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THE PPC
NONPROFIT UPDATE

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# AICPA Issues Omnibus SAS 135—Part 1

In May 2019, the AICPA issued SAS 135, *Omnibus Statement on Auditing Standards—2019*, which amends 13 sections of the Statements on Auditing Standards. The amendments result from the evaluation of three auditing standards that have been issued by the Public Company Accounting Oversight Board (PCAOB) since the AICPA's Auditing Standards Board (ASB) completed its auditing standards clarity project: AS 1301, *Communication With Audit Committees*; AS 2701, *Supplementary Information*; and AS 2410, *Related Parties*. The ASB determined that these PCAOB standards included guidance not found in current SASs that enhance audits of the financial statements of nonissuers. Based on its review and evaluation of the PCAOB standards, the ASB made certain amendments to existing GAAS.

No changes were considered necessary related to AS 2701 on supplementary information. However, amendments are made based on the ASB's review of AS 1301 on communication with audit committees and AS 2410 on related parties. The following paragraphs highlight some of the key changes made by the SAS relating to communications with audit committees, related parties, and significant unusual transactions. We'll cover other amendments in an upcoming issue of *The PPC Nonprofit Update*.

## Communication with Audit Committees

The changes arising from AS 1301 affect AU-C 260, *The Auditor's Communication With Those Charged With Governance*. These changes add requirements for the auditor to communicate views pertaining to the entity's significant unusual transactions and matters for which the auditor consulted outside the engagement team that are, in the auditor's judgment, significant and relevant to those charged with governance relating to their responsibility to oversee the financial reporting process. In addition, the auditor should communicate the possible effects of uncorrected misstatements on future period financial statements. In some situations, management may have already communicated to those charged with governance

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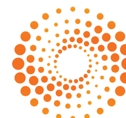

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some or all of the matters the auditor is required to communicate. Thus, the auditor did not communicate such matters at the same level of detail as management. However, the auditor is required to communicate to those charged with governance any matters that management omitted or didn't adequately describe. The SAS notes that the auditor doesn't have to communicate the required items at the same level of detail as management if the auditor was present during management's discussion with those charged with governance and confirmed to those charged with governance that management's communication of such matters was adequate. In addition, the auditor should document the details of these communications in the workpapers.

## Related Parties

Amendments that result from the evaluation of AS 2410 primarily affect AU-C 550, *Related Parties*. These amendments are intended to sharpen the auditor's focus on related parties, relationships, and associated transactions. The SAS enhances existing requirements to identify related parties or significant related-party transactions that were previously unidentified or undisclosed. Also, the auditor's response to the risks of material misstatement relating to related parties, relationships, and associated transactions is enhanced by including procedures for testing the completeness and accuracy of related party relationships and transactions identified by the entity.

This is accomplished by requiring auditors to do the following—

- Perform additional inquiries of—
  - Management and others within the entity regarding the business purpose of entering into a transaction with a related party versus an unrelated party.
  - Management and others within the entity regarding new, modified, or terminated transactions with related parties during the period, including the business purpose of the transaciions.
  - Management and others within the entity regarding whether there are any related party transactions that haven't been properly authorized and approved, if there were any exceptions to the authorization/approval process, and the reasons for granting those exceptions.
  - Those charged with governance (unless all are involved in the entity's management) regarding their understanding of the entity's significant relationships and transactions with related parties, if they have any concerns with the relationships or transactions with related parties, and, if so, the substance of those concerns.
- Evaluate whether the entity has properly identified its related party relationships and transactions through procedures to test the accuracy and completeness of the related party relationships and transactions identified by the entity.
- Perform procedures on balances with affiliated entities as of concurrent dates, even if fiscal years of the respective entities differ, to address the risks of material misstatement associated with the entity's accounts with affiliates.

In addition, amendments to AU-C 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*, require communication with component auditors about the nature of relationships and transactions with related parties.

## Significant Unusual Transactions

Amendments to AU-C 240, *Consideration of Fraud in a Financial Statement Audit*, address significant unusual transactions as follows—

- Define *significant unusual transactions* as those that are either outside the entity's normal course of business or appear unusual due to timing, size, or nature.
- Require an additional management inquiry regarding whether the entity has entered into any significant unusual transactions. If they have, the auditor should also ask for details concerning the nature, terms, and business purpose and whether such transaction(s) were with a related party.
- Require the design and performance of procedures addressing the risk of management override of controls to include: reading the underlying documentation supporting the business purpose of significant unusual transactions and evaluating the consistency with explanations from inquiries and other audit evidence; determining whether these transactions have been properly authorized and approved in accordance with established policies and procedures; and evaluating whether identified significant unusual transactions have been properly accounted for and disclosed in the financial statements.

### Practical Consideration:

The practice aids in the 2019 edition of *PPC's Guide to Audits of Nonprofit Organizations* (NPO) have not been updated for SAS No. 135 since the SAS had not yet been issued. The 2020 edition of NPO will have updated practice aids when it becomes available in the spring of 2020.

# OMB Releases Revised Compliance Supplement

On September 20, 2019, the OMB released a revised edition (dated August 2019) of the 2019 Compliance Supplement. *The August 2019 edition replaces the previous June 2019 edition in its entirety*. As discussed in the October 2019 edition of *The PPC Nonprofit Update*, the revised edition was necessary due to a significant number of errors and other issues that were identified by the AICPA and other stakeholders as they reviewed the initial edition.

## Corrections Made

The August 2019 edition of the Compliance Supplement contains an "Errata Page" section after the Table of Contents that identifies the corrections and other changes made. The OMB has included the term "revised" in the footer on pages with changes to assist users in identifying where changes were made. However, certain pages with minor changes are not marked as being revised. The changes made in the revised Compliance Supplement do not address all of the questions and errors raised in the AICPA comment letter to the OMB. There continue to be certain areas in the revised Compliance Supplement that have inconsistencies or other issues. Most of the changes in the revised edition were made in Part 2, Matrix of Compliance Requirements; Part 4, Agency Program Requirements; and Part 5, Clusters of Programs.

## Advice for Auditors about Engagements in Process and Uncorrected Items

In GAQC Alert No. 387, the GAQC staff notes that they are aware that some June 30, 2019, single audits have been completed and that they may include major programs that have been corrected or changed in the revised Compliance Supplement. The GAQC has asked OMB to issue definitive guidance about OMB's expectation for these completed audits—with the GAQC advocating that the federal government accept the completed audits as originally performed. Auditors should be alert for additional information from the OMB or the AICPA on this issue. Also, the Alert recognizes that there are situations where auditors have completed single audit fieldwork or are close to issuing compliance audit opinions and have concerns about the timing of the revised Compliance Supplement's issuance. To the extent such audits include a program that has now been corrected or changed and auditors are looking for direction, the GAQC recommends that auditors contact the relevant agency National Single Audit Coordinator (NSAC) using the contact information in Appendix VIII of the Compliance Supplement.

Similarly, for errors or areas that the AICPA requested OMB provide clarification on that were not addressed in the revised edition, the Alert suggests that auditors contact the NSAC for advice (and document that consultation) when they identify errors or requirements or procedures that are unclear.

### Practical Consideration:

The changes in the August Compliance Supplement do not affect the practice aids in *PPC's Guide to Single Audits* (GSA). *PPC's SMART Single Audit Suite* will be re-released with updated information from the August 2019 Compliance Supplement. Auditors should document in their workpapers that they used the August 2019 Compliance Supplement when performing single audit procedures.

# Auditing Brief

**TQAs ON REPORTING RELEASED.** The AICPA has issued three nonauthoritative Technical Questions and Answers, at Q&A 9110.25–.27 (with background information at 9110.24), which indicate that changes to the 2019 Compliance Supplement's approach for identifying the types of compliance requirements subject to the compliance audit does not warrant a change in the auditor's reporting on compliance. However, Q&A 9110.27 states that the auditor is not precluded from including an other-matter paragraph in the auditor's report to communicate information about the change in the Compliance Supplement.

### Practical Consideration:

The Q&As are available at **www.aicpa.org/interestareas/frc/recentlyissuedtechnicalquestionsandanswers.html** and on Checkpoint at **checkpoint.riag.com**. The Q&As do not change the reporting guidance or illustrations in the 2019 edition of GSA.

# Reporting As Single-entity Approved

Recently a Community Foundation (F) formed as a trust under state law, and its supporting organization, a 501(c)(3) tax-exempt corporation (C), requested to be treated as a single entity for tax purposes. F proposes to operate C as one of its component parts and not as a separate supporting organization recognized under IRC Sec. 501(c)(3). C and F are seeking permission to file one annual return (Form 990) as a single entity. Two letter rulings were issued. One is directed only to F and the other is directed to C (Ltr. Ruls. 201936002 and 201936003).

## Community Trusts—Let's Review

Community trusts are established to attract large endowment contributions for the benefit of a particular community. Such contributions are often received and maintained in separate trusts or funds subject to varying degrees of control by the community trust's governing body.

A community trust must meet either the $33^1/_3$% test or the facts and circumstances test to qualify as a publicly supported organization. It can be treated as a single entity instead of a combination of separate funds if it meets all of the following requirements:

1. The organization is commonly known as a community trust or similar name.
2. All of its funds are subject to a common governing instrument.
3. All of its funds have a common governing body that monitors distributions from the funds exclusively for charitable purposes and has certain other powers to modify or restrict the terms of each trust or fund.
4. The organization prepares its periodic financial reports treating all the funds in the aggregate as a single entity (as opposed to separate entities).

To be treated as part of a community trust rather than a separate trust or not-for-profit corporation, a trust or fund (1) must be created by a transfer to a community trust that is treated as a single entity, and (2) may not be directly or indirectly subjected by the transferor to any material restriction on the transferred assets.

## The Facts

F is a publicly supported organization making distributions for charitable, educational, and scientific purposes in a certain region of the state. F is the sole member of C, a tax-exempt organization described in IRC Sec. 509(a)(3). C's governing documents provide that (1) C is organized and operated exclusively for charitable, educational, and scientific purposes for the benefit of F; and (2) C's purpose is to receive gifts, devises, bequests, and contributions and use, invest, reinvest, or distribute funds to support F's exempt purposes. C indicates that it has been described to the local community as a supporting organization of F since its inception. In addition, they use a single distribution committee to evaluate grant requests and make recommendations to F's board. F and C represent they have filed separate Form 990s each year, although F has included the net value of funds held by C on its Form 990 balance sheet as other assets of F.

C and F propose to amend their governing documents to (1) make both entities subject to a common governing body; (2) provide that all gifts, devises, and bequests to C are subject to the terms and conditions of the organizing and common governing documents of F; and (3) provide that C's board shall consist of all the current members of F's board of trustees, so that all individuals are concurrently serving as members of both boards. F will operate C as one of its component parts and not as a supporting organization separate from F.

## The Rulings

Based on the facts and representations submitted, the IRS ruled that F will be treated as a single entity, and C will be treated as a component part of Foundation. C and F will file an annual return (Form 990) as a single entity.

# Service Agreements Not Self-dealing

Recently, the IRS issued a pair of related private letter rulings that provided guidance on whether future payments made by a private foundation (F) to its founder/substantial contributor's disregarded entities would be considered self-dealing (Ltr. Ruls. 201937003 and 201937004). Apparently, for several years, the employees of founder's disregarded entities (A and B), had been providing free services to, and paying operating costs of, F. In an effort to secure future self-sufficiency, F was planning to enter into a service agreement with A. As part of that agreement, A will contract with B to assist A in delivering investment management and advisory services to F and other entities at F's direction.

The parties sought to clarify the tax treatment of these potential transactions.

## A Review of the Rules

A tax is imposed on a disqualified person (DQP) for each act of self-dealing between the DQP and a private foundation (PF) (IRC Sec. 4941). The tax may also be imposed on the foundation manager if the manager willfully participates in an act of self-dealing, knows the transaction is a prohibited act, and does not have reasonable cause for participating in the act. In addition, a person liable for the tax on self-dealing may also be subject to a penalty for (1) repeated or (2) willful and flagrant violations of the self-dealing provisions (IRC Sec. 6684).

For an act of self-dealing to occur, there must be a direct or indirect transaction between a PF and a DQP. For this purpose, a DQP includes a (1) substantial contributor; (2) foundation manager; (3) greater than 20% owner (voting stock, profits interest, or beneficial interest) in a substantial contributor; (4) family member of (1)–(3); (5) a corporation, partnership, or trust/estate in which disqualified people in (1)–(4) own a greater than 35% interest; or (6) government official [IRC Sec. 4946(a)(1)]. When an act of self-dealing has occurred, it is irrelevant whether the PF benefits or suffers a detriment as a result of a transaction.

**Specific Acts of Self-dealing.** Self-dealing is defined as any of the following direct or indirect transactions between a DQP and a PF:

1. Selling, exchanging, or leasing of property.
2. Lending money or extending credit.
3. Furnishing goods, services, or facilities.
4. Paying compensation (or reimbursing expenses) to a DQP.
5. Transferring a PF's income or assets to (or allowing their use by) a DQP.
6. Agreement by a PF to pay money or other property to a government official [as defined in IRC Sec. 4946(c)], other than an agreement to employ such individual for any period after his or her government service terminates if such individual is terminating government service within a 90-day period.

**Exceptions of Self-dealing.** Not every transaction between a DQP and a PF is an act of self-dealing. There are several important exceptions to the general rules regarding self-dealing including:

*Initial Status as a DQP.* A transaction between a PF and a DQP is not self-dealing when the DQP's status arises only from the transaction (e.g., a person makes a bargain sale of property to a PF and therefore becomes a substantial contributor).

*Former DQPs.* An exchange of property between a PF and a former foundation trustee is not an act of self-dealing. Foundation managers who are not otherwise DQPs (e.g., a substantial contributor, or creator) are no longer DQPs once they resign and are unable to exert influence over a foundation.

*Transactions Not Deemed Indirect Self-dealing.* A transaction between a DQP and an organization controlled by a PF is not indirect self-dealing in certain circumstances [see Reg. 53.4941(d)-1(b)(1)].

*Property Leases without Charge.* Although leasing property by a DQP to a PF is normally an act of self-dealing, a lease without charge is not. Caution must be exercised in structuring a rent-free lease. For example, building improvements (paid for by the foundation) that become part of the real property and increase its value result in self-dealing. The foundation can agree to pay for janitorial services, utilities, or other maintenance costs it incurs for the use of the property provided the payments for these expenses are not made directly or indirectly to a DQP (i.e., these payments should be made to the third-party vendor). The lease, which should be in writing, should not contain a clause requiring the foundation to indemnify the DQP-owner for any loss caused by a foundation employee since an indemnification clause can create self-dealing.

*Loans.* Interest-free loans made by a DQP to a PF are not acts of self-dealing if made without any other charges and if the proceeds are used exclusively for the foundation's exempt purposes.

*Goods, Services, or Facilities.* Furnishing goods, services, or facilities (and even personal living quarters) by a PF to a foundation manager (or other employee) or to a volunteer is not an act of self-dealing if the value is not excessive and the items provided are reasonable and necessary to performing the tasks involved in carrying out the foundation's exempt purpose. The IRS has held that this rule also exempts low-interest mortgage loans to foundation managers. A foundation can provide goods, services, or facilities to a DQP if made on a basis no more favorable than to the general public.

*Compensation for Personal Professional Services.* Compensation paid (or expenses reimbursed) by a PF to a DQP is an act of self-dealing unless the compensation is for professional services that are necessary to carrying out the foundation's exempt purpose and

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are not excessive. Personal services that are reasonable and necessary to carry out the exempt purpose of a PF include legal services, investment counseling services, and general banking services. Accounting and tax services are analogous to legal services and, therefore, within the scope of permissible personal services. Investment services include investment manager selection, asset allocation and rebalancing services, review and payment of investment manager fees, and investment performance monitoring.

**Incidental Benefits to DQP.** A DQP receiving an incidental benefit from a foundation's use of its income or assets will not, by itself, make the use an act of self-dealing.

## The Rulings

The two rulings [Ltr. Rul. 201937003 (directed to the founder) and 201937004 (directed to the foundation)] address the service agreements that F will enter into to hire A (and indirectly B for investments services) to provide certain charitable program, grant-making, and consulting services. The IRS determined the agreements provide for reasonable and necessary services enabling F to carry out its charitable purposes. Even though the services are between a DQP and a PF, they will qualify under the IRC Sec. 4941(d)(2)(E) exception from self-dealing as long as the compensation is not excessive.

The rulings further determined that the F's fee payments to A for programmatic, grant-making, and charitable consulting services will be considered qualifying distributions under IRC Sec. 4942, assuming these expenses are paid to accomplish one or more of F's exempt purposes. Additionally, these funds expended as qualifying distribution will not be subject to the taxable expenditure excise tax under IRC Sec. 4945.

### Practical Consideration:

By laying out a complicated fact pattern, the foundation convinced the IRS that the service agreements providing for services performed by the founder, and employees of the founder's disregarded entities, were necessary for the foundation to carry out its exempt purpose. Not surprisingly, the rulings included cautionary language "as long as the amount of the payment is not excessive."

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# Tax Brief

**NEW PRIVATE DELIVERY ADDRESS FOR REQUESTS.** Forms 1023, 1024, 1024A, 1028, 8940, and group exemption requests submitted through private delivery/express mail should now be addressed to: IRS, Mail Stop 31A: Team 105, 7940 Kentucky Drive, Florence, KY 41042. Recently submitted forms will be forwarded. **Note:** The post office box address for regular mail remains unchanged: IRS, P.O. Box 12192, Covington, KY 41012-0192.

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