Nonprofit Observer

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Tax Cuts and Jobs Act

Planning can help your nonprofit minimize negative effects

Months after the Tax Cuts and Jobs Act (TCJA) was signed into law, nonprofits are still trying to assess its consequences. Some of the early proposals that raised alarms in the charitable sector — such as a repeal of the Johnson amendment — didn't make it into the final version of the law. But there's still plenty to mull over and plan for.

How deductions affect donations

The biggest news for nonprofits is that the TCJA nearly doubles the standard deduction to $12,000 for individuals and $24,000 for joint filers. Fewer Americans are expected to claim itemized deductions starting in 2018 because their standard deduction will exceed their itemized deductions. Therefore, fewer are expected to make charitable giving part of their tax planning strategy. Unfortunately, it's impossible to predict to what extent this provision will affect donations. After all, people give to charity for many reasons besides the tax benefits.

One likely consequence, however, is that, while the higher standard deduction is in effect (2018–2025), some taxpayers who previously made annual gifts — often in December — will now itemize deductions only every other year and "bunch" their donations into those years. Nonprofits may need to adjust their expectations and budgeting processes accordingly.

The TCJA also doubles the estate tax exemption to $10 million (plus inflation adjustments) through 2025. With fewer wealthy individuals exposed to the tax, fewer may make the generous donations that can shrink their taxable estates. Plus, the law eliminates deductions for donations made in exchange for the right to buy season tickets to college athletic events.

The law does raise the limit on cash donation deductions from 50% of adjusted gross income to 60%. But cash donations at this level are uncommon, so the higher limit may not stimulate much additional giving.

How UBIT rules are changing

The TCJA has substantially lowered the maximum corporate tax rate to 21%. This is a benefit to any nonprofit that's already paying unrelated business income tax (UBIT) for income that exceeds $50,000, because UBIT is paid at the applicable corporate rate, which previously ranged from 25% to 35% for income above this level. However, nonprofits with taxable net income under $50,000 will now pay the 21%, vs. the former 15%, rate.

The new law requires nonprofits to calculate unrelated business taxable income (UBTI) separately for each unrelated business activity and pay tax on

any activity with net income. That means you can't use a loss from one unrelated business to offset income from a different unrelated business for the same tax year.

Your nonprofit generally still can, however, use one year's losses on an unrelated business to offset profits in a different year for that business, subject to certain restrictions. For example, if you incurred a loss in your bookstore business in 2018, you could use that loss to offset bookstore profits in 2019.

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The TCJA also includes certain fringe benefits in UBTI. Beginning in 2018, your nonprofit must pay the 21% UBIT on any expenses you incur to provide qualified transportation (such as transit passes) or qualified parking fringe benefits and access to on-site athletic facilities.

Which compensation faces excise tax

Under the TCJA, a 21% excise tax will now be imposed on high executive compensation. The tax applies to the sum of any compensation (including most benefits) in excess of $1 million paid in the tax year to a covered employee — plus any "excess parachute payments."

A "covered employee" means a current or former employee reported as one of your five highest paid employees for any taxable year beginning after 2016. Licensed medical professionals aren't covered employees for this tax as long as compensation is for medical services.

A payment generally is considered an excess parachute payment if it's contingent on the employee's departure *and* the present value of the payment equals or exceeds three times the base amount, which is the employee's average annual compensation for the preceding five years. The excess parachute payment subject to the excise tax is the amount of the parachute payment less the base amount.

Why financing may get more expensive

If your nonprofit issues tax-exempt bonds to finance construction and other capital activities, you know that they typically pay lower interest rates than other bonds. Investors are willing to accept the lower rates because they aren't required to pay income taxes on the interest.

But the TCJA repeals the tax-exempt treatment for interest paid on an "advance refunding bond." This is a refunding bond used to pay principal, interest or redemption price on another tax-exempt bond (the refunded bond) if the refund*ing* bond is issued more than 90 days before redemption of the refund*ed* bond.

Let's say you issue tax-exempt bonds at 4% interest but later discover you can refinance the bonds at 3% interest. Under the TCJA, interest payments on the 3% advance refunding bonds won't be tax-exempt for investors. That means you'll need to pay more interest to attract investors.

Where to start

It's not surprising that many nonprofits regard the TCJA as a blow to charitable organizations and the communities they serve. The Tax Policy Center estimates that rules related to deductions will reduce charitable giving by as much as $20 billion a year. But it's important to remember that every nonprofit is different. By understanding how the law is likely to affect your unique organization, you can plan to minimize negative effects.

3 tips for achieving your mission more cost-effectively

Do you want to control costs and improve delivery of your nonprofit's programs and services? It may not be as difficult as you think. Several simple initiatives can make a big difference in how efficiently your organization operates. Here are three:

1. Monitor measures that matter

First, you need to know how much of your nonprofit's expenditures go toward programs, as opposed to administrative and fundraising costs. Key ratios can help your organization measure and monitor program efficiency.

For example, the *percentage spent on program activities* offers insight into how much of your total budget is used to provide direct services. To calculate this measure, divide your total program service expenses by total expenses. Many watchdog groups are satisfied with 65%.

Also look at the *percentage spent on fundraising*. To calculate this number, divide total fundraising expenses by contributions. The standard benchmark for fundraising and admin expenses is 35%.

Your nonprofit's *current ratio* represents its ability to pay its bills. This measure is worth monitoring because it provides a snapshot of financial conditions at any given time. To calculate, divide current assets by current liabilities. Generally, this ratio shouldn't be less than 1:1.

Finally, *reserve ratio* indicates your ability to sustain programs and services during temporary revenue and expense fluctuations. The key is having sufficient expendable net assets and related cash or short-term securities. To calculate, divide expendable net assets (unrestricted and temporarily restricted net assets less net investment in property and equipment and less any nonexpendable components) by one day's expenses (total annual expenses divided by 365).

For most nonprofits, this number should be between three and six months. Base your target on the nature of your operations, your program commitments and the predictability of funding sources.

2. Orient your organization toward outcomes

Unlike output measures, which quantify the number of products or services delivered, outcomes focus on results that relate directly to your mission. Examples of outcome measures might include changes experienced by program participants, such as increased knowledge or improved skills.

To shift your focus to outcomes, review your mission statement and consider the goals you have for your programs and services. Say, for example, that your mission is to raise awareness about asthma and support a community health center that treats the disease. Outcome-based measures might include

the number of patients treated or the decline of asthma rates in the community over time.

3. Engage entrepreneurial experts

Your nonprofit can hire a consultant to help you improve program delivery. But if you don't have the budget, you might be able to achieve a similar result through a social entrepreneurship program. For example, you may be able to form an alliance with a for-profit company that offers an executive's services on a short-term advisory basis.

"Loaned" professionals can bring innovative business ideas (such as how to streamline processes) and a fresh perspective to your organization. The result: less time and money spent on inefficient practices and more on delivering services. Although an executive may not have time to join your nonprofit's board of directors, consider asking him or her to serve on an ad hoc board for a special project.

Building on success

These tips are just a start. Once you begin to see positive results, build on your success by adopting new initiatives. Consult with your financial advisors for additional ways to achieve greater operating efficiency. ●

Have faith … but take precautions

Financial best practices for religious congregations

Because they aren't required to file tax returns, many churches, synagogues, mosques and other religious congregations don't hire independent accountants to perform regular audits. But regardless of size, religious organizations often are subject to other requirements, such as reporting unrelated business income tax (UBIT) and properly classifying employees. Without the oversight of tax authorities or outside auditors, religious leaders may not be aware of all requirements to which they're subject. This could leave the organization vulnerable to fraud and its trustees and employees subject to liabilities.

Common vulnerabilities

To effectively prevent financial and other critical mistakes, make sure your religious congregation complies with IRS rules and federal and state laws. In particular, pay attention to:

Employee classification. Determine which workers in your organization are full-time employees and which are independent contractors. Depending on many factors, including their responsibilities, work location and form of compensation, individuals you consider independent contractors may need to be reclassified as employees. In most cases, employee wages are subject to Social Security and Medicare taxes.

Clergy wages. Most clergy should be treated as employees and receive W-2 forms. Typically, they're exempt from Social Security taxes, Medicare taxes and federal withholding, but clergy are subject to self-employment tax on wages. A parsonage (or rental) allowance can reduce income tax, but not self-employment tax.

UBIT. If your organization regularly engages in any type of business activity that's unrelated to

its religious mission, be aware of certain tax and reporting rules. For example, do you rent your parking lot when it's not in use during religious services or sell ad space in your newsletter? Such income could be subject to UBIT.

Lobbying. Your organization shouldn't devote a substantial part of its activities in attempting to influence legislation. Otherwise you might risk your tax-exempt status and face potential penalties. Of course, terms like "substantial" and "attempting to influence" are open to interpretation. But, in general, avoid making specific endorsements "from the pulpit," supporting candidates for office financially or sponsoring events that might be interpreted as partisan.

Trust and protect

Like all nonprofits, religious organizations need good internal controls. Faith groups are particularly vulnerable to fraud because they generally foster an environment of trust. Also, their leaders may be reluctant to punish the offenders. Just keep in mind that even the most devout and long-standing members of your congregation are capable of embezzlement when faced with extreme circumstances such as bankruptcy and substance abuse issues.

To ensure employees and volunteers can't help themselves to collections, require that at least two people handle all contributions. They should count cash in a secure area and verify the contents of offering envelopes. Next, they should document their collection activity in a signed report. For greater security, encourage your members to make electronic payments on your website or sign up for automatic bank account deductions. Also protect fund disbursements by requiring that a nonaccounting employee or trustee receive and review bank statements and that all checks above a specified amount have dual signatures.

Case for audits

Although your congregation is subject to less IRS scrutiny than even your fellow nonprofit organizations, that doesn't mean you can afford to ignore financial best practices. Consider conducting periodic audits — even if it's not required.

INTERNAL CONTROLS ARE JUST THE START

Internal controls are critical to preventing fraud in religious organizations. But a comprehensive risk-reduction program contains other elements, as well. For example, always perform background and credit checks on employees and volunteers who will be entrusted with financial matters. You should also:

- Maintain insurance coverage that's regularly reviewed as your organization grows and its needs change,
- Have an investment policy that describes procedures for handling donated stock and other securities,
- Undertake an inventory of securities, valuables and equipment at least once a year, and
- Create a personnel manual that outlines the rights and responsibilities of employees and documents expectations regarding work policies, ethical behavior, and technology use, including social media.

Stop employee credit card abuse before it starts

A nonprofit staffer charged legitimate travel-related expenses to her employer's credit card. Although she intended to file an expense report, her employer never asked for it — nor did the employer question her when it received the card statement. The employee was recently divorced and under unusual financial pressure, so when she couldn't pay for a personal purchase she reached for her work credit card. She kept reaching for it until she had racked up several thousand dollars — at which time the nonprofit finally noticed the illicit charges.

There's no reason your organization should experience this kind of credit card misuse or fraud. In fact, protecting it is as easy as writing a credit card use policy and following it.

Choose cardholders carefully

Start with who has the right to a card. Nonprofits commonly issue cards to their executive directors, program directors and office managers (or other employees responsible for buying supplies). Before issuing a card to other staffers, consider whether they really need it. Most can pay out of pocket and submit reimbursement requests. However, if employees travel or entertain donors regularly on your nonprofit's behalf, it may make sense to give them cards.

Just ensure that cardholders understand the rules. Explicitly say (even if it seems obvious) that they can't use the card for personal expenses, and list prohibited uses such as cash advances and electronic cash transfers, as well as charges over a specified amount. State that reimbursement for returns of goods or services must be credited directly to the card account. Employees should *never* accept cash or refunds directly.

Get managers involved

Manager involvement is essential to preventing credit card abuse. Require employees to seek pre-approval prior to incurring any credit card charge. Stress that unauthorized purchases (and related late fees and interest) will become the employee's responsibility. Employees should have to provide documentation (such as itemized receipts) to their authorizing supervisor for review.

Supervisors need to indicate their approval of the charges by a signature and date on the receipts or on a standardized expense form. Your accounting department should reconcile monthly credit card statements, and the statements should be reviewed by an executive or board member.

Give it teeth

Finally, make sure your credit card policy has teeth. Explain that violations will result in disciplinary action, including the possibility of employment termination and criminal prosecution. And if an employee violates your policy, do exactly as you promised. To ensure that staffers understand your policy, require them to acknowledge that they've read and agree to follow it.

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