certified Public Accountants.

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EXECUTIVE COMPENSATION: DID WE DO ALL THE RIGHT THINGS?

By Mike Conover

We have included articles in the past three issues of the *Nonprofit Standard* (see the Fall 2011, Summer 2011 and Winter 2010 issues) that deal with the issue of executive compensation from various angles. Each article begins with an introduction of surprise, lamentation or resignation to the ongoing stories of sensational executive pay practices being exposed among various nonprofit organizations. As 2011 draws toward a close, the "bad examples" and investigations by outside authorities continue. Interestingly, the issues continue despite extensive information about IRS intermediate sanctions being spread far and wide by BDO and numerous other professional service firms serving nonprofit organizations, embarrassing public disclosures and expanded reporting requirements. That brings us to our topic for this edition, an examination of Form 990, Schedule J reporting related to compensation practices. Specifically we will share our thoughts about the need to ensure that the "right things" are being done AND whether they are actually being done right.

California, Massachusetts and New York are at least three of the states that have launched significant investigations into tax-exempt pay practices in 2011. Compensation for executives, board member pay practices and executive severance awards are among the areas examined. In most cases these situations were triggered by media reporting on a specific situation for a single organization. It is interesting to know that these organizations (and probably many others) all "checked" the "right" boxes on their Form 990 and Schedule J filings. To many observers this might suggest that despite efforts to ensure compliance with intermediate sanctions, the types of issues sensationalized in the media can still occur. How could this happen?

Form 990 and Schedule J contain inquiries directly related to intermediate sanctions and other practices used by an organization to manage its executive pay practices. For example:

Form 990 – Part IV – Section B – Policies – Item #15

"Did the process for determining the compensation of the following persons (CEO, other officers and key employees) include review and approval by independent persons, comparability data, and contemporaneous substantiation of the deliberations and decisions?"

Form 990 – Schedule J – Part 1 – Questions Regarding Compensation – Item #3

"Indicate which, if any, of the following the organization uses to determine the compensation of the organization's CEO / Executive Director. Check all that apply.

- ☐ *Compensation committee*
- ☐ *Written employment contract*
- ☐ *Independent compensation consultant*
- ☐ *Compensation survey or study*
- ☐ *Form 990 of other organizations*
- ☐ *Approval by Board or Comp Committee"*

Those already familiar with intermediate sanctions and the "presumption of reasonableness" available to exempt organizations will immediately recognize that these two examples actually provide an organization with the opportunity to report compliance as well as the major components of the process used to do so. Other items throughout the Form 990 and Schedule J touch on related areas and even go so far as to ask if the organization has somehow managed to engage in an "excess benefit transaction".

The more extensive probing about compensation practices is, of course, a part of the IRS' stepped-up efforts to ensure that nonprofit organizations are correctly compensating their leadership and executive levels. And, not surprisingly, the "check box" responses provided by many organizations suggest that the majority of organizations are doing most, if not all, the right things. If so, the question remains as to why the continuing "bad examples" appear.

Despite claims that the "right" things are being done, we often note that they are not being done "right" by some organizations. In

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EXECUTIVE COMPENSATION

some organizations, longstanding practices (i.e., "traditions") continue unchanged aside from a few new steps which are solely to check the boxes. I'll share some observations related to intermediate sanctions guidelines and offer some suggestions about how best to make the effort to comply.

▶REVIEW AND APPROVAL BY INDEPENDENT PERSONS

The annual pay decision or discussion of budget appears on the calendar of many organizations at fiscal or calendar year-end. For any number of reasons, the event has settled into a comfortable (sometimes uncomfortable) routine where a group of individuals who've always participated do so again.

Sometimes because the process is so familiar, the organization so small or the practice so informal, it may not be carried out with the full level of independence and objectivity one would hope to find. Input on pay recommendations, discussions about proposed pay actions and final decisions may somehow involve participants who are not completely independent. A former organization executive sitting on the board, executives or board members with family relationships in the organization, etc., may not be as removed from the deliberations and decision making as they should.

Steps should be taken to ensure that these sorts of independence situations do not occur. Excusing affected individuals from the room while deliberations and decisions take place ensures that only independent parties engage in them. And, as noted later, this should be clearly documented in meeting minutes (e.g., "Person X was excused from the meeting at 2 p.m. and the compensation program discussion continued."; "Person X rejoined the meeting at 3 p.m. and the committee continued with other business.")

▶COMPARABILITY DATA

In some instances, organizations do not use authoritative information about pay practices among relevant and comparable organizations as a context for their compensation decisions. Because the organization is too small, unique or simply "never has done it that way," little if any pertinent information finds its way into pay deliberations or discussions. Anecdotal information may be drawn from outsiders in different fields on the board, Form 990s filed by other organizations, articles from a recent business publication or some other source may be offered. Worse yet, many of these informal sources are not formally entered into the meeting record or kept for future reference.

For some, these efforts may be sufficient to prompt them to check the box on Schedule J. However, it is quite doubtful that a claim could be supported that reasonable and relevant information was used to support the organization's pay decisions.

Organizations would be well advised to take steps to obtain authoritative information from several different sources for use in compensation decision making. Published compensation surveys are available for many different types of exempt organizations (e.g., foundations, higher education, trade & professional associations, etc.). Public filings can also be used so long as the organizations are reasonable and relevant to the organization in question (i.e., same field of interest, similar size, scope of operations, etc.) and a sufficient sample can be drawn from which legitimate conclusions can be reached. There are also consultants who specialize in virtually every type of exempt organization who can provide information and advice.

Finally, any data sources obtained and used in compensation deliberations should be kept and included in the minutes as part of the record of a meeting concerned with compensation. If inquiries are ever made about the organization's pay practices it will be important to be able to provide the data sources.

▶CONTEMPORANEOUS DOCUMENTATION

While many organizations maintain some form of documentation related to meetings where compensation decisions are made, the documentation often has one or more of the following issues:

- Fails to satisfy the "contemporaneous" requirement. Minutes must be prepared before the next meeting or 60 days after the meeting, whichever is sooner.
- No information about the basis for, substance of, or participants in any deliberations upon which a decision is based are noted.
- Documentation does not include copies of any pertinent documents used in the decision making (e.g., reports, surveys, Form 990s, etc.)
- Sometimes documentation includes information that may raise more questions than answers.

Clearly, organizations should maintain complete and contemporaneous records of all meetings related to compensation for executives. These records should be sufficiently detailed and supported by related documents to allow an independent reviewer to fully understand the basis for the actions undertaken by a compensation committee or executive committee in the past.

There are some steps that can be taken to determine the adequacy of an organization's practices and make sure that the right boxes are checked on the forms and that more importantly the steps behind these boxes are being done right:

- Review responses to questions on Form 990 and Schedule J. Examine the practices that the organization uses to determine if all the components support the fact that the box was checked.
- Ensure that committee minutes, especially those for the Compensation Committee, are documented in a timely fashion and contain all necessary information.
- Ensure that the competitive/comparability data used by the organization for its compensation decisions are maintained with the minutes and that the minutes document the reasons this data was used.

Taking some time to actually examine the facts that substantiate the organization's answers to the check boxes should offer all the proof needed to determine whether or not the right things are being done right.

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DISASTER PLANNING: IS YOUR ORGANIZATION ADEQUATELY INSURED?

By Tammy Ricciardella, CPA

Many organizations have disaster plans in effect that address many different scenarios. One very critical component of any disaster plan is insurance coverage. This component can be easy to overlook and too many organizations assume that their coverage is adequate since it is the same as it has been for years. However, with the recent hurricanes and earthquakes occurring on the East Coast, where this is traditionally not a major issue, some organizations may have been taken by surprise. These and other large disasters that have occurred throughout our country and the world should show that they can happen anywhere.

The first step to determine if your organization is adequately insured is to schedule a meeting with your insurance agent. At this discussion have your insurance agent provide you with information about the various types of insurance that are available. Before this meeting an organization should consider its operations and determine if there are any characteristics related to locations or operations that might require special insurance coverage or higher amounts of insurance coverage. An organization should consider all its office and program locations as well as locations where they may house off-site inventory and/or records, as well as locations where they may be conducting meetings or other activities.

There are many types of specialized insurance and not all organizations will need all of these but a few to consider are:

Flood insurance – This is a special policy purchased in addition to normal business coverage. The premiums and availability of flood insurance is based on floodplain zones. The floodplain areas are established by the Federal Emergency Management Agency (FEMA) and are published on the agency's website.

Earthquake insurance – This is a special policy that generally has high deductibles so the premiums remain affordable.

Valuable papers and electronic media insurance – This type of insurance protects such documents as client and member records, staff records, financial records, and various forms of electronic media. These items are usually covered under a normal business insurance policy but an organization should review this to ensure that the coverage is adequate for both the paper copy of such records as well as records stored electronically. In addition, you should review your policy to ensure that software you have purchased is also insured. An organization that has established off-site storage for electronic and/or hard copy records should ensure that the insurance coverage includes these areas as well.

Accounts receivable insurance – This is a separate policy designed to protect an organization against losses on receivables. These policies are designed to protect an organization that cannot collect its receivables due to the loss of the underlying records as a result of a fire or other disaster. This coverage does not insure against a debtor failing to pay (i.e., bad debts) in normal circumstances.

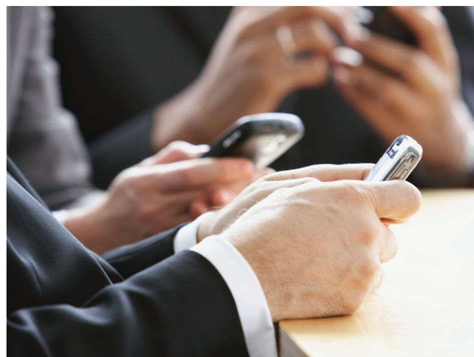
This is only a sample of potential insurance coverage options that an organization may want to consider in addition to the normal business policies. An organization should ensure that a careful review is done of all insurance coverage to ensure that the coverage is comprehensive and adequate. Insurance companies will often provide checklists and expert advice that can help you perform an initial review of your coverage. At times an organization may want to consider obtaining legal advice if there are complex issues to ensure coverage is adequate. If your organization has not completed this exercise in the last year, now would be a good time to embark on this exercise.

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

IRS ISSUES GUIDANCE ON TAX TREATMENT OF CELL PHONES AND PROVIDES RECORDKEEPING RELIEF

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

IT MAY BE HARD TO BELIEVE BUT THE IRS HAS PROVIDED US WITH AN EARLY HOLIDAY GIFT!



The IRS recently issued Notice 2011-72[1] (the Notice) that provides guidance on the treatment of employer-provided cell phones and grants relief from the burdensome recordkeeping requirements that the IRS had previously imposed. The Notice provides that when an employer provides an employee with a cell phone primarily for noncompensatory business reasons, the business and personal use of the cell phone is generally nontaxable to the employee. The IRS will not require recordkeeping of business use in order to receive this tax-free treatment.

If the employer provides its employees with cell phones primarily for noncompensatory business reasons, the value of any personal use is excludable from the employee's income as a de minimis fringe benefit. *Noncompensatory business reasons* exist when there are substantial reasons relating to the employer's business, other than providing compensation to the employee, for providing the phone. The notice suggests this may include: (1) when the employer may need to contact the employee at all times for work-related emergencies, and (2) the employer requires the employee to be available to speak with clients when the employee is away from the office, and (3) when the employee needs to speak with clients located in other time zones outside his/her normal workday. Noncompensatory business reasons would not include a cell phone an employer provides to promote the morale or goodwill of an employee, or to attract a prospective employee, or to attract a prospective employee as a means of furnishing additional compensation.

▶EMPLOYER'S REIMBURSEMENT OF BUSINESS USE OF AN EMPLOYEE'S PERSONAL CELL PHONE

The Notice does not address the treatment of reimbursements received by employees for the business use of an employee's personal cell phone but the IRS simultaneously announced in a memo to its examiners a similar approach that applies to businesses that provide cash allowances and reimbursements for work-related use of personally owned cell phones.[2] The memo states that examiners should analyze reimbursements of employees' cell phone expenses in a manner that is similar to the approach described in Notice 2011-72. Examiners are advised that they should not necessarily assert that the employer's reimbursement of expenses incurred by employees after Dec. 31, 2009, results in additional income or wages to the employee.

The memo indicates that the employee must maintain the type of cell phone coverage that is reasonably related to the needs of the employer's business and the reimbursement may not exceed the expenses that the employee actually incurred in maintaining the cell phone. For example, an employer's reimbursement to an employee (whose responsibilities are limited to working only in the U.S.) for international or satellite coverage, would not be reasonably related to the needs of the employer's business.

▶WHEN ARE THESE PROVISIONS EFFECTIVE?

The provisions under Notice 2011-72 and the IRS memo to its examiners are effective for all taxable years after Dec. 31, 2009.

▶DOES THIS GUIDANCE APPLY TO TABLET DEVICES TOO?

Although there is no official guidance on this question, an IRS employee[3] commented that tablet devices such as iPads could possibly be considered telecommunications equipment under Notice 2011-72. He cautioned however, that the documentation of usage of a tablet may differ from the liberal cell phone rules of the notice.

▶DOES THIS GUIDANCE APPLY ONLY TO NONPROFITS?

The provisions under IRS Notice 2011-72 and its associated memo to examiners are not limited to nonprofit organizations. Many nonprofits however may find comfort in knowing that "automatic" excess benefit transactions under the intermediate sanctions of Section 4958 of the Internal Revenue Code[4] may not be applicable as a result of employer-provided cell phones or the reimbursement of employee personal cell phone usage.

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

1 http://www.irs.gov/pub/irs-drop/n-11-72.pdf
2 http://www.irs.gov/pub/foia/ig/sbse/sbse-04-0911-083.pdf
3 Paul Carlino, Branch 1 chief (employment tax) in the IRS Tax-Exempt and Government Entities Division, during the Employment taxes session of the American Bar Association Section of Taxation meeting in Denver.
4 Failure to Properly Report Compensation Can Result in "Automatic" Excess Benefit Transactions by Paul E. Hammerschmidt, CPA http://www.bdo.com/publications/industry/nonprof/np_mar_04/failure.asp

MORE CHANGES AND DEBATE OVER THE FASB'S PROPOSED LEASING STANDARD

By Tammy Ricciardella, CPA

The saga continues around the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board's (IASB) proposed changes to the current leasing standards contained in Accounting Standards Codification (ASC) Topic 840. See the Spring 2011 and Winter 2010 issues of the *Nonprofit Standard* for previous articles discussing the proposed standards.

There were approximately 800 public comment letters received in response to the exposure draft issued in 2010. One of the largest topics commented on is the "right of use" concept that would require entities to capitalize operating leases for office space and equipment that traditionally has not been recorded on the statement of financial position but only disclosed in footnotes.

One area in which the two boards are considering modification of the original exposure draft guidance is the proposed treatment for lease-renewal options. In the original exposure draft, entities would have been required to include in the lease term any renewal periods that were included in leases that the entity was likely to exercise. This would have been included in the calculation of the asset and liability that would be recorded in the statement of financial position (balance sheet). Under the new proposal, lessees would account for a renewal period only if they had "significant economic incentive to exercise" the option. Such an economic incentive might include renewal rates that are priced at a bargain, penalty payments for relocating or significant improvement costs that were expended at the onset of the lease. One example provided by a member of the IASB working group is as follows: A company that invests millions of dollars to renovate a store may be required to account for the renewal period because it would be compelled to recover its costs by extending the lease.

The FASB and IASB plan to release the revised exposure draft for further public comment at the beginning of 2012 and have expressed their desire to have a final rule in place by the end of 2012.

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

ITEMS OF NOTE....

FASB Adds Two Agenda Projects for Nonprofits

The FASB has added a standard-setting project and a research project to its agenda. These projects were added based on suggestions from FASB's Not-for-Profit Advisory Committee (NAC). The NAC was established in 2009 to serve as a standing resource for the board in obtaining input from the nonprofit sector on existing guidance, current and proposed technical agenda projects, and longer-term issues affecting nonprofits.

The standard-setting project will focus on the financial statements and related disclosures that are unique to nonprofit organizations. FASB will re-examine existing standards for financial statement presentation by nonprofit organizations and focus on improving the net asset classification format and other information provided regarding an organization's liquidity, financial performance and cash flows.

The research project will study ways that nonprofit organizations use to tell their financial story outside of the numbers. The project will review best practices followed by nonprofit organizations in this area. The study will look at how such communications enhance the understanding of financial health and performance by donors, creditors and other stakeholders. The project will also determine whether FASB can assist in promoting such communications either through its leadership or standard-setting efforts.

3 Percent Withholding Requirement

On Nov. 21, 2011, President Obama signed into law the *Three Percent Withholding Repeal and Job Creation Act* (the Act) (H.R. 674).

The Act repeals the requirement that 3 percent of payments be withheld by federal or state governments or their instrumentalities or subdivisions to any person for services or property. This withholding requirement had not yet gone into effect so it is as if the requirement had never been enacted.

The Act also creates the Returning Heroes Tax Credit and the Wounded Warriors Tax Credit. Employers that hire veterans who have been looking for employment for more than six months may be eligible for a Returning Heroes Tax Credit of up to $5,600 per employee. Employers that hire veterans who have been looking for employment for less than six months may be eligible for a credit of up to $2,400 per employee. Employers that hire veterans with service-connected disabilities who have been looking for employment for more than six months may be eligible for a Wounded Warriors Tax Credit of up to $9,600 per employee. There are other employment scenarios where employers may be eligible for other opportunity credits under the Act. These tax credits are available for eligible individuals who begin work for the employer after Nov. 21, 2011.

The Act will also allow the IRS to impose a 100 percent levy against payment due to a vendor of property sold or leased to the federal government if the vendor has an unpaid federal tax liability. Under the previous law only vendors of goods or services were subject to the 100 percent levy.

The Act also amends the definition of modified adjusted gross income under Internal Revenue Code Section 36B(d)(2) which determines eligibility for certain health care benefits and insurance coverage provisions under the Patient Protection and Affordable Care Act of 2010.

The full text of the Act can be found at http://www.gpo.gov/fdsys/pkg/BILLS-112hr674enr/pdf/BILLS-112hr674enr.pdf.

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BDO NONPROFIT & EDUCATION PRACTICE

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The Institute offers both live and local seminars, as well as webinars, on a variety of topics of interest to nonprofit organizations and educational institutions. Please check BDO's web site at www.bdo.com for upcoming local events and webinars.

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