

OSCPA Annual Not-for-Profit Conference 2006

When Worlds Collide: GAAP vs. TAX

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- Some issues in accounting may look differently if viewed narrowly through either a GAAP or a TAX lens.
- Managers are often advised by a practitioner well-versed in one discipline but not the other.
- This can lead to problems.
- Management planning can help. Managers need to know what they want and why. Practitioners need to be on guard to see both points of view.

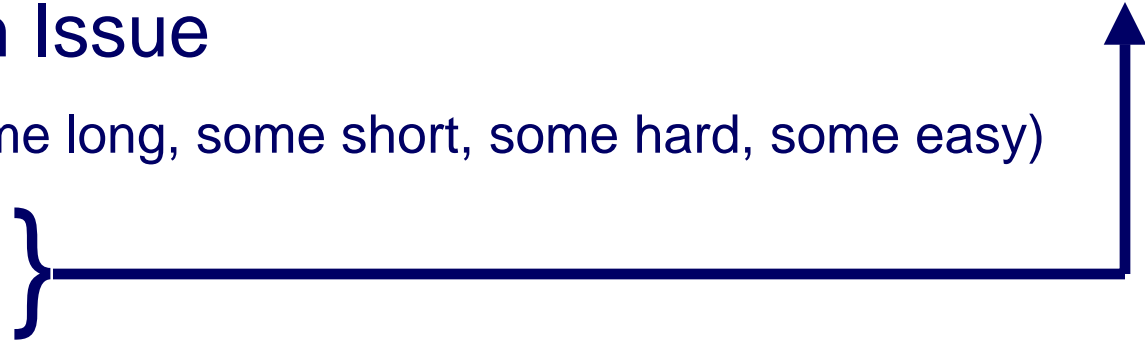
Issues Overview

- Government Awards: Fee or gift?
- Cost-sharing Arrangements: Revenue or reimbursement?
- Fiscal Sponsorship: What to do about imperfect Variance Power?
- Gifts in Kind of Property or Services: Proper reporting
- Joint Costs and SOP 98-2: Avoiding distortion
- Prepaid Fundraising Costs: Expense or asset?
- FMV on Investments: Proper reporting

Slides: Structure

➤ Cites

- Slides on each Issue
 - The Issue (some long, some short, some hard, some easy)
 - GAAP View
 - TAX View
 - Planning / Solutions



- Some departures for special topic discussion
- **Outline & Supplemental materials:**

- **More detailed outline numbered as lower slide corner**
- **Additional materials follow outline**

4

Overarching Considerations

- Nonprofits are creatures of the tax code
 - SAS 5, 69 “The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles”
- GAAP requires **Professional Judgment**: avoid misleading financial statements that technically conform to GAAP but distort nonetheless
 - Form 990 2005 Instructions, General Instruction G
- TAX generally requires use of same method as book “unless instructed otherwise”
- Era of Transparency

Government Awards: The Issue

- Government Award: Fee or Grant?
- Government Awards are often titled “Contract,” have specific deliverables, and are paid on a reimbursement basis, so practitioners (and managers) conclude that all government awards are exchange transactions – earned fees, rather than conditional gifts
- **Earned income can wreak havoc with the public support test**
 - *some social service agencies at risk of private foundation classification under IRC 509(a)*
- **Government grant support is very helpful**
 - *vital balance to potential future major private foundation or donor support*

Government Awards: GAAP View

➤ FAS 116, ¶56 & 48

- GAAP does NOT require that all government awards be treated as [reciprocal] Exchange Transactions
 - *“The Board believes that whether a grant is from a government agency, private foundation, or corporation, the difficulties in determining whether a transfer is an exchange transaction or a contribution are substantially the same.”*
 - *“...excluding [as contributed income] all governmental transfers is neither necessary nor desirable because that would further delay improvements to practice.”*

➤ FAS 116, ¶22

- Conditional Promises to Give may resemble Exchange Transactions, in a ‘pay for unit of delivery’ manner

Government Awards: TAX View

- Regs 1.170A-9(e)(8) and (9) & 1.509(a)(3)(f) and (g) [Re: 509(a)(1) & (2)]
 - Form 990 2005 Instructions, Page 19, Column 1

- Reg 1.170A-9(e)(8)(ii): [grant support] “if the purpose of the payment is primarily to enable the organization to provide a service to, or maintain a facility for, the direct benefit of the public ...rather than to serve the direct and immediate needs of the payor.”
- Examples given
 - maintenance of library facilities
 - amounts paid to nursing homes or homes for the aged
 - amounts paid to child placement or guidance organizations

“are considered payments the purpose of which is primarily to enable the recipient organization to provide a service or maintain a facility for the direct benefit of the public, rather than to serve the direct and immediate needs of the payor.”

Government Awards: Planning / Solutions

- **Management / auditor discussion, record properly (more often donative than what we see in practice)**
 - Why is it earned income if a government pays to help the public but donated income if a foundation does so?
 - Downside: not so easy to make “profit” on grant as on earned income
- **Split Book v. Tax: Exchange Transaction for GAAP, Donative Support for Tax**
 - Does this violate general rule to use same method? Argue that Tax Regs are different than GAAP, ergo split method is allowed
 - Note: will not show up on Form 990 v. Audit reconciliation, (Form 990 Part IV-A) which measures total income
 - Be sure to think through:
 - deferred revenue vs. temporarily restricted net assets
 - cost of Fee generation is Mgt & Gen, Grants generation is Fundraising

Cost-sharing Arrangements: The Issue

- Consider C3 charity “OldCorp” starting C4 lobby “NewCorp”
- OldCorp allows NewCorp to share resources and reimburse
- OldCorp inter entity: revenue or expense reduction?
- If revenue, OldCorp might “own” all of the activities, possibly defeating the reason for the spin-off
- If revenue, total economic activity is overstated: “the world does not add up”
- If revenue for GAAP but expense reduction for TAX: it shows up on the 990 reconciliation schedule, must explain to public

Cost-sharing Arrangements: GAAP View

- Disclosure: FAS 57. A&A Guide P8.12
- Consolidated: SOP 94-3, A&A Guide, 8.Appendix B and Chapter 3.23
- Combined: ARB 51, P22
- Disclosure (footnotes) is required & recommended
- If consolidated or combined f/s, tax return becomes “net” due to elimination entries
 - Consolidated required if parent/sub and economic interest
 - Combined sometimes permitted if common control
- Practitioners hesitant to combine dissimilar tax types
- If not combined, GAAP tends towards revenue
- Analogous to shipping & handling? Revenue
- Analogous to travel reimbursement for speech by CEO?
Reimbursement

Cost-sharing Arrangements: TAX View

- C4 affiliate: Regan v. Taxation with Representation of Washington, 461 U.S. 540 (1983)
- TAX wants net
- OldCorp C3 does not want to “own” the extra lobbying activities; (could be same problem with commercial sub)
- “Other revenue” is also a drag on the public support test

Cost-sharing Arrangements: Planning / Solutions

- Management / auditor discussion, use one of two analogies:
 - 1) either: joint dominion & control over a resource, reimbursement for efficiency,
 - 2) or: simple reimbursement such as a travel bill paid by a separate entity
- Full disclosure, in financial statement footnotes and Form 990, explaining dollar transactions between entities:
 - total amount,
 - component parts in relevant summary,
 - method of calculation
- Treat all reimbursements as expense reductions, using contra-sub-expense lines if necessary, to facilitate disclosure

Fiscal Sponsorship: The Issue

- “Fiscal sponsorship” (here) means grantor payment to intermediary “sponsor” public charity, which in turn grants to end recipient that is not a public charity
 - NPOs often incorrectly refer to “pass-through”
- If sponsor does not have full “discretion and control” (TAX), or “variance power” (GAAP), then it IS a pass-through transaction
 - If so, sponsor is agent for originating donor or end recipient; only one gift per IRS
 - If so, donor loses deduction or makes taxable expenditure; sponsor loses good relationship

Fiscal Sponsorship: 5 Elements in an Ideal World

- The elements of the re-granting sponsor's position that should be in place:
 1. **Bylaws** clauses: default for all gifts is discretion; “pass-through” requires Board approval, and
 2. Decision by the sponsor's **Board** affirming each sponsorship as advancing sponsor's purposes, and
 3. Transaction hits **income stmt**, not just balance sheet, and
 4. Written **proposal from project to sponsor**, in advance, and
 5. **Explicit written notice to or from grantor that sponsor retains “unilateral power to redirect” the funds**

Fiscal Sponsorship: GAAP View

➤ FAS 136 ¶ 12

- If end recipient is named, GAAP is particularly insistent on explicit notice to or from grantor that sponsor retains “unilateral power to redirect” funds

➤ FAS 136, ¶ 70, 84-86

- some slight wiggle room if
 - request to donor is made somewhat broadly, or
 - the governing documents of the sponsor make it clear that the sponsor always retains variance power; ergo ‘donor knew or should have known’

Fiscal Sponsorship: TAX View

- *Fiscal Sponsorship: 6 Ways to Do It Right, Greg Colvin, San Francisco Study Center Press (2d Ed.)*
- *IRS 2002 CPE Article: "Agency: A Critical Factor In Exempt Organizations And UBIT Issues"*
- *See also FAS 136 ¶84*

- TAX: overall facts and circumstances, not just explicit written variance power, but discourages conduit arrangements:
 - “The Service's longstanding position is that an EO receives a charitable contribution where it has full control and discretion as to the use of donated funds, but not where the donor earmarks the contribution for use by an individual or nonexempt organization (or makes the contribution pursuant to a commitment or understanding that the funds will be so used).” (CPE Article)

Variance Power: 2 Other Considerations

- 1. Federated Fundraising Campaigns
 - Problem: need to show Fundraising as Percent of Total Raised, even if no variance power
 - See display suggestions @ FAS 136, ¶ 109

- 2. Sometimes pass-through is desirable and should be planned accordingly
 - Sub-grantees are known, are public charities, and sponsor may have a tipping problem

Fiscal Sponsorship: Planning / Solutions

- Managers: Plan ahead, do it right
- Practitioners: keep in mind the overall situation,
 - carefully interpret and factor client intentions
 - consider “passing” on a mildly flawed variance setup for one year and
 - use the management letter to induce the client to put the necessary elements in place

Gifts of Property or Services: The Issue

- With regard to non-cash gifts, donated use of facilities, and donated services:
- GAAP statements are frequently inadequate
 - Transactions not recognized
 - Disclosures not made

Gifts of Property or Services: GAAP View

- Record gifts of property at fair market value
- Record gifts of use of facilities if would need to be paid for otherwise
 - FAS 116, ¶ 9 & 10
- Recognize contributions of services if:
 - “Create or enhance non-financial assets or
 - Require specialized skills...and would typically need to be purchased if not provided by donation”
- Disclose in footnotes extent of donated services even if not at level that leads to recognition

Gifts of Property or Services: TAX View

- Form 990 2005 Instructions, Page 5, Column 1; Page 19, Column 1
 - Form 990, Line 1d
 - Form 990, Lines 82a/82b note 82b might exceed Parts IV-A&B
 - Schedule B, Parts I and II
- Record gifts of property at fair market value
- Do **NOT** record use of facilities (in most cases) or gifts of donated services
- Form 990 explicitly provides spot for reconciliation to audited GAAP statements
 - Form 990, Part IV-A, Line b2, and Part IV-B, Line b1

Gifts of Property or Services: Planning/Solutions

3x3 Table:	TAX	GAAP	Bragging Rights (Annual Reports, Funder Proposals, web)
Donated property: stock, laser printer, substantial amount of office supplies	Yes	Yes	Yes
Certain donated services: professional services pro-bono or discounted, services you would have had to pay for, some facilities such as meeting rooms, lodging for guest speakers	NO	Yes	Yes
Volunteer time , Board, grassroots volunteers	NO	NO	Yes

Joint Costs and SOP 98-2: The Issue

- Costs of certain kinds of mixed purpose (program+fundraising) activities that include a fundraising “ask” get counted as 100% fundraising under SOP 98-2, causing distortion: overstatement of fundraising costs
- This distortion weakens donor confidence and harms the reporting organization

Joint Costs and SOP 98-2: GAAP View

SOP 98-2

- Subject to multiple tests and criteria:
 - audience,
 - content,
 - compensation,
 - purpose

any of which can lead to 100% Fundraising

Joint Costs and SOP 98-2: TAX View

- Form 990 asks if SOP 98-2 is used
- Practitioners disagree about whether this:
 - means reporting entity may depart by not checking 98-2 box on joint costs
 - or is simply asking “are your books [and 990] on a GAAP basis?”
- GAAP is legally required by charities fundraising in California, for example

Joint Costs and SOP 98-2: Planning / Solutions

- Use professional judgment to override SOP 98-2, or
- If SOP 98-2 causes distortion, discuss in audit footnotes and split TAX & GAAP reporting of functional totals, or
- Do a qualified audit, and for transparency, prepare a footnote showing functional totals under both methods even though 98-2 is not being used

Prepaid fundraising costs: The Issue

- TAX, unlike GAAP, allows prepaid fundraising costs to be expensed over the life of the effect of the effort
- 990 constantly scrutinized for functional totals; big fundraising drive to build a list, for example, can make one particular year look bad to the public
- What to do?

Prepaid fundraising costs: GAAP View

➤ *A&A Guide, ¶ 13.06*

- Requires expensing of all promotional costs

Prepaid fundraising costs: TAX View

- 990 2005 instructions, Page 26, Column 2
- Form 990, Line 53 prepaid expenses
- Form 990 contemplates, even invites, use of prepaid fundraising costs
 - Can be used to avoid overstating fundraising cost in one year as proportion of total costs; might be useful if a big campaign would drive supporting functions over a level which is publicly palatable or qualifies for participation in federated fundraising

Prepaid fundraising costs: Planning / Solutions

- If using this TAX option,
 - prepare to explain variance on GAAP v. TAX reconciliation schedule (Form 990, Part IV-B) with a good attached explanation, because it will change total expense between the two; explanation may sound like “fast” accounting to public, watchdogs
- Alternately, follow GAAP and
 - consider expensing all in one year and attaching explanation of why supporting costs are unusually high this one year

FMV on Investments: The Issue

- TAX forms are often done incorrectly
- GAAP requires investments be recognized at Fair Market Value (FMV), but TAX makes it optional
- Confusion reigns on reporting unrealized gains and losses for TAX

FMV on Investments: GAAP View

- A&A Guide, Chapter 8
- FAS 124

- Show most investments at Fair Market Value

FMV on Investments: TAX View

- Form 990 2005 Instructions, Page 20, Column 3; Page 22, Column 2
 - Form 990, Line 20 **OR** Form 990, Part IV-A / IV-B
- If using FMV, show unrealized gains and losses on Line 20
- If not using FMV, show variance in income/expense on GAAP reconciliation, Part IV

FMV on investments: Planning / Solutions

- Increased rigor and consistency by tax preparers & reporting entities: get it right!

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Judgment

“Judgment pervades accounting and auditing. It is exercised in considering whether the substance of transactions differs from their form, in resolving questions of materiality and adequacy of disclosure, in deciding whether an estimate can be made of the effects of future events on current financial statements, and in allocating receipts and expenditures over time and among activities.”

“The Commission on Auditors Responsibilities: Report, Conclusions, And Recommendations,” An Independent Commission Established by the AICPA (1970’s)