THOMSON REUTERS
CHECKPOINT™

S. Davis & Associates, P.A.
Certified Public Accountants & Consultants

THE PPC
NONPROFIT UPDATE

MAY 2022, VOLUME 29, NO. 5

In-relation-to Opinion on the SEFA with Out-of-period Amounts

Title 2 U.S. Code of Federal Regulations Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance), section 200.515(a) requires the auditor to give an opinion "as to whether the schedule of expenditures of federal awards is fairly stated in all material respects in relation to the financial statements as a whole." This requirement is based on AU-C 725, *Supplementary Information in Relation to the Financial Statements as a Whole*. The issue is that for many new COVID-19-related programs, the federal government is dictating that certain transactions appear in the SEFA in a different period than when they occurred in the financial statements.

Among other requirements to issue an in-relation-to opinion, AU-C 725.05 requires that the information has to relate to the same period as the financial statements. However, the U.S. Department of Health and Human Services Provider Relief Fund (PRF) has unique SEFA reporting requirements. Part 4 of the Compliance Supplement provides specific guidance for amounts to report on the SEFA for entities who receive and expend PRF by their respective fiscal year ends. Those amounts are directly tied to reporting periods that are associated with the PRF Reporting Portal requirements. Therefore, there will be instances where meeting the requirements of AU-C 725.05 is not possible based on the fact that PRF expenditures (and lost revenues, if applicable) relate to different periods than that of the financial statements.

Practical Consideration:

Many new COVID-19-related programs provide for a period of performance and allow for costs (and lost revenues, if applicable) incurred in periods both before and after an award existed, in addition to the fact that the period of performance could span more than one fiscal year.

In order to address these issues, the AICPA released Q&A 9160.36, *Reporting on the Provider Relief Fund in the Schedule*

In this Issue:

of Expenditures of Federal Awards in Relation to the Financial Statements in a Single Audit (**https://us.aicpa.org/content/dam/aicpa/interestareas/frc/downloadabledocuments/tqa-sections/tqa-section-9160-36.pdf**). The Q&A provides an exception to the criteria that the SEFA must relate to the same period as the financial statements. The Q&A clarifies that if all other criteria in AU-C 725.05 are met, and the schedule can be reconciled back either to underlying accounting and other records used in preparing the financial statements or to the financial statements themselves, the auditor may issue an in-relation-to opinion on the SEFA.

FASB ASC 842 Refresher for Lessees

FASB ASU 2016-02, *Leases (Topic 842)*, will be effective for most nonprofit organizations for fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022, with early implementation allowed. The effective date for nonprofit organizations that are public debt obligors was for fiscal years beginning after December 15, 2018, but if they had not issued or made available for issuance financial statements as of June 3, 2020, then ASU 2020-05 delayed the effective date of FASB ASC 842 for them to fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. When effective, FASB ASC 842 supersedes FASB ASC 840, *Leases*. After the issuance of ASU 2016-02, the FASB issued additional ASUs (with the same effective date and transition requirements as ASU 2016-02) that addressed implementation issues and made corrections.

FASB ASC 842 must be applied either retrospectively to all periods presented, with the cumulative effect adjustment recognized at the beginning of the earliest period presented, or retrospectively at the beginning of the period of adoption through a cumulative effect adjustment to net assets and no change to how comparative periods presented are reported. There are a number of practical expedients provided in the transition guidance that lessees may elect.

Disclosure requirements of FASB ASC 842 include specific qualitative and quantitative disclosures. Their objective is to provide more information about amounts, timing, judgments, and cash flow uncertainties resulting from lease transactions.

The guidance in FASB ASC 842 does not apply to leases (1) of intangible assets under FASB ASC 350, (2) for the exploration or use of minerals, oil, natural gas, and other similar resources under FASB ASC 930 and FASB ASC 932, (3) of biological assets, including timber under FASB ASC 905, (4) of inventory under FASB ASC 330, and (5) of assets under construction under FASB ASC 360.

This article provides a refresher on FASB ASC 842 and implementation issues *lessees* should keep in mind as they prepare to adopt the new guidance. It is a high-level overview only, so preparers should refer to the detailed guidance in FASB ASC 842 and related ASUs for further guidance. A subsequent article will focus on *lessors*.

The Basics

The most significant change for lessees under FASB ASC 842 is the requirement to recognize operating leases as lease assets and liabilities on the statement of financial position. Nonprofit organizations should apply the guidance consistently to leases with similar characteristics and in similar circumstances. Related party leases are accounted for the same as other leases.

There are defined terms in FASB ASC 842, including the lease's commencement date, term, and what a lease payment includes, that are critical to correct application of the guidance.

FASB ASC 842 retains the differences in FASB ASC 840 between operating leases and capital leases (now referred to as finance leases). Judgment is required to determine whether a lease is a finance lease because there are no percentage tests to apply under FASB ASC 842 as there were in FASB ASC 840.

Accounting and Reporting

Classification. A lease is classified as a finance lease if it meets any of these criteria at the commencement date (these are the same criteria a lessor uses to determine whether a lease is classified as a sales-type lease):

- It transfers ownership of the underlying asset to the lessee on or before the end of the lease term.
- It gives the lessee the option to purchase the asset, and the lessee is reasonably certain to exercise the option.
- The lease term is for the major part of the underlying asset's remaining economic life.
- The present value of the sum of the lease payments and any residual value guaranteed by the lessee not already included in the lease payments equals or is greater than the asset's fair value.

- The underlying asset is so specialized that it isn't expected to have an alternative use to the lessor at the end of the lease.

Lease Inception. At the beginning of a contract, the lessee must determine whether the contract is or contains a lease. The definition of a *lease* is a contract, or part of one, that conveys the right to control the use of identified property, plant, or equipment for a period of time, in exchange for consideration. This determination requires considering all contract terms and conditions and all relevant facts and circumstances. If the lessee determines a contract exists, it must then identify the separate lease components within that contract and allocate the contract consideration to each separate lease and nonlease component at the contract commencement date based on relative standalone prices of the separate components (estimated if not observable).

A *nonlease component* is an activity that transfers a separate good or service to the lessee (such as maintenance services and utilities in a real estate lease). A component is separate if the lessee can benefit from the right to use the asset individually or with other readily available resources and the right of use is not highly dependent or interrelated with other rights to use assets in the contract.

Lessees can make an accounting policy election by class of underlying asset to account for lease and nonlease components as a single lease component and not separate them.

Initial Recognition. A lessee recognizes a right-of-use asset and lease liability at the commencement date for both operating and finance leases. The lease liability is calculated as the present value of the total lease payments. The right-of-use asset may or may not be the same amount as the lease liability. For short-term leases (original term of less than 12 months and no purchase option), lessees may make a policy election to expense lease payments straight-line over the lease term and not recognize the lease assets or liabilities.

Subsequent Accounting. Lease classification is not reassessed after the commencement date unless there is a change in lease term, a contract modification not accounted for as a separate contract, or a reassessment of whether the lessee will exercise an option to purchase the leased asset. Modifications require consideration of whether the initial lease contract already considered the changes and whether the contract remains a lease. Modifications could be accounted for as a change to the accounting for the existing lease or a separate, new contract with the existing lease remaining unchanged.

For finance leases, lessees recognize amortization expense on the right-of-use asset (straight-line over the shorter of the asset's useful life or the end of the lease term, unless there is a purchase option) and interest expense on the lease liability, along with any variable lease payments not included in the lease liability. The lease liability is increased for interest and reduced by lease payments. The leased asset should be evaluated for impairment when a triggering event occurs.

For operating leases, lessees recognize a single lease cost each period for the straight-line allocation of the remaining cost of the lease over the lease term, along with any variable lease payments not included in the lease liability. The leased asset should be evaluated for impairment when a triggering event occurs. The lease liability is measured as the present value of the unpaid lease payments.

If the lease terminates before the end of its term, the lessee removes the right-of-use asset and lease liability from the statement of financial position and recognizes the difference in the statement of activities as a change in net assets.

Financial Statement Presentation. Right-of-use assets for finance and operating leases are presented separately from other assets and from each other, and lease liabilities for finance and operating leases are presented separately from other liabilities and from each other. All should be classified as current or noncurrent.

For finance leases, the interest expense on the lease liability and amortization of the asset should be presented on the statement of activities with other interest, depreciation, and amortization. For operating leases, lease expense should be included in operating expenses.

For finance leases, interest on the lease liability is an operating cash flow on the statement of cash flows unless interest is capitalized. For operating leases, lease payments are included in operating activities unless payments are capitalized. Any variable or short-term lease payments are included in operating activities.

Practical Consideration:

Because the new guidance will result in lessees recognizing additional lease assets and liabilities on their statement of financial position for leases they currently account for as operating leases, nonprofit organizations should evaluate the potential impact their leasing transactions will have on the organization and future audits. They also should consider the effects on any debt agreements, financial ratios, and other legal contracts that have financial statement requirements.

Fiscal Sponsorships

Would you like to operate a charitable activity without going through the time and expense of creating a new nonprofit organization and applying for tax-exempt status? Or are you an existing Section 501(c)(3) public charity willing to sponsor programs that align with your mission and vision? If so, a fiscal sponsorship arrangement may be appealing. However, before entering such a relationship, both the sponsor and the sponsored program should understand the structure and potential difficulties of such an arrangement.

Fiscal sponsorships typically take one of three forms:

- Model A: Often referred to as the *Comprehensive Fiscal Sponsorship*, the activity becomes one of the sponsor's internal programs and has no separate legal existence. The sponsor owns the funds and administers the activity. The sponsor often appoints a project director to manage the activity and engages its own employees and volunteers to operate the program.
- Model B: Similar to Model A, but the sponsor hires independent contractors to operate the program.
- Model C: Often referred to as the *Indirect Fiscal Sponsorship*, the sponsor grants the donated funds to an outside entity that operates the program, exercising less control over the operations. Individuals working on the project are employees of the program, which typically has its own legal existence (such as an LLC, a nonprofit corporation that hasn't obtained tax-exempt status yet, or even a for-profit company performing a charitable function). Additional administrative services or office space provided by the sponsor should have a separate written agreement from the sponsorship agreement. Participants must be careful that the arrangement doesn't become a mere conduit for funneling tax-deductible donations to a nonexempt organization, causing the IRS to consider the donations to be nondeductible and disallowing the donors' tax deduction.

Regardless of the form chosen, there should be a formal written agreement between the sponsoring organization and the founders of the project. If the project has no separate legal existence, then the founders of the project can form a steering committee to represent their interests. The agreement should define how the dedicated funds will be accounted for, any variance powers the sponsor has, the fees the sponsoring organization is entitled to collect, and the exit provisions if the sponsored program decides to terminate or spin off.

Both parties must understand that the sponsoring organization retains ownership of the funds and has discretionary authority over the program while honoring the donors' intentions. The sponsor is responsible for providing the donors with contemporaneous written acknowledgments. Because donors are contributing directly to the Section 501(c)(3) sponsor, the program can begin soliciting donations immediately rather than waiting for its own exemption application to be approved, a process that can take anywhere from six to nine months.

Programs with more independence, such as Model C relationships, should provide periodic reports to the sponsor regarding accomplishments—detailing when, why, and how expenditures were made. The sponsor will usually describe the program separately from its other programmatic accomplishments in Form 990, Part III.

Sponsoring organizations typically charge an administrative fee that ranges from 5% to 10%. In contrast, forming a new nonprofit organization can create $15,000 to $50,000 in startup costs, including legal fees, accounting fees, IRS user fees, bookkeeping setup, software, and state solicitation registration, not to mention the additional costs of hiring employees to manage and operate the program.

Sponsoring organizations should be aware of the risks of sponsoring new programs:

- Consider whether the new program will result in an increased level of charitable solicitation and ensure that the organization is properly registered in any newly affected jurisdictions.
- Avoid "mission drift" by sponsoring programs that align with its mission and existing exempt functions.
- Contemplate how the sponsoring organization's reputation may be affected if the program doesn't perform well.
- Determine how to monitor the new program for activities that may create tax reporting and disclosure requirements for the sponsor (such as lobbying, political activity, providing private benefit, and operating an unrelated trade or business).
- Ensure the program is respecting the intellectual property rights of outside entities.
- Determine the ownership of any trademarks, patents, or trade secrets developed by the program.
- Identify the responsible party for hiring, training, promoting, disciplining, and firing the employees and contractors working on the project.
- Clearly define the exit provisions, including the variance power retained by the sponsor and any prerequisites for the release of funds upon termination of the relationship.

Practical Consideration:

When appropriately structured, fiscal sponsorships can be an effective way for a new activity to get its start. Whether housed within the sponsor temporarily or permanently, the arrangement can allow smaller charitable endeavors to operate without the initial startup costs that can otherwise hinder the creation of programs designed to address current economic, environmental, or social crises.

2022 Filing Season Expectations

The 2022 filing season is underway, and the Internal Revenue Service (IRS) has faced increased pressure from Congress and the general public because of the substantial backlogs from 2021. According to the 2021 National Taxpayer Advocate's Annual Report to Congress, the IRS is experiencing numerous serious issues, including significant backlogs, refund delays, lack of sufficient trained employees, and ineffective communications. At the end of the 2021 filing season, the IRS had 35.3 million returns awaiting manual processing. This created millions of correspondences with taxpayers. As of March 2022, the IRS reported that the agency still had more than 20 million unprocessed returns and related taxpayer correspondences.

The IRS contends that the backlogs are the result of reduced financial and human resources. According to the 2021 Annual Report to Congress, the agency's budget has decreased by nearly 20% since 2010 in inflation-adjusted dollars and it has lost more than 33,000 full-time employees over the past decade. Meanwhile, IRS personnel were obliged to spend significant amounts of time processing Economic Impact Payments and enhanced Child Tax Credit payments. As a result, taxpayers encounter excessive processing and refund delays and challenges reaching IRS representatives.

In fiscal year 2021, the IRS received 282 million telephone calls, but representatives were able to answer only 32 million of them, roughly 11%. IRS Commissioner Charles Rettig testified that the IRS has received as many as 1,500 phone calls per second on its busiest days. In March 2022, the IRS announced that the agency plans to hire 10,000 new employees by 2023, including 5,000 positions in its service centers in Austin, Texas; Kansas City, Missouri; and Ogden, Utah. While the increased hiring may improve future filing seasons, such efforts are probably too late to affect the 2022 filing season.

The IRS faces significant obstacles to its efforts to improve staffing. Most importantly, it cannot offer competitive compensation packages to hire and retain skilled employees due to its limited budget, resulting in increased time needed to fill available positions and expand the experience level of its new hires.

Commissioner Rettig told House members in March 2022 that it would take the agency six to eight months to get a new hire on board compared to one week in the private sector. Once hired, the new employees require significant training, creating further demands on time and resources. According to the IRS's hiring plan, many of the hiring positions are entry-level. As a result, taxpayers may not experience an immediately improved process. The agency is requesting sustained multi-year funding and more hiring flexibility to build a workforce capable of meeting future needs.

Additionally, the IRS faces several technology issues. The 2021 Annual Report to Congress pointed out that IRS online accounts do not have sufficient functionality and integration with existing tools to meet the needs of taxpayers and practitioners. The IRS online accounts serve as stand-alone portals with limited features focused on payments and compliance instead of a one-stop solution. The online accounts do not facilitate interactions or communications between the IRS, individual and business taxpayers, and the tax professionals who represent them. As a result, the taxpayers cannot access important and useful information using their online accounts, and tax professionals cannot access their clients' data.

Automatically generated notices from the IRS have added to the confusion and frustration for taxpayers waiting for their tax returns to be processed. As a result, more than 100 members of Congress representing both chambers and both parties, the AICPA, taxpayers, and various associations requested the agency temporarily suspend automated notices to give some relief to taxpayers. In February 2022, the IRS suspended some automated collection notices for individuals and businesses and paused collection activity until 45 days after it addresses the merits of a taxpayer's response to an adjustment.

The PPC Nonprofit Update is published monthly by Thomson Reuters/Tax & Accounting, P.O. Box 115008, Carrollton, Texas 75011-5008, (800) 431-9025.

THOMSON REUTERS®

Tax & Accounting - Checkpoint
P.O. Box 115008
Carrollton, Texas 75011-5008
UNITED STATES OF AMERICA

ADDRESS SERVICE REQUESTED

PRSRT STD
U.S. POSTAGE
PAID
Thomson

Additionally, in March 2022, the IRS announced the temporary suspension of the issuance of 10 notices that are generally mailed to tax-exempt or governmental entities in case of a delinquent return. The suspended delinquency notices include Forms 990, 990-PF, 990-EZ, 990-N, 990-T, and 1120-POL. Organizations that continue to receive delinquency notices are advised to disregard them if they are certain that the returns have been filed.

Observation: The February 2022 issue of this newsletter indicated the exempt organization community is encountering several issues because of errors with the Exempt Organization Business Master File (EO BMF).

While the IRS backlog will remain a reality for the foreseeable future, there are a few actions that taxpayers can take to minimize delays. Tax professionals advise that electronic filing is the fastest, easiest way to ensure that the IRS acknowledges a timely filed return and processes it efficiently. (Form 990-series returns are required to be electronically filed. It is important to retain evidence that the return has been received by the IRS.)

Organizations should promptly share any IRS correspondence they receive with their tax advisors. Errors in the IRS EO BMF can be addressed, although corrections can take considerable time. Individuals who attempt to call the IRS should ensure that they have all the relevant information readily available. Finally, tax practitioners should submit a Power of Attorney authorization using their IRS online account a few days in advance of placing a phone call to the IRS.

Tax Briefs

IRS PUBLISHES NEW TECHNICAL GUIDANCE. The IRS announced that *TG 58 Excise Taxes on Self-dealing under IRC 4941* and *TG 62 Excise Taxes on Taxable Expenditure under IRC 4945* are available at **www.irs.gov**. These guides provide comprehensive, issue-specific information.

2022 STANDARD MILEAGE RATE. Beginning January 1, 2022, the standard mileage rates used to calculate the deductible costs of operating an automobile are (Notice 2022-3, 2022-2 IRB)—

- 58.5 cents per mile driven for business use, up 2.5 cents from the rate for 2021,
- 18 cents per mile driven for medical, or moving purposes for qualified active-duty members of the Armed Forces, up 2 cents from the rate for 2021, and
- 14 cents per mile driven in service of charitable organizations; this rate is set by statute and remains unchanged from 2021.