

# Hertzbach Nonprofit Advisor



## The New Revenue Recognition Standard Applies to Nonprofits, too!

By Mark P.S. Edward, CPA, CCMA, FCA

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standard Update (ASU) 2014-09, Revenue from Contracts with Customers (Topic 606). The purpose of this ASU, a joint project between the FASB and the International Accounting Standards Board (IASB), was to clarify the principles for recognizing revenue and to develop a common revenue standard for U.S. GAAP and IFRS.

The core principle of this ASU is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. There are five steps an organization should apply under this new guidance:

1. Identify the contract(s) with a customer.
2. Identify the performance obligations in the contract.

3. Determine the transaction price.
4. Allocate the transaction price to the performance obligations in the contract.
5. Recognize revenue when (or as) the entity satisfies a performance obligation.

The new revenue recognition standard will be effective for nonpublic entities for annual reporting periods beginning after December 15, 2017. While that may seem like a long way away, there are actions that can be taken now to be adequately prepared for the standard's implementation. Here are some actions to consider:

1. Take inventory of all current revenue streams and evaluate whether there are differences between current GAAP practices and the new standard. Be skeptical when a contract manager is adamant that nothing needs to be reviewed.

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Our dedicated Nonprofit Services Group offers the hands-on expertise and technical skills needed to serve the distinct needs of this important sector. As trusted business advisors, we are proactive in assisting each association's management team and board of directors.

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# Establishing The Groundwork For Joint Ventures Between Nonprofit & For-Profit Organizations

By Laura Kalick, JD, LLM  
& David Friend MD



**Joint ventures between nonprofit and for-profit entities are very popular these days, especially in the healthcare arena, where nonprofits are hungry for access to new sources of capital to fund efforts that will give them a competitive advantage in a rapidly changing environment.**

While joint ventures between nonprofit and for-profit entities aren't a new concept, the rules have changed over the years. Initially, the Internal Revenue Service (IRS) opposed arrangements in which the exempt organization acted as the general partner of the arrangement, since it subjected the assets of the organization to the claims and creditors of the partnership. As the industry has evolved, so has the IRS' position: Now, the exempt organization can be a general partner, so long as the partnership furthers its purpose and there are effective controls to protect its assets.

Whether the joint arrangement is through a partnership, limited liability company or management contract, the general financial considerations remain the same. The key issues to consider with joint venture arrangements include:

## **Economic Justification**

Does the transaction make sense from a business and economic perspective? Simply seeking to perform a tax arbitrage will not yield a satisfactory result.

## **Proper income Treatment**

Joint ventures taxed as partnerships are "passthrough" entities. This means the venture is taxed as if the exempt organization entered into the venture directly. Securing favorable tax status for the venture weighs heavily on not only "what" the venture is doing, but "how" it is being done. The key question to ask: Would the venture be considered an unrelated trade or business if the exempt organization operated it directly? If so, it would create unrelated business income if operated through a joint venture.

In order to avoid unrelated business income taxes, there must be documents and evidence to suggest that the venture is operated in a manner that is consistent with the nonprofit's purposes. Thus, the exempt organization must maintain sufficient control over the venture to ensure it is run in a manner that prioritizes the exempt organization's purposes over profitmaking objectives. If the exempt organization does not have an interest large enough to exercise control, other safeguards should be implemented, such as super majorities required for certain actions or veto powers.

If one of the exempt partners happens to be a hospital, the hospital must be able to ensure that the venture's activity will be conducted to further the community's benefit.

Otherwise, the income stream could create unrelated business income. Furthermore, if the joint venture partner is involved in a hospital department's operation, the hospital's section 501(r) financial assistance policy and billing and collection policies must still cover the department to avoid creating tax issues that would cause revenue to be treated as unrelated business income.

## **Quid Pro Quo Funding**

The exempt organization's share of profits and losses from the venture must be proportionate to its contribution to avoid tax issues, such as private inurement.

## Buying, Leasing and Lending

In some cases, the exempt organization may lease or sell property to the joint venture, or buy or lease property from the for-profit entity. In either case, the transaction must be transparent and for fair market value. This also holds true for loans and guarantees.

Intermediate Sanctions rules could apply if transactions are not at fair market value and if the for-profit entity is one that can exercise substantial influence over the organization. Whether a party can exercise substantial influence over an exempt organization must be determined through a facts and circumstances analysis. For cases in which the joint venture is with physicians, their previous relationships with a hospital, including how many patients their practices admitted, may factor into the analysis.

Organizations can pro-actively work to prevent the levying of Intermediate Sanctions by establishing the rebuttable presumption of reasonableness when negotiating lease or sales arrangements. This shifts the burden of proof to the IRS to show that the amount involved is excessive. An independent governing body can establish the presumption by approving the transaction based on comparable data and then documenting its decision contemporaneously. Appraisals are always useful in establishing fair market value.

## Management contracts

New combinations of tax-exempt organizations and for-profit entities often involve a management contract. These contracts should be structured carefully for bond-financed facilities, paying special attention to “qualified use,” which can affect the tax-exempt status of the bonds. The IRS also expanded its 1997 safe harbor as to what provisions of a

management contract will allow it to be considered qualified use. The new provision allows the manager to be paid an annual productivity reward, in addition to other compensation, if the reward is based upon the quality of services provided under the contract, rather than increases in revenues or decreases in expenses of the facility. The amount of the productivity award must also meet certain criteria.

It is likely that in the not-too-distant future, there will be increasing combinations of for-profit and nonprofit corporate structures as organizations look to access capital and management talent. In order for these arrangements to be successful, organizations must lay considerable tax, business and governance groundwork to ensure efficiency and tax effectiveness. (1)



## Nonprofit Facts: Did you know?

**Fifty-seven percent** of internships at nonprofit organizations are unpaid, compared to 48 percent at government offices and 34 percent at for-profit businesses, according to a 2010 Intern Bridge study.

**The Center for Responsive Politics (CRP)** projects that spending in the current election cycle by 501(c)(4) groups that do not disclose donors will break all previous records. Spending by these groups rose from \$1.3 million in 2006 to \$256.3 million in 2012, according to the CRP.

**From 2007 to 2012**, the number of jobs at organizations registered as charities with the Internal Revenue Service increased 8.6 percent, climbing from 10.5 million to 11.4 million, according to new research from the Bureau of Labor Statistics.

**According to a new report** from UBS Wealth Management Americas, nine in 10 affluent Americans say they donate to charity, yet only 20 percent consider their giving to be effective.

**The tax-exempt sector** in the U.S. contributed 5.4 percent — or \$887.3 billion — of the nation’s gross domestic product (GDP) during 2012, according to the most recent Nonprofit Sector in Brief report by the Urban Institute’s Center on Nonprofits and Philanthropy.

**According to the Chronicle of Philanthropy’s** annual nonprofit executive compensation survey, the median change in CEO salary among 82 organizations between 2011 and 2012 was 4.9 percent. (2)

*(1) (2) These articles originally appeared in BDO USA, LLP’s “Nonprofit Standard” newsletter (Winter 2014). Copyright © 2014 BDO USA, LLP. All rights reserved. [www.bdo.com](http://www.bdo.com)*

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## New Revenue Recognition (continued from cover)

2. Systems, processes, and controls may need to be evaluated and updated as a result of the new criteria and any changes in the timing of revenue recognition.
3. Identify data gaps between what information is presently available and what will need to be collated for the required disclosures in the new standard.
4. Attend technical trainings and seminars related to the new standard to ensure staff are knowledgeable of the new standard and required disclosures. Talk to your independent CPA firm.
5. Consider creating proforma financial statements which present revenue in accordance with the new standard to understand how this will affect your financial statements and related disclosures.

*Note: Certain parts of this article have been excerpted from the BDO blog article "Think the New Revenue Recognition Accounting Standard Won't Apply to Your Nonprofit? Think Again"*

## New Form 1023- EZ

### Can Private Foundations Rely on Determination Letters?

By Jeffrey Schragg, CPA

**The Internal Revenue Service (IRS) rolled out the new form 1023-EZ on July 1, 2014 for use by small organizations to achieve tax-exempt status under Internal Revenue Code (IRC) Section 501(c)(3).**

As with any change, questions can arise. For example, may a private foundation and other grantors rely on a determination letter issued to an organization that submitted a Form 1023-EZ in the same manner and to the same extent as a determination letter issued to an organization that submitted a Form 1023?

Typically, a private foundation need not exercise expenditure responsibility when making a grant to certain organizations, including those eligible for Form 1023-EZ use. Revenue Procedure 2014-40, provides that a determination letter "issued to an organization that submitted a Form 1023-EZ. . . may not be relied upon if it was based on any inaccurate material information." For this purpose, "inaccurate material information includes an incorrect attestation as to the organization's organizational documents, the organization's exempt

purposes, the organization's conduct of prohibited and restricted activities, or the organization's eligibility to file Form 1023-EZ."

As such, there may be concerns whether a private foundation can rely on the Form 1023-EZ determination letter or whether they must exercise expenditure responsibility. A private foundation does not have the ability to determine whether the organization made an "incorrect attestation" on its tax-exemption application without undertaking the in-depth review that once would have been done by the IRS via the Form 1023 application review process, nor should they have to.

And although the instructions for Form 1023- EZ say, "donors and contributors may rely on an organization's favorable Determination Letter under section 501(c)(3) until the IRS publishes notice of a change in status, unless the donor or contributor was responsible for or aware of the act or failure to act that results in the revocation of the organization's Determination Letter," the instructions do not reference grantors. However, the instructions cite Revenue Procedure 2011-33,

which actually references "grantors." Therefore, the question becomes whether it is safe to assume the grantors may also rely on the Form 1023- EZ determination letter. It is easy to differentiate determination letters issued to Form 1023 filers vs. Form 1023-EZ filers. Determination letters issued to Form 1023-EZ filers are issued on "Letter 5436," which opens with: "We're pleased to tell you we determined you're exempt from federal income tax . . .". Currently, determination letters issued to Form 1023 filers, on the other hand, are issued on "Letter 947," which opens with: "We are pleased to inform you that upon review of your application for tax exempt status we have determined that you are exempt from Federal income tax . . .".

Hopefully, the IRS or the Treasury Department will issue guidance or revise the instructions clarifying that a determination letter issued to an organization that submitted a Form 1023-EZ may be relied on by private foundations and other grantors in the same manner and to the same extent as a determination letter issued to an organization that submitted a Form 1023.