

Fundamentals

Second Quarter 2008

Ways and means for the public sector

New tax reporting requirement for not-for-profits: What FIN 48 means for your organization

In June 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes*, which clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. FIN 48 prescribes a comprehensive model for recognizing, measuring, presenting and disclosing in financial statements tax positions taken or expected to be taken on a tax return. This includes decisions to classify a transaction or entity as tax exempt.

FIN 48 requires an organization to record in financial statements the uncertainty that a tax position will be sustained if examined by the taxing authorities. If a tax position is more-likely-than-not (MLTN) — more than 50 percent — to be expected to be sustained by taxing authorities, or if taxing authorities were in possession of all relevant information to ascertain the position is MLTN, then that tax position isn't considered uncertain and FIN 48 accounting and reporting provisions wouldn't apply. Basically, the goal of FIN 48 is to identify uncertain tax positions taken by an entity and determine the impact of that uncertainty on the organization's financial statements.

For tax exempt entities, two universal tax issues should be considered when performing audit procedures under FIN 48: Exemption/exempt status and unrelated business income tax. (Additional issues exist when NFPs control taxable subsidiaries.)

After specific tax positions have been identified, FIN 48 analysis begins with a two-step process:

1. Determine whether a tax position will be sustained or not based on an examination by taxing authorities of the tax position if the taxing authorities are in possession of all relevant facts pertaining to the tax position. The assumption under FIN 48 is that the tax position will be examined by taxing authorities.
2. Identify what tax benefit would be realized (or liability required to be paid) — if the MLTN threshold is met. This process is based on judgment — at various

probabilities beginning with complete success (at 100 percent sustainability) — working down a matrix of possibilities that would then cumulatively result in an MLTN position.

The amount of benefit recognized in the statement of financial position and the amount taken, or expected to be taken, on the tax return may be different. These differences represent unrecognized tax benefits. The unrecognized tax benefits and the related interest and penalties will generally result in the recognition of a liability under FIN 48. Alternatively, the amount of any net operating loss carry forward or amount of refundable tax may be reduced.

An NFP that has a liability for unrecognized tax benefits, and presents a classified statement of financial position, must classify this liability separately from other tax balances based on the expected timing of the cash flows. Deferred liability classification is either current or non-current and is based on a one-year or operating cycle criterion used for classifying other liabilities. The liability cannot be combined with deferred tax liabilities or assets.

In addition, the tax position recognized as a result of applying FIN 48 may also affect the tax basis or liabilities which would create temporary variations. A taxable and deductible temporary difference is the distinction between the book values in the statement of financial position and the tax basis of an item as determined by FIN 48 application. A liability recognized as a result of FIN 48 application cannot be classified as a deferred tax liability unless it arises from a taxable temporary difference.

If there are changes in net assets as a result of FIN 48 application, they will be accounted for as an adjustment to the opening balance of retained earnings. Additional disclosures about the impact of FIN 48 will also be required.

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New Form 990: The schedules

This is a companion article to the first quarter Fundamentals article “Not-for-profits talked and the IRS listened – Input helps with redesign of Form 990.”

When the IRS released the new Form 990 to be filed for 2008 tax years, the package included 16 schedules organizations may or may not be required to file. Part IV of the core form contains a 37-question checklist where “yes” answers indicate the need to file each schedule.

The following is an overview of six of the schedules that will have relevance for many not-for-profits:

Schedule A, Public Charity Status and Public Support

This schedule — to be completed by all public charities — replaces the old schedule A, parts III and IV-A and now includes a catch-all “supplemental information” page that resembles a blank piece of notebook paper. Organizations must use their book method of accounting (as stated on Form 990, Part IX, line 1) rather than the cash basis on the support schedules. This will likely result in restating or explaining prior year columns from the support schedule. Interestingly, the IRS has stated the support schedules are designed to supersede a new organization’s requirement to file Form 8734 after 60 months of operations. The plan is to do away with the “advance ruling letters.” Therefore, a new charity will receive its exemption letter at the time the IRS approves its exempt application and will have five years to establish that it isn’t a private foundation.

Schedule D, Supplemental Financial Statements

Part IV of Form 990 has seven questions that, if answered “yes,” filing of Schedule D is required. If you have land, buildings, equipment, investments or “other liabilities” on your books; engage an audit firm to conduct a GAAP audit; maintain donor advised funds; received conservation easements; hold art collections; provide credit counseling; and/or maintain endowment funds you are required to file Schedule D. Furthermore, if your NFP maintains donor advised funds, receives conservation easements, holds art collections, provides credit counseling or maintains endowment funds, you’re required to file Schedule D. This schedule will affect the majority of NFPs.

There are sections that require additional information about all of the items listed above, especially investments

and other liabilities. As with several of the new schedules, D has a full page of space for supplemental information.

Schedule F, Statement of Activities outside the United States

The IRS has backed off on requiring organizations with foreign operations to report the exact locations of those endeavors. Reporting is now on a regional basis. The proposed regions are Central America and the Caribbean; East Asia and the Pacific; Europe (including Iceland and Greenland); Middle East and North Africa; North America (which includes Canada and Mexico, but not the United States); Russia and the newly Independent States; South America; South Asia; and Sub-Saharan Africa. Information required for activities include region; number of offices and employees in region; activities conducted; program service activities; and total expenditures in region.

Schedule J, Supplemental Compensation Information

If any officer, director or key employee received more than \$150,000 in total compensation, your organization will need to file schedule J. Again, the amounts are based upon W-2s and 1099-MISCs filed in the year of reporting. Part I asks questions about fringe benefits provided and how your board arrived at your CEO’s compensation (The IRS has eliminated reporting of amounts of de minimis fringe benefits and expense reimbursements.). In Part II, you must breakdown base compensation, bonus and incentive comp, other comp, deferred comp and nontaxable benefits. Schedule J actually gives you two “supplemental information” sub-schedules and there is also a column to report “compensation reported in prior Form 990.” *Note: The compensation nuances of the new Form 990 and schedules will be covered deeper in a future Fundamentals article.*

Schedule O, Supplemental Information to Form 990

This “blank slate” schedule allows exempt organizations to add “all the news that fits.” Per the instructions, it “permits organizations to supplement information provided on the Form 990, even if there is not a specific instruction requiring the organization to do so.” Many in the NFP arena expect this form to be the place where organizations are expected to tell their story — and anyone can go here to find out what you do.

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Conditional asset retirement obligations – is your NFP familiar with them?

In March 2005, the Financial Accounting Standards Board published FASB Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations*, to provide guidance for more consistent recognition of liabilities relating to conditional asset retirement obligations and more information about future cash outflows relating to these obligations. FASB Statement No. 143 (FIN 47), *Accounting for Asset Retirement Obligations*, requires entities to record an obligation, when incurred, for the cost of retiring assets through renovation, demolition or sale. For example, if an organization is legally obligated to restore a building site back to a certain condition, it's required to accrue that obligation once the contract or law establishes the obligation, as opposed to at the end of the asset's useful life. In addition, these liabilities need to be recorded even if the entity plans to sell the facility versus actually performing the remediation.

Entities may mistakenly believe FIN 47 applies only to "dirty" industries (e.g., mining or nuclear power production) because they need to accrue clean up costs (such as land reclamation or nuclear decommissioning). Actually, asset retirement obligations exist in substantially all industries. Throughout the U.S., FIN 47 implementation has resulted in universities, hospitals, nursing homes and medical clinics, among others, recognizing asset retirement obligations when none had previously been recognized. For instance:

- University A knows some of its facilities contain asbestos and that they're located in a state that requires asbestos abatement – if the facilities undergo major renovations or are demolished. The university's 10-year strategic plan calls for major renovation of two buildings within the next five years. Therefore, it has the information needed to estimate a range of potential dates for asbestos removal, possible methods of removal and related costs and probabilities associated with those dates and methods. Consequently, the university is

able to approximate the fair value of the liability for the special handling of the asbestos using an expected present value technique. The university would recognize the cumulative effect of initially applying FIN 47 as a change in accounting principle reflected as of the beginning of the first period presented.

- Hospital B realizes some of its facilities contain asbestos and they're located in the same state that requires asbestos abatement – if the facilities undergo major renovations or are demolished. However, the hospital has no plans to renovate or demolish any of the facilities that would trigger a future outflow of cash for asbestos remediation. It's also unaware of any need for major renovations caused by technology changes, operational changes or other factors. Additionally, the hospital is unsure whether it will ever renovate or sell the facilities "as is" once the facilities are near or at the end of their useful life. It has concluded it doesn't have the information needed to estimate the range of time over which the entity may need to remove the asbestos and cannot reasonably assess the fair value of the liability. The hospital isn't required to estimate or record the abatement liability, but the circumstances must be disclosed in the financial statements. Although, in the future when this information becomes available, such as when it makes plans to renovate or demolish the facility, it will need to record the fair value of the abatement liability using an expected present value technique.

Interpretation 47 was effective no later than the end of fiscal years ending after Dec. 15, 2005. If FIN 47 wasn't properly implemented in the financial statements of a period for which it was effective, such an error must be reported as a prior-period adjustment.

For the full text of the interpretation, visit www.fasb.org/pdf/fin%2047.pdf.

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In February 2008, the FASB delayed the FIN 48 effective date for certain nonpublic enterprises to annual financial statements for fiscal years beginning after Dec. 15, 2007. NFPs that aren't obligors on debt securities traded in a public markets will be required to adopt FIN 48 in the preparation of their 2008 annual financial statements.

For NFPs that are obligors, the interpretation became effective for periods beginning after Dec. 15, 2006.

Proper evaluation of the implications of FIN 48 will likely take management a considerable amount of time, so organizations should start the evaluation process as soon as possible.

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Printed in U.S.A.