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AICPA Releases 2019 Nonprofit Risk Alert

This year's AICPA Audit Risk Alert (Alert), *Not-for-Profit Entities Industry Developments—2019*, has been released, and much of the information is helpful to auditors and nonprofit organization managers alike. This article summarizes key features of the 2019 edition.

Economic and Industry Developments

This section provides information about key economic indicators and how nonprofit organizations fit into the economy. Specific factors to consider include:

Current Economic Indicators. The Bureau of Economic Analysis reports an estimated overall increase in GDP, which measures output of goods and services by labor and property within the U.S., of 3.4% for 2018 (an increase from the rate of 2.3% in 2017) and an unemployment rate of 3.9%, including a dip to 3.7% in the third quarter of 2018, which is the lowest unemployment rate since 1969. The rate of unemployment at the end of 2018 represents approximately 6.3 million people out of work, excluding the 4.7 million part-time workers unable to find full-time work in 2018 (4.9 million in 2017), as well as the 1.6 million (also 1.6 million in 2017) people who have given up looking for work altogether. Additionally, 2018 was marked by escalating trade disputes between the United States and China and exports contracted for the first time in two years. The Federal Reserve raised the federal funds rate four times during 2018, with additional federal fund rate increases expected in 2019 (at press date for the Alert).

State of Nonprofit Organizations. There are currently over 1.5 million IRS-registered nonprofit organizations receiving more than $400 billion in contributions in 2017 (the first time ever over this mark). In 2017, the amount of contributions for all nonprofit sectors increased 5.2%, with donor-advised funds continuing to become increasingly popular, growing

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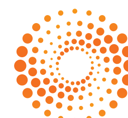

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to $29.23 billion. The Tax Cuts and Jobs Act of 2017 (TCJA) may cause donor-advised funds to become more popular as individuals consider grouping donations to give every other year in order to take advantage of higher standard tax deductions for the non-giving years. In addition, the low unemployment rate is affecting the availability and retention of staffing in the finance functions of nonprofit organizations, which in turn create risks to the organization.

Higher Education. Moody's indicated a second consecutive negative outlook for higher education for 2019 and into 2020, due to continued expense growth that is greater than low tuition revenue growth. Enrollment at institutions has essentially been flat over the past three years. In 2018, investment returns remained strong, providing a favorable effect on endowment distributions; however, the return of volatility to financial markets may result in future endowment spending that exceeds actual investment returns. Several newly effective or upcoming accounting standards will need to be assessed or implemented by institutions. The Alert also provides an update on the Perkins Loan Program and personal identification information requirements.

Other Areas. The Alert also discusses carryover of election-year reporting, software as a service, outsourcing certain activities, cybersecurity (including threats), authentication controls, and AICPA cybersecurity resources.

Legislative and Regulatory Developments

This section of the Alert discusses the following topics in detail:

- IRS Tax-Exempt and Government Entities division Issue Snapshots;
- Unrelated business taxable income (UBTI) separate reporting guidance related to the TCJA;
- UBTI issues from the parking tax, including limited relief;
- Excess compensation excise tax;
- Form 990-T changes;
- New Form 990-T, Schedule M;
- Generally accepted accounting principles versus Form 990 accounting;
- The *Wayfair* decision impact on sales tax requirements; and
- Matters affecting higher education and religious organizations.

Audit and Attestation Issues and Developments

Auditors are reminded to consider the impact of economic, legislative, and regulatory developments on each unique nonprofit organization engagement. The Alert covers the following areas to consider this year:

- Audit risks for nonprofit organizations;
- New auditing standards, including changes to the auditor's report and an omnibus statement that amends many auditing standard sections;
- Data analytics in audits;
- Auditing cryptocurrency donations;
- Auditing alternative investments;
- Fraud trends at nonprofit organizations; and
- New Yellow Book independence rules.

Accounting Issues and Developments

This section of the Alert discusses the following topics in detail:

- The FASB's nonprofit financial statement presentation standard;
- Guidance on revenue from contracts with customers;
- Leases;
- Restricted cash;
- Credit losses standard;
- Definition of collections update; and
- FASB versus GASB for nonprofit organizations.

Other Items

Other items discussed in the Alert include recent pronouncements; recent AICPA Technical Questions and Answers; recent AICPA independence and ethics developments; AICPA nonprofit initiatives; other projects on the horizon and in the pipeline; and other online or print and internet resources.

AICPA Q&A 6140.27 Issued on Definition of *Direct Care* of Collection Items

In March 2019, the FASB issued 2019-03, *Not-for-Profit Entities (Topic 958): Updating the Definition of Collections*. The ASU aligns the definition of *collections* in GAAP with the definition used by the American Alliance of Museums (AAM). Additionally, the ASU requires additional disclosures for an entity that has collection items.

Practical Consideration:

The guidance in ASU 2019-03 must be applied prospectively and is effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. Early adoption is permitted.

Background on the ASU and *Direct Care*

The May 2019 issue of *The PPC Nonprofit Update* includes an article on the provisions of recently issued ASU 2019-03. One of the changes the ASU makes is to amend the definition of a collection item relating to the requirement about the use of sales proceeds. Under the clarified definition, proceeds from the sale of collection items can be used for either of the following purposes—

- acquiring new collection items; and/or
- the *direct care* for existing collection items.

However, FASB ASU 2019-03 does not define or provide additional guidance on *direct care*. The FASB's basis for conclusions indicates that each industry should be able to determine what it considers to be *direct care*.

Practical Consideration:

The Board was concerned that if FASB defined *direct care* in the ASU, that definition could result in a new misalignment between the GAAP and AAM's definition of collections. Additionally, the Board also had concerns that it would be unable to develop a definition that would apply to all types of collection that an entity may hold.

Q&A 6140.27 Guidance on Characteristics of *Direct Care*

In May 2019, the AICPA issued Q&A Section 6140.27, *Not-for-Profit Entities, Definition of Direct Care of Collection Items*. The nonauthoritative guidance discusses characteristics to consider when determining which costs are considered direct care.

Characteristics of *Direct Care*. When an entity is determining which costs are considered *direct care*, these characteristics include, but are not limited to, whether the costs—

- enhance the life, usefulness, or quality of the entities collection;
- provide a benefit to the collections (and not the entity as a whole or other area of the entity beyond the collections); and
- exclude expenditures that are regular and ongoing in nature (such as expenditures for routine maintenance of the collection).

Practical Consideration:

The AAM white paper (*Direct Care of Collections—Ethics, Guidelines and Recommendations*, which was published in April 2016) provides additional guidance to help entities determine what is considered direct care for collection items.

Website of Interest

The following website may be of interest to the nonprofit sector.

www.buzzfeed.com/tag/nonprofit

The BuzzFeed section for Nonprofits is a collection of tongue-in-cheek content (articles and videos) curated for the nonprofit organization audience. Some are silly, but a little scrolling reveals jewels such as "23 Situations Only Nonprofit People Can Understand" and "19 Struggles You'll Only Understand If You Work For a Nonprofit." Also available are heartwarming items of nonprofits doing good in the world ("Nonprofit Creates Halloween Costumes for Kids in Wheelchairs") when you need that little pick-me-up on those trying days. Warning: It can get a little salty.

The Qualified Business Income Deduction

Background

Exempt organizations are generally subject to income tax on their unrelated business taxable income (UBTI). UBTI is the gross income derived from any profitable unrelated trade or business, less directly connected allowable deductions, plus certain disallowed fringes [IRC Sec. 512(a)]. In addition, certain exceptions, additions and limitations may apply, as well as a specific deduction of $1,000 [IRC Sec. 512(b)]. This tax is reported on Form 990-T, "Exempt Organization Business Income Tax Return."

An organization calculates its unrelated business income separately for each unrelated trade or business. A *loss* from an unrelated trade or business can no longer be taken in the current year [IRC Sec. 512(a)(6)]. Instead, it is carried forward and can be used in a future year to reduce income or gain from the *same* unrelated trade or business.

Navigating IRC Sec. 199A

Tax-exempt trusts that have UBTI for tax years 2018–2025 can claim a qualified business income (QBI) deduction. This deduction is generally equal to—

- 20% of the trust's QBI from a partnership, S corporation, or sole proprietorship; plus
- 20% of qualified real estate investment trust (REIT) dividends and qualified publicly traded partnership income [IRC Sec. 199A(a)].

The deduction is limited to the lesser of this calculation amount or 20% of the trust's taxable income minus its net capital gain.

A qualified trade or business is generally an activity considered a trade or business within the meaning of IRC Sec. 162, other than one conducted through a C corporation. The ownership and rental of real property may be considered a trade or business. Notice 2019-7 (2019-9 IRB 740) provides a safe harbor for treating rental real estate as a trade or business for purposes of the QBI deduction. The safe harbor requires maintaining separate books for each property; at least 250 hours spent each year performing rental services for years prior to January 1, 2023 (a different rule applies for 2023–2025); and the maintenance of contemporaneous records (after 2018) detailing services performed, time spent, and dates of services. Rental real estate that does not meet these requirements may still be treated as a trade or business if it qualifies under IRC Sec. 162.

The QBI deduction is subject to multiple limitations. The trust's UBTI, the type of trade or business, the amount of W-2 wages paid by the trade or business, and the unadjusted basis immediately after acquisition (UBIA) of qualified property held by the trade or business all impact this limitation.

The calculation of QBI excludes income, gain, deductions, W-2 wages, and UBIA from any unrelated trade or business that operated at a loss for the year, since such loss is not currently included in UBTI.

Reporting on Form 990-T

The total of a trust's UBTI is reported on line 36 of Form 990-T and the specific deduction of $1,000 is claimed on line 37. A trust's taxable income for computing the QBI deduction is the amount reported on line 36 less the specific deduction on line 37.

Add the QBI deduction to any specific deduction allowable and report the sum on line 37. Attach a statement to Form 990-T identifying the amount of the QBI deduction on line 37.

Practical Consideration:

Additional information on the QBI deduction, including worksheets is available in Chapter 12 of Publication 535, "Business Expenses."

Publication of Racially Nondiscriminatory Policy

Background

A private school must have a racially nondiscriminatory policy regarding students and operate in accordance with that policy in order to be exempt under IRC Sec. 501(c)(3).

Section 4.03 of Revenue Procedure 75-50 (1975-2 CB 587) requires a private school to make its racially nondiscriminatory policy known to all segments of the

general community that it serves in one of two ways:

- By publishing, at least once annually, a notice of its racially nondiscriminatory policy in a newspaper of general circulation that serves all racial segments of the community.
- Through broadcast media, provided that the media used to communicate the policy is reasonably expected to be effective.

A New Publication Method

The IRS has recognized that technological advances since the publication of Revenue Procedure 75-50, including the advent and widespread use of the internet, enable many schools to satisfy the publicity requirement by using their internet websites (Rev. Proc. 2019-22, 2019-22 IRB 1260).

A school can now use a third method to satisfy the publicity requirement—it can display a notice of its racially nondiscriminatory policy on its primary *publicly accessible* internet homepage at all times during its tax year (excluding temporary outages due to website maintenance or technical problems) in a manner reasonably expected to be noticed by visitors to the homepage. A publicly accessible homepage is one that does not require a visitor to input information, such as an email address or a username and password to access it.

Factors to be considered in determining whether a notice is reasonably expected to be noticed include the size, color, and graphic treatment of the notice in relation to other parts of the homepage, whether the notice is unavoidable, whether other parts of the homepage distract attention from the notice, and whether the notice is visible without a visitor having to do anything other than simply scrolling on the homepage.

A link on the homepage to another page where the notice appears in a carousel or only by selecting a dropdown or by hover (mouse over) is unacceptable. If a school does not have its own website, but it has webpages contained in a website, the notice of its racially nondiscriminatory policy must be on its primary landing page within the website in a manner that satisfies all the other requirements explained previously.

Beyond Policy Notice

Simply publishing a nondiscrimination notice is not enough for a school to secure or maintain tax-exempt status. It must demonstrate that it does not practice racial discrimination (e.g., a lack of minority students may suggest that there is discrimination, but a school can rebut the assumption by showing that it vigorously tries to recruit minority students).

Practical Consideration:

Racial discrimination is a sensitive social and political issue. Consequently, tax-exempt schools must satisfy the policy publication requirements.

Notifying the IRS of Activity Changes

Background

An organization that applies for exempt status on Form 1023 must provide a detailed, narrative description of its past, present, and planned activities (Part IV). This description is critical in determining whether exemption is granted or denied.

This explanation concerning an organization's activities should normally include—

- the disclosure of each activity;
- where the activity will be conducted and who will conduct it;
- the percentage of total time devoted to each activity;
- how the activity is funded; and
- how the activity furthers the organization's exempt purpose(s).

Changes after Exemption Granted

It is not unusual for an organization to alter or expand its activities as it grows and new personnel join it. What notification must an organization provide to the IRS when proposed changes to curb or expand activities are being seriously considered?

Part IV, Line 33 of Form 990-EZ requires an organization to provide a detailed description of any significant activity not previously reported to the IRS. Although not specifically required, the termination of a significant activity that was the basis for exemption approval should also be disclosed. Similarly, Part III, lines 2 and 3 of Form 990 ask whether any new significant program services were undertaken during the year; or whether the organization ceased conducting or made significant changes in how it conducts any program services. Consequently, Form 990-EZ or Form 990 can be used to notify the IRS of changes in activities that clearly do not jeopardize an organization's exemption.

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Under some circumstances, prudence may dictate that advance approval is secured from the IRS before a proposed change is implemented.

Request for Miscellaneous Determination. Form 8940 provides a simplified means for a charitable organization to get assurance from the IRS on several matters. For public charities, these include the following:

- A request for exemption from the Form 990 filing requirements (e.g., because the organization has become affiliated with a church or a convention or association of churches).
- A request for advance approval that a potential grant or contribution will be an *unusual grant* and, therefore, will not jeopardize an organization's public charity status.
- A change in the type of a Section 509(a)(3) organization.

The user fee is $400 for each of the three examples cited but is higher for other types of determination requests using Form 8940 (Appendix A of Rev. Proc. 2019-5, 2019-1 IRB 230).

Letter Ruling. When Form 8940 cannot be used to request IRS approval of a proposed activity, an organization's alternative is to request a ruling. For example, an organization may want IRS assurance that a proposed revenue-producing activity will not be deemed an unrelated trade or business and will seek a ruling to that effect.

Practical Consideration:

An expansion into new activities or a curtailment of existing exempt purpose activities can jeopardize an organization's exemption. Whenever a proposed change is more than inconsequential, the narrative description of activities in the exemption application should be reviewed to determine whether and how the IRS should be apprised of the change.

Tax Brief

DONOR DISCLOSURE DEVELOPMENTS. In the September 2018 issue of *The PPC Nonprofit Update*, we discussed Rev. Proc. 2018-38 (2018-31 IRB 280), which relaxed the Form 990, Schedule B donor disclosure requirements. New York and New Jersey have recently sued the IRS and Treasury in federal district court to force them to turn over records concerning the development and decision making behind the relaxed rules. Stay tuned for further Schedule B developments.