This article is not about obvious tax aspects of accounting, such as application of the accounting standard on uncertain tax positions (set forth in Financial Accounting Standard (ASC) 740-10), or how to compute the provision for tax on unrelated business income. Those are well covered in other literature. Rather the purpose here is to illustrate how accounting decisions or judgments can affect taxes – on an organization or on its donors, and vice versa.

It is well known that accounting is not always the exact science that some perceive it to be. It is actually replete with estimates and judgments – nowhere more so than in accounting by not-for-profit organizations, especially in the areas of allocation of expenses and categorization of revenue.

► EXPENSE ALLOCATION

The allocation of expenses among and within functional areas is often quite subjective. Yes, there are rules, but the application of those rules to specific situations generally requires judgment. An example usually encountered is how much of someone’s compensation and related occupancy costs is appropriate to charge to one function versus another. For someone who performs only one function, that is easy. But many people perform more than one function during their work hours, and tracking how those hours are spent is often judgmental (as well as an administrative burden). Even more challenging is when a person is actually performing two functions simultaneously, such as the person who creates a brochure that will be used for both public education – say, about symptoms of a disease, as well as for fundraising. (American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) 98-2, codified in ASC 958-720, discusses the accounting aspects of this subject.)

Three ways in which this expense allocation can have tax consequences are:

- When one of the functions involved generates unrelated business income, how expenses are allocated to it will affect the amount of deductions allowable against that income in computing the organization’s tax on the net unrelated income.
- When the expenses are related to the conduct of a fundraising event such as a dinner or a walkathon, whether and how much the expenses are considered to provide a direct benefit to the participants (e.g., diners, walkers) may affect the amount of personal tax deduction available to them for the payments they make to participate.
- When an organization engages in an activity that might be construed as lobbying, the amount of expenses allocated to that activity may affect the organization’s compliance with very strict tax rules about how much lobbying is permissible for an exempt organization. Violation of those rules can result in monetary penalties and/or loss of exempt status.

When considering these issues, keep in mind that not-for-profit organizations usually have four goals relevant to expense allocation:

- Minimizing the amount of unrelated business income tax paid by the organization.
- Maximizing the amount of charitable contribution tax deductions available to their donors.
- Reporting as high a percentage as possible of the organization’s expenses as program expenses, while minimizing the amounts reported as management and – especially – fundraising expenses.
- Remaining in compliance with the tax laws related to limitations on lobbying.

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Sometimes these four goals conflict with each other. Let’s look at some examples:

1. As noted above, more expenses properly charged against unrelated business income will reduce the tax on that income. But ‘unrelated’ activities are often not program activities (if they were program activities, they might not be unrelated). So charging more expenses to them will adversely affect the percentages reported in the financial statements as program versus other types of expenses, thus making it seem that the organization is not using as much of its resources for direct conduct of its programs. It is important to note that expenses allocated to unrelated business income be primary and proximate to the unrelated activity.

2. Accounting rules related to the costs of so-called ‘special events’ (e.g., dinners, walkathons) permit the costs of ‘direct benefits to participants’ to be reported in the organization’s financial statements as deductions from the revenue generated by the event rather than as fundraising expenses. This has the desirable effect of reducing the organization’s reported fundraising expenses, thus increasing the reported ratio of program expenses to total expenses. But judgment is often required to determine just what costs relate to benefits to participants, versus other costs of the event.

   So for accounting purposes why not try to allocate as much of the event cost as possible into the ‘direct benefit’ bucket? Because that would push the donor up against the tax rule that requires donors to a charity, who receive a benefit in exchange for their donation (e.g., dinner, food along the walk), to reduce the amount of their personal charitable tax deduction by the amount of the benefits they receive (technically the relevant reduction is the ‘value’ to the participants of the benefits received, but determining that value is normally judgmental, and the actual costs incurred may figure in that determination.) Tax rules also require the organization to explicitly tell donors of larger amounts what part of their payment is not deductible because it is the value of benefits received. (Relevant tax law includes certain de minimus thresholds, which do not affect the general point being made here.) So if more costs are considered to provide benefits to donors, their tax deductions will be lower – which will not make the donors happy.

   But if less of the event costs are treated as provision of donor benefits, so donors can take a bigger deduction, more of those costs will end up being reported by the charity as fundraising, thus hurting its expense ratios.

3. An activity involving lobbying is probably a program activity, so an organization would like to charge more ‘overhead-type’ expenses to it rather than to management and general. But the more expenses that are charged to this activity, the higher the risk of violation of the Internal Revenue Service’s (IRS) limitations on allowable lobbying activities.

   In all of these examples, think of ‘rocks’ and ‘hard places.’

**REVENUE RECOGNITION**

The issue here is one of unrelated business income, and judgment also plays a role. Many types of judgments enter into accounting for revenue – especially for contributions. One important judgment is whether a particular item of revenue is in fact a contribution, or whether it is properly an ‘exchange transaction,’ where the payor is receiving goods or services roughly commensurate in value with the amount of the payment. Examples of exchange transactions for nonprofits include tuition, membership dues, ticket sales, bookstore and gift shop sales, some research grants and the like.

Two issues flow from this judgment: one can have tax consequences to the recipient. The first issue is the timing of recognition of the revenue. Under generally accepted accounting principles (GAAP), contribution revenue is recognized when a gift is made or unconditionally promised, while exchange revenue is recognized only when the exchange is completed. This timing difference normally does not have tax consequences since contributions are, by law, not unrelated business taxable income.

The issue that has tax consequences is the characterization of the revenue as either a contribution or exchange. It is in many cases not clear as to how a given item should be classified, and judgment is required to make this determination. This is especially true with government and foundation grants. The AICPA audit guide for not-for-profit organizations (Chapter 5; ASC 958-605) includes a list of indicators (Table 5-1) to consider in making this accounting judgment.

If an item can be justifiably characterized as a contribution, it will be reported on Line 1 (of Part VIII) of IRS Form 990, and will not be unrelated business income. But if it is characterized as an exchange transaction, it will be reported on one of Lines 2 to 11, and it is now at risk of the IRS alleging it is unrelated to the organization’s exempt purpose, and thus taxable – which, of course, the organization would not like. In addition, Form 990 requires that for each revenue item other than contributions, the organization provide an explanation of why it should not be considered unrelated (there are certain other statutory exemptions); the burden of proof of relatedness is on the organization. (There are also tax consequences to the payor in that contributions are tax-deductible (within limits), while payments by individuals for goods or services probably are not. However, how the recipient categorizes a payment does not determine its deductibility by the payor, and the IRS is unlikely to relate the two anyway.)

Again, an accounting judgment can lead to tax consequences if the judgment is not (1) made appropriately and (2) the logic behind it adequately documented in case it is challenged.

So, be careful what accounting and reporting practices you choose and judgments you make, because sometimes they can have tax consequences you might not like. And don’t automatically make choices to minimize taxes, because the accounting results might not always be what you want.

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