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News for Nonprofits

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NONPROFIT AGENDAS

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Excess benefit transactions

Tax Court clarifies definition of "disqualified persons"

Excess benefit transactions, where economic benefits provided to so-called "disqualified persons" are greater than the value of what was received by the nonprofit organization, can lead to hefty excise taxes for those individuals, as well as reputational damage to organizations themselves. And the definition of "disqualified persons" may be much broader than you realize.

In a recent ruling, the U.S. Tax Court rejected the notion that only people with a formal affiliation with an organization can be disqualified persons. Rather than focusing on narrow definitions, the court considered the substance of the relationship with the nonprofit.

Rotten relationship

The taxpayer in the case was a Pennsylvania state senator from 1978 to 2008. In 2009, he was convicted of federal corruption charges, including wire and mail fraud. One of his victims was an organization that three of his staff members incorporated in 1991, at his direction, which was later granted tax-exempt status. Two of the staff members served as officers, and one as executive director, at various times, but all while still employed by the senator.

The senator was never an officer or employee. However, he used his position as chair of a senate appropriations committee to obtain funding for the organization, including at least $15 million in public grants and a comparable amount from private sources. In addition, he testified at his criminal trial that he approved most significant projects and directed many major expenditures. He also admitted to receiving numerous "perks and gifts" from the nonprofit, such as tools worth $43,000, a bulldozer used exclusively on his farm and the use of various vehicles. The nonprofit paid for foreign travel, the services of a private investigator and cell phone service for his chauffeurs and daughter.

In May 2013, the IRS determined the senator was liable for excise taxes under Internal Revenue Code Section 4958. That section imposes a tax on disqualified persons involved in excess benefit transactions with a charity. The former senator contended that he wasn't a disqualified person with regard to the nonprofit.

Relevant factors

Under federal tax law, a disqualified person is someone who, during a five-year look-back period, was in a position to exercise "substantial influence" over an organization's affairs. Certain individuals are automatically deemed to be in such a position, including voting board members, presidents, CEOs, COOs and CFOs. Certain family members of disqualified persons also are considered disqualified.

A disqualified person is a person who, during a five-year look-back period, was in a position to exercise "substantial influence" over the organization's affairs.

As the court noted, though, those aren't the only parties who exert substantial influence over an organization. The applicable tax regulation enumerates seven nonexclusive factors that tend to show a person has substantial influence under a "facts and circumstances" test. The court found several of these went against the senator.

For example, the first factor is whether the person founded the organization. The senator testified that he "created" the nonprofit. It was incorporated at his direction by his staff members, two of whom listed his senate office as their address. The senator's assertion that he didn't form the entity because the staff members were the literal incorporators, the court said, was a "hypertechnical argument that ignored the substance of what occurred."

The senator also satisfied the second factor — he was a "substantial contributor." Someone can qualify as a substantial contributor if the person's annual contributions represent as little as 2% of total contributions. Although the senator didn't appear to donate directly, he was responsible for raising virtually all the organization's funding.

Finding substantial influence

The clearest indicator that the senator was in a position to exercise substantial influence, though, was that he in fact exercised such influence repeatedly over a period of many years. The trial court in the criminal case found that the benefits he extracted from the organization caused it to suffer a cumulative loss of more than $1.1 million. The Tax Court found he couldn't have achieved this without wielding substantial influence.

UNCORRECTED EXCESS BENEFIT TRANSACTION HIKES EXCISE TAXES

Two months after ruling in the *Fumo* case (see main article), the U.S. Tax Court released its decision in another "disqualified person" dispute. In that case, the determination that the individual was a disqualified person was more clear-cut, but the case illustrates the danger of not promptly addressing excess benefit transactions when the IRS flags them.

The taxpayer was married to the nonprofit's founder and president. In 2015, the IRS opened an examination into the organization. Among other things, it determined the taxpayer received unreported excess benefit transactions of $130,000 (including $15,000 in health insurance), which were used to cover the family's personal expenses.

The court held that the health insurance benefits didn't constitute an excess benefit but found the taxpayer owed a first-tier tax of $28,750 (25% of the $115,000 excess benefits). She also was liable for a second-tier tax of $230,000 (200% of the excess benefits) because she failed to correct the excess benefit transaction in a timely manner after IRS notification.

Is it time to review your spending policy?

Well-managed investments play a critical role in the sustainability of many organizations, including nonprofits. A key element is your nonprofit's spending policy, essentially the formula used to determine how much of the value of your investments will be tapped each year for such expenses as operating costs and capital projects.

It's generally advisable to stick with your spending policy once it's established, but circumstances can arise that support review and potential revision. With the past two years of unprecedented events, both operationally and financially, it might be time for your organization to reconsider its spending approach.

Different techniques

Unfortunately for leaders who prefer to focus on their mission rather than their finances, there's no one-size-fits-all optimal spending policy. But several types have emerged, each of which have pros and cons. They include:

Fixed rate. Also known as the simple spending rule, this approach specifies a spending rate that's applied annually to the beginning-period market value of the investment portfolio. It's simple to understand and apply but can result in big swings in spending from one year to the next based solely on the investment portfolio's performance the prior year. In a multi-year period of strong investment performance, the fixed-rate approach can lead to the highest spending increases compared with alternative techniques, which undermines the portfolio's growth.

Rolling average. The organization applies a spending rate to a moving market value average of its investment portfolio, usually determined over a three-year period. A rolling average generally ensures more consistency in spending from year

to year but is vulnerable to market volatility. For example, this rule could dictate more spending than would be wise in a year when the portfolio value has dropped substantially or produce a low spending amount when nonprofits need extra financial support.

Inflation-based. With this method, the nonprofit sets an initial dollar amount for spending, which is then adjusted annually for inflation (sometimes with a cap and a floor based on beginning market value). It can simplify budgeting, stabilize spending and help grow the investment portfolio because the spending amounts tend to be smaller — but it doesn't take into account the portfolio's market value. On the other hand, it can facilitate more spending in challenging times when compared with the rolling average (of course, higher spending also can eat into the portfolio).

Geometric spending. The formula for geometric spending is complicated, but it reflects movement in both inflation and the market. Although it can be difficult to calculate, a geometric spending rule reduces volatility between years and can lessen the impact of market declines on spending.

Hybrid. This approach generally considers both inflation and market value. A large chunk of the yearly spending is based on an inflation adjustment to the previous year's spending. The remainder is based on, for example, the application of a fixed rate to the portfolio's market value or a percentage of the rolling-average rule amount. Hybrid spending policies tend to result in stable spending, in terms of both dollar amounts and the percentage of portfolio value.

Note that each of these policies generally should include a provision allowing spending to exceed the prescribed amount as necessary, as determined by the board of directors or other authorized party.

Right approach for you

With the environment for many nonprofits still far from "normal," a disciplined approach to spending and investing is vital. We can help you select the best policy for your current circumstances based on the long-term goals for both your investments and your organization.

Key performance indicators

Using financial and nonfinancial metrics to flourish

As we near the two-year mark of the first COVID-19 lockdowns and stay-at-home orders, some nonprofits still are struggling with financial sustainability. This can mean that your board of directors is taking a greater interest in your organization's financial performance. Key performance indicators (KPIs) can help focus your board's attention on important metrics.

Identify KPIs

Although organizations will see quite a bit of overlap, a nonprofit's KPIs will depend largely on the organization's specific characteristics. That includes its revenue streams, key expense factors, and budget and strategic goals. Put another way, you need to identify your organization's "business-drivers."

Determine which factors affect the reliability of your revenue streams — and which factors influence whether your expenses rise or drop. Then create KPIs that monitor those factors. Consider the level at which you want to track selected KPIs. You could monitor them by individual program or function, or at the organizational level.

Over time, you'll likely need to adjust your KPIs as your strategies, priorities or programs change. What's "key" today won't necessarily be key in five years. For each KPI, you should develop a target, which may be based on your current budget or part of your strategic plan.

Financial KPIs

Seven financial KPIs have emerged as must-haves for nonprofits, including:

1. Current ratio. This KPI reflects your financial standing, specifically your organization's ability to satisfy debts coming due within the coming year. Divide current assets by current liabilities. A ratio of "1" or more generally means you can meet those obligations.

2. Projected year-end cash. Based on the current cash position plus budgeted cash flows through the end of the fiscal year, this projects liquidity and ability to satisfy upcoming commitments.

3. Year-to-date revenue and expense. These KPIs measure your actual results against your budget and let you know separately if revenues and expenses are in line with expectations or within a reasonable range — say 10%.

4. Reliance ratios. To determine your organization's reliance on a specific type of funding (for example, government grants or individual donations), divide the amount of that funding by total income.

5. Cost per dollar raised. This measure shows your return on investment in fundraising costs. Divide the total funds raised by the total fundraising expenses. You want a figure greater than "1."

6. Cost per unit of service. Divide program expenses by the number of units of service (for example, meals served) provided in a period to shed light on that program's financial efficiency.

7. Program efficiency ratio. The ratio assesses an organization's mission efficiency by showing the amount of funding that goes to programs (vs. administrative or other expenses). Compute it by dividing a program's expenses by its overall expenses. The goal is often over 75%, but this is dependent on the organization type. *Note:* There is debate about the accuracy of this ratio.

Nonfinancial KPIs

Don't stop with just financial KPIs. Nonprofits can use KPIs in nonfinancial areas of the organization such as:

Risk management and governance. Track Form 990 filing compliance (completeness and timeliness), on-time completion of board and employee training, board engagement, and board composition (constituents and skill sets).

Program and service delivery. This delves into the number of clients served, staff utilization rates, client satisfaction and volunteer hours.

Outreach and advocacy. This KPI covers the number of public events, number of volunteers, response time to inquiries and advocacy presentations/events.

Marketing and communications. Here you'll track the number of unique website visitors, social media followers, social media engagement and your net promoter score.

Human resources. This looks at employee retention, the time it takes to fill vacancies, the timeliness of evaluations, and salaries and benefits compared to a compensation study.

Technology. This KPI studies the economic value added by technology, the total cost of ownership, and timely data entry.

Meaningful numbers

Just tracking numbers won't be meaningful for your board members. Solicit input from them. Although they might not name specific indicators, their priorities can create appropriate KPIs you can use to facilitate informed, timely decisions.

News for Nonprofits

Organizations struggle with staff retention

Forty-two percent of nonprofits expected to experience more turnover in 2021 than they did in 2020. That's according to the *2021 Nonprofit Talent Retention Practices Survey* from Washington, D.C.-based Nonprofit HR. The firm queried more than 500 organizations in the United States and Canada, with budgets ranging from less than $5 million to more than $500 million.

The top reasons cited for voluntary turnover were better opportunities presented to former employees (49%) and the lack of opportunity for upward mobility/career growth (44%). Only 32% cited compensation/benefits.

Almost half of respondents had the greatest trouble retaining employees under age 30. In terms of career level, 45% found it most difficult to retain entry-level employees, followed by 35% who said mid-level employees were the hardest to keep onboard. By far, the department struggling the most with retention was programs (34%).

How a new PayPal app expands fundraising options

PayPal is giving its customers new avenues for supporting the causes they care about. The company's recently launched app adds new features to its Generosity Network. PayPal introduced the network in 2020 to offer customers a way to create customized fundraising campaigns for themselves or other individuals or small businesses in need. The new app builds on the existing features to provide more methods for customers to raise funds.

Now customers in the United States and the United Kingdom can use the new Generosity Network for Charity to fundraise for their favorite organization. Unlike the Generosity Network, where donated funds are sent to the customer's PayPal account, donations will go directly to the PayPal Giving Fund, which in turn grants the funds to the respective organizations.

Underwater annuities may threaten nonprofits

Not every gift annuity is able to fulfill its donor's charitable intent. In fact, according to BNY Mellon Wealth Management's *2021 Annual Charitable Gift Report,* 56% of the charitable organizations it surveyed that were issuing gift annuities had at least one "underwater gift."

Underwater annuities occur where gift assets are exhausted before the death of the income beneficiaries. This puts financial pressure on charities because the distributions made each payment cycle reduce the value of the gift assets. A nonprofit may eventually need to fund the beneficiary distributions with money from outside the gift annuity pool, undermining its ability to serve its mission.

As the report notes, underwater annuities can pose serious financial, regulatory and reputational risks if not managed proactively and effectively. The report cautions that even well-intentioned gifts to a prudently managed gift annuity program can end up costing, rather than aiding, the causes for which they were intended.

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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