

THE NEWSLETTER OF THE BDO NONPROFIT & EDUCATION PRACTICE

# NONPROFITSTANDARD



## IRS GOVERNANCE CHECKLIST – PRELIMINARY RESULTS

By R. Michael Sorrells, CPA

**IN AN EFFORT TO ADD FURTHER TRANSPARENCY INTO NONPROFIT ORGANIZATION REPORTING, THE IRS ADDED PART VI TO THE REVISED FORM 990 IN 2008. THIS SECTION ASKS A VARIETY OF QUESTIONS WHICH COVER A SPECTRUM OF BEST PRACTICES IN THE AREAS OF GOVERNANCE, POLICY AND DISCLOSURES.**

**W**hile most of the questions in this section do not refer to legal requirements, they do provide a good snapshot concerning governance, policies and transparency to the reader.

The Tax Exempt/Government Entities (TE/GE) Advisory Committee on Tax Exempt and Government Entities (ACT) suggested that

more research was required in this area and the IRS designed a governance questionnaire that is used in all 501(c)(3) examinations strictly for research purposes. This is a 26-question document which goes into much more detail than Part VI of the Form 990.

The IRS has performed an initial analysis of data collected to date from these

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## IRS GOVERNANCE CHECKLIST

questionnaires. Lois Lerner, the director of the IRS Exempt Organization Division (EO), shared some of this preliminary analysis with the public at a recent nonprofit tax conference.

She shared that certain correlations emerged between some questions related to certain governance practices and tax compliance:

- Organizations with a written mission statement are more likely to be compliant.
- Organizations that always use comparability data when making compensation decisions are more likely to be compliant.
- Organizations with procedures in place for the proper use of charitable assets are more likely to be compliant.
- Organizations where the 990 was reviewed by the entire board of directors are more likely to be compliant. Lerner emphasized that this indicates having the entire board engaged in the 990 process is not only helpful but correlates to better compliance.

She also stated that when the questionnaire indicated that control of the organization was vested in one individual, or a small select group, that the organization was less likely to be compliant.

The IRS also found that responses to some questions had no statistically significant correlation with tax compliance. These questions included:

- Conflict of interest policies
- Organizations that never or only occasionally use comparability data to set compensation
- Voting board members that have a family relationship and/or outside business relationship with any other voting or non-voting board member, officer, director, trustee or key employee

Lerner concluded that these initial results are generally consistent with the premise that good governance and tax compliance go hand in hand. She noted that this conclusion is based only upon a select group (i.e., 501(c)(3) organizations selected for examination) and does not provide a statistically representative sample or an analysis of the entire population

### INSTITUTE PROFESSIONAL PROFILE

#### MEET WAYNE BERSON

BDO CEO-elect Wayne Berson (effective Nov 1) currently wears a number of different hats within the firm. He is the Atlantic region's Assurance regional business line leader, the national director of the Nonprofit & Education practice and the national director of BDO's Institute for Nonprofit Excellence<sup>SM</sup>. Wayne has more than 20 years of experience in all phases of client service and accounting practices. He serves as the responsible partner in a variety of industries for many of the office's larger and more prominent clients, including many that are deeply involved in multinational operations. In addition to North America, he has directed engagements in Central America, Asia, Europe, and Africa.



He has lectured on various nonprofit and management topics for a variety of organizations, including the American Institute of Certified Public Accountants at its annual Management of an Accounting Practice and Nonprofit conferences, American Society of Association Executives, Greater Washington Society of Certified Public Accountants and many others.

Wayne recently participated in the 125th anniversary celebration of the American Institute of Certified Public Accountants (AICPA). The AICPA celebrated by hosting top U.S. and international financial regulators, CEOs of large accounting firms, chief financial officers of major companies and other business leaders in the nation's capital to discuss issues affecting global and Main Street commerce. Wayne participated in this event and served on a CEO panel discussing current issues impacting public accounting firms.

Wayne is a member of the American Institute of Certified Public Accountants, Greater Washington Society of Certified Public Accountants, and is the founding member of NPO Cooperation Circle. Wayne is also active in the community as a trustee of the Federal City Council and a member of the board of directors of the GAVI Fund – a multinational, multibillion dollar humanitarian not-for-profit organization.

Wayne earned his B.Comm, Accounting at the University of Cape Town and his Accounting Science degree, Honors, at the University of South Africa.

of exempt organizations. She has tasked the EO strategic planning group to design a project that will gather a statistically representative sample from the general EO population to determine if these results hold true for the population as a whole.

*For more information, contact Michael Sorrells, national director, Nonprofit Tax Services, at [msorrells@bdo.com](mailto:msorrells@bdo.com).*

# "THERE'S SOMEONE ON THE PHONE FROM THE NEWSPAPER. THEY'RE ASKING ABOUT THE DIRECTOR'S PAY."

By Michael Conover

While many might view this as a fictional scenario, it occurs routinely. Every year, in virtually any type of tax-exempt organization, a situation like this will arise. Compensation information found in the organization's Form 990 will trigger a question, a challenge or even outrage focused on the organization, its governing body and/or the individual in question. This situation may arise in a number of different contexts ranging from the annual "10 highest-paid executives" review to an attempted exposé of a troubled organization.

Regardless of the background, this is a situation that any organization, board member or executive may one day face. Much more information about the organization's compensation practices is now available due to required disclosures in the Form 990. In some cases, details about compensation are too technical and not understood by those who simply 'add up the numbers' and assume that the total was received in paychecks. With executive compensation already under attack from many fronts, few organizations are given the benefit of the doubt when these numbers are released.

Let's use this 'call from the newspaper' scenario to examine the benefits a properly governed and administered compensation program can offer to support the organization's response to the call. It will make the rationale behind many of the recommended compensation program principles easier to understand and appreciate as they are called into play.

The organization's Form 990 is not only the means by which the compensation information is discovered. It also represents an opportunity to communicate the details of the compensation program, especially if there are any unusual arrangements or one-time events appearing in Schedule J items. Specifically, Schedule O is not only provided



for additional information required to be disclosed in Form 990, it also represents an area where explanations and background related to compensation program features can be provided. Clearly, a well-documented explanation provided here may eliminate or minimize any confusion or controversy that an unusual entry in Schedule J might prompt. In addition, if all board members have read and understood the Form 990 in advance of its filing, everyone in the governing body is, at a minimum, acquainted with its contents.

The organization's Compensation Committee, a subset of the board composed entirely of outside/independent members, will likely become the focal point for the organization's response to an outside inquiry. While other members of the governing body or even

some staff members may be acquainted with aspects of the compensation program, Compensation Committee members should generally be in the best position to speak authoritatively about it. For this reason, it would be logical for the organization to refer all inquiries to the Compensation Committee for any reply.

In addition to its overall familiarity with the organization's compensation program, the Compensation Committee would work with outside professionals (i.e., counsel, consultants, and auditor) that support the program's governance and administration. This is especially likely if the organization adopts a new compensation program component or encounters an unusual/one-time event

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## THE DIRECTOR'S PAY

involving compensation. This involvement provides committee members with in-depth exposure to the issue and an opportunity to explore alternative courses of action, as well as the implications of the decisions made in terms of required disclosures that will follow.

Credible competitive data supplied to the Compensation Committee adds an important context for its decision making and recommendations to the full board for implementation. The data allows any particular component of the program to be understood in terms of its overall prevalence and prominence in the external market. The data also allows a particular program component or pay decision to be understood in terms of the resulting, overall compensation package offered. With the benefit of competitive information, the likelihood of a pay decision that is wildly out of line with the organization's mission is minimized. This information can also be helpful to communicate an aspect of the reasoning behind the organization's pay actions.

For those organizations that have adopted them, a formal compensation strategy / statement of guiding principles can also be useful when outside questions are raised about pay. These principles articulate the organization's beliefs about pay and the rationale on which they are based. They reduce the likelihood of ad hoc decisions to address a specific situation which might later be found to run contrary to the organization's best interests or sensibilities of the public. While primarily for internal use as a resource to policy makers on the organization's governing body these principles can, under some circumstances, be useful for helping outsiders understand the pay decisions.

Finally, detailed minutes of meetings in which the Compensation Committee's decisions are made provide not only a complete record of proceedings, but a template for the way these meetings should be conducted. Minutes should include, but are not limited to, the following types of information:

- Advance notice given to meeting participants as well as any preparation materials submitted prior to the meeting

- A record of all parties attending the meeting, including committee members and any staff members or consultants (as well as a record of any point in meeting proceedings where these individuals are dismissed to allow private committee deliberations)
- Issues placed before the committee, recap of the analyses and information presented to examine them, alternatives offered for consideration and, importantly, the discussions/deliberations of committee members
- Finally, the decision(s) ultimately made by the committee to arrive at the final pay action

Meetings conducted in a manner that readily allows each of the areas highlighted above to be 'filled in' will not only help support the organization's efforts to comply with the IRS Intermediate Sanctions, but also ensure effective meetings that support good decision making and decisions that can be explained as the result of a sound process followed by the governing body.

An organization having each of the governance and administrative features highlighted to this point would be well positioned to respond to any outside question about its pay practices. In fact, these practices would minimize the likelihood of a controversial pay decision in the first place. However, these outside inquiries can and will arise. All organizations would be well advised to adopt these practices in order to best be prepared to reply when the questions come. In addition, organizations would be well advised to think through a process/protocol for responding to an outside inquiry in advance of a situation to ensure their position is as well supported as possible.

Imagine the circumstances facing an organization with few or none of the supports for its compensation program that we have described when a question or challenge to its pay practices is raised:

- Calls from the newspaper answered by an individual unfamiliar with the subject or caught like a deer in the headlights with a hollow "No comment..."

- Surprised to discover the newspaper's analysis showing the organization's position substantially deviating from competitive practices
- At a loss to explain its pay decision in the context of the organization's beliefs about compensation or a governance process that produced it

There is really no need for an organization to find itself in this position. Following best practices that support the organization's efforts to comply with the IRS Intermediate Sanctions can minimize the likelihood that questions about pay decisions will be raised or cannot be effectively addressed if they are.

*For more information, contact Michael Conover, senior director, Specialized Tax Services – Compensation and Benefits, at [wconover@bdo.com](mailto:wconover@bdo.com).*



# BE CAREFUL WHAT YOU ASK FOR

or: How accounting and tax issues can affect each other.

by Dick Larkin, CPA

**T**his article is not about obvious tax aspects of accounting, such as application of the accounting standard on uncertain tax positions (set forth in Financial Accounting Standard (ASC) 740-10), or how to compute the provision for tax on unrelated business income. Those are well covered in other literature. Rather the purpose here is to illustrate how accounting decisions or judgments can affect taxes – on an organization or on its donors, and vice versa.

It is well known that accounting is not always the exact science that some perceive it to be. It is actually replete with estimates and judgments – nowhere more so than in accounting by not-for-profit organizations, especially in the areas of allocation of expenses and categorization of revenue.

## ►EXPENSE ALLOCATION

The allocation of expenses among and within functional areas is often quite subjective. Yes, there are rules, but the application of those rules to specific situations generally requires judgment. An example usually encountered is how much of someone's compensation and related occupancy costs is appropriate to charge to one function versus another. For someone who performs only one function, that is easy. But many people perform more than one function during their work hours, and tracking how those hours are spent is often judgmental (as well as an administrative burden). Even more challenging is when a person is actually performing two functions simultaneously, such as the person who creates a brochure that will be used for both public education – say, about symptoms of a disease, as well as for fundraising. (American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) 98-2, codified in ASC 958-720, discusses the accounting aspects of this subject.)



### Three ways in which this expense allocation can have tax consequences are:

- When one of the functions involved generates unrelated business income, how expenses are allocated to it will affect the amount of deductions allowable against that income in computing the organization's tax on the net unrelated income
- When the expenses are related to the conduct of a fundraising event such as a dinner or a walkathon, whether and how much the expenses are considered to provide a direct benefit to the participants (e.g., diners, walkers) may affect the amount of personal tax deduction available to them for the payments they make to participate
- When an organization engages in an activity that might be construed as lobbying, the amount of expenses allocated to that activity may affect the organization's compliance with very strict tax rules about how much lobbying is permissible for an exempt organization. Violation of those rules can result in monetary penalties and/or loss of exempt status.

### When considering these issues, keep in mind that not-for-profit organizations usually have four goals relevant to expense allocation:

- Minimizing the amount of unrelated business income tax paid by the organization
- Maximizing the amount of charitable contribution tax deductions available to their donors
- Reporting as high a percentage as possible of the organization's expenses as program expenses, while minimizing the amounts reported as management and – especially – fundraising expenses
- Remaining in compliance with the tax laws related to limitations on lobbying.

### Sometimes these four goals conflict with each other. Let's look at some examples:

1. As noted above, more expenses properly charged against unrelated business income will reduce the tax on that income. But 'unrelated' activities are often not program activities (if they were program activities,

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## BE CAREFUL WHAT YOU ASK FOR

they might not be unrelated). So charging more expenses to them will adversely affect the percentages reported in the financial statements as program versus other types of expenses, thus making it seem that the organization is not using as much of its resources for direct conduct of its programs. It is important to note that expenses allocated to unrelated business income be primary and proximate to the unrelated activity.

2. Accounting rules related to the costs of so-called 'special events' (e.g., dinners, walkathons) permit the costs of 'direct benefits to participants' to be reported in the organization's financial statements as deductions from the revenue generated by the event rather than as fundraising expenses. This has the desirable effect of reducing the organization's reported fundraising expenses, thus increasing the reported ratio of program expenses to total expenses. But judgment is often required to determine just what costs relate to benefits to participants, versus other costs of the event.

So for accounting purposes why not try to allocate as much of the event cost as possible into the 'direct benefit' bucket? Because that would push the donor up against the tax rule that requires donors to a charity, who receive a benefit in exchange for their donation (e.g., dinner, food along the walk), to reduce the amount of their personal charitable tax deduction by the amount of the benefits they receive (technically the relevant reduction is the 'value' to the participants of the benefits received, but determining that value is normally judgmental, and the actual costs incurred may figure in that determination.) Tax rules also require the organization to explicitly tell donors of larger amounts what part of their payment is not deductible because it is the value of benefits received. (Relevant tax law includes certain *de minimis* thresholds, which do not affect the general point being made here.) So if more costs are considered to provide benefits to donors, their tax deductions will be lower – which will not make the donors happy.

But if less of the event costs are treated as provision of donor benefits, so donors can take a bigger deduction, more of those costs will end up being reported by the charity as fundraising, thus hurting its expense ratios.

3. An activity involving lobbying is probably a program activity, so an organization would like to charge more 'overhead-type' expenses to it rather than to management and general. But the more expenses that are charged to this activity, the higher the risk of violation of the Internal Revenue Service's (IRS) limitations on allowable lobbying activities.

In all of these examples, think of 'rocks' and 'hard places.'

### ►REVENUE RECOGNITION

The issue here is one of unrelated business income, and judgment also plays a role. Many types of judgments enter into accounting for revenue – especially for contributions. One important judgment is whether a particular item of revenue is in fact a contribution, or whether it is properly an 'exchange transaction,' where the payor is receiving goods or services roughly commensurate in value with the amount of the payment. Examples of exchange transactions for nonprofits include tuition, membership dues, ticket sales, bookstore and gift shop sales, some research grants and the like.

Two issues flow from this judgment; one can have tax consequences to the recipient. The first issue is the timing of recognition of the revenue. Under generally accepted accounting principles (GAAP), contribution revenue is recognized when a gift is made or unconditionally promised, while exchange revenue is recognized only when the exchange is completed. This timing difference normally does not have tax consequences since contributions are, by law, not unrelated business taxable income.

The issue that has tax consequences is the characterization of the revenue as either a contribution or exchange. It is in many cases not clear as to how a given item should be classified, and judgment is required to make

this determination. This is especially true with government and foundation grants. The AICPA audit guide for not-for-profit organizations (Chapter 5; ASC 958-605) includes a list of indicators (Table 5-1) to consider in making this accounting judgment.

If an item can be justifiably characterized as a contribution, it will be reported on Line 1 (of Part VIII) of IRS Form 990, and will not be unrelated business income. But if it is characterized as an exchange transaction, it will be reported on one of Lines 2 to 11, and it is now at risk of the IRS alleging it is unrelated to the organization's exempt purpose, and thus taxable – which, of course, the organization would not like. In addition, Form 990 requires that for each revenue item other than contributions, the organization provide an explanation of why it should not be considered unrelated (there are certain other statutory exemptions); the burden of proof of relatedness is on the organization. (There are also tax consequences to the payor in that contributions are tax-deductible (within limits), while payments by individuals for goods or services probably are not. However, how the recipient categorizes a payment does not determine its deductibility by the payor, and the IRS is unlikely to relate the two anyway.)

Again, an accounting judgment can lead to tax consequences if the judgment is not (1) made appropriately and (2) the logic behind it adequately documented in case it is challenged.

So, be careful what accounting and reporting practices you choose and judgments you make, because sometimes they can have tax consequences you might not like. And don't automatically make choices to minimize taxes, because the accounting results might not always be what you want.

For more information, contact Dick Larkin, director, BDO Institute for Nonprofit Excellence<sup>SM</sup>, at [dlarkin@bdo.com](mailto:dlarkin@bdo.com).

# IRS UPDATES PROGRAM-RELATED INVESTMENT GUIDANCE



By Joyce Underwood, CPA

## ON APRIL 18 THE INTERNAL REVENUE SERVICE (IRS) RELEASED PROPOSED REGULATIONS (REG-144267-11) THAT PROVIDE EXPANDED GUIDANCE ON PROGRAM-RELATED INVESTMENTS (PRIs).

**R**egulations under Internal Revenue Code (IRC) section 4944(c) define a PRI as an investment: the primary purpose of which is to accomplish the organization's exempt purpose; no significant purpose of which is the production of income or the appreciation of property; and no purpose of which is to attempt to influence legislation or participate in or intervene in any political campaign. Section 4944, which imposes an excise tax on jeopardizing investments, excepts program-related investments from treatment as jeopardizing investments, and from the assets a private foundation takes

into account when determining how much it must distribute under section 4942 as a "distributable amount" for the taxable year.

The proposed rules do not change existing regulations, but use more modern circumstances in new examples to illustrate a variety of charitable purposes and different types of investments with the intent to reflect current investment practices and illustrate key principles based upon relevant published guidance and financial structures described in private letter rulings.

### Key principles of the IRS' guidance<sup>1</sup>:

- An activity conducted in a foreign country furthers a charitable purpose if the same activity would further a charitable purpose if conducted in the United States.
- The charitable purposes served by a PRI are not limited to situations involving economically disadvantaged individuals and deteriorated urban areas.
- The recipients of PRIs need not be within a charitable class if they are the instruments for furthering a charitable purpose.
- A potentially high rate of return does not automatically prevent an investment from qualifying as program-related.
- PRIs can be achieved through a variety of investments, including loans to individuals, tax-exempt organizations and for-profit organizations, and equity investments in for-profit organizations.
- A credit enhancement arrangement may qualify as a PRI; and a private foundation's

<sup>1</sup> REG-144267-11

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acceptance of an equity position in conjunction with making a loan does not necessarily prevent the investment from qualifying as a PRI.

**The new examples are included here to illustrate the scenarios considered by the IRS in drafting the proposed regulations. They are numbered 11 through 19 to follow the existing numbering of the previously existing examples:**

**EXAMPLE 11.** X is a business enterprise that researches and develops new drugs. X's research demonstrates that a vaccine can be developed within 10 years to prevent a disease that predominantly affects poor individuals in developing countries. However, neither X nor other commercial enterprises like X will devote their resources to develop the vaccine because the potential return on investment is significantly less than required by X or other commercial enterprises to undertake a project to develop new drugs. Y, a private foundation, enters into an investment agreement with X in order to induce X to develop the vaccine. Pursuant to the investment agreement, Y purchases shares of the common stock of S, a subsidiary corporation that X establishes to research and develop the vaccine. The agreement requires S to distribute the vaccine to poor individuals in developing countries at a price that is affordable to the affected population. The agreement also requires S to publish the research results, disclosing substantially all information about the results that would be useful to the interested public. S agrees that the publication of its research results will be made as promptly after the completion of the research as is reasonably possible without jeopardizing S's right to secure patents necessary to protect its ownership or control of the results of the research. The expected rate of return on Y's investment in S is less than the expected market rate of return for an investment of similar risk. Y's primary purpose in making the investment is to advance science. No significant purpose of the investment involves the production of income or the appreciation of property. The investment significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the investment and Y's exempt activities. Accordingly, the purchase of the common stock of S is a program-related investment.

**EXAMPLE 12.** Q, a developing country, produces a substantial amount of recyclable solid waste materials that are currently disposed of in landfills and by incineration, contributing significantly to environmental deterioration in Q. X is a new business enterprise located in Q. X's only activity will be collecting recyclable solid waste materials in Q and delivering those materials to recycling centers that are inaccessible to a majority of the population. If successful, the recycling collection business would prevent pollution in Q caused by the usual disposition of solid waste materials. X has obtained funding from only a few commercial investors who are concerned about the environmental impact of solid waste disposal. Although X made substantial efforts to procure additional funding, X has not been able to obtain sufficient funding because the expected rate of return is significantly less than the acceptable rate of return on an investment of this type. Because X has been unable to attract additional investors on the same terms as the initial investors, Y, a private foundation, enters into an investment agreement with X to purchase shares of X's common stock on the same terms as X's initial investors. Although there is a high risk associated with the investment in X, there is also the potential for a high rate of return if X is successful in the recycling business in Q. Y's primary purpose in making the investment is to combat environmental deterioration. No significant purpose of the investment involves the production of income or the appreciation of property. The investment significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the investment and Y's exempt activities. Accordingly, the purchase of the common stock is a program-related investment.

**EXAMPLE 13.** Assume the facts as stated in Example 12, except that X offers Y shares of X's common stock in order to induce Y to make a below-market rate loan to X. X previously made the same offer to a number of commercial investors. These investors were unwilling to provide loans to X on such terms because the expected return on the combined package of stock and debt was below the expected market return for such an investment based on the level of risk involved,

and they were also unwilling to provide loans on other terms X considers economically feasible. Y accepts the stock and makes the loan on the same terms that X offered to the commercial investors. Y plans to liquidate its stock in X as soon as the recycling collection business in Q is profitable or it is established that the business will never become profitable. Y's primary purpose in making the investment is to combat environmental deterioration. No significant purpose of the investment involves the production of income or the appreciation of property. The investment significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the investment and Y's exempt activities. Accordingly, the loan accompanied by the acceptance of common stock is a program-related investment.

**EXAMPLE 14.** X is a business enterprise located in V, a rural area in State Z. X employs a large number of poor individuals in V. A natural disaster occurs in V, causing significant damage to the area. The business operations of X are harmed because of damage to X's equipment and buildings. X has insufficient funds to continue its business operations and conventional sources of funds are unwilling or unable to provide loans to X on terms it considers economically feasible. In order to enable X to continue its business operations, Y, a private foundation, makes a loan to X bearing interest below the market rate for commercial loans of comparable risk. Y's primary purpose in making the loan is to provide relief to the poor and distressed. No significant purpose of the loan involves the production of income or the appreciation of property. The loan significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the loan and Y's exempt activities. Accordingly, the loan is a program-related investment.

**EXAMPLE 15.** A natural disaster occurs in W, a developing country, causing significant damage to W's infrastructure. Y, a private foundation, makes loans bearing interest below the market rate for commercial loans of comparable risk to H and K, poor individuals who live in W, to enable each of them to start a small business. H will open a roadside fruit stand. K will start a weaving business.

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Conventional sources of funds were unwilling or unable to provide loans to H or K on terms they consider economically feasible. Y's primary purpose in making the loans is to provide relief to the poor and distressed. No significant purpose of the loans involves the production of income or the appreciation of property. The loans significantly further the accomplishment of Y's exempt activities and would not have been made but for such relationship between the loans and Y's exempt activities. Accordingly, the loans to H and K are program-related investments.

**EXAMPLE 16.** X is a limited liability company treated as a partnership for federal income tax purposes. X purchases coffee from poor farmers residing in a developing country, either directly or through farmer-owned cooperatives. To fund the provision of efficient water management, crop cultivation, pest management and farm management training to the poor farmers by X, Y, a private foundation, makes a loan to X bearing interest below the market rate for commercial loans of comparable risk. The loan agreement requires X to use the proceeds from the loan to provide the training to the poor farmers. X would not provide such training to the poor farmers absent the loan. Y's primary purpose in making the loan is to educate poor farmers about advanced agricultural methods. No significant purpose of the loan involves the production of income or the appreciation of property. The loan significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the loan and Y's exempt activities. Accordingly, the loan is a program-related investment.

**EXAMPLE 17.** X is a social welfare organization that is recognized as an organization described in IRC section 501(c)(4). X was formed to develop and encourage interest in painting, sculpture and other art forms by, among other things, conducting weekly community art exhibits. X needs to purchase a large exhibition space to accommodate the demand for exhibition space within the community. Conventional sources of funds are unwilling or unable to provide funds to X on terms it considers economically feasible. Y, a private foundation, makes a loan to X at an interest rate below

the market rate for commercial loans of comparable risk to fund the purchase of the new space. Y's primary purpose in making the loan is to promote the arts. No significant purpose of the loan involves the production of income or the appreciation of property. The loan significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the loan and Y's exempt activities. Accordingly, the loan is a program-related investment.

**EXAMPLE 18.** X is a nonprofit corporation that provides child care services in a low-income neighborhood, enabling many residents of the neighborhood to be gainfully employed. X meets the requirements of section 501(k) and is recognized as an organization described in IRC section 501(c)(3). X's current child care facility has reached capacity and has a long waiting list. X has determined that the demand for its services warrants the construction of a new child care facility in the same neighborhood. X is unable to obtain a loan from conventional sources of funds including B, a commercial bank, because X lacks sufficient credit to support the financing of a new facility. Pursuant to a deposit agreement, Y, a private foundation, deposits \$h in B, and B lends an identical amount to X to construct the new child care facility. The deposit agreement requires Y to keep \$h on deposit with B during the term of X's loan and provides that if X defaults on the loan, B may deduct the amount of the default from the deposit. To facilitate B's access to the funds in the event of default, the agreement requires that the funds be invested in instruments that allow B to access them readily. The deposit agreement also provides that Y will earn interest at a rate of t percent on the deposit. The t percent rate is substantially less than Y could otherwise earn on this sum of money, if Y invested it elsewhere. The loan agreement between B and X requires X to use the proceeds from the loan to construct the new child care facility. Y's primary purpose in making the deposit is to further its educational purposes by enabling X to provide child care services within the meaning of IRC section 501(k). No significant purpose of the deposit involves the production of income or the appreciation of property. The deposit significantly furthers the accomplishment of Y's exempt activities

and would not have been made but for such relationship between the deposit and Y's exempt activities. Accordingly, the deposit is a program-related investment.

**EXAMPLE 19.** Assume the same facts as stated in Example 18, except that instead of making a deposit of \$h into B, Y enters into a guarantee agreement with B. The guarantee agreement provides that if X defaults on the loan, Y will repay the balance due on the loan to B. B was unwilling to make the loan to X in the absence of Y's guarantee. X must use the proceeds from the loan to construct the new child care facility. At the same time, X and Y enter into a reimbursement agreement whereby X agrees to reimburse Y for any and all amounts paid to B under the guarantee agreement. The signed guarantee and reimbursement agreements together constitute a "guarantee and reimbursement arrangement." Y's primary purpose in entering into the guarantee and reimbursement arrangement is to further Y's educational purposes. No significant purpose of the guarantee and reimbursement arrangement involves the production of income or the appreciation of property. The guarantee and reimbursement arrangement significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the guarantee and reimbursement arrangement and Y's exempt activities. Accordingly, the guarantee and reimbursement arrangement is a program-related investment.<sup>2</sup>

As a result of this new guidance, private foundations will be able to participate in a broader range of investments that more clearly qualify as program-related investments without triggering an excise tax. They will be better able to apply the rules to complex modern circumstances, investments in foreign organizations and domestic organizations that have operations abroad.

The proposed rules appeared in the Federal Register on April 19. The IRS has asked for comments and requests for a public hearing to be submitted by July 18.

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# DISASTER RELIEF ORGANIZATIONS

By Laura Kalick, JD, LLM

**THERE HAVE BEEN SO MANY DISASTERS IN RECENT YEARS, BOTH NATURAL AND FINANCIAL, AND MANY INDIVIDUALS AND COMPANIES ARE SEEKING WAYS TO HELP THOSE IN NEED.**

Existing charities often take the lead in collecting funds and goods that can be used for relief. In some cases an employer group will want to provide relief to employees and communities where they are located. We have seen many new organizations formed for disaster relief and assistance and believe it may be useful to outline some of the rules. The information below is a summary and in part excerpted from IRS Pub 3833, *Disaster Relief, Providing Assistance Through Charitable Organizations*, cited at the end of this article.



## ►INTERNAL REVENUE CODE (IRC) 501(c)(3) STATUS FOR DISASTER RELIEF ORGANIZATIONS

Relief of the poor and distressed is a 501(c)(3) charitable purpose. Relief can take many forms including providing food or shelter after a flood or earthquake, counseling of victims of crime or physical abuse, or assisting with longer term needs of housing, health care or education. Providing relief to persons in distress therefore can be a charitable purpose, provided that the class of persons assisted is broad enough to constitute a charitable class, as opposed to being a single family or individual. A charitable class is one that is large enough or sufficiently indefinite that the community as a whole, rather than a

pre-selected group of people, benefits from the charity's assistance. So, for example, if the class of people benefitted is all the people in a particular town that was hit by a tornado, the class is sufficiently large and indefinite to qualify.

Even if the group is smaller and limited to a particular group of employees or franchisees, the group could still qualify as a charitable class if the group is indefinite and open ended, such as one that includes victims of a current disaster and future disasters.

Assuming that an organization qualifies as a 501(c)(3) organization, a determination must still be made as to whether the organization is a public charity or a private foundation. The

classification as a public charity will depend upon whether there is broad-based public support as opposed to a few individuals or a company making the major contributions. Or, in some cases a disaster relief organization may be classified as a public charity because it supports another public charity such as a community foundation. In the case of a new organization that is formed by a company to help employees in communities where there has been a disaster, it may be possible for that charity to show broad public support if other employees make donations. Even though the employees are associated with the company, they are still considered the general public when it comes to individual donations that are attributable to them personally.

►CONTINUED FROM PAGE 10

## DISASTER RELIEF ORGANIZATIONS

In addition to the charitable class requirement, an employer relief organization cannot excessively control the public charity or impermissibly serve the related employer's private interest.

The following requirements should be met:

- The recipients must be selected based on an objective determination of need or distress.
- The recipients must be selected by an independent selection committee or similar procedures to ensure that any benefit to the employer is incidental and tenuous.

The charity's selection committee is independent if a majority of the members of the committee consists of persons who are not in a position to exercise substantial influence over the affairs of the employer.

If these requirements are met, the public charity's payments to the employer-sponsor's employees and their family members in response to a disaster or emergency hardship are presumed: (1) to be made for charitable purposes and (2) not to result in taxable compensation to the employees.

Regardless of the public charity or private foundation status, a new nonprofit organization must submit an application for exemption (Form 1023) to the Internal Revenue Service. If the organization can show that the victims of the disaster will be adversely affected if the application is not reviewed expeditiously, the application may receive an expedited review. Some of the elements of a request for expedited treatment include:

- a compelling reason to process the application ahead of others
- a brief description of the disaster and details of how the organization will provide relief
- an explanation of the immediate need for the specific disaster relief services the organization provides

- a description of any pending grants, including information about the grantor and the amount or property to be received
- an explanation of how the loss of the grant(s) might impact the organization's ability to operate and provide relief
- any other anticipated consequences should the expedited processing be denied

Private foundations can make need-based distributions to victims of disasters or to the poor or distressed. However, several issues arise when an employer-sponsored private foundation provides aid that favors the employees of the sponsoring employer, but only when it involves qualified disasters as defined in section 139<sup>1</sup> of the Internal Revenue Code. Also, some community foundations and other public charities maintain donor-advised funds that can be used for employees who are victims of qualified disasters.

All organizations should maintain records to document that payments are for charitable purposes and made on an appropriate assessment of the individuals' needs. An organization providing short-term emergency assistance would only be expected to maintain records showing the type of assistance provided, criteria for disbursing assistance, date, place, estimated number of victims assisted (individual names and addresses are not required), charitable purpose intended to be accomplished, and the cost of the aid.

This information is a summary of the information provided by the IRS on its website. For more detailed information, see the IRS website and Pub 3833 at <http://www.irs.gov/pub/irs-pdf/p3833.pdf>.

**For more information, contact Laura Kalick, national director, Nonprofit Tax Consulting, at [lkalick@bdo.com](mailto:lkalick@bdo.com).**

## 2011 FORM 990 CHANGES – K-1 REPORTING OPTIONAL

As noted in the (March 2012 *Nonprofit Standard* article entitled "Update on 2011 Form 990: Some Changes and Clarifications," the 2011 Form 990 and 990-EZ instructions state that a filing organization should report its proportionate interests in a joint venture's or other partnership's revenue, expenses and assets using information from the Form 1065, Schedule K-1 (K-1), provided by the joint venture/partnership. However, since publishing the instructions in January 2012, the Internal Revenue Service (IRS) has received public comments arguing against such reporting, and as a result has published Announcement 2012-19: Reporting Information Regarding Joint Ventures and Other Partnerships on Forms 990 and 990-EZ for Tax Year 2011, making these requirements optional for Tax Year 2011.

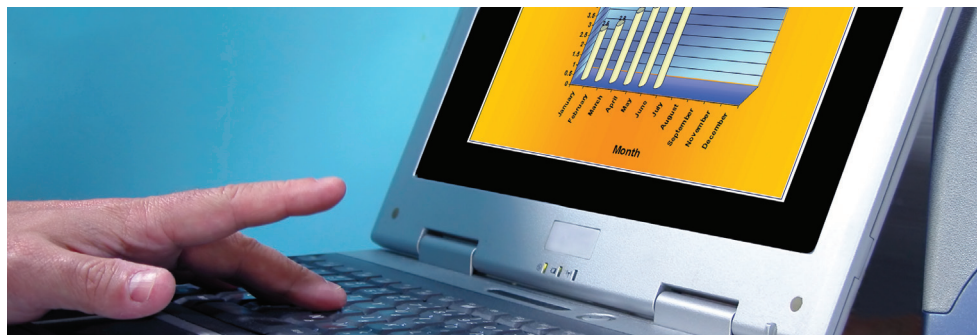
Critics argue that reporting an organization's interests using the organization's books and records provides a more accurate value of those assets, that use of Schedule K-1 information can be burdensome, that K-1s often report on a different fiscal year than an organization and that organizations cannot report information from all K-1s they receive because some partnerships do not submit the K-1s until after the Form 990 filing due date. The IRS will more fully consider these comments and determine how best to promote compliance and transparency while minimizing burden in reporting of partnership interests.

<sup>1</sup> For purposes of this section, the term "qualified disaster" means -

(1) a disaster which results from a terroristic or military action (as defined in section 692(c)(2)), (2) a Presidentially declared disaster (as defined in section 1033(h)(3)), (3) a disaster which results from an accident involving a common carrier, or from any other event, which is determined by the Secretary of the Treasury (Secretary) to be of a catastrophic nature, or (4) with respect to amounts described in subsection (b)(4), a disaster which is determined by an applicable Federal, State, or local authority (as determined by the Secretary) to warrant assistance from the Federal, State, or local government or agency or instrumentality thereof.



# TAPPING INTO TECHNOLOGY TO WIN AND MANAGE GRANTS



By Tammy Massey

**D**oes your staff's time seem slavishly devoted to chasing the latest grantor's request for fund-related data? It's a shame that nonprofit professionals often spend more time managing spreadsheets to allocate funds and project future performance than actually focusing on improving the programs or budget efficiency or increasing awareness of a nonprofit's mission. It can be an exhausting cycle that traps an organization from moving ahead. And it can be a frustrating disadvantage in the current funding climate, where there is both growing competition to win limited funds and ever-increasing demand for financial evidence of accountability.

Many nonprofits are unaware of the availability of grant management technology that can automate the processes to manage existing grants and provide an edge for winning new ones. Smart organizations that take the time to examine the long-term benefits of technology will see that the right investment can ultimately assist their overall mission and financial position.

Grant technology can mean fast, integrated answers when you need them: Imagine being able to easily check the budget and ensure that funds are fully utilized, and forecast expenditures for remaining periods. What if you could view all activity related to a given grant, including outstanding invoices, and then drill down to the details associated with every transaction?

Instant access to this type of information can improve your relationships with your grant

makers and ease the stress of your hard-working team. Missed deadlines, unreturned calls and inaccurate reporting discourage renewed funding, and can open the door for other organizations with similar missions to vie for the grantors' attentions and funds. Using grant management technology can help track deadlines, and ensure timely and accurate information. Grant management technology makes it easier to show how you used each dollar, and to project your performance in the next grant year – vital facts for renewing grants.

With a little breathing room from frantic grant-data gathering, your hard working staff can look to the future and can work to secure new funding. Accurate forecasting and measurement help you back up your proposal with the hard data that shows grant makers exactly what you can accomplish with the funds. And when you can precisely track past budgets and results, your organization knows exactly how much it will need in the future, allowing your team to "outbid" grant competitors that aren't able to demonstrate effectiveness on such a detailed level. In addition, grant management technology can make sure every donation eligible for a match is always found and accounted for so you never miss a match opportunity.

The most important aspect of tapping into technology is intelligently planning for your organization's future. Having the tools to perform hypothetical budgeting scenarios and planning how to backfill funding if a grant is not renewed, provides your organization with the security of fully understanding your financial status and plan for changes.

Over the last two decades, nonprofits have seen how fundraising technology has streamlined donor communication and improved fundraising results. Now it's time to apply the same efficiencies and improvements to grants and other financial planning. The investment in the right technology can defray staff costs, diminish headaches and streamline processes to help your team get more done each day. Tapping into this next level of technology helps ensure that nonprofits maximize limited resources, cultivate important relationships and obtain more money to secure the long-term health of their organizations.

If your organization is managing more than three grants, is struggling with timely and accurate reporting or could use some improvement measuring and tracking its success, it's a good time to start exploring grant management technology solutions.

If you are ready to start the search for grant management technology, start by looking for local accounting consultants who specialize in fund accounting or serving nonprofit organizations and/or review [www.IdealWare.org](http://www.IdealWare.org), a site dedicated to helping nonprofits make smart software decisions. It will help guide you through the things you will need to consider as well as help you identify systems and technology that may fit your organization's needs.

Before making a decision, you may also want to check with the Grant Professionals Association (GPA), formerly American Association of Grant Professionals (AAGP), (<http://grantprofessionals.org>) which provides endorsements of products – including software – that an expert committee studies before making an endorsement decision. Those endorsement decisions are based on objective, reasonable criteria and all potential vendors are considered.

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# WHY ARE THOSE FINANCIAL REPORTS SO CONFUSING?

By Tammy Ricciardella, CPA

**D**o you ever hear this complaint from program staff at your organization? Does your operational management team seem to lose interest during your financial presentation? Are board members getting the information they really need from the financial reports? Persons who rise to the level of senior management, as well as members of governing boards, in nonprofit organizations often come from the programmatic ranks, and do not have the degree of training and experience in financial matters normally possessed by their counterparts in the business world. This is not to say they are not intelligent; they just have not been exposed to finances as much. But they definitely need to understand the financial side of an organization if they are to adequately discharge their responsibilities of ensuring sound management of the organization they serve.

Individuals responsible for the financial operations of their organizations need to work with program personnel and the management team to design reports that present the critical financial information to those who need to know in a way that they can understand.

Program personnel below the senior management level often do not need to get involved in all the financial reporting data. However, they do need to focus on their specific program budget and results of operations. Each program manager will have certain critical data that they use to measure the financial results of their program. It is the responsibility of the financial team to identify what this measurement is and develop a way to communicate the operations of the program and this statistic so the program personnel can understand the meaning. Often times this may require a brief training to explain how to interpret the monthly activity reports that show the amount of revenue from a program and the amount spent. It is critical for each program director to understand that their program must generate revenue in accordance with budgeted amounts to

cover the expenses they incur to provide their services. This information should be presented and reviewed with the program director each month so they can discuss the status of the program's operations and address any issues.

The senior management team will need to review operational data for the organization as a whole. The members of the team who are responsible for making decisions regarding the future of the organization need to understand not only how the organization is doing currently but what resources will be available later or those resources that will need to be raised before certain activities can begin. Conducting brief training sessions would be very useful for this team also and need not focus on the intricacies of accounting but the interpretation of the financial situation. Understanding what the assets of the organization are and how liquid these assets are and what obligations have been incurred and when they must be satisfied is critical. Knowing the source of revenues and the necessary expenses and the actual results of these components in comparison to the budget is necessary so that informed decisions can be made regarding future actions. These are the critical concepts that need to be explained, not the detail process of how the numbers were recorded.

The finance team can assist in making financial information easier to understand in many ways. One popular way is to convert the financial reports into graphs and charts that summarize the financial results. This is a very powerful and effective way to get the message across. Preparing clear charts that show the major measures of success that the organization uses is a very good way of showing not only current results but, importantly, the trends in these results over a period of time.

Another common method used to help explain financial data is for a financial person (this can be a board member such as the treasurer or a staff person such as the CFO) to prepare an information packet that accompanies financial information – either those presented in traditional statement format or pictures – that

walks through an explanation of the various line items as well as the issues and trends noted.

An additional practice that can be very helpful is for financial personnel to communicate in plain English. Financial terms can be overwhelming and will make listeners lose focus. Whenever discussing issues, try to use terms that everyone can understand and, wherever possible, try to explain the issues in relation to either an individual's personal accounting or measures that they focus on from a program perspective.

The same issues discussed above also apply to the board. When new members are added to the board, a financial person should participate in the new board orientation training to assist in explaining the operations and critical financial components to new board members. The board is looking for an overview, and any presentations made should be designed to cover the critical issues and focus on the significant items that need to be addressed at this level.

The main focus should be to explain the financial situation of the organization in a manner that conveys the message that is needed. If an organization is financially stable, much of this message is straightforward and can summarize why this is the case and then try to focus efforts on the future. If an organization is struggling overall or in one area of operations, this needs to be highlighted and communicated so that the hard discussions regarding what the organization can do will take place.

Overall, the person with the responsibility for the financial operations of an organization needs to ensure that their program personnel, management team and board understand the critical issues the organization is facing and that these personnel receive the information they need to make the correct decisions to ensure that the organization can fulfill its mission and survive in the future.

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

## BDO INSTITUTE FOR NONPROFIT EXCELLENCE<sup>SM</sup> 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. Following is a list of some of the upcoming events where you can hear BDO Institute professionals speaking. In addition to these external venues, BDO will be offering both live local seminars, as well as webinars, on such topics as nonprofit tax and accounting updates, international accounting and business issues, disaster recovery and preparedness and insurance needs, executive compensation and employee benefit plan issues. The Institute is planning to conduct a webinar discussing the 2012 OMB A-133 Compliance Supplement during July 2012. Please check BDO's website at [www.bdo.com](http://www.bdo.com) for upcoming local events and webinars.

### JUNE

**Dick Larkin** will be presenting a session entitled "Advanced Accounting Issues for Nonprofits" at the Illinois Society of CPAs at their Not-for-Profit Complex and Emerging Accounting and A-133 Issues Conference on June 12 in Chicago, Ill.

**Mike Sorrells** will be presenting a nonprofit tax update session for the Nebraska Society of CPAs at the Not-for-Profit Conference on June 14 in Lincoln, Neb.

**Dick** will be presenting a session on financial statement interpretation at the AICPA National Not-for-Profit Industry Conference on June 20 in Washington, D.C.

### SEPTEMBER

**Dick** will be presenting a session entitled "Nonprofit Accounting and Auditing" update at the Virginia Society of CPAs 42nd Annual Accounting and Auditing Conference being held on Sept. 24 in Roanoke, Va.

## OTHER ITEMS TO NOTE....

### OMB Circular A-133 Compliance Supplement

The Office of Management and Budget (OMB) informed the AICPA Government and Audit Quality Center (GAQC) that the OMB clearance process for the 2012 OMB Circular A-133 *Compliance Supplement* (the Supplement) is taking longer than expected. Due to the delay, OMB has released a final draft of the Supplement to the GAQC and it is available on the AICPA GAQC website for members and nonmembers alike. OMB has stated that it does not expect any significant changes but notes that this is still a draft and changes can occur to the final version. As in years past, Appendix V of the Supplement lists a summary of significant changes from the prior year's guidance.

### Problems with the IRS Revocation Process Reported

Recently, the Treasury Inspector General for Tax Administration (TIGTA) released a report that disclosed that although the Internal Revenue Service (IRS) appropriately identified and informed more than 279,500

organizations in 2011 that their tax-exempt status had been automatically revoked due to a failure to file a return or notice for three consecutive years, there were potentially more than 15,000 organizations the IRS did not identify. Also, not all organizations received notices and there was some concern whether revoked organizations could still receive tax-deductible contributions they are not entitled to. It was found in most cases that the IRS appropriately identified organizations. The problems are reported to be the result of incomplete computer programming changes. The IRS is taking corrective action to identify these organizations.

There continues to be confusion about the process for regaining exempt status. The IRS has followed up with a great deal of information about the revocation process through the "Frequently Asked Questions" on its website.

For the full TIGTA report, see (2012-10-027, dated 3/30/12) [www.treasury.gov/tigta/auditreports/2012reports/201210027fr.pdf](http://www.treasury.gov/tigta/auditreports/2012reports/201210027fr.pdf)

### IASB Convergence Project

The Financial Accounting Standards Board (FASB) expects to send its financial instruments proposal out for a second round of public comment in the second half of 2012 and to wrap up all of its major convergence projects – on financial instruments, leases, revenue recognition and insurance – in mid-2013.

FASB and the International Accounting Standards Board (IASB) have worked closely on standards for leasing, revenue recognition and insurance contracts, but pursued separate approaches in financial instruments until recently. The boards have started to pursue more common approaches with respect to how to classify and measure financial instruments and how they should be assessed for a markdown, giving the chairmen of these two boards hope that they can ultimately publish more converged standards.

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### BDO NONPROFIT & EDUCATION PRACTICE

For 100 years, BDO has provided services to the nonprofit community. Through decades of working in this sector, we have developed a significant capability and fluency in the general and specific business issues that may face these organizations.

With more than 2,000 clients in the nonprofit sector, BDO's team of professionals offers the hands-on experience and technical skill to serve the distinctive needs of our nonprofit clients – and help them fulfill their missions. We supplement our technical approach by analyzing and advising our clients on the many elements of running a successful nonprofit organization.

In addition, BDO's Institute for Nonprofit Excellence<sup>SM</sup> (the Institute) has the skills and knowledge to provide high quality services and meet the needs of the nation's nonprofit sector. Based in our Greater Washington, DC Metro office, the Institute supports and collaborates with BDO offices around the country and the BDO International network to develop innovative and practical accounting and operational strategies for the tax-exempt organizations they serve. The Institute also serves as a resource, studying and disseminating information pertaining to nonprofit accounting and business management.

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](http://www.bdo.com) for upcoming local events and webinars.

### ABOUT BDO

BDO is the brand name for BDO USA, LLP, a U.S. professional services firm providing assurance, tax, financial advisory and consulting services to a wide range of publicly traded and privately held companies. For more than 100 years, BDO has provided quality service through the active involvement of experienced and committed professionals. The firm serves clients through more than 40 offices and more than 400 independent alliance firm locations nationwide. As an independent Member Firm of BDO International Limited, BDO serves multinational clients through a global network of 1,118 offices in 135 countries.

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Material discussed is meant to provide general information and should not be acted upon without first obtaining professional advice appropriately tailored to your individual circumstances.

To ensure compliance with Treasury Department regulations, we wish to inform you that any tax advice that may be contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax-related penalties under the Internal Revenue Code or applicable state or local tax or (ii) promoting, marketing or recommending to another party any tax-related matters addressed herein.

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