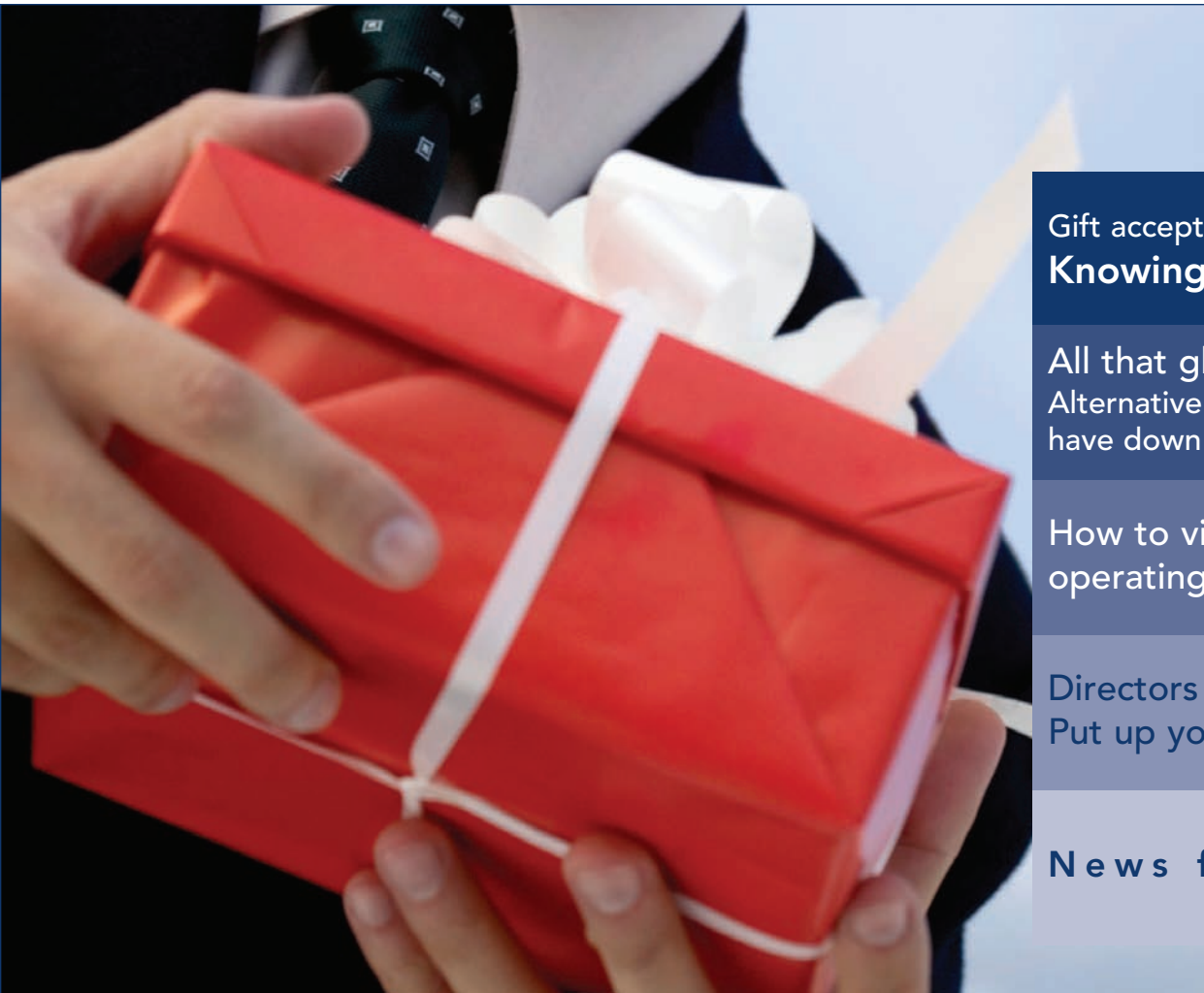


# nonprofit agendas

OCTOBER/NOVEMBER 2008



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**News for Nonprofits**

## *Gift acceptance policies*

# Knowing when to say “no”

**Would your organization ever turn down a charitable gift donation? If your answer is “no,” you should step back and reconsider.**

Take the situation in which the New York Metropolitan Museum of Art (the Met) found itself in 2006. Some 20 years earlier, a donor gifted a sculpture to the Met with the understanding that it wouldn't sell the work for 25 years (the museum's practice at the time). But, as it turned out, the sculpture was large and difficult to display, and after 20 years the museum decided to part with it. The donor got wind of the news from a friend and wasn't pleased. Bad national press followed, and a substantial donor was likely lost.

### **FORMAL POLICY**

This example begs the question, “What could the Met have done differently?” For situations like these, nonprofits need a formal and politically correct way of declining unwanted gifts. In fact, the acceptance of a charitable gift, in general, isn't something that should be decided on the spur of the moment. Instead, you need guidelines for how to handle such opportunities when they arise. A formal, written gift-acceptance policy should:

- \* Offer guidance for accepting gifts,
- \* Provide a roadmap for administering gifts, and
- \* Supply guidance to donors and their advisors on how to make the gift to the organization.

The purpose of a gift-acceptance policy is to make clear to board members, staff and donors what type of gifts are acceptable. Having a formal policy also will help create consistency from year to year as your board changes.

In addition, a formal policy can protect your organization's exempt status. Consider this: What would happen if a donor contributed an actual business to your organization? If you started managing the business and it became a significant part of your activity, your tax-exempt status could be lost.

Considerations for accepting gifts vary by gift type. Formulating a checklist by gift type can help you complete the necessary due diligence in the acceptance process. Here are some industry norms:

**Cash gifts.** Cash is always welcome unless certain restrictions are placed on the donation. For instance, the donor could restrict the use of the cash to an activity that's not in the nonprofit's best interest. Let's say an animal shelter receives a cash donation that comes with a restriction that the money be used only to build a second facility. It would not be in the shelter's best interest to accept the donation if it didn't have manpower or capital to support the additional space.



**Securities.** Nonprofits usually welcome publicly traded securities. What your organization should consider, though, is what types of stocks would not be welcome. Accepting donations of stock in a tobacco company, for example, may not be a good move by a cancer support organization.

Your acceptance policy also should address any restrictions on the sale of donated stock. Typically, you want to be able to convert the stock to cash soon after receiving it.

**Closely held securities.** These securities are another matter. Placing a value on stock and partnership interests is difficult in closely held companies because they're not traded on the open market.

So you need to address how to value these gifts. And your organization must consider whether owning such securities aligns with its mission. If you can sell the security shortly after receiving it, this may not be an issue. But, in many cases, this may be impossible if the company whose stock you're receiving has sales restrictions — or it's difficult to find a buyer.

The tax impact of an investment also must be considered. Holding the investment may create unrelated business income tax (UBIT) — possibly leading to the loss of your nonprofit's exempt status. Also, keep in mind that the capital gain from the sale of S corporation stock is subject to UBIT, unlike the gain from the sale of most other assets.

**Tangible personal property.** This category includes such things as art, cars, boats and collections (such as coins and stamps). As with closely held securities, the value of the gift should be a significant consideration when accepting it. The method of valuation should be addressed in your gift-acceptance policy, especially if the gift is made in exchange for an annuity. This is because, when an annuity is made to the donor, the payment is based upon the gift's value. If the valuation is too high, the organization could be liable for a payout beyond the income from the gift. The property also needs to produce an income stream to pay the annuity.

Other issues that should be addressed are alignment with your mission, any restrictions on the item's use or sale, and its marketability.

**Intangible property.** Gifts of intellectual property, royalties and life insurance policies are examples of intangible property. The same valuation, mission and annuity factors are considerations for these types of gifts as they are for tangible property.

**Real estate.** This type of gift is one of the most difficult to deal with and one of the most important to address in your gift-acceptance policy because of the due diligence required. It's imperative for your organization to verify that: 1) the property has a clear title, 2) there are no environmental problems and 3) there are no undisclosed debts on the property.

Another important consideration is the cost of holding the property — will your organization be expected to maintain the property and pay utilities and taxes? If the real estate is debt-financed, it could be subject to UBIT. Restrictions, such as

## What's in your gift-acceptance policy?

Work with your advisors when addressing these items in your policy:

1. Your mission,
2. Types of assets that are acceptable: cash, stocks, real estate and so on,
3. Forms of gifts that will be accepted, such as outright, split-interest (for example, charitable annuities) and donor-advised funds,
4. The organization's role in administering the gift,
5. Who within your organization can accept a gift, keeping in mind that only the board of directors should make the final decision, within specific dollar parameters and donation types,
6. Use of legal counsel, both for the organization and the donor to review any legal documents such as trusts and contracts,
7. Who will pay legal and accounting fees,
8. Any restrictions that can be placed on gifts,
9. Requirements for naming rights, and
10. Communication policy with donors.

property use, also should be weighed when accepting the gift.

## ONGOING CONSIDERATIONS

A number of examples of gift acceptance policies are available on the Internet. These may be used as guidelines in creating your own policy.

Once the acceptance policy is in place, you may want to have a development/fundraising committee review all gifts above a certain dollar value and recommend them to the board for approval.

And after it's implemented, be sure to review your policy periodically to update it with new developments. \*

# All that glimmers ...

## *Alternative investments have down side*



With traditional investments having lost a lot of their luster in today's environment, many nonprofits are turning to alternative investments for a better return. But before you put part of your nest egg into investments such as venture capital funds, hedge accounts or private equity funds, be sure you fully understand their possible tax consequences.

### REALIZING HOW THEY'RE DIFFERENT

Alternative investments can be U.S. or international investments. They are commonly organized as partnerships or limited liability companies (LLCs), with income passing through to the investors and taxes levied at the partner level, which creates a tax dilemma for you.

Here's why: Traditional investments typically produce interest, dividends or capital gains — and none of

these are generally taxable as unrelated business taxable income (UBTI). But when alternative investments are made in a partnership (as they typically are), your nonprofit is taxed as if it were performing the activities itself. So if the partnership is involved in a business activity unrelated to your exempt purpose, your portion of the partnership income as reported on Schedule K-1 will be taxed as UBTI.

### READING FORM K-1

If you've made the alternative investment through a brokerage firm, your monthly and year-end statements should report the investment and what appears to be its income. *But don't be misled:* The statement only reports the distributions you receive from the partnership. You must wait for a Form K-1 (sent out by partnerships to investors) to get an accurate reporting of the investment activity.

The K-1 for a typical alternative investment reports income from a business activity (most often unrelated to your exempt purpose and thus taxable). It also reports interest income, dividends — and perhaps some capital gains. In most cases, these latter amounts will be tax-exempt. The K-1 also reports the income that is subject to unrelated business tax (reported on a separate line, identified as UBTI).

One exception to the tax-exempt treatment is debt-financed property. If you take out a loan to purchase the alternative investment, all of the income from the investment becomes taxable to the extent it's debt-financed. If capital gains are produced by the sale of partnership property that is debt-financed, those capital gains are taxable.

### WEIGHING THE PROS AND CONS

Although alternative investments carry more risk than traditional investments, they also can produce more favorable returns. But the tax consequences can lower these returns, and you may need to make additional filings as well. (See "Extra tax filings" at left.) In addition, there's an accounting issue for organizations that prepare financial statements according to Generally Accepted Accounting Principles (GAAP):

### Extra tax filings

Additional filings that could be required as a result of alternative investments include:

- \* Form 990-T: filing for unrelated business taxable income (UBTI),
- \* Estimated tax payments: quarterly payments of current year tax,
- \* Foreign filing: informational filing to report foreign activity, commonly Form 8865 for involvement in a partnership with foreign activity,
- \* Form 8886 for reportable transactions — informational filing for involvement in a transaction with the potential for tax evasion (the partnership should advise you if this applies), and
- \* State filings, as required for UBTI: Watch for partnerships that do business in multiple states; your nonprofit could be subject to tax in multiple states.

Statement of Financial Accounting Standards No. 157, *Fair Value Measurements*, can create additional costs because the nonprofit will need to be able to support fair market value using specific methodology, which can be difficult and, thus, expensive. Related costs — appraisals, information gathering and the drafting of disclosures — can add to the expense.

As with any investment decision, you'll need to weigh the pros and cons of alternative investments. And if you truly understand what you're getting into — their nature and the tax consequences — alternative investments could be a sound choice for your organization. \*

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# How to view operating reserves

**Nonprofits often ask their advisors how to look at an operating reserve: Is it cash set aside for a rainy day? Is it the same as an organization's net worth? How much is too little — or too much?**

## WHAT AN OPERATING RESERVE IS — AND ISN'T

An operating reserve is a portion of an organization's net assets that is unrestricted in nature and relatively liquid. But it shouldn't be defined so narrowly that only cash or cash equivalents can meet its definition. That would make it a working capital reserve created to ease routine cash flow swings. Funds that shouldn't be considered part of an operating reserve include:

- \* Endowments and temporarily restricted funds that your organization doesn't have the prerogative to use as it sees fit, and
- \* Net assets tied up in illiquid fixed assets used in operations, such as your buildings and equipment.

Rather, an operating reserve is more long-term in nature. It generally spans a period of years and usually comes from operations that create a surplus. Receiving unrestricted contributions, generating investment income and budgeting for a surplus are all ways to create unrestricted net assets. And that, in turn, can be considered your operating reserve.

## WHO SHOULD BE IN THE LOOP?

Involve your board in determining your nonprofit's policy on building an operating reserve, the desired fund amount, and the circumstances under which it

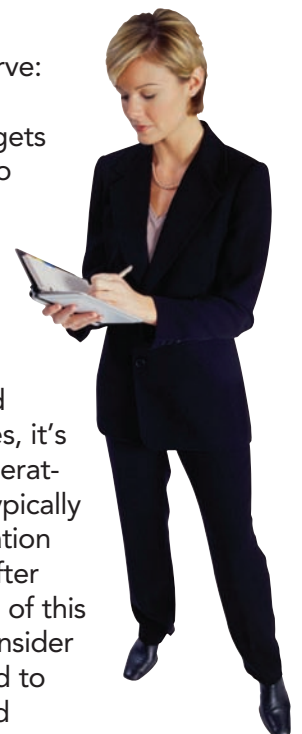
can be drawn down. Many organizations have the board designate a portion of their unrestricted net assets as an operating reserve, implying that they must authorize any of the fund's releases.

Determining how much should be in your operating reserve depends on your organization and its operations. Generally, if you depend heavily on only a few funders or government grants, your nonprofit would benefit from a larger reserve. Likewise, if personnel costs make up a significant part of your expense budget, your organization could use the cushion a healthy operating reserve provides.

## HOW MUCH IS RIGHT?

On the other hand, there are nonprofits that need less in reserve: for example, those with diverse funding, or whose expense budgets are less personnel-intensive. Also included are nonprofits whose expenses are more heavily pass-through expenditures that can shrink with a reduction in funders' awards.

If there is any generally accepted benchmark for operating reserves, it's usually three to six months of operating expenses. Three months is typically considered a minimum accumulation and six months a more sought-after amount. But rather than thinking of this as a benchmark, it's better to consider it a safe-harbor range established to cover any emergency. This would



enable an organization to continue its operations only for a relatively brief transition in operations or funding. Or, in the worst-case scenario, it would allow for an orderly winding up of affairs.

An operating reserve of more than six months of expenses provides more flexibility. For example, it might give your nonprofit funds to pursue a new program initiative that's not fully funded, or to leverage debt funding for needed facilities or equipment.

Accumulating more than a year's worth of expenses in reserves, not designated by the board for specific

purposes, must be approached carefully. You should look at it through the eyes of your donors and the general public: How would they perceive that kind of nest egg?

### WHAT'S NEXT?

As your nonprofit establishes its operating reserve, it's important to consider all factors that impact your organization's finances. What's right for one organization might not be right for another. Take into account the variables mentioned above and tailor-make an operating reserve that's right for you. \*

## Directors and officers: Put up your dukes



What would happen if a claim were filed against your organization? Would you have the proper insurance to handle it? Or would you be without a paddle up the proverbial creek?

### Get defense against lawsuits

Should a lawsuit arise — and they increasingly do for nonprofits — directors and officers (D&O) liability insurance can help protect both the organization and its key individuals: directors, officers, employees and even volunteers and committee members.

A D&O policy normally covers allegations of a wrongful act, an error, a misleading statement, neglect or a breach of duty in connection with a person's performance of duties. Simply put, it's a safety net that all not-for-profits should consider putting in place. You may need D&O insurance protection for employment-related matters, such as harassment, discrimination and wrongful termination; mismanagement of funds; self-dealing; and failure to fulfill fiduciary duties.

A unique characteristic of D&O policies is that they are *claims-made* policies; they pay for claims filed during the policy period even if the alleged wrongful act occurred *outside* of the policy period. Once a policy is canceled, however, no coverage is provided on a lawsuit filed after the cancellation date — even if the alleged act happened during the policy period.

When a claim is filed, you contact the insurance company to determine whether the matter is insurable and if defense costs will be covered. Most policies reimburse the insured for reasonable defense costs, in addition to covering judgments against the insured.

### Check the coverage carefully

D&O coverage varies from insurer to insurer. Each policy must be examined closely to make sure it provides the protection you need — who is covered, what is excluded. Your policy doesn't need to cover bodily injury or property damage; these types of claims usually are covered under general liability insurance.

The cost of D&O insurance varies significantly. The premium amount depends on the extent of coverage as well as your organization's type, operating characteristics and location.

With the filing of lawsuits becoming more frequent, it's imperative that not-for-profits take the necessary steps to protect themselves and the people who work for them. With that considered, D&O liability insurance is a logical solution.

# NEWS FOR NONPROFITS

## IRS PLANS TO "RE-ENERGIZE" USE OF COMMENSURATE TEST

The commissioner of the Tax Exempt and Government Entities Division of the IRS has indicated that the IRS will take a more aggressive approach to making certain that not-for-profit organizations are acting as charities. In April, Commissioner Steven T. Miller said at the 25th annual Georgetown Law Center Seminar, "Representing and Managing Tax-Exempt Organizations," that he'd like to "re-energize a little-used line of legal precedent." He was referring to the so-called commensurate test, a 1964 ruling that entitles tax exemption when a charity is "shown to be carrying on through such contributions and grants a charitable program commensurate in scope with its financial resources."



In a letter last May to Treasury Secretary Henry Paulson, Jr., leaders of the U.S. Senate Finance Committee urged the Department of Treasury and the IRS "to put more teeth" into the commensurate test, as they view it as "an important part of assessing whether a charity is acting as a charity." Although the Senate Finance Committee has been especially interested in how tax-exempt colleges and universities are using their endowments, Miller said the IRS isn't looking only into using the commensurate test for these organizations. He went on to note that the agency expects to have developed, by late 2009, plans to apply the test to a broad range of charities. \*

## DONORS JUST A MOUSE CLICK AWAY

Many Web sites have popped up over the years to help the public find reputable not-for-profit organizations to which they can contribute or serve as volunteers. But online databases that compile donor



information for use by not-for-profit organizations are the latest development. This trend's pioneer is NOZA, Inc. ([nozasearch.com](http://nozasearch.com)), a two-year-old company whose online searchable database contains more than 32 million charitable donation records dating back more than a decade.

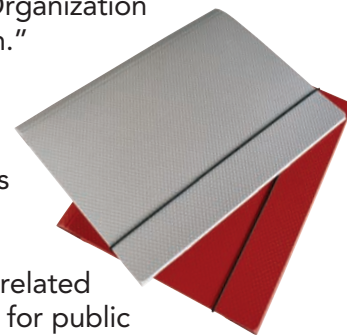
Users have the option of searching by a variety of criteria including donor name, charitable cause, size of gift or year of donation. According to the company's Web site, information is gathered from publicly available Internet locations, such as Internet-based annual reports, newsletters, press releases and sponsor lists.

Most of NOZA's services are fee-based, but it offers foundation grant searching and 990-PF tax records for free. Other sites currently offer searchable databases of 990-PF tax records, such as GuideStar ([guidestar.org](http://guidestar.org)) and the Foundation Center ([foundationcenter.org](http://foundationcenter.org)), for a subscription fee. \*

## CLARIFYING PUBLIC DISCLOSURE RULES

The IRS has clarified public disclosure requirements for Form 990-T, "Exempt Organization Business Income Tax Return."

Notice 2008-49, issued in May, explains that it isn't necessary to make available schedules, attachments and supporting documents filed with Form 990-T, and that aren't connected to unrelated business income tax (UBIT), for public inspection and copying. Charities must make Form 990-T available for public inspection and copying only for the three-year period starting on the last day required for filing.



These clarifications were made in response to the signing of the Tax Technical Corrections Act of 2007, which amended IRC Section 6104. The act clearly states that charities must make available for public inspection and copying only those returns filed under IRC Sec. 6011 and related to the organization's UBIT. \*