BROWNEDWARDS
certified public accountants

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Education and Not-for-Profit Update

Domicile Change-Is Relief from Exemption Reapplication Imminent?

Most organizations must apply to the IRS in order to be tax-exempt. A few are automatically exempt, the most notable of which are-

- churches and certain church-related organizations;
- an organization (other than a private foundation) normally having annual gross receipts of no more than $5,000; and
- subordinate organizations (other than a private foundations) covered by a group exemption letter.

In addition, a single member limited liability company formed by an exempt organization will be treated as part of the exempt organization and is not required to file for exempt status unless it elects to be treated as a separate association.

Current IRS Position

Exempt organizations sometimes move their legal domiciles from the state of original incorporation to another state by reincorporating in the second state. The IRS currently treats the reincorporation as creating a new legal entity, even when there is no change in the organization's original purposes. Consequently, unless an organization was automatically exempt from applying for tax-exempt status initially, it must normally reapply when it reincorporates in a different state.

The IRS relaxed this position somewhat in Ltr. Rul. 201446025 . In this ruling, the laws of both the original incorporation state and the reincorporation state provided that an exempt organization would be deemed the same entity that existed under the laws of the original incorporation state. Under this circumstance, a new exemption application was unnecessary

Relief on the Horizon?

The IRS's current 2016-2017 Priority Guidance Plan indicates that *https://www.**irs**.gov/pub/**irs**-tege/rr**67-390**.pdf* will be updated. However, there is no indication whether it will be liberalized in reincorporation situations other than those described in *https://www.**irs**.gov/pub/**irs**-wd/**201446025**.pdf*. In an ideal world, the IRS would ease the compliance burden on exempt organizations by providing that reincorporation will not require reapplication for exempt status as long as there is no change in the organization's purposes.

IRS Priority Guidance Plan

The 2016-2017 Priority Guidance Plan (the Plan) lists several exempt-organization projects that the IRS expects to accomplish during this fiscal year in addition to the update of Rev. Rul. 67-390 discussed previously. Three of these projects are discussed.

Reliance on Pub. 78

The IRS periodically updates its guidance on the extent grantors, contributors, and donors can rely on Pub. 78 or the Business Master File (BMF) extract for deducting charitable contributions and making charitable grants. Generally, grants and contributions will be allowed for donations to organizations listed in Pub. 78 or the BMF if made (1) on or before the date of a public announcement by the IRS that the organization is no longer qualified; or (2) on or before the revocation date was published if exempt status was lost because returns were not filed for three years.

The Plan envisions an update of IRS Rev. Proc. 2011-33 , which is currently the most recent update of the checklists.

Expense Allocation Methods

An asset or facility may be used for both exempt purposes and unrelated business activities. When there is such dual usage, the related expenses for facilities and personnel must be allocated between the two uses on a reasonable basis. The IRS intends to provide further guidance concerning expense allocation methods.

Excise Taxes-Donor Advised Funds

Certain transactions of donor advised funds (DAFs) can be subject to excise tax.

Prohibited Benefit. A distribution from a DAF that results in *more than an incidental benefit* to certain persons can trigger two taxes. First, a tax equal to 125% of the benefit amount is imposed on the person who advised that the distribution be made or who received the benefit. Second, a tax equal to 10% of the amount of the benefit is levied on any fund manager who agreed to the distribution knowing that it would result in a prohibited benefit.

Taxable Distribution. A tax equal to 20% of any taxable distribution from a DAF is imposed on the sponsor. A tax equal to 5% of any taxable distribution (up to a maximum of $10,000) is also imposed on any fund manager who agreed to a distribution knowing that it was a taxable distribution.

Further guidance will be provided with respect to the imposition of these excise taxes.

New Overtime Rules

The Fair Labor Standards Act (FLSA) is the federal wage and hour law that applies nationwide. On May 16, 2016, the U.S. Department of Labor (DOL) published its final rule updating overtime regulations pursuant to FLSA.

Basic Applications of FLSA to EOs

There are two ways an individual employee may be covered under FLSA: enterprise coverage and individual coverage.

An exempt organization (EO) is considered a covered enterprise if it engages in ordinary commercial activities that result in sales made or business done that meets a $500,000 coverage threshold. Income that an EO uses to further its charitable activities is not counted towards this $500,000 threshold. Consequently, many EOs are not covered enterprises under FLSA rules

Nevertheless, an EO that is not covered under the enterprise standard may have individual employees who are covered. An employee who engages in interstate commerce or in the production of goods for interstate commerce is potentially covered by FLSA and entitled to overtime pay for time worked over 40 hours per week. The definition of interstate commerce is broad. For example, an employee who solicits donations via telephone calls across state lines or receives or sends interstate mail is considered engaged in interstate commerce

Salary and Duties Tests

Even though an employee is potentially eligible for overtime compensation, he or she may be exempt from the overtime rules. Use the following process to determine if an employee is exempt.

- *Professions Exempt. If the employee is a teacher, doctor, lawyer, or person with essential religious duties, they are automatically exempt from these rules.*
- *Salary Test. If not automatically exempt under specific professions mentioned previously, ask if the employee is paid more than $913 per week ($47,476 per year). These amounts go in effect on December 1, 2016, and will be adjusted every three years. If no, they are nonexempt and eligible for overtime pay. If yes, take a look at the employee's duties to see if the employee may qualify for exemption because of the duties performed.*
- *Duties.If an employee is paid more than $913 a week ($47,476 a year), they must also meet a duties test to be exempt from these rules. Duties include executive (such as managing a department or the organization or directing the work of employees); administrative (such as office work related to the management of the organization or decision-making authority over significant matters); professional (such as work that requires an advanced degree or specialized training); computer professional; or sales professional. Note that these are some examples (not an exhaustive list).*
- *Highly Compensated. If the employee does not meet the duties test, a final test for potential exemption is salaried employees who are paid more than $134,004 per year (beginning December 1, 2016).*

Employer Alternatives

Employers have a range of options for responding to the updated standard salary level. For each affected employee newly entitled to overtime pay, employers may, for example:

- *increase the salary of an employee who meets the duties test to at least the new salary level to retain his or her exempt status;*
- *pay an overtime premium of one and a half times the regular rate of pay for any overtime hours worked; or*
- *reduce or eliminate overtime hours.*

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Tax Brief

NEW FORM 8976 FILED ONLINE.An organization that intends to be a Section 501(c)(4) organization must notify the IRS within 60 days of its formation as a legal entity. Notification is accomplished by electronically filing Form 8976 [Notice of Intent to Operate Under Section 501(c)(4)] and paying a $50 fee. A $20 per day penalty, up to a maximum of $5,000, will be assessed for late filing of Form 8976.

Organizations that filed Form 990 (or, if eligible, Form 990-EZ or Form 990-N) or a Form 1024 seeking a determination letter recognizing exemption under IRC Sec. 501(c)(4) before July 9, 2016, need not file Form 8976.

FASB Issues Long-awaited Standard Changing Nonprofit Financial Reporting

On August 18, 2016, the FASB issued Accounting Standards Update (ASU) 2016-14, *Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities*. The new standards are effective for annual financial statements issued for fiscal years beginning after December 15, 2017 (for example, years ending December 31, 2018, and years ending June 30, 2019), and for interim periods within fiscal years beginning after December 15, 2018. Early application of the amendments in the ASU is permitted.

The new standards, which result from Phase 1 of a two-phase project, make significant changes in five areas:

- Net asset classes.
- *Liquidity and availability of resources.*
- *Expense reporting.*
- *Statement of cash flows.*
- *Investment return.*

Net Asset Classes

The three classes of net assets used in financial statements of nonprofit organizations (unrestricted, temporarily restricted, and permanently restricted) will be replaced with two classes of net assets-*net assets with donor restrictions* and *net assets without donor restrictions*. Because the definition of donor-imposed restriction is essentially unchanged, the effect of the change is that temporarily restricted net assets and permanently restricted net assets are combined in the statement of financial position and the statement of activities to become the class *net assets with donor restrictions*. Unrestricted net assets are now referred to as *net assets without donor restrictions*.

The ASU adds the phrase *donors include other types of contributors, including makers of certain grants* to seven glossary definitions, including the definition of donor-imposed restriction. There is no explanation of which grants are the *certain grants* referred to in the change. However, since the added phrase refers to those grantors as contributors, and because the ASU doesn't change the implementation guidance for distinguishing contributions from exchange transactions (FASB ASC 958-605-55-3 through 55-8), the change could've been made merely in anticipation of another FASB project, *Revenue Recognition of Grants and Contracts by Not-for-Profit Entities*, and isn't intended to change practice at this time.

In conjunction with the changes in the net asset classes, there are new accounting and disclosure requirements for underwater endowment funds. (An *underwater endowment fund* is one in which the fair value of the endowment fund at the reporting date is less than either the original gift amount or the amount required to be maintained by the donor or law that extends donor restrictions.) Current standards require the deficit of a donor-restricted endowment fund to be included in unrestricted net assets. ASU 2016-14 requires the deficit of a donor-restricted endowment fund to be included in net assets with donor restrictions-the endowment balance is simply reduced. In other words, the endowment balance for a donor-restricted endowment fund is classified entirely within *net assets with donor restrictions*, and the endowment balance for a board-designated endowment fund is classified entirely within *net assets without donor restrictions* (unless the governing board designated resources that were purpose-restricted by the donor to serve as an endowment).

To help readers of the financial statements understand the effects on availability of resources caused by an underwater condition, ASU 2016-14 includes required disclosures of the governing board's interpretation of laws affecting the ability to spend from underwater endowment funds, the organization's policies for spending from underwater endowment funds, and any actions taken during the period concerning appropriation from underwater endowment funds. The new standards also will require disclosure of the aggregate fair value of the underwater funds and the aggregate of the original endowment gifts (or other level required to be maintained by donor stipulation or law), in addition to the currently required disclosure of the aggregate amount by which the funds are underwater.

Liquidity and Availability of Resources

Combining the two restricted net asset classes into a single class could make it more difficult for readers of the financial statements to assess the organization's liquidity and to determine the availability of restricted resources to fund expenditures. Therefore, the new standards add disclosures about liquidity and availability of resources.

An organization will be required to disclose qualitative and quantitative information about how the organization manages its liquid resources to meet cash needs for general expenditures within one year of the date of the statement of financial position.

ASU 2016-14 doesn't provide details as to the types of qualitative or quantitative information to include. However, there are two examples of notes that meet the requirements (Note G in FASB ASC 958-205-55-21 and Example 2 in FASB ASC 958-210-55). Those examples include qualitative disclosures about-

- *The organization's responsibility to maintain resources to meet donor restrictions, which makes those resources unavailable for general expenditures.*
- *The organization's goals for maintaining financial assets.*
- *The organization's policies for investing excess cash.*
- *The organization's policies for spending from board-designated quasi-endowment funds.*
- *Contractual agreements that make certain financial assets unavailable to fund general expenditures.*
- *Lines of credit that would be drawn down if the organization didn't have any liquid, available financial assets.*

One of the examples provides quantitative information in the form of a reconciliation, as of the financial statement date, of total financial assets to financial assets available to meet cash needs for general expenditures within one year. The reconciling items include amounts for financial assets that aren't available for general expenditures, which are financial assets restricted by donors (time or purpose restrictions), endowment assets subject to appropriation and satisfaction of donor restrictions, investment assets held in split -interest trusts, board-designated endowment funds, and financial assets held as a liquidity reserve.

The other example provides quantitative information in the form of a list of financial assets that are available to meet cash needs for general expenditures. A financial asset is available if it isn't affected by external limits imposed by donors, by laws, by contracts with others, or by internal limits imposed by governing board decisions. The nature of the asset itself may also cause a financial asset to be unavailable. For example, an alternative investment would be unavailable if a lock-up provision prevents the organization from selling it or a privately-held stock would be unavailable if there was no market for selling it.

Expense Reporting

ASU 2016-14 expands to all nonprofit organizations the requirement to present an analysis of expenses by functional and natural classifications. The information, currently required only of voluntary health and welfare entities, must be provided in one location on the face of the statement of activities, as a schedule in the notes to the financial statements, or in a separate financial statement. The analysis must disaggregate the functional expense classifications (such as major classes of program services and supporting activities) by their natural expense classifications (such as salaries, rent, electricity, interest expense, supplies, depreciation, awards and grants to others, and professional fees). Although the term *matrix* isn't included in the standards, a matrix format is the only method illustrated in the ASU of providing the information.

In addition, organizations must describe the method(s) used to allocate costs among program and support functions. The new standards provide guidance (in the form of examples) on activities that constitute direct conduct or supervision of program activities (and thus are program expenses rather than management and general expenses). There are examples for the costs related to the chief executive officer, the chief financial officer, the human resource department, and for grant accounting and reporting.

Statement of Cash Flows

The new standards continue to permit an organization to choose whether to provide a statement of cash flows using the direct or indirect method of reporting operating cash flows. However, to encourage greater use of the direct method, a presentation of the reconciliation from change in net assets to operating cash flows is no longer required when using the direct method. There are no changes to the classification of operating, investing, and financing cash flows.

Investment Return

The new standards require that investment expenses be netted against investment return on the statement of activities and eliminate the requirement to disclose investment expenses that have been netted. That change was made to provide a more comparable measure of investment return across all nonprofit organizations, regardless of whether the investment activities are managed internally or by outside investment managers, volunteers, or some combination. The new measure is also more comparable across organizations that invest in mutual funds, hedge funds, or other vehicles for which the management fees are embedded in the investment return of the vehicle. Because the disclosure of the netted expenses is eliminated, the difficulties and related costs in identifying embedded fees are eliminated, and the resultant inconsistencies in the reported amounts of investment expenses are avoided.

Investment expenses that are netted against investment return shouldn't be included in the analysis of expenses by functional and natural classifications.

Other Changes

In addition, nonprofit organizations will now be required to-

- Use the placed-in-service approach to report expirations of restrictions on gifts of cash or other assets to be used to acquire or construct a long-lived asset (in the absence of specific donor restrictions stating otherwise).
- Disclose, as of the end of the reporting period, the amounts and purposes of governing board designations, appropriations, and similar actions that result in self-imposed limits on the use of resources that are free of donor-imposed restrictions.

Future Changes to the Financial Reporting Model

Phase 2 of the financial reporting model project will involve reconsideration of other changes proposed in the April 2015 exposure draft. The changes deferred to Phase 2 were expected to require more time to resolve, either because they involve consideration of alternatives suggested by stakeholders that weren't previously considered by FASB or because they are related to similar issues being addressed in other FASB projects. Among the changes expected to be addressed in Phase 2 are the following:

- *Whether one or more intermediate measures of operations should be required, and, if so, whether business-oriented health care organizations would continue to provide the currently defined performance indicator.*
- *How to define any required operating measure, and which items would be excluded or included in the measure.*
- *Whether and how to align line items included in a required operating measure (presented in the statement of activities) with line items included within operating cash flows (presented in the statement of cash flows).*
- *Whether using a disaggregation and classification approach in the statement of activities other than an operating/nonoperating classification would be more useful to readers of financial statements, and, if so, whether that approach would be an addition to or an alternative to an operating/nonoperating classification.*
- *Whether business-oriented health care organizations should provide segment information (similar to for-profit* hospitals) instead of the required analysis of expenses by their natural and functional classifications.

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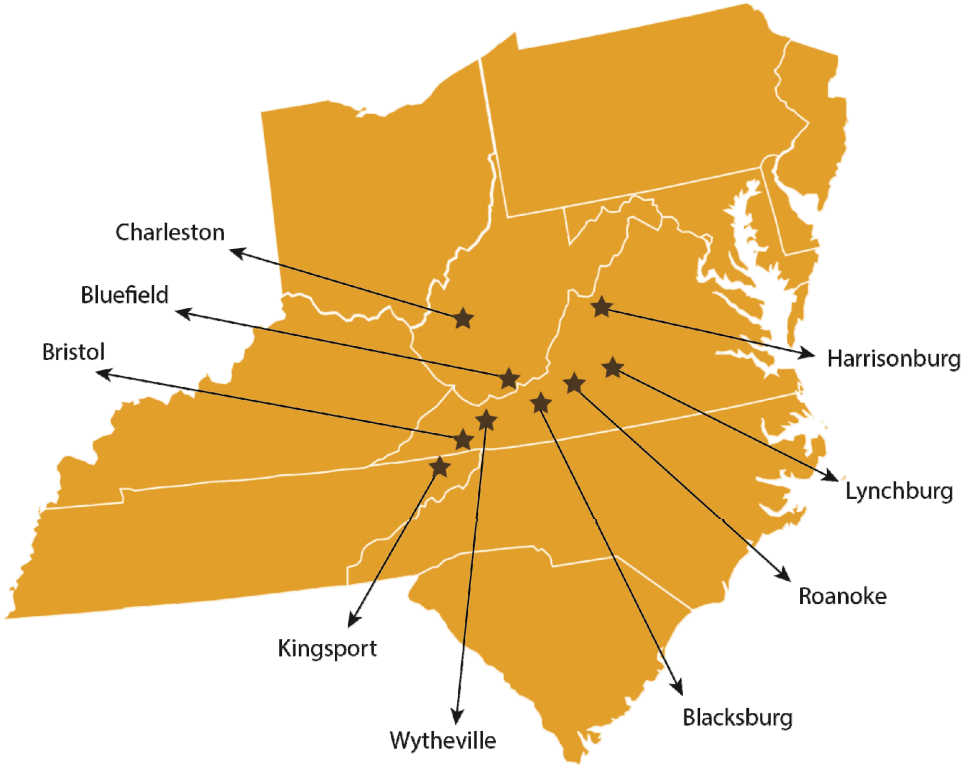
presented by the

Brown Edwards Education & Not-for-Profit Service Team



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