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Audit and Tax Updates for Nonprofits in 2023

February 2, 2023



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Learning Objectives

At the end of this session, you will be able to:

- Outline new and current accounting guidance affecting nonprofits
- Identify upcoming accounting standards and recognize the important items to consider during implementation of the leasing standard
- Recall current tax developments
- Identify tax opportunities and risks that may affect your organization



Audit Update - Introductions



Marcus Harwood



Jen Olivier



Chris Prenger



ASC 842 (Leases)

Lease Liability – Initial Measurement

- Present value of the lease payments not yet paid, discounted using the discount rate for the lease at lease commencement
- Other than PBEs and entities that hold conduit debt nonprofits may elect to use the risk-free rates for measurement of all lease liabilities
 - Simpler, but will likely result in recording a larger asset and liability
 - Accounting policy election made by class of underlying asset
- Real estate taxes and insurance
 - Sometimes included in lease liability measurement



Lease Right of Use Asset – Initial Measurement

- Consists of all the following at commencement date:
 - Initial measurement of lease liability
 - Any lease payments made to the lessor at or before the commencement date, minus any lease incentives received
 - Any initial direct costs incurred by the lessee
 - Initial direct costs **include** commissions and payments made to an existing tenant to incentivize that tenant to terminate its lease
 - Initial direct costs **do not include** costs to negotiate or arrange a lease that would have been incurred regardless

Leases Financial Statement Impact – Balance Sheet

Finance Lease

- Right-of-Use Asset
- Lease Liability

Operating Lease

- Right-of-Use Asset
- Lease Liability



Lease Financial Statement Impact - Income Statement

Finance Lease

- Amortization Expense
- Interest Expense

Operating Lease

- Lease Expense



Lease Financial Statement Impact - Cash Flow Statement

Finance Lease

- Operating – Cash Paid For:
 - Interest Payments
 - Variable Portions of the Lease Payments
- Financing – Cash Paid For:
 - Principal Payments

Operating Lease

- Operating – Cash Paid For:
 - Lease Payments



Example – Operating Lease

3-year lease term

Annual rent of \$100, escalating \$3 annually

7% interest rate

Example – Operating Lease

- Initial Recognition:

Dr. ROU Asset	270	
Cr. Lease Liab		270

- Year 1 Entry:

Dr. Lease Exp	103 A	
Dr. Lease Liab	81 D	
Cr. Cash		100 B
Cr. Accum Amort		84 A-C

- NOTE: No amortization expense is recorded! It is a component of the lease expense!

	Expense	Liability			Asset
		Payment	Interest	Principal	Amortization
Year	A	B	C	D	A-C
1	103	100	19	81	84
2	103	103	13	90	90
3	103	106	7	99	96
	309	309	39	270	270



Example – Finance Lease

3 year lease term

Annual rent of \$100, escalating \$3 annually

7% interest rate

Example – Finance Lease

- Initial Recognition:

Dr. ROU Asset	270	
Cr. Lease Liab		270

- Year 1 Entry:

Dr. Interest Exp	19 C	
Dr. Amort Exp	90 A	
Dr. Lease Liab	81 D	
Cr. Cash		100 B
Cr. Accum Amort		90 A

- NOTE: No lease expense is recorded. Each component is recorded.

	Asset	Liability			Expense
	Amortization	Payment	Interest	Principal	
Year	A	B	C	D	A+C
1	90	100	19	81	109
2	90	103	13	90	103
3	90	106	7	99	97
	270	309	39	270	309



Disclosures

Objective

- Enable users of financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases

Requirement

- Enhanced qualitative and quantitative disclosures



Transition Methods Available

CY = year of
adoption
PY =
comparative
period

Original
Transition
Method (ASU
2016-02)

- CY - 842
- PY - 842

Cumulative effect
adjustment at the
beginning of the
earliest period
presented

Additional
Transition
Method (ASU
2018-11)

- CY - 842
- PY - 840

Cumulative effect
adjustment at the
beginning of the
CY



Transition – Package of Practical Expedients

- An entity need not reassess:
 - Whether any expired or existing contract are/or contain embedded leases
 - Lease classification of any expired or existing leases
 - Initial direct costs for any existing leases
- Applies to leases that commenced **BEFORE** the effective date
- Must apply as a package to all leases
 - Can not pick and choose which leases
 - Can not pick and choose which practical expedients



Transition – Hindsight Practical Expedient

- Hindsight can also be elected as a practical expedient
 - Determination of lease term
 - Impairment of right-of-use assets
 - Can be used separately or in conjunction with package
 - Must apply consistently to all leases



Leases – Completeness Challenges

- Review existing and future agreements
- Existing systems (e.g., spreadsheets and software) may include lease information
 - All information required to make the calculation
 - Judgements (including on going assessments) and information for disclosures?
- Significant effort could be required to manually gather lease information

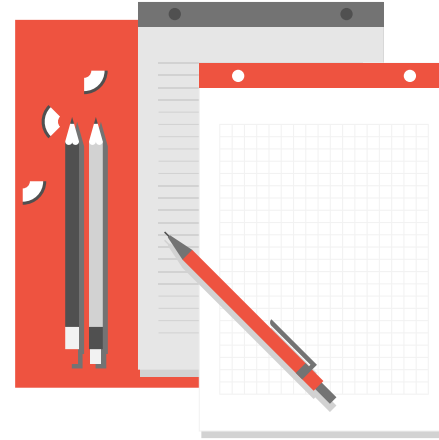
Leases – Completeness Challenges

- Decentralized lease procurement and administration depending on the business unit, geographic location, or type of leased asset could be a challenge
- Determining the **completeness** of the lease portfolio, as well as the accuracy and completeness of the lease data, may require considerable effort



Leases – Completeness Challenges

- Treatment of lease and non-lease components within a contract
 - For contracts with multiple components, a company is required to identify and separate non-lease components (e.g., operations, maintenance services) from the lease component
 - Practical expedient option to account for each separate lease component and the non-lease components associated with that lease component as a single lease component



Leases Completeness Question 1

- What are the steps an organization needs to take to ensure they have collected a complete lease population from their existing systems?

Leases Completeness Question 2

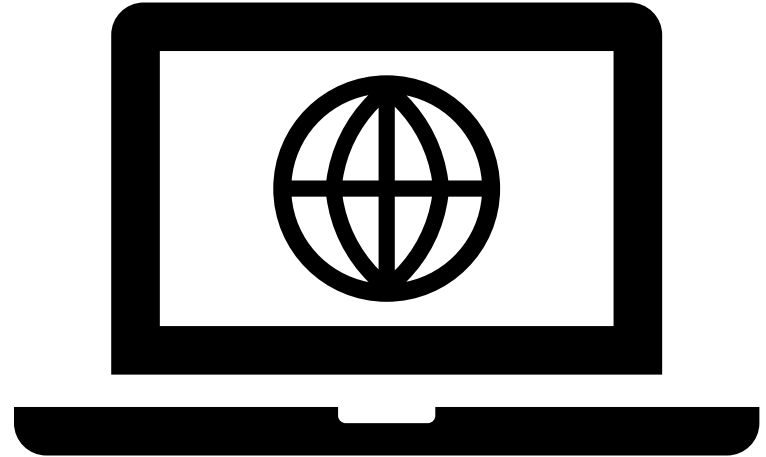
- For organizations with decentralized lease procurement and administration, what are some considerations to be made by administration?

Leases Completeness Question 3

- Organizations with a vast number of service agreements may have a hard time separating potential lease components in these contracts. How can the organization identify the contracts that need to be analyzed?

Leases – IT Systems and Policies

- Update existing systems or implement new
- Require input, not only from accounting, but also from the lease administration and IT functions, depending on the existing enterprise resource planning (ERP) environment
- Define system requirements and the expectations of relevant stakeholders prior to selecting a potential vendor



Leases – IT Systems and Policies

- Ensure accurate and consistent policies and processes around areas of judgement and estimates
 - Evaluating whether an arrangement meets the definition of a lease
 - Certain arrangements such as those with significant service component
- Other key decisions requiring judgement include
 - Lease payments and lease term
 - Ongoing evaluations of lease term
 - Accounting for lease modifications



Leases – IT Systems and Policies Question 1

- Outside of the accounting department and IT, who should be included in the analysis of the IT system in relation to leases?

Leases – IT Systems and Policies Question 2

- When negotiating the terms of a lease agreement in relation to a lease accounting policy, what types of things should be kept in mind to reduce the potential lease liability? What are the risks associated with a lower lease liability?



Presentation and Disclosures by Not-for-Profit Entities for Contributed Nonfinancial Assets (Gifts in Kind) ASU 2020-07

Gift In-Kind Standard Reminder

- Clarifies the presentation and disclosure of contributed nonfinancial assets; recognition and measurement requirements remain unchanged
- Effective date
 - Annual reporting periods beginning after June 15, 2021
- Preparing for implementation
 - Track amounts separately
 - Prepare for additional disclosures
 - Review related accounting policies



Gift In-Kind Specified Changes

- Financial Statement Presentation
 - Contributed nonfinancial assets as a separate line in the statement of activities
- Disclose:
 - Disaggregation of the amount of contributed nonfinancial assets by category
 - For each category disclose
 - Qualitative information about monetized vs utilized. If utilized, then a description of the programs or other activities in which they were used
 - Policy about monetizing rather than utilizing
 - Description of donor-imposed restrictions
 - Description of valuation techniques and inputs to determine FMV
 - Principal market used to arrive at FMV in NFP is prohibited from participating in that market



Gifts in Kind (ASU 2020-07) Income Statement Presentation

Not-for-Profit Entity A
Statement of Activities
Year Ended June 30, 20X1
(in thousands)

	<u>Without Donor Restrictions</u>	<u>With Donor Restrictions</u>	<u>Total</u>
Revenues, gains, and other support:			
Contributions	\$ 8,640	\$ 8,390	\$ 17,030
<u>Contributions of cash and other financial assets</u>	<u>\$ 6,790</u>	<u>\$ 7,430</u>	<u>\$ 14,220</u>
<u>Contributions of nonfinancial assets</u>	<u>1,850</u>	<u>960</u>	<u>2,810</u>
Fees	5,200		5,200
Investment return, net	6,650	18,300	24,950
Gain on sale of equipment	200		200
Other	150		150
Net assets released from restrictions (Note D):			



Gifts in Kind Disclosure Example I

Contributed Nonfinancial Assets

For the years ended December 31, contributed nonfinancial assets recognized within the statement of activities included:

	20X9	20X8
Building	\$ 550,000	\$ -
Household goods	95,556	100,486
Food	85,407	86,633
Medical Supplies	90,389	115,173
Pharmaceuticals	111,876	113,982
Clothing	85,765	83,890
Vehicles	127,900	-
Services	73,890	65,392
	<u>\$ 1,220,783</u>	<u>\$ 565,556</u>

NFP K recognized contributed nonfinancial assets within revenue, including a contributed building, vehicles, household goods, food, medical supplies, pharmaceuticals, clothing, and services. Unless otherwise noted, contributed nonfinancial assets did not have donor-imposed restrictions.

It is NFP K's policy to sell all contributed vehicles immediately upon receipt at auction or for salvage unless the vehicle is restricted for use in a specific program



Gifts in Kind Disclosure Example II

Contributed Nonfinancial Assets

	<u>Revenue Recognized</u>	<u>Utilization in Programs/Activities</u>	<u>Donor Restrictions</u>	<u>Valuation Techniques and Inputs</u>
Building	\$550,000	General and Administrative	No associated donor restrictions	In valuing the contributed building, which is located in Metropolitan Area B, NFP K estimated the fair value on the basis of recent comparable sales prices in Metropolitan Area B's real estate market.
Household goods	\$95,556	Domestic Community Development; Community Shelters	No associated donor restrictions	NFP K estimated the fair value on the basis of estimates of wholesale values that would be received for selling similar products in the United States.
Food	\$85,407	Natural Disaster Services; Domestic Community Development; Community Shelters	No associated donor restrictions	NFP K estimated the fair value on the basis of estimates of wholesale values that would be received for selling similar products in the United States.



Gifts in Kind Disclosure Example III

CONTRIBUTED NONFINANCIAL ASSETS

For the year ended December 31, 20XX, contributed nonfinancial assets recognized within the statement of activities:

<u>Nonfinancial Asset</u>	<u>Revenue Recognized</u>	<u>How Utilized</u>	<u>Donor Restrictions</u>	<u>Valuation Technique</u>
Clothing	\$3,500	Community Shelter	No associated restrictions	Thrift store price guides
Children's books	\$2,200	Afterschool program	No associated restrictions	Used bookstore pricing



Other Current Accounting Topics, Upcoming Standards, and Operational Considerations

Other Current Accounting Topic Upcoming Standards

- Reference Rate Reform
- ASU 2016-13 Current Expected Credit Losses (CECL)



Current Tax Developments and Opportunities for Nonprofits

Today's Speakers



Laura Kenney



Michael De Prima



Ann Neil

IRS 2022-2023 Priority Guidance Plan

- Donor Advised Funds
 - Four out of the ten exempt organization topics are focused on DAFs



Donor Advised Funds

- Regulations under §4966 regarding donor advised funds, including excise taxes on sponsoring organizations and fund management.
 - Expanded focus from prior years' priorities
 - Pension Protection Act of 2006 codified the definition of DAF
 - Taxable Distributions for disqualified persons

Donor Advised Funds

- Regulations under §4967 regarding prohibited benefits, including excise taxes on donors, donor advisors, related persons, and fund management.

Notice 2017-73

Bifurcating
DAF
Distributions

Donor's
Charitable
Pledges

Public
Support
Calculations



Donor Advised Funds – Proposed ACE Act

Guidance regarding the public-support computation with respect to distributions from donor advised funds

- Accelerating Charitable Efforts (ACE) Act
 - Introduced to Senate on June 9, 2021
 - Introduced to House & referred to the House Committee on Ways and Means on February 3, 2022
- Designed to encourage DAFs and private foundations to distribute funds more rapidly
- Discouraging the shifting charitable funds between DAFs & private foundations
- Could have a negative affect on public charities
- Pending – we will be tracking



Charitable guidance for cryptocurrency

- New guidance – ILM 202302012 released January 13
 - To qualify for a charitable contribution deduction, taxpayer must submit a qualified appraisal over \$5,000
 - Can't rely on value listed on a cryptocurrency exchange
 - Cryptocurrency doesn't fit statutory exceptions on appraisal requirements under section 170



Other new charitable laws and proposals

- Consolidated Appropriations Act of 2023 - Secure Act 2.0
- \$300 charitable contribution deduction - eliminated
- 100% AGI charitable contribution deduction – eliminated
- Current written acknowledgement - proposal



Mayo Clinic vs. U.S. tax case

- Classification – educational or healthcare organization?
- UBI exception for educational institution
- What does the tax law say?
- What does the regulation say?
- *Chevron* doctrine
- \$11.5m tax refund dispute



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Church tax case

- Special rules to open a church tax inquiry §7611
- Issues:
 - Church or thrift shop?
 - Coffee shop UBI
 - Employment taxes
 - Political activity
- 3rd party bank records



Associations IRS guidance

- New IRS technical guide for §501(c)(6) organizations
- Exemption requirements
- Political and legislative activities
- Unrelated business income
- Compensation and inurement
- Examination techniques



Exempt Organizations Technical Guide

TG 6 IRC 501(c)(6) Business Leagues

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Technical Guide Revision Date: 9/16/2022



Juice and smoothie bar ruling

- Purpose to provide fresh organic and affordable healthy juices
- Rural area customers cannot afford expensive healthy juices
- Charge less than for-profits
- Monthly health seminars
- Do not make a profit



Recent IRS audit activity

- Exemption issues
- Related party transactions
- Employment tax matters
 - Residence
 - Personal services
 - Below market housing
 - Employee meals
 - Gift cards



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Employee Retention Credit Opportunity

- Still a great opportunity if you have not yet looked into it!
- Reconciliation of ERC revenue to Form 990 revenue
- Reduce compensation tax deductions for UBI on Form 990-T
- American Rescue Plan Act of 2021 - expanded statute of limitations
- IRS Information Release IR-2022-183
- CLA webinar coming soon-March 1, 2023!



Inflation Reduction Act

- Alternative minimum tax (AMT)
- \$79.6 billion IRS improvements and enforcement
- Climate investment incentives



Refundable Tax Credit Opportunities for Tax-Exempts

Inflation Reduction Act Credit Opportunities

- IRA of 2022 created and modified several green energy credits
- IRC Section 6417 provides a “direct pay” option for tax-exempts and certain governmental entities
- Many credits have prevailing wage requirements that increase credit, in most cases from 6% to 30%
- Applies to tax years beginning after Dec. 31, 2022
- Unique opportunity for NFPs to get cash refunds from the federal government for green energy investments



Section 6417 Overview

- **Sec. 6417(a):** “In the case of an applicable entity making an election...with respect to any applicable credit determined with respect to such entity, such entity shall be treated as making a payment against the tax imposed by subtitle A (for the taxable year with respect to which such credit was determined) equal to the amount of such credit.”
- **Applicable Entity:**
 - Any organization exempt from the tax imposed by subtitle A,
 - Any state or political subdivision thereof,
 - The Tennessee Valley Authority,
 - An Indian tribal government,
 - Any Alaska Native Corporation, or
 - Any corporation operating on a cooperative basis which is engaged in furnishing electric energy to persons in rural areas
- **Election Timing**
 - In the case of any government, or political subdivision for which no return is required under section 6011 or 6033(a), such date as is determined appropriate by the Secretary, or
 - In any other case, the due date (including extensions of time) for the return of tax for the taxable year for which the election is made, but in no event earlier than 180 days after the date of the enactment of this section



Section 6417 Direct Pay Credits

§30C Alternative fuel vehicle refueling property credit

§45 Electricity produced from certain renewable resources, etc.

§45Q Credit for carbon oxide sequestration

§45U Zero-emission nuclear power production credit

§45V Credit for production of clean hydrogen

§45W Credit for qualified commercial clean vehicles

§45X Advanced manufacturing production credit

§45Y Clean electricity production credit

§45Z Clean fuel production credit

§48 Energy credit

§48C Advanced energy project credit

§48E Clean electricity investment credit



Guidance Still Needed...

How will credits be refunded?

- “The Secretary may require such information or registration as the Secretary deems necessary for purposes of preventing duplication, fraud, improper payments, or excessive payments under this section”
- Excessive payment penalty of 20%

What support will be required?

- Will the projects/costs/credits have to be certified by a third party?
- What forms or applications will need to be submitted?
- Will there be a “monitoring” period?





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