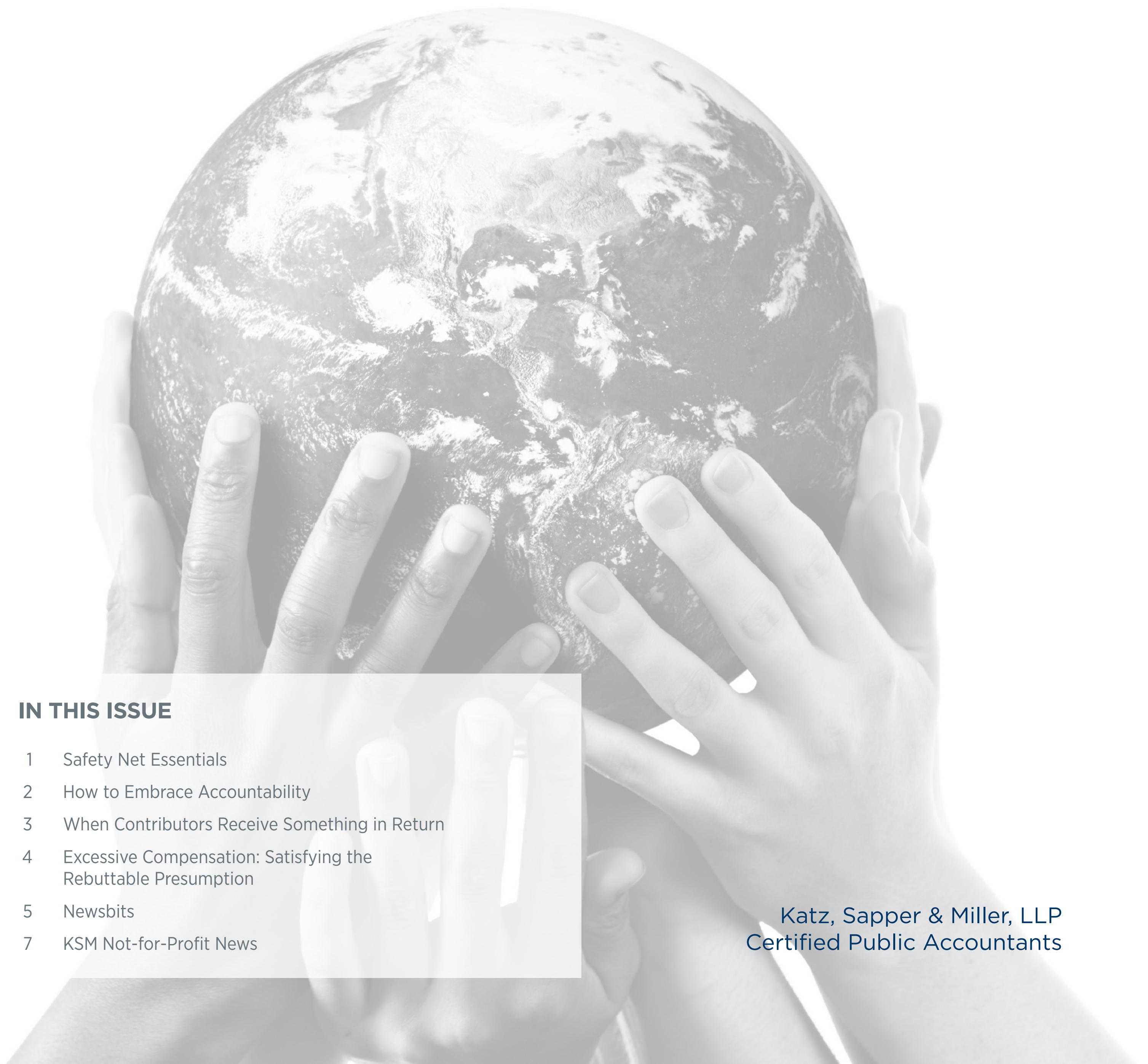
Spring 2012

profitable solutions for nonprofits

The Financial Side of the Nonprofit Industry



IN THIS ISSUE

Katz, Sapper & Miller, LLP
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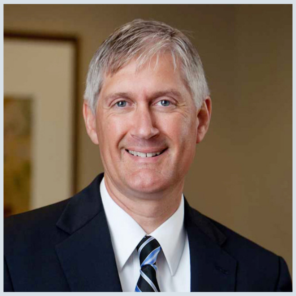
Safety Net Essentials

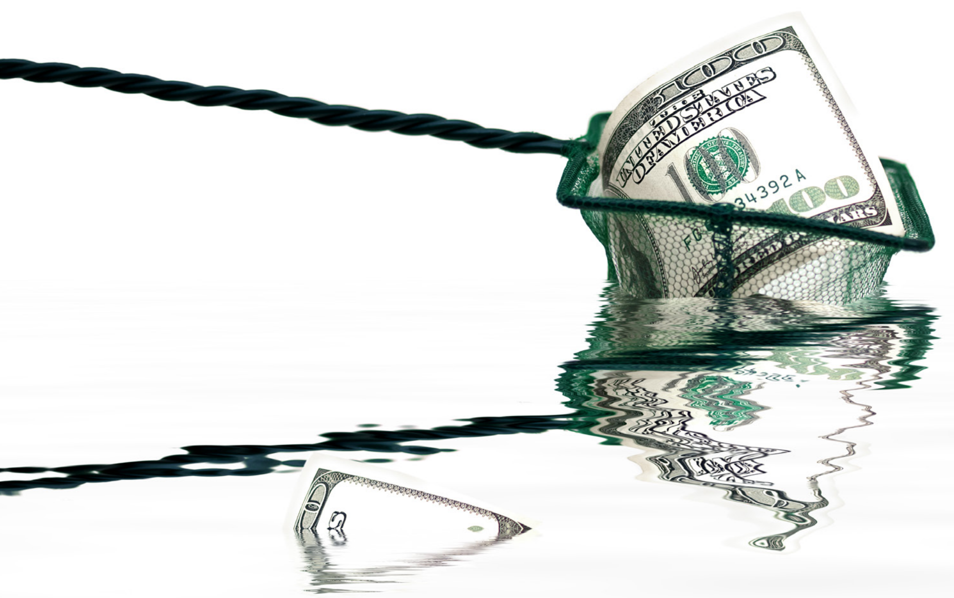


By Scott Schuster, CPA
Partner
sschuster@ksmcpa.com

Too few nonprofits keep healthy operating reserves. A study of charities in the Washington, D.C. area, for example, found that 57 percent of the organizations had insufficient operating reserves to cover three months of expenses — the minimum level many experts consider necessary to maintain financial stability.

Forgoing reserves leaves nonprofits vulnerable to rapid or unexpected drops in revenue or increases in expenses. Such funds may be regarded as optional or a luxury, but that is not the case.

What Are Operating Reserves?
The Nonprofit Operating Reserves Initiative Workgroup defines "operating reserves" as the portion of unrestricted net assets that nonprofits designate to sustain financial operations. The assets would be tapped in the event of significant unbudgeted increases in operating expenses or losses in operating revenues.



Reserves also should be liquid, or easily converted to cash.

Note that operating reserves and cash on hand are not the same. Cash is often restricted for specific purposes, such as future projects or programs, and are therefore unavailable for other uses, unlike reserves.

Operating reserves also are distinct from endowments. Endowments are restricted as well, and the organization can typically spend only the interest generated by the principal funds, making that money unavailable for daily operations.

Why Are Reserves Needed?
The times are turbulent, and even when the economy recovers, it will not stay that way indefinitely. Operating reserves can help nonprofits bridge the gap when revenue streams or donations decline because of an unstable economy.

Robust reserves also allow organizations to seize unexpected opportunities, set aside funds for long-term goals and plans, and cover increased expenses after a natural disaster or other emergency hits.

Nonprofits can also tap reserves to add staff and deliver services under federal contracts that do not provide payment for 30 to 60 days. Reserves will come in handy, too, if grants fail to materialize, or major fundraising events are delayed or canceled.

Continued on page 6.
See "Safety Net."

How to Embrace Accountability

By Amanda McGinity, CPA
Manager
amcginity@ksmcpa.com

There is much talk about accountability, especially financial accountability for charitable and other exempt organizations.

Nonprofits need to embrace accountability to protect the organization and its people, to demonstrate openness and forthrightness in external dealings, and to support the greater good. Embracing accountability also helps nonprofits fulfill their fiduciary responsibilities to donors, constituents and the public, but how can nonprofits truly embrace this abstract term?

Draw the Big Picture
There can be no accountability without good governance. Nonprofits must set in place the means and measures to stay in compliance with all applicable laws and rules as well as best practices. And most important, a nonprofit must keep in line with its mission and guiding principles, including integrity.

Author and nonprofit expert J. Steven Ott describes an organization's governance as "a product of its purposes, people, resources, contracts, clients, boundaries, community coalitions and networks, and actions as prescribed (or prohibited) in its articles of incorporation and bylaws, state laws and codes, and the IRS codes and rules."

When it comes to accountability and governance, the buck unquestionably stops with the board. Therefore, it is critical that management staff help the board understand its responsibilities and focus its attention on carrying out the organization's mission — not the process-oriented details best handled at the staff or committee level.

Watch the Numbers
Keeping the financials spotless is critical. So make sure to conduct regular, board-approved audits that are attested to by the executive director and principal financial manager. Management should present internal financial statements to the board — or its audit or finance committee — and review performance against approved budgets on at least a quarterly basis. In addition, the board should establish and regularly assess financial performance measurements.

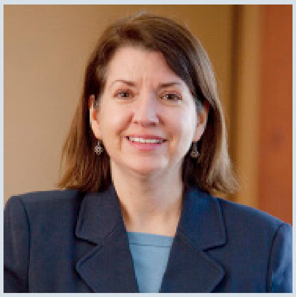
When it comes to accountability and governance, the buck unquestionably stops with the board.

Nonprofits must comply with all legally required reporting procedures — and certain financial practices that may apply to a specific activity. For example, a major funder of the organization might require key performance indicators or other reports linking operational results with financial information.

Respect the Mission
As the organization carries out its initiatives, it should do so fairly and in the best interests of its constituents and community. A nonprofit status means the organization is obligated to use its resources only toward its mission and to benefit its community. Programs should be evaluated accordingly, both in respect to the activities and the results or outcomes.

Continued on page 6.
See "Accountability."

When Contributors Receive Something in Return



By Sarah Nanos, CPA
Manager
snanos@ksmcpa.com

Do most nonprofit organizations understand how to treat quid pro quo arrangements? "Quid pro quo" describes an arrangement in which a contributor gives money in exchange for something else. Whether it is a supporter buying a ticket for a charity ball or an attendee at a charity auction successfully bidding on a hotel stay, such situations create an obligation for nonprofits.

Understanding the Requirements

According to IRS rules, nonprofit organizations may ignore contributions of less than $75, but if a nonprofit receives more than $75 *and* provides a benefit to the donor, it must advise the donor that it is a quid pro quo contribution. With such contributions, donors can deduct only the amount they pay *in excess* of the value of the goods or services.

The charity must put in writing the amount donated, the goods or services provided in return, and a good-faith estimate of their value.

Additionally, the charity must put in writing the amount donated, the goods or services provided in return, and a good-faith estimate of their value. Nonprofits must also provide written acknowledgment when the donation is solicited or when it is received.

If a nonprofit organization is holding a musical performance for which tickets are sold, for example, each ticket should disclose the tax-deductible portion of the ticket price (in this case, the market value of a similar event in the area). The organization must make the disclosure in a readily visible format. Examples can be found in IRS Publication 1771, *Charitable Contributions — Substantiation and Disclosure Requirements.*

Organizations could be penalized for failing to furnish the proper acknowledgment and disclosure. Fines are $10 per contribution, up to $5,000 for the fundraising event. If the contribution is $250 or more, failure to provide and describe a good-faith value of the benefit may cost the donor the contribution deduction.

Valuing the Goods and Services

A key task for the charity is to value the goods or services. An example: An organization takes a group of supporters to a sporting event and pays for their tickets. The supporters then make large donations. Determining quid pro quo is fairly simple in such cases: The amount the organization paid for the tickets would be considered the fair market value, and only the amount of the contributions in excess of this value would be a tax-deductible contribution for the donor.

It is not as easy when some of the items given away have been donated to an organization.

Continued on page 6.
See "Contributions."

Excessive Compensation: Satisfying the Rebuttable Presumption

By Casse Tate, CPA, MS
Manager
ctate@ksmcpa.com

An August *New York Times* article put the spotlight on the generous compensation enjoyed by two executives at the nonprofit Young Adult Institute — totaling nearly $2 million a year. The organization's behavior lit a firestorm, prompting the state government to seek compensation data at other New York–based nonprofits.

Exempt organizations across the country should be sensitive to the issue. When a nonprofit executive receives excessive compensation, the Internal Revenue Service (IRS) can impose excise taxes on the executive, and the organization will suffer reputational damage. Fortunately, nonprofits can limit potential liability by taking advantage of a three-step procedure known as the rebuttable presumption.

The Law on Compensation
Internal Revenue Code Section 4958 prohibits 501(c)(3) and 501(c)(4) organizations from engaging in an "excess benefit transaction" with a "disqualified person." Disqualified persons generally include anyone in a position to exercise substantial influence over the organization's affairs at any time in the five-year period preceding the transaction, such as officers and directors.

An excess benefit transaction takes place when a disqualified person receives a benefit that exceeds the value of the benefit the organization receives in exchange — for example, when an executive director is paid a salary that

Continued on page 5.
See "Excessive Compensation."

Defining a Conflict of Interest

A member of the authorized body (see main article) charged with approving a compensation arrangement has a conflict of interest with respect to the arrangement if he or she:

- Is a disqualified person participating in or economically benefiting from the compensation arrangement or is a family member of any such disqualified person;
- Is in an employment relationship subject to the direction or control of any disqualified person participating in or economically benefiting from the compensation arrangement;
- Receives compensation or other payments subject to approval by any disqualified person participating in or economically benefiting from the compensation arrangement;
- Has a material financial interest affected by the compensation arrangement; or
- Approves a transaction providing economic benefits to any disqualified person participating in the compensation arrangement, who in turn has approved — or will approve — a transaction providing economic benefits to the member.

Excessive Compensation

(continued from page 4)

far exceeds the salary of executive directors at similar organizations. Violations of Sec. 4958 can lead the IRS to impose excise taxes (intermediate sanctions) on the disqualified person who benefited from the transaction as well as the nonprofit's managers (for instance, board members) who approved it.

The Rebuttable Presumption

Federal tax regulations provide a rebuttable presumption of reasonableness for compensation arrangements that satisfy three requirements. If all of the following are met, it is up to the IRS to show that compensation was nonetheless unreasonable.

1. The compensation arrangement was approved in advance by an authorized body of the organization. Compensation generally must be set by the board of directors or a subcommittee composed of board members. It is critical that none of the participants have a conflict of interest regarding the arrangement. For example, neither the executive nor a subordinate of the executive can participate in the compensation decision.

2. The authorized body relied upon appropriate comparability data prior to making its determination. That entity can rely on data derived from industry surveys, documented compensation of individuals in similar positions in similar organizations, expert compensation studies or other comparable data about reasonable compensation for the position.

If an organization's gross annual receipts are less than $1 million, it only needs compensation data for three similar positions in similar communities. The regulations do not specify the requisite number of comparables for larger organizations.

Remember that similar job titles do not necessarily mean similar jobs. When evaluating comparability data, the positions must have comparable duties, not just titles.

Exempt organizations across the country should be sensitive to the issue.

3. The authorized body adequately documented the basis for its determination while making that determination. This requirement is often overlooked. Documentation must include terms of the arrangement and the date it was approved, members of the body who were present during debate on the arrangement and those who voted on it, comparability data that was relied on and how it was obtained, and any actions by a member with a conflict of interest.

Nonprofits must prepare the documentation before the later of the next meeting of the authorized body or 60 days after the body's final actions. The body also must approve the documentation within a reasonable time after preparation.

A Best Practice

Organizations not already abiding by the rebuttable presumption requirements when setting compensation for disqualified persons should start now. Otherwise, costly excise taxes and long-lasting reputational damage could result.

Newsbits

Tax Treatment of Cell Phones

New IRS guidance describes how employers can handle the cost of cell phones they provide to employees. The guidance, found in IRS Notice 2011-72 and the Sept. 14 memorandum to field examiners, "Interim Guidance on Reimbursement of Employee Personal Cell Phone Usage in light of Notice 2011-72," also describes how to handle reimbursement of cell phone costs if the employee provides the cell phone.

Providing a cell phone — or a cell phone allowance — to employees can be tax-free in many situations, including if your organization needs to be able to contact an employee at all times for work-related emergencies or if you require that an employee away from the office be available to speak with clients or constituents.

In other words, the cell phone must be needed for the nonprofit's benefit and cannot be provided simply as a form of compensation. For more details, contact your tax advisor.

Safety Net

(continued from page 1)

How Much Is Needed?

There is no universal operating reserves benchmark that applies to every organization, and the question of an appropriate operating reserves amount can raise some difficult issues among stakeholders. Some may argue, for example, that the nonprofit has an ethical obligation to devote as much of its available resources as possible to carrying out its mission. Others might worry about the appearance or difficulty of soliciting additional donations while sitting on significant reserves.

Reserves, however, are not about accumulating wealth. They are about securing the financial stability necessary to function effectively for the long run.

According to the workgroup, nonprofits need to consider several questions when setting the goal amount, including:

- Are revenue sources subject to large unexpected negative fluctuations?
- Are resources subject to sudden increases in demand?
- Are income and expenses subject to significant day-to-day fluctuations?
- Have planning and budgeting processes been historically accurate in forecasting financial results?
- Are adequate backup resources likely to be available?
- Is the governing body trying to expand the organization?

The workgroup recommends a *minimum* reserves level of 25 percent or three months of the nonprofit's annual expense budget. The adequacy of reserves beyond that amount will depend on specific circumstances.

Accountability

(continued from page 2)

Make It Clear

Communication is a big part of accountability. An annual report, for example, should reflect the mission and summarize the year's activities. It is a best practice for the report to also provide financial data for the year and other information, such as a list of board members, management staff and other key employees.

As a public document, a nonprofit's Forms 990 for the previous three years will give the public a good overview of the organization's exempt activities, finances, governance, compliance and compensation methods.

Accountability Pays Off

An organization's demonstration of accountability can generate a positive response from its constituents, whether it is in the form of donations, funding, volunteering or simply spreading the word about the merits of the nonprofit — that is the kind of outcome worth pursuing.

Contributions

(continued from page 3)

For example, if a charity hosted a one-day chocolate lovers event with live music, and the hosting hotel charged the charity a reduced amount for candy and desserts as its contribution and the chamber quartet performed at no cost, to establish the value to be reported to the donor, the charity must determine what it would cost someone to attend a similar event.

Placing Value on Auctioned Items

All items auctioned at a charity auction (silent or regular) must have a value placed on them. The charity should ask the donor to put a value on the item unless it is readily apparent, such as with a $50 gift certificate. The value should be the amount that a willing buyer would pay for the item in an "arm's length" transaction — that is, in the marketplace. The charity can then publish the item's value on bid cards or in a catalog of auction items. This serves as the acknowledgment, and the buyers will be entitled to a deduction for the amount paid *in excess* of that value.

Understanding Exceptions to the Rule

There are a few instances when quid pro quo reporting is not necessary:

> ***Membership exception*** - This exception happens when membership benefits (free admission or free parking, for example) are provided, but the annual membership fee is $75 or less.
>
> ***Token exception*** - This exception takes place when a contribution is for $49.50 or more and the goods cost less than $9.90, or the value of the benefit to the donor does not exceed 2 percent of the donation or $99, whichever is less.
>
> ***Intangible religious exception*** - This exception pertains to religious benefits, such as religious services or classes that are provided by an organization operated exclusively for religious purposes (excluding travel, education and consumer goods). In other situations, it is safer to report quid pro quo than not.

Subjective Decisions

Making decisions on the value of items an organization gives to contributors in exchange for contributions often involves a degree of subjectivity — value is sometimes in the eye of the owner.

KATZ SAPPER & MILLER

800 E. 96th Street
Suite 500
Indianapolis, IN 46240-0857

Our People: Your Success

KSM Not-for-Profit News

KSM's Commitment to the Not-for-Profit Industry:
Our staff is personally, not just professionally, committed to the not-for-profit industry. Many KSM partners and staff members serve on boards, supporting Indiana's not-for-profit organizations through their contributions of time and talent.

- **Patrick Brauer** – Named to the board of trustees and finance committee of Booth Tarkington Civic Theatre
- **Keith Gambrel** – Named to the board of directors of Conner Prairie Museum
- **Justin Hayes** – Appointed treasurer of AYS, Inc., board of directors
- **David Resnick** – Named to the board of directors of Methodist Health Foundation
- **Connie Runkel** – Elected president of Catholic Charities Indianapolis Agency Council
- **Kevin Sullivan** – Named to the board of directors of The Julian Center
- **Casse Tate** – Named to the Young Professionals Advisory Council of the Children's Bureau, Inc.

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

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