# Nonprofit Observer

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The pitfalls of dealing with disqualified persons

Maintaining your tax-exempt status

Don't ignore outside auditors' findings

News for Nonprofits

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# Avoiding excess benefit transactions

## The pitfalls of dealing with disqualified persons

The IRS has released new guidance on excess benefit transactions (EBTs). So-called disqualified persons and organization managers who engage in such transactions with nonprofits face stiff excise taxes — also known as intermediate sanctions — under Section 4958 of the Internal Revenue Code. But not every transaction between disqualified persons and nonprofits is prohibited. Here's what you need to know.

### What's an EBT?

An EBT generally is any transaction in which a nonprofit (other than a private foundation) provides an economic benefit to a disqualified person that exceeds the value of the consideration received in exchange for the benefit. "Consideration" might include, for example, the performance of services. Although EBTs often involve unreasonable employment compensation, a variety of other transactions also can fall into the definition (see "Tread carefully with these transactions" on page 3).

Disqualified persons include those:

- In a position to exercise substantial influence over the organization's affairs,
- A disqualified person's family members,
- 35% controlled entities (generally, entities in which disqualified persons have a 35% or greater stake),
- Persons involved with a related supporting organization,
- Donors or donor advisors involved in a transaction with a donor-advised fund (DAF), or
- Investment advisors to a DAF sponsoring organization.

A disqualified person who engages in an EBT is liable for an excise tax equal to 25% of the excess benefit. If the transaction isn't timely corrected after the tax is imposed, an additional excise tax of 200% of the excess benefit is imposed. An organization manager found to have knowingly participated in an EBT could incur an excise tax equal to 10% of the excess benefit, up to $20,000.

### Is there a rebuttable presumption?

Tax regulations provide a route for an organization to establish a "rebuttable presumption" that a certain transaction with a disqualified person isn't an EBT. A rebuttable presumption is a legal principle that assumes something to be true unless proven otherwise. The requirements for such a presumption provide a roadmap for how organizations should handle transactions with disqualified people.

The regulations presume fair market value in arrangements involving employment compensation, the transfer of property or the right to use property. To start, the organization's authorized body (for example, the board of directors or a board committee) must be composed entirely of individuals without a conflict of interest regarding a transaction.

The authorized body must approve the compensation arrangement or property transfer terms in advance. Additionally, the authorized body must obtain and rely on appropriate data as to comparability before making its determination. For example, it can use an independent compensation survey for functionally comparable positions or an independent appraisal of the property being transferred.

It must also adequately and "concurrently" document the basis for its determination as it was making the determination. This includes the transaction's terms, approval date and who voted, as well as comparability data relied on and how it was obtained. Concurrent documentation means it's prepared by the later of:

1. The next meeting of the authorized body, or
2. 60 days after the authorized body's final action on the matter.

The comparability data is particularly important. If the above requirements are satisfied, the IRS can rebut the presumption only by developing sufficient contrary evidence to rebut the relevance of the data.

## Is there help for small organizations?

Although small nonprofits may find the prospect of obtaining adequate comparability data daunting, IRS regulations provide some relief to nonprofits with annual gross receipts of less than $1 million. Your authorized body will be deemed to have appropriate data if yours details compensation paid for similar services by three comparable organizations in your community or similar ones.

Annual gross receipts are your average gross receipts during the three prior taxable years. But you must aggregate annual gross receipts of all organizations if your nonprofit is controlled by or controls another entity.

## Don't risk it

The potential repercussions of an EBT go beyond the financial costs for the disqualified persons and organization managers involved. Your nonprofit also could suffer bad publicity and reputational damage that harms your ability to raise funds. Consult with your CPA before entering any transactions with disqualified persons to avoid prohibited transactions.

## TREAD CAREFULLY WITH THESE TRANSACTIONS

So when does an excess benefit transaction (EBT) occur? The new IRS guidance on EBTs identifies examples of transactions between a tax-exempt organization and disqualified person that could raise Section 4958 issues. These include:

- An organization's payment of personal expenses for a disqualified person or family members,
- A disqualified person's use of the organization's vehicles or real property for personal reasons,
- A disqualified person's lease of property to the organization for rent,
- Loans between the organization and a disqualified person (in either direction),
- Payments to a for-profit corporation owned by a disqualified person,
- Revenue-sharing arrangements, and
- An organization's transfer of assets to or from a for-profit organization controlled by a disqualified person.

The IRS stresses that the above list isn't all-inclusive. It's a safe bet, though, that any such transactions will pique the interest of an IRS auditor.

# Maintaining your tax-exempt status

Tax-exempt status isn't necessarily forever. It may not happen frequently, but the IRS does revoke the status when nonprofits engage in substantial disqualifying or nonexempt activities. In fact, the agency recently updated the audit guidance for its examiners regarding such tax-exempt status violations. If your organization is venturing into business activities these days, know what the IRS is looking for.

## Operational test

A 501(c)(3) nonprofit must be both "organized" and "operated" exclusively for an exempt purpose. The new guidance focuses largely on the second factor, the so-called operational test.

When applying the operational test, the IRS will examine an organization's activities and how they further exempt purposes. No more than an "insubstantial part" of its activities may further a nonexempt purpose. The IRS will look at your Form 990 and review your mission and activities, employees, volunteers, changes in programs, and any unrelated business income. The IRS also will scrutinize your financial information to determine if income, expenses and assets are appropriate for your exempt functions — or if they indicate a nonexempt trade or business.

*The IRS will scrutinize an organization's financial information to determine if the income, expenses and assets are appropriate for the exempt functions.*

## Fragmentation rule

Although the tax code requires tax-exempt organizations to be organized for exempt purposes, it does allow them to conduct some activities similar to those of a trade or business — that is, activities conducted to produce income from the sale of goods or the performance of services. But if these activities aren't substantially related to your organization's exempt purpose, they might jeopardize its exempt status under the operational test.

This is where the fragmentation rule comes into play. This rule recognizes that an activity doesn't lose its identity as a trade or business simply because it's conducted:

1. Within a larger aggregate of similar activities, or

2. Within a larger complex of other activities that may or may not be related to your organization's exempt purpose.

As a result, the IRS will *separately* analyze each trade or business activity as to whether it furthers an exempt purpose, even when it's engaged in alongside similar exempt activities.

## Commerciality doctrine

The commerciality doctrine is relevant to the operational test, too. Under the doctrine, an organization can be found to have operated for nonexempt commercial purposes because of the commercial manner by which it conducted activities.

The IRS has reasoned that a nonprofit operating in a commercial manner has commercial activity as its primary purpose, making the commercial activity substantial and unrelated to exempt purposes. In recent years, for example, the IRS denied tax-exempt status to a community coffeehouse because it was operating for a substantial nonexempt commercial purpose, rather than an exempt purpose.

The IRS will consider the extent and degree of below-cost services provided (nonprofits generally should price at below-cost, rather than at fair market value or cost), as well as the extent of charitable donations (donations should represent a significant percentage of a nonprofit's total support). It also examines whether the business sells to the general public, rather than to a discrete charitable class (for example, other nonprofits or a disadvantaged population). Other factors relevant to the commerciality evaluation include:

- Competition with for-profit commercial entities,
- Reasonableness of financial reserves (nonprofits shouldn't accumulate unreasonable reserves),
- Use of commercial promotional methods, such as advertising,
- Whether the business is staffed by volunteers or paid employees, and
- Whether unprofitable programs are discontinued.

No single factor is determinative.

## Better safe than sorry

If your organization has begun conducting business activities and you're uncertain about the impact on your tax-exempt status, check with your CPA. We can help ensure you stay on the right side of the IRS.

# Don't ignore outside auditors' findings

Has your nonprofit had an outside audit recently? If so, did your organization act on the findings? The cost of not responding to audit results can be steep. Read on to learn why constructive follow-up is in your organization's best interest.

## Reviewing the draft report

Once outside auditors complete their work, they typically present a draft report to the subject's audit committee, executive director and senior financial staffers. Those individuals should take the time to review the draft before it's presented to the board of directors.

Your audit committee and management should meet with auditors prior to their board presentation. Often auditors will provide a management letter highlighting operational areas and controls that need improvement. Your team can respond to these comments, explaining how your organization plans to improve operations and controls, to be included in the final letter.

Your audit committee also can use the meeting to ensure that the audit is properly comprehensive. The auditors will provide a governance letter (also called "communication with those charged with governance"), which should confirm cooperation

from your organization's staff and whether they received all requested documentation. They'll also disclose any difficulties or limitations encountered during the process, accounting adjustments required, and any significant audit plan changes and the reasons for such changes. Finally, they'll report if there are any unresolved matters. Your audit committee should determine whether there were any conflicts of interest between the auditors and your team and how they might have affected the scope of the audit.

## Considering input from others

The committee should obtain your executive director's impression of the auditors and the audit process, too. Did the auditors demonstrate the requisite expertise, skills and understanding? Were they disruptive to operations? The board should consider this input when deciding whether to retain the same firm for the next audit.

Your audit committee and management also might want to seek feedback from the employees who worked most closely with auditors. In addition to feedback on the auditors, they may have suggestions on how to streamline the process for the next audit. For example, your staff could develop a checklist of documentation the auditors requested so it can be gathered and properly formatted in advance.

## Taking next steps

The final audit report will state whether your organization's financial statements are fairly presented in accordance with U.S. Generally Accepted Accounting Principles. The statements must be presented without any material — meaning *significant* — inaccuracies or misrepresentation.

As noted above, the auditors also may identify, in a separate letter, specific concerns about material internal control issues. Adequate internal controls are critical for preventing, catching and remedying misstatements that could compromise the integrity of financial statements, whether due to error or fraud.

*If the auditors find an organization's internal controls weak, the organization must promptly shore them up.*

If the auditors find your internal controls weak, your organization must promptly shore them up. You could, for instance, set up new controls, such as segregating financial duties or implementing new accounting practices or software. Such measures can reduce the odds of fraud, improve the accuracy of your financial statements and help reduce future audit costs.

## Don't waste your money

Regular outside financial audits can provide assurance to your donors and other stakeholders about your nonprofit's stability, while also revealing financial risks. The key is to respond to the results. Failing to act on issues identified in an audit isn't only a waste of money. It also may threaten your organization's long-term viability.

# News for Nonprofits

## Will the U.S. Senate streamline the grant process?

A bipartisan bill introduced in the U.S. Senate in July 2023 would help simplify the administration of grant programs across the federal government. The *Streamlining Federal Grants Act of 2023* (S. 2286) builds on the *Grant Reporting Efficiency and Agreements Transparency (GREAT) Act,* enacted in 2019, which requires federal grant programs to streamline data standards for applications and reporting.

In particular, the new bill would assist governments and organizations in small and rural communities that often struggle with complicated application processes when applying for federal grants. Among other things, the legislation would lead to easier-to-understand notices of funding opportunities, updated software and systems for applying for and managing federal grants, and common data standards for data reporting. The bill has been referred to the Senate Committee on Homeland Security and Governmental Affairs.

## How a Charity Navigator partnership can promote impact data

Independent charity evaluator Charity Navigator recently announced it has joined forces with social impact registry Impact Genome. The registry allows nonprofits to report and independently verify their impact based on 132 standardized social outcomes. Donors are increasingly interested in where their donations go and what they actually accomplish, and this move is the latest in Charity Navigator's efforts to shift the focus of its ratings from overhead to outcomes.

The partnership is intended to improve the quality and availability of nonprofit impact data so donors can make more informed giving decisions. Nonprofits will now be able to seamlessly report their results just once each year, making the reporting much less burdensome for organizations that frequently have limited resources. At the same time, donors will benefit from the use of consistent impact data in Charity Navigator's ratings.

## Study highlights nonprofit website flaws

While nonprofit websites have made significant progress in areas such as search engine optimization and web accessibility, a new report from fundraising firm RKD Group is raising the alarm on user experience. The firm analyzed the websites of more than 2,000 nonprofits using Google's PageSpeed Insights tools and describes the results of its analysis as "quite shocking."

According to the *2023 Nonprofit Website Performance Report,* 80% of nonprofit websites were ranked "poor" in terms of their mobile performance, and 86% of nonprofit websites were found to "need improvement" in their desktop performance. Both the user experience and the page-loading speed for nonprofit sites lagged behind the performance of commercial websites. On the positive side, nonprofits fared better in scores that evaluate how up-to-date websites are when it comes to factors like script errors and cybersecurity measures. Overall, though, many nonprofit websites have room for improvement.

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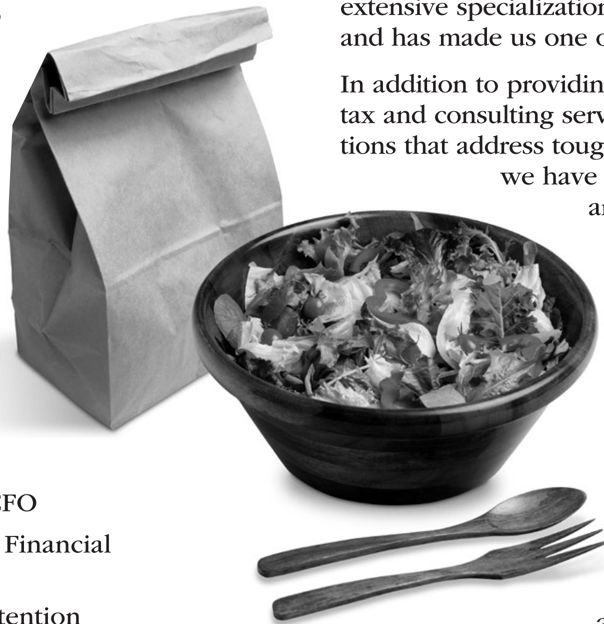
# Yes, you can have your lunch — and learn too

## At the Jones and Kolb monthly Tax Exempt Association (TEA) Group luncheon

Don't miss these highly popular and informative presentations on solutions to the many challenges facing nonprofit organizations. You'll not only pick up helpful ideas about ways to increase your organization's efficiency and effectiveness, you'll also get to network with your peers and learn what others are doing to address problems you may be struggling with yourself.

At each luncheon, a Jones and Kolb shareholder or a distinguished guest speaker will talk about current issues of relevance to the nonprofit community and suggest ways to address them. There will also be time for questions, answers and discussion.

To sign up, go to www.joneskolb.com or call our office at 404.262.7920. To whet your appetite, here are some of the topics the luncheons have covered over the past year:



- Record Retention Policies – What Information and How You Need to Keep It
- AICPA Not-for-Profit Section Resources and the NFP Advisory Council
- What Keeps NFP Management Awake at Night?
- Tax Red Flags and Myths
- The Many Hats of a Nonprofit CFO
- Proposed Changes to Nonprofit Financial Reporting – You Get a Vote!
- If You Want to be Successful, Attention to Detail Matters
- Setting Criteria for Board Members
- The Management of Investment Decisions – Building a Framework for Success
- The Fraud-Resistant Organization: Tools and Techniques to Deter and Detect Fraud
- Cyber Crime – What Can You Do to Protect Yourself and Your Organization?
- NPO Board Priorities and Best Governance Practices
- Balancing Brevity, Understandability and Completeness of Financial Statements

Since our founding in 1976, Jones and Kolb has strived to be positive, practical and proactive in serving our clients' needs. This philosophy has enabled us to develop extensive specialization in serving nonprofit organizations and has made us one of Atlanta's Top CPA firms.

In addition to providing outstanding audit, accounting, tax and consulting services, we excel in developing solutions that address tough and unusual issues. For example, we have helped clients increase revenue and membership, create deferred compensation programs, set up foundations and account for qualified corporate sponsorships, payments and advertising.

We welcome you to experience the TEA Group and talk with your peers over lunch. We also invite you to sign up for our complimentary quarterly newsletter, *Nonprofit Observer*. Please call us at 404.262.7920 or e-mail info@joneskolb.com and let us know how we can be of assistance. ✱

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