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Update on Standard Setters' Implementation Delays

In the June 2020 edition of *The Nonprofit Update*, we discussed deferrals of the implementation dates of certain standards. Here's an update on what's going on.

FASB

In April, the FASB exposed a proposed ASU, *Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities*. The FASB met on May 20, 2020, and directed the staff to draft a final ASU for vote.

As exposed, the ASU would have delayed the implementation of FASB ASC 606 only for certain franchisors for one year. The FASB received 46 comment letters. The theme of many of them was the impact that COVID-19 has had on nonprofit organizations and private companies who haven't yet issued their first financial statements with FASB ASC 606 implemented. When the FASB redeliberated the proposed ASU, it decided to amend the effective date for entities that have not yet issued financial statements reflecting the adoption of FASB ASC 606 to be for annual reporting periods beginning after December 15, 2019, and interim reporting periods within annual reporting periods beginning after December 15, 2020. Entities may continue to early adopt the standards.

> **Practical Consideration:**
>
> Auditors of nonprofit organizations may find audit procedures for revenue before the adoption of FASB ASC 606 in the Other Audit Procedures section of NPO-AP-8 of *PPC's Guide to Audits of Nonprofit Organizations*.

The FASB decided to amend the effective date for FASB ASC 842, as discussed in the exposure draft. Thus, for most nonprofit organizations, it will be for fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2020. Entities may continue to early adopt the standard.

In this Issue:

PEEC

On May 5, 2020, the AICPA Professional Ethics Committee met and, as expected, voted to extend the effective dates of three interpretations of the *Code of Professional Conduct* by one year. Those interpretations are:

- *Information Systems Services* (now effective January 1, 2022),
- *State and Local Government Client Affiliates* (now effective for years beginning after December 15, 2021), and
- *Leases* (now effective for fiscal years beginning after December 15, 2020).

Practical Consideration:

Updated information and financial statement considerations related to the coronavirus are located at the 2020 COVID-19 Guidance tab on Checkpoint at **www.checkpoint.riag.com**. Remember that the deferrals discussed in this article and in the June issue were issued after the new edition of the AICPA Audit and Accounting Guide and Risk Alert were finalized.

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, 2020 (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. 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, 2019. This includes relevant guidance issued up to and including the following:

- ASU 2020-02, *Financial Instruments—Credit Losses (Topic 326) and Leases (Topic 842)—Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin No. 119 and Update to SEC Section on Effective Date Related to Accounting Standards Update No. 2016-02, Leases (Topic 842)*.
- SAS 138, *Amendments to the Description of the Concept of Materiality*.
- SOP 17-1, *Performing Agreed-Upon Procedures Related to Rated Exchange Act Asset-Backed Securities Third-Party Due Diligence Services as Defined by SEC Release No. 34-72936*.

As usual, the Audit Guide reflects relevant guidance that is issued but not effective as of March 1, 2020, but that will become effective for fiscal years ending on or before June 30, 2020, 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 ASU 2018-08, *Not-for-Profit Entities (Topic 958): Clarifying the Scope and the Accounting Guidance for Contributions Received and Contributions Made*. Additional dual guidance includes SAS 134, *Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements*, and SAS 138, *Amendments to the Description of the Concept of Materiality*.

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."

Appendix E of the Audit Guide presents a discussion, "New Auditing Standards to Change the Auditor's Report." This material provides a summary of SAS 134, SAS 137, *The Auditor's Responsibilities Relating to Other Information Included in Annual Reports*, and SAS 138 and the resulting changes to the auditor's report.

Practical Consideration:

See the related articles in this newsletter and the June issue about deferrals of effective dates by the respective standard setters. Such deferrals were finalized after the Audit Guide was finalized.

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 edition.

Practical Consideration:

The March 2020 edition of the Audit Guide is available on Checkpoint or may be ordered from the AICPA at (888) 777-7077 or **www.aicpastore.com**. See the related articles in this newsletter and the June issue about deferrals of effective dates by the respective standard setters. Such deferrals were issued after the Audit Guide was finalized.

2020 Nonprofit Risk Alert

This year's AICPA Audit Risk Alert (Alert), *Not-for-Profit Entities Industry Developments—2020*, has been released, and much of the information is helpful to auditors and nonprofit organization managers alike. This article summarizes key features of the 2020 edition relating to economic and industry developments. Legislative and regulatory developments; audit and attestation issues and developments; accounting issues and developments; and other items will be discussed in a future edition of this newsletter.

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 the following:

Current Economic Indicators. The Bureau of Economic Analysis reports an estimated overall increase in annual GDP, which measures output of goods and services by labor and property within the U.S., of 2.1% for 2019 (a decrease from the rate of 3.4% in 2018) and an unemployment rate of 3.5% from December 2018 to December 2019, which is the lowest unemployment rate since 1969. The rate of unemployment at the end of 2019 represents approximately 5.8 million people out of work, excluding the 4.1 million part-time workers unable to find full-time work in 2019 (4.7 million in 2018), as well as the 1.2 million (1.6 million in 2018) people who have given up looking for work altogether. Although the federal minimum wage rate remains unchanged at $7.25 since 2009, on January 1, 2020, 22 states increased their minimum wages, totaling an estimated $8.2 billion in additional 2020 earnings for an estimated 7 million workers. In addition, the Federal Reserve decreased the federal funds rate three times during 2019 (compared with four increases in 2018).

State of Nonprofit Organizations. There are currently over 1.6 million IRS-registered nonprofit organizations receiving more than $427 billion in contributions in 2018. In inflation-adjusted dollars, giving declined 1.7% from 2017 to 2018, largely attributed to the significant decrease in the number of taxpayers that itemized deductions since the 2017 Tax Cuts and Jobs Act doubled the amount of the standard deduction. Notably, giving by foundations reached a record-breaking $75.86 billion and accounted for 18% of total giving. Giving to donor-advised funds reached an all-time high in 2018 of $37.12 billion, with significant growth in contributions to individual donor-advised funds—growth that is attributed to new fund sponsors offering simple, flexible models that are popular with employees and simplify multigenerational giving.

Other Areas. The Alert also discusses considerations when accepting electronic payments and donations, ERP implementation considerations, practical use of SOC 1 reports, the need for vendor management, the EU's General Data Protection Regulation and privacy, and the importance of financial storytelling.

Investment Activities Treated as a Separate Unrelated Business

Background

As discussed in this newsletter last month, IRC Sec. 512(a)(6), enacted as part of the Tax Cuts and Jobs Act, requires that unrelated business taxable income (UBTI) be separately calculated for each unrelated trade or business (UTB) conducted by an exempt organization (EO). A loss from one UTB cannot be used to offset the income of another UTB.

Proposed regulations provide the latest guidance on the identification of separate trades or businesses. As mentioned in last month's article, some investment activities can be a UTB for Section 512(a)(6) purposes.

Some Investments Activities Can Be Single UTB

Certain investment activities can be treated as a *single* UTB for Section 512(a)(6) purposes. These investment activities are limited to [Prop. Reg. 1.512(a)-6(c)(1)]—

1. qualifying partnership interests [other than those of Section 501(c)(7) social clubs];
2. debt-financed properties; and
3. qualifying S corporation interests.

The Treasury and the IRS are going to consider a broader definition of *investment activities* based on additional comments on this issue.

Qualifying Partnership Interests

A qualifying partnership interest (QPI) is a partnership interest that satisfies the requirements of either a *de minimis* test or a control test [Prop. Reg. 1.512(a)-6(c)(2)].

If a directly-held partnership interest is not a QPI, the general principles of IRC Sec. 512(c) apply and the EO must identify the UTBs of both the directly-held partnership and any indirectly-held (lower-tier) partnership.

***De Minimis* Test.** The *de minimis* test requires that the EO own directly no more than 2% of the profits interest of a partnership and no more than 2% of a capital interest [Prop. Reg. 1.512(a)-6(c)(3)]. As discussed later, an EO is not required to combine certain related interests when determining whether a partnership interest meets the *de minimis* test.

The proposed regulations deal with the complex issue of indirect ownership of a partnership interest [Prop. Reg. 1.512(a)-6(c)(2)]. Suppose an EO owns a directly-held partnership interest but the interest is not a QPI because the EO does not meet the *de minimis* test (e.g., its capital interest is more than 2%). Under these circumstances, any partnership in which the EO holds an *indirect* interest (i.e., a lower-tier partnership) because of its ownership in a direct partnership interest may be a QPI if the indirectly-held interest meets the *de minimis* test requirements. The proposed regulations permit, *but do not require*, an EO to aggregate the UBTI from an indirectly-held QPI with a directly-held QPI. However, this look-through rule does not apply to indirectly held QPIs that do not meet the requirements of the *de minimis* test even though they satisfy the requirements of the control test discussed later.

Example: EO directly owns 50% of the capital interests of Partnership A that it does not control. In turn, A owns 4% of the capital and profits interest of a lower-tier Partnership B and 10% of the capital and profits of lower-tier Partnership C. EO can aggregate its interest in B with its other QPIs because it indirectly owns only 2% capital and profits interest in B (4% × 50%). However, EO cannot aggregate its interest in C because it indirectly owns 5% (10% × 50%) of C's capital and profits interests, which exceeds the 2% allowable under the *de minimis* test.

Control Test. A partnership interest is a QPI if the EO directly owns no more than 20% of the capital interest *and* does not have influence or control over the partnership [Prop. Reg. 1.512(a)-6(c)(4)].

Control is a subjective question. All facts and circumstances, including the partnership agreement, are relevant in determining whether an EO controls a partnership.

The proposed regulations provide circumstances that evidence control [Prop. Reg. 1.512(a)-6(c)(4)]. For example, an EO has control if it, by itself, can require the partnership to perform, or prevent it from performing, any act that significantly affects the partnership's operations. An EO also is deemed to have control if it has the power to appoint or remove any of the partnership's officers, employees, or a majority of the directors.

Other circumstances focus on whether any of the EO's officers, directors, trustees, or employees have the right to participate in partnership management at any time. No exception is provided for certain professionals who may serve on the boards of both the EO and partnerships in which it is a partner.

Combining Related Interests. The proposed regulations have an aggregation rule to address situations in which an EO may control a partnership by combining ownership interests. (This aggregation rule applies only for the control test.) Specifically, the ownership interests of a supporting organization [as defined in IRC Sec. 509(a)(3)] and of a controlled entity [as defined in IRC Sec. 512(b)(13)] in the same partnership are aggregated with the EO's interests to determine the ownership percentage of the *control* test. However, ownership interests of disqualified persons are not aggregated for the control test.

Treasury and the IRS are still considering whether the aggregation of the interests of supporting organizations is appropriate when the EO is a supported organization that has little or no control over its supporting organizations.

Relying on Schedule K-1 Ownership Percentage. An EO can rely on the Schedule K-1 (Form 1065) it receives from the partnership if this form shows the EO's percentage profits interest or its percentage capital interests, or both, at the beginning and end of the year [Prop. Reg. 1.512(a)-6(c)(5)]. An EO cannot rely on Schedule K-1 if any information concerning the EO's percentage interest is not specifically provided. For example, if the Schedule K-1 shows the EO's percentage capital interest at the beginning and end of the year, but shows its profits interest as "variable," the EO can rely on the form only for the percentage capital interest.

Irrevocable Designation. Under the proposed regulations, an EO's designation of a partnership interest as a QPI in a tax return according to the form and its instructions is generally irrevocable. The EO cannot later identify the trades or businesses conducted by the partnership as UTBs using the North American Industry Classification System (NAICS) two-digit codes. However, if the partnership interest ceases being a QPI, then the EO would be required to identify the partnership's UTBs using NAICS two-digit codes.

Transition Rule. Interim guidance permitted an EO to treat each partnership interest acquired prior to August 21, 2018, that failed to satisfy either the *de minimis* test or the *control* test as one UTB regardless of whether more than one UTB was conducted directly or indirectly (through lower-tier partnerships) by the directly-held partnership [Notice 2018-67 (2018-36 IRB 409)]. The proposed regulations clarify that a partnership interest acquired prior to August 21, 2018, will continue to be covered by the transition rule even if the EO's percentage interest changes after August 21, 2018. However, an EO can rely on the transition rule only until the first day of its first tax year beginning after the date final regulations are published [Prop. Reg. 1.512(a)-6(c)(7)(iii)]. In addition, an EO can apply either the transition rule or the look-through rule, but not both, to a partnership interest that meets the requirements for both rules.

Unrelated Debt-financed Income

Income from dividends, interest, real property rents, annuities, royalties, and capital gains is normally excluded from UBTI. But such income is UBTI if the property producing the income is debt-financed within the meaning of IRC Sec. 514(a). Debt-financed income is included in the list of investment activities treated as a separate unrelated business under IRC Sec. 512(a)(6).

However, the debt-financed property rules are not applicable to income that is included in UBTI under other rules. Examples include—

- rents from real and personal property are included in UBTI if more than 50% of the total rent is attributable to the personal property;
- payments for the use or occupancy of rooms or other space where services are rendered to the occupant are not excludible from UBTI under the rents from real property exclusion.

Therefore, since these types of rental income are included in UBTI, the EO must identify the unrelated business using the NAICS two-digit code for real estate rental and leasing (53).

Payments from a Controlled Entity

An EO (controlling organization) that receives any interest, annuity, royalty, or rent from another entity that it controls (controlled entity) must treat the payment as UBTI to the extent that it reduces the net unrelated income (or increases the net unrelated loss) of the controlled entity. For this rule, control means ownership of more than 50% of the stock in a corporation, of the profits interests or capital interests in a partnership, or of the beneficial interest of any other type of entity.

An EO can aggregate all of the payments received from a controlled entity and treat them as received from a single separate UTB under IRC Sec. 512(a)(6) [Prop. Reg. 1.512(a)-6(d)]. On the other hand, when a controlling organization receives payments from two or more controlled entities the payments from each controlled entity are treated as a separate UTB.

S Corporation Stock Ownership

An EO's ownership of S corporation stock is treated similarly to the treatment of ownership in a controlled corporation. Each S corporation interest is treated as

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an interest in a separate UTB. An EO that has two S corporation interests will report two UTBs, one for each S corporation interest [Prop. Reg. 1.512(a)-6(e)].

S Corporation Exception. An EO may hold S corporation stock for investment purposes. Consequently, the proposed regulations permit an EO to aggregate its UBTI from an S corporation with its UBTI from other investment activities if the EO's percentage of stock ownership meets the requirements provided in the *de minimis* test or the control test for QPIs [Prop. Reg. 1.512(a)-6(e)]. Therefore, for Section 512(c)(6) purposes, the treatment of S corporation stock ownership is similar with that for the ownership of partnership interests.

Special Entities

The UBTI of social clubs, voluntary employees' beneficiary associations, and supplemental unemployment benefits trust is calculated differently than for other EOs. For example, the UBTI of a Section 501(c)(7) social club includes interest, annuities, dividends, rents, royalties, and capital gains unless this income is set aside (and used) for a purpose specified in IRC Sec. 170(c)(4) (i.e., exclusively for religious, charitable, scientific, literary, or educational purposes). Therefore, under the proposed regulations, a social club must identify its unrelated business using NAICS codes and treat the income derived from investment activities as a separate unrelated business for Section 512(a)(6) purposes.

Observation: A social club faces a bit of a challenge in using NAICS codes. It cannot use the two-digit code generally applicable for social clubs (71) to describe all its non-member income. Although code 71 may describe some of a social club's non-member income (such as green fees), other codes more appropriately describe other non-member income, such as merchandise sales (45) and food and beverage services (72).

The Charitable Contribution Deduction

An EO can reduce its UBTI by a deduction for charitable contributions, whether or not the deduction is directly connected to the conduct of the unrelated business. Contributions that exceed the deduction allowable for a particular year can be carried forward for five years. Suppose an EO has NOL carryover from more than one unrelated business and a charitable contribution carryover. The proposed regulations do not provide guidance for this situation. However, the proposed regulations clarify that the charitable contribution limit is determined after IRC Sec. 512(a)(6) is applied.

Practical Consideration:

Based on the number of instances in which further comments are requested in the explanations of the proposed regulations, it appears that we can expect significant additional guidance in the final regulations.