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News for Nonprofits

# NONPROFIT AGENDAS

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# IRS explains new UBTI rules

## Clearing up the “silo rule” confusion

Several provisions of the Tax Cuts and Jobs Act (TCJA) have significant implications for nonprofits, especially those with unrelated business taxable income (UBTI). These organizations must now calculate their UBTI separately for each unrelated business.

Not surprisingly, this new “silo rule” has led to some head-scratching. The IRS has issued interim guidance to eliminate the perplexity. Nonprofits may rely on this guidance (IRS Notice 2018-67) until proposed regulations are issued.

### New UBTI provisions carry high cost for nonprofits

Research commissioned by Independent Sector and conducted by the Urban Institute and George Washington University indicates that two provisions of the Tax Cuts and Jobs Act (TCJA) addressing unrelated business taxable income (UBTI) will divert thousands of dollars from nonprofit missions. The findings are based on a survey of more than 700 nonprofit organizations.

The survey found that the new 21% federal tax on transportation fringe benefits, including transit and parking, will redirect an average of about $12,000 away from each nonprofit’s mission per year. About 10% of respondents reported that they’re considering dropping transportation benefits altogether, because of the changes in their tax treatment.

The survey also examined the effects of the TCJA’s requirement that nonprofits report unrelated business profits and losses separately for each activity. (See the main article.) According to the survey, this change will result in an average of about $15,000 in additional new taxes per organization.

### Calculating total UBTI

Before passage of the TCJA, nonprofits with multiple unrelated businesses could aggregate income and deductions from those activities. As a result, they could offset income from one business with deductions from another. And that reduced their total UBTI.

The TCJA requires nonprofits to calculate UBTI for each business separately. Now, an organization’s total UBTI is the sum of the UBTI for each business, less the $1,000 “specific deduction” generally allowed when computing UBTI. In other words, the specific deduction doesn’t come into play until the individual UBTI amounts are totaled, not when computing those individual amounts.

### Identifying separate businesses

The TCJA doesn’t provide criteria for determining whether a nonprofit has more than one unrelated business. Nor does it describe how to identify separate unrelated businesses. The IRS plans to propose regulations addressing these issues. In the meantime, it will allow organizations to apply a “reasonable, good-faith” standard based on all of the facts.

For example, the guidance states that nonprofits can use the North American Industry Classification System (NAICS) codes to determine if they have more than one unrelated business. Nonprofits already are required to use the codes when identifying unrelated businesses for IRS Form 990-T, “Exempt Organization Business Income Tax Return.”

The guidance also notes that the “fragmentation principle” for separating exempt and nonexempt activities could prove helpful. This principle generally provides that an activity doesn’t stop qualifying as a business merely because it's conducted within a context of exempt activities. For example, selling ad space in your magazine is considered a business even though the magazine also has content related to your exempt purpose.

### Accounting for partnership income

The IRS guidance provides several interim and transition rules for investments in partnerships where a nonprofit doesn't significantly participate in any of the partnership's business (for example, investments in private equity funds). Some organizations had worried they would need to calculate UBTI separately for each unrelated business the partnership conducts.

Until the IRS issues proposed regulations on the topic, you can aggregate the UBTI from your interest in a single partnership that has multiple unrelated businesses under an interim rule. That's as long as the partnership interest satisfies one of two tests:

1. Under the *de minimis* test, your organization can hold no more than 2% of the partnership's profits interest or capital interest.


2. Under the *control* test, the nonprofit can hold no more than 20% of the partnership's capital interest and can't have control or influence over the partnership.

Additionally, a transition rule allows you to treat any partnership interest acquired before August 21, 2018, as a single business, regardless of whether it meets one of the tests or conducts more than one trade or business.

### And that's not all

The interim guidance covers several other topics related to the calculation of UBTI, including the use of net operating losses, effect of transportation fringe benefits, inclusion of certain investment and insurance income, and income generated from debt-financed properties. Your financial advisor can help you decipher the rules and stay in compliance. ■

# Proper preparation can cut your audit costs

Outside financial audits may seem like an extravagance to nonprofits working to contain costs and focus on their mission. But undergoing regular audits allows organizations to identify risks early and act quickly to prevent problems. Independent audits also provide valuable reassurance to donors and other stakeholders that your ship is on course.

Fortunately, you can reduce the cost of external audits by preparing properly. Here are some suggestions.

### Draw the initial road map

Part of effective audit preparation happens before the audit is even scheduled — the drafting of a request for proposals (RFP) from prospective auditors. The RFP should describe your organization, its programs, major funding sources and the type of service you need. Once selected, the audit firm will provide an engagement letter outlining the scope of the audit services to be performed and assigning responsibility for various tasks to staff or auditors.

The preaudit meeting with your auditors comes next. Finance staff and management should attend, as well as representatives from your board of directors or audit committee. Those involved will draw up a timeline for the work, and the auditors can answer any questions about the information they'll need. This also is a good time to ask auditors about their preferred format for documentation (for example, print copy or digital, PDF or Excel file).

You should use the preaudit meeting to inform the auditors of any changes in your organization's activities since you first met. Let them know in advance of new or eliminated programs, new grant reporting requirements, and changes to internal controls and staff. This heads-up lets them plan accordingly.

## Assemble documents

Collecting and organizing the documentation the auditors need before they arrive saves them time and you money. Usually the auditors will provide you a list of information to provide and the date when each item is needed. Of course, keeping accurate, complete and up-to-date accounting-financial records throughout the year will make this key step much easier.

You'll also benefit from staying abreast of changes to the Financial Accounting Standards Board's rules for nonprofits. By implementing new accounting standards on a timely basis, you won't have to backtrack to make adjustments during the audit.


In addition to the organization's year-end financial statements, the auditors will want to see accounting-related records, including:

- Journals and ledgers,
- Bank statements and canceled checks,
- Payroll for employees and other tax records,
- Accounts payable and receivable schedules and records,
- Depreciation schedules,
- Expense account records,
- Physical inventories,
- Fixed asset schedules, and
- Investment-related documents.

Auditors also need relevant organizational records such as articles of incorporation; financial policies; exemption letters; board meeting minutes; grant agreements, pledges and other funding documents; contracts; leases; and insurance policies. They usually appreciate having a current organizational chart, too.

You should gather support for the footnote disclosures, as well. This includes documentation of significant estimates, pending litigation, restricted contributions and related-party transactions.

The good news is that, while the necessary documentation often is extensive, it won't change much from year to year. That's unless there are major changes in your organization's circumstances. Using audit schedules for your monthly accounting can better prepare you for next year's audit.

## Do a preliminary analysis

Don't wait for the auditors to find problems and ask questions. You can expedite the audit and reduce costs when you identify and address issues before they're even raised by auditors.

After you make your year-end closing entries, reconcile all your schedules and workpapers to the trial balance and review for obvious anomalies. Double-check manual journal entries, accrual calculations, entries that require estimates, and in-kind donation valuations. Compare actual figures with budgeted ones and be ready to explain any significant variances.

### A different perspective

Annual independent audits needn't be stressful experiences. Organizations that devote proper time and attention to their accounting throughout the year can find audits affirming — and a source of suggested improvements that help ensure long-term viability. ■

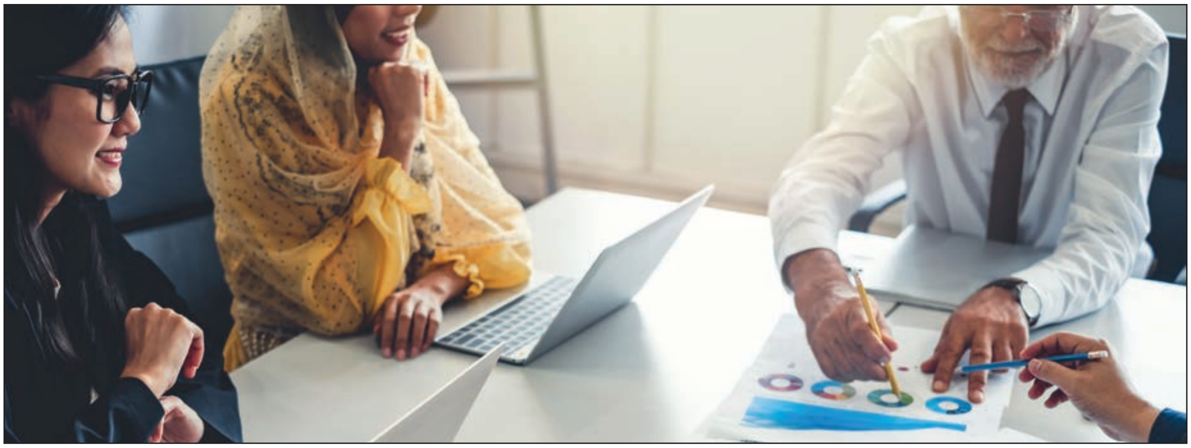
# Is your religious congregation meeting its financial responsibilities?

Churches, synagogues, mosques and other religious congregations are subject to many of the same financial requirements as other nonprofit organizations are. And other requirements and responsibilities are unique to these congregations. Here's an overview of areas you should be mindful of.

### Stay alert to employee-related rules

Your religious congregation must comply with IRS rules and federal and state laws. For example, when it comes to wages, most clergy should be treated as employees and receive W-2 forms. Typically, you're not required to withhold Social Security, Medicare and federal withholding taxes. However, clergy are subject to self-employment tax on wages and must pay federal income tax on their earnings. A parsonage (or housing) allowance can reduce income tax, but not self-employment tax.

Also keep in mind that proper employee classification has been on the IRS's radar screen in recent years. Your congregation must determine which of your workers are employees and which are independent contractors. Depending on many factors — for example, their responsibilities, work location and form of compensation — individuals you consider independent contractors may need to be reclassified as employees. For most nonclergy employee wages, you must withhold Social Security and Medicare taxes.



## Other rules apply

Like other not-for-profits, your congregation needs to pay close attention to unrelated business taxable income (UBTI). If your organization regularly engages in any type of business activity that's unrelated to its religious mission, be aware of certain tax and reporting rules. For example, do you sell items from a bookstore attached to your place of worship? Such income could be considered UBTI. Paid parking for employees, along with certain other fringe benefits, is also considered UBTI starting in 2018.

Activities such as raffles or traditional bingo games that are run by all-volunteer labor have been granted a specific exemption from income tax (although other IRS reporting may be required). A 990T filing is required only if unrelated business income exceeds $1,000.

In another area, your organization shouldn't devote a substantial part of its activities attempting to influence legislation — that is, lobbying. If you do so, you could risk your tax-exempt status and face potential penalties. Of course, terms like "substantial" and "attempting to influence" are open to interpretation. But specifically endorsing candidates, supporting candidates for office financially, or sponsoring events that might be interpreted as partisan is strictly prohibited.

## What about internal controls?

All organizations, including religious congregations, need strong internal controls. Faith groups are particularly vulnerable to fraud because they generally foster an environment of trust. But keep in mind: Even the most devout and long-standing members of your congregation are capable of embezzlement when faced with extreme circumstances, such as bankruptcy or gambling problems.

Pay special attention to collections. To ensure employees and volunteers can't help themselves to cash and checks, require that at least two people count cash in a secure area and verify the contents of offering envelopes. Next, they should document their results in a signed report.

For even greater security, encourage your members to make electronic payments or sign up for automatic bank account deductions. Also, ensure authorized disbursements by requiring that a nonaccounting employee or trustee receive and review bank statements. All checks above a specified amount should require dual signatures.

## Other measures to prevent fraud

While internal controls are critical to preventing fraud in religious organizations, a comprehensive risk-reduction program contains other elements as well. For example, always perform background and credit checks on employees and volunteers who'll be entrusted with financial matters. Additionally, maintain adequate insurance coverage to protect against possible loss. Review it regularly as your organization grows and your needs change.

Your congregation also should have an investment policy that describes procedures for handling donated stock and other securities. At least once a year, take an inventory of the congregation's securities, valuables and equipment.

## Seek expertise

Many religious congregations don't hire independent accountants, because they aren't required to file income tax returns. That doesn't mean that your organization will never need independent financial advice. Independent CPAs can be engaged to perform a variety of services that provide assurance to your congregation and the community. ■

# NEWS FOR NONPROFITS

## Transparency drives higher contributions

Transparency can pay off for nonprofits — literally. A new study published by the *Journal of Accounting, Auditing & Finance* suggests that the public sharing of information results in increased contributions. The researchers examined more than 6,300 nonprofits, comparing those that have achieved recognition for their transparency (specifically, recipients of a "GuideStar Seal of Transparency") with those that haven't.

Nonprofits with stronger governance, better performance and more professional staff typically had greater transparency than their counterparts. Interestingly, the researchers found that funders respond to higher transparency by upping their funding. Organizations that went from not transparent to transparent saw an increase of 53% in total contributions in one year. ■

## Pilot program tests "Impact Security"

The finance firm NPX Advisors has launched its first Impact Security, a financial product that brings together donors and investors to fund nonprofits. The pilot program involves The Last Mile, a nonprofit starting a Web development shop inside San Quentin State Prison. The organization raised $800,000 from investors and $900,000 from donors. The investment money immediately went to fund the shop.

As The Last Mile progresses toward its impact goals (based on "inmate hours worked"), the donor fund will pay up to $900,000 to the investors. This means that the potential return on the initial investment is $100,000. If the project falls short of its goals, investors could lose some or all of their investments. Donors would redirect their remaining funds to other nonprofits. ■

## Boards struggle to achieve diversity

Nonprofit board members overwhelmingly think that board diversity is critical. However, they lack the knowledge, skills, resources and commitment required to turn their awareness into reality. That's the conclusion in a survey report titled *The Governance Gap: Examining Diversity and Equity in Nonprofit Boards of Directors*.

Koya Leadership Partners, an executive search firm for nonprofits, surveyed 102 boards of directors. It found that 96% of organizations believe diversifying is a key objective, while only 24% have taken "action steps" to increase diversity. The report explores common obstacles and provides advice on how boards can move toward greater inclusion. ■

## Facebook fundraising tops $1 billion

Many people complain about Facebook, but there's no denying the social media giant's effectiveness when it comes to fundraising. The company recently announced that users have raised over $1 billion on its platform for nonprofit and personal causes, helping to raise awareness and make an impact in their communities around the world. Save the Children, for example, has reaped more than $7.5 million, and the ASPCA raised more than $4.4 million from nearly 170,000 donors. ■

# The support you need. The service you're looking for.

**Succeeding in the not-for-profit sector today requires more than a strong commitment to your mission. It takes shrewd fiscal management, careful regulatory compliance, skillful use of technology and the assistance of advisors who know the issues nonprofit organizations face and how to address them.**

This is where Sechler Morgan CPAs, PLLC comes in. Our team of experienced professionals cherishes the opportunity to support nonprofit organizations, meet their management challenges and fulfill their missions. We offer a variety of specialized accounting, tax and consulting services including:

- Audit intermediary services
- Budget and policy design
- Outsourced accounting/bookkeeping
- Tax form preparation (990, etc.)
- Strategic and management consulting
- Speaking on financial literacy and other topics
- Technology and virtual system design

## RESPONSIVE QUALITY

We are committed to providing responsive, personalized service to the highest quality. We take time to truly understand your Organization so that we can customize our recommendations to your specific situation. Our goal is to make your processes easier, streamline your operations and ensure your success in reaching *your* goals.

We welcome the opportunity to discuss your mission and vision so that we may assist you with our expertise. Please call us at 602-230-2700 or e-mail info@azcpa.com and let us know how we may support you. Be sure to visit our website at www.azcpa.com for additional tools and information, as well as our archive of this newsletter.

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