



Education and Not-for-Profit Update

ASU 2016-15 Clarifies Classifications of Certain Cash Flows

In August 2016, the FASB issued ASU 2016-15, *Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments*, to address some questions about the presentation and classification of certain cash receipts and payments in the statement of cash flows. These classification issues had arisen because there was either unclear or no applicable guidance for such cash flows in FASB ASC Topic 230, *Statement of Cash Flows*. Although the issues addressed by this ASU are narrow, we'll discuss the ones that are most likely to be applicable to nonprofit organizations in this article.

Debt Extinguishment or Debt Prepayment Costs

ASU 2016-15 amends FASB ASC 230 to specifically list debt prepayment and debt extinguishment costs as cash outflows for financing activities. These costs include third-party costs, premiums, and other fees paid to lenders that are directly related to the settlement of the debt (excluding the payment of accrued interest).

Insurance Proceeds

ASU 2016-15 states that the classification of cash received from the settlement of an insurance claim is dependent on the nature of the loss. For example, insurance proceeds relating to the loss of equipment would be classified as a cash inflow from investing activities.

The new guidance also clarifies that proceeds received on the settlement of a life insurance policy owned by the organization are to be classified as cash inflows from *investing* activities. Cash payments for premiums on such policies, however, may be classified as outflows for investing activities, operating activities, or a combination of both.

Distributions from Equity Method Investees

If an organization has equity method investees, ASU 2016-15 requires the organization to make an accounting policy election regarding the classification of distributions from those investees in the cash flow statement. The accounting methods are as follows:

- *The nature of distribution approach.* Under this approach, distributions are classified based on the nature of the activity or activities that created the distribution. Distributions that are a return on investment are classified as cash inflows from *operating* activities. Distributions that are a return of investment are classified as inflows from *investing* activities. (Additional guidance is provided for when this accounting policy has been elected and in later periods the information needed to apply this approach is not provided by the investee.)
- *The cumulative earnings approach.* This approach generally treats distributions as returns on investment that are classified as cash inflows from *operating* activities. However, if the cumulative distributions received, less distributions received in prior periods that were treated as returns of investment, exceed the cumulative equity in earnings that have been recognized by the investor, the current-period distribution up to this excess is treated as a return of investment and reported as a cash inflow from *investing* activities.



Contingent Consideration Payments after a Business Combination

A liability for contingent consideration sometimes needs to be established when a nonprofit organization acquires another entity. ASU 2016-15 states that when cash payments to settle a contingent consideration liability are made soon after the acquisition date, they are to be classified as cash flows from *investing* activities. However, when cash is paid to settle a contingent consideration liability and it is not soon after the acquisition date, the payment should be classified as a cash outflow for *financing* activities-but only up to the amount of the contingent consideration liability that was recognized as part of the acquisition. Any excess payments over that amount should be classified as cash outflows for *operating* activities.

Settlement of Zero-coupon Debt or Other Debt Instruments with Insignificant Rates

The new ASU states that when zero-coupon debt instruments or other debt instruments with coupon rates that are insignificant in relation to the effective interest rate are settled, only the cash paid on the principal of the debt is to be classified as a cash outflow for *financing* activities. The part of the cash payment for accreted interest attributable to the debt discount should be reported as a cash outflow for *operating* activities. (This operating cash outflow related to accreted interest should be included in the disclosure of the amount of cash paid for interest that is required if the indirect method of presenting operating cash flows is used.)

Separately Identifiable Cash Flows

The ASU also provides expanded guidance for classifying cash receipts and payments that have aspects of more than one class of cash flows. If there is no specific guidance in Topic 230 for classifying the particular cash flow item, each separately identifiable source or use within the cash receipt or payment needs to be identified based on the nature of the underlying cash flows and classified accordingly. If the cash flows have aspects of more than one class and cannot be separated by source or use, they should be classified based on the activity that is likely to be the predominant source or use of cash flows.

Practical Consideration: For nonprofit organizations, ASU 2016-15 is effective for fiscal years beginning after December 15, 2018, with early adoption permitted. The ASU must be applied using a retrospective transition method to each period presented. The ASU may be obtained on the FASB website at www.fasb.org.

2016 Data Collection Form for Uniform Guidance Single Audits

The Federal Audit Clearinghouse (FAC) recently released a new Form SF-SAC or Data Collection Form (DCF) for use in submission of audit packages for audits of fiscal years beginning on or after December 26, 2014, which must be performed in accordance with the Uniform Guidance. The FAC will only accept electronic submissions of the reporting package, and the audit and package must be submitted using the FAC's Internet Data Entry System (IDES). The new form is available on the FAC's website at <https://harvester.census.gov/facweb/>. The previous form must be used for audits performed under OMB Circular A-133.

Part II Changes

Part II, "Federal Awards," will now be completed by the auditee and includes a listing of the federal awards expended during the year. Changes to this information include-

- *Addition of a column (f) for identification of the award cluster name.*
- *Removal of the Recovery Act column.*
- *Separation of the column on Loan/Loan Guarantees into two columns with the end of period outstanding loan balance being required for loan programs identified in Part II, Item 1(i).*
- *Addition of three new columns (m, n, and o) related to pass-through awards.*

Part III Changes

Part III, "Information from the Schedule of Findings and Questioned Costs," is completed by the auditor and now includes information on-

- *Major program information and audit findings. Item 1 of Part III is shown as a continuation on the right side of the same schedule as Part II, "Federal Awards" (which is completed by the auditee).*
- *Financial statement information. The auditor provides information on the type of auditor's report issued on the financial statements and whether the financial statements were prepared in accordance with GAAP or a special purpose framework. Additional information is required if a special purpose framework was used to prepare the financial statements.*
- *Whether a going concern emphasis-of-matter paragraph was included in the auditor's report.*
- *Whether significant deficiencies, material weaknesses, or material noncompliance was identified during the audit.*

Item 3 on Federal Programs has only minor changes to it to reflect the revised dollar threshold for single audits of \$750,000 and some minor wording changes. Additionally, Item 4 of Part III contains information on the Federal Award Audit Findings. Columns a-d are automatically populated from Part II, Item 1 (completed by the auditee). If there are no audit findings reported in Part III, Item 1c, the page will not be used.

For those with audit findings, there are two new questions (m and n) on repeat audit findings from the prior year. If the finding is a repeat finding from the prior year, it should be identified in these columns with its finding reference number from the prior year.

Certifications

The date the auditor certifies the auditor's statement indicates the completion date of the form as it relates to the auditor. The auditor certifies-

The data elements and information in the DCF are limited to those prescribed by the Uniform Guidance.

- The information in Part II of the form is the responsibility of the auditee and based on information in the reporting package required by the Uniform Guidance.
- The information in Part III, except for Part III, Item 2(a)(iii), Item 3(d), and Items 4(a)-(d), if applicable, was transferred by the auditor from the auditor's reports for the reporting period and is not a substitute for such reports.
- The auditor has not performed any auditing procedures since the date of the auditor's report(s) or any additional auditing procedures in connection with the completion of the DCF.
- A copy of the complete reporting package is required by the Uniform Guidance to be made available by the FAC on their website.
- A copy of the complete reporting package is also available from the auditee and the address provided on the form.

The auditee certification now includes language about ensuring the data collection form and reporting package do not include any protected personally identifiable information or business identifiable information. Additional auditee certifications have been added to certify compliance with the requirements of the Uniform Guidance, the accuracy and completeness of the information, as well as the authorization to make the form and reporting package publicly available on a website.

Accounting and Auditing Briefs

SSARS 22 ISSUED. The AICPA has completed its project to clarify the compilation and review standards by issuing SSARS 22, Compilation of Pro Forma Financial Information. SSARS 22 clarifies and supersedes SSARS 14 of the same title and is effective for compilation reports on pro forma financial information dated on or after May 1, 2017. It will be codified in AR-C 120.

Advertising revenue is unrelated business income (UBI) unless the advertising activities are structured to fit within one of the exemptions from UBI. There are four primary opportunities to insulate advertising income from UBI taxation.

Limiting Advertising Activities

Advertising revenue isn't considered UBI if the revenue-producing activity is not regularly carried on. When the advertising is not tied to a specific fundraising event (e.g., the advertising is in an annual yearbook or membership directory), the *regularly carried on* test is based on the duration of the advertising activities. Consequently, an organization should try to engage in selling activities in the shortest feasible time span.

When the advertising is in a publication related to a specific event, the regularly carried on test becomes more difficult to apply. The Tax Court ruled that the test should be based solely on the duration of the event rather than the period over which the advertising activities occur. The courts later ruled that selling advertising is a separate business, but that the actual *selling* only occurred when the programs were sold to spectators. Soliciting and preparing were a pretense to the actual selling. The length of the specific event was the relevant time frame to determine whether the activity was regularly carried on [NCAA].

Volunteers Needed

Advertising revenue is not UBI if substantially all of the advertising work is performed by volunteers. Although the phrase *substantially all* is not defined in the UBI context of volunteer labor, other areas of exempt organization law use a guideline of 85% of the work, as measured by the number of hours worked. The 85% amount may be tightly interpreted by the courts. For example, the 5th Circuit held that the volunteer labor exception to UBI wasn't available where 21% of the work performed was compensated.

An organization that intends to rely on the volunteer labor exception should make sure that its volunteers carefully substantiate all time spent. Substantiation is wise in case the IRS is tempted to assert that hours of advertising activities other than selling (e.g., preparing the ad copy for publication) must also be counted.

Exempt Purpose Relationship

Advertising is not UBI if the advertising activity is substantially related to the organization's exempt purpose. For example, the advertising function in a student-run newspaper was held to be a substantially related activity because it provided training for the students (TAM 199914035).

Royalty Income

Royalty income is generally not UBI. An exempt organization (EO) may attempt to avoid taxable advertising income, for example, by outsourcing the production of its publication to an unrelated publisher in exchange for a royalty from the publisher based upon advertising revenue. However, this strategy will fail if the EO is an active participant in publication activities or retains editorial control over the publisher. The contract should separately charge for (1) services to be rendered and (2) royalties for the use of the EO's intangible assets (e.g., name, logo, and mailing list).

Unfortunately, this strategy will not work in the 8th Circuit. In that circuit, the Court has, in effect, held that an EO cannot convert advertising income into royalty income regardless of the level of participation in publication activities. The Court's rationale was that a royalty exists only if the publisher uses an intangible asset of the EO to promote the publisher's product or services. If the publisher uses the EO's intangible assets to promote the publication, the income is *not a royalty in the Court's view*.

Practical Consideration: Tax exempt organizations can use the exemptions from UBI to structure advertising activities to minimize the tax on UBI or to avoid it entirely.

Sponsorship Income Can Generate UBI

Sponsorship arrangements between business entities and exempt organizations (EOs) provide a major revenue source for EOs. If certain guidelines are observed in structuring the sponsorship contract, the resulting income will not be unrelated business income (UBI).

Qualified Sponsorship Payment

A payment (in money, property, or services) by a business entity (i.e., the sponsor) to an EO will not be UBI, provided it is a *qualified sponsorship payment* (QSP). The only requirement that a QSP must satisfy is that there be no arrangement or expectation that the sponsor will receive any *substantial return benefit* (SRB) from the EO. It is immaterial whether the sponsored activity is related or unrelated to the EO's exempt purpose.

Benefit Categories

There are four categories of benefits that, if provided by the EO to the sponsor or persons designated by the sponsor, can violate the SRB prohibition. These are-

- *advertising that benefits the sponsor;*
- *an exclusive provider arrangement;*
- *providing facilities, services, or other privileges beyond a de minimis amount; and*
- *granting the right to use an intangible asset of the EO (e.g., a trademark, patent, or logo).*

Certain limited forms of recognition of a sponsor by an EO are not considered an SRB and are allowed. For example, the EO can use or acknowledge the sponsor's name, logo, or product lines. Additionally, in acknowledging the sponsor's support, the EO can mention the sponsor's business location(s), telephone number, internet address, slogans, and value-neutral descriptions of the sponsor's goods or services. The sponsor's products can even be displayed or distributed to the general public at the sponsored activity without disqualifying a payment as a QSP.

The EO should seek to make its obligation to provide any substantial benefit to the sponsor the subject of a contract separate from a contract that results in a QSP.

Advertising Exposure

Sponsor recognition that promotes (i.e., advertises) the sponsor's products, facilities, or services is an SRB that prevents all or a portion of a payment from being a QSP. Only the portion that exceeds the FMV of the advertising is a QSP. *Advertising* is any sponsor recognition or message that contains qualitative or comparative language (e.g., sponsor's product is better than competitor "X's" product); price information (or other indications of savings or value); an endorsement; or an inducement to purchase, sell, or use the sponsor's products or services. Logos or slogans that are an established part of a sponsor's identity are not considered to contain qualitative or comparative descriptions. A single message containing both advertising and an acknowledgment is advertising.

In addition, certain sponsor recognition will prevent a payment from being a QSP even though it does not contain qualitative or comparative language. Any payment that entitles the payor to have its name, logo, or product lines used in the organization's periodical is not a QSP. A *periodical* is defined as regularly scheduled and printed material that is not related to and primarily distributed in connection with a specific event conducted by the EO. Printed material includes electronically published material. An acknowledgment in a periodical that is *required* as a condition of the sponsorship payment causes it to be advertising income. The taxability of such payments is determined under the general UBI rules other than the sponsorship rules. If such acknowledgment is voluntary, it is not clear whether the QSP rules apply.

Certain other payments are also excluded from the definition of QSP. For example, any payment that is contingent, contractually or otherwise, upon the amount of public exposure received by the sponsor (e.g., the level of attendance at the EO's event) is not a QSP. However, a payment can be contingent upon whether an event actually occurs.

Exclusive Provider Contracts

Exclusive provider contracts currently generate substantial revenue for many EOs, especially colleges and universities. They are typically structured as follows: Company (C) agrees to pay School (S) a stipulated dollar amount if S agrees to permit only the sale of C's products on campus and at S sporting events. S is not obligated to provide any services or publicity for C to earn the contract payments-it merely agrees to keep the products of C's competitors off campus. An arrangement limiting the sale, distribution, availability, or use of competing products, services, or facilities in connection with a sponsored activity generally results in a SRB and the income received is not a QSP.

Occasionally, the nature of the goods or services to be provided necessitates the use of only one provider because of limited space or because a competitive bidding process requires that only the lowest bid be accepted. As long as there is not an agreement to limit the distribution of competing goods or services, a contract will not be deemed an exclusive provider contract.

An exclusive provider contract payment is not automatically UBI-it simply is not a QSP. All other exemptions from UBI are available. Specifically, such revenue is not taxable where the EO's actions required by the contract are not considered the conduct of a trade or business (e.g., when the EO has little or no responsibility to perform services or otherwise assist the exclusive service provider). However, if the EO agrees to perform substantial services in connection with the exclusive provider agreement, the income received is likely to be UBI. Examples of services include promotional appearances by the EO's personnel, assisting the payor in developing marketing plans, and participating in joint promotional opportunities. The acknowledgment of a payor as the exclusive sponsor is not considered a service and is generally permissible.

Limited Benefits

The *de minimis* exception allows the EO to provide a sponsor with goods or services that have an aggregate fair market value (FMV) of not more than 2% of the sponsor's payment. However, if the FMV of the benefits flowing from the EO to the sponsor exceeds the permissible limit, the *entire* FMV (not merely the excess amount) is a SRB that potentially causes the sponsorship payment to be UBI in an amount equal to the FMV of the benefits.

Other Exclusions from UBI

Even when a sponsorship payment does not qualify as a QSP, the income is not UBI unless it is produced in an unrelated business activity. To be considered an unrelated business activity, the activity must be both unrelated to the exempt function of the organization and regularly carried on for the production of income. Additionally, sponsorship income from an unrelated business activity is not UBI if it fits within one of several exceptions or exclusions, such as the volunteer labor exception discussed in the preceding article.

Practical Consideration: Determining the UBI consequences of sponsor arrangements can be both subtle and complex. Consequently, it is prudent that the EO's tax counsel review such contracts before execution

TAX BRIEF

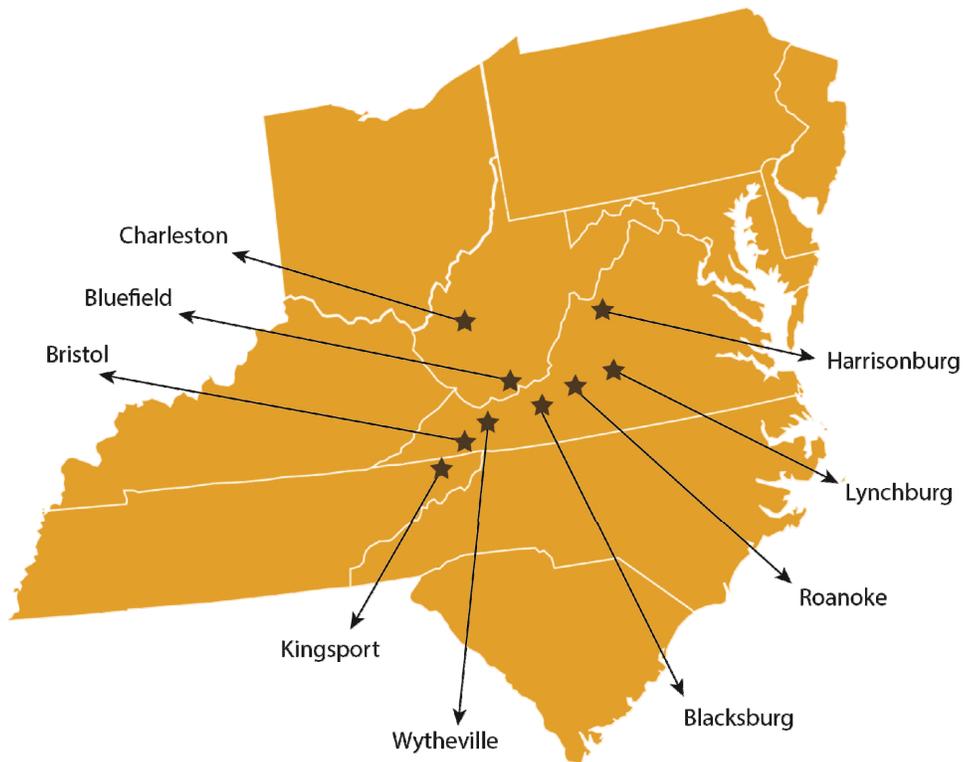
PRIVATE BENEFIT IN IRS CROSSHAIRS.The IRS has stated that it plans to emphasize inurement and private benefit issues in the coming year, especially where private foundations are involved. The cornerstone of this focus will be the use of statistical sampling to assess overall compliance and to aid in selecting returns for audit.



Education and Not-for-Profit Update

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