THOMSON REUTERS
CHECKPOINT™

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

THE PPC
NONPROFIT UPDATE

JULY 2021, VOLUME 28, NO. 7

AICPA Updates the *Not-For-Profit Entities* A&A Guide

The AICPA has updated its Audit and Accounting Guide, *Not-for-Profit Entities*, with conforming changes as of March 1, 2021 (Audit Guide). The Audit Guide applies to not-for-profit entities that meet the definition of a not-for-profit entity included in the Financial Accounting Standards Board (FASB) Accounting Standards Codification™ (ASC) glossary.

Hierarchy Status of Audit Guide

Accounting Guidance. The Audit Guide provides guidance on accounting, reporting, or disclosure matters that are not covered in the FASB ASC. Because only the FASB ASC is an authoritative source of GAAP, the accounting guidance included in the Audit Guide is nonauthoritative.

Such nonauthoritative financial accounting and reporting guidance is reviewed and approved by the AICPA's Financial Reporting Executive Committee (FinREC). In addition to discussing the requirements of GAAP in the ASC, the Audit Guide contains FinREC's understanding of industry practices. In some cases, FinREC may express a preference for certain practices.

Auditing Guidance. The auditing guidance included in the Audit Guide is considered an interpretive publication under AU-C 200 (AU-C 200B). The Auditing Standards Board (ASB) has authority over interpretive publications, and auditors should consider them when planning and performing their audits. Auditors who don't follow interpretive publications should document how GAAS was complied with in the circumstances.

Contents of the Audit Guide

The most recent edition of the Audit Guide considers relevant accounting and auditing guidance contained in official pronouncements issued through March 1, 2021. Guidance issued up to and including the following was considered—but not necessarily incorporated—based on applicability:

- ASU 2020-11, *Financial Services—Insurance (Topic 944): Effective Date and Early Application*

In this Issue:

This newsletter is also available online.
Please call (800) 431-9025, or order online:
https://tax.thomsonreuters.com/products/brands/checkpoint/ppc/

THOMSON REUTERS™

- SAS 143, *Auditing Accounting Estimates and Related Disclosures*
- Interpretation 5, *Communicating Critical Audit Matters When Reporting on Audits Conducted in Accordance With Auditing Standards Generally Accepted in the United States of America and the Standards of the PCAOB*
- SOP 20-1, *Reporting Pursuant to the 2020 Global Investment Performance Standards*.

SAS 142, *Audit Evidence* (AU-C 500), issued in July 2020, is effective for audits of financial statements for periods ending on or after December 15, 2022. SAS 142 supersedes AU-C 500A, *Audit Evidence*, and amends various other AU-C sections. SAS 143, *Auditing Accounting Estimates and Related Disclosures*, issued in July 2020, is effective for audits of financial statements for periods ending on or after December 15, 2023. SAS 143 supersedes AU-C 540A, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, and amends various other AU-C sections. Note that the 2021 edition of the Audit Guide has *not* been updated to reflect changes that result from these SASs.

In October 2019, the ASB issued Interpretation 5 of AU-C 700. It provides guidance on how an auditor complies with AU-C 700, *Forming an Opinion and Reporting on Financial Statements*, when performing an audit in accordance with GAAP and PCAOB standards and communication of critical audit matters under PCAOB standard AS 3101 is required. The Interpretation states that the auditor would follow requirements in PCAOB standards for determining and reporting critical audit matters unless it is determined by management that the entity is not subject to critical audit matters reporting.

As usual, the Audit Guide reflects relevant guidance that is issued but not effective as of March 1, 2021, but that will become effective for fiscal years ending on or before June 30, 2021, as shaded gray text with a footnote indicating the effective date of the new guidance. Such guidance primarily is comprised of ASU 2016-02, *Leases (Topic 842)*, and Statements on Auditing Standards Nos. 134–141. Guidance that will become effective after June 30, 2021 is presented in a "guidance update box."

Appendix Highlights. The following paragraphs highlight many of the appendixes to the Audit Guide.

Appendix A of the Audit Guide, FASB Accounting Standards Codification 958, *Not-For-Profit Entities, Topic Hierarchy*, lists the subtopics and sections included within FASB ASC 958, *Not-for-Profit Entities*, as of March 1, 2021. It is nonauthoritative and is included for informational purposes only to assist readers understand the structure of the FASB ASC.

Appendix B of the Audit Guide presents an informational discussion, "The New Revenue Recognition Standard: FASB ASC 606." This material is for reference only and "has not been reviewed, approved, disapproved, or otherwise acted on by any senior committee of the AICPA and does not represent official positions or pronouncements of the AICPA." In June 2020, the FASB issued ASU 2020-05, which deferred the effective date for applying FASB ASC 606 for entities that had not yet adopted the guidance and issued financial statements or made financial statements available for issuance as of June 3, 2020, to annual reporting periods beginning after December 15, 2019, and interim periods within annual periods beginning after December 15, 2020. There was no deferral for entities that were required to adopt FASB ASC 606 before the issuance of ASU 2020-05, including nonprofit organizations that issued, or are conduit bond obligors for, securities traded, listed, or quoted on an exchange or over-the-counter market.

Appendix C of the Audit Guide presents an informational discussion, "The New Leases Standard: FASB ASC 842." FASB ASU 2016-02, *Leases (Topic 842)* was issued in February 2016 and was subsequently amended by a number of ASUs that made narrow scope improvements to Topic 842. ASU 2020-05 deferred the effective date for applying FASB ASC 842 for entities that had not yet adopted the standard by one year to annual reporting periods beginning after December 15, 2021, and interim periods within annual periods beginning after December 15, 2022. There was no deferral for entities that were required to adopt FASB ASC 842 before the issuance of ASU 2020-05, including nonprofit organizations that issued, or are conduit bond obligors for, securities traded, listed, or quoted on an exchange or over-the-counter market.

Appendix E of the Audit Guide presents a discussion, "Auditor Reporting Standards," concerning the ASB's issuance in May 2020 of SAS 141, *Amendment to the Effective Date of SAS Nos. 134–140*. This material provides a summary of the suite of standards affecting the auditor's report: SAS 134, *Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements*; SAS 137, *The Auditor's Responsibilities Relating to Other Information Included in Annual Reports*; SAS 138, *Amendments to the Description of the Concept of Materiality*; SAS 139, *Amendments to AU-C Sections 800, 805, and 810 to Incorporate Auditor Reporting Changes from SAS No. 134*; and SAS 140, *Amendments to AU-C Sections 725, 730, 930, 935, and*

940 to Incorporate Auditor Reporting Changes from SAS Nos. 134 and 137. SAS 141 is effective upon issuance. SAS 134–140 are generally effective for audits of financial statements for periods ending on or after December 15, 2021, with early implementation permitted. The ASB recommends that SAS 134–140 be implemented at the same time.

The Office of Management and Budget (OMB) issued the 2020 *OMB Compliance Supplement* in August 2020 and the *Addendum to the 2020 Office of Management and Budget Compliance Supplement* in December 2020, which contains guidance for programs with expenditures of COVID-19 awards and must be used in conjunction with the August 2020 Supplement. The effective dates for both are for audits of fiscal years beginning after June 30, 2019. In September 2019, the AICPA issued Technical Q&A's on single audit reports due to the Supplement revising the federal government's approach for identifying compliance requirements subject to the single audit.

Practical Consideration:

The August 2020 Supplement and the Addendum to the Supplement are available on the OMB's website at **www.whitehouse.gov/omb/office-federal-financial-management/**. The Compliance Supplement and Addendum and reporting guidance are discussed in previous issues of *The PPC Nonprofit Update*.

Changes from the Prior Edition of the Audit Guide

The Audit Guide includes a table, Appendix G, that contains a schedule of changes identifying areas in the text and footnotes of the Audit Guide that were changed from the previous editions. The following paragraphs highlight some of the significant changes to the Audit Guide:

Paragraph 4.85 was added to reflect the issuance of FASB ASU 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*. ASU 2017-12, as amended by ASU 2019-10, is effective for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021. For qualifying fair value hedges, the "Pending Content" in FASB ASC 815-20-45-1A requires that the change in the fair value of the hedging instrument included in the assessment of hedge effectiveness and the amount excluded from the assessment of hedge effectiveness be presented in the same line item in the statement of activities that is used to present the earnings effect of the hedged item.

In March 2019, the FASB issued 2019-03, *Not-for-Profit Entities (Topic 958) Updating the Definition of Collections*, effective for annual financial statements issued for fiscal years beginning after December 15, 2019, and for interim periods within fiscal years beginning after December 15, 2020. Early application is permitted, and the amendments should be applied on a prospective basis. Section 7.30 of the Audit Guide was added to provide examples of notes to the financial statements concerning collection items, and Section 7.49 was added to include suggested audit procedures to consider for noncapitalized collections.

Paragraph 13.25 of the Audit Guide was revised to reflect the AICPA's April 2020 issuance of Q&A section 6400.53, "Accounting for Costs Incurred in Connection With the Implementation of Electronic Health Record Systems." This Q&A stated that health care entities should consider guidance in FASB ASC 720 and FASB ASC 350 to account for implementation costs incurred in connection with electronic health record systems for internal use, similar to other information system conversions.

Paragraph 14.10 of the Audit Guide was revised to provide additional understanding of scope limitations. No new authoritative guidance was issued. AU-C 705, *Modifications to the Opinion in the Independent Auditor's Report*, provides circumstances when GAAP departures and audit scope limitations would require a qualified or adverse opinion, or a disclaimer of opinion, and examples of auditor reports. For financial statements of nonprofit organizations, possible GAAP departures include failure to—

- recognize or appropriately measure promises to give, contributed services, or depreciation in conformity with GAAP.
- provide information about expenses reported by their functional classification.

Possible scope limitations include the auditor's inability to obtain sufficient appropriate audit evidence with regard to recorded contributed services, fundraising receivables and revenues, existence or valuation of alternative investments, or existence or valuation of investments held by others.

Companion Travel Costs

In hopes that the worst of the COVID-19 pandemic has passed, at least domestically, the possibility of travel is on the horizon. Many exempt organizations are considering whether and when it is safe for employees and board members to travel for business. When planning for travel, it's important to comply with the rules to avoid running afoul of the excess benefit transaction (EBT) penalties under IRC Sec. 4958 that are triggered by unreported compensation. Organizations need proper policies and procedures in place to handle travel expenses. An area of particular concern is that of companion (or spousal) travel.

In most circumstances, travel expenses of a spouse, dependent, or other companion are not considered deductible business expenses. An employer's reimbursement of companion travel expenses generally is taxable compensation to the employee. However, in limited circumstances, companion travel expenses may be considered a deductible business expense or a working condition fringe benefit.

Business Expense Treatment

Travel expenses, including meals, incurred for a spouse, dependent, or other individual accompanying an officer or an employee on business travel generally are nondeductible unless all of the following conditions are met [IRC Sec. 274(m)(3); Reg. 1.274-12(a)(4)(iii)]:

1. The accompanying individual is an employee (or volunteer) of the employer.
2. The travel of the accompanying individual is for a bona fide business purpose.
3. The travel expenses would otherwise be deductible by the accompanying individual.

If all three of the conditions are met, the employer's reimbursement of the travel expenses would not be taxable compensation to the employee, and the employer can pay and deduct the companion's travel costs as a business expense. However, in most situations, the travel companion will not be an employee of the organization.

Business associates. The restriction on deducting travel expenses for other individuals does not apply to business associates whose travel expenses are for a bona fide purpose and otherwise would be deductible [Reg. 1.274-2(g)]. A *business associate* is a person with whom the officer or employee could reasonably expect to engage or deal in the active conduct of the employer's trade or business such as a customer, client, supplier, employee, agent, partner, or professional advisor, whether established or prospective [Reg. 1.274-12(b)(3)]. The travel costs paid or incurred for a business associate can be deductible and reimbursed tax-free if they meet the normal rules for deductible travel expenses.

Working Condition Fringe Benefit Treatment

If the travel companion is not an employee but there is a bona fide business purpose for the companion's travel expenses, the employer's payment of the companion's travel costs may still be tax free to the employee as a working condition fringe benefit. However, no income tax deduction is allowed to the employer for the expense. The reimbursement of companion travel expenses qualifies as a nontaxable working condition fringe benefit if all of the following conditions are met [Reg. 1.132-5(t)]:

1. The reimbursement is not treated as compensation to the employee.
2. The companion's presence on the employee's business trip was for a bona fide business purpose.
3. The employee substantiates the expenses as required under an accountable plan.

Employer payments for companion travel expenses lacking a bona fide business purpose are treated as compensation to the employee. The amount of the employee's taxable fringe benefit equals the increase in cost over what the cost would have been if the employee had traveled alone (Rev. Rul. 56-168, 1956-1 CB 93).

Note: When the companion's travel costs are not deductible, the employer is still entitled to deduct the travel expenses the employee would have incurred to travel alone. Consequently, the employer can claim a deduction for lodging based on a single-rate cost of similar accommodations, not half of the double rate actually paid. The deductible amount is generally more than simply half the total costs.

What Is a Bona Fide Business Purpose?

For a bona fide business purpose to exist, there must be a real business purpose for the individual's presence. Unfortunately, this may be difficult to prove. The IRS and courts have ruled the following circumstances did not establish the requisite business purpose:

1. Providing incidental services, such as taking notes during a meeting or performing light clerical duties (Rev. Rul. 56-168, 1956-1 CB 93).

2. Presence of the spouse was helpful, but not necessary [*Moorman* (26 TC 666, 1956); *Johnson* (TC Memo 1966-164)].
3. Staffing a convention, hosting a reception, or socializing with business associates [*Sheldon* (9 AFTR 2d 782, 7th Cir., 1962); *Fenstermaker* (TC Memo 1978-210)].

In a few cases, the courts have found a legitimate business reason for a companion's presence on a business trip. The following situations were found to provide a bona fide business purpose:

1. The business required the spouse to help promote the company's public image [*Disney* (24 AFTR 2d 69-5123, 9th Cir., 1969)].
2. The spouse was required by the business to enhance the morale of company representatives (*Disney*).
3. The business required the spouse to improve business relationships [*Bank of Stockton* (TC Memo 1977-24)].
4. The spouse attended various trade shows and conventions at which she occupied the display booth, talked to people about the company's products, met new or prospective customers, learned more about the market, and solicited new business [*Thorpe* (TC Memo 1998-115)].

The IRS Is Paying Attention

The IRS has found significant errors and omissions in executive compensation reporting on Forms 990, employment tax returns, and other information reporting forms. Because of this, the IRS will likely include an analysis of compensation in all tax-exempt organization audits. They may target companion travel during an examination by reviewing travel and entertainment accounts, flight logs, and schedules for instances where spouses or other related parties accompany the employee on trips. An organization must be careful that all taxable compensation items are properly reflected in an individual's Form W-2, Form 1099-MISC, or Form 1099-NEC, especially the personal use of the organization's assets (e.g., car and credit card).

Hold the *Mayo*

The October 2019 issue of this newsletter included a discussion of the ruling in the *Mayo Clinic* case [124 AFTR 2d 2019-5448 (DC MN, 2019)]. The 8th Circuit Court of Appeals (CA8) recently ruled that the District Court (DC) wrongly invalidated some key statutory provisions regarding the *primary function* test. Let's review the issues in this case.

Background

For the unrelated debt-financed income rules of IRC Sec. 514(a), the term *acquisition indebtedness* does not include indebtedness incurred by an educational organization (EDU) in acquiring or improving any real property [IRC Sec. 514(c)(9)(C)].

An EDU is defined as an organization that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at the place where the educational activities are regularly carried on [IRC Sec. 170(b)(1)(A)(ii)].

According to the regulations, an organization can qualify as an EDU only if, among other requirements, its *primary function* is the presentation of formal instruction [Reg. 1.170A-9(c)(1)]. Therefore, an organization engaged in both educational and non-educational activities is not an EDU unless the latter are merely incidental to the educational activities.

The Facts

The Mayo Clinic (M) is the parent organization of several hospitals, clinics, and the Mayo Clinic College of Medicine and Science. M was seeking a refund in unrelated business income tax paid on debt-financed income from real estate. The IRS concluded that M was entitled to the refund if it met the requirements of IRC Sec. 170(b)(1)(A)(ii) during the tax years in question.

The IRS argued that M was not an EDU because it did not pass the *primary function* and *merely incidental* tests in the regulations since its primary function was health care, not education. Further, even if that were not so, M's healthcare activities were not merely incidental to its education activities.

The Original Ruling

The District Court (DC) focused on the validity of the regulation's *primary function* and *merely incidental* tests. It concluded that the regulations were invalid because the IRS had exceeded its statutory authority by the addition of those requirements. Consequently, M was awarded a multimillion-dollar tax refund.

The DC noted that the *primary function* test and the *merely incidental* test are essentially one test. If an organization's primary function is education, then all other activities will necessarily be incidental. Since the IRS improperly included the *primary function* requirement in the regulation, the DC found it was also improper to include the *merely incidental* requirement.

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

The Appeal

The appeal considered whether the regulation at issue is a valid interpretation of complex, interwoven provisions of the Internal Revenue Code. The 8th Circuit noted in *Mayo Clinic* [127 AFTR 2d 2021-2013 (8th Cir.) 2021] the following:

- Although the regulation unreasonably limited an EDU to those principally providing formal instruction, it was reasonable that the organization under IRC Sec. 170(b)(1)(A)(ii) be construed as one that was *organized and operated exclusively* for one or more qualifying charitable uses.
- It was valid to interpret the statute as requiring that a qualifying organization's primary purpose be educational and that its noneducational activities be merely incidental to that primary purpose.
- Regulations interpreting Section 501(c)(3)'s *organized and operated exclusively* requirement included educational in the list of qualifying charitable purposes and reflected a broader definition of tax-exempt educational purpose.

In applying the law to the facts in *Mayo Clinic*, the 8th Circuit noted that the question of whether the taxpayer is an educational organization is a mixed question of law and fact that was not addressed on appeal. The analysis normally unravels in three parts: (1) whether the taxpayer is *organized and operated exclusively* for one or more exempt purposes; (2) whether the taxpayer is *organized and operated exclusively* for educational purposes; and (3) whether the taxpayer meets the statutory criteria of faculty, curriculum, students, and place. Failure to satisfy any part renders the taxpayer ineligible for the UBIT exemption provided to Section 170(b)(1)(A)(ii) organizations. The government concedes that Mayo satisfies the first criteria. Further, by virtue of the Mayo College, the government also concedes the third criteria. Thus, it must be determined whether Mayo's overall purpose and operations establish that is it *organized and operated exclusively* for educational rather than other purposes.

Reversed and remanded. The taxpayer's arguments that IRC Sec. 170(b)(1)(A)(ii)'s criteria of faculty, curriculum, students, and place unambiguously defined the term *educational organization* were rejected, and the underlying DC decision that found Reg. 1.170A-9(c)(1) invalid was reversed and remanded for further proceedings with respect to whether taxpayer's overall purpose and operations established that it was *organized and operated exclusively* for educational purposes. Due to Mayo's status as an academic medical center, the medical and educational purposes (and the operations supporting those functions) are inextricably intertwined. The proceedings will involve a difficult and fact-intensive review by the DC of the revenues and expenses, separating the educational purposes from the noneducational.

Practical Consideration:

The 8th Circuit has upheld Reg. 1.170A-9(c)(1)'s requirement that an organization engaged in both educational and noneducational activities cannot qualify as an educational organization unless the noneducational activities are merely incidental to the educational activities. For Mayo, the rest of the story will be determined on remand.