

# NONPROFIT STANDARD

THE NEWSLETTER OF THE BDO INSTITUTE FOR NONPROFIT EXCELLENCE<sup>SM</sup>



## FASB ISSUES ASU 2016-14, PRESENTATION OF FINANCIAL STATEMENTS OF NOT-FOR-PROFIT ENTITIES

By Lee Klumpp, CPA, CGMA and Tammy Ricciardella, CPA

The Financial Accounting Standards Board (FASB) released the Accounting Standards Update (ASU) 2016-14, *Not-for-Profit Entities* (Topic 958): *Presentation of Financial Statements of Not-for-Profit Entities* on Aug. 18, and you can read the full ASU [here](#).

The standard aims to improve presentation of financial information, ultimately making not-for-profit financial reporting statements more informative, transparent and useful to donors, grantors and other users. This is the first major change to the nonprofit financial statement model in over 20 years.

ASU 2016-14 impacts all not-for-profit entities in the scope of Accounting Standards Codification (ASC) Topic 958. The ASU addresses the following key qualitative and quantitative matters:

- ▶ Net asset classes
- ▶ Investment return
- ▶ Expenses
- ▶ Liquidity and availability of resources
- ▶ Presentation of operating cash flows

In addition, the ASU includes illustrative financial statements for not-for-profit entities, which reflect changes made by the new standard.

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**FASB****Net asset classes:**

The effects of the ASU on net asset classes are as follows:

- ▶ The current presentation of three classes of net assets (unrestricted, temporarily restricted and permanently restricted) is replaced with two classes of net assets—net assets with donor restrictions and net assets without donor restrictions. The totals of these two required net asset categories must be reported in the balance sheet and the changes in these two net asset categories must be presented in the statement of activities. However, this is a minimum presentation requirement. An entity may choose to disaggregate within these two net asset categories.
- ▶ The current requirement to provide information about the nature and amounts of different types of donor-imposed restrictions is retained and includes the need to highlight how these restrictions affect the use of the resources and their impact on liquidity.
- ▶ Changes the net asset classification of underwater amounts of donor-restricted endowment funds to net assets with donor restrictions and requires additional disclosures related to these underwater endowment funds.
- ▶ Eliminates the over-time approach for the expiration of restrictions on capital gifts and requires the use of the placed-in-service approach in the absence of donor explicit stipulations otherwise.

**Investment return:**

The ASU requires the following items with regard to investment return (relates to total return investing and not programmatic investing):

- ▶ Investment return should be presented in the statement of activities net of all related external and direct internal expenses. The ASU provides definitions and examples of what qualifies for direct internal expenses to assist entities with this presentation.
- ▶ The current requirement to disclose the netted investment expenses has been eliminated.

**Expenses:**

- ▶ All nonprofit organizations currently must present expenses by function. The ASU introduces a requirement to present expenses by nature and function, as well as an analysis of these expenses in one location by both nature and function. The intent is to provide additional information to the users of the financial statements regarding how the nonprofit uses its resources. This analysis can be presented in the face of the statement of activities, as a separate statement (not a supplemental statement) or in the notes to the financial statements.
- ▶ This analysis should be supplemented with enhanced disclosures about the allocation methods used to allocate costs among the functions.

**Liquidity and availability of resources:**

To improve the ability of financial statement users to assess a nonprofit entity's available financial resources and the methods by which it manages liquidity and liquidity risk, the ASU contains specific disclosures including:

- ▶ Qualitative information that communicates how a nonprofit entity manages its liquid available resources to meet cash needs for general expenditures within one year of the balance sheet date.
- ▶ Quantitative information that communicates the availability of a nonprofit's financial assets to meet cash needs for general expenditures within one year of the balance sheet date. Items that should be taken into consideration in this analysis are whether the availability of a financial asset is affected by its nature, external limits imposed by grantors, donors, laws and contracts with others, and internal limits imposed by governing board decisions.

**Presentation of Operating Cash Flows:**

The ASU maintains the option for nonprofit organizations to present their statement of cash flows on either the direct or indirect method of reporting. If an organization chooses to use the direct method, the reconciliation of changes in net assets to cash provided by (used in) operating activities is no longer required.

**Effective Date of ASU:**

The amendments in ASU 2016-14 are effective for annual financial statements issued for fiscal years beginning after Dec. 15, 2017 (2018 for calendar year ends and 2019 for fiscal year ends), and for interim periods within fiscal years beginning after Dec. 15, 2018. Application to interim financial statements is permitted but not required in the initial year of application. The amendments in this ASU can be adopted early. Entities presenting comparative financial statements must apply the amendments retrospectively; however, the following optional practical expedients are available for periods presented prior to adoption. For prior periods presented organizations can opt not to include:

- ▶ The analysis of expenses by nature and function and/or,
- ▶ Disclosures related to liquidity and availability of resources.

**Actions to Take Now:**

- ▶ Read through the ASU and watch for further alerts from BDO with more details related to the implementation of this ASU.
- ▶ Discuss the new ASU with your audit committee, board members and external auditors to prepare for the changes introduced.
- ▶ Refer to BDO's [Nonprofit Standard Blog](#) and [Nonprofit Financial Reporting Resource Center](#) for further information.

**ON THE HORIZON**

This ASU completes the first phase of the FASB's project to improve the financial reporting of not-for-profit entities. As we have discussed in earlier newsletters, the FASB determined that a second phase would consider other potential changes that are likely to require more time to resolve, including potentially reconsidering intermediate operating measures and certain other enhancements. For more information see BDO's [Nonprofit Financial Reporting Resource Center](#).



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# TELEMEDICINE AND POTENTIAL TAX IMPLICATIONS FOR TAX-EXEMPT PROVIDERS

By Sandra Feinsmith, CPA, and Laura Kalick, JD, LL.M. in Taxation



**It is hard to believe that telemedicine has been a clinical reality for almost 60 years, if you count from the literally space-age technologies NASA developed to monitor astronauts' health in the 1960s.**

Physician/technician collaboration expanded in following years with programs like NASA's Space Technology Applied to Rural Papago Advanced Healthcare (STARPACH) program, which linked paramedical professionals on the remote Papago Indian Reservation with doctors in Phoenix and Tucson via two-way microwave audio and video link. And in 1999, telemedicine pioneer Medical Missions for Children was founded, an entity that now serves children in remote areas in over 100 countries.

Now telemedicine has both expanded in availability and contracted to a more local level, becoming an important part of many hospitals, home health agencies,

private physician practices, as well as our homes. In 2015, according to the American Telemedicine Association, more than 15 million Americans received some type of remote medical care via technologies such as remote monitoring, video conferencing with physicians and smart phone chronic disease management apps.

It may be even harder to believe, then, that in those 60 years, the Internal Revenue Service (IRS) hasn't yet settled on a way to tax telemedicine—a lingering question that exposes the providers exploring it to potential audit and accounting risks.

## **A CLEAR BENEFIT TO CARE AND COSTS... WITH LESS-THAN-CLEAR TAX IMPLICATIONS**

Telemedicine has become an increasingly relevant business driver because its benefits complement the demands of an era of digital advances, increased consumerism by patients and pressure to reduce overall healthcare

costs. It can reduce wait time, travel time and stress levels for patients; facilitate lower-cost preventive care and chronic care management; and allow specialty services to be more broadly distributed to new patients by (virtually) bringing specialists to remote and rural areas.

Yet the potential tax implications from both the federal and states' perspectives are unclear, particularly as they relate to unrelated business income (UBI).

The IRS defines UBI as income from a trade or business that is regularly carried on by a tax-exempt organization and that is not substantially related to the organization's exempt purpose.

To date, the IRS has not issued any guidance or rulings regarding telemedicine UBI, specifically. For now, tax-exempt healthcare organizations participating in telemedicine are subject to the IRS rules and principles that apply more broadly to UBI and healthcare activities—some of which, frankly, don't



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neatly fit, and some of which require careful documentation to avoid triggering UBI status.

Traditionally, the IRS has focused on whether an individual is receiving a healthcare service or an ancillary service. Healthcare services to individuals are considered substantially related to a hospital's exempt purposes. On the other hand, if the service is an ancillary service, such as diagnostic lab testing or the provision of pharmaceuticals, then the income is excluded only if the person is a patient of the hospital, and then this is based upon an exception to UBIT for the convenience of the hospital's patients. There are also exceptions for casual sales or services to small hospitals at or below costs.

### WHAT MAKES A PATIENT... A PATIENT?

Interestingly, most of the tax uncertainty of UBI comes not from the definition of "telemedicine" but from the formal definition of "patient." IRS Revenue Ruling 68-376 defines a patient as:

- ▶ A person admitted to a hospital as an inpatient
- ▶ A person receiving emergency or preventive health services from outpatient facilities of a hospital
- ▶ A person referred to a hospital's outpatient diagnostic facilities for a

specific diagnostic procedure. The procedure is administered by a hospital-based practitioner affiliated with the hospital.

- ▶ A person refilling a prescription written while in the course of treatment at the hospital
- ▶ A person receiving medical care in a hospital affiliate
- ▶ A person receiving care in his home where the services are rendered by, and under the supervision of, the professional staff of the hospital as an extension of its inpatient and outpatient care

In this current definition, the operative theme appears to be either that the person is or has been physically in the hospital or an affiliate, or that the person is receiving care or treatment by a hospital professional. Therefore, the question becomes whether the person receiving remote care delivered by a hospital physician or hospital professional becomes a patient of the hospital or, more significantly, is the service being provided considered substantially related to the hospital's healthcare mission.

In telemedicine, of course, the entire point is often to deliver care outside the traditional setting.

Given the uncertainty, tax-exempt healthcare organizations must be diligent in

documenting how the care provided meets the organization's exempt purpose by:

- ▶ Maintaining detailed medical records
- ▶ Showing how the organization is serving the needs of the community
- ▶ Documenting any direct interaction between physicians and the patient, or
- ▶ Written treatment consent (provided or secured or authorized)

Another piece of evidence may be whether the malpractice insurance covers the activity.

Further, state-level definitive tax guidance has not been issued in this area. Currently, as the federal government is doing, states are following traditional rules in regards to UBI. From most states' perspective, if any of the telemedicine activity generates UBI and crosses state lines, the income may require apportionment among the states based on activity in the respective states and the hospital may have to file a tax return in that state. The organization needs to address where the sale of the personal services occurs, where the patient is located and where the services are being performed. Some states look to where the cost of performance are incurred, and other states look to where the time is spent performing the services in determining if there is nexus and requirements to report items in those states. While the provision of a cyber space consultation may be considered related to exempt purposes, questions could arise as to whether the sale of pharmaceuticals to the out-of-state patient creates UBI and also, whether the sale is subject to sales tax.

As the traditional patient and nonpatient criteria for determining UBI is dated, so both the IRS and the states need to re-examine the definitions of a patient as well as the definition of providing healthcare services.

*This article first appeared in "Becker's Health IT & CIO Review." Reprinted with permission.*



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# LAWSUITS TARGET HIGHER EDUCATION: WHAT RETIREMENT PLAN SPONSORS NEED TO KNOW

By Beth Garner, CPA



## Retirement plan excessive fee litigation surrounding 403(b) plans was a hot topic in the employee benefit plan world this past week.

Several universities that sponsor 403(b) plans were added to excessive fee litigation filed by the law firm of Schlichter, Bogard & Denton, bringing the total to eight universities having to defend their decisions for their retirement plans. These suits are the first of their kind in the 403(b) plan industry, while these lawsuits have been occurring for the past decade for 401(k) plans.

Some of the shortcomings of the plan sponsor's duties based on the litigation include:

1. Improper investment selections,
2. Too many service providers,
3. Too many investment choices, and
4. Plan sponsors not using their plan size as a bargaining chip to reduce costs.

The recent uptick in litigation makes it clear that retirement plans in higher education will be under increased, unprecedented scrutiny. What can you do as the plan sponsor of a benefit plan, whether that plan is a 403(b) or a 401(k)?

Those charged with governance for an employee benefit plan have a fiduciary

responsibility to act solely in the interest of participants and beneficiaries of the plan. Although there is no rule on the proper number of investment options that should be available for a plan, the plan sponsor is responsible for selecting and monitoring the investment alternatives that are made available under the plan. This responsibility also includes ensuring that the plan pays only reasonable administrative fees, which may be made up of fees relating to investments within the plan. Additionally, those charged with governance should understand how fees are paid and monitor those fees and expenses.

Is your head hurting yet? If you are considered one of the professionals charged with governance, how do you go about making sure your plan is making the best decisions?

An employee benefit plan should have an investment policy statement (IPS). The IPS should outline the process in which plan investments are selected, monitored and terminated. Monitoring of plan investments would include benchmarking the fees associated with the investments and assessing the reasonableness of those fees. Once again, there is no rule on the benchmarking of fees; however, it is best practice to assess and review plan fees annually or at least every two years.

The Department of Labor (DOL) has noted that even a small increase in plan fees paid from plan assets can, over time, significantly eat away at the ultimate account balance. When assessing whether the fees are "reasonable," consider that you're ultimately answering to the DOL and the participants. One of the best ways to demonstrate that you're a prudent fiduciary is to document. Having meeting minutes, copies of documents analyzed and other documentation can demonstrate how you've complied with these regulations and carried out your fiduciary duties. The DOL realizes the amount of complexity involved with being a plan fiduciary and has formulated well-documented responsibilities on its [website](#) as a resource.

Many plan sponsors have decided to hire an investment advisor to help those charged with governance. Dealing with investment selections, fee analysis, share class and continued monitoring has proven to be too much for some plan sponsors. Investment advisors can help those charged with governance.

For additional information on best practices for your plan, picking advisors, benchmarking strategies and regulatory oversight, take a look at BDO's four-part Web-Ex series: BDO's Fiduciary Gridiron Series.

Access the full series here:

[Part One: Selecting Your Retirement Plan Team](#)

[Part Two: Kicking Off the Season](#)

[Part Three: Push for the Playoffs](#)

[Part Four: On the Road to the Championship](#)

Article reprinted from the BDO Nonprofit Standard blog.



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# INTERNATIONAL GRANTMAKING ISSUES FOR NONPROFITS

By Jeffrey Schragg, J.D., CPA



**International risks for nonprofits took center stage in recent headlines, and as organizations increasingly expand beyond domestic borders, it's clear the conduct of foreign employees can have a real impact on an organization's ability to carry out its mission and maintain its reputation.**

Does your organization face international compliance issues? The answer may surprise you, as there are many activities common to the nonprofit sector that are subject to international taxes and regulations—even some that are conducted from within the United States.

Does your organization:

- ▶ Invest abroad by awarding international grants?
- ▶ Employ foreign nationals in their home countries or in the United States?
- ▶ Conduct operations in a foreign country?

If so, it is important to consider a variety of tax issues that may impact your organization's bottom line.

While organizations of all types face international risk, certain organizational structures may encounter specific sets of challenges with regard to international grantmaking:

## PRIVATE FOUNDATIONS

Foundations are required to evaluate grant recipients and determine whether they qualify as the equivalent of a U.S. public charity. Equivalency determination is the most common process used to perform this initial due diligence. Revenue Procedure 92-94 outlines the information that foundations must collect about the grantee's operations and finances. The grantmaker should have a process to collect the information necessary to determine equivalency and can use a qualified tax practitioner to perform the determination.

In some cases, foundations may choose to perform expenditure responsibility instead, which ensures that grant funds are used for charitable purposes regardless of whether the grantee qualifies as a public charity. Although expenditure responsibility may be a cheaper option, it entails more long-term data collection.

As a best practice, foundations should have a checklist of information needed prior to making a payment to a foreign entity and another for post-grant compliance. Private foundations that are deemed noncompliant are subject to an excise tax and could experience negative publicity if funds they send overseas are misused.

## PUBLIC CHARITIES

While public charities are not subject to the same Treasury regulations on foreign grantmaking, they are wise to follow the same guidelines issued for private foundations. The most pressing concerns for public charities are reputational concerns, which can tarnish their brand or negatively impact donor relations. Performing adequate due diligence on potential grant recipients can help mitigate these risks.

## DONOR ADVISED FUNDS

Under the Pension Protection Act, donor-advised funds (DAFs) are subject to a series of potential restrictions on international activity. In particular, DAFs are prohibited from issuing grants to individuals. In addition, when making grants to foreign charities, DAFs must take reasonable efforts to ensure that monies are spent for their intended purposes by exercising expenditure responsibility.

Regardless of structure, there are certain international considerations that all nonprofits should remain aware of when operating or funding across borders.

As a result of recent legislation, U.S.-based charities making grants to international



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organizations are required to comply with various anti-terrorism measures. To ensure they do not issue funds that assist, sponsor or support terrorist activities, organizations are required to check the names of foreign grant recipients against terrorist lists maintained by the U.S. and the United Nations. Additionally, organizations must obtain an agreement that the grant is not U.S. source income and that no withholding will be made. Organizations should implement policies to educate staff and the board on anti-terrorism programs, and put in place a compliance checklist outlining the necessary steps before issuing payments.

Nonprofits operating abroad are also subject to legislation specific to each foreign nation where they are based. In April, the Chinese government [passed a law](#) mandating that all foreign organizations (including Nongovernmental Organizations (NGO)) register with the police and obtain a Chinese sponsor in order to continue their work within China. This is not the first piece of legislation limiting international activity in the nonprofit sector; the Chinese ruling is reminiscent of [legislation](#) passed in Russia throughout the past decade that imposed further governmental controls on NGOs operating in Russia.

Whether or not other foreign nations will introduce similar legislation remains to be seen. However, many organizations may consider establishing in-country legal entities as a precautionary measure, in order to efficiently and successfully comply with unexpected legislation changes.

*Article reprinted from the BDO Nonprofit Standard blog.*



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## BDO PROFESSIONALS IN THE NEWS

**BDO professionals are regularly asked to speak at various conferences due to their recognized experience in the industry. You can hear BDO professionals speak at these upcoming events:**

## OCTOBER

**Marc Berger** will be speaking at the BDO Nonprofit and Government Accounting and Tax Update conference in Miami Fla. on Oct. 6.

**Dick Larkin** will be presenting two sessions at the Michigan CPA Society Nonprofit Conference on Oct. 7 in East Lansing, Mich. He will present the keynote presentation entitled "Not-for-Profit Financial Statements: Beyond the Looking Glass" and he will present a second session entitled "Budgeting Variance—When the Money Doesn't Go As Planned."

**Berger and Laura Kalick** are presenting a session entitled "Tax Update" at the EACUBO 2016 Annual Meeting on Oct. 18 in Washington, D.C.

**Rebekuh Eley** will be presenting a session entitled "509(a)(3) Supporting Organizations" at the Illinois CPA Society Nonprofit Roundtable on Oct. 20 in Chicago, Ill.

## NOVEMBER

**Eley** is the conference chair for the Illinois CPA Society 2016 Nonprofit Conference being held Nov. 16–17 in Rosemont, Ill. Eley, along with other BDO professionals will present

at the conference. Details of BDO presentations are as follows:

- **Eley** will present a session entitled "Learning Lab: Tax Update" on Nov. 17.
- **Lee Klumpp** will be a co-presenter for a session entitled "Accounting and Auditing Update: Hear the Latest Developments in GAAP That Are of Interest to NFP Entities" on Nov. 17.

Several professionals are scheduled to speak at the 2016 GWSCPA Annual Nonprofit Finance and Accounting Symposium being held Nov. 29–Dec. 1 in Washington, D.C. Here is a summary of the BDO speakers:

- **Berger** will be a co-presenter at a session entitled "Tax-Exempt Bonds: The IRS is Lookin'" on Dec. 1.
- **Klumpp and Larkin** will present a session entitled "Accounting & Auditing Update" on Nov. 30.
- **Jeffrey Schragg** will be a co-presenter for the session entitled "Anatomy of an EO Merger" on Nov. 30.

## DECEMBER

**Berger and Kalick** will discuss nonprofit tax issues at the BDO Nonprofit and Higher Education breakfast session on Dec. 6 in Philadelphia, Pa.

**Matt Cromwell** will be a co-presenter at a session hosted jointly by BDO and Venable LLP entitled "Top Ten Risks Facing Nonprofits Operating Internationally" on Dec. 12 in Washington D.C. or via webinar.

# UNIFORM GUIDANCE PROCUREMENT RULES ARE COMING... IS YOUR ORGANIZATION PREPARED?

By Andrea Wilson

**Time is running out! For organizations that receive federal funding subject to Uniform Guidance (UG), 2 CFR 200, the time to update procurement standards is rapidly approaching.**

The UG provided a two-year grace period, which expires two full fiscal years following Dec. 26, 2014. This means organizations with a Dec. 31 fiscal year-end must have the new standards in place by Jan. 1, 2017.

The UG procurement standards remove much of the ambiguity and relative freedom organizations had under the previous A-110 standards in favor of more stringent and prescriptive requirements. Specifically, the new standards require quotes and/or price analysis for procurements in excess of \$3,500 and open competition for those in excess of \$150,000, and significantly limit the permissible justifications for sole source procurements. The standards also introduce new concepts of cost and price analysis to the government grants world, and require profit to be negotiated separately in certain circumstances.

While some organizations chose to proactively implement these changes ahead of the mandated timing, the new procurement standards represent a major shift in the way nonprofits approach procurement, and are tough to implement for even the most diligent of organizations. Many early adopters are still struggling with these changes, finding themselves unprepared to handle the stringent new compliance requirements, policy overhauls, training needed at all levels and—most importantly—the cultural shift the standards introduce. While organizations grapple with these significant changes, they are simultaneously finding themselves under increased audit scrutiny from external and governmental auditors.

## SO WHAT HAVE BEEN THE MOST SIGNIFICANT LESSONS LEARNED?

- ▶ The cultural shift resulting from new procurement standards should not be underestimated. Most organizations choose vendors and contractors based on past performance and existing relationships, and have done so for many years. These factors will no longer be a permissible basis of selection for direct federally funded procurements, so organizations need to be ready to make major changes in their procedures.
- ▶ The need for documentation has expanded significantly. Organizations must now keep all of the quotes received, rationale for selection, cost/price analysis and negotiation memorandum.
- ▶ Purchase orders and contract templates must be updated to include new required flow-down clauses.

In advance of the deadline, organizations that haven't already adopted new procurement policies should take steps to get compliant now and should consider these best practices in their efforts:

- ▶ Conduct a gap assessment by reviewing current policies and procedures and comparing them to the new requirements under Uniform Guidance.
- ▶ Based on the flags raised during the assessment, revise your procurement policy. Be sure to include written standards of conduct covering conflicts of interest in your procurement policy.
- ▶ Think about your culture: How do you buy goods and services? Who are the buyers within your organization? How will this new policy affect them? What practices can be used to be sure that your programs and mission are not negatively impacted?

- ▶ Understand when cost and/or price analysis is necessary, and how it can be documented. For example, how does your organization document sole source cost analysis during an emergency procurement?
- ▶ Ensure everyone involved in the procurement process understands the new requirements and policy. Provide multiple rounds of training at every level of your organization.
- ▶ Once your policy changes have been effective for a reasonable amount of time, use your internal audit function to ensure your new procedures and controls are operating effectively.
- ▶ Many nonprofit organizations have limited resources to identify compliance issues and craft policy updates and solutions. Seeking outside help often proves to be an efficient way to be honest about your compliance, identify any flaws and get compliant quickly.

Compliance with these new standards is tough, but not impossible. Be thoughtful when drafting your new policy—a policy that is not grounded in your organization's mission and culture will prove almost impossible to implement. It's critical that organizations begin this process well in advance of the deadline, so they have time to strategically execute changes. Start now and ensure you have time to train staff and test the effectiveness of your new policies and controls.

This article originally ran in [New York Nonprofit Media](#) and the [BDO Nonprofit Standard blog](#).



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# NEW DEFERRED COMPENSATION REGULATIONS: WHAT NONPROFITS NEED TO KNOW

By Joan Vines, CPA



## The Internal Revenue Service (IRS) released proposed regulations that provide guidance for the nonqualified deferred compensation arrangements of tax-exempt organizations in June.

The regulations, which have been anticipated by the industry since 2007, address the interplay between Internal Revenue Code Section 457 and Section 409A, which govern the nonqualified deferred compensation arrangements of *all* employers, including tax-exempt organizations. The newly proposed Section 457 regulations provide plan design opportunities specifically for tax-exempt employers, which could aid in the recruitment and retention of key executives.

The proposed regulations provide comprehensive guidance for nonprofit employers and offer several options for employers structuring deferred compensation plans. Section 457(f) requires the immediate taxation of nonqualified deferred compensation upon vesting. Its newly proposed regulations contain plan design features that effectively delay the vesting

event, thereby avoiding immediate taxation and providing much-needed clarity to when compensation is subject to or exempt from Section 457(f).

The proposed regulations become effective upon finalization, but may be relied upon in the meantime.

The new regulations distinguish between for-profit and nonprofit deferred compensation requirements with changes specific to six aspects—risk of forfeiture, salary deferrals, noncompete agreements, short-term deferrals, severance pay and other welfare plans.

## ROLLING RISK OF FORFEITURE

The proposed regulations permit an upcoming vesting date, as well as the point of taxation, to be extended, provided:

- ▶ The extension is made at least 90 days before the vesting date;
- ▶ The extended vesting is conditioned upon the employee's provision of substantial services for at least two years (absent

an intervening event such as death, disability or involuntary severance from employment); and

- ▶ The present value of the amount to be paid at vesting must be more than 125 percent of the amount the employee otherwise would have received in absence of the extended vesting date.

**BDO Insight:** Section 409A similarly disregards an extended risk of forfeiture, unless the present value of the deferral is materially greater than the amount otherwise payable absent such extension. However, Section 409A does not provide a bright line test to determine "materially greater" and does not require a two-year, service-based minimum extension. The Section 457 proposed regulations are more rigid with respect to tax-exempt employers. Where an employer is exempt from U.S. taxation, the employee derives a tax benefit from the deferral while the employer is indifferent. The additional payout required under the Section 457 proposed regulations is designed to constrain tax-motivated deferrals by employees. A tax-exempt employer may not be as willing to agree to the additional vesting period if the payout is significantly higher. For instance, an employer might prefer to pay \$100,000 in 2018, rather than potentially more than \$125,000 in 2020.

## SALARY DEFERRALS

Under prior guidance, current compensation, including salary, commissions and certain bonuses, was considered vested and therefore ineligible for deferral under Section 457(f). However, the proposed regulations permit current compensation to be deferred under Section 457(f), provided the following rules are met:

- ▶ The deferral election must be made in writing before the beginning of the calendar year in which any services that give rise to the compensation are performed (or within 30 days after a new employee's hire date for pay

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attributable to services rendered after the deferral election);

- ▶ Payment of the deferred amounts must be conditioned upon the employee's substantial services for at least two years (absent an applicable intervening event); and
- ▶ The present value of the amount to be paid at vesting must be more than 125 percent of the amount the employee otherwise would have received in absence of the deferral.

**BDO Insight:** The two-year minimum deferral period applies separately to each payroll deferral. Additionally, an employer match of more than 25 percent may be required to satisfy the 125 percent rule for salary deferrals.

## NONCOMPETE AGREEMENTS

Under prior guidance, the vesting schedule for deferred compensation served as a retention mechanism, requiring the employee's continuous services through the vesting date as a condition to receive the amount. Under the newly proposed regulations, vesting may also serve as an enforcement mechanism for a noncompete covenant, requiring an employee to refrain from providing services to a competitor for a specified period. Provided the noncompete is a written, bona fide and enforceable covenant, the vesting period may be extended through the end of the restrictive period, allowing tax-exempt employers to make post-employment payments during such period. In addition, deferred compensation payable upon a voluntary termination is no longer treated as fully vested at all times if the amounts could be forfeited in accordance with the terms of a bona fide noncompete covenant.

**BDO Insight:** Among other factors applied to determine a bona fide noncompete covenant, the facts and circumstances must show that the employer has a substantial interest in preventing the employee from performing the prohibited services. To the extent the compensation paid to the employee for entering into a noncompete agreement exceeds the value of such agreement, (measured, for example, by the economic

damages the organization would incur from an employee's violation of that covenant), then the restrictive covenant may not be a bona fide noncompete agreement for purposes of Section 457. A valuation of the noncompete agreement may be in order to support an extension of the vesting date to the end of the restrictive period.

## SHORT-TERM DEFERRALS

The proposed regulations provide that Section 457(f) does not apply to an arrangement in which payment is made within the "2 ½ month short-term deferral period" under Section 409A, which is generally March 15 of the first calendar year following the year of vesting.

**BDO Insight:** The Section 457 proposed regulations apply the Section 409A definition of short-term deferral, but substitute its own definition for "substantial risk of forfeiture." Accordingly, a short-term deferral under Section 457 may not constitute a short-term deferral under Section 409A as is the case of a plan with a noncompete vesting provision. Technically, income taxes are due upon vesting under Section 457(f). However, the proposed regulations make clear that short-term deferrals are not subject to Section 457(f), thereby allowing income taxes to be collected upon distribution, which is administratively convenient where there is a gap between the vesting and distribution dates.

## SEVERANCE PAY

The proposed regulations provide that Section 457(f) does not apply to severance pay in connection with an involuntary separation from service (including a voluntary termination by the employee for a pre-established, good reason condition that has not been remedied by the employer) or pursuant to a window program or an early retirement incentive plan. Payments under such "bona fide severance pay plans" must not exceed two times the employee's annualized compensation for the preceding calendar year (or the current calendar year if the employee had no compensation from the employer in the preceding year) and payment must be made by the last day of the second calendar year following the calendar year in which the severance occurs.

**BDO Insight:** Pay due to an involuntary separation from service or participation in a window program is similarly exempt from Section 409A in limited amounts (the lesser of two times the employee's annual rate of pay for the preceding year or two times the compensation limit set forth under Section 401(a) (17) for the year of separation).

## OTHER WELFARE PLANS

The proposed regulations clarify that Section 457(f) does not apply to bona fide death benefit, disability pay, sick leave and vacation leave plans.

**BDO Insight:** Section 409A similarly exempts such welfare plans from its deferred compensation rules.

## WHAT SHOULD I DO NOW?

Prior to the finalization of these regulations, tax-exempt organizations can take immediate action to align current deferred compensation procedures with the recent changes. Nonprofits, foundations and universities should review their current arrangements, severance plans and welfare benefit plans in light of these proposed regulations, and develop a plan to implement the necessary updates. Additionally, nonprofit executives should be proactive and take steps to effectively communicate with their employees in regards to the changes.



For more information contact Joan Vines, managing director, National Tax – Compensation and Benefits, at [jvines@bdo.com](mailto:jvines@bdo.com).

# PHILANTHROPIC PLANNING: DONOR ADVISED FUND VS. PRIVATE FOUNDATION?

By Rebekuh Eley, CPA, MST



**Donor advised funds (DAF), which are often alternatives to establishing a private foundation, have received much attention in recent years.**

Their rise in prominence has prompted financial institutions and other public charities to offer DAF arrangements. There are several considerations in choosing a DAF or a private foundation to fulfill a donor's philanthropic needs. Some of the considerations include:

## ADMINISTRATION

Both cost and time should be considered when determining whether to establish a private foundation or a DAF, along with the amount of the gift or assets within the private foundation or DAF. Private foundations are separate legal entities and carry the administrative costs of formation, operation and annual reporting. A private foundation with a larger asset base can better

manage the administrative costs, costs of annual legal and tax compliance, and the mandatory annual five percent distributions.

The time involved to maintain annual compliance for a separate entity may create a burden for the founders of the private foundation. Additionally, the establishment of a private foundation can take a year or longer to complete which may not be within the donor's timeframe for distributing the initial contribution. A DAF is typically a segregated fund within an existing public charity. There are little to no start-up costs because the gift is made to an existing Section 501(c)(3) public charity. Since a DAF is housed in an existing entity, this allows an immediate contribution or grant to be made once approved by the DAF.

## LEGACY

Family legacy and continuity of the fund is another factor in determining the proper vehicle for philanthropic giving.

A private foundation can be maintained in perpetuity, and be an institution that carries on a family name. A private foundation provides opportunities for board selection and succession planning, as well. However, depending on the arrangement with the sponsoring Section 501(c)(3) organization, DAFs may have time limits for the funds. And although it may carry the family name on the fund, a DAF is not legally a separate organization from the sponsoring organization.

## GRANTMAKING AND CONTROL OF ASSETS

Assets contributed to a DAF are no longer legally under the control of the donor. The donor may advise on the use of those assets in the community, but there is no legal obligation for the DAF to abide by that request, although most do. Some DAF's may have geographical or other restrictions on where the funds may be granted. The administrative cost to identify community needs to make a greater impact and evaluate qualified organizations is housed within the sponsoring organization of the DAF. A private foundation would need to make this assessment internally and bear that cost.

Private foundations must distribute five percent of the fair market value of their investment assets every year. DAFs do not currently have a mandated distribution requirement by law; although a plan to distribute assets should be implemented to facilitate funding into the community.

DAFs are limited in their ability to make grants, and generally, grants must go to a public charity. A DAF is prohibited from distributing to a natural person. Grants to organizations that are not public charities must be for a charitable purpose, and the DAF must exercise expenditure responsibility to avoid an excise tax. Private foundations are subject to similar rules requiring expenditure responsibility for grants to organizations that are not public charities.



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## PHILANTHROPIC PLANNING

There are rules for both DAFs and private foundations regarding scholarships. A DAF is prohibited from making a contribution to an individual, which prevents DAFs from making grants for travel, study, or similar purposes. However, a sponsoring organization may maintain a fund for this purpose and the donor may be an advisor for this fund. A DAF may grant funds to the sponsoring organization's scholarship fund. A private foundation is permitted to grant scholarships to individuals, provided the private foundation receives approval from the Internal Revenue Service before distributing scholarship funds. With these differences in mind, a donor wishing to provide scholarships will need to determine how much control they would like over a scholarship fund when choosing between a DAF and a private foundation.

Both DAFs and private foundations have prohibitions against certain transactions with the donor or persons related to the donor. The prohibitions are enforced in the form of an excise tax to the donor or the advisor/manager over the DAF or private foundation. DAFs are prohibited from making any distribution that has a direct or substantially indirect benefit to the donor or related persons. Private foundations are prohibited from entering into any transaction, regardless of the dollar amount, with the founder of the private foundation and related persons. There are certain exceptions to this rule for private foundations, but the prohibitions are stricter within a private foundation than a DAF. We've [discussed](#) some of the most common risky transactions for private foundations on our Nonprofit Standard blog. When weighing a private foundation or DAF, the intended transactions with a donor or persons related to the donor should be considered to determine if the transaction is prohibited from all entities or may be permissible in either a DAF or private foundation.

Certain DAFs may also mandate certain investment options, particularly when a DAF is associated with a financial institution. Private foundations may have more flexibility in their investment options provided they are investing as a prudent investor, and not in excessive business holdings.



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Stay tuned to the *Nonprofit Standard* blog or refer to [www.bdo.com](http://www.bdo.com) for further details and registration information.

The remaining 2016 calendar of events currently scheduled is below.

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10/10/2016 **How to Prepare for an IRS Audit**

[Register here](#)

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11/17/2016 **Joint Costing Activities—Continued Controversy After 15 Years**

[Registration link coming soon]

## TAX CONSIDERATIONS

A donation to either a private foundation or a DAF is tax deductible. A donation to a DAF is limited to 30-50 percent of a donor's gross income, whereas a private foundation which has a 20-30 percent limitation. The value of a cash or publicly traded stock gift is fair market value for both a DAF and a private foundation. The value of a gift of closely held stock or real estate is fair market value for a DAF and limited to a donor's cost basis for most private foundations. A donation to a DAF may present a greater immediate tax deduction. Private foundations are also subject to a 1-2 percent excise tax on all investment income. This tax is not applicable to DAFs.

## PRIVACY

The annual compliance filing for a private foundation, Form 990-PF, includes the listing

of contributors and the amount that was given for the year. Since the Form 990-PF is a public document, donors should consider this requirement if privacy is important to them. DAFs are not required to provide the donor listing to the general public, which allows donors to make anonymous gifts.

## IN CONCLUSION

There are many considerations in determining the proper vehicle for continuous philanthropic planning. Assessing the purpose, along with operating and tax considerations, will help guide donors in the right direction.



For more information, contact Rebekah Eley, Nonprofit tax managing director, Central Region Nonprofit & Education Practice Leader, at [reley@bdo.com](mailto:reley@bdo.com).

## OTHER ITEMS **TO NOTE**

### OMB Issues 2016

#### Compliance Supplement

The Office of Management and Budget (OMB) released the final 2016 Compliance Supplement at the end of July. The Compliance Supplement is now an appendix to 2 CFR Part 200 and is entitled the *2016 2 CFR 200, Appendix XI, Compliance Supplement* (the Supplement). This edition of the Supplement will be used to perform single audits under OMB's *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards at 2 CFR 200* (Uniform Guidance). The 2016 Supplement may be accessed directly on the [OMB Grants Management Circular page](#). The Supplement is effective for audits of fiscal years beginning after June 30, 2015, and it supersedes the 2015 Supplement.

The audit requirements of the Uniform Guidance (contained in Subpart F, "Audit Requirements") are effective for audits of fiscal years beginning on or after Dec. 26, 2014. The 2016 Supplement is a critical tool for performing audits under the Uniform Guidance audit requirements. Part 3, *Compliance Requirements*, is a key part of the Supplement. It is broken into two parts to facilitate an outline of the compliance testing requirements of older and newer awards. Part 3.1 is applicable to federal awards made prior to Dec. 26, 2014, and Part 3.2 is applicable to federal awards subject to the Uniform Guidance (i.e., new awards made on or after Dec. 26, 2014, or funding increments made on or after that date). Keep in mind that auditors may need to use both sections to understand the compliance testing requirements for awards expended for certain major programs.

To learn more about the types of changes made and the specific programmatic changes by Catalog of Federal Domestic Assistance (CFDA) number, review Appendix V, *List of Changes for the 2016*

*Compliance Supplement*. To understand the latest OMB announcements that may be relevant to 2016 single audits, carefully review Appendix VII, *Other Audit Advisories*.

#### Changes to the Uniform Guidance Data Collection Form

On July 15, 2016, the Federal Audit Clearinghouse (FAC) issued the [updated Data Collection Form \(DCF\)](#) and related instructions. The new Form will be used for audits of fiscal periods beginning on or after Dec. 26, 2014, and can be accessed on the FAC website.

The vast majority of the changes made to the DCF are to address new requirements in OMB's *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards at 2 CFR 200* (Uniform Guidance). Keep in mind that the new DCF is only to be used for audits of fiscal periods beginning on or after Dec. 26, 2014 (generally Dec. 31, 2015, and later year-end single audits).

Under 2 CFR 200.512, auditees are required to authorize the FAC to make reporting packages publicly available (note that there is an exception to this requirement for Indian Tribes and Tribal Organizations, further described in 2 CFR 200.512). Auditees should carefully review all documents that will be made publicly available before finalizing to ensure they do not include any protected personally identifiable information.

#### Revenue Recognition of Grants and Contracts by Not-For-Profit Entities

As discussed in Lee Klumpp's article entitled, "Revenue Recognition of Grants and Contracts by Nonprofits—Is It Time for a Change?" in the [Summer 2016 issue of the Nonprofit Standard](#), the FASB added the project "Revenue Recognition of Grants and Contracts by Not-for-Profit Entities". This project was added to address

the difficulty and diversity in practice for recognizing revenue from grants and contracts for not-for-profit (NFP) entities that stem from the following two issues:

- ▶ Issue 1: How NFPs characterize grants and similar contracts with government agencies and others as (i) reciprocal transactions (exchanges) or (ii) nonreciprocal transactions (contributions).
- ▶ Issue 2: Distinguishing between conditions and restrictions for nonreciprocal transactions.

At the Aug. 31 meeting of the Financial Accounting Standards Board (FASB), members discussed various ways to improve the existing guidance for distinguishing between conditions and restrictions for nonreciprocal transactions (contributions). The Board did not make any technical decisions at this meeting. However, the Board did direct FASB staff to explore further an approach based on the existence of a right of return. The FASB staff was asked to explore the following aspects of the existence of a right of return approach:

- ▶ How determinative a right of return should be in indicating the existence of a donor-imposed condition (and the implications of trivial right-of-return stipulations), and
- ▶ Whether a right of return must be explicit in the agreement.

The Board also asked the staff to conduct additional outreach and research with preparers and users of NFP financial statements related to the proposed approach and to see if it might be operational in practice.

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