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profitable solutions for nonprofits

The Financial Side of the Nonprofit Industry

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The Value of Donated Property Is in the Eye of the Marketplace

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Nonprofit organizations often struggle with valuing noncash and in-kind donations, including the value of houses or other buildings. Whether for record-keeping purposes or when helping donors understand proper valuation for contributed property, the task is not easy.

Although the amount that a donor can deduct generally is based on the fair market value (FMV) of the property at the time of contribution, there is no single formula for calculating FMV for every type of gift.

FMV Basics

The Internal Revenue Service (IRS) defines FMV as the price that property would sell for on the open market. (A donor cannot claim a deduction for the contribution of services.) For example, if a donor contributes used clothes, the FMV would be the price that typical buyers actually pay for clothes of the same age, condition, style and use.

If the property is subject to any type of restriction on use, the FMV must reflect that restriction. If a donor contributes land to a nonprofit and restricts its use to agricultural purposes, the land must be valued for agricultural purposes, even though it would have a higher FMV for nonagricultural purposes.

Ultimately, FMV must consider all facts and circumstances connected with the property, such as its desirability, use and scarcity.

Three FMV Factors

According to the IRS, there are three particularly relevant FMV factors:

1. Cost or selling price — The cost of the item to the donor or the actual selling price received by an organization may be the best indication of the item's FMV. Because market conditions can change, the cost or price becomes less important the further in time the purchase or sale was from the date of contribution.

For example, a donor may have paid $2,500 for a top-of-the-line computer in 2005, but that computer certainly is not worth $2,500 in 2012 because it is no longer top of the line. It may still have *some* value, though.

A documented arm's-length offer to buy the property close to the contribution date may help prove its value to the IRS. The offer must have been made by an independent, unrelated party willing and able to complete the transaction.

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Internal Controls Fight Technology-Related Fraud

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The ability to accept and make online payments and maintain databases with detailed constituent profiles offers obvious benefits to nonprofits under constant time and money pressures but may also make the nonprofit more susceptible to certain fraud attempts that can dodge traditional internal controls. Fortunately, measures are available to combat these risks.

Making Online Disbursements

Many nonprofits are now paying bills online, rather than mailing payments. Of course, the ability to make online payments essentially provides an employee the potential to make unauthorized payments. Similarly, the employee who oversees direct deposit payroll transactions could create and pay "ghost" employees, give unauthorized raises or otherwise divert funds.

If a nonprofit makes these types of online disbursements, management should ensure that all payments are subject to an independent review by another employee not directly involved in the particular area. The reviewer can verify payments online or examine the bank statements for discrepancies. The reviewer should also review payroll reports that come directly from the payroll system (versus reports generated by the employee who oversees payroll). Of course, management should be aware that employees could work together to commit fraud. Banks also might offer verification services to confirm that payments are authorized before they clear.

Accepting Payments

One of the most significant changes in how nonprofits conduct business in recent years has been the widespread adoption of systems that allow online payments for event registrations, membership fees, product purchases and donations. These payments are generally deposited directly into the organization's bank account.

The risk associated with a system that allows for online collections is that the employee responsible for the online system could redirect the ultimate destination of payments. If the accounting department records income based on bank deposits, this fraud could go undetected. To close this control gap, nonprofits should make sure to take the added step of reconciling the bank deposits against online income from the donor system.

Protecting Privacy

Many nonprofits possess their members' and donors' credit card information and other personal data, making them potential targets for both internal and external hackers. Criminal access to constituents' data could be disastrous in terms of remedial costs, legal liability and reputational damage.

A simple, but effective privacy control is adherence to the Payment Card Industry (PCI) Data Security Standard (DSS). DSS applies to all entities that store, process or transmit credit cardholder data and outlines technical and operational system requirements to protect that data.

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Employees vs. Independent Contractors: Classify Workers per IRS Guidelines

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The Internal Revenue Service (IRS) has publicly stated it plans to crack down on organizations that improperly classify workers as independent contractors instead of employees. Nonprofits should be confident their employee classifications would stand up to IRS scrutiny.

Understand the Requirements

If a worker is an *employee*, nonprofits must provide a Form W-2 annually and withhold income tax and the employee's portion of Social Security and Medicare taxes from the employee's pay. Nonprofits also must pay the employer portion of Social Security, Medicare and unemployment taxes on the employee's wages.

If a worker is an *independent contractor*, nonprofits should provide a Form 1099-MISC, which reports the amount the organization has paid to the person that year. The independent contractor is responsible for paying employment taxes (both the employee and employer portions) and income taxes on his or her own.

While the IRS generally should receive the same amount of total income and employment taxes regardless of whether someone is an employee or an independent contractor, the agency has found that it is more difficult to collect from independent contractors. Thus, the IRS tends to favor employee status.

Should the IRS determine a nonprofit has improperly classified an employee as an independent contractor, the organization may be held liable for that worker's applicable employment taxes.

Take the Test

To determine whether a worker is an employee or an independent contractor, nonprofits must consider the degree of control and the person's level of independence. The IRS has assembled a number of questions to help employers decide. Commonly referred to as the "20-factor test" or "common law rule," the questions revolve around:

- Whether an organization has the right to control the individual and how that person performs his or her duties (that is, *behavioral control*),
- Whether there is a written contract between the individual and the nonprofit, and if the person receives employee benefits (that is, *type of relationship*), and
- Which aspects of the business relationship an organization controls, for example, are expenses reimbursed, who provides tools/ supplies, etc. (that is, *financial control*).

The IRS has suggested asking certain questions when determining status. For example, must a worker follow someone else's instructions regarding when, where and how he or she completes work? If so, the person is probably an employee.

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Classification

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Employees are typically trained how to perform a given job, whereas independent contractors are expected to already know how to do it. Independent contractors must pay their own assistants. And someone who retains the ability to set his or her own daily hours (within reason) is generally regarded as an independent contractor.

Another factor to consider is whether the person works for more than one business at a time, which would indicate contractor status. Someone paid by the hour, week or month (rather than by the job), on the other hand, typically signals employee status.

Meeting the Challenge

The IRS has reported that it loses millions in unpaid taxes and uncollected penalties for misclassified workers each year — and is looking to get it back; therefore, nonprofits should be sure they are following the rules.

Fraud

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Although DSS is not technically a law, several states have enacted legislation mandating compliance with some of its provisions.

The DSS requirements vary depending on the number and type of credit card transactions an organization conducts, both online and offline. It is a good idea, though, to take steps to comply with the strictest requirements, including:

- Installing and maintaining a firewall to protect cardholder data,
- Encrypting the transmission of cardholder data,
- Restricting access to cardholder data with unique IDs and on the basis of “need to know,” and
- Using and regularly updating antivirus software.

Although it is not a requirement, PCI also strongly recommends “segmenting” (or isolating) the cardholder data environment from the rest of your network. To learn more, visit www.pcisecuritystandards.org.

Proceed with Caution

There is no turning back from the technological advances nonprofits are currently enjoying. The key to avoiding trouble is to remain vigilant against the evolving risk of fraud by maintaining an effective control system.

Donated Property

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2. Comparable sales — The sales price of a property similar to the donated property often is critical in determining FMV. The weight that the IRS gives to a comparable sale depends on:

- The degree of similarity between the property sold and the donated property,
- The time of the sale,
- The circumstances of the sale, and
- The market conditions.

The degree of similarity must be close enough that reasonably well-informed independent buyers or sellers of the donated property would have considered that selling price. The greater the number of similar sales for comparable selling prices, the stronger the evidence of the FMV.

It is important that the transactions take place in an open market.

It is important, though, that the transactions take place in an open market. If the sales were made in a market that was artificially supported or stimulated, they might not be representative or indicative of the FMV. For example, liquidation sale prices typically do not indicate FMV.

3. Replacement cost — FMV should consider the cost of buying, building or manufacturing property similar to the donated item, but the replacement cost must have a reasonable relationship with the FMV. Also, if the supply of the donated property is more or less than the demand for it, the replacement cost becomes less important to FMV.

Gifts of Inventory

If a business contributes inventory, it can deduct the smaller of its FMV on the day of the contribution or the inventory's basis. (The *basis* of donated inventory is any cost incurred for the inventory in an earlier year that the business would otherwise include in its opening inventory for the year of the contribution.) If the cost of donated inventory is not included in the opening inventory, its basis is zero and the business cannot claim a deduction.

Inventory that may receive a better valuation than other inventory includes that which is used solely for the care of the ill, needy or infants; book inventory or food for public schools; and scientific property for research. The special provisions for books, food, and inventory for the care of the ill, needy or infants expired at the end of 2011, but have been extended retroactively in the past. In addition, certain industries, such as the pharmaceutical industry, have specific standards for valuing donated inventory.

An Important Reminder

Even if a donor cannot deduct a noncash or in-kind donation (usually a piece of tangible property or property rights), the donation may need to be recorded on the nonprofit's financial statements. Recognize such donations (including the donation of services) at their fair value, or what it would cost if the nonprofit were to buy the donation outright from an unrelated third party.

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Donated Property

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The Appraisal Issue

Potential donors might be deterred because of the hassle involved in getting noncash donations appraised. Yet appraisals generally are not needed for items of property for which the donor will claim a deduction of $5,000 or less.

Donors who deduct more than $500 for any single item of clothing or any household item that is not in "good used condition" or better, and that was donated after Aug. 17, 2006, however, must include a qualified appraisal with their income tax returns. In these cases, the donor should understand that the IRS will weigh the appraisal based on the report's completeness and the appraiser's qualifications and demonstrated knowledge of the donated property. The agency requires appraisals to provide all facts applicable to giving an "intelligent judgment" of the property's value, such as purchase price and comparable sales.

The IRS and courts are requiring donors to follow the requirements for appraisals — even when the value of the property is certain.

Newsbits

Accounting Body Explores Nonprofit Financial Reporting

The Financial Accounting Standards Board (FASB) is conducting two projects directly related to nonprofits. The "Not-for-Profit Financial Reporting: Financial Statements" project is re-examining existing accounting standards for organizations' financial statements, with a focus on improving 1) net asset classification requirements, and 2) the information provided in financial statements and notes about liquidity, financial performance and cash flows. FASB will likely propose a revised standard and request feedback in the future.

FASB also is conducting a research project called "Not-for-Profit Financial Reporting: Other Financial Communications." That project is looking at other types of communications nonprofits use to tell their financial stories. FASB's staff, for example, is reviewing existing best practices followed by organizations to determine how such communications may enhance the understanding of donors, creditors and other stakeholders of the organizations' financial health and performance.

Quantifying the Cost and Benefits of Social Media Fans

Having people "like" an organization on popular social media sites may cost more than one might think and is worth tracking. The fourth annual Nonprofit Social Network Benchmark Report found that the average cost of a "like" on Facebook was $3.50, while the average cost of a Twitter "follower" was $2.05. The report surveyed more than 3,500 nonprofit professionals about their organization's use of social media to build their supporter base. The survey also found, however, that the average yearlong value of a supporter acquired via Facebook — that is, the amount of revenue received from a supporter over the 12 months following acquisition — was almost $215. It is no surprise, then, that 81 percent of the respondents deemed their social network communities as somewhat or very valuable.

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Our People: Your Success

KSM Not-for-Profit News

KSM's Not-for-Profit Services Group hosted a seminar on nonprofit board governance best practices on Oct. 9, 2012. Gerry Zack, CPA, of the Nonprofit Resource Center was the featured presenter. Gerry is recognized as one of the nation's foremost authorities on the unique management issues of nonprofit organizations. During his 30 years of professional experience, he has worked with nonprofit organizations of all types, specializing in issues such as anti-fraud, ethics, compliance and governance.

In addition to explaining key fiduciary duties and obligations, topics discussed at the seminar included the following:

- Committee structure and responsibilities
- The role of a board in strategy
- Financial oversight, including budgets, audits, investments, etc.
- Best practices for policies, procedures, minutes and other documentation
- Form 990-related best practices
- Relationship between board and staff
- Striking the proper balance of oversight
- Risk management for board members
- The board as fundraisers and representatives of the organization

KSM's fourth annual firm-wide volunteer community service project will take place Oct. 22 – 26. More than 200 KSM employees will work in partnership with Habitat for Humanity of Hamilton County to complete a "Blitz Build" at a home located in Noblesville, Indiana. The project will include demolishing much of the existing home and detached garage. KSM will then rebuild both structures - in one week - alongside the family who will take ownership of the home when completed.

For more information about Katz, Sapper & Miller, please visit ksmcpa.com.

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