NONPROFIT AGENDAS

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TAKING CARE OF BUSINESS

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Financial statements

How to report programmatic investing

Rather than making cash grants, some nonprofits are increasingly using financial instruments known as *programmatic investments* to pursue their missions. An organization, for example, might extend loans to low-income constituents to help them acquire an education or a home. But how should the nonprofit report these investments (which may generate monetary returns) on its financial statements?

Investments vary widely

Programmatic or mission investing is intended to carry out a nonprofit's mission, rather than produce income or grow assets. The most common types of programmatic investments are loans, equity interests and loan guarantees.

In contrast with typical commercial loans, programmatic loans generally carry far lower interest rates than the borrower could otherwise obtain. The loan terms also might include forgiveness of all or a portion of the principal upon reaching a programmatic goal. One example is student loan forgiveness after completing community service after graduation.

Programmatic equity investments are purchases of ownership in entities that provide goods or services that accomplish the nonprofit's mission. They usually are interests in for-profit businesses with the potential to provide a return on investment. For instance, a nonprofit whose mission focuses on providing employment and job training might purchase stock in a business that provides significant job opportunities and training programs in an economically distressed area. If the business pays dividends or increases in value, the nonprofit will report the returns they receive as investment income.

Private foundations face rules on program-related investments

While public charities may make programmatic investments, only private foundations hold "program-related investments" (PRIs). In 2016, the IRS issued updated regulations on the types of investments that qualify as PRIs and emphasized that these can't be used for political campaigns or lobbying. As with any programmatic investments, PRIs' main purpose must be to support the foundation's mission and can't be significantly motivated by a profit incentive.

PRIs aren't subject to the excise tax imposed for higher-risk investments that jeopardize the carrying out of a private foundation's exempt purposes. And they can be included in the calculation of the 5% minimum annual gifting required, while providing other tax benefits.

Although initial IRS examples mainly focused on domestic investments related to economically disadvantaged individuals and deteriorated urban areas, additional examples made clear that PRIs can accomplish a variety of other exempt purposes, fund activities in one or more countries, and earn a high potential rate of return. The final regulations permit private foundations to provide capital to individuals or entities that aren't tax-exempt themselves, as long as nonexempt entities help the foundation accomplish its exempt activities.

Loan guarantees often are made with a programmatic objective and no expectation of a return. The nonprofit takes on the potential liability to repay the loan if the original borrower can't. A foundation, for example, might guarantee a bank loan to a business, enabling funding for a project that advances the foundation's purpose.

Accounting issues emerge

Organizations generally should report programmatic investments according to the same GAAP rules that apply to other financial instruments. So, if you've made a programmatic loan, you would report the loan receivable as an asset on the statement of financial position. Several complications can arise, however.

For example, the programmatic loan may have a contribution element, such as a low interest rate or no interest rate. In those cases, the interest the organization forgoes is considered contribution expense and should be recorded accordingly.

Equity investments might convey additional rights and privileges, such as the right of the nonprofit to obtain future services from the for-profit entity at reduced rates. The cost must be allocated between the equity interest and the additional rights and privileges, and accounted for under the applicable GAAP rules.

Loan impairments

Loans and equity investments also may be subject to "impairment." That means nontemporary reductions in value, which is generally dependent on the company repaying the loan or generating the return on investment. Loans may be impaired due to a lower likelihood of repayment. Impairment of equity investments is based on the increased likelihood that the investee will experience losses.

Signs of investment impairment include:

- A series of operating losses, negative cash flows or working capital deficiencies,
- A significant deterioration in earnings, performance, credit rating, asset quality or prospects,
- A significant adverse change in the regulatory, economic or technological environment, or in the general market condition of the relevant geographic area or industry,
- An offer to buy or sell the interest for an amount less than its cost, or
- Noncompliance with statutory capital requirements or debt covenants.

If any of these indicators are present, the nonprofit must estimate the investment's fair value to determine if the fair value is less than the investment's cost. If so, the investment must be "written down" to its fair value.

Proceed with caution

The appropriate reporting for programmatic investments ultimately rests on their significance to your operations and financial position. You must also gauge the accompanying risks. Your CPA can help you navigate the rules.

Are you holding a raffle?

This ticket to revenue carries compliance concerns

Raffles are tried-and-true fundraising vehicles. They can be attractive to your constituents, easy to put together and profitable. But organizations need to put on their "compliance hats" when holding this activity. Each state has its own set of laws regulating raffles. And all organizations must comply with federal income tax requirements about unrelated business income, reporting and tax withholding.

Handling winnings

Your nonprofit must report when the winnings are $600 or more and at least 300 times the amount of the winner's wager (the raffle ticket price). You can deduct the wager amount when determining if the $600 threshold is met.

Say that you sell $4 tickets and your winner receives $2,000. Because the winnings ($1,996) are more than $600 and more than 300 times the amount of the $4 wager, you must report them to the IRS.

Tax considerations

Nonprofits must pay income tax on unrelated business income (UBI). The IRS defines UBI as income from a trade or business, regularly carried on, that isn't substantially related to a nonprofit's exempt purpose. The tax agency considers raffles to be a form of gaming, which is a trade or business. If you routinely hold raffles, it's possible they could be considered "regularly carried on." And raffles likely aren't related to your exempt purpose.

But raffle income can be exempted from UBI tax, if the raffle is conducted with "substantially all" volunteer labor. The term "substantially all" hasn't been formally defined. But the IRS's unofficial guideline is that 85% or more of the labor running the raffle should be from volunteers. Document the hours worked by staff and volunteers to demonstrate your degree of volunteer support.

File Form W-2G, "Certain Gambling Winnings," with the IRS, generally by February 28 following the year of the payment. Give a copy to the winner by January 31 to show reportable winnings along with related income tax withheld. The winner must provide you with his or her name, address and Social Security number and return a signed copy of the W-2G if he or she is the sole winner. Form 5754 should be completed if there are multiple winners.

Withholding responsibilities

Federal income tax must be withheld from the winnings and remitted to the IRS if the proceeds (the difference between the winnings and the amount of the wager) are more than $5,000. If the winnings aren't in cash (for example, a vacation package), the proceeds are the difference between the fair market value (FMV) of the item won and the wager amount. When the value of a noncash prize isn't obvious, obtain a valuation before the drawing.

You must withhold tax, equal to 24% of the total proceeds, from the winnings. Imagine that you hold a raffle with $1 tickets. The winner receives $6,000. But, because the proceeds ($5,999) exceed $5,000, you must withhold $1,440 ($5,999 × 24%).

For a noncash prize with proceeds of more than $5,000, you may 1) have the winner reimburse you the amount of withholding tax required, or 2) pay the withholding tax on behalf of the winner, calculated at 31.58% of the FMV of the prize, less the wager.

Taxes withheld from raffle winnings must be reported on Form 945, "Annual Return of Withheld Federal Income Tax," and deposited as nonpayroll withholding.

Learn more

There are differing deposit requirements, depending on whether the total taxes withheld annually are under or over $2,500. Also note that your organization might be required to withhold 24% of raffle prizes for federal income tax backup withholding if the winner doesn't furnish a correct Social Security number.

Strategic planning: A better "real-time" approach

"Life moves pretty fast." So observed Ferris Bueller back in the summer of 1986 — and that pace has only accelerated in the 30+ years since. Yet many nonprofits continue to take an old-school approach to strategic planning, spending months or even years to develop formal written plans that lay out specific goals for set periods of time.

And those plans can have a downside. As a *Harvard Business Review* article notes, traditional strategic planning requires leaders to confront a future they can only guess at. Moreover, choosing a strategy under this approach requires an organization to explicitly shut down other options and possibilities.

That's why some nonprofits have adopted a more fluid and ongoing approach known as "Real-Time Strategic Planning" (RTSP). Its proponents say the process helps nonprofits quickly and efficiently identify, understand and act on challenges and opportunities to advance their missions.

What is it, exactly?

RTSP was first introduced in nonprofit consultant David La Piana's book *The Nonprofit Strategy Revolution: Real-Time Strategic Planning in a Rapid-Response World*. According to La Piana, strategy is "a coordinated set of actions designed to create and sustain a competitive advantage in achieving a nonprofit's mission." A successful nonprofit plan requires three levels of strategy: organizational, programmatic and operational, using the following building blocks of strategy formation through RTSP:

Understanding your identity. RTSP is rooted in a firm and honest understanding of the organization's identity. What is your organization's mission and impact? What do you do (programs and services), where (geographic scope) and for whom (constituent, client or customer)? And how do you pay for it?

Identifying your competitive advantage. What strengths do you leverage to differentiate your organization from others and compete effectively for resources and clients? This step requires analyzing other organizations in the same geographic area that offer the same or similar programs, to the same or similar constituents, with similar funding sources.

Knowing how you will make decisions. Develop a "strategy screen" composed of the criteria you'll use to choose strategies or courses of actions. A strategy screen might consider, for example, if an option advances your organization's mission and enhances its competitive advantage. It also considers if you have the capacity to carry the option out and if you can pay for it.

Defining the right strategic questions. Many questions naturally arise when presented with an opportunity, but they aren't all strategic. You need to identify the strategic questions that must be answered now and sort operational questions (for example, "Will we be able to hire more employees to do this?") from strategic questions ("What are the implications for our mission?").

What about "competitive advantage"?

La Piana pegs an organization's competitive advantage as one of the most important components of its strategy — perhaps *the* most important. For purposes of RTSP, competitive advantage is the ability to advance your mission by 1) using a unique asset — or strength — no competitor in your area possesses, or 2) having outstanding execution of programs or services. Your competitive advantage must be something clients and funders value.

Asset advantages include:

- Better program design leading to better outcomes, including unique attributes of programs or services,
- Accessible locations or specialized property that enhances program delivery,
- A robust, diversified funding base that provides flexibility and stability,
- Great name recognition and reputation among funders and constituents, and
- Powerful partnerships and a well-connected board of directors.

Examples of execution advantages include lower costs to funders or customers, greater efficiency per dollar spent, faster delivery of programs or services, sound marketing and communications, or better accountability and public reporting.

To make comparative judgments, of course, you also need to identify and understand your competitors and their strengths. As La Piana notes, though, "competitor" in this context isn't a negative term. In the nonprofit arena, "competitors" often are organizations you collaborate with. Nonetheless, you're likely competing for donors, media coverage, board members, employees, volunteers or clients.

A continuing process

Effective strategic planning for today's fast-moving world requires more than a weekend meeting every three years. Organizations that implement RTSP have the tools to align their daily actions with the organization's overall strategy and can work toward having a clear vision of their long-term direction.

NEWS FOR NONPROFITS

Netflix changes the landscape for donor retention

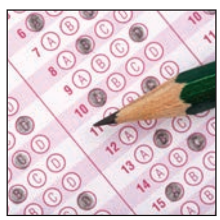
Nonprofits could learn a lot from Netflix when it comes to hanging onto donors. That's the conclusion of a three-year analysis of 2,000 nonprofits' fundraising activities by Network for Good, an online-giving software provider.

Why Netflix? Because it has successfully wielded a multichannel strategy to achieve a retention rate of 91%. The company immediately and continually demonstrates the value of a subscription to each customer, but in the simplest way possible. It stays in contact with subscribers through automated email and smartphone push notifications based on their viewing habits. These communications often contain surprising and useful information.

Today, consumers and donors expect such engagement from any organization hoping to hold their attention long enough to prompt action, whether a purchase or a donation. Nonprofits need to regularly — and through multiple channels — deliver program-based information describing the impact of contributions, the study suggests. The potential payoff is significant. The study found that the average gift size, total fundraising yield and donor retention rate almost doubled when fundraisers used a combination of email, direct mail, text messages and Facebook to communicate with donors.

Higher education fears admissions scandal backlash

According to the *Chronicle of Philanthropy*, higher-education fundraisers and advocates are worried that the headlines-grabbing college admissions scandal could prompt efforts to limit the tax deduction for giving to universities. For example, Ron Wyden, the top Democrat on the Senate Finance Committee, has announced his intention to introduce a bill that would eliminate the itemized tax deduction for donations made to universities or colleges before or while the donor's children are enrolled in those schools.



But fundraisers and advocates say such legislation would discourage the charitable support many institutions rely on to fund financial aid and scholarship programs. They emphasize, too, that most donations from parents are small-dollar contributions of $25 to $100, not enough to buy influence.

Tax credits boost projects

Some nonprofits are turning to the New Markets Tax Credit (NMTC) program to increase investment, and jobs, in economically distressed areas. Community Development Entities (CDEs) compete to receive NMTC allocations from the federal government, which are offered to investors in exchange for equity investments in the CDE. Business or individual investors receive significant credits to offset their federal income taxes. The CDEs invest in or lend the proceeds to projects in low-income communities. Plus, the loans come with favorable terms, including lower-than-market interest rates. The NMTC is set to expire at the end of 2019, but Congress has repeatedly extended it in the past.

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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