Profitable Solutions *for* Nonprofits

Fall 2012

The value of donated property is in the eye of the marketplace

Employees vs. independent contractors
Classify your workers per IRS guidelines

Are you covered?
Internal controls fight technology-related fraud

Newsbits

The value of donated property is in the eye of the marketplace

Nonprofits often struggle with valuing non-cash and in-kind donations, including the value of houses or other buildings. Whether for record-keeping purposes or when helping donors understand proper valuation for their charitable tax deductions, the task isn't easy.

Although the amount that a donor can deduct generally is based on the donation's fair market value (FMV), there's no single formula for calculating FMV for every type of gift. (Note: This article focuses on valuing gifts for tax purposes rather than financial accounting purposes.)

FMV BASICS

The IRS defines FMV as the price that property would sell for on the open market. (A donor can't claim a deduction for the contribution of services.) For example, if a donor contributes used clothes, the FMV would be the price that typical buyers actually pay for clothes of the same age, condition, style and use.

If the property is subject to any type of restriction on use, the FMV must reflect that restriction. Say a donor contributes land to your not-for-profit and restricts its use to agricultural purposes. The land must be valued for agricultural purposes, even though it would have a higher FMV for nonagricultural purposes.

Ultimately, FMV must consider all facts and circumstances connected with the property, such as its desirability, use and scarcity.

3 FMV FACTORS

According to the IRS, there are three particularly relevant FMV factors:

1. Cost or selling price. The cost of the item to the donor or the actual selling price received by your organization may be the best indication of the item's FMV. Because market conditions can change, though, the cost or price becomes less important the further in time the purchase or sale was from the date of contribution.

For example, you may have paid $2,500 for a top-of-the-line computer in 2005. But that computer certainly isn't worth $2,500 in 2012 because it's no longer top of the line. It may still have *some* value, though.

A documented arm's-length offer to buy the property close to the contribution date may help prove its value to the IRS. The offer must have been made by an independent, unrelated party willing and able to complete the transaction.

2. Comparable sales. The sales price of a property similar to the donated property often is critical in determining FMV. The weight that the IRS gives to a comparable sale depends on:

- The degree of similarity between the property sold and the donated property,
- The time of the sale,

- The circumstances of the sale (was it at arm's length?), and
- The market conditions.

The degree of similarity must be close enough that reasonably well-informed buyers or sellers of the donated property would have considered that selling price. The greater the number of similar sales for comparable selling prices, the stronger the evidence of the FMV.

It's important, though, that the transactions take place in an open market. If the sales were made in a market that was artificially supported or stimulated, they might not be representative or indicative of the FMV. For example, liquidation sale prices typically don't indicate FMV.

3. Replacement cost. FMV should consider the cost of buying, building or manufacturing property akin to the donated item, but the replacement cost must have a reasonable relationship with the FMV. And if the supply of the donated property is more or less than the demand for it, the replacement cost becomes less important to FMV.

The cost of an item to the donor or the actual selling price received by your organization may be the best indication of the item's fair market value.

GIFTS OF INVENTORY

If a business contributes inventory, it can deduct the smaller of its FMV on the day of the contribution or the inventory's basis. (The *basis* of donated inventory is any cost incurred for the inventory in an earlier year that the business would otherwise include in its opening inventory for the year of the contribution.) If the cost of donated inventory isn't included in the opening inventory, its basis is zero and the business can't claim a deduction.

THE APPRAISAL ISSUE

Potential donors might be deterred because of the hassle involved in getting noncash donations appraised. Yet appraisals generally aren't needed for items of property for which the donor will claim a deduction of $5,000 or less.

Donors who deduct more than $500 for any single item of clothing or any household item that isn't in "good used condition" or better, and that was donated after Aug. 17, 2006, however, must include a qualified appraisal with their income tax returns. In these cases, the donor should understand that the IRS will weigh the appraisal based on the report's completeness and the appraiser's qualifications and demonstrated knowledge of the donated property. The agency requires appraisals to provide all facts applicable to giving an "intelligent judgment" of the property's value, such as purchase price and comparable sales.

The IRS and courts are requiring donors to follow the requirements for appraisals — even when the value of the property is certain.

Inventory that may receive a better valuation than other inventory includes that which is used solely for the care of the ill, needy or infants; book inventory or food for public schools; and scientific property for research. The special provisions for books, food, and inventory for the care of the ill, needy or infants expired at the end of 2011, but have been extended retroactively in the past. (For the latest, check with your CPA.) In addition, certain industries, such as the pharmaceutical industry, have specific standards for valuing donated inventory.

AN IMPORTANT REMINDER

Even if a donor can't deduct a noncash or in-kind donation (usually a piece of tangible property or property rights), you may need to record the donation on your financial statements. Recognize such donations (including the donation of services) at their fair value, or what it would cost if your not-for-profit were to buy the donation outright from an unrelated third party.

Employees vs. independent contractors

Classify your workers per IRS guidelines

The IRS has publicly stated it plans to crack down on organizations that improperly classify workers as independent contractors instead of employees. Are you confident your employee classifications would stand up to IRS scrutiny?

UNDERSTAND THE REQUIREMENTS

If a worker is an *employee,* your nonprofit must provide a Form W-2 annually and withhold income tax and the employee's portion of Social Security and Medicare taxes from the employee's pay. You also must pay the employer portion of Social Security, Medicare and unemployment taxes on the employee's wages.

If a worker is an *independent contractor,* your organization generally should provide a Form 1099-MISC, which reports the amount you've paid to the person that year. The independent contractor is responsible for paying employment taxes (both the employee and employer portions) and income taxes on his or her own.

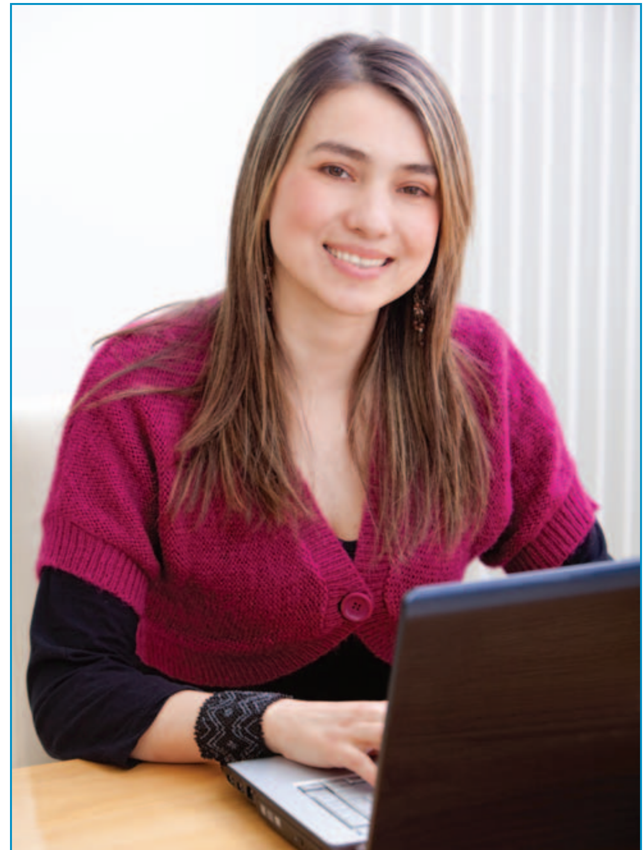
While the IRS generally should receive the same amount of total income and employment taxes regardless of whether someone is an employee or an independent contractor, the agency has found that it's more difficult to collect from independent contractors. Thus, the IRS tends to favor employee status.

Should the IRS determine you've improperly classified an employee as an independent contractor, you may be held liable for that worker's applicable employment taxes.

TAKE THE TEST

To determine whether a worker is an employee or an independent contractor, you must consider your nonprofit's degree of control and the person's level of independence. The IRS has assembled a number of questions to help employers decide. Commonly referred to as the "20-factor test" or "common law rule," the questions revolve around:

- Whether your organization has the right to control the individual and how that person performs his or her duties (that is, *behavioral control*),
- Whether there's a written contract between the individual and your nonprofit, and if the person receives employee benefits (that is, *type of relationship*), and
- Which aspects of the business relationship your organization controls (that is, *financial control*).



The IRS has suggested asking certain questions when determining status. For example, must a worker follow someone else's instructions regarding when, where and how he or she completes work? If so, the person is probably an employee.

More examples: Employees are typically trained how to perform a given job, whereas independent contractors are expected to already know how to do it. Independent contractors must pay their own assistants. And someone who retains the ability to set his or her own daily hours (within reason) is generally regarded as an independent contractor.

Another factor to consider is whether the person works for more than one business at a time, which would indicate contractor status. Someone paid by the hour, week or month (rather than by the job), on the other hand, typically signals employee status.

LET THE IRS HELP

If you're unsure whether an individual should be classified as an employee or an independent contractor, you can complete Form SS-8, "Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding," and the IRS will decide for you. The process is free, though it might take six months or more to receive the determination.

Organizations that inadvertently misclassify an employee as an independent contractor may be able to mitigate the consequences under the IRS's Voluntary Classification Settlement Program. Ask your tax advisor for details.

MEETING THE CHALLENGE

The IRS has reported that it loses millions in unpaid taxes and uncollected penalties for misclassified workers each year — and is looking to get it back. Make sure your nonprofit is following the rules. ❋

Are you covered?

Internal controls fight technology-related fraud

The ability to accept and make online payments and maintain databases with detailed profiles of constituents offers obvious benefits to nonprofits under constant time and money pressures. But it may also be subject to fraud attempts that can dodge your traditional internal controls. Fortunately, measures are available to combat these risks.

MAKING ONLINE DISBURSEMENTS

Many nonprofits are now paying their bills online, rather than mailing payments. Of course, the ability to make online payments essentially makes the employee who does so a check *signer* who can, in turn, make unauthorized payments. Similarly, the employee who oversees direct deposit payroll transactions may choose to pay "ghost" employees, give unauthorized raises or otherwise divert funds.

If your not-for-profit makes these types of online disbursements, ensure that all payments are subject to an independent review by a different employee. The reviewer can check payments online or examine the bank statements for discrepancies. The reviewer should also study payroll reports that come straight from the payroll system (vs. coming from the employee who oversees payroll). Of course, the reviewer should be aware that those two employees might be working together to commit fraud. Your bank also might offer verification services to confirm that payments are authorized before they clear.

ACCEPTING PAYMENTS

One of the most significant changes in how nonprofits conduct business in recent years has been the widespread adoption of systems that allow online payments for event registrations, membership fees, product purchases and donations. These payments generally are deposited directly into an organization's bank account.

The risk is that the employee responsible for the online payment system could redirect the ultimate destination of payments. If the accounting department records income based on bank deposits, this fraud could go undetected. To close this control gap, make sure you take the added step of reconciling the bank deposits against online income from the donor system.

Take the added step of reconciling bank deposits against online income from the donor system.

PROTECTING PRIVACY

Many nonprofits possess their members' and donors' credit card information and other personal data, making them potential targets for both internal and external hackers and fraudsters. Imagine the consequences if criminals were to access your constituents' data. It could be disastrous in terms of remedial costs, legal liability and reputational damage.

Perhaps the most effective privacy control is adherence to the Payment Card Industry (PCI) Data Security Standard (DSS). DSS applies to all entities that store, process or transmit credit cardholder data and outlines technical and operational system requirements to protect that data. Although DSS isn't technically a law, several states have enacted legislation mandating compliance with some of its provisions.

The DSS requirements vary depending on the number and type of credit card transactions an organization conducts, both online and offline. It's a good idea, though, to take steps to comply with the strictest requirements, including:

- Installing and maintaining a firewall to protect cardholder data,
- Encrypting the transmission of cardholder data,
- Restricting access to cardholder data with unique IDs and on the basis of "need to know," and
- Using and regularly updating antivirus software.

Although it isn't a requirement, PCI also strongly recommends "segmenting" (or isolating) the cardholder data environment from the rest of your network. (To learn more, visit pcisecuritystandards.org.)

PROCEED WITH CAUTION

There's no turning back from the technological advances nonprofits are currently enjoying. The key is to remain vigilant against the evolving risk of fraud. ❋

Newsbits

QUANTIFYING THE COST AND BENEFITS OF SOCIAL MEDIA FANS

Having people "like" you on popular social media sites may cost more than you think and is worth tracking. The fourth annual Nonprofit Social Network Benchmark Report found that the average cost of a "like" on Facebook was $3.50, while the average cost of a Twitter "follower" was $2.05. The report surveyed more than 3,500 nonprofit professionals about their organization's use of social media to build their supporter base.

Don't let the costs scare you off, though. The survey also found that the average yearlong value of a supporter acquired via Facebook — that is, the amount of revenue received from a supporter over the 12 months following acquisition — was almost $215. It's no surprise, then, that 81% of the respondents deemed their social network communities as somewhat or very valuable. ❋

DOES DUAL-CHANNEL FUNDRAISING PAY?

A study of donors to the national humanitarian organization CARE suggests that engaging donors through both online and offline approaches can pay off for nonprofits. According to the study, dual-channel donors (those who give both online and offline) have the highest annual donor value, returning about 46% more value than donors giving only through direct mail.

The study also found that dual-channel donors gave almost as much through offline channels as offline-only donors ($74 vs. $85). This led the researchers to conclude that adding digital channels of donation doesn't materially cannibalize revenue from direct mail. Moreover, traditional offline direct response donors who were engaged through online communications demonstrated higher retention rates than offline donors not engaged online. ❋

ACCOUNTING BODY EXPLORES NONPROFIT FINANCIAL REPORTING

The Financial Accounting Standards Board (FASB) is conducting two projects directly related to nonprofits. The "Not-for-Profit Financial Reporting: Financial Statements" project is re-examining existing accounting standards for organizations' financial statements, with a focus on improving:

1) net asset classification requirements, and

2) the information provided in financial statements and notes about liquidity, financial performance and cash flows. FASB will likely propose a revised standard and request feedback in the future.

FASB also is conducting a research project called "Not-for-Profit Financial Reporting: Other Financial Communications." That project is looking at other types of communications nonprofits use to tell their financial stories. FASB's staff, for example, is reviewing existing best practices followed by organizations to determine how such communications may enhance the understanding of donors, creditors and other stakeholders of the organizations' financial health and performance. ❋

This publication is distributed with the understanding that the author, publisher and distributor are not rendering legal, accounting or other professional advice or opinions on specific facts or matters, and, accordingly, assume no liability whatsoever in connection with its use. ©2012 PSNfa12