Nonprofit Observer

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IRS guidance: Publishing relationship didn't produce UBTI

You're no doubt aware of the risk of generating unrelated business taxable income (UBTI). But you might not realize that the terms of your relationship with an outside publisher for your membership magazine or journal can trigger the tax on UBTI by creating an agency relationship. Some recent guidance from the IRS sheds light on how you can avoid this liability.

Tax issue summed up

Nonprofits are required to pay income tax on UBTI. UBTI is defined as income 1) from a trade or business, 2) regularly carried on and 3) not substantially related to the organization's exempt purpose (aside from the organization's need for funding or the way it uses any profits).

An activity doesn't stop qualifying as a business simply because it's conducted within a context of exempt activities. So, selling commercial advertising in your magazine or journal is considered a business even if the publication includes content related to your exempt purpose.

Technical direction

Discussions of UBTI often focus on its third element. A 2018 IRS technical advice memorandum (TAM 201837014), however, illustrates that the "regularly carried on" element also can trip up a nonprofit. In the memo, the IRS discusses a nonprofit that receives UBTI from advertising in its international, peer-reviewed journal. The journal is published under a contract with a for-profit publisher.

The agreement with that publisher gives the nonprofit complete responsibility for its editorial content. But the publisher is solely responsible for selling ad space in the journal, subject to the nonprofit's advertising standards. (The relationship between the two is described as that of independent contractors.)

According to the agreement, the publisher paid an annual stipend for salaries and expenses of the journal's editorial office, as well as expenses for the annual editorial board meeting. The agreement also states that the publisher will publish, produce, sell, distribute and promote the journal at its own expense. It pays the organization a percentage of "revenues" as an "earned royalty" for publishing and distribution rights. The agreement specifically excludes ad revenues from its definition of "revenues."

The IRS concludes that publishing commercial advertising is a trade or business not substantially related to the nonprofit's exempt purpose. The real issue, according to the tax agency, is whether it's regularly carried on by the organization. Although the nonprofit itself wasn't

directly engaged in advertising activities, the publisher's regularly carried-on activities were attributable to the organization — if the publisher acted as its agent with respect to those activities.

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Agency question

Agency arises when a principal (for example, a nonprofit) authorizes an agent (such as an independent publisher) to act on its behalf. Although the parties may label their relationship in some way other than "agency" in an agreement, that designation isn't the controlling factor for tax purposes. Instead, the IRS considers the facts and circumstances of each case.

In the TAM case, for instance, the IRS concluded that the agreement's provisions were consistent with the description of the publisher as an independent contractor. Citing earlier court opinions for guidance, the IRS noted that under the agreement the:

- Nonprofit didn't retain tight control over the method and manner of ad solicitation,
- Payments for ads weren't made to or collected by the nonprofit,
- Publisher's payments didn't vary based on ad revenue (so the publisher assumed all potential for gain and loss from ad sales), and
- Publisher didn't purport to act on behalf of the nonprofit.

Moreover, the agreement didn't require the publisher to seek advertising for the journal.

Review your agreement

While TAM conclusions apply only to a specific taxpayer's circumstances, they can give valuable insights on IRS thinking. If your organization has a relationship with an outside publisher, review the agreement in light of this memo — particularly the revenue allocation and compensation provisions. ●

DON'T COUNT ON THE ROYALTY EXCLUSION

Royalty income generally is excluded from a nonprofit's unrelated business taxable income (UBTI) if it's generated "passively" — or not in competition with taxable businesses. As explained in the main article, though, labels don't matter to the IRS or courts. Titling an agreement as a "Royalties and Licensing Agreement" won't help if the agreement is actually an agency relationship.

In one case, for example, a federal court of appeals rejected a nonprofit's claim that payments it received from a company, which published the nonprofit's magazine three times a year, were passive royalty payments. The "passive" part wasn't in doubt — the court acknowledged that the organization spent little time working on the magazine.

But the court found that the payments weren't royalties because the publisher used the organization's name to promote the organization, not its own products. The court noted that the publisher's ad solicitors indicated they were calling on behalf of the nonprofit. Plus, the advertisers' checks were payable to the nonprofit. The payments, therefore, weren't royalties and qualified as UBTI.

New overtime rules could inflate payroll expenses

A proposed rule, issued by the U.S. Department of Labor (DOL), would update the overtime exemptions for so-called white-collar workers under the Fair Labor Standards Act. If finalized, the new rule could lead to higher compensation and payroll tax expenses for employers, including nonprofits.

What are the current rules?

Under the existing regulations, an employer generally can't classify a white-collar employee as exempt from requirements for the payment of overtime compensation when working more than 40 hours in a week. That's unless the employee satisfies three tests:

- **Salary basis.** The employee is paid a predetermined and fixed salary (and it's not subject to reduction due to variations in the quality or quantity of the work performed).
- **Salary level.** The employee is paid at least $455 per week ($23,660 annually).
- **Duties.** The employee primarily performs executive, administrative or professional duties.

Job title or salary alone won't justify an exemption if the employee's job duties and earnings don't satisfy applicable requirements.

Certain employees (for example, doctors, teachers and lawyers) aren't subject to salary basis or salary level tests. The current rules also provide a "relaxed duties" test for these "highly compensated employees" (HCEs) who're paid at least $100,000 in total annual compensation and at least $455 in salary per week. Typically, these are employees who earn commissions, bonuses and other nondiscretionary compensation.

What changes are proposed?

Here are some highlights of changes proposed in the new rule. It would increase the standard salary level threshold to $679 per week, or $35,308 per year. If an employee's salary exceeds this threshold, his or her overtime eligibility will then prompt the duties test. The proposal pushes up the total annual compensation requirement for HCEs to $147,414. HCEs also must make at least $679 per week on a salary or fee basis, excluding nondiscretionary bonuses and incentive payments.

The proposed rule would increase the standard salary level threshold to $679 per week, or $35,308 per year.

Another change allows bonuses to be used for up to 10% of the total compensation during the analysis. This would have the effect of moving more people off the eligibility list, as their compensation would be higher.

The proposed rule doesn't include automatic adjustments to the salary thresholds that were part

of the regulations proposed during the Obama administration. Instead, the DOL suggests making updates every four years.

Useful strategies?

If your employees never work overtime, you don't need to worry about the proposed changes. But nonprofits that have employees logging overtime have several options to reduce the impact if the proposed rule is approved.

For example, you might want to raise the salaries of employees who satisfy the duties test, earn a salary near the new threshold and often work overtime. The salary boost could cost you less than the overtime pay in the long run. You also could reorganize your workload distributions or revise employee work schedules to redistribute work hours that exceed 40 per week among current staff. Or you might hire new employees to trim or eliminate overtime hours of existing staffers.

Whatever direction you decide to pursue, remember that the proposed changes aren't written in stone. While the Trump administration probably would like to implement it before the 2020 election, any new rule may face opposition and land in court. That's what happened to the Obama administration's proposed rule, which ultimately was halted by a federal court, days before it was to take effect.

The big picture

Bear in mind, too, that you'll incur more than just the increased compensation and administrative costs. Your payroll tax liability also will grow as you pay more to employees who work over 40 hours a week or higher salaries to retain exemptions. ●

Attesting to your nonprofit's ability to survive

Are you certain that your organization is financially stable enough to be operating in a year? U.S. Generally Accepted Accounting Principles (GAAP) give your nonprofit a reason to evaluate that proposition.

Evaluating your organization

Accounting Standards Codification (ASC) 205-40 requires management to perform a going-concern evaluation each time annual or interim financial statements are issued. Management's responsibilities are *in addition* to the auditor's going-concern responsibilities — both parties must conduct evaluations.

The management evaluation comprises two steps. First, your management team must evaluate whether conditions and events exist that raise substantial doubt about your organization's ability to continue as a going concern. Second, if doubt exists, it must consider whether your plans meant to mitigate those conditions or events will alleviate the doubt. And your plan must be feasible to implement.

If substantial doubt is found about your nonprofit's ability to survive, management must make certain disclosures in its financial statements' footnotes. The extent of the disclosures will vary depending on whether management concludes that its plans will allay the doubt.

Gauging financial stability

Substantial doubt exists when relevant conditions and events, considered together, indicate that it's

likely an organization won't be able to meet its financial obligations. That assessment involves obligations that come due within one year after the date of the financial statements' issuance.

Relevant factors include your nonprofit's current financial condition and obligations anticipated within one year. You also should consider the funds needed to maintain operations given your organization's current financial condition, liabilities and other expected cash outlays within one year. Also weigh in conditions and events that may adversely affect your ability to meet anticipated expenses over the next year.

Adverse conditions and events that raise substantial doubt include negative financial trends (for example, negative cash flows from operations) and indications of possible financial difficulties (such as loan default or denial of credit by suppliers). Litigation, legislation or other matters that threaten the nonprofit's ability to operate also count in the doubt equation.

Mitigating uncertainty

As part of a plan to lessen the conditions and events that create substantial doubt, you may want to dispose of an asset, borrow money, or reduce or delay expenditures. But, you can consider the mitigating effect only if the plan 1) will lessen the conditions that raised the substantial doubt about the ability to continue as a going concern, and 2) can be effectively implemented. The likelihood of effective implementation is based on the feasibility of this action in light of your nonprofit's individual circumstances. For example, do you have the necessary resources to carry out the plan?

As for the likelihood of mitigation, consider the expected magnitude and timing of your plan's mollifying effect. In other words, will the plan alleviate the conditions and events within one year?

Disclosing required information

Disclosures are required when substantial doubt exists, regardless of whether your plans will significantly lessen the doubt. You must disclose information that allows financial statement users to understand the principal conditions and events that raise the doubt. Your disclosure also must include management's evaluation of their significance in relation to the organization's ability to meet its obligations.

During the process, don't neglect to disclose information about any plans to alleviate relevant conditions and events. If you determine that your management's plans won't mitigate the conditions or events within the year, include a statement in the footnotes. It must indicate that substantial doubt exists about your ability to continue as a going concern for one year after the date the financial statements are issued.

Once you determine that a substantial doubt exists about your organization's ability to continue, your disclosure obligation is ongoing. Until the related conditions or events are resolved, you must make these disclosures. And, as the conditions or events change over time, so should your disclosures — to ensure that your financial statement users receive the most current information.

Turn things around

Evaluating your organization's financial durability may cause some trepidation. But the requirement to assess your nonprofit's ability to continue as a going concern lays the groundwork for fixing problems. ●

Philanthrokids

The next generation of donors is here

It's not hard to find insights and advice about the importance of appealing to potential donors who are Millennials, Generation Xers and Baby Boomers. But you should also start thinking about the next crop of donors — Generation Z, those born after 1996.

Getting to know Gen Z

Gen Zers typically are either in school or just launching their careers, so you can understand why they haven't yet attracted a lot of interest from many nonprofits. After all, according to a study conducted by one market research firm, their contributions represent only about 2% of total giving. And their average donation tops out at $341 per year. But — and it's a big "but" — about 44% of Gen Zers have given to charity. These youngsters aren't waiting until they're older and wealthier to try to make a difference.

Sometimes dubbed "Philanthrokids" or "Philanthroteens," Generation Z may be more driven to pursue social impact than earlier generations at their age. Many are hyperaware of what's going on in both the world and their local communities.

As digital natives who have grown up surrounded by technology, they have the skills to be adept at peer-to-peer fundraising. Whether convincing their friends and families to sponsor them in fun runs and similar events, or using social media to generate direct donations to their favored causes, Gen Zers often make valuable resources for nonprofits.

Many are also working as advocates for more politically oriented causes they see affecting their own lives, such as gun control, climate change and inequality. Consider, for example, the teenagers and young adults who mobilized ongoing gun control campaigns in the wake of the Parkland shooting. Or the almost two dozen youths currently suing the federal government for failing to fight climate change.

Connecting

To reach Gen Z, you'll need to use channels such as Snapchat, Instagram and Twitter — obviously different from those used for older generations. The good news? Gen Zers are receptive to digital ads. The bad? They're well aware of the mounds of their personal data out there. Many of them expect outreach to be narrowly tailored to their interests.

Gen Zers also tend to want to be more involved than many of their predecessors. They may not be satisfied with just writing a check or setting up recurring payments (likely to be microdonations initially). They often desire a hands-on role.

Not too soon

You can find more lucrative demographic segments than Gen Z to target in the short term. But if you take advantage of this generation's charitable inclinations and get them involved now, you might end up with decades-long relationships.

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MW&A's nonprofit professionals have significant hands-on experience working with nonprofit organizations and become integral members of your internal team. As passionate advocates, we strive to help every organization we serve reach its highest potential.

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Achieve Your Highest Potential

In keeping with our dedication to meeting the accounting and business needs of nonprofit organizations, MW&A established The Midwest Resource Group – a network of highly experienced advisors serving nonprofit organizations that we can draw upon to support our clients. Services available through the Midwest Resource Group range from insurance, HR, investment and IT consulting to executive search, training, research, website and marketing services.

We also participate in the Association Forum of Chicagoland and are active members of the Illinois CPA Society's Not-For-Profit Organizations Committee. In addition, we are members of the American Institute of Certified Public Accountants' (AICPA) Not-For-Profit Section and its Center for Governmental Audit Quality and Employee Benefit Plan Audit Quality Center.

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